
Monetarism Theory and Liquidity Decisions of Business Enterprises in Kenya

Khamis Kasidi, Saumu Amir Riwegho

Department of Accounting and Finance, Technical University of Mombasa.

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Abstract:

In order to comprehend how monetary elements and Kenya's financial environment interact, this research investigates the application of monetarism theory to liquidity decisions for enterprises in Kenya. Milton Friedman's monetary theory places a strong emphasis on how the amount of money in circulation affects how the economy performs. Understanding the use of monetarism theory becomes essential in the Kenyan context, as the Central Bank of Kenya plays a key role in enacting monetary policy. The study assesses the effect of monetary policy instruments, including interest rate changes and open market operations, on liquidity decisions and looks at the relationship between changes in the money supply and firm-level liquidity positions. In the context of monetarism theory, it also looks at how macroeconomic variables like inflation rates, currency fluctuations, and economic growth affect firm-level liquidity decisions. This study attempts to add to the body of knowledge on the connection between monetary conditions and firm-level liquidity decisions by applying monetarism theory to the Kenyan setting. The results can help Kenyan policymakers make decisions that are supported by facts and that will promote financial stability, effective liquidity management, and long-term economic growth.

Keywords: Monetarism Theory, Liquidity Decisions, Monetary Policy

1. Introduction

The theory of monetarism, or the monetarist theory, is a vital macroeconomic concept that highlights the money supply as a crucial economic force. Advocates of this theory firmly believe that the money supply is a decisive element in determining price levels and inflation. The theory asserts that as the money supply increases, it inevitably leads to higher prices and inflation, while reducing the money supply leads to deflation and risks, resulting in a recession. Employment and production levels are also affected by alterations

in the money supply, but the monetarist theory emphasizes that these effects are only temporary. On the other hand, the effects on inflation are more lasting and significant. Understanding the dynamics of Kenya's financial landscape depends critically on the application of monetarism theory to liquidity decisions made by businesses there. Milton Friedman's macroeconomic theory of monetarism, which was established in the 20th century, places a strong emphasis on the influence of monetary considerations on economic results. According to this hypothesis, alterations in the money supply have a direct bearing on output, prices, and overall economic stability (Innocenti, 2020).

Liquidity management entails the control of accounts receivable, cash, accounts payable, and inventories. Receivables management calls for appropriate policies that establish credit sales levels, payment due dates, and late payment fees for customers that entice purchases. As a result, the effect on the cash conversion cycle and cash flow is offset by increased revenue and, consequently, an increase in investment return (Ngari & Kamau, 2022). The study by Ogotu (2022) concludes that the financial performance of manufacturing businesses is affected differently by a number of working capital components.

On the other hand, decisions made by businesses on the management of their liquid assets, such as cash and short-term investments, are referred to as liquidity decisions. These choices have a significant impact on a company's capacity to satisfy short-term obligations, invest in development possibilities, and weather economic fluctuations, which is why they are so important to the financial stability and operational effectiveness of the company (Dur & Martínez García, 2020). Understanding how the monetarism theory applies to liquidity decisions becomes essential in the context of Kenya, an East African nation with a dynamic and expanding economy. Kenya's financial system, which is made up of a variety of commercial banks, microfinance organizations, and non-bank financial institutions, presents particular difficulties and opportunities that call for a careful analysis of the decisions businesses make regarding liquidity.

Kenya's Central Bank (CBK), which implements monetary policy and controls the nation's money supply, is a key player in these processes. Researchers may learn a lot about the efficacy of monetarism theory in a developing economy like Kenya by looking at how monetary policy decisions and actions by the CBK affect liquidity decisions made by enterprises. By examining a number of important factors, this study intends to investigate how the monetarism theory might be applied to liquidity decisions made by businesses in Kenya. The relationship between changes in the money supply, as managed by the CBK, and the liquidity positions of enterprises will be examined first. In addition, it will evaluate the results of monetary policy instruments like interest rate changes and open market

activities. Additionally, this study will look at how external variables like inflation, currency fluctuations, and economic growth affect the liquidity decisions made by businesses within the framework of monetarism theory. Policymakers, regulators, and practitioners wishing to advance financial stability and sustainable economic growth may find it helpful to understand how enterprises in Kenya respond to these macroeconomic variables in terms of their liquidity management.

