POSITION PAPER ON PUBLIC DEBT MANAGEMENT: A CASE FOR KENYA

April 2018

BACKGROUND INFORMATION

There is a consensus that prudent public debt management can help economies reduce their borrowing cost, contain financial risk, and develop their domestic debt market. Debt can also facilitate maintaining financial stability and assist countries develop their domestic financial system.

Why public debt?

a) A government, like any other economic unit, collects revenue and spends it on various programmes. There are instances when its expenditures will exceed its receipts and vice versa.

b) Sudden surge in government expenditure- For instance in cases of wars, natural calamities may force government to incur larger expenditure and run into a debt.

Debt sustainability is therefore imperative. It implies the ability to service debt obligations as they fall without disrupting budget implementation. This position paper analyses Kenya's public debt situation with a view to giving recommendations on prudent debt management. The paper asks questions on the sustainability Kenya's public debt.

Kenya’s Public Debt Management and Legal framework

The Constitution of Kenya (2010) stipulates that public debt is a charge on the Consolidated Fund. The Constitution defines public debt as all financial obligations attendant to loans raised or guaranteed and
securities issued or guaranteed by the national government.

Equally, the Public Finance Management Act 2012, establishes important institutions and principles on public debt. These Fiscal Responsibility Principles include but not limited to the following:

(i) Over the medium term, the National Government’s borrowings shall be used only for the purpose of financing development expenditure and not for recurrent expenditure.
(ii) Public debt and obligations shall be maintained at a sustainable level as approved by Parliament (for National Government) and County Assemblies (for County Governments)

Table 1: PFMA Provisions on Public Debt Management

Section	Provision
49-65	Prescribes for the receipt & use of grants & loans; guaranteeing loans, lending money; establishes a fully-fledged Public Debt Management Office(PDMO) in the National Treasury
49	Authority for borrowing by the National Government
50	Obligations and restrictions on national government guaranteeing and borrowing- Parliamentary approval. Guarantee of debt shall be done in terms of criteria agreed with the Intergovernmental Budget and Economic Council(IBEC)
55	Establishes the office of the Registrar of the National Government Securities under PDMO. Securities issued by or on behalf of the national government shall be published & publicized
62 – 63	Establishes and empowers PDMO with objects of minimizing debt financing costs, maintaining reliable debt data, prepare annual and medium-term debt strategy

CURRENT PUBLIC DEBT SITUATION IN KENYA

Kenya is an economy that is exceedingly vulnerable to destabilizing influences beyond the control of its government. Kenya's public debt has for the first time exceeded Ksh. 4.5 Trillion mark reflecting the government's increasing appetite for the loans despite the warnings over the pace at which the debt is accumulating.

According to the Treasury's last Quarterly Economic and Budgetary Review Report, the total public debt stood at 4.57 Trillion at the end of 2017 as the build-up of massive borrowing that began 5 years ago continued unabated.

Compared to revenue generation trend over the years, debt accumulation has been increasing at an alarming rate indicating widening gap and mounting pressure on government's capacity to repay loans. The ability to generate and grow tax revenue is a strong indicator for future ability to repay loans. The table below compares revenue generation vis-à-vis deficit in budget implementation over the years.

Table 2: Revenue Table

Financial Year	Revenue Generated	% of GDP	Budget Deficit
2010/11	621,852	18.04%	**(160,164)**
2011/12	681,766	17.07%	**(197,185)**
2012/13	775,698	17.23%	**(265,621)**
2013/14	918,990	18.11%	**(326,172)**
2014/15	1,031,248	17.69%	**(532,821)**
2015/16	1,152,875	17.71%	**(549,398)**
2016/17	1,305,794	16.93%	**(708,373)**

In order to effectively execute the budgetary functions of the government, the deficit is plugged in by borrowing to finance the projects that would otherwise not be implemented for lack of funds. The huge infrastructural projects like Standard Gauge Railway takes a huge chunk of the revenue.

Similarly, recurrent expenditure that goes to wage bill compounds the problem thereby increasing the appetite to borrow both from domestic and foreign sources.

