Analysis of Kenya’s Public Debt, Implications and Options

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Introduction

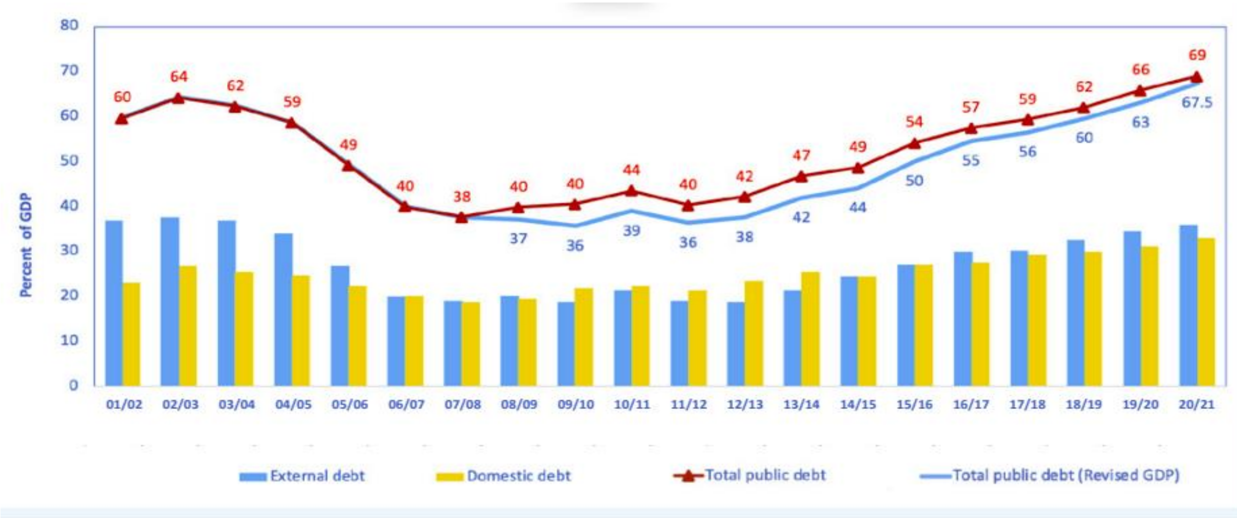
Historically, the government of Kenya has suffered budget deficits since independence due to government revenues falling short of expenditure demands. To achieve Vision 2030 targets, Kenya embarked on implementation of ambitious infrastructural projects such as Lamu Port South Sudan-Ethiopia Transport project (LAPSSET), Standard Gauge Railway (SGR) and geothermal power generation which require large amount of funds beyond the government revenue collection capacity. To finance the deficit, the government decided to borrow to bridge the revenue and desired expenditure gap.

According to Kenya’s Vision 2030 Kenya aimed to attain an annual GDP growth rate of 7.0% by 2021 and achieve a 3.6 percent budget deficit by 2024/25. However, the budget policy statement of the year 2021 sets a new target of a budget deficit of 5% of GDP by 2027/2028 fiscal year. With a budget deficit of 6.2% of the GDP in the fiscal year 2022/2023, the governments has to sustain borrowing to finance the deficit.

The sustainability of the country’s public debt is now a key point of debate among the Kenyan authorities, the population, financial institutions, and other key stakeholders. Other than the consistent increase in the debt stock, debt-to-GDP ratio and the cost of debt service, concerns are also ripe on the progressive shift of the debt portfolio in favour of expensive commercial loans and the bilateral loans (majority of which is held by China – about 70 per cent) observed in the recent years.

Debt to GDP ratio

Debt to GDP ratio is a measure of a country’s indebtedness and is used by investors to measure the ability of a country to make future payments on its debt, which affects the country „s borrowing costs and government bond yields. Kenya’s fiscal policy space has changed significantly in the last 10 years on account of an expansionary fiscal policy driven by large infrastructure spending. This has pushed gross public debt as a percentage of GDP from 44.4% at the end of 2010 to an estimated 69% at the end of 2021. There was a decline from 64.1% in 2003 to 38.1% in June 2012, followed by a rapid increase due to large spending on infrastructure and more recently, COVID-19 related spending. Central Bank of Kenya (2022) data shows the growth of public debt over the recent years as shown in the following chart.



