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The Political Economy of Private Investment in a Developing Economy: The Case of Kenya

Abstract:

Existing theories of investment look at private investment mainly from the point of view of the investor in terms of profitability, costs, market value of the firm or demand expectations. Consequently, public policy is directed at creating an environment where pecuniary benefits of investors can be maximized. There is little or no regard as to how the investment activities relate to material welfare of the people domiciled in a particular region. This approach has important shortcomings. First, it fails to recognize the weakness of the private sector to meet the material welfare the populace aspire to achieve. Secondly, the importance of sociopolitical factors becomes supernumerary. This study discusses an approach to investment that recognizes the importance of institutions, nature of businesses and direction of investment expenditure emphasizing improvement and 'innovation' as the central element of investment in a developing economy.

Using the conventional approaches to investment, we document the problems of private investment in Kenya over the period 1975-1996 and attempt to explain the factors responsible for the observed dismal performance. Our results suggest that excessive borrowing by the government from the financial sector may have occasionally 'crowded out' private investment. Contrary to 'financial repression' predictions, high interest rates seem to have a dampening effect on private investment. Macro economic policies in terms of price stability, budget deficits, exchange rate, external debt and financial intermediation may help explain cross country differences in investment performance. This underscores the importance of sound macroeconomic management.

Declining returns on investment on account of weak domestic and foreign demand, and declining productivity help explain the observed trends in investment. Our results seem to confirm the complementarity hypothesis as regards public investment on infrastructure. The study concludes that if private investment activities in a developing nation are to be geared toward upgrading in terms of product technology or production efficiency and diversification, then the current reforms in developing countries are necessary but not sufficient to produce a dynamic private sector.