Table 3: Kenya's Public Debt status

FY	Debt amount	% debt increase	Actual Gross Expenditure	Debt as a % of Total Budget
2010/11	1,382,382,194,875		999,277,657,525	
2011/12	1,495,956,531,695	8%	1,066,835,338,744	
2012/13	1,767,017,069,021	18%	1,275,862,845,060	20%
2013/14	2,250,845,910,286	27%	1,461,965,849,061	15%
2014/15	2,674,806,364,195	19%	1,906,841,500,924	30%
2015/16	3,385,910,449,825	27%	1,999,174,760,912	5%
2016/17	4,407,001 M			

Table 4: Public Debt Financing

Financial Year	***Net debt estimate (Ksh. Billion)***
2013/14	232.3
2014/15	459.9
2015/16	436.5
2016/17	459.9

Table 5: Debt Stock (June 2012 to June 2015 Ksh. Billion)

Financial Year	Domestic debt	Foreign debt	Total
2012/13	858.83	763.97	1,622.8
2013/14	981.67	818.76	1,894.12
2014/15	1,231.18	940.4	2,422.83
2015/16	1,420.44	1,423.25	2,843.69

The World Economic Forum ranks Kenya at number 77 out of 138 countries using the GDP to debt ratio score. Japan is the most indebted country with a score of 248.1 percent, followed by Greece 178.4 percent and Lebanon at 139.1 percent. The United States, ranked at 128, has a debt to GDP ratio of 105.8 percent, but with the highest total debt of $17.9 trillion.

Hong Kong, Brunei and Saudi Arabia are the least indebted countries at 0.1, 3.1 and 5.8 percent respectively. Algeria is fourth globally at 8.7 percent, while Nigeria is seventh at 11.5 percent of the GDP.

In Africa, Kenya lies 14th, ranking slightly lower than Zambia 52.9 percent, Zimbabwe 53 percent and Tunisia 54.5percent.

How does Kenya Compare with other Countries?

Table 6 below compares Kenya's Public debt as a percentage of its GDP to other countries in the East Africa Region. From the Table, Kenya's percentage is higher than that of its neighbors.

Table 6: EAC Region -Public Debt as a percentage of the GDP

Country	Public Debt as % of the GDP as by 2016
Kenya	53.5 %
Burundi	37.20 %
Tanzania	36.90%
Uganda	34.80 %
Rwanda	33.70 %

Source: World Fact book

Equally, Table 7 compares the country's performance to some select global economies.

Table 7: Public Debt as a percentage of the GDP-Select Economies

Country	Public Debt as % of the GDP as by 2016
Japan	240.3
Greece	180.18
Lebanon	152.29
Italy	133.02
Cabo Verde	128.75
Eritrea	127.42
Portugal	125.72
Republic of Congo	117.7
Buhtan	112.83

Gambia	112.68
Singapore	110.58
Kenya	55.2
Kazakhastan	17.37
Russia	17.35
Saudi Arabia	17.01
DRC	16.99
Botswana	15.45
Uzbekistan	14.14
Solomon Islands	10 .04
Estonia	8.71
Afghanistan	7.64

Percentage of a country's public debt to its GDP is not the only sure measure to determine whether its public debt is sustainable. For instance, Japan, the third world largest economy has the highest public sector. Its debt- to-GDP ratio currently stands at 240.3% and is projected to be around 290 percent of the GDP by 2030. However, given that it's an advanced economy, it is anticipated that its economic growth and other fiscal measures will be sufficient in pushing down its debt levels.

Nevertheless, a look at the Greece crisis points to the dangers of high public debt. Indeed, Greece and other countries with higher percentages of debt to GDP such as Ireland and Portugal were not able to refinance their debt without help from international institutions. The situation can be harsh for the middle income and developing economies which are vulnerable to internal and external economic shocks.

IS KENYA'S PUBLIC DEBT SUSTAINABLE?

Public debt has risen in Kenya in the recent years with the better part of debt financing going to investment infrastructure to address the bottlenecks and boost sustainable economic growth. The bulk of Kenya's foreign debt carries concessional terms. However, the recent commercial borrowing entails huge repayment needs in 2017 for the 2015 syndicated loan and 2019, 2024 for the 2014 sovereign bond issuance.

The debt ratio to GDP for Kenya currently stands at 57% which is above the income level that Kenya can sustain. Recent forecasts indicate that the borrowings could soon take the debt load past 60 per cent of GDP. Data from the National Treasury indicates that the interest charged on Kenya's public debt rose by Sh56 billion in the 2016/17 fiscal year compared to the previous period, with debt payments gobbling up more than a third of the country's annual revenue.

