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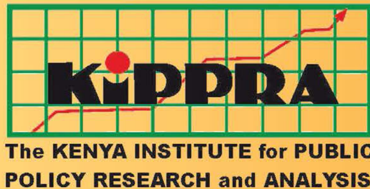

Public Debt in Kenya: Management and Sustainability

James Ochieng', Hellen Chemnyongoi, Daniel Omanyo, Benson Kiriga, and Jacob Nato

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James Ochieng', Hellen Chemnyongoi, Daniel Omanyo, Benson Kiriga, and Jacob Nato

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Abbreviations and Acronyms

CBK	Central Bank of Kenya
CPIA	Country Policy Institutional Assessment
DCC	Debt Carrying Capacity
DSA	Debt Sustainability Analysis
DSF	Debt Sustainability Framework
DSSI	Debt Service Suspension Initiative
GDP	Gross Domestic Product
EEF	Extended Fund Facility
IMF	International Monetary Fund
KIPPRA	Kenya Institute for Public Policy Research and Analysis
KNBS	Kenya National Bureau of Statistics
LIC	Low Income Country
LMIC	Lower Middle-Income Country
MAC	Market Access Country
MTDS	Medium Term Debt Strategy
PDM	Public Debt Management
PDMO	Public Debt Management Office
PFM	Public Finance Management
PPG	Public and Publicly Guaranteed
RCF	Rapid Credit Facility
SSA	Sub-Saharan Africa

Executive Summary

Public Debt Trend in Kenya

Kenya witnessed accelerated debt accumulation in the post-2010 period. The period was characterized by heavy infrastructural development, implementation of devolved system of government and multiple shocks including the COVID-19 pandemic. As of March 2023, total public debt was Ksh 9.4 trillion (64.7% of GDP) amounting to 94 per cent of the debt ceiling. Domestic debt stood at Ksh 4.5 trillion (48% of the total debt). The debt ceiling was raised in June 2022, raising it to Ksh 10 trillion, to facilitate the government in meeting its financial obligations effectively.

The composition and structure of debt has evolved over time. To minimize exchange rate risks associated with the external debt, the government adopted a strategy to increase the composition of domestic debt. The public debt mix changed from 60:40 in 2000 to 52:48 in March 2023 for external to domestic debt, respectively. Furthermore, the domestic debt saw emphasis on long-term government securities. The share of treasury bonds in total domestic debt was 83 per cent in March 2022. The preference for long-term maturities was in line with the government strategy to minimize refinancing risks. Commercial banks are the largest holders of government securities.

Further, with increased demand to finance infrastructure spending and favourable external financial conditions especially in the period following the financial crisis in 2008, commercial borrowing increased through issuance of syndicate loans and sovereign bonds. Further, the classification of Kenya as a lower middle-income country in 2014 implied that the country had the ability to access non-concessional funding from even the multilateral development banks. As a result, the share of commercial debt in total external debt increased from 6.3 per cent in June 2000 to a record high of 35.6 per cent in June 2019. However, the share of commercial loans declined to 25.3 per cent in March 2023. With COVID-19, the financial conditions were tightened, and the government acquired more concessional loans to contain the spread of the pandemic. Consequently, multilateral debt constituted 46.3 per cent of the external debt in March 2022.

Kenya's pursuit of syndicate loans played a significant role in diversifying its external financing sources and supporting key development initiatives. The country successfully tapped into the international capital markets to secure funding for infrastructure projects and budgetary needs. Notably, Kenya issued sovereign bonds in 2014 and 2021, enabling the government to bolster its budget and finance critical infrastructure ventures such as the Standard Gauge Railway. The uptake of syndicate loans provided Kenya with a viable avenue to access long-term funding, albeit with increased exposure to external market dynamics and high-cost borrowing. However, prudent debt management practices and adherence to fiscal discipline will be crucial in ensuring the sustainability of these borrowings and mitigating potential risks associated with currency fluctuations and refinancing pressures.

Bilateral debt is largely owed to China and was 71 per cent as of March 2023. In 2014, China overtook Japan to become Kenya's largest bilateral lender. The increase in Chinese debt is attributed to increased funding of key infrastructure projects in the country through state-sponsored banks such as Exim Bank. Japan was the second largest bilateral creditor with a debt share of 9 per cent in March 2023. Other main bilateral creditors were France and Italy with shares of 9 and 4 per cent, respectively, as of March 2023.

Legal, Policy and Institutional Framework

Kenya has a sound legal and institutional framework for public debt management laid out in the Constitution of Kenya 2010, the Public Finance Management (PFM) Act 2012 and PFM Regulations 2016. The legal frameworks detail the various aspects of public debt, including the purpose of borrowing, management of the public debt portfolio and debt sustainability. County government borrowing framework is similarly stipulated in the Constitution of Kenya 2010, the PFM Act 2012, and the County Governments Act, 2012. The county governments are given a window to borrow in Section 212 of the Constitution subject to the National Government's guarantee and approval by the County Assembly.

The annual Medium-Term Debt Management Strategy (MTDS) further guides public debt management in Kenya. The debt management strategy was established to minimize the cost and risk of borrowing in the long run and deepen the domestic market for government securities. It ensures consistency with both fiscal and monetary policy objectives while on external borrowing emphasis should be on acquiring loans on concessional terms as a strategy for minimizing borrowing costs. In addition, Kenya has a Public Debt and Borrowing Policy that provides guidance on raising resources through borrowing to finance the budget and managing debt portfolio at minimum cost while ensuring that public debt remains within sustainable levels. The policy underscores the need to adhere to the laws and regulations governing public debt management.

Whereas the country has a sound public debt management, there are gaps on the undertaking the annual debt sustainability analysis and information on the utilization and purpose of public debt in the various debt reports. Therefore, there is need for the various institutions managing debt to collectively conduct Debt Sustainability Analysis for the country annually. This is instrumental in assessing the country's debt portfolio and the potential for future borrowing that would place the country on a sustainable debt path over the medium term. In addition, consistency in reporting the public debt and its purpose is important to promote transparency and accountability in debt management.

Public Debt Sustainability

Kenya's debt was sustainable based on various debt sustainability analysis (DSA) frameworks undertaken by the World Bank and IMF from 2002 to January 2022. However, Kenya faces a high risk of external debt distress and high overall risk

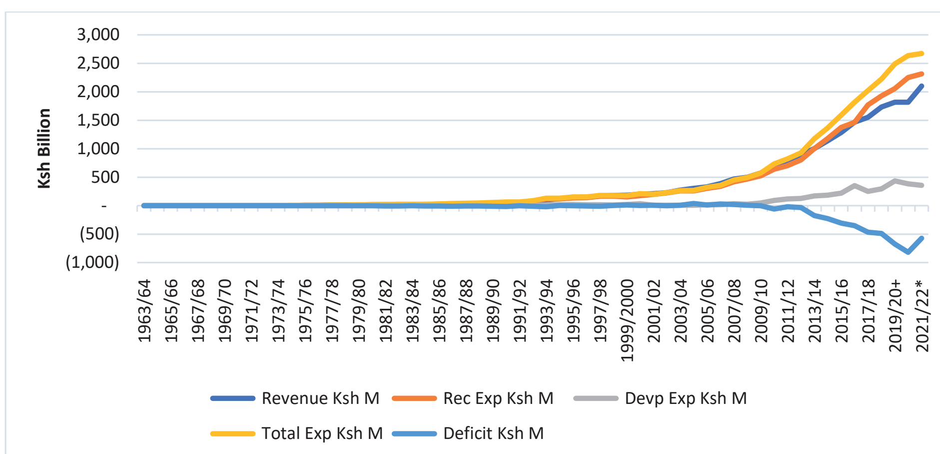
of debt distress. Kenya's credit risk ratings have been declining since 2007 when it was first assessed at B+ in 2006 by Standard and Poor's (S&P). The risk rating for Kenya was also downgraded to B (stable outlook) from B+ as of June 2022 by the S&P. Debt Sustainability Analysis became operational in 2002 based on an IMF framework that captured existing best practices in the assessment of fiscal and external sustainability analysis. DSA is basically the ability of the country to service its debt obligations as they mature. Debt sustainability assessments are considered to determine access to IMF financing, and for the design of debt limits in Fund-supported programmes. The World Bank uses it to determine the share of grants and loans in its assistance to each low-income country (LIC) and to design non-concessional borrowing limits. Kenya's external debt as a ratio of GDP is projected to decline over the horizon from 49.4 per cent in 2021 to 38.4 per cent in 2028 and decline further to 33.0 per cent by 2038. The sustainability indicators for Kenya are expected to improve (or decline) over time.

Kenya has benefited from debt relief measures such as DSSI and Paris Club creditors and should consider taking advantage of emerging relief measures such as the recent resilience and sustainability trust by the IMF. Total public debt as a share of GDP remains well below the LIC DSA public debt benchmark. However, the DSA finds that Kenya's risk of external debt distress has changed from low to moderate due to rising refinancing risks and narrower safety margins. The framework for DSA is a comprehensive tool for analyzing the debt sustainability of a country. However, it has a few challenges; for example, the DSA does not capture domestic debt as a component on its own; some of the assumptions require to be reviewed and capture Kenya's stylized facts to give room for a more realistic future projection; only provides for data on the central and general government in its public debt coverage and leaves out the County Governments borrowing requirements to fulfill their budgetary operations. Therefore, determination of an optimal or threshold point for public debt in Kenya is required to guide policy makers in the future borrowing plans. With the establishment of a new debt sustainability tool by the IMF, the sovereign risk and debt sustainability framework, this offers a new opportunity to re-evaluate Kenya's debt sustainability and the need for capacity building for country staff.

1. Introduction

Kenya's public debt[1] had been on the rise since 2010 due to increased infrastructure developments and widening of fiscal deficit. Examples of infrastructural projects include the Thika-Nairobi Superhighway, the Standard Gauge Railway (SGR) line, the Lamu Port South Sudan Ethiopia Transport (LAPSSET) corridor project, and other infrastructure projects that have been made possible through public borrowing, and are projects in the country's development blueprint, the Kenya Vision 2030. Increased investments in infrastructure projects have led to a rise in Kenya's public debt in the post-2008 period. Further, the implementation of devolution that began in 2013 has also resulted into expanded government budget since the national government supports the devolved units through transfers in the form of equitable share. Public debt also played an important role during the COVID-19 pandemic. Kenya, like most countries across the globe, expanded public expenditures to mitigate the social and economic effects of the pandemic. As a result, the budget deficit widened, and public debt increased substantially (Figure 1.1 and 2.1).

Figure 1.1: Trend of fiscal deficit in Kenya



Source of data: KNBS (Various), Economic Survey

Public debt has not only increased, but its structure started changing in the 2000s along two major dimensions. First, the average share of public debt held by domestic banks increased over time from 3.1 per cent in 2002 to 49.1 per cent in 2021 and has stayed above 40 per cent in the post-2010 period. Second, the volume (and the share) of external public debt due to emerging donors (mostly China) and private creditors increased substantially between 2000 and 2022. For instance, between 2000 and 2006. China accounted for an average of 40 per cent external bilateral; however between 2014 and 2022, the share increased to

1 Public debt refers to the outstanding liabilities of government requiring future payment of principal and/or interest. Liabilities represent the total outstanding borrowings or obligations of government and comprise of internal (owing to national creditors) and external (owing to foreign creditors). Government borrows internally from domestic markets through issuance of Treasury bills and bonds by the Central Bank of Kenya and externally through bilateral and multilateral borrowings, and sovereign bonds.

over 65 per cent (Figure 2.9 and 2.10). Similarly, commercial debt owed to private creditors increased from an average of 3.2 per cent between 2000 and 2010 to an average of 22.5 per cent between 2011 and 2022 (Figure 2.8). These trends, which are accompanied by a reduction of official concessional debt, imply an increasing risk profile of public debt, and could crowd out private sector lending.

Kenya, like most countries in Sub-Saharan Africa, has in the past decade experienced increased vulnerabilities to shocks, including but not limited to global financial crises, extreme weather events, COVID-19 pandemic, and the spillover effects of the ongoing Russia-Ukrain war. Amidst the complex global economic landscape and within this changing public debt landscape, with new creditors and a reduced reliance on concessional lending, public debt management then becomes increasingly important to ensure debt sustainability and mitigate risks. It has been established that when public debt is poorly structured in terms of maturity, currency or interest rate composition and large and unfunded contingent liabilities are key factors that drive countries into economic crises (Cecchetti and Zampolli, 2010; Werner, 2014; Pedersoli and Presbitero, 2023). The International Monetary Fund (IMF)[2] notes that vulnerability to economic and financial shocks increases even when the macroeconomic fundamentals are sound.

The IMF defines public debt management as the process of establishing and executing a strategy for managing the government's debt to raise the required amount of funding and achieve its risk and cost objectives. The process involves putting up policies and making choices that ensure debt sustainability and minimize borrowing cost, which encompasses the composition of debt (domestic and external), the maturity structure, the currency denomination of debt securities, the use of contingent instruments, and the relative supply of different securities (Jonasson et al., 2019).

Existing literature shows that sound debt management is crucial for fiscal sustainability and macroeconomic and financial stability. This is because public debt affects demand management in a country. Demand management refers to the use of fiscal and monetary policies to influence the level of aggregate demand in the economy in relation to production (Khan, 1986). For example, the choice of monetary instruments can have an impact on the functioning of government debt markets. Similarly, by borrowing for spending, public debt leads to an expansionary fiscal policy. Such borrowing is more meaningful especially in times of recession, where government increases spending on growth-enhancing projects and employment creation in the economy. Thus, public debt is a key instrument in devising both monetary and fiscal policies (Minea and Parent, 2012; Matiti, 2013; and Babu et al., 2015). As an instrument of monetary policy, central banks use public securities (bills and bonds) to control market liquidity and stabilize the currency. These securities are also vital to the private sector since they serve as key benchmarks for issuing corporate bonds. Both fiscal policy and monetary policy makers share a similar concern that public debt needs to be well managed and sustainable and ensure that debt is not excessive (IMF and World Bank, 2001). This therefore means that public debt management requires good coordination

2 IMF (2001), Guidelines for Public Debt Management, https://www.imf.org/external/np/mae/pdebt/2000/eng/index.htm

by fiscal and policy makers and debt managers and ensure clarity of roles to avoid likely conflicts. However, for debt management to be more effective, it needs to be supported by sound fiscal and monetary policies.

With vast developmental aspirations that Kenya has, the recent surge in borrowing has raised questions regarding the management practices employed, potential risks associated with debt accumulation, and the sustainability of the debt burden. As the country continues with the implementation of the development agenda as outlined in its Vision 2030 and the accompanying medium term development plans, and considering that public debt is a critical financing source, it is imperative that public debt management activities are performed in accordance with sound principles of public financial management and best public debt management practice. This entails transparency, accountability, and predictability. It is also important to ensure that government financing needs are met (by raising the required amount of funding), sovereign wealth is created while mitigating risks, borrowing costs are minimized, the domestic market is developed, and debt levels remain sustainable and do not compromise economic stability.

This report aims to provide a comprehensive understanding of the multifaceted aspects of Kenya's public debt, facilitating informed policy decisions and promoting financial prudence. Specifically, this report seeks to answer the following questions:

(i) What is the status of public debt in Kenya and what drives the increasing debt levels?

(ii) What is the legal and policy framework for public debt in Kenya, and what institutional architecture supports the management of public debt in Kenya?

(iii) How has Kenya fared in terms of its public debt sustainability, what do the trends show for the future debt sustainability and what gaps exist in Kenya's debt sustainability framework and how can they be tackled?

This report is divided into four chapters, each addressing a critical dimension of public debt management and sustainability. These chapters provide a holistic assessment, drawing upon empirical evidence, and best practices across the globe. The second chapter presents an in-depth analysis of the historical trends, composition, and drivers of public debt in Kenya. It examines the key factors contributing to the increase in debt levels and explores the implications for fiscal policy, debt servicing, and overall macroeconomic stability. The third chapter assesses the legal, policy and institutional frameworks for debt management in Kenya and the robustness. The final chapter assesses the sustainability of Kenya's public debt trajectory, considering both internal and external factors. It delves into the analysis of debt sustainability indicators, contingent liabilities, and external vulnerabilities, with a view to identifying policy measures for mitigating risks and ensuring long-term debt sustainability.