Source; Central Bank of Kenya, (2022)

It therefore shows that domestic and external debt has grown almost at the same rate over the period. As of 6th May 2022, banking institutions were the biggest holders of the domestic debt at 49%, followed by pension funds (31.93%), Insurance Companies (6.96%), and Parastatals (5.78%), while others hold 6.32% of domestic debt. The share of commercial loans which are relatively more expensive grew to 36 per cent of the country's external debt in 2019 from just 4 percent in 2010, before declining to 28.8 percent in 2021

External debt composition

External debt exposes the country in case of the risk of depreciation of the local currency against the dollar. An analysis of the structure of Kenya's external (public and publicly guaranteed) between 2010 and 2020 shows an increased uptake of commercial debt. External commercial debt decreased in 2020, as the authorities prioritized concessional borrowing during the pandemic after several years of reliable access to global financial markets. Commercial debt (mainly Eurobonds and syndicated loans) accounted for about 26 percent of external public debt at end of 2020 modestly above its share at end of 2015. Multilateral foreign debt is largely composed of concessional facilities from organizations such as the International Development Association (IDA), African Development Bank (ADB) among others.

Kenya: External Public Debt

	2015		2016		2017		2018		2019		2020	
	US$bn	Share	US$bn	Share	US$bn	Share	US$bn	Share	US$bn	Share	US$bn	Share
Multilateral creditors	7.3	46.5	7.6	41.2	8.2	35.8	8.6	32.1	10.2	33.4	13.7	39.7
Bilateral creditors	4.7	29.8	6.3	33.8	7.6	33.3	8.8	32.8	10.1	33.0	11.3	32.7
Commercial creditors	3.6	22.7	4.5	24.2	6.9	30.1	9.2	34.4	10.2	33.1	8.9	25.9
Others (supplier credits)	0.2	1.0	0.1	0.8	0.2	0.7	0.2	0.6	0.2	0.5	0.6	1.7
Total	15.8	100	18.5	100	22.8	100	26.7	100	30.7	100	34.5	100

Source: Kenyan National Treasury.

