PRIVATE CAPITAL FLIGHT IN KENYA (1986 - 1995)

BY

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A PROJECT REPORT submitted to the Graduate Faculty of Business Administration and Management in partial fulfilment of the course requirements for the Masters in Business Administration Degree (MBA).

July 1999
STUDENT DECLARATION

I, the undersigned, declare that this is my original work and has not been submitted to any other college, institution, or university other than United States International University for academic credit. It is as a result of my investigation except where I have indicated my indebtedness to other sources in the notes, references and bibliography.

Signed:.................................
Ali, Aden Mohamed

Date: 9/10/99

This project has been presented for examination with my approval as the appointed supervisor.

Signed:.................................
Mr. J. O. Aduda

Date: 2/7/99

Signed:.................................
Professor Isaac C. Riak
Chairman, Division of Business Administration

Date: 2/7/99

Signed:.................................
Dean, Academic Affairs

Date: 2/7/99
ACKNOWLEDGEMENTS

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I should also thank my wife, Deeqa Hassan Sheikh, my two sons, Abdullahi and Mohamoud, and my brother, Feysal M. Ali, for their patience in allowing me to spend a great deal of time in collating material for this document. Without their moral support, I could not have finished it.

Also, my deep acknowledgement goes to my colleagues at the United Nations Co-ordination Unit (UNCU) at the United Nations Development Programme (UNDP) Somalia office, who encouraged me to keep my studies despite the workload in the office.
DEDICATION

I dedicate this study to my country and my people, i.e. Somalia and Somalis... as a small way for me to express my deepest, heartfelt sympathies for them and dutifully pray for the end of the unfortunate civil conflict that mercilessly engulfed the whole country.
ABSTRACT

In this study, capital flight is discussed at the conceptual level with a thorough analysis of measures of capital flight. The research attempts to study the trends and annual rates of private capital flight in Kenya from the period 1986 – 1995 by employing the “Mirror Statistics Method” and utilizing bar charts and tables to expose the reality of capital flight. The period covered in this study is from 1986 – 1995 due to unavailability of data beyond this period. The figures used in the study were obtained from the International Monetary Fund’s (IMF) International Financial Statistics booklet. The study established that there had been an average annual outflow of US $890 million over a period of ten years. For the period covered, Kenyan wealth owners deposited some US $8.9 billion in bank accounts abroad.

The study also identifies various escape routes used by the wealth owners to smuggle money out the country. The purpose of this study was to help elucidate the significance of money outflow from Kenya and annual variation of the flight. In many instances capital and money are used interchangeably since the thrust of the study is the private capital flight, i.e. technically speaking, money. The study gives some policy recommendations to the decision-makers, urging them to put proper policy packages in place, enhance investment opportunities, and fight corruption. It will, hopefully, make a good reading for economic planners, financial analysts, and indeed researchers at the Central Bank of Kenya and other institutions of learning.
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CHAPTER ONE

1.1. BACKGROUND AND INTRODUCTION

Capital flight is defined in many ways. Some analysts view capital flight as structural economic deficiencies limiting investment opportunities in developing countries. Others view capital flight as the cause of heavily indebted countries’ inability to recover from their present debt problems. Capital flight is regarded by others as a “pejorative description of natural, economically rational responses to the portfolio choices that have confronted wealthy residents of some debtor countries in recent years” (Lessard and Williamson, 1987, p. 202). The controversy surrounding the term is due partly to the lack of a precise and universally accepted definition in economic theory and partly because of the way the term is used between developed and developing countries. It is usual for economists to refer to capital outflows from developed countries as foreign investments while the same activity when undertaken by residents of developing countries is referred to as capital flight.

Private capital flight occurs when private wealth owners would withdraw their money or wealth from their national countries and deposit it often in offshore bank accounts. Such individuals might be forced to do so by various circumstances, including unstable local currency, corrupt financial management practices, poor security conditions and lack of transparent macro-economic policies. These days, almost all developing countries are characterized by persistent balance of payments deficits, accelerating rates of inflation, heavy debt burdens and slow economic growth in general. It appears that their socio-economic political structures are being stretched to the breaking point. In recent times, attention has shifted to the issue of capital flight with policy implications for debt crisis management. Some analysts claim that capital flight issues predate the debt crisis while others argue that the debt crisis was precipitated by the capital flight. According to Lawrence Birns, director of the Washington-based council on hemispheric affairs, capital flight had reached a chronic and seemingly irreversible pace in much of Latin America in the period leading to the open eruption of the debt crisis in 1982. For some authors, “the cascade of capital that has flowed from developing countries is a key element in keeping
third world debt a lingering crisis” (Glynn and Koenig, 1984, p. 109). Traditionally, capital flows from developing to developed countries apart from those necessitated by normal business transactions are considered economically unsound¹.