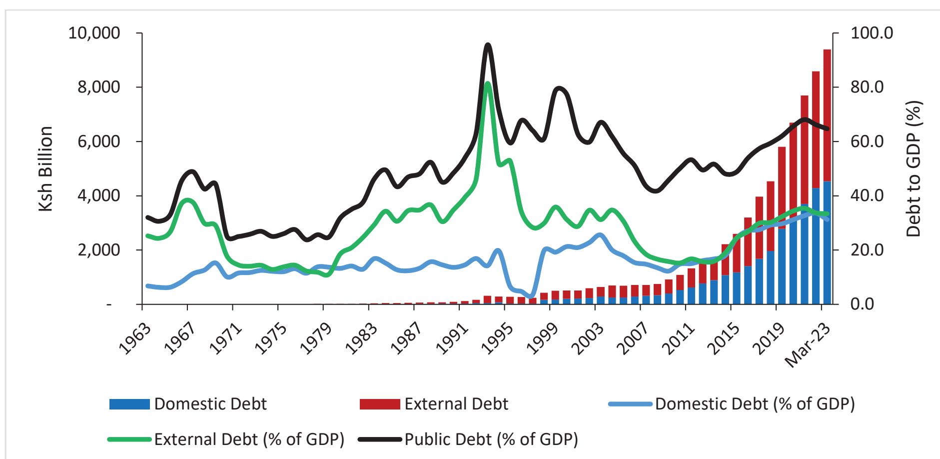
2. Public Debt Trend in Kenya

Kenya's public debt stock accumulation pace was relatively faster in the post-2010 period due to increased investment in infrastructure, and implementation of devolution. Over the years, there has been a significant shift in the composition of debt, with a growing share of domestic debt and an increase in commercial debt. By end of March 2023, Kenya's stock of public debt stood at Ksh 9.4 trillion, with a mix of 52:48 for external and domestic debt, respectively, while the share of commercial debt in total external debt stood at around 26 per cent. This shift poses risks, as the reliance on domestic debt can crowd out private sector credit, while the rise in commercial debt exposes the economy to refinancing and exchange rate risks. The dominance of commercial banks in holding government securities, coupled with the concentration of bilateral lending from countries such as China and Japan, raises concerns about potential vulnerabilities and dependency. Additionally, the increase in debt service, particularly domestic debt service, calls for prudent fiscal management and the need to strike a balance between debt sustainability and meeting development needs. There is a pressing need for Kenya to strengthen debt management practices, enhance transparency, and improve debt risk assessment frameworks to ensure the sustainable management of public debt. It is important for policy measures to focus on diversifying funding sources, strengthening domestic revenue mobilization, and promoting investment-friendly environments to stimulate economic growth and reduce the debt burden. It is, therefore, important to intensify the fiscal consolidation programme in the medium-term and borrow mainly from concessional sources.

2.1 Public Debt Trends

Kenya's public debt has witnessed a significant increase over the years, primarily driven by a widening budgetary gap and increased borrowing for infrastructure projects. Public debt accumulation pace was relatively slow between the 1970s and 1980s but has exhibited an upward trend since early 1990s due to continued widening of the budgetary gap. Public debt increased from Ksh 1.6 billion in 1963 to Ksh 95.2 billion in 1990 (Figure 2.1). Public debt stock increased fifteen-fold, from Ksh 0.5 trillion in June 2000 to Ksh 7.7 trillion in June 2021. More accumulation was experienced particularly between 2008 and 2021 as a result of increased borrowing due to widening fiscal deficit because of increased public investment, particularly on large infrastructure projects such as railway and roads. Total nominal public debt stood at Ksh 8.6 trillion (66.2% of GDP) by the end of June 2022. The COVID-19 pandemic led to heightened accumulation of both domestic and external debts by Ksh 1.1 trillion and Ksh 0.8 trillion, respectively, between June 2020 and June 2022. In March 2023, total debt was Ksh 9.4 trillion (64.7 % of GDP). Out of this, domestic debt constituted Ksh 4.5 trillion (31.3% of GDP) while external debt was Ksh 4.9 trillion (33.4% of GDP).

Figure 2.1: Trend of public debt stock as of 30th June[3]



Data Source: National Treasury

As a share of GDP, public debt took an upward trend from the 1970s but peaked at 95.6 per cent of GDP in June 1993 (Figure 2.1). The increase in debt in 1993 is attributed to expansionary fiscal policy and disruption in foreign aid inflows leading to more uptake of foreign debt (Ryan and Maana, 2014). Thereafter, public debt declined to 41.8 per cent of GDP in June 2008 before rising steadily to 66.2 per cent of GDP in December 2021, surpassing the IMF's recommended threshold of 50 per cent. The decline in the proportion of public debt to GDP between 1999 and 2008 is partly attributed to faster economic growth experienced especially during the implementation of the Economic Recovery Strategy 2003-2007. Public debt as a percentage of GDP has been on an upward trend since 2008, mainly driven by increased borrowing. Additionally, public debt stock has been growing relatively faster than the GDP growth between 2008 and 2022. Public debt grew by an average of 18 per cent annually between 2008 and 2022 compared to a GDP growth rate of about 4.5 per cent per year over the same period.

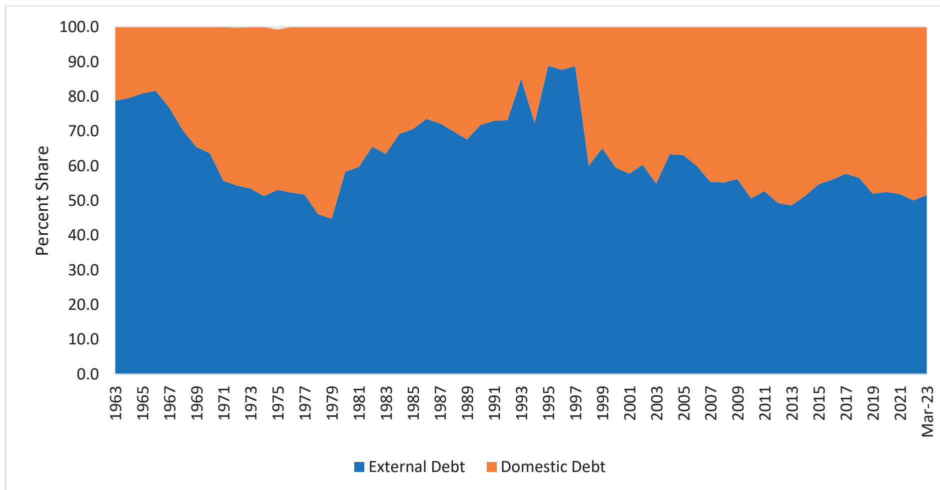
The proportion of external debt to GDP in Kenya followed an upward trajectory, rising from 11 per cent in 1979 to a peak of 81.4 per cent in 1993, before gradually decreasing to 15.3 per cent in 2010. The surge in external debt in 1993 can be attributed to the significant depreciation of the Kenyan shilling against major currencies in which the debts were denominated. In contrast, domestic debt as a share of GDP remained relatively stable, experiencing a modest increase from 6.8 per cent in 1963 to 14.8 per cent in 2010. However, in the post-2010 period, the share of domestic debt in GDP started to grow steadily, reaching a high of 31.3 per cent in March 2023. This suggests a shift in the composition of debt towards a greater reliance on domestic borrowing.

External debt has historically constituted a significant portion of Kenya's total public debt, although there has been a notable shift towards domestic debt since 2000. From 1963 to 1970, the average composition of public debt stock was 75 per cent external and 25 per cent domestic (Figure 2.2). This ratio changed to 52 per

3 The period 30th June refers to end of each financial year in Kenya's fiscal calendar.

cent external and 48 per cent domestic between 1971 and 1980 due to increased domestic borrowing. Subsequently, the ratio shifted to 68 per cent external and 32 per cent domestic between 1981 and 1990, and further changed to 75 per cent external and 25 per cent domestic between 1991 and 2000. As of March 2023, the debt mix was 51 per cent external and 49 per cent domestic. Between 2000 and 2021, the share of domestic debt stock exhibited an upward trend, indicating a preference for domestic borrowing. The increase in the share of domestic debt can be attributed to the government's preference for domestic borrowing as a strategy to mitigate exposure to exchange rate risks. By relying more on domestic sources, Kenya aims to reduce vulnerability to fluctuations in foreign exchange rates.

Figure 2.2: Composition of Kenya's public debt stock as of 30th June



Data Source: The National Treasury

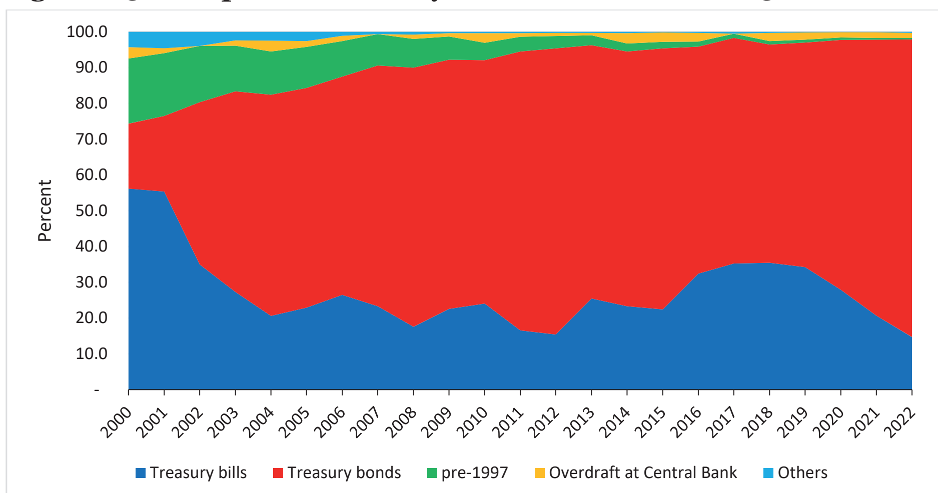
2.2 Composition and Structure of Domestic Debt

Domestic borrowing occurs mainly through issuance of treasury bills and treasury bonds by the Central Bank of Kenya. Treasury bills were first issued in the market in 1969 and were issued in different maturities until 1996. In 1993, 30-day and 60-day treasury bills were issued while in 1995, 9-day, 16-day and 23-day treasury bills were issued. Between September 1996 and June 1997 28-day treasury bills were issued. After 1996, treasury bills were issued in maturities of 91-days and 182-days. In August 2009, the government introduced a 364-days treasury bill in the market. Since 2009, treasury bills have been issues in maturities of 91-days, 182-days, and 364-days. Treasury bonds were first introduced in Kenya's market in 1986 but faced numerous challenges that hindered their development until early 2000 when the government took a deliberate initiative to shift to long-term debt instruments. After the launch in 1986, the market remained dormant for about 8 months after which the operations were resumed in September 1987 with issuance of 6-months and 1-year maturities. However, the issuance of 6-month maturity bonds was stopped to prevent a negatively sloped yield curve. New

issues were launched in February 1988 with extended maturities for the bonds. The market for treasury bonds became dormant in the 1990s because of more favourable returns on the market for treasury bills. In 2001, the government took a deliberate move to reduce the proportion of short-term securities in favour of long-term securities. Treasury bonds are currently issued in maturities of between 1-year and 30-years.

The dominance of Treasury bills and Treasury bonds in Kenya's domestic debt mix has seen a shift towards a higher proportion of Treasury bonds, aligning with the government's strategy to minimize refinancing risks and ensure debt sustainability. Treasury bills and Treasury bonds have consistently held a significant share in Kenya's domestic debt mix, accounting for 90 per cent on average. In June 2000, they accounted for 74.4 per cent of the total domestic debt, which increased to 97.8 per cent by June 2021. The composition of domestic debt between Treasury bonds and Treasury bills improved from 24:76 in June 2000 to 74:26 in June 2010, before slightly deteriorating to 71:29 in June 2020. The targeted mix set by the domestic debt strategy was 80:20. Between June 2003 and June 2015, Kenya relied more on Treasury bonds, after which the proportion of Treasury bills to total domestic debt started to rise relative to that of Treasury bonds (Figure 2.3). The share of Treasury bills increased from 26 per cent in June 2010 to 35 per cent in June 2019, before declining to 27.9 per cent in June 2020 and further dropping to a low of 14.7 per cent in June 2022. This strategic shift aligns with the government's objective of reducing the reliance on Treasury bills in domestic debt, aiming to minimize refinancing risks and ensure debt sustainability. A high proportion of Treasury bills can pose challenges in terms of restructuring and refinancing since they are short-term instruments primarily used for cash management purposes. Therefore, the government's strategy focuses on reducing the share of Treasury bills in the domestic debt mix to enhance overall debt management and mitigate potential risks.

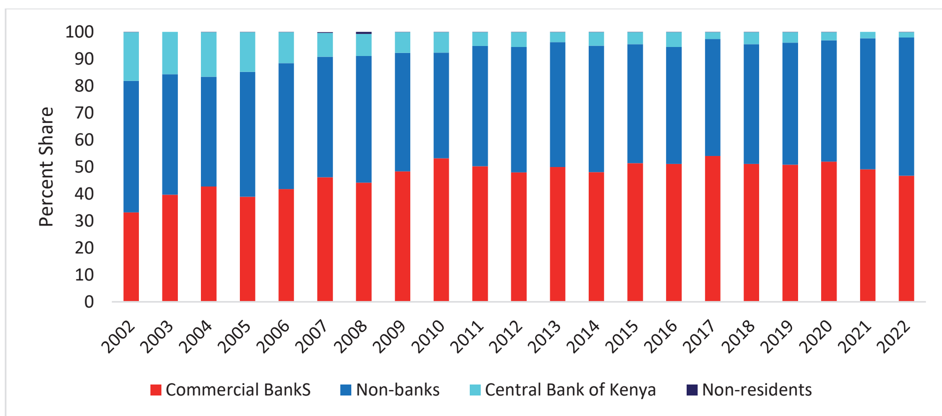
Figure 2.3: Composition of Kenya's domestic debt as of 30th June



Data Source: Central Bank of Kenya

Commercial banks hold most government securities, posing a potential crowding-out risk, more so in the absence of non-bank creditors. Commercial banks have a dominant presence as investors in government securities, which raises concerns about the possibility of crowding-out effects, particularly in the absence of non-bank creditors. The proportion of government securities held by commercial banks increased from 33.1 per cent in June 2002 to 46.7 per cent in June 2022. In contrast, the share held by non-bank entities experienced a slight decline, decreasing from 48.8 per cent in June 2002 to 51.3 per cent in June 2022. Non-bank financial institutions (NBFIs), encompassing insurance companies and pension funds, accounted for 50.6 per cent of government securities' holdings in June 2022. However, the share held by the Central Bank of Kenya (CBK) declined from 18.1 per cent in June 2002 to 2.0 per cent in June 2022. Additionally, the proportion of domestic debt held by non-residents decreased from 4.6 per cent in June 2002 to 0.7 per cent in June 2022 (Figure 2.4). These trends highlight the dominance of commercial banks as investors in government securities and the potential implications for crowding-out effects on other market participants.