(아래 파이 그래프 말고 위 테이블 표로 교체요청)
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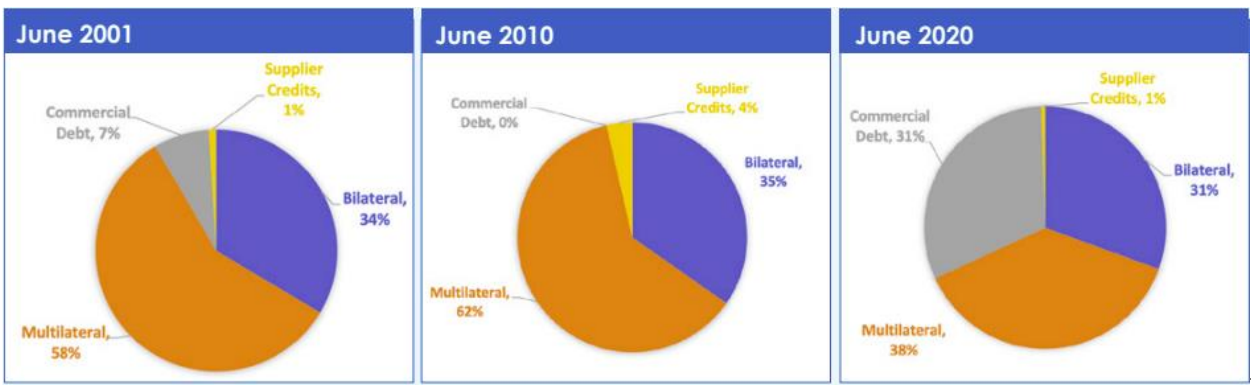
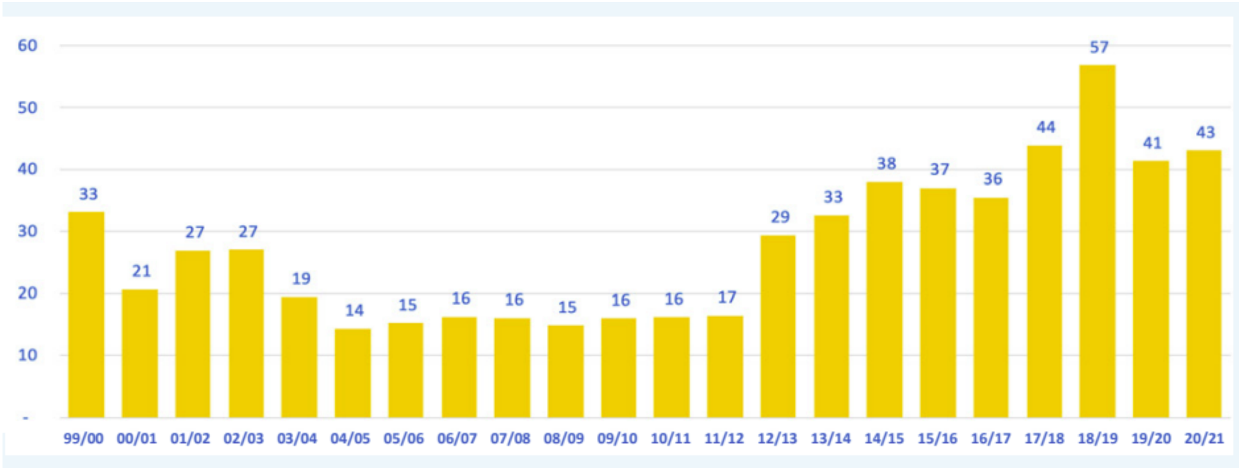


Source: Central Bank of Kenya (2021)

Total debt service to revenues

This is a measure of how much of the government's revenue is used to service debt. The total debt service to revenues increased exponentially to 57 percent in 2019 from 17 percent in 2012, higher than the recommended threshold of 30.0% and as such elevating the risks of repayment following shocks arising from the Covid-19 pandemic and low revenue collection. The change is debt service ratios can be attributed to increased debt stock and changing terms on new loans including one-off repayment of syndicated loans and Eurobonds in 2019.

It is estimated that Kenya will use 63% of fiscal year 2022/23 total ordinary revenues in settlement of debt. This reflects an increased constrained fiscal space and high debt burden environment. Central Bank of Kenya estimates that this trend will reverse in the medium term due to improving terms on new loans, and the restructuring of external commercial loans that have heavy maturities and high interest cost. It is expected that the country's cost of debt servicing will continue to rise due to the continuous depreciation of the Kenya shilling for fourteen straight months, to now trade at an average of KES/USD117.



External debt repayment has been growing as a share of total debt service. In 2017/18, Kenya's debt service was predominantly composed of domestic debt repayments amounting to 69 percent of the total as compared to 31 percent for external debt. However, this picture changed significantly in 2018 with the share of external debt rising from 31 percent to 48 percent. This was mainly driven by some of the commercial debt obligations that came due in 2019, including some to the Chinese Exim Bank for the SGR loan.

This is a shift from previous years where approximately 70 percent of the debt service bill was to repay domestic debt. Generally, while domestic debt service still accounts for the larger share of all payments, its share has been gradually reduced as that of external debt increases. There are advantages to having a large share of debt service being domestic. A key one is that it is in local currency which reduces the risks associated with foreign exchange volatility; and, secondly, it is easier to restructure domestic debt in case of shocks that could lead to defaults. The increase in the proportion of external debt service erodes these two advantages and is of concern. Kenya is now among 23 African countries that are at risk of debt distress due to weak fiscal management and macroeconomic frameworks to support growth, changing composition of debt towards more expensive sources of financing, and high levels of public spending.