Wealthy Kenyans may be holding sufficient resources to solve most of the economic problems facing the nation today. The disaster lies in the fact that a substantial amount of this money is stashed away in secret accounts in the Carribeans, Britain, Switzerland, Austria, United States or other places, where it is absolutely of no use to this country.

The increasing interest in capital flight in recent times is dictated by the paradoxical situation of high accumulation of external debt by developing countries on the one hand and the acquisition of foreign assets by the citizens of the indebted countries on the other. Consequently, interest is shown in capital flight at the policy level. Indeed, the Brady plan in the case of Mexico (Which is also relevant to other countries in similar position) places heavy emphasis on economic adjustments that are designed to secure, among other things, a reversal of capital flight as an opportunity to not only improve on the external liability situation but also to promote growth. Indeed the arguments against flight of capital has been an important factor in the resultant decline of lending to developing countries. Following the lead of Brady, the IMF made adoption of policies for capital reversal a condition for its support of debt reduction policies (Pastor, 1989; Truell, 1989)². Interest in capital flight also arises from the role that such externally stocked away assets can play in the domestic economy if left at home. This constitutes part of the economic arguments against capital flight.

It appears that the arguments against capital flight from developing countries are not only convincing but are often too strong to be ignored. First, the outflow of capital can cause a shortage of liquidity in the economy, and thereby create a shortfall in the amount of funds required for the importation of tools and equipment needed for development. In addition, the shortage of liquidity in the economy can lead to the exertion of upward pressure on interest rates. According to economists, capital flight leads to a net loss in the total

resources that are available to an economy for the purpose of investment and growth. Given the fact that capital flight is a diversion of domestic savings away from domestic real investment, the pace of growth and development in the economy is retarded from what it would have otherwise been.

Second, income that is generated abroad and the wealth that are held abroad are outside the authority of domestic authorities and cannot therefore be taxed. Thus, potential government revenue is reduced and hence debt-servicing capacity of government debt is affected. Capital flight can exacerbate balance of payments crisis if at the time it exists capital flows are also being experienced. Capital flight can compound the financial problems of heavily indebted countries if creditors are reluctant as a result of capital outflows to give further financial assistance.

Third, income distribution is negatively affected by capital flows. This is due to the fact that the poor in indebted countries are subjected to austerity in order to pay for debt obligations to international banks who in turn pay interests to those sending assets abroad (Pastor, 1989)

The prevailing causes of capital flight are often attributed to economic factors. These are often traced to disincentives created by mainly by distortions in domestic macroeconomics policy. These distortions manifest themselves in large public sector deficits, exchange rate misalignment, inflation and financial repression. As part of the economic causes are the incentives provided by foreign banks and governments. These include attractive returns and the maintenance of secrecy on deposits.

Capital flight can also be attributed to political factors such as corruption [a problem which is hardly limited to Less Developed Countries (LDCs)]. It has been alleged that some political leaders use their offices to siphon funds to foreign countries. It has been agreed that in the years when petrodollar surged in Mexico, Venezuela and Nigeria, the

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3. Ibid
opportunity for graft multiplied in these countries and a lot of money consequently was siphoned abroad. While the amounts of money that are left in the bank deposits in foreign countries is a fair direct pointer to this possibility, it is difficult to be conclusive, in attributing all of the deposits to capital flight or indeed to stolen or bribery money. Some of the deposits may have arisen in the course of the performance of normal business transactions.

Kenya, which is one of the heavily indebted countries, is grappling with a total external debt that currently stands at more than US $7.273 billion. According to Jubilee 2000 Kenya Coalition, part of an international group lobbying for the write-off of Third World debts by the year 2000, the domestic debt is estimated at more than Sh150 billion or 20 percent of GDP. What this means is that every new born child in Kenya automatically inherits a debt of more than Shs18,000, of which more than Shs15000 is owed to external agencies. In a country with per capita GDP of US $270 (Shs14,855 at rate of $1 = Shs55), there is no doubt that this is a cause for concern. This means that budgetary resources which ought to go into assuring this child of good health services, secure future and education, are diverted to servicing the debt and repaying the domestic debt. (Daily Nation, Tuesday, July 21 1998, business supplement page 8).