Figure 2.4: Domestic debt by holder as of 30th June (%)

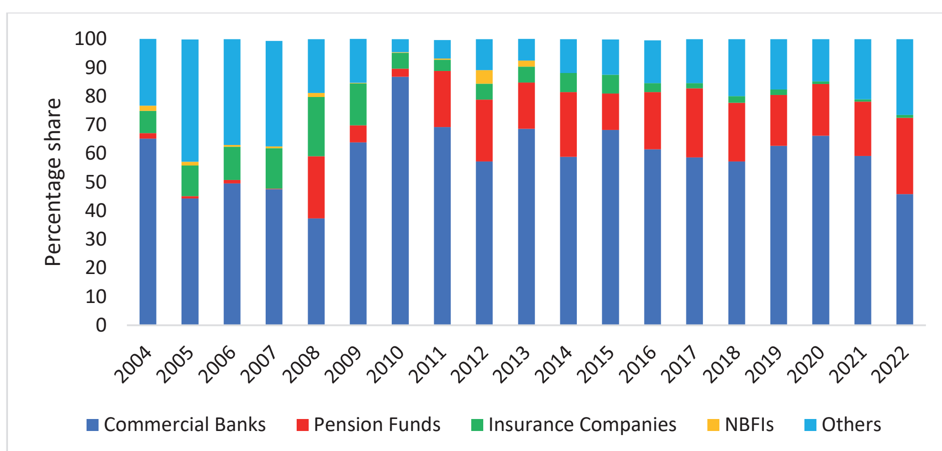


Data Source: Annual Public Debt Management Report (Various issues)

Commercial banks maintain a significant share in holding Treasury bills, while pension funds and other entities also contribute to the overall ownership. When it comes to holding Treasury bills, commercial banks play a dominant role. On average, between June 2004 and June 2022, commercial banks held around 60 per cent of Treasury bills. Pension funds and other entities[4] held an average of 14.4 per cent and 18.9 per cent, respectively. Insurance companies and other non-bank financial institutions (NBFIs) averaged holdings of 6.6 per cent and 0.7 per cent, respectively (Figure 2.5). The amount of Treasury bills held by insurance companies has been declining significantly since June 2014, falling from 6.6 per cent to 1 per cent in June 2022. The largest share of Treasury bills was held by commercial banks as of June 2022, accounting for 45.8 per cent, followed by pension funds at 26.7 per cent. This highlights the significant presence of commercial banks in the ownership of Treasury bills, with pension funds also making notable contributions to the overall holdings.

4 Others refer to CBK Overdraft to government, cleared items awaiting transfer to Pay Master General account (PMG), commercial banks advances and Tax Reserve Certificates.

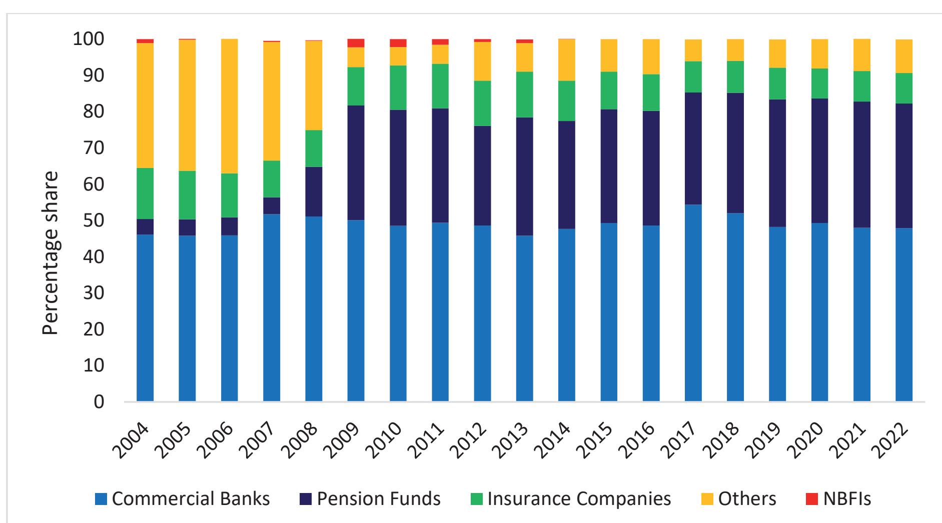
Figure 2.5: Treasury bills by holder as of 30th June (%)



Data Source: Annual Public Debt Management Report (Various issues)

Commercial banks are the largest holders of Treasury bonds, with significant participation from non-banking institutions. As of June 2022, commercial banks were the primary holders of Treasury bonds, although non-banking institutions continued to play a substantial role. In June 2022, commercial banks held 47.9 per cent of Treasury bonds, and an average of 48.9 per cent between June 2004 and June 2022. Pension funds held 34.3 per cent in June 2022, with an average of 25.4 per cent between June 2004 and June 2022. Insurance companies and other entities held an average of 10.7 per cent and 14.5 per cent, respectively, during the same period (Figure 2.6).

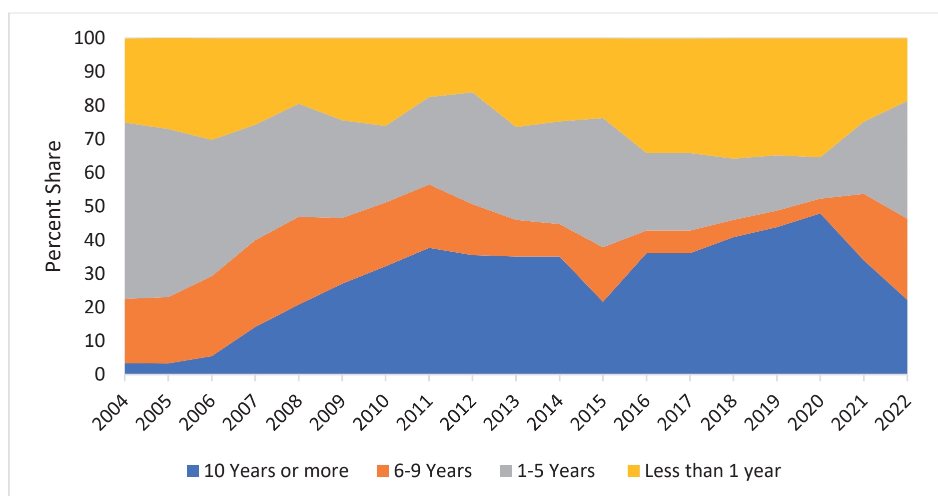
Figure 2.6: Treasury bonds by holder as of 30th June (%)



Data Source: Annual Public Debt Management Report (Various issues)

Kenya has focused on restructuring its domestic debt into long-term instruments, with Treasury bonds holding a significant share to minimize refinancing risk. Kenya has undertaken a strategic approach to restructure its domestic debt, prioritizing long-term maturities to optimize the composition of its public debt portfolio. This preference for Treasury bonds over Treasury bills aims to mitigate the refinancing risk associated with shorter-term instruments. As of June 2021, Treasury bonds with a tenor of 10 years and above constituted the largest portion of government securities, accounting for 33.9 per cent. This marked a substantial increase from 3.4 per cent in June 2004. However, there was a decline in holdings of bonds with a tenor of 10 years and above to 22.2 per cent in June 2022. Conversely, bonds with a tenor of 6-9 years experienced a decline from 19.1 per cent in June 2004 to 4.4 per cent in June 2020, but rebounded to 24.1 per cent in June 2022. Bonds with a tenure of 1-5 years declined from 52.4 per cent in June 2004 to 21.5 per cent in June 2021 but increased to 35.0 per cent in June 2022. Consequently, as of June 2021, Treasury bonds with a tenor of 1 year or more accounted for 81.3 per cent of government securities, while Treasury bills represented 18.7 per cent (Figure 2.7). This strategic shift towards longer-term Treasury bonds reflects the government's efforts to enhance the stability and sustainability of the domestic debt profile, reducing the dependence on short-term financing and minimizing the risks associated with frequent refinancing.

Figure 2.7: Treasury bills and bonds by tenor as of 30th June (%)



Data Source: Annual Public Debt Management Report (Various issues)

2.3 Composition and Structure of External Debt

Kenya's external financing in the period after independence to late 1980s relied heavily on bilateral creditors. Bilateral debt accounted for an average of approximately 70.0 per cent of total external debt between 1963 and 1989, while multilateral debt averaged 29.0 per cent over the same period. Since 2000,

Kenya's external debt stock has been on the rise, driven by various factors such as the issuance of sovereign bonds, commercial syndicated loans, increased bilateral credits, and foreign exchange rate fluctuations. The share of commercial debt in external debt increased significantly from 6.3 per cent in June 2000 to a record high of 35.6 per cent in June 2019 (Figure 2.8). The growth in commercial loans in Kenya's external debt stock was driven by the issuance of Eurobonds between 2014 and 2021 to support the government budget and finance infrastructure projects contributed to the increase in commercial debt (Box 2.1). However, by June 2022, the proportion of commercial debt had dropped to 26.8 per cent due to a shift towards more concessional borrowing aimed at addressing the challenges posed by the COVID-19 pandemic. In June 2000, multilateral debt accounted for 70.3 per cent of total external debt. However, in June 2022, the share of multilateral debt had decreased to 46.3 per cent. This indicates a reduction of nearly 24 percentage points in the share of multilateral debt since 2000. The shift towards commercial debt resulted in a lower share of multilateral debt in the overall external debt stock. Kenya actively pursued alternative sources of financing, including commercial borrowing. The government issued sovereign bonds and engaged in commercial syndicated loans to access funds for budgetary needs and infrastructure development.

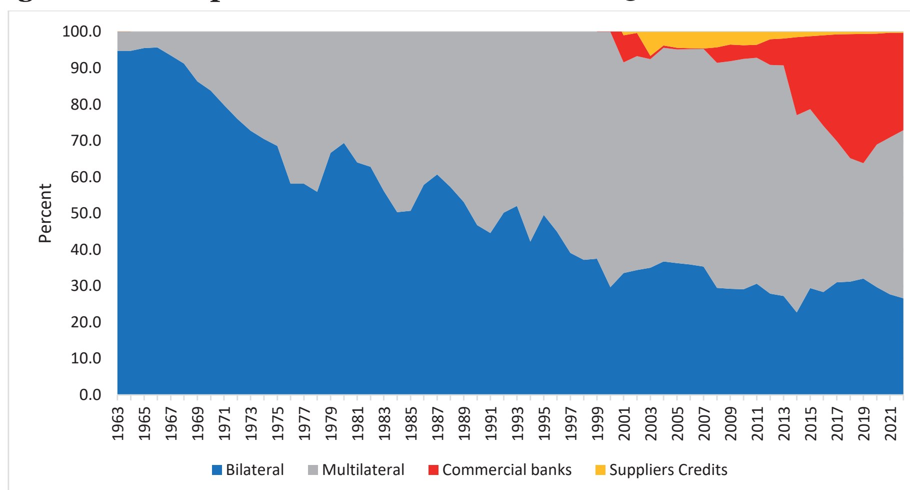
Box 2.1: Kenya's Issuance of Eurobonds and Syndicate Loans: 2014-2021

- In June 2014, Kenya issued its first Eurobond valued at US$ 2 billion at 5-year and 10-year maturities. The issuance was done in 2 tranches, US$ 500 million with a 5-year maturity at a coupon of 5.875 per cent and US$ 1.5 billion with a 10-year maturity at 6.875 per cent.
- In December 2014, Kenya issued another Eurobond valued at US$ 750 million. The issuance was done in 2 tranches, US$ 250 million with a 5-year maturity at 5.0 per cent yield and US$ 500 million with a 10-year maturity at 5.9 per cent.
- In February 2018, Kenya issued another sovereign Eurobond raising US$ 2 billion and another in May 2019 raising US $ 2.1 billion. The US$ 2 billion was issued in 2 tranches, a 10-year US$ 1 billion at 7.25 per cent and a 30-year US$ 1 billion bond at 8.25 per cent. The US$ 2.1 billion in May 2019 was issued in 2 tranches, 7-year US $ 900 million bond at 7.0 per cent and a 10-year US $ 1.2 billion bond at 8.0 per cent.
- Other than the Eurobond, Kenya also contracted a 2-year syndicate loan valued at US $ 750 million at 8.0 per cent in October 2015 and a 10-year US $ 250 million syndicate loan in January 2019.
- Further for refinancing needs, Kenya contracted another 9-year US$ 1.25 billion syndicate loan in February 2019.
- In June 2021, Kenya issued a 12-year Eurobond raising US$ 1 billion at 6.3 per cent. The Eurobond is to be repaid in 2 equal tranches in January 2033 and January 2034.

Source: National Treasury (2021) and IMF (2020)

However, the share of bilateral debt remained relatively stable between June 2000 and June 2022. Bilateral debt accounted for 35.0 per cent in total external debt in June 2000 but declined to 26.6 per cent in June 2022. The decreasing share of multilateral debt and the increasing share of commercial debt is in part due to change in Kenya's income status. In 2014, Kenya transitioned from a low-income country (LIC) to a lower middle-income country (LMIC). Consequently, Kenya, by World Bank and IMF standards is not meant to access concessional loans meant for the LICs, pushing the country to go for the commercial loans, which have little conditionalities compared to the multilateral loans.

Figure 2.8: Composition of external debt as of 30th June

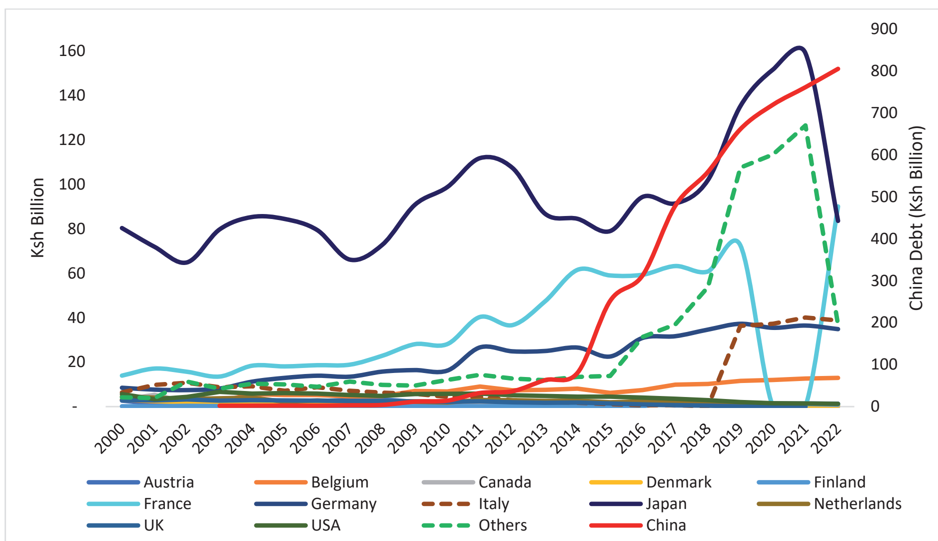


Data Source: Annual Public Debt Management Report (Various issues) and KNBS (Various), Economic Surveys

During the period from 2000 to 2014, Japan held the position of Kenya's primary bilateral lender, extending loans with an average annual value of Ksh 84,366 million and accumulating to a total of Ksh 1.27 trillion. However, China surpassed Japan as Kenya's leading lender starting from 2015 until 2022 (Figure 2.9). Chinese loans, which averaged Ksh 568.6 billion per year, amounted to a total of Ksh 4.5 trillion between 2015 and 2022. By the end of June 2022, Chinese loans constituted a substantial 73 per cent of Kenya's total bilateral debt. The remarkable growth of Kenya's debt from China, increasing ten-fold between 2014 and 2022, can be attributed to the relatively fewer policy conditionalities attached to the credit provided. These loans primarily originate from state-sponsored banks, such as the Exim Bank, resulting in a streamlined process with reduced bureaucratic hurdles. This aligns with Kenya's significant demand for debt to finance ambitious national projects, including the Standard Gauge Railway (SGR) and the Lamu Port-South Sudan-Ethiopia Transport (LAPSSET) corridor, among others.

Among other major lenders to Kenya between 2000 and 2022, France, Germany, Italy, and Belgium played a significant role, providing loans amounting to Ksh 804.7 billion, Ksh 498.9 billion, Ksh 250.4 billion, and 164.4 billion, respectively. However, loans from the United States (USA), the United Kingdom (UK), and the Netherlands have declined over the past decade. Specifically, loans from the USA decreased by more than half, plummeting from Ksh 5.6 billion in 2000 to Ksh 1.3 billion in June 2022. Similarly, loans from the Netherlands and the UK declined from Ksh 4.5 billion and Ksh 2.9 billion in 2000 to Ksh 55 million in 2019 and Ksh 60 million in 2018, respectively. Notably, no loans have been reported from Canada and the UK since 2020. Furthermore, in 2021 and 2022, there was no recorded stock of debt from the Netherlands. These trends highlight the changing landscape of Kenya's borrowing patterns and the varying levels of lending activities among different countries.