Latest Treasury data from the 2017 Budget outlook and review paper (BROP) shows that the country spent Sh271.3 billion in interest payments, of which Sh212.9 billion went towards domestic debt interest and Sh58.4 billion in external debt interest payments. This does raise concerns over the sustainability of Kenya's recent spike in public debt.

Possible Economic Benefits of Kenya's Public debt

It is important to note that debt financing in most cases puts pressure on future generations in their ability to continue paying debt and related costs while at the same time maintaining economic stability. Consequently, a debt is sustainable if it is used to generate economic benefits higher than the initial costs.

According to the Cabinet Secretary, National Treasury, Kenya's debt is principally focused on development of infrastructure and such it will significantly be beneficial to Kenyans. As such, the economic benefits of the Standard Gauge Railway and other infrastructural projects may outweigh the initial costs incurred through debt financing.

REASONS FOR CONCERN?

As illustrated above, Kenya's public debt has been rapidly growing over the years. The growth of the country's public debt can be attributed to many factors such as supporting the national budget and investment in essential infrastructure projects among others. Kenya issued its maiden Eurobond to support infrastructural development. Moreover, the Country has entered into strategic partnerships with China aimed at supporting the development of the Standard Gauge Railway among other projects.

However, the high level of public debt in Kenya narrows the window for future borrowing, and increases vulnerability to fiscal risk in the event of any urgent need for borrowing.

Against the backdrop of unsteady economic growth, it becomes unsustainable in the long run for Kenya to have a huge public debt burden to be serviced by the taxpayer. The trend in GDP growth is as follows;

Table 8: Trend in GDP Growth

Financial Year		***2013/14***	***2014/15***	***2015/16***	***2016/17***	***2017/2018***
GDP growth percentage		5.9	5.4	5.7	5.9	4.9
Current account balance as % of GDP		-8.8	-10.4	-6.7	-5.2	-6.7
Inflation		5.7	6.9	6.6	6.3	8.0
Total new jobs created (000)	Formal	134.2	106.3	128.0	84.8	110.0
	Informal	621.6	695.9	716.5	747.2	787.8
CBR Rate average		9.3	9.7	11.9	9.8	8.4
Growth of financial and insurance activities		8.2	8.3	9.4	6.7	3.1

The growth in the key sectors such as agriculture, and manufacturing have been decelerating due to politics and uncertainty of weather conditions. These are key sectors for sustained revenue growth that would cushion the country against escalating public debt levels.

Similarly, Balance of payment widened to a deficit of 16.9 Billion in 2017.

The volume of trade rose to 2.3 Trillion in 2017 out of which, the value of imports were 1725.6 B and exports were 594.1 Billion. This illustrates a skewed balance of trade which does not bring enough influx of foreign exchange sufficient to fund the development projects in Kenya. This trend will still perpetuate more borrowing to increase public debt.

Table 8: External Outstanding Debt: Leading Countries

	KSh Million				
Leading Countries	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2014/15**
Germany	26,670.05	24,878.80	25,042.37	26,571.29	25,558.54
Japan	111,842.72	107,402.77	86,788.50	84,514.51	79,016.83
France	40,347.13	36,708.95	47,397.05	61,579.73	59,032.26
USA	5,901.00	5,136.78	4,816.04	4,542.27	4,461.92
Netherlands	3,011.87	2,925.78	2,599.67	2,701.91	1,960.29
Denmark	2, 774.66	2,076.63	1, 987.79	1, 1991.76	1,437.14
Finland	132.30	104.81	96.64	93.59	71.43
China	**32,453.00**	**36,661.87**	**63,123.40**	**80,858.59**	**252,039.33**
Belgium	9,037.00	7,365.07	7,607.22	8,096.36	6,141.68
Other	28,839.52	20,281.11	22,048.18	22,907.13	18,337.23
Total(Bilateral)	261,009.25	243,542.57	261,506.86	293,857.14	445,056.63

Source: The National Treasury

a) Debt servicing charges as a percentage of export earnings increasing?

Similarly, other factors such as debt servicing charges indicate that Kenya's debt position is not that rosy. For instance, in 2014/15, the debt servicing charges as a percentage of export earnings increased to 11.0 percent from 9.9 percent in 2013/14.