Relative to the several studies that have been carried out for Latin American countries, there are limited studies on the magnitude of capital flight in Kenya. There is no comprehensive study on the causes, measurement, conduits, economic determinants and empirical estimate including econometric investigation and consequences of capital flight. There are “words of mouth” or anecdotal evidences that the Asian business community, which controls the bulk of the country’s economy, and the insecurity in the run-up to the 1992 and 1997 elections have contributed to capital flight in different ways. In addition, people talk of a lot of money siphoned out of the country by some politicians. These were reportedly done through the retention of some percentages of contract money deposited in a foreign bank account. This amount of money would only show up in the statistics if deposited in a foreign bank that is within the financial reporting system. Any amount of money not so deposited like those left in a Swiss bank secret code account, for example, are very difficult
to detect. Similarly, if the money was (is) spent in buying property almost immediately they were (are) deposited, it would also escape being counted.

I.2. DIFFERENT MEASURES OF CAPITAL FLIGHT

With the many possible definitions of capital flight, there are several different measures. Some measures are complimentary. The four most common approaches are the residual measure (used by the World Bank, Morgan Guaranty and Cline); measuring the stock of unreported foreign assets (Dooley’s method); hot money measures (Cuddington); and measuring trade mis invoicing. For each, there are variations that lead to (minor) differences. Among the most common measure is the balance-of-payment which uses standard notations, supplemented by World Bank debt data and based on the IMF’s Balance of Payments Yearbook.

NOTATIONS
A. Current Account Balance
B. Net Foreign Direct Investment
C. Private Short Term Capital Outflows
D. Portfolio Investment
E. Banking System Foreign Assets
F. Changes in Reserves
G. Errors and Omissions
H. Changes in Debt
I. IMF Credit
J. Travel Credit
K. Reinvested FDI Income
L. Other Investment Income
M. Counterparts Item
CAPITAL FLIGHT ESTIMATES

World Bank  =  [Changes in Debt (H) + Net Foreign Direct Investment (B) + Current Account Balance (A) + Changes in Reserves (F)]

Erbe  =  [Changes in Debt (H) + Net Foreign Direct Investment (B) + Current Account Balance (A) + Changes in Reserves (F)]

Morgan  =  [Changes in Debt (H) + Net Foreign Direct Investment (B) + Current Account Balance (A) + Banking System Foreign Assets + Changes in Reserves (F)]

Cline  =  [Changes in Debt (H) + Net Foreign Direct Investment (B) + Current Account Balance (A) + Banking System Foreign Assets (E)] – Travel Credit (J) + Reinvested FDI Income (K) + Other Investment Income (L)]

Duwendag  =  [(Changes in Debt (H) + Net Foreign Direct Investment (B) + Current Account Balance (A) + Changes in Reserves (F) + Errors and Omissions (G) + IMF Credit (I) + Counterparts item (M)]


The study adopts the “Mirror Stock Statistics” method, which utilizes the statistics published by the International Monetary Fund (IMF). Under this method, capital flight is derivable from the “Cross Border Bank deposits of Non-banks by residence of depositor” published in the International Financial Statistics. This method of capital flight estimation was used by Khan and Ul Haque in 1987; and the Bank of England in 1987. It is particularly useful in determining the minimum level of assets held abroad. For this method, the recorded statistics by the IMF are called Cross Border Bank Deposits of Non-banks by Residence of Depositors. This amount represents stocks per year. When capital flight is defined as the increase over the previous year, we find that the amount is relatively very small. In all cases, the amount represents the lowest of all estimates.
There are a number of explanations why the estimates so derived cannot be an adequate measure of capital flight. First, some funds are held in deposits outside the major financial centers. Indeed, the nationality of depositor(s) in some foreign banks are never revealed. The most often cited example is that of the Swiss Bank accounts where secret codes are utilized to hide not only the identity of the depositor(s) but also in most cases the nationality. Second, substantial amounts of money which are not revealed are held in other financial assets: equities, bonds, treasury bills, etc. and physical assets. As a result of the above reasons, the figures represent an underestimate of capital flight. In a large sense, however, foreign deposits give some indication of the amount of money which could have been used domestically. Such deposits are better seen within the context of other macroeconomics variables such as external debt and GNP.