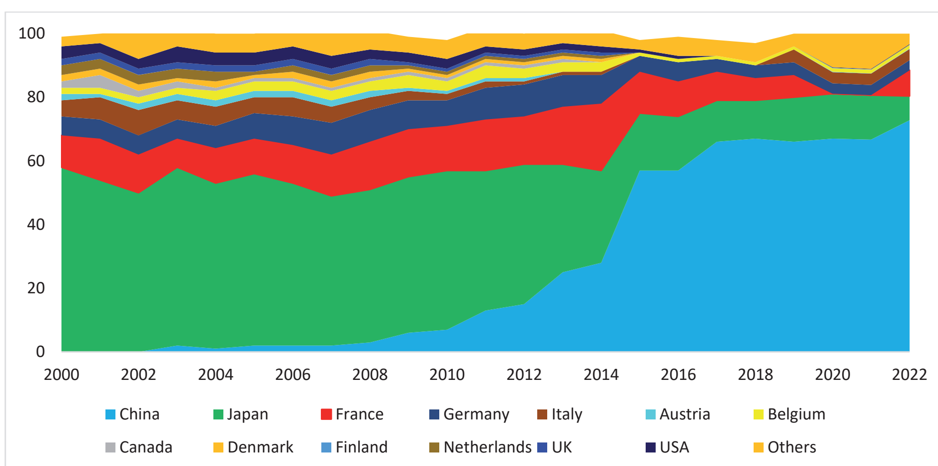
Figure 2.9: Bilateral debt by major creditors as of 30th June (Ksh million)



Data Source: National Treasury (Various Issues), , Annual Public Debt Report

Between 2000 and 2014, Japanese loans accounted for an average of 48 per cent of Kenya's total bilateral debt. However, their share dropped significantly to an average of 13.7 per cent between 2015 and 2022. In contrast, China's share of bilateral loans experienced a remarkable rise, increasing from 2 per cent in 2003 to 73 per cent in 2022, establishing it as the largest bilateral lender as of 2022 (Figure 2.10). Chinese loans, on average, accounted for about 65.0 per cent of Kenya's bilateral debt between 2015 and 2022. Loans from France, Germany, Italy, and Belgium held a combined share of 16 per cent in 2022.

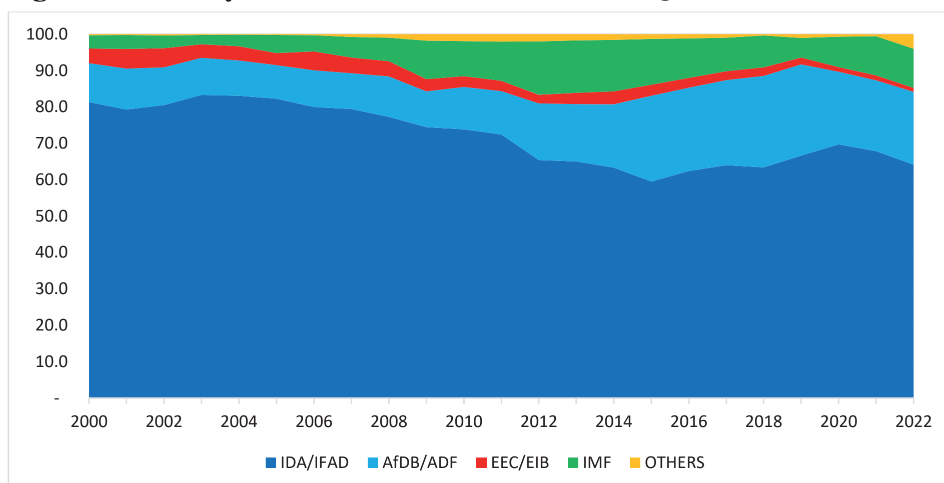
Figure 2.10: Composition of bilateral debt (% share) as of 30th June



Data Source: National Treasury (Various Issues), Annual Public Debt Report

Among multilateral creditors, the World Bank's International Development Association (IDA) is the primary lender to Kenya. Loans from IDA increased remarkably over six-fold, surging from Ksh 181.8 billion in June 2000 to Ksh 1.2 trillion in June 2022. As of June 2022, Kenya's total debt owed to IDA represented 64.1 per cent of the country's overall multilateral debt (Figure 2.11). Additionally, other multilateral creditors include the African Development Bank (AfDB) and African Development Fund (ADF), alongside the International Monetary Fund (IMF). Notably, loans from the IMF registered a substantial growth rate of 61 per cent, increasing from Ksh 110.6 billion in 2020 to Ksh 206.4 billion in 2022. This increase is primarily attributed to the IMF's support through various facilities such as the Rapid Credit Facility (RCF), Extended Credit Facility (ECF), and Extended Fund Facility (EFF) to address the challenges posed by the COVID-19 pandemic and manage debt vulnerabilities (refer to Box 2.2 for additional arrangements). Moreover, the share of loans from the ADF displayed an upward trajectory, reaching a peak of 25.1 per cent in June 2019 before slightly decreasing to 20.0 per cent in June 2022. The expanded funding from the AfDB/ADF has been predominantly directed towards financing crucial infrastructure projects in the energy, transport, and agricultural sectors. Furthermore, the AfDB has been actively supporting initiatives in the education sector, particularly the Technical Industrial Vocational and Entrepreneurship Training (TVET) programme.

Figure 2.11: Kenya's multilateral creditors as of 30th June



Data Source: National Treasury (Various Issues), Annual Public Debt Report

Box 2.2: IMF-Kenya history of lending commitments (US$ millions)

Date	Facility	Amount Agreed	Amount Drawn
7th Jul 1975-6th Jul 1978	EFF	85.5	9.8
13th Nov 1978-19th Aug 1979	Standby Arrangement	22.0	22.0
20th Aug 1979-14th Oct 1980	Standby Arrangement	155.8	0.0
15th Oct 1980-7th Jan 1982	Standby Arrangement	307.1	114.5
8th Jan 1982-7th Jan 1982	Standby Arrangement	173.9	103.3
21st Mar 1983-20th Sept 1984	Standby Arrangement	190.6	190.6
8th Feb 1985-7th Feb 1986	Standby Arrangement	82.3	82.3
1st Feb 1988-15th May 1989	Standby Arrangement	115.4	85.0
1st Feb 1988-15th May 1989	Structural Adjustment Facility Commitment	134.9	38.6
15th May 1989-31st Mar 1993	ECF	331.3	274.0
22nd Dec 1993-21st Dec 1994	ECF	62.4	62.4
26th Apr 1996-25th Apr 1999	ECF	216.1	36.0
4th Aug 2000-3rd Aug 2003	ECF	248.7	44.0
21st Nov 2003-20th Nov 2007	ECF	216.5	216.5
31st Jan 2011-19th Dec 2013	ECF	763.0	763.0
2nd Feb 2015-4th Mar 2016	Standby Arrangement	497.1	0.0
2nd Feb 2015-4th Mar 2016	Standby Arrangement	191.2	0.0
14th Mar 2016-3rd Mar 2018	Standby Arrangement	494.8	0.0
14th Mar 2016-3rd Mar 2018	Standby Arrangement	989.8	0.0
6th May 2020-11th May 2020	Rapid Credit Facility	739.1	739.1
2nd Apr 2021-1st Jun 2024	ECF	577.4	300.3
2nd Apr 2021-1st Jun 2024	EFF	1,770.7	673.7
2nd Apr 2021-1st Jun 2024: 18th July 2022	ECF/EFF second instalment	-	235.6
2nd Apr 2021-1st Jun 2024: 19th December 2022	ECF/EFF third instalment	-	447.39

Note:

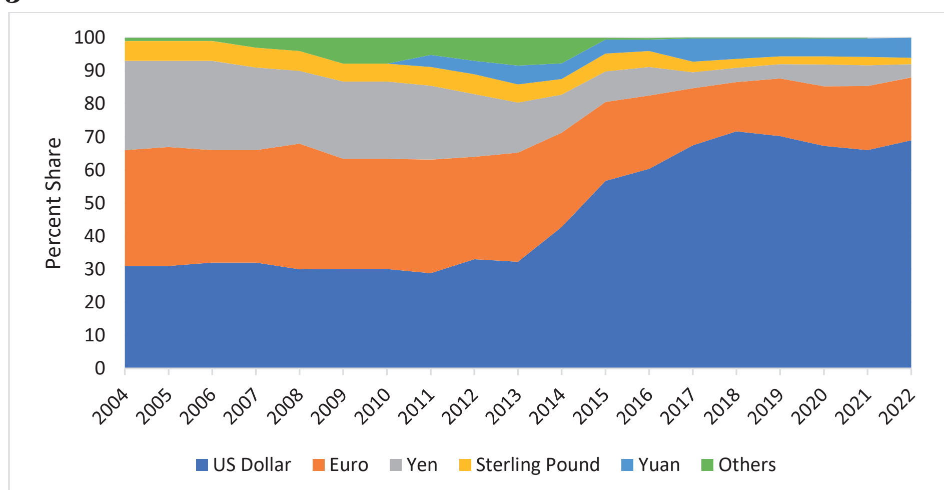
EFF and ECF -are IMF's tools of lending for medium-term support to low-income countries (LICs) facing protracted balance of payments (BoP) problems.
Stand-by Arrangement-is meant for member countries facing actual or potential external financing needs. It is mainly used by middle-income or advanced member countries.
RCF-it provides rapid concessional financial assistance to LICs facing urgent BoP needs with no ex-post conditionality.

Source: IMF

Kenya's external debt is primarily denominated in US dollars, which exposes the country to exchange rate risks. The proportion of external debt held in US dollars has significantly increased, rising from 31 per cent in June 2004 to 69.0 per cent in June 2022. In June 2004, Kenya's external debt was mainly held in Euros (35%),

US dollars (31%), and Japanese Yen (27%) (Figure 2.12). The Sterling pound and other currencies accounted for 6 per cent and 1 per cent of the external debt, respectively. However, as of June 2022, the US dollar dominated the external debt portfolio with a share of 69.0 per cent. The proportion of external debt held in Euros declined from 35 per cent in June 2004 to 19.0 per cent in June 2022. Similarly, the shares of Japanese Yen and Sterling Pound decreased to 4.0 per cent and 2.0 per cent, respectively, in June 2022, compared to 27.0 per cent and 6.0 per cent in June 2004. The share of Chinese Yuan increased from 3.6 per cent in June 2011 to 6 per cent in June 2022. The dominance of the US dollar in Kenya's external debt portfolio indicates an increasing burden of external debt and higher costs of debt servicing as the Kenyan Shilling (Ksh) continues to depreciate against the US dollar. For instance, in December 2020, the exchange rate was 110.6 Ksh against the US$, while in December 2022, it depreciated to 122.9 Ksh against the US$, representing a depreciation rate of 9.3 per cent.

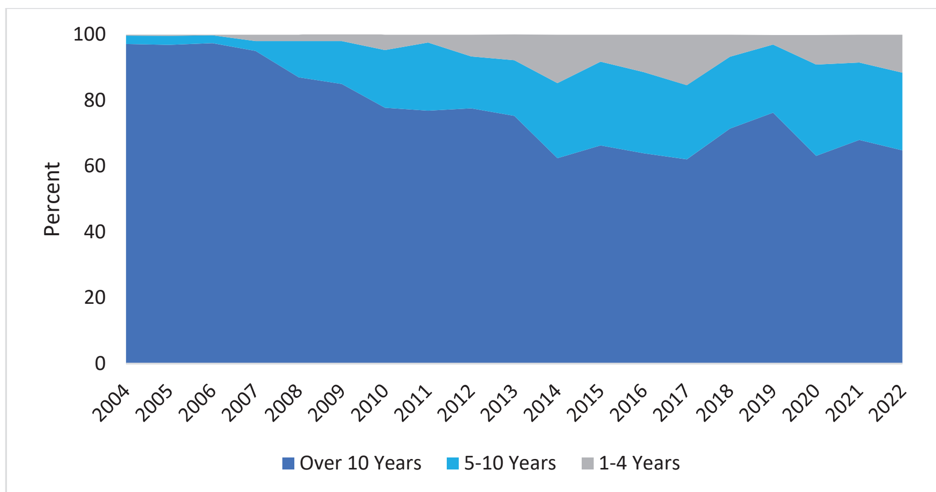
Figure 2.12: Kenya's external debt composition by currency (%) as of 30th June



Data Source: National Treasury (Various Issues), Annual Public Debt Report

Kenya's external debt primarily consists of long-term obligations, although there has been a notable shift in the maturity profile over the years. In June 2004, debt with a maturity exceeding 10 years accounted for a significant 97.2 per cent (Figure 2.13). However, by June 2022, this proportion had decreased to 64.8 per cent. However, the share of external loans maturing between 5 and 10 years witnessed an increase from 2.6 per cent in June 2004, reaching its highest point at 27.8 per cent in 2020 before declining slightly to 23.6 per cent in June 2022. In contrast, the proportion of external loans maturing within 4 years experienced fluctuations, standing at 14.7 per cent in 2014 and 15.4 per cent in 2017, before declining to 11.6 per cent in June 2022. This shift reflects the government's strategic objective of mitigating refinancing risks by elongating the maturity profile of its debt portfolio.

Figure 2.13: Kenya's external structure by maturity (%) as of 30th June



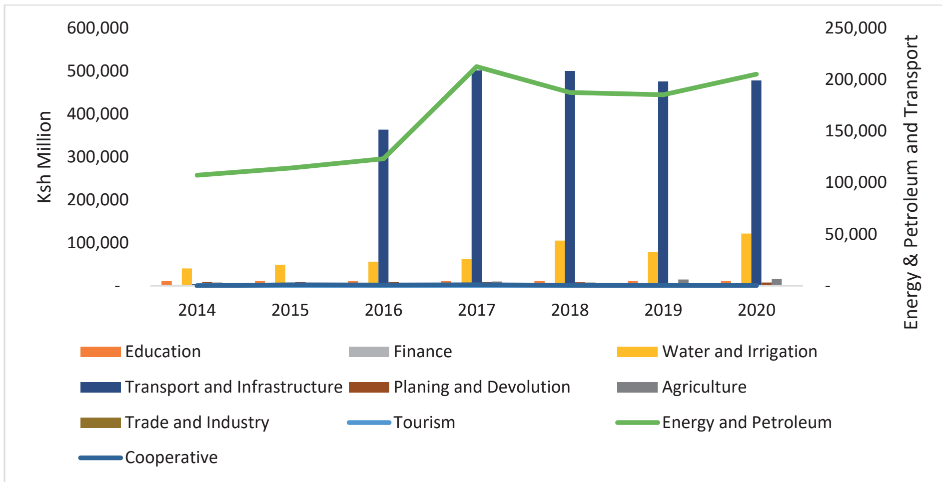
Data Source: National Treasury (Various Issues), Annual Public Debt Report

2.4 Stock of on-Lent Loans in Kenya

Domestic debt is used to finance primary deficits in Kenya when domestically raised revenues and external borrowing falls short of expenditure, to implement monetary policy through open market operations, and to enhance development of financial markets. Domestic debt is also used to finance infrastructure projects through the issuance of infrastructure bonds.

The government can also borrow from domestic or external sources for on-lending to State Corporations. As of 2018/19 and 2019/20, the stock of on-lending to State Corporations stood at Ksh 797.8 billion and Ksh 867.0 billion, respectively. On-lending is mainly issued to corporations that play strategic roles in the economy, have weak balance sheet and cannot attract competitive funding and to those corporations that perform social projects that would be efficiently executed on behalf of the Government. For example, on-lending for transport and infrastructure increased from Ksh 3.6 billion in June 2015 to Ksh 363.2 billion in June 2016 because of lending to Kenya Railways Corporation for the development of the Standard Gauge Railway (Figure 2.14). The largest stock of on-lent loans was in parastatals in the energy and petroleum and in transport and infrastructure sectors, totalling to Ksh 205.1 billion and Ksh 477.8 billion, respectively, as of June 2020. On-lent loans to transport and infrastructure accounted for 55.1 per cent of the total stock of on-lent loans in June 2020.