This was attributable to a faster growth in debt servicing charges compared to the growth in export earnings[1]. This is illustrated in Table 2 below:

Table 9: Ratio of National Government Debt Service Charges on External Debt to Exports of Goods and Services, 2011-2015

	Debt service Charge on External Debt (Fiscal Year)	**Export of Goods and Services (Calendar Year)**	**External debt service charges as a percentage of export of goods and services**
	KSh Million	KSh Million	%
2011	31,805.55	885,248.9	3.6
2012	35,705.51	947,189.7	3.8
2013	45,142.66	945,477.6	4.8
2014	98,014.23	992,326.0	9.9
2015	112,687.54	1,028,867.9	11.0

Source: The National Treasury and Kenya National Bureau of Statistics

All these factors point to the need for tightening our strategies to control the growing public debt. It is already noted that Public debt portfolio is large and may pose substantial risk to the government's balance sheet and the country's financial stability. If not managed prudently, it poses risks to the budget and large economic losses in future.

EFFECT OF INTEREST RATE CAPPING ON PUBLIC DEBT IN KENYA

Interest rate cap was introduced in Kenya for three major reasons;

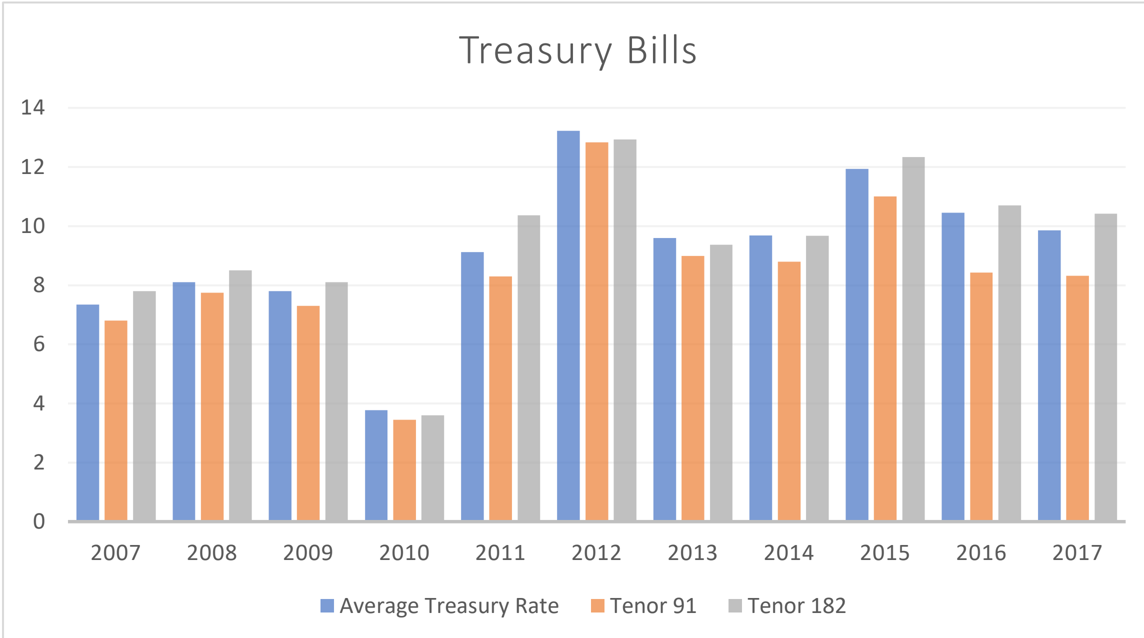
1. To protect consumers from high interest rates
2. To increase access to finance
3. To make loans more affordable

Since the rate cap was introduced, growth of credit to private sector has stagnated at single digit levels of circa 4% over the past 6 months. Commercial banks increase their lending to the government which is considered as a safer haven.