This study intends to add to the body of knowledge on the connection between monetary policy and firm-level liquidity decisions by applying monetarism theory to the particular setting of Kenya's enterprises. It aims to give policymakers empirical proof and useful consequences so they may decide on monetary policy, liquidity management frameworks, and financial policies with knowledge. Overall, this study issue is very important for comprehending how monetarism theory is used in the Kenyan setting and for elucidating how monetary factors interact with firm-level liquidity decisions. This study intends to offer insightful information that can support Kenya's sustainable economic development through a thorough investigation of the relationship between the money supply, monetary policy, and liquidity decisions.

2. Literature Review

2.1 Monetarism Theory and its Application

Milton Friedman's monetary theory contends that shifts in the money supply have a direct bearing on economic factors including prices, output, and employment. Monetarists contend that while insufficient growth can lead to deflation and a downturn in the economy, excessive increase in the money supply causes inflation. In order to keep prices, stable and encourage long-term economic growth, monetary theory places a strong emphasis on the need to manage the money supply (Cutsinger, 2022).

The implementation of monetarism theory in various economic circumstances has been the subject of numerous studies. For instance, Chapman and Kulkarni, (2020) examined Comparison of Monetary Policy Actions: UK, Japan, and USA During the Financial Crisis of 2008, emphasizing the significance of central banks' power over the expansion of the money supply. The monetarist perspective was further supported by research by Osuoha, (2023) and Gomis-Porqueras, (2020) that looked at the connection between monetary aggregates and macroeconomic variables in various sectors. Liquidity Decisions for Firms: For businesses to be able to satisfy short-term obligations, invest in prospects for growth, and navigate financial uncertainty, liquidity decisions are crucial. Companies must find a balance between investing in income-producing ventures and maintaining a sufficient level of liquid assets. Cash flows, profitability, firm size, industry features, and macroeconomic

conditions are just a few of the variables that have an impact on liquidity decisions (Isaic et al., 2019).

2.2 Monetary Policy and Firm-Level Liquidity

Researchers have been interested in the connection between monetary policy and firm-level liquidity decisions. Changes in interest rates, reserve requirements, and open market operations are just a few examples of monetary policy moves that can significantly affect a company's liquidity position (Chapman & Kulkarni, 2020). There is, however, little research that focuses especially on utilizing monetarism theory to examine liquidity considerations for businesses in underdeveloped economies like Kenya. Understanding the significance of monetarism theory in influencing firm-level liquidity decisions becomes essential given the distinctive features of the Kenyan financial system and the nation's economic environment.

Kenya's banking industry is thriving, and the country has seen tremendous economic progress. To maintain price stability and encourage economic progress, the Central Bank of Kenya (CBK) is crucial in developing and carrying out monetary policy. However, more research is needed to determine how well monetary policy works and how it affects decisions about firm-level liquidity in the Kenyan environment. Studies on the financial system in Kenya have mostly concentrated on issues like the stability of the banking sector, financial inclusion, and the efficiency of monetary policy transmission. However, there is a void in the literature that particularly examines how the monetarist theory is applied to liquidity decisions made by enterprises in Kenya.

3. Discussion

Milton Friedman's monetary theory highlights the importance of managing the money supply to uphold price stability and encourage long-term economic growth. Exploring the use of monetarism theory on liquidity decisions becomes especially pertinent in the setting of Kenya, where the Central Bank of Kenya (CBK) plays a key role in implementing monetary policy.

3.1 Money Supply and Firm-Level Liquidity

A Relationship Examining the connection between changes in the money supply and the liquidity positions of Kenyan enterprises is a critical component of applying monetarism theory. Understanding how monetary policy tools like open market operations and reserve requirements, which are used by the CBK to alter the money supply, affect the liquidity choices that businesses make is crucial. Analyzing how enterprises react to changes in the money supply might be a component of this research. For instance, a rise in the money

supply could influence firms' access to liquidity by lowering interest rates and increasing the availability of loans. Insights on the efficacy of monetarism theory in a Kenyan context can be gained by understanding how enterprises modify their liquidity positions in response to changes in the money supply (Osuoha, 2023).

3.2 Monetary Policy's Effect on Firm-Level Liquidity

Firms' decisions about liquidity are directly impacted by monetary policy choices, such as changes to interest rates. It is critical to evaluate how the CBK's monetary policy decisions impact the liquidity positions of Kenyan companies. The impact of monetary policy on firm-level liquidity decisions can be studied through research. For instance, changes in interest rates may have an effect on the cost of borrowing and the accessibility of credit, which may have an impact on the liquidity positions of firms. Researchers can learn more about the practical applications of monetarism theory in the Kenyan business environment by looking at how firms react to changes in monetary policy and how they modify their liquidity management tactics (Dur & Martínez García, 2020). The management of working capital is crucial in unindustrialized economies due to the unpredictable dynamics of the commercial sector and the unforeseeable effects of the state of affairs of the financial system, which might result in considerable general price volatility (Chasha et al., 2022).