Figure 2.14: Stock of on-lent loans as of 30th June (Ksh million)



Data Source: National Treasury (Various Issues), Annual Public Debt Report

Box 2.3: Issuance of infrastructure bonds in Kenya

Infrastructure bonds are usually issued by the government to finance specific infrastructure projects. In Kenya, the returns from infrastructure bonds are tax exempt. The first successfully issued infrastructure bond was in 2009 by KENGEN raised a total of Ksh 18.5 billion and was oversubscribed by 45 per cent. It aimed at raising funds for Kenya's power sector and the expansion of its energy infrastructure. The success of KenGen's Infrastructure Bond paved way for subsequent infrastructure bond issuances in Kenya, unlocking new avenues for funding critical projects across various sectors. Selected previous issuance of infrastructure bonds are shown as follows:

Issue number	Issue date	Tenure (years)	Redemption yield (%)	Amount raised (Ksh billion)
IFB 1/2009/12	23/02/09	12	12.5	18.5
IFB 2/2010/9	30/08/2010	9	7.3	30.6
IFB 1/2015/9	14/12/2015	9	13.3	14.0
IFB1/2016/9	23/05/2016	9	14.8	39.6
IFB1/2018/20	19/11/2018	20	12.3	27.6
IFB1/2019/16	28/10/2019	16	12.5	68.5
IFB1/2020/9	13/04/2020	9	12.3	39.0
IFB1/2021/16	25/01/2021	16	12.4	81.1
IFB1/2021/18	12/04/2021	18	12.7	81.9
IFB1/2022/19	21/02/2022	19	13.0	98.6
IFB1/2022/18	13/06/2022	18	13.7	73.8
NO. IFB1/2022/6	05/12/2022	6	13.2	49.1
IFB1/2023/17	13/03/2023	17	14.4	50.9

Data Source: Central Bank of Kenya

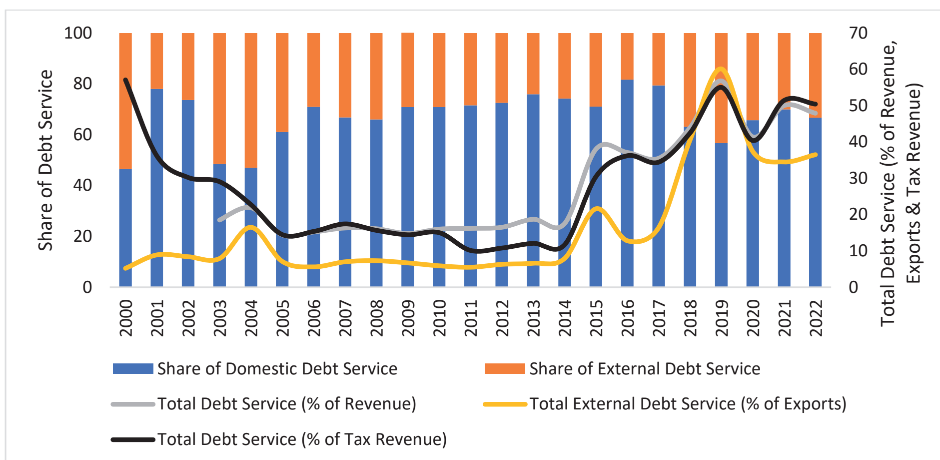
2.5 Public Debt Service

The burden of public debt service in Kenya has been on the rise, primarily driven by the dominance of domestic debt service, which carries relatively higher costs (Figure 2.15). The share of domestic debt service in total debt service exhibited an upward trend, increasing from 46.5 per cent in June 2000 to a peak of 81.6 per cent in June 2016. This escalation in domestic debt service can be attributed to the increased utilization of treasury bills and elevated service costs associated with treasury bonds in certain years. On average, the share of domestic debt service accounted for 67.0 per cent of total debt service between June 2000 and June 2022.

As a share of revenue, the share of external debt service experienced fluctuations, rising from 18.5 per cent in June 2003 to a high of 56.8 per cent in June 2019, before declining to 47.9 per cent in June 2022. This increase was primarily driven by the greater uptake of commercial loans over time. Similarly, the total external debt service as a proportion of exports rose from 5.2 per cent in June 2000 to a peak of 60.1 per cent in June 2019, before subsequently declining to 36.5 per cent in June 2021. The spike in 2019 can be attributed to substantial principal payments made to commercial creditors and sovereign bond holders, particularly for the 5-year bond issued in 2014, which matured in 2019.

When examining debt service in relation to tax revenue, the total debt service as a share of tax revenue averaged 13.6 per cent between 2005 and 2014. However, it surged to 30.4 per cent in 2015 and reached a peak of 55.0 per cent in 2019, before slightly decreasing to 50.4 per cent in 2022. Overall, total debt service declined significantly in 2019/20 by 23.4 per cent. The significant decline in debt service observed can be attributed to reduced debt service obligations for the financial year 2019/20, and a decrease in bilateral debt service payments resulting from the debt service suspension extended to Kenya under the G20-Debt Service Suspension Initiative (DSSI).

Figure 2.15: Public debt service as of 30th June (%)

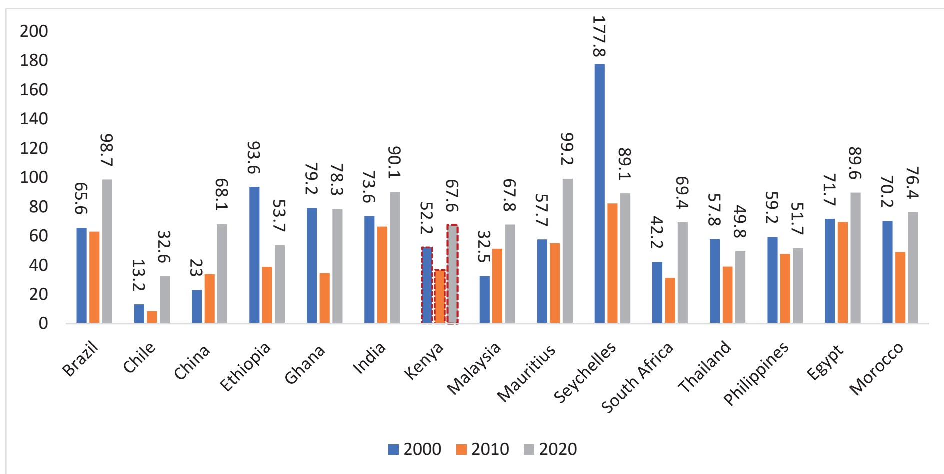


Data Source: National Treasury (Various Issues), Annual Public Debt Report

2.6 International Debt Experiences

Most of the comparator countries had debt levels higher than Kenya in the year 2000, but some have managed to reduce it to levels below Kenya as of 2020 (Figure 2.16). In 2000, Seychelles had the highest level of debt to GDP at 177.8 per cent but managed to reduce it to 89.1 per cent of the GDP in 2020. Other countries such as Ethiopia, Thailand and Philippines had debt levels of 93.6 per cent, 57.8 per cent, and 59.2 per cent, respectively, in the year 2000. These countries, Ethiopia, Thailand, and Philippines managed to reduce their debt levels to 53.7 per cent, 49.8 per cent and 51.7 per cent, respectively, in the year 2020. However, a country such as South Africa had a debt level of 42.2 per cent and 31.2 per cent in 2000 and 2010, respectively, but increased the debt level to 69.4 per cent, a higher level than that of Kenya. Other African countries whose debt levels remained higher than Kenya both in 2000 and 2020 are Ghana, Mauritius, Egypt, and Morocco. Chile had the lowest debt levels both in 2000 and 2019 at 13.2 and 32.6 per cent, respectively.

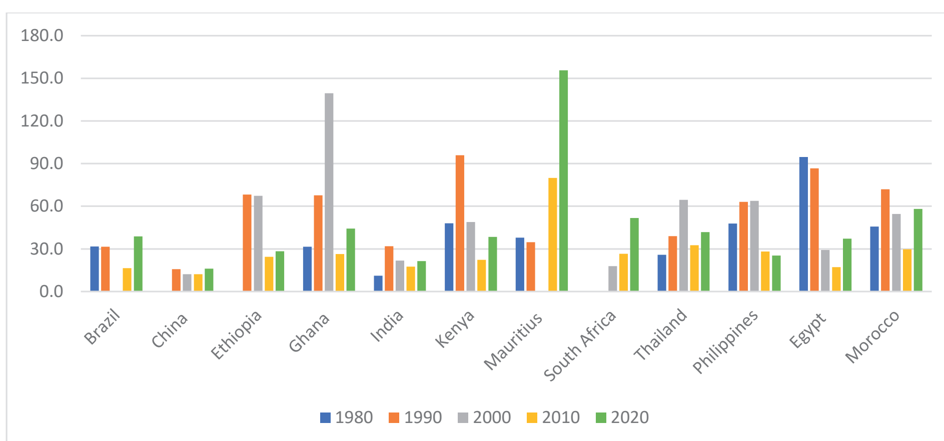
Figure 2.16: Select country general government gross debt (% of GDP)



Data Source: IMF, World Economic Outlook (April 2022)

As a percentage of gross national income, Ghana's external debt stock stood at 31.6 per cent in 1980 and increased to a high of 139.4 per cent in 2000. However, this decreased to 44.3 per cent in 2020. Brazil, India, Mauritius, Philippines, and Morocco had lower external debt stocks as a share of gross national income compared to Kenya in 1980. However, in 2020, Brazil, Mauritius and Morocco had their debt levels increase to levels above Kenya, at 38.8 per cent, 155.7 per cent, and 58.1 per cent, respectively. Kenya's external debt stock to GNI stood at 48.9 per cent in 2000 but decreased to 38.5 per cent in 2020. Ethiopia's external debt level was at 68.2 per cent in 1990 but declined to 28.4 per cent in 2020 (Figure 2.17).

Figure 2.17: Select country external debt stock (% of GNI)

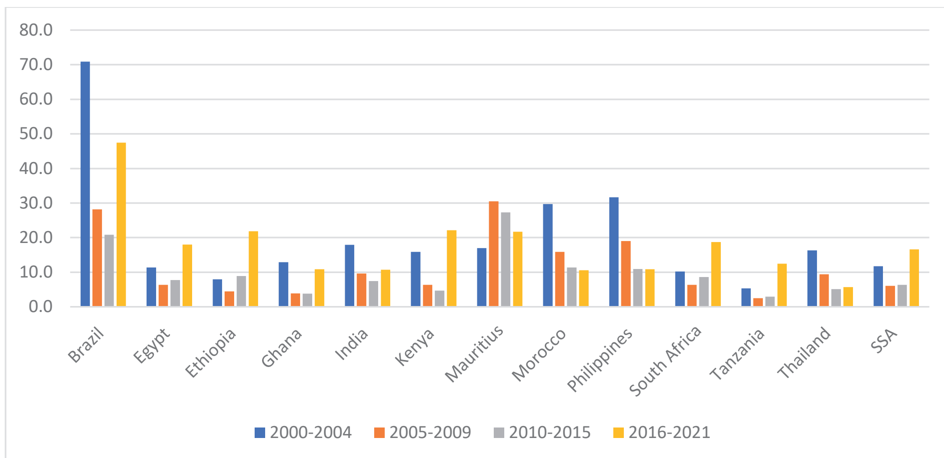


Data Source: World Bank (2022), World Development Indicators

In the period 2000-2004, Kenya's median debt service as a share of exports was 15.9 per cent, which was higher than the SSA average of 11.7 per cent (Figure 2.17). However, it was relatively lower compared to countries such as Brazil (70.9%) and Morocco (29.7%). From 2005 to 2009, Kenya experienced a decline in median debt service, reaching 6.3 per cent. This reduction was in line with the overall trend in SSA, which saw a decrease to 6.1 per cent. Notably, Ghana (3.9%) and Tanzania (2.5%) had the lowest levels of debt service during this period. Between 2010 and 2015, Kenya's median debt service continued to decrease to 4.7 per cent. This trend of declining debt service was also observed in most comparator countries, reflecting favourable debt dynamics and improved fiscal management. Notably, Ghana (3.8%) and Tanzania (2.9%) maintained low levels of debt service.

In the most recent period 2016-2021, Kenya's median debt service rose to 22.2, surpassing the SSA level of 16.6 per cent. This increase in debt service indicates higher debt burdens due to increased update of commercial loans. Kenya's level was comparable to Ethiopia (21.9%) and higher than countries such as Egypt (18.0%) and South Africa (18.7%). Overall, Kenya has experienced fluctuations in median debt service over the years, with a general decline followed by an upward trend in recent years.

Figure 2.18: Median debt service by country (% of exports)

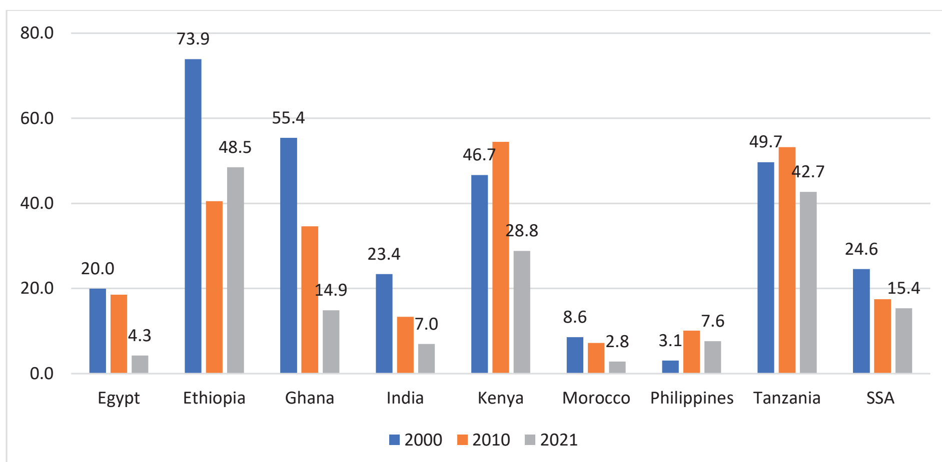


Data Source: World Bank (2023), World Development Indicators

In 2000, Kenya had a relatively high proportion of concessional debt in its total external debt, at 46.7 per cent (Figure 2.19). This indicates that a significant portion of Kenya's external debt consisted of concessional loans, which usually have more favourable terms, lower interest rates, and longer repayment periods. This proportion was higher than the SSA average of 24.6 per cent and higher than many comparator countries, including Egypt (20.0%) and Morocco (8.6%). By 2010, Kenya's proportion of concessional debt had increased further to 54.5 per cent. This indicates that Kenya continued to rely on concessional loans to finance its external debt, emphasizing its commitment to obtaining more favourable financing terms. During this period, Kenya's proportion of concessional debt was higher than the SSA average of 17.5 per cent and higher than most comparator countries, highlighting its efforts to manage debt sustainability.

However, in 2021, Kenya's proportion of concessional debt in total external debt had declined to 28.8 per cent. While still significant, this decrease suggests a shift in Kenya's external borrowing composition towards non-concessional loans after its classification as a lower middle-income country in 2014. Multilateral and bilateral lenders may offer fewer concessional loans to countries that have achieved a certain level of income (middle-income). It is worth noting that this proportion remained higher than the SSA average of 15.4 per cent and higher than several comparator countries, including Ghana (14.9%) and Morocco (2.8%). The decline in Kenya's proportion of concessional debt implies an increased reliance on non-concessional financing sources. In March 2023, Kenya's share of commercial loans in total external debt was around 26.0 per cent. While non-concessional loans may provide access to additional funds, they typically involve higher interest rates and shorter repayment periods, which could potentially impact on debt sustainability and debt service costs in the long term.

Figure 2.19: Concessional debt by country (% of total external debt)



Data Source: World Bank (2023), International Debt Statistics

Conclusion

Kenya's debt has grown significantly since independence. However, relatively faster accumulation was witnessed in the post-2010 period due to large budget deficits because of increased investment in infrastructure projects, and implementation of devolution. It is noteworthy that the government made deliberate efforts to shift to long term domestic debt and more concessional external borrowing. To minimize high debt accumulation, the government has been working on a fiscal consolidation programme aimed at reducing the fiscal deficit and consequently borrowing. Going forward, it is crucial for Kenya to prioritize sustainable debt management, strengthen fiscal discipline, and carefully assess borrowing options to ensure long-term debt sustainability and mitigate potential risks associated with debt.

Key Messages

(i) The build-up of public debt has been more pronounced in the last decade compared to the pre-2010 period. Total public debt accumulation between June 2010 and June 2022 was Ksh 7.5 trillion, more than seven-fold the amount accumulated between 1963 and 2009. Increased debt accumulation in the last decade is partly attributed to increased infrastructure investment and implementation of a devolved system of government.

(ii) Kenya's public debt mix is shifting towards domestic, with an aim of mitigating the exchange rate risks associated with external debt. As of June 2022, the external to domestic debt mix was 50:50.