Implications and Policy Recommendations

Unsustainable public debt can have serious implications on the economy and the ability of the government to provide services. Debt is the first charge on the consolidated fund. Debt is included among the items that the government is obligated to pay in the first charge of budget payments before spending money on service delivery or for development projects. Therefore, debt and all basic service-related recurrent expenditures and non-debt financed capital expenditures have to compete for domestically raised resources. The more spent on repaying debt, the smaller the amount remaining to provide basic services. This includes money that goes to government ministries, department agencies (MDAs) and also the allocation going to the devolved units of government. There is therefore a possibility of government sacrificing development and social welfare programs in the face of mounting debt obligations.

There is a possible depreciation of the local currency as other governments demand hard currency to service the debt increases. Indeed, the Kenya shilling has depreciated for fourteen straight months, to currently trade at an average of KES/USD 117.5. Out of the currency depreciation alone, the foreign debt portfolio has gone up by an excess of KES 500 billion Kenya shillings. Therefore, the higher cost of debt servicing may lead to higher taxation as the local government tries to keep up with its debt obligations. There is also the possibility of a higher cost of further borrowing since lenders will price the new debt considering the possible increased risks. As a matter of fact, Fitch rated Kenya's sovereign credit risk in March 2022 at B+ with a negative outlook. The 'B+ is due to a record of strong growth and relative macroeconomic stability. However, there is an elevated public debt, high net external indebtedness, and GDP per capita and governance indicators that explained the negative outlook. Also, risks to economic growth around the August 2022 general election and the surge in global commodity prices have exerted an upward pressure on inflation and the current account deficit. In May 2020, IMF downgraded the country's risk of external debt distress from moderate to high due to elevated vulnerabilities as a result of the Covid-19 pandemic. Kenya's the debt-carrying capacity was also downgraded by the IMF from strong to medium in April 2021

In an environment of limited fiscal space by the government, the risk of crowding out of the private sector by the government is real. This may lead to lower projected economic growth, further leading to lower tax collection. Equally, the government will experience a diminished ability to respond to problems, especially unexpected events due to the limited financing options available. The way out for the government of Kenya is improving on public debt management, fiscal consolidation and exploring other options of financing key public projects without incurring large amounts of debt. Improving debt management should at basic involve managing debt at minimum cost and risk. This may also involve using various liability management tools like debt restructuring, including debt securities buy back, switches and exchanges; transforming fixed rate debt into floating rate debt; and changing or swapping the currency denomination of old debt.

Fiscal consolidation should entail reducing the budgetary financing needs progressively through expenditure rationalization and domestic revenue mobilization. The government should continue undertaking reforms in the tax system and administration to improve revenue performance and reduce the cost of tax administration. The Kenya Revenue Authority has recently been focusing on improving efficiency and service delivery, enforcing compliance, promoting transparency and enhancing accountability, and increasing the tax base, among others. Some of the recent (or ongoing) reforms include, modernization and automation/digitization of tax administration, and introduction of new tax incentives. Exploring other options of financing public projects without incurring large amounts of debt will not only reduce the debt burden but will also reduce on volatile foreign currency borrowing and domestic non-tax revenue. Other financing options may include public-private partnership framework, state-contingent, resource-backed, or other collateralized innovative risk-sharing instruments among others to share downside risks as well as upside potential in economic performance with international investors and stimulate foreign direct investment.

Conclusion

The incoming government must handle the issue of national debt as a matter of priority. The constrained government fiscal space will ultimately affect the ability of government to provide essential services and any economic shock can actually lead to default. Rapid depreciation of the shilling against the dollar has already increased the debt by over KES 500 billion (over USD 4.3) without factoring the extra borrowing by the government. With the escalating international crude oil prices, the slow recovery of the global economy from the Covid-19 pandemic and the improvement in interest rates in western countries, leading to a withdrawal of funds from emerging markets, sovereign risk as a result of national debt can increase. This is the reason why management of national debt must now take the centre of priority.

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