1.3. PROBLEM STATEMENT

Kenya, like many other developing countries, has limited domestic resources for development. The government’s efforts to develop economy have been constrained by the mounting external debt, low rate of investment and balance of payments deficits, all of which have been blamed on capital flight (Ng’eno, 1994, pp. 13). The flight of capital from Kenya, which is a relatively capital poor country, has been of concern to the government, specially following the emergence of balance of payments crisis in 1991. After the government recognized the problem, it took some steps to reverse the outflow of capital, which included relaxing foreign exchange controls, amnesty and informing Kenyans through the media of the illegality of operating foreign accounts. In the first half of the 1998, His Excellency President Daniel arap Moi appealed to Kenyans with money abroad to bring back their cash holdings into the country. On Madaraka Day of 1998, the Head of State urged all Kenyans, especially the Asian businessmen, who have money abroad to bring it back to strengthen the economy. Also a couple of years back, there were a plenty of disquiet from, some members of the parliament - and a figure of around US $1.2 billion was bandied around. This kind of money has the potential to revolutionize infrastructure. One would also expect that the amount of the money held abroad should post substantial interest gains. It is assumed that the bulk of the money abroad is merely held in bank accounts and
that interest rates thereon is fed into similar accounts. Although the government is trying to encourage repatriation of capital, in the first quarter of 1995, capital estimated to a tune of US $2.29 billion (International Financial Statistics, 1995) was held in foreign bank accounts compared to an estimated capital of US $1.50 billion in 1986 (IMF, International Financial Statistics, 1993, pp. 51). Of course, there is an annual rate of flight of capital that needs to be determined. This annual rate is high and needs to be addressed if not arrested. Given the present magnitude of Kenya’s external debt and the possible impact of private capital flight on her debt-servicing capacity, a study of capital flight in general and private capital flight in particular, is appropriate at this time. Despite all these facts, there has been no comprehensive study on the causes, measurement, conduits, economic determinants and empirical estimate including econometric investigation and consequences of capital flight let alone policies to arrest or reverse the trend of the outflow.

1.4. THE OBJECTIVE OF THE STUDY

The study focuses on the following:

1. Presenting the trend (highs and lows) of the private capital flight in Kenya covering the period 1986 to 1995.\(^5\)

2. Determining the average annual outflow and rate of private capital flight in Kenya from 1986 to 1995.\(^6\)

3. Identifying the conduits of private capital flight.

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\(^4\) General capital flight, which covers all kinds of material outflow from a given country, is beyond the scope of this paper. Here, there is graphical presentation of how much money private individuals keep in overseas accounts and annual variations of the money flight.

\(^5\) The period covered in this study is from 1986 – 1995 due to unavailability of data beyond this period.

\(^6\) Ibid
1.5. IMPORTANCE OF THE STUDY

The study could serve as a strategic window to show the magnitude and trend of private capital flight and the underlying factors that forced money owners to take their wealth out of this country. The findings would encourage further research, which would help policy makers put in place the necessary macroeconomics policies for Kenya. For example, it is significant for the Central Bank of Kenya to be aware of the rate at which private capital flows out of Kenya. Control measures and other policies that would properly address the issue could be developed therefrom. The study is very useful to the managers of the emerging financial and capital markets in Kenya in order to help the country open up its economies to foreign investment for the sums of money needed for the country’s development. It is also important for the investors, bankers, and other monetary institutions to avoid irresponsible financial sector that could lend large sums of money even to those who were not even capable of putting it to good use. The irresponsible lending by the banks simply turns into bad loans, making even the banks bankrupt.
CHAPTER TWO

LITERATURE REVIEW

Capital flight implies a loss of resources that could have been used to increase domestic investments and that could in turn have significantly increased countries’ debt servicing capacity. The simultaneous occurrence of large inflows of foreign capital and large capital flight from developing countries in the 1970s and early 1980s reflected the different perceptions of foreign lenders and domestic residents of developing countries about the risks of holding domestic claims. Since the emergence of debt crisis in 1982 the differences in perceived risks have been reduced and have resulted in a decline of foreign capital inflows coupled with continuation of capital flight. If concerns about default risks have played a major role in the portfolio decisions of the domestic residents of heavily indebted developing countries, the policies with the greatest chance of stemming capital flight are those that decrease the risks of holding domestic assets. In this situation, sound macroeconomic policies complemented by appropriate structural reforms would have to be key elements in stemming or reversing capital flight.