(iii) Kenya's domestic debt mix has shifted towards long-term, minimizing the refinancing risks associated with short-term instruments. The share of Treasury bills reduced to 14.7 per cent in June 2022 compared to 56 per cent in June 2000 while Treasury bonds was at 83.2 per cent in June 2022 compared to 18 per cent in June 2000.

(iv) Kenya's domestic debt is mainly held by commercial banks. On average, commercial banks hold more than half of Kenya's domestic debt. This could increase the risk of crowding out of private sector investments due to credit shortages.

(v) The share of commercial loans in total external debt has been increasing in the last two decades, driven by the need to support infrastructure projects and other elements in the government budget. The share of commercial debt stood at 26.8 per cent in June 2022.

(vi) However, the government's debt strategy is to increase the uptake of concessional external loans, which are cheaper compared to domestic and commercial loans. This has led to a strong shift towards concessional loans, which stood at 46.3 per cent of the total external debt as of June 2022.

(vii) Kenya's external debt is dominated by the US$, exposing the country to vulnerabilities associated with exchange rate fluctuations.

(viii) Between 2000 and 2020, countries such as Ethiopia, Thailand and Philippines had higher debt levels than Kenya but managed to reduce their debt to levels lower than that of Kenya. However, in 2000, South Africa's debt level was lower than Kenya's, but increased to a higher level in 2020.

Recommendations

1. Implement prudent fiscal consolidation measures to keep a check on debt sustainability and promote efficient use of public resources. This includes enhancing revenue mobilization efforts, rationalizing expenditure, and improving the efficiency of public investment projects.
2. Prioritize efforts to increase domestic revenue mobilization through measures such as broadening the tax base, improving tax administration, and reducing tax evasion. This will help reduce the need for excessive borrowing and enhance fiscal sustainability.
3. Reduce reliance on a few bilateral lenders and commercial creditors by diversifying funding sources. Explore opportunities to access financing from multilateral institutions, and development partners to reduce concentration risks and lower borrowing costs. It is also key to capitalize on public-private partnerships to tap private sector capital.
4. Restructure domestic debt policies to mitigate the inherent risks associated with crowding-out of private sector credit.

3. Legal, Policy and Institutional Framework

An effective and transparent policy, legal and institutional framework is key for efficient public sector borrowing. A robust framework aids to promote discipline, transparency, and accountability, all of which are critical in achieving sustainable debt. Kenya has a sound legal and institutional framework for public debt management laid out in the Constitution of Kenya 2010, the Public Finance Management (PFM) Act 2012 and PFM Regulations 2016. The legal documents detail the various aspects of public debt, such as the purpose of borrowing, management of the public debt portfolio and debt sustainability. In addition, the country has a Public Debt and Borrowing Policy that provides guidance on raising resources through borrowing to finance the budget and manage debt portfolio at minimum cost while ensuring that public debt remains within a sustainable level. It further underscores the need to adhere to the laws and regulations governing public debt management. Notwithstanding the progress made towards having robust frameworks, there is need for the various institutions managing debt to collectively conduct Debt Sustainability Analysis for the country annually. This will be instrumental in assessing the country's debt portfolio and the potential for future borrowing that will place the country on a sustainable debt path over the medium term. In addition, consistency in reporting the public debt and its purpose is important to promote transparency and accountability while providing information that would be used for policy analysis and recommendations.

3.1 Introduction

Efficient public sector borrowing requires an effective and transparent policy, legal and institutional framework in a country. The legal framework covers legislations for borrowing by the National government, County governments, state enterprises and for regulating and monitoring external borrowing by the private sector. The legislation must be supported by regulations and procedures that clearly outline the functions of different institutions involved in loan operations. Therefore, a clear legal framework is essential for making appropriate institutional arrangements for public sector borrowings.

Moreover, a robust legal, policy and institutional framework is vital for effective public debt management (PDM), given the significance of law to public debt. According to Awadzi (2015), a good framework aids to promote discipline, transparency and accountability, all of which are critical in achieving sustainable debt. Further, for effective PDM, a good framework ought to establish broad parameters while providing sufficient clarity on several key issues. Some of the key issues include:

(i) The scope of public debt; defining clearly what constitutes public debt, public institutions, and public debt instruments.

(ii) Establishing the objectives of PDM, medium term debt management strategy (MTDS) and debt sustainability analysis (DSA).

(iii) Legal mandate to borrow clarifying sources from which government may borrow and debt service.

(iv) The purpose for which government may borrow and debt ceiling.

A clear debt policy for a country is essential to ensuring that the relevant bodies are in place to steer on strategies to be adopted when contracting, negotiating, and managing public debt in addition to a legal and institutional framework. Specifically, it sets out the underlying policy, legal and institutional framework within which debt is incurred, managed, and used. In Kenya, the debt policy framework developed in 2020 broadens the scope for debt management beyond the explicit external and domestic debt to include implicit contingent liabilities to cushion their effect on the financial stability of the economy.

This chapter provides an overview of the policy, legal, and institutional framework for Kenya and compares it with those of other countries to draw lessons. It expounds on the key issues identified and, most importantly, discusses the pertinent debt aspects as reflected in the various frameworks.

3.2 Policy Framework

Public debt management in Kenya is guided by the Medium-Term Debt Management Strategy (MTDS) published every year. The debt management strategy was established in 2009, with an aim to minimize the cost and risk of borrowing in the long-run and deepen the domestic market for government securities. It ensures consistency with both fiscal and monetary policy objectives while on external borrowing emphasis is on borrowing on concessional terms as a strategy for minimizing borrowing costs.

The MTDS outlines the optimal strategy for funding the fiscal deficit considering the cost and risk implication of the borrowing mix annually. In addition, it complements the debt sustainability framework, which is concerned with long-term sustainability of debt. Annually, it discusses the country's debt sustainability position and proposes ways of ensuring that public debt remains sustainable. For instance, the 2023 MTDS emphasized the need to step up reforms in the domestic debt markets to support public debt sustainability. It further envisages maximization of concessional and semi-concessional external debt while proposing liability management operations in the domestic and international capital markets.

The National Treasury, in June 2020, formulated a Public Debt and Borrowing Policy in pursuit of reducing the vulnerabilities to risks of public debt. The policy is meant to act as an additional guideline for debt management practices of the government, including the issuance process, management of the debt portfolio, and adherence to various laws and Regulations governing debt contracting and management. Specifically, it provides guidance on raising resources through borrowing to finance the budget and manage the debt portfolio at minimum cost while ensuring that public debt remains within a sustainable level. Further, it underscores the need to adhere to the laws and regulations governing public debt management.

To undertake effective public debt management, the debt policy and borrowing framework lists important documents that need to be prepared and made readily available. These documents include the public debt and borrowing policy (completed in 2020), Medium Term Debt Management Strategy, Budget Policy Statement, monthly debt bulletin, debt sustainability report, and annual public debt management reports.

In line with the Section 25 of PFM Act 2012, the National Treasury prepares the Budget Policy Statement (BPS) every financial year. The BPS gives broad strategic priorities and policy goals that guide the National and County Governments in preparing budgets for the financial year and over the medium term. It presents the state of the current economy and outlook over the medium term, the financial outlook with respect to Government revenues, expenditures and borrowing for the next financial year and over the medium term, the proposed expenditure limits for the national government and indicative transfers to county governments and the fiscal responsibility principles and financial objectives over the medium-term including limits on total annual debt.

The National Treasury also publishes debt statistics in the monthly debt bulletin that details the country's public debt, both external and domestic. In addition, it publishes the Annual Public Debt Report in compliance with the Constitution and the PFM Act (2012). The report covers the legal framework on public debt, public debt market reforms, the level of public debt, non-guaranteed debt, on-lent loans, status of implementation of the Medium-Term Debt Management Strategy (MTDS) and evaluates the outcome of the recent Debt Sustainability Analysis (DSA). The report highlights the changing structure of public debt portfolio and debt service during the period under review.

CPIA Debt Policy Rating

The Country Policy and Institutional Assessment (CPIA) of the World Bank is an annual rating system designed to assess the performance of countries' policy and institutional frameworks in terms of their capacity to ensure growth and poverty reduction. The CPIA rates countries against a set of 16 criteria grouped in four clusters: economic management, structural policies, policies for social inclusion and equity, and public sector management and institutions.

CPIA Debt policy assesses whether the debt management strategy is conducive to minimizing budgetary risks and ensuring long-term debt sustainability. The rating runs from 1 to 6 with 1=low and 6=high. Table 3.1 below presents the CPIA rating for selected countries. Kenya's performance has been moderate, averaging 4.2 between 2008 and 2021. Compared to its peer countries, the performance ranks second after Uganda that had an average of 4.4 during the same period.

Table 3.1: CPIA rating for selected countries

CPIA debt policy rating (1=low to 6=high)														
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Ethiopia	3.5	3.5	3.5	4.0	4.0	4.0	4.0	4.0	4.0	3.5	3.5	3.5	3.5	3.4
Ghana	4.0	4.0	4.0	4.0	4.0	3.5	3.0	3.0	3.5	3.5	3.5	3.5	3.5	3.6
Kenya	4.0	4.0	4.0	4.5	4.5	4.5	4.5	4.5	4.5	4.0	4.0	4.0	3.7	3.8
Malawi	3.0	3.0	3.0	3.5	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.1
Nigeria	4.5	4.5	4.5	4.0	4.0	4.5	4.5	4.5	4.5	4.0	4.0	4.0	3.2	3.2
Rwanda	3.5	3.5	3.5	3.5	3.5	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.1	4.1
Tanzania	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0	3.5	3.5
Uganda	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.5	4.0	4.5	4.5	5.0	3.6	3.6
Zambia	3.5	3.5	3.5	3.5	3.5	3.5	4	3.5	3.5	3	3	3	3.1	3.1

Source of data: World Bank (2022); CPIA Africa: Assessing Africa's policies and institutions.

Notably, the CPIA rating for Kenya was upgraded to 3.7 in 2021 from 3.6 in 2020 based on improved performance in the economic management and public sector management and institutions (World Bank, 2022). The country's score on transparency, accountability and corruption in the public sector improved from 3.0 in 2020 to 3.5 in 2022 because of the revisions of the Public Procurement Act 2015 and Procurement Regulations 2020, which increased disclosure requirements and full automation of the procurement process with inbuilt controls. In addition, the institutionalization of transparency, accountability, and participation processes within the country's decentralization process improved the integrity and efficiency of public spending in the counties. Notable areas of improvement for the country included the quality of budgetary and financial management, fiscal policy, and financial sector where the score was below 3.5.

3.3 Legal/legislative Framework

International experience in public debt management emphasizes the role of establishing a legal framework for public debt management as key to ensuring effective public debt management. The design of a legal framework for PDM requires striking a balance between government's flexibility in exerting its authority, and putting in place requisite controls and safeguards. International best practice reveals that an efficient and effective legal framework for PDM should encompass the constitution, primary legislation, and secondary legislation. In terms of the content of the legal framework for PDM, Awadzi (2015) suggests it should be comprehensive and, at the very minimum, include the mandate to borrow and to issue guarantees; establish the authority to conduct debt management activities; determine the roles and responsibilities of various players; include disclosure clauses; and outline borrowing restrictions, such as the scope of debt, the purpose of borrowing, a debt ceiling, among other things.

International best practice in PDM requires the adoption of a designated PDM law to provide a clear framework for strategic debt management (Cabral, 2015). For Kenya, the legal framework on debt management is laid out in the Constitution of Kenya 2010, the Public Finance Management (PFM) Act, 2012 and PFM Regulations 2015. The PFM Act, 2012 consolidated all the Acts of public finance governing public debt management, such as Internal Loans Act (Cap 420), the National Government Loans Guarantee Act (Cap 461) and External Loans and Credits Act (Cap 422) that were repealed. The legal documents detail the various aspects of public debt, for example the definition of public debt, purpose of borrowing, management of the public debt portfolio and debt sustainability. Therefore, this section discusses the various aspects of public debt as provided by the legal documents.

3.3.1 Definition of public debt and guiding principles

One of the key salient elements of a sound PDM legal framework as noted by Awadzi (2015) is the scope of public debt. This entails the definition of public debt, relevant public debt institutions and public debt instruments representing liabilities. The Constitution of Kenya, 2010 under Article 214(2) defines public debt to comprise all financial obligations attendant to loans raised or guaranteed and securities issued or guaranteed by the national government. The PFM Act (2012) adopts the definition of public debt given by the Constitution of Kenya (2010). Pending bills according to National Treasury (2021) is any outstanding and undisputed invoices or payment due for more than the corporation's credit period and in any event more than ninety (90) days from due date.

The guiding principles and framework of public finances are outlined in Chapter 12 of the Constitution of Kenya (2010). These principles also apply to all public borrowing and debt management. Among the key principles are requirements that there need to be openness, accountability, and public participation; equitable sharing of debt benefits and burden between current and future generations; prudent and responsible use of public resources and responsible financial management with clear fiscal reporting. The country's performance on transparency, accountability, and corruption in the public sector, as rated in the 2022 CPIA report, improved to 3.5. However, there is still room for improvement to attain the desired score of 6.

Further, Article 211 of the Constitution gives powers to parliament through legislation to prescribe the terms on which the national government may borrow and impose reporting requirements. Whereas the Constitution stipulates the functions of the legislature in government borrowing, the challenge arises as to how such power is to be balanced without the legislature interfering with the powers of the executive and the allocation of resources. To address this challenge, independent institutions such as the Office of the Controller of Budget, and Auditor General have been established under the Constitution. The Controller of Budget oversees implementation of the budgets at the county and national level while the Auditor General audits and reports, within six months of every financial year,

whether public money has been lawfully applied in an effective way. Moreover, the Constitution sets out the principles of public finance relevant to public debt under Article 201. These principles are meant to ensure the purpose for which debt is incurred is implemented.

3.3.2 Purpose and sources of borrowing

A sound PDM legal framework needs to provide the legal mandate to borrow, which includes the legal sources of government borrowing, the purpose of the borrowed funds, the person that exercises the authority to borrow and servicing of the debt (International Monetary Fund, 2015). In that regard, Section 49 of the PFM Act (2012) grants the Cabinet Secretary for the National Treasury the powers to borrow, within Kenya (domestic) or from outside Kenya (foreign), on behalf of the national government. The PFM Act, 2012 and the Constitution of Kenya (2010) do not explicitly define the sources from which the government can borrow. However, this may be guided by Section 187 of PFM Regulations of 2015. The section stipulates that the Cabinet Secretary may borrow through the issuance of external government securities, treasury bills, bonds, or stocks, requesting for advances from Central Bank of Kenya, and/or bank overdraft on Exchequer Account.

The purposes of borrowing are specified under Section 192 of the PFM Regulations. In that case, the National Government is mandated to borrow in accordance to requirements[5] outlined in Section 49 of the PFM Act to: finance national government budget deficits, mitigate against significant balance of payment imbalances, meet any other development policy objectives that the Cabinet Secretary shall deem necessary, consistent with the law, and as Parliament may approve, mitigate against adverse effects caused by an urgent and unforeseen event, for purposes of cash management, honouring obligations under outstanding national government guarantees and refinancing outstanding debt or repaying a loan prior to its date of repayment.

For transparency and accountability, the PFM Act (2012) sets out guidelines and reporting obligations to ensure that Parliament and the public are well informed on government borrowing. The Cabinet Secretary is required under Section 31 (3) of the PFM Act to submit to Parliament, every four months, a report of all loans made to the national government, national government entities and county governments, in accordance with Section 211(2) of the Constitution. In addition, Section 32 of the Act requires the Cabinet Secretary to submit to Parliament a record of all guarantees given by the National government, not later than seven days after receiving a request to do so from either House of Parliament. The Cabinet Secretary is further mandated to submit to Parliament a report statement setting out the debt management strategy of the national government over the medium term with respect to its actual liability and potential liability in respect of loans and guarantees and its plans for dealing with those liabilities. The report also

5 The fiscal responsibility principles and objectives in the most recent Budget Policy Statement, the debt management strategy of the national government over the medium term and the loan may be raised either within Kenya or from outside Kenya.

includes a review of the previous year's financing on budget deficit, composition of the external debt, publicly guaranteed debt, on-lent loans and contingent liabilities, debt strategy and debt sustainability, outlook for the medium term and any commitment fees and penalties paid on any undisbursed amounts of a loan.