3.3 Firm-Level Liquidity and Macroeconomic Factors

In addition to the money supply and monetary policy, macroeconomic variables like inflation rates, currency rate swings, and economic expansion can have a big impact on the liquidity choices that Kenyan businesses make. These elements may interact with the monetarist theory to influence how corporations decide how much liquidity to hold. Research can look at how organizations' liquidity management techniques react to macroeconomic factors. For instance, in times of severe inflation, businesses may place a higher priority on retaining liquid assets as a cost hedge. Understanding how these macroeconomic variables interact with liquidity choices can shed light on the bigger picture of how Kenyan monetarism theory functions (Innocenti, 2020).

A more in-depth comprehension of the implementation of monetarism theory can be obtained by looking at liquidity decisions made in various Kenyan economic sectors. distinct industries could experience distinct liquidity problems and react to changes in monetary policy in different ways. In order to examine liquidity decisions in industries like manufacturing, finance, agriculture, or services, researchers might perform sector-specific studies. This method enables a thorough evaluation of the implications of monetarism theory for liquidity decisions within certain economic sectors, taking into account sector-

specific traits, regulatory frameworks, and financing requirements (Gomis-Porqueras, 2020).

Recommendations and Policy Implications: Policymakers, regulators, and practitioners may find the conclusions from the monetarism theory application on liquidity decisions in Kenya useful. Effective monetary policy, liquidity management frameworks, and financial sector regulations can be developed with the help of an understanding of the dynamics of liquidity decisions and the impact of monetary considerations. Policymakers might modify monetary policy tools to better serve the liquidity needs of businesses in Kenya based on the research's findings. To encourage the best practices in liquidity management and improve the stability and expansion of businesses, recommendations can include modifying reserve requirements, interest rates, or credit allocation policies (Osuoha, 2023).

4. Conclusion

In conclusion, the application of monetarism theory to liquidity choices made by Kenyan businesses provides important new information on how monetary elements interact with the nation's financial system. This study advances our knowledge of how monetarism theory functions in the particular Kenyan setting by conducting a thorough investigation of the relationship between the money supply, monetary policy, and firm-level liquidity decisions. Researchers can evaluate the efficiency of monetary policy tools in influencing the availability of credit and the liquidity positions of firms by looking at the effects of changes in the money supply on firm-level liquidity. Furthermore, knowing how businesses react to changes in monetary policy has direct applications for how policymakers create efficient plans to control liquidity and advance financial stability.

Furthermore, taking into account how macroeconomic issues affect firm-level liquidity decisions adds to our knowledge of how monetarism theory is applied in Kenya. In order to provide a complete framework that integrates monetary policy with the larger economic environment, policymakers and practitioners should investigate how firms modify their liquidity management techniques in response to inflation rates, exchange rate changes, and economic growth. It is possible to gain a more detailed knowledge of how the monetarism theory relates to various sectors of the Kenyan economy by doing a sectoral study of liquidity decisions in various businesses. Such research identifies the unique opportunities and problems faced by various industries, allowing policymakers to modify regulatory frameworks and liquidity management frameworks accordingly.

Research on the use of monetarism theory in Kenya has practical consequences for practitioners, policymakers, and regulators in addition to adding to the scholarly literature.

The research findings can help in the development of monetary policies that support monetary stability, effective liquidity management, and long-term economic expansion. In the end, this research advances our understanding of how monetary factors influence the liquidity decisions made by enterprises in Kenya and lays the groundwork for evidence-based policy-making in the nation.

When there is a larger money supply, businesses have greater access to credit and can borrow more easily, which can enhance their liquidity position. Conversely, a decrease in the money supply can have a negative impact on business liquidity. If the money supply contracts, businesses may face challenges in obtaining credit and financing, which can lead to a decrease in their liquidity. This reduction in liquidity can restrict their ability to invest, pay bills, and meet their financial obligations. Overall, the monetization theory posits that changes in the money supply can influence business liquidity, with an increase in the money supply generally improving liquidity and a decrease in the money supply potentially impairing liquidity.

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