According to Cuddington, (1986, pp. iii), capital flight refers to short term private capital outflows. It involves “hot money” that responds to political or financial crises, heavier taxes, a prospective tightening of capital or a major devaluation of the domestic currency arising from a high mismanagement of the currency. Morgan Guaranty Trust Company (1986, p. 13) defined capital flight as “the reported and unreported acquisition of foreign assets by the non-bank private sector and elements of the public sector.” In order to clarify our thoughts on capital flows, table 1 presents a taxonomy of factors explaining international capital flows.
<table>
<thead>
<tr>
<th>Economic risk and returns.</th>
<th>One-way flows</th>
<th>two-way flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Natural resources endowments</td>
<td>Differences in absolute risks of economics</td>
<td></td>
</tr>
<tr>
<td>Terms of trade</td>
<td>Low correlation of risky outcome across country</td>
<td></td>
</tr>
<tr>
<td>Technological changes</td>
<td>Differences in investor risk preferences</td>
<td></td>
</tr>
<tr>
<td>Demographic shifts</td>
<td></td>
<td></td>
</tr>
<tr>
<td>General economic managements</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial risk and returns.</th>
<th>One-way flows</th>
<th>two-way flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes (deviations from world levels)</td>
<td>Differences in taxes and their incidence between residents and non-residents</td>
<td></td>
</tr>
<tr>
<td>Inflation</td>
<td>Differences in nature and incidence of country risk</td>
<td></td>
</tr>
<tr>
<td>Default on government obligations</td>
<td>Assymetric application of guarantees</td>
<td></td>
</tr>
<tr>
<td>Devaluation</td>
<td>Differences in interest ceiling for residents and non-residents</td>
<td></td>
</tr>
<tr>
<td>Financial repression</td>
<td>Differences in access to foreign exchange denomination claims</td>
<td></td>
</tr>
<tr>
<td>Taxes on financial intermediation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Political instability, potential</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


The upper left quadrant of the table identifies various factors based on differences in economic returns across countries. In the upper right quadrant are those additional factors that deal with the two-way flows—"normal" portfolio diversification. Most of the theoretical and empirical studies of capital flight place emphasis on the lower left and right quadrants. The factors emphasized are those that create a "wedge between economic and
financial returns” regardless of “whether they operate across the board or asymmetrically among residents or non-residents”. (Lessard and Williamson, 1987, p. 217).

From the above table and analysis therein, normal capital outflows are the ones that take place in order to maximize economic returns and opportunities between countries. Normal portfolio diversification takes place on the basis of differentials in economic returns. Capital flight on the other hand as seen from this analysis is that “subset of capital outflows that are propelled by source country policies”. (Lessard and Williamson 1987, p. 217).

By its very nature, it is difficult to measure capital flight. Nevertheless, a number of capital flight estimates have been made over the last several years. These various studies differ from one another in terms of the methodological approaches of measurement, country coverage and time span.

Cuddington (1986) defined capital flight as short-term speculative outflows. Capital flight is viewed as short-term external assets by the non-bank private sector plus the errors and omissions in the balance of payments. This approach is concentrated on what is popularly referred to as “hot money flows” method because of the fact that funds are expected to respond quickly to changes in expected returns or to changes in risk. Variations on economic conditions are likely to affect the magnitude of such flows. These in essence are funds “on the wings” that are expected to return very quickly to the country of origin when economic conditions are favourable- that is when appropriate macroeconomics policy stance is adopted.

Khan and Ul Haque (1987) calculated capital flight for eight highly indebted developing countries for the period 1974 – 1982. Capital flight is defined in two ways. First, it is defined simply as gross private short-term capital flows plus net errors and omissions in the country’s balance of payments accounts. This is the same as Cuddington estimate. The second method tries to take account of normal capital flows. Capital flight is defined as that part of the increase in the external claims that yield no recorded investment income. This in
essence is the Dooley (1986) approach, which seeks to measure the stock of privately held foreign asset that do not generate income to the domestic authorities. It does so by cumulating the identified capital outflows in the balance-of-payments accounts and making three adjustments to capture unreported capital flows. The first is to add errors and omissions (G). The second is abased on a comparison of the World Bank data on the stock of external debt and external borrowing flows reported in the balance-of-payments accounts. Dooley adds the difference between each year’s change in private-sector foreign assets. Dooley assumes thus the entire difference is private-sector acquisition of foreign assets. The third adjustment is to calculate the stock of external assets needed to give the (balance-of-payments) investment income, by using an international market interest rate. If investment income is under-reported, then the inputed stock of external assets will less than external assets using balance-of-payments figures (and after making the previous two adjustments). The difference between the two is the stock of flight capital; and difference from year-to-year is the measure of capital flight.

In the Morgan Guaranty Trust Company study (1986, p.13) capital flight is defined as “the reported and unreported acquisition of foreign assets by the non-bank private sector and some elements of the public sector”. Capital flight is estimated “indirectly as the counterpart of net direct investment inflows plus increases in gross external debt less recorded outflows through current account balance deficits and less the building of foreign assets by the banking system and the official monetary authorities.”