The purpose of borrowing and reporting channels are clearly stipulated in the legal framework. However, there is limited information publicly on the purpose of the money borrowed. The information stated under Section 31(3) of the PFM Act, 2012 on reports of the new loans contracted by the government and their uses ought to be published in the annual public debt management report. However, over the las ten years, the information was only published in the annual public debt management report for financial year 2021/22. Therefore, there is need to maintain consistency in reporting to aid on the principle of transparency and accountability.

3.3.3 County government borrowing

The county government borrowing framework is stipulated in the Constitution of Kenya, 2010, the PFM Act, 2012 and the County Governments Act, 2012. The over arching legal mandate for counties to borrow is outlined in Section 212 of the Constitution of Kenya, 2010. The county governments are given a window to borrow in Section 212 of the Constitution subject to the National Government's guarantee and county government's assembly approval. This is affirmed in Section 8 of County Governments Act, 2012 where the county assembly is mandated to approve the county borrowing in accordance with Section 212 of the Constitution.

The constitutional provision on county borrowing is operationalized by various sections of the PFM Act, 2012. Section 58 of the PFM Act grants powers to the Cabinet Secretary to guarantee loans of county governments and other borrowers on behalf of the national government subject to Parliamentary approval. The Cabinet Secretary guarantees the loan under the following caveats as per Section 58(2) of the PFM Act:

(i) The loan is for a capital project.

(ii) The county can repay the loan and paying any interest or other amount payable in respect of it.

(iii) The financial position of the county over the medium-term is likely to be satisfactory.

(iv) The terms of the guarantee comply with the fiscal responsibility principles and financial objectives of the national government.

(v) Where Parliament has passed a resolution setting a limit, the amount guaranteed should not exceed that limit or if it exceeds that limit, the draft guarantee document has been approved by resolution of both Houses of Parliament.

(vi) The Cabinet Secretary considers the equity between the national government's interests and the county government's interests to ensure fairness.

(vii) The county complies with any conditions imposed by the Cabinet Secretary in accordance with the regulations.

(viii) The Cabinet Secretary has considered the recommendation of the Intergovernmental Budget and Economic Council in respect of any guarantee to a county government; and

(ix) The loan is made in accordance with provisions of the PFM Act and any regulations made thereunder.

Where Parliament sets a borrowing limit for county governments and the limits are exceeded, the Cabinet Secretary may only guarantee the loan if the guaranteed document has been approved by resolution of both Houses of Parliament and if the loan is geared towards stimulating economic growth in a county government according to the PFM Act, 2012.

Notably, Section 107 of the PFM Act limits the use of county government's borrowings for financing development expenditures only and not for recurrent expenditures. In addition, it mandates the county assembly to manage the county's debt at sustainable levels. To remain at sustainable levels, county governments are to ensure that financing needs and payment obligations are met at the lowest possible cost in the market and borrowing is within the limit set by the county assembly.

The authority for borrowing by county governments is outlined in Section 140 of the PFM Act. The county government is authorized to borrow either within or outside Kenya. Further, the Act gives power to the County Executive Committee member for finance to borrow on behalf of the county government only if the loan and the terms and conditions for the loan are set out in writing and are in accordance with Article 212 of the Constitution and Section 58 and 142 of the PFM Act. The terms and conditions ought further to be in line with the fiscal responsibility principles and the financial objectives of the county government set out in its most recent County Fiscal Strategy Paper and the Debt Management Strategy of the county government over the medium term. The counties are required to submit county government debt management strategy by 28th February every year with regard to its actual liability and potential liability in respect of loans.

In addition, county government entities are authorized to borrow to a maximum of 5 per cent of the most recently audited revenues of entity for cash management only. The regulations require that such borrowing by the entities be repaid within a year from the date of borrowing.

At the county government level, the County Executive Committee member for finance or any person designated by the County Executive Committee member for finance in writing is authorized to execute loan documents for borrowing. For a county government entity, the accounting officer responsible for the entity and any

other specified office holder authorized by legislation to execute such documents on behalf of an entity are authorised to execute loan document as per the PFM Act regulations.

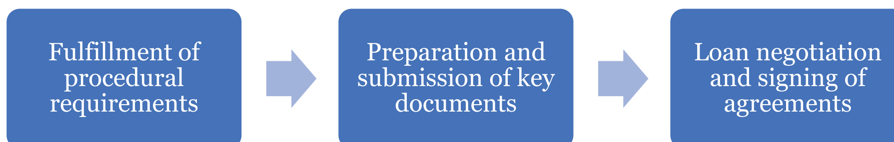
Laikipia County was the first devolved unit to float a bond to raise funds in Nairobi Security Exchange. The County floated an infrastructure bond worth Ksh 1.16 billion following the National Cabinet approval on 4th April 2022. The National Treasury in collaboration with Laikipia County prepared and submitted a sessional paper to Parliament for approval of the guarantee. The infrastructure bond is expected to unlock the huge investment opportunities in the county. Kirinyaga and Nakuru counties also submitted requests for guarantees for similar infrastructural bond during the 2021/22. The requests were reviewed by PDMO, and the counties provided guidance on the next steps to secure the loans. The disbursement of the bonds applied by the three counties will be instrumental in drawing lessons for the other counties to learn from. Further, it will act as a benchmark for the other counties to borrow a leaf and explore bonds as a way of financing their development projects, where financial resources are limited.

3.3.4 Borrowing procedures

The procedures for external and domestic borrowing by the National and County Governments and their agencies are outlined in Section 8 of the Public Debt and Borrowing Policy. The National Government and its agencies are mandated to obtain Budget Policy Statement, Medium Term Debt Strategy and Annual Budget estimates approvals annually from the National Assembly prior to any consideration of requests for borrowing. Similarly, a County Government seeking to borrow should obtain County Strategy Paper, County MTDS and Annual Budget Estimates approvals from the County Assembly prior to consideration of request for guarantee by the National Government.

The borrowing framework may be summarized in three key steps as shown in figure 3.1 below.

Figure 3.1: Borrowing framework



Source: National Treasury (2020), Public Debt and Borrowing Policy

The first step in borrowing entails fulfilment of procedural requirements. Under domestic borrowing, the PDMO in consultation with department responsible for cash management and CBK prepares the Annual Borrowing Plan to assist in financing the budget deficit whereas for external borrowing, the PDMO provides the composition of net external borrowing during the fiscal year. Thereafter,

the National Treasury initiates the process of contracting loans in accordance with best practice. All borrowing by the National and County governments are issued/contracted by the Cabinet Secretary/County CECs through a transparent, accountable process, at the lowest possible risk, and in accordance with the Annual Borrowing Plan. The project implementing agency is then mandated to submit a checklist of conditions precedent to signing any financing agreements by the Cabinet Secretary in accordance with the format prescribed by the Cabinet Secretary.

In the second step, the PDMO facilitates and participates in the preparation of key documents to guide its effectiveness in public debt management functions. The documents include legal framework governing public debt management, Public Debt and Borrowing Policy, Medium-Term Debt Management Strategy, Annual Borrowing Programme and Issuance Calendar, Procedure manuals on debt management operations, Debt statistical reports, Risk Management Framework for Debt Management, Debt Sustainability Analysis Reports, Public Debt Management Reports, Agency Agreement between the National Treasury and fiscal agents, and Bilateral cooperation agreements between the government and development partners.

In the last process of loan negotiation and signing of agreement, the Cabinet Secretary constitutes in each case: a negotiation committee for each external loan and grant, a government securities auction committee for issuance of domestic securities, and a committee for issuance of government securities in the local or international bond market. Upon finalization of negotiations of a loan agreement and legal clearance by the Attorney General, the Cabinet Secretary signs a loan agreement as per the relevant law.

The stipulated processes aid in ensuring that funds are borrowed in accordance with the legal framework. This helps to curb unnecessary borrowings that can adversely affect the country's public debt sustainability. The government over the years have adhered to the borrowing procedures, aiding it to manage its public debt.

3.4 Institutional Framework

The institutional framework for debt emphasizes the importance of sound governance and good management of operational risks involved in public debt management. It recommends a clearly and well specified organization framework and authority to borrow and undertake transactions related to public debt management. The institutional framework similarly outlines all responsible bodies that coordinate the process of debt, from sourcing to approval, acquisition, and management. It stresses the importance of separating the execution of market transactions (front office) from the entering of transactions into the accounting systems (back office). This section discusses the role of key institutions in public debt management and compares them with those of other countries.

3.4.1 Raising loans, issuing guarantee and loan approvals

The legal authority to borrow by the central government in most countries rests with the parliament or congressional legislative body. Practices, however, differ when it comes to delegation of borrowing power from parliament to public debt managers. In most countries, laws governing public debt management have delegated the borrowing authority to the ministry (Minister) of finance or its equivalent to borrow on behalf of the government. In other countries, this power is vested in the Council of Minister (Cabinet) while in other countries such as India the power is given to the central bank to directly borrow on behalf of the government.

The Constitution of Kenya, 2010 grants the authority for all government borrowing to the Cabinet Secretary, National Treasury subject to Parliamentary approval. Further, the Constitution and Section 12 of the PFM Act (2012) mandates the National Treasury to manage the level and composition of national public debt, national guarantees, and other financial obligations of national government within the PFM framework and develop a framework for sustainable debt control. The mandate of the National Treasury in Kenya compares to the functions of Ministry of Finance in several jurisdictions. In Nigeria, the Federal Ministry of Finance (FMF) oversees and provides strategic leadership to the Debt Management Office (DMO) as the supervising ministry. In addition, it approves the proposals for borrowing both in the domestic and international capital markets. In Uganda, the Ugandan PFM Act of 2015 bestows the powers of raising money, loans and issuing guarantees for and on behalf of the government to the Minister of Finance. Specifically, the Ministry of Finance, Planning and Economic Development (MoFPED) is required by the Constitution of Uganda to present information regarding guarantees of loans and grants to the Ugandan parliament for approval. Most importantly, the institution leads in carrying out Debt Sustainability Analysis for Uganda to assess its debt sustainability. Further, it advises the government on the overall debt management policy. Similarly, in Ghana public debt management is a core function of the Ministry of Finance. The legislative framework for debt management is entrenched in the Constitution of the Republic of Ghana (1992) and the PFM Act (2016). In Tanzania, both the Ministry of Finance and the Bank of Tanzania manage the public debt.

To carry out its mandate, the National Treasury established the Public Debt Management Office (PDMO) and Public-Private Partnership (PPP) Unit.

3.4.2 Public Debt Management Office (PDMO)

International best practise requires that debt functions are centralized in a single office. Centralization of debt functions in one single office or department reduces fragmentation while increasing coordination in debt management, according to International Monetary Fund (2015). In most countries, debt management functions are consolidated under a single office termed as Debt Management Office/Department/Unit. This aids governments to maintain a holistic view on

all its debt obligations, hence enhancing effective risk management of the overall debt portfolio.

In Kenya, PDMO was established within the National Treasury under Section 62 of the PFM Act with three main objectives. These are: to minimize the cost of debt management and borrowing over the long-term taking account of risk, to promote the development of market for government debt securities and to ensure the sharing of benefits and costs of public debt between the current and future generations. The office is mandated to prepare and submit various reports to the Cabinet Secretary for submission to Parliament. Some of the reports include: Medium-Term Debt Strategy, the government borrowing plan for approved Annual Budget, statistical and analytical reports on debt and borrowing and report of all loans made to the national government, national government entities and county governments. The overall functions of the PDMO are outlined under Section 63 of the PFM Act and Section 61 of the Debt and Borrowing Policy (2020) to include: carrying out the government's debt management policy of minimizing its financing cost, maintaining a reliable dataset for all loans taken by the national government, preparing and updating the medium term debt strategy including debt sustainability analysis, managing financial transactions on public debt and borrowing and supporting county governments and public entities on debt management and capacity development, among others.

The office is organized into three technical departments, in accordance with international best practices, that include resource mobilization (front office), debt policy, strategy and risk management (middle office) and debt recording and settlement (back office) each with distinct functions and separate reporting lines. According to Proite (2020), it is important to organize the debt management office along the three functions to ensure that staffs executing debt transactions and those that enter the transactions into recording systems are different to avoid collusion and prevent operational errors. The separation helps to promote independence among the key players in charge of debt management. In general[6], the front office executes transactions in financial markets. The middle office or risk management office undertakes risk analysis, monitors, and reports on portfolio-related risks. The office also assesses the performance of debt against strategic targets. The back office is responsible for settlement of transactions and maintenance of financial records.

In Kenya, the functions of resource mobilization department (front office) include but not limited to the development and implementation of external resources mobilization policies; external loans, aid, and grants resource mobilization; harmonization, alignment, and co-ordination of aid effectiveness in line with the Paris Declaration 2005; evaluation of external loans proposals; and co-ordination of donors. The department also develops domestic debt markets, domestic borrowing, aid, and grant resource mobilization and the global investor relations programme that reflects the government's investment climate. The middle office functions include establishing and updating debt risk management framework, preparing and reviewing the MTDS, analyzing fiscal risks associated with

6 The general functions of the separate offices internationally as outlined in the IMF Policy Paper on revised guidelines for public debt management. https://www.imf.org/external/np/pp/eng/2014/040114.pdf

government guarantees, establish and update debt risk management framework, prepare statutory debt-related reports for Cabinet Secretary, and reviewing public debt management policy and guidelines, among others. The back office is mandated to process and settle debt service, process disbursement of loans and grants, maintain public debt registry, monitor, and report disbursement of loans and grants, and maintain a comprehensive and reliable debt database, among others.

The Debt Management Office in Kenya compares to those of Uganda, Nigeria, and Ghana. However, in Uganda and Nigeria, the offices play a key role in conducting Debt Sustainability Analysis (DSA) for their respective countries. The Debt Management Unit (DMU) in Uganda was established within MoFPED to centralize debt management functions, taking on all the middle office and back-office functions. With MoFPED as the lead institution, the unit conducts DSA annually to assess the country's level of debt and its prospective borrowing. Similarly, in Nigeria, the Debt Management Office (DMO) Act of 2003 established the DMO as a semi-autonomous office where all public debt management functions are centralized. The DMO ensures transparency and effective reporting of debt at a national and sub-national level and provides guidance on debt sustainability. The office annually conducts Debt Sustainability Analysis to assess the current and future debt portfolio with an aim of ascertaining the country's debt sustainability, detecting any potential risks and giving guidance to the government on its borrowing. In Ghana, the Debt Management Division was created to minimize the financial cost of public debt while maintaining the market and operational risks at an acceptable level. The division is further set up with a front, middle and front office, each with its specific functions as laid out in the PFM Act (2016).

Best practice requires that the existing law such as the Constitution, PFM Act or an Act of Parliament accord the legislature power to borrow or act as a guarantor on government's behalf. In Kenya, the Parliament is responsible for approving new loans that the government intends to acquire and the amount to be borrowed domestically each year as provided for in the Constitution of Kenya, 2010 and the PFM Act, 2012. In many jurisdictions, parliaments retain this very important role of approving borrowing transactions and their terms and conditions. According to the IMF (2015), best practise suggests that parliament's role of debt transactions approval ought to be minimal given that it could be cumbersome and could also increase transaction costs. Similar procedures apply for jurisdictions including Ghana, Uganda, Tanzania, Nigeria, Eswatini and South Africa where legal framework gives powers to parliament to approve all borrowing transactions. This implies that the Minister of Finance may not borrow without prior approval from Parliament. However, compared to other countries whose Constitutions are precise on the role of Parliament in approving loans before acquisition, the Constitution of Mauritius (1968) is silent on it. Article 109 of the Constitution of Mauritius requires loan agreements to be presented before the National Assembly after the agreements have been signed and has no mention of seeking parliamentary approval before loan engagements. In Namibia, the Namibian Constitution does not explicitly refer to loan and debt management process. Despite Parliament having an oversight role over public finances, the Executive has powers to finalize

loan transactions before parliamentary approval. Similarly, in Zambia, the law does not provide for oversight functions by Parliament. Specifically, there is no legal framework that provides for parliamentary oversight in contraction and management of public debt. The limited involvement of the legislature in loan approvals weakens accountability and constrains the fiscal strategies meant to contain public debt.