Private sector credit growth in the interest rate cap regime has been constrained by the following factors:

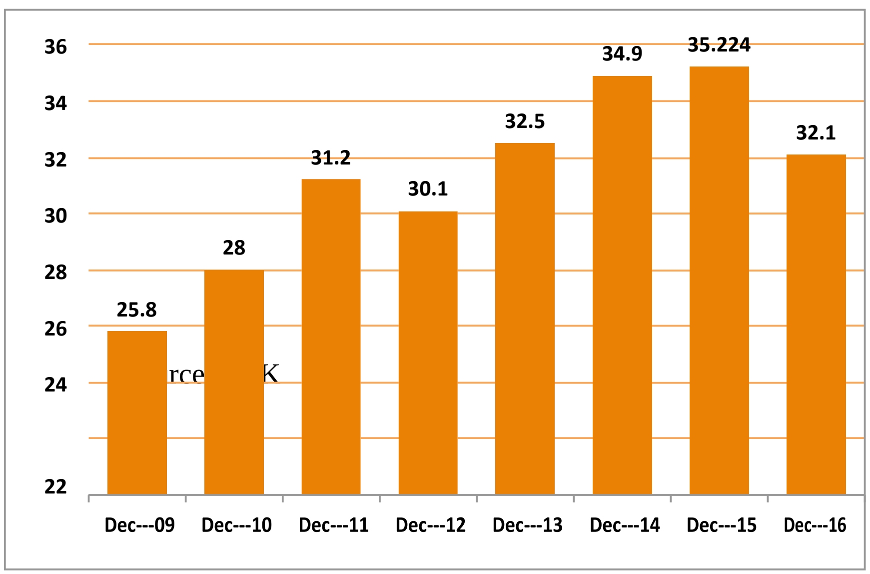
1. The interest rate cap has discouraged the banks from lending to the private sector which is considered as a risky segment.
2. Weak private sector economy lowers the demand for goods and services makes appetite for credit reduce in the private sector. The total domestic credit grew by 7.9% in 2017 while credit to the private sector growth remained at 2.4%.
3. Crowding out effect by the public sector which is a result of government's increased demand for funding. This is evidenced by Treasury bill offers which have increased to a total of Kes 24 billion in 2017 from Kes 16 billion in 2016 across the three tenors of 91, 182 and 364 days. In the last Treasury bond auction which also included a tap sale (a tap sale is used to borrow more money at the same face value, maturity and coupon rate as the initial issue except price), Central Bank picked funds at 12.5% and 13.1% respectively for what are effectively 3 and 7-year papers. With lending rates capped at 14%, banks are better off lending to government than to the private sector.

Figure 1: Treasury Bills tren



Trends in Private sector credit flows

Figure 2: Private sector credit flows



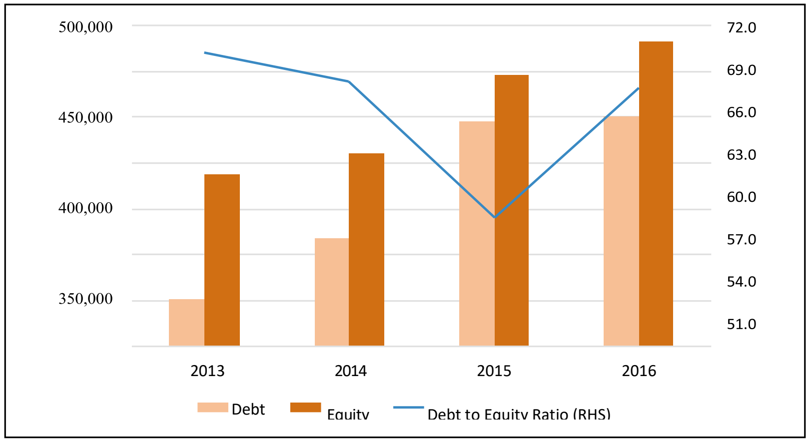
Private sector credit grew steadily from 2012 to 2015 but declined in 2016 following the enactment of interest rate capping. It slumped further to 25.8% in 2017. Several corporates face unfavorable business environment because of the government involvement in borrowing. Banks feel safer lending to the government which is considered risk-free.

Consequently, the banks shortened their loans maturity to less than five years owing to the instability in the banking sector coupled with interest rates capping. Banks have changed their business models to limit their exposure to credit risks and liquidity challenges by lending more to government. This has also reduced the borrowing space for the private sector firms leading to

SPILLOVER OF REDUCED CREDIT TO THE PRIVATE SECTOR TO THE MARKET

Growth in credit slowed down significantly all sectors of the economy. However, some sectors have recorded faster decline especially agriculture and manufacturing.