Cline (1986) critiques the capital flight definition adopted by the Morgan Guaranty Trust Company study. He argues that income from tourism and border transaction should be subtracted since these earnings are beyond the control of the relevant foreign exchange authorities. He also argues that reinvested investment income should not be considered as capital flight since this is also beyond control of authorities. The Cline method is similar to Morgan’s but subtracts travel (credit), reinvested foreign direct investment (FDI) income (abroad and domestically), and other investment income (credit).
An examination of the literature shows that there are a variety of ways of measuring capital flight. The measuring techniques can be classified into six categories. In the first category is the "narrow" definition and measurement of capital flight. Capital flight is defined as the net short term capital outflows plus errors and omissions in the balance of payments. This is the Cuddington (1986) approach.

The second category is the "derived" measure of capital flight. Capital flight is that part of the increase in external claims that yields no recorded investment income. This is the approach adopted by Dooley (1986, 1988).

The third category consists of a broad measure of capital flight. In this approach, capital flight is the measured acquisition of foreign assets by the non-bank private residents plus errors and omissions. Specifically, the broad measure equals capital inflows in the form of changes in external debt and net foreign investment minus the current account deficit and changes in the assets of the banking system. This measure of capital flight is adopted by various authors including Morgan Guaranty Trust Company (1986), World Bank (1985), Erbe (1985).

The fourth measure is the private claims measure which defines capital flight as the acquisition of external claims by the private sector including deposit in banks and the non-bank sector plus recorded errors and omissions in the balance of payments. This is the one applied by Cornes (1986).

The fifth measure is loosely referred to as the "mirror stock statistics" method. This method utilizes the statistics that is published by the International Monetary Fund (IMF). Capital flight measure under this method is derived from the "Cross Border Bank deposits of Non-banks by residence of depositor" published in the International Financial Statistics. This measure has been used by Khan (1986). It is this measure that is used in this research paper.
The sixth popular method is that adopted by Pastor (1989, 1990). This method is labelled the “sources and uses” approach to capital flight. Capital flight is derived residually from the balance of payments equation. Capital flight is defined as the change in debt plus foreign direct investment minus the sum of current account plus the changes in reserves. The various approaches listed is as comprehensive as it can be when due cognizance is taken of the different names that are often used for the same thing.
CHAPTER THREE
RESEARCH METHODOLOGY

III.1. DATA COLLECTION

Data for this study was obtained from the Central Bank of Kenya, the World Bank and the IMF, inter alia. It was basically a library research backed by interviews to selected individuals in the research department of the Central Bank of Kenya. The study is therefore utilizing a rich secondary data recorded in the International Financial Statistics Monthly booklet for the period 1986 – 1995. From here, the author tabulated the secondary data and then translated into a bar chart to analyze the capital flows and annual rate of flight of capital.

III. 2. NATURE OF DATA

The data population was limited to secondary data and the sampling method used was convenient one. The nature of the data to be collected was any official data relating to Kenyan nationals depositing banks abroad. Eventually due to paucity of data, use the International Financial Statistics Monthly Booklet, which give tabular statistics concerning international bank credit to nonbanks reporting on the claims of deposit banks on non-resident nonbanks was preferred. All major financial institutions around the world declare the wealth of their nonbank depositors by nationality to the IMF and thus recorded in IFS publication.

III.1.4. JUSTIFICATION FOR DATA COLLECTION

There is a general lack of data on capital flight in the Central Bank and other financial institutions of Kenya. In addition, the author looked for information regarding how much money are private individual Kenyans holding in overseas accounts. This information is recorded quarterly in the IFS monthly booklet from reports submitted by major banks in the world. Kenya is number 664 of the IFS International Banking tables.
CHAPTER FOUR
DATA PRESENTATION AND FINDINGS

IV.1. DATA PRESENTATION

The statistical approach used in this study is what was referred to as the “mirror stock statistics” method. The estimates of capital flight using this method is shown in the table below. This method draws on the international banking statistics to evaluate the amount of assets held by the residents of developing countries abroad. This method of estimating capital flight has been used by Khan and Ul Haque (1987) and the Bank of England (1987). It is particularly useful in determining the minimum level of assets held abroad. For this method, the recorded statistics by the IMF are called Cross Border Bank Deposits of Non-banks by Residence of Depositors.


<table>
<thead>
<tr>
<th>YEAR</th>
<th>CROSS BORDER BANK DEPOSITS OF KENYAN DEPOSITORS</th>
<th>FLOWS OF CROSS BORDER DEPOSITS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1986</td>
<td>1.50</td>
<td>0.34</td>
</tr>
<tr>
<td>1987</td>
<td>1.84</td>
<td>-0.03</td>
</tr>
<tr>
<td>1988</td>
<td>1.81</td>
<td>-0.03</td>
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<tr>
<td>1989</td>
<td>2.01</td>
<td>0.2</td>
</tr>
<tr>
<td>1990</td>
<td>2.64</td>
<td>0.63</td>
</tr>
<tr>
<td>1991</td>
<td>2.53</td>
<td>-0.11</td>
</tr>
<tr>
<td>1992</td>
<td>2.22</td>
<td>-0.31</td>
</tr>
<tr>
<td>1993</td>
<td>2.17</td>
<td>-0.05</td>
</tr>
<tr>
<td>1994</td>
<td>2.20</td>
<td>0.03</td>
</tr>
<tr>
<td>1995 (first quarter)</td>
<td>2.29</td>
<td>0.09</td>
</tr>
</tbody>
</table>

Source: Figures are adapted from IMF, International Financial Statistics, 1995, pp. 51

The first column of the table indicates the year and the second column shows the amount of money held by Kenyan depositors in foreign bank accounts. The third column determines
the difference between each two succeeding years, which is the flow of cross border deposits. The lesser the difference the lesser the flow. This amount represents the stocks per year. When capital flight is defined as the increase over the previous year, we find that amount is relatively small but significant in cumulative terms. This method is particularly useful in determining the minimum level of assets held abroad.


Note that data is available only up to the first quarter of 1995.


In the above chart, the X-axis shows the number of years and the Y-axis indicates the amount of money owned by Kenyans and deposited in bank accounts abroad. The periodic chart implies that the trend of private capital flight in Kenya has been increasing at different rates during the period covered in the study. It was at its peak during early 90s when the winds of change, i.e. multiparty politics, unrest in the neighbouring countries, privatization and liberalization with its associated uncertainties, unethical financial scandals such as Goldenberg, corruption, etc stormed the country.
IV.2. DATA FINDINGS

It is established that there is a significant outflow of private capital in Kenya. Although the amount of private capital flow, referred as “flows of cross border deposits”, varied from year to year, there had been an average annual outflow of US $890 million over a period of ten years covered in this study. The cumulative flight of private capital derived from the ten-year period data is therefore equivalent to US $8.9 billion.

As explicitly shown in the table, in the first quarter of 1995, capital to the tune of US $2.29 billion was held in foreign bank accounts compared to an estimated US $1.50 billion in 1986. This makes the rate of capital flight 52 percent.

The avenues through which capital flies from its national country are not only many but also varied. They come in various forms and it is almost impossible to develop an exhaustive list of the channels. While some escape routes are not discernible to the general public or the law enforcement bodies, others are well documented and are known. There are a number of channels through which capital flight can take place in Kenya.

1. Transfers can take place through cash or monetary instruments. These are usually in the form of either foreign or domestic currency, travellers checks or other checks.

2. Capital flight can take place through bank transfers from a local affiliate of a foreign owned bank to a designated recipient abroad. This amount of money can be exchanged at the market rate where no constraints or restrictions are in place. Transfers can still be possible in the face of exchange controls but possibly at a less favorable rate. Given this institutional set up, transfers of the type mentioned take place and are indeed still taking place even though the exact statistics on the magnitudes are lacking.

3. Transfer of wealth through precious metals and collectibles including works of art. This is a substitute for currency movement. Local currency is converted into gold, silver or other precious metals, precious stones, jewelry and similar assets that cannot only be moved
abroad but that will also be able to retain their value. The sale value of these are usually high in foreign currency. Usually, governments tend to restrict or prohibit imports and exports of any such items. Laxity in port controls facilitate the smuggling of materials.

4. Transfer of wealth through false invoicing of trade transactions. In this case, invoices are issued that are different from agreed prices. Substantial amount of money can arise from the systematic faking of imports and exports. The expectation in the case of capital flight is that exporters will systematically engage in under-invoicing while importers over-invoice and in the process derive foreign exchange gain that is outside the control of the foreign exchange authority. The worst case scenario is when collusion exists between exporters and importers, trade faking is an effective means of acquiring excess foreign exchange. This practice is common through local affiliates of multinational companies, and owners of businesses engaged in international trade.

5. Transfer of money abroad through the black market itself. This until recently has been a thriving source of transferring funds abroad. The amount of money so transferred is difficult to estimate.

6. Transfer of capital through commissions and agents’ fees which are paid by foreign contractors into the foreign bank accounts of residents. Commissions and agents’ fees are in some cases polite words for a myriad of kickbacks on foreign contracts.