Figure 3: Leverage of the NSE 20 listed non-financial Companies



Source: Nairobi securities exchange

Manufacturing sector

The sector has been sluggish in the past five years. The sector was affected by uncertainties relating to high cost of production and competition from imported goods.

	2013	2014	2015	2016	2017
Growth of manufacturing Real Gross Value Added %	5.6	2.5	3.6	2.7	0.2

Construction sector

The trend shows a declining construction as depicted by cement consumption. This could be attributed to the completion of the first phase of the Standard Gauge Railway.

	2013	2014	2015	2016	2017
Cement Consumption ('000) Tonnes	4200	5100	5700	6200	5800

This demonstrates the early evidence of crowding out of the private sector as the banks prefer lending to government- quantity channel (less money to private sector) as opposed to the price channel (expensive money to private sector). It also means that credit will be concentrated among the large borrowers with the attendant risks of non-performing loans and possible systemic risks. For the sectors to grow, a slowdown in lending to government must be enhanced since it offers better returns given its risk-free perception.

CONCLUSION

The government must create a favorable environment in the banking sector to enhance competition that would lead to lower cost of and access to credit. This can be achieved through;

1. Stable macroeconomic conditions through appropriate legal and regulatory frameworks

2. Consumer financial literacy
3. Availability of financial information
4. Strong financial architecture such as bureaus and credit agencies

RECOMMENDATIONS

The Institute recommends the following:

Transparency and Accountability

There is need to adhere to Article 206 of the Constitution of Kenya and provisions of the Public Finance Management Act, 2012 in the management of public resources. This includes but not limited to the following:

(i) Over the medium term, the National Government's borrowings shall be used only for financing development expenditure and not for recurrent expenditure.

(ii) Public debt and obligations shall be maintained at a sustainable level as approved by Parliament (for National Government) and County Assemblies (for County Governments).

The objectives for debt management should be clearly defined and publicly disclosed, and the measures of cost and risk that are adopted should be explained.

Consider other Measures

(i) Keep an eye on the Current Account Deficit: It should not rise higher than 9 per cent and must be maintained at reasonable levels.

(ii) Exports of goods and services must continue to grow past the 7 per cent medium term projection.

(iii) Real GDP growth must recover closer to its long-term average projection of 6 per cent – still about 5-5.6 per cent. For the overall public debt, sustainability could deteriorate if a significantly lower than anticipated growth thrives.

(iv) Kenya needs to implement policies that make public investment more efficient to ensure public investment spurs economic growth.

(v) Stretching the debt tenure quantum- bringing down the interest rates. The Kenyan debt is shrinking. Most loans are maturing in 2019 e.g. Eurobond and SGR loans from China. This puts the government under pressure to borrow to repay the loans plus the interest.

(vi) PPPs are essential in sharing risks between the public and the private sector. The government ought to enhance these partnerships to tap into the benefits that the contribution of the private sector brings to the economy which will eventually help bring down the level of external debt financing.

(vii) Debt management strategies should be fostered to ensure that the government focuses on development initiatives that strive to lower the level of funding debts through debt financing. The Auditor General should be actively involved in auditing the debt books and making the debt register authentic for the benefits of the public.

(viii) Debt management should be anchored in sound macroeconomic and financial sector policies to ensure that the level and rate of growth in public debt are sustainable.

(ix) The projects implemented through debt financing must reflect the benefits for which they were initiated before accruing more debts. The public must be involved actively to conduct social audits to put the government to task in showing how it used the resources available for development.

(x) We must deal with the ethical issues, corruption and fear of whistleblowing. Both the state and public officers must uphold ethical standards of integrity, accountability and transparency in their dealings to safeguard the interest of the public by ensuring prudent use of public resources.

(xi) Essential outcomes for debt instruments must be well articulated and demonstrated i.e., economic growth status before and after the intervention, significant change in poverty levels and increasing financial inflows. These indicators will help to gauge whether the debt that was borrowed served the purpose for which it was intended or failed.

(xii) The institute being one of the key stakeholders in protecting and upholding public interest, it was proposed that there be some liaison with the Office of the Auditor General to share with the members some of the audit projects through Public Audit Act, 2015, to circulate audit processes. This should include among others the mega projects that the government has financed through debt financing with a view to informing the public how the borrowed money is being utilized.

(xiii) Kenya needs to implement policies that make public investment more efficient to ensure public investment spurs economic growth.

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