7. Transfer of money through Bureau de changes. Liberalization has led to the proliferation of Bureau de change. This is an important mechanism through which a lot of capital can be transferred abroad. The number of such institutions and the transactions undertaken by them have been rising in recent times. Apart from those sponsored by international money changers, there are increasingly regional ones that operate within East Africa.
CHAPTER FIVE
SUMMARY AND CONCLUSION

V.1. SUMMARY

An attempt has been made to address private capital flight in this paper and estimates of annual outflows were determined using the mirror statistics method. It uses a recorded statistics by IMF, which is called Cross Border Bank Deposits on Non-banks by Residence of Depositors. The study is about vast amounts of money owned by Kenyan wealth owners and held in bank accounts outside Kenya. Using the definitions of capital flight in a variety of contexts, the study has explored the mechanisms of capital flight.

Private capital flight has been viewed as a constraint on economic growth. It contributes to the external debt problem by intensifying the shortage of foreign exchange required to service the debt and increasing the cost of borrowing which often rises with the amount borrowed. Capital flight also shrinks the tax base of the economy. Since most of the resources invested abroad are out of the reach of the government and the revenue generated by such investment is not repatriated back to the domestic economy, such investment cannot be taxed. It is also often argued that a reversal of capital outflows could significantly contribute to the solution of the external debt problem and poor economic performance. Even though the government has tried to encourage repatriation (bringing back) of capital, in the first quarter of 1995, capital estimated to a tune of US $2.29 billion (International Financial Statistics, 1995) was still held in foreign bank accounts compared to an estimated capital of US $1.50 billion in 1986 (IMF, International Financial Statistics, 1993, pp. 51). An increase of 52 percent had been detected over the studied period. Also, the cumulative flight of private capital derived from the ten-year period data amounted to US $8.9 billion. If this money were invested in Kenya, it could revolutionize the infrastructure and help create employment for many Kenyans.
V.2. RECOMMENDATIONS

There is need for the maintenance of sound macroeconomics policy in order to control capital flight. There is a need to ensure that the nation’s currency is not overvalued or undervalued. This can be done by setting it at a realistic level or by allowing the currency to float. There is a lot to be gained for the free flow of capital as this would prevent the need to use trade faking for the illicit acquisition of foreign exchange. In addition an integrated and unified tariff structure would be useful as it will reduce the rewards of trade faking. Thus a viable trade policy is essential for preventing illicit activities.

It is necessary also to ensure that the exchange rate does not appreciate in real terms by high domestic inflation. It would therefore be necessary to ensure that there is fiscal discipline so that deficits as a proportion of the gross domestic product is kept in check as this is crucial to the maintenance of macroeconomics stability. Economic growth provides the opportunities for possible investments and will therefore help reduce if not totally eliminate capital flight. As investment opportunities are enhanced and profitability ensured within the domestic economy, the retention of domestic money would be less difficult. There is need to ensure a positive real rate of interest. The rate should be high enough to attract funds but not too high to stifle investment initiatives. If proper policy package are pursued rightly and with consistency, it should be possible to minimize if not totally eliminate capital flight.

The issue of the existence of and how to deal with corruption is certainly more difficult to prescribe. It is nevertheless part of the general problem of capital flight. One can only safely say that there is a need for attitudinal changes on the part of those who hold public offices and have access to foreign funds directly or through the contracts which they award. This attitudinal changes involve a serious commitment to honest government. The importance of honesty cannot be overemphasized. It is true to assert that “a society that lacks the social cohesion to ensure its leaders place public duties ahead of personal gain may well be condemned to repeated bouts of capital flight.” (Lessard and Williamson, 1987, p. 34).
The repatriation or bringing back of capital to the domestic economy subsequent to adoption of appropriate macroeconomics policies to forestall capital outflow poses more challenges to the economy than is often realised. Part of the challenges arises from the fact that the adoption of appropriate macroeconomics policy is not a one-shot affair. Therefore, it is wise to use macroeconomic policies that are not only consistent but also suitable to any given point of the ups and downs of the Kenya economy.

V.3. LIMITATION OF THE STUDY

The method used in the study utilizes the recorded statistics of Cross Border Bank Deposits of Non-banks by Residence of Depositors, which is documented by the IMF in its International Financial Statistics monthly books. Therefore, when capital flight is defined as the increase over the previous year, we find that the amount is relatively very small. However, the amounts reflected in this method represents ONLY private capital flight and thus lowest of all estimates of capital flight. Another limitation is the unavailability of data beyond 1995. At the time of the study, data beyond the first quarter of 1995 was not ready for perusal.

V.4. SUGGESTIONS FOR FURTHER RESEARCH

As the study focused on the period from 1986 through 1995, it would need continuous update as soon as data beyond 1995 is received from the IMF. In order to determine a comprehensive estimate of capital flight in Kenya, it would be worthwhile to conduct a further research into the assets held abroad by the national companies or business groups by using all the various measures of capital flight.