In other countries, parliamentary approvals are required for specific transactions only. For example, in Belize, parliamentary approval is required only for any government borrowing above a specified threshold during a fiscal year. In Ghana, Article 181 (5) of their Constitution requires parliamentary approval for only international transactions involving the Government. Similarly, only loans obtained from foreign lenders and denominated in foreign currency in Bosnia require parliamentary approval[7].

Parliamentary approvals continue to be deemed as a vital component of public debt governance and accountability. However, the extent to which the Executive could be depended upon to manage public debt without parliamentary approvals hinges on the level of institutional development in a country. In countries where transparency and accountability are deemed to be high, with low levels of corruption in institutions, then the Executive could be relied upon with less parliamentary approvals.

3.4.3 Public debt management

International best practice on public debt management has evolved in recent years and has been classified by the IMF and World Bank into six key elements emphasizing priority of goals and coordination, transparency, risk management and sound governance. IMF (2014) defines public debt management as the process of establishing and executing a strategy for managing the government's debt to raise the required amount of funding at the lowest possible cover cost over the medium to long-run, consistent with a prudent degree of risk. Moreover, it is required that it meets any other public debt management goals the government may have set, such as developing and maintaining an efficient market for government securities or debt to GDP ratio.

Management of public debt is crucial for several reasons. Sound debt management is important because government borrowing decisions can have substantial impact on government budget and its financial standing. Situations where the cost of the debt increases when the primary deficit is high or rising could force the government to cut expenditures and/or increase taxes, and in the worst cases default on its obligations. The implication is that a good understanding of the government's revenues and expenditures and its assets and liabilities is essential for sound debt management. The revised guidelines for public debt management (2014) indicate that sound risk management practices are essential given that a government's debt portfolio is usually the largest financial portfolio in the country and can contain complex and risky financial structures, which have the potential

7 Bosnia Law on Debt, Debt Issuance and Guarantees of the Federation, 2005.

to generate substantial risk to the government's balance sheet and overall financial stability.

Effective public debt management can reduce financial vulnerabilities, contribute to macroeconomic stability, preserve debt sustainability, and protect a government's reputation among investors. The best practice guidelines on public debt management aim to strengthen the international financial architecture, promote policies and practices that contribute to financial stability and transparency and reduce the external vulnerabilities of member countries.

Broadly, in the macroeconomic policy context, governments ought to ensure that the level and growth rate of public debt is on a sustainable path. The structure of public debt in terms of maturity, currency, interest rate and contingent liabilities need to be monitored adequately. Further, sound risk management practices are key. According to Vinals and Lewis (2014), in addition to sound debt structures, governments need to ensure reduced exposure to interest rate, currency and refinancing risks. It is prudent to establish targets and thresholds for key indicators or where possible target portfolios related to desired currency composition, duration, and maturity structure to guide public debt transactions and borrowings.

IMF (2014) provides guidelines that can help countries develop strong systems of public debt management. These encompass public debt management objective, transparency and accountability, institutional and legal framework, debt management strategy and risk management framework. Cabral (2015) notes that there is a slightly positive correlation between level of indebtedness and transparency of the strategy document. He argues that higher-indebted countries face higher pressure (from creditors, investors, and so forth) to publish the debt management strategy.

The guidelines on debt management differ from one country to another. In Sweden, for example, the Council of Ministers specify targets for foreign currency debt, inflation-linked debt, and nominal domestic currency debt. The Council also outlines the government's preferred average duration for total nominal debt, the maturity profile of the total debt, and rules for the evaluation of the debt management. Portugal, which also has a separate debt agency, provides for debt management at three different decisions. First, the Minister of Finance sets long-term benchmarks for the composition of the debt portfolio. These reflect selected targets concerning the duration, currency risk, and refinancing risk, and they are used to evaluate the cost and performance of the debt portfolio. Second, the government (Council of Ministers) specifies annually which debt instruments are to be used and their respective gross borrowing limits. Finally, the Minister of Finance annually approves guidelines for specific operations, such as buybacks; repos; the issuing strategy in terms of instruments, maturities, timing, and placement procedures; measures regarding the marketing of the debt; and the relationship with the primary dealers and other financial intermediaries.

The Central Bank in most countries plays the role of fiscal agent, which entails acting as an issuing and registering agent of government securities. As such, where the Central Bank is authorized to act as an agent to the government, the

legal framework needs to precisely define the scope of the agency relationship. This ought to be reflected in the Central Bank's law and be consistent with the core function of the Bank. For instance, Section 44 of the Central Bank of Kenya Act provides for CBK to act as fiscal agent and banker to the Government while highlighting its functions. This compares with Section 43 of the Central Bank of Lesotho Act of 2000, which explicitly provides that the Bank may act as an agent for the Government and that its role should be consistent with the functions and duties of the Bank. This prevents instances where conflict of interest may arise or where the fiscal agency role is inconsistent with the Bank's core mandate of price stability.

In Kenya, Section 45 of the CBK Act provides the legal framework for the Bank to manage public domestic debt on behalf of the government. This includes contracting domestic debt through sale of Treasury bills and bonds, extending overdraft facilities to the Government, maintaining domestic debt register and making payments of domestic debt. As a Banker to the Government, CBK effects payments to external creditors on specific instructions from the National Treasury.

The mandate of the CBK as an agent compares to those of various Central Banks in other countries. Specifically, the Central Bank of Nigeria Act of 2007 enables the Central Bank of Nigeria (CBN) to act as the fiscal agent (registrar and settlement bank) for Federal Government of Nigeria securities issued in the domestic market. Further, it empowers the CBN to consider and approve new products to be issued for borrowing purposes and implement the externalization of the External Debt Service payments. Of interest to note is that the CBN participates in conducting the annual Debt Sustainability Analysis on the country's debt portfolio. Similarly, the Bank of Uganda Act of 2000 mandates the Bank to act as the government's agent but limits its functions to only issuance of domestic securities. In addition, the Bank of Uganda in collaboration with MoFPED (lead institution) carries out Debt Sustainability Analysis annually to assess the country's level of debt and prospective new borrowing to establish its debt sustainability. Therefore, in contrast with CBK, the Central Bank of Nigeria and the Bank of Uganda play a critical role in conducting the Debt Sustainability Analysis, which is essential in analyzing a country's debt position and the potential to future borrowing.

Other institutions relevant to the management of domestic debts in Kenya include:

- **The Attorney General's Office**: Is the principal legal adviser to Government and is responsible for reviewing draft loan agreements to ensure conformity with the relevant legislation. In the Debt Policy and Borrowing Framework, the AG's Office is required to offer advisory services to the National Treasury regarding negotiations, drafting and interpretations of local and international documents, agreements, and treaties. Further, where legal opinion is required by a creditor on the validity of loan documents, the AG's office is mandated to advise.
- **The Office of Controller of Budget (CoB):** CoB was established under Article 228 of the Constitution of Kenya, 2010 to oversee implementation of the budgets of the National and County governments by authorizing withdrawals from public funds. It is also responsible for issuance of authority

to debit the Consolidated Fund Service account to settle government debts and undertakes periodic audits of public debt. The office as outlined in the Debt Policy and Borrowing Framework is mandated to oversee the utilization of budgeted borrowed funds for the national and county governments by authorizing withdrawals from public funds.

- **Public-Private Partnership (PPP) Unit:** The Public-Private Partnership Unit is a specialized unit established under Section XI of the PPP Act, 2013 within National Treasury. Their main role is to serve as secretariat and technical arm of the PPP committee; provide support to all Contracting Authorities (CAs) from project identification, appraisal, procurement negotiations and operation phases; and enhance capacity building and PPP awareness.

3.4.4 Debt ceiling

Debt ceilings/limit determines the maximum amount of debt that a government can undertake. Often, they are imposed by governments as part of measures to ensure fiscal discipline and promote debt sustainability. In other instances, debt targets are set below debt ceilings to create a buffer between the actual debt levels and the specified ceiling. Governments may impose debt ceilings in nominal terms (specified in absolute numbers of specific currency) or relative terms (expressed as a percentage of GDP). Most countries express their ceiling in relative terms; however, Denmark, the United States of America and recently Kenya use nominal debt limits. As such, the countries legal framework ought to be precise in terms of the type of ceiling envisioned.

In most countries, the law restricts the amounts to be borrowed either by a borrowing limit expressed in net or gross terms or restriction by a clause in respect of the purpose of borrowing. The most common structure in Europe is that parliament sets an annual limit in connection with the approval of the fiscal budget, which then functions as a means for it to control the budget. The clause that restricts purpose usually ensures that the borrowing mandate is on specified purposes with the main ones being to finance the budget deficit and refinance existing obligations.

In Poland, for example, there is a clause in their Constitution that requires that total government debt, augmented by the amount of anticipated disbursements on guarantees, be less than 60 per cent of GDP. The US and Denmark also have legislative limits on stock of debt outstanding. In Ghana, the government through the passage of PFM regulations and the Fiscal Responsibility Law made inclusion of debt ceilings in the economic tool kit setting the debt limit at 65 per cent of GDP. In the UK, the mandate on borrowing is open. The National Loans Act of 1968 permits the Treasury to raise any money that it considers expedient for the purpose of promoting sound monetary conditions. Debt ceilings may be established in various ways as discussed by IMF report of 2015 outlined in Box 1.

The debt limit in Kenya as outlined in Section 50 (2) of the PFM Act 2012 is set by Parliament. Specifically, the national government is mandated to borrow in

accordance with the PFM Act or any other legislation if it does not exceed the limit set by the Parliament. Section 50 (5) of the PFM Act 2012 outlines that the "Parliament shall provide for thresholds for the borrowing entitlements of the national government and county governments and their entities". The debt limit as per the Legal Notice No. 34 of 2015 ought to be specified annually in the budget policy statement and the medium-term debt management strategy paper. However, this has not been the case over the years.

Box 3.1: Ways of establishing debt ceilings

- ***Political Commitments:*** Debt ceilings in some countries (Canada and Cape Verde) are established as part of a fiscal responsibility framework based on policy commitments rather than explicit legal instruments.
- ***Supranational ceilings:*** Refers to instances where debt ceilings are established as part of fiscal rules under regional treaties that bind members of monetary unions. For example, debt ceiling imposed on EU member states, EAC (debt-to-GDP ratio of 50%), SADC (debt-to-GDP ratio 60%), WAEMU (debt to GDP ratio of 70%) and the CEMAC (debt to GDP ratio of 70%).
- ***Constitutional ceilings:*** Refers to the establishment of debt ceiling under the constitution. This applies for a limited number of countries such as Hungary and Poland. The prescription of the ceiling in the constitution makes the debt ceiling rule more permanent and not subject to arbitrary changes, given that the procedures for constitutional amendments are often more stringent than for ordinary laws. However, in instances of economic challenges, the rigidities may lead to unintended consequences, which should be carefully considered.
- ***Statutory ceiling:*** Refers to the establishment of the debt ceiling under statute, such as the public debt law, fiscal responsibility law or budget/public finance management law. The level of flexibility provided in the case of a statutory debt ceiling may be slightly higher than under the Constitution given that Parliament may typically amend such statutory ceilings.
- ***Annual ceilings set by Parliament:*** In some countries (Argentina, Brazil, Canada, Japan, New Zealand, and Spain), parliament is empowered to establish debt ceilings under the annual Budget/Appropriations Act. The U.S. before the coming into force of the 1974 Congressional Budget Act, required the House of Representatives to pass a resolution to approve the annual debt limit, with the budget.
- ***Ministerial action:*** Some jurisdictions provide much more flexibility by empowering the Minister of Finance to periodically set the debt ceiling by secondary legislation. This may however leave too much discretion in the hands of the Minister, especially where there is no requirement for Parliament to affirm such regulations.

Adapted from IMF Working Paper (2015)

In 2013, the EAC Monetary Union Protocol, signed by the regional Heads of State, set a 50 per cent debt-to-GDP ratio as the convergence criteria for the attainment of a single currency regime. Borrowing from that, the Legal Notice No. 34 of 2015 set the overall debt limit for national government at 50 per cent of the Net Present Value (NPV) of GDP and for county governments at 20 per cent of the audited total annual revenue and approved by the county assembly. However, in 2019, Parliament scrapped off the debt ceiling pegged to GDP and set the debt ceiling to Ksh 9 trillion. Further, Parliament revised the debt ceiling to Ksh 10 trillion in 2022. The amendment was envisioned to create more room for external borrowing as domestic borrowing crowded out private sector borrowers since the government is deemed to be risk-free with guaranteed returns.

The Budget Statement for 2022/23 proposed for the replacement of current legal numerical public debt ceiling with a debt anchor set at 55 per cent of debt

to GDP in present value terms. It was noted that the current legal numerical public debt ceiling constrained public funding of projects while not considering the effects of external shocks of the economy. The proposed debt ceiling is in line with internationally accepted conventional practice and is envisaged to entrench accountability and transparency in public debt management while ensuring that debt remains within sustainable levels.

Key Messages

1. Kenya has a sound legal framework for public debt management that is laid out in the Constitution of Kenya 2010, the Public Finance Management (PFM) Act 2012 and PFM Regulations 2016. The Constitution of Kenya, 2010 grants the authority for all government borrowing to the Cabinet Secretary, National Treasury subject to parliamentary approval.
2. Public debt management is guided by the Medium-Term Debt Management Strategy and the Public Debt and Borrowing Policy. The policy stipulates the required documentation to be submitted annually for effective debt management.
3. The CPIA rating for Kenya was upgraded to 3.7 in 2021 from 3.6 in 2020 based on improved performance in the economic management and public sector management and institutions. However, there is need for improvement in the country's performance on quality of budgetary and financial management, fiscal policy and financial sector as the ratings were low.
4. The Constitution of Kenya, 2010, the PFM Act, 2012 and the County Governments Act, 2012 clearly stipulate the County government borrowing framework. County governments are granted a window to borrow in Section 212 of the Constitution subject to the National Government's guarantee and County government's assembly approval.
5. The National Treasury and Central Bank of Kenya, like in other jurisdictions, are the key institutions that manage public debt. However, unlike the jurisdiction, the institutions need to improve on performing the annual debt sustainability analysis for Kenya to help in assessing the country's debt performance.
6. Prudent use of debt, coupled with transparency and accountability is essential to ensure that borrowed money can achieve development goals or is spent on the intended projects so that wastage is minimised or overcome as this would enhance value for money. Nevertheless, there is limited information available publicly on the uses of public debt.

Conclusion

Efficient public sector borrowing requires an effective and transparent policy, legal and institutional framework in a country. A robust framework aids to promote discipline, transparency, and accountability, all of which are critical in achieving sustainable debt. The legal framework covers legislations for borrowing by the National government, County governments, state enterprises and for regulating and monitoring external borrowing by the private sector. The legislation is supported by regulations and procedures, which clearly outline the functions of different institutions involved in loan operations.

Kenya has a sound legal and institutional framework for public debt management laid out in the Constitution of Kenya 2010, the Public Finance Management (PFM) Act 2012 and PFM Regulations 2016. The legal documents detail the various aspects of public debt including the purpose of borrowing, management of the public debt portfolio and debt sustainability. The roles played by various institutions in debt management in Kenya compares to those of other countries.

The Constitution of Kenya, 2010 grants the authority for all government borrowing to the Cabinet Secretary, National Treasury subject to Parliamentary approval. The Parliament of Kenya, like many of other jurisdictions, is responsible for approving new loans that the Government intends to acquire and approves the amount to be borrowed domestically each year as provided for in the Constitution of Kenya, 2010 and the PFM Act, 2012. In addition, the County governments are granted a window to borrow in Section 212 of the Constitution subject to the National Government's guarantee and County government's assembly approval.

Recommendations

1. It is important for the various institutions managing debt to conduct Debt Sustainability Analysis for the country annually. This will be instrumental in assessing the current country's debt portfolio and the potential for future borrowing that will place the country on a sustainable debt path over the medium term.
2. While the Kenyan PDM allows for contingent liabilities, guarantees, and loans, it does not provide a comprehensive cover of other contingent liabilities. As such, it is important to increase the scope of such liabilities to cover liabilities that arise from court judgements, natural disasters such as flooding and droughts.
3. Therefore, there is need for consistency in reporting the public debt and its purpose to promote transparency and accountability while providing information that may be used for policy analysis and recommendation.

4. Debt Sustainability Analysis

Debt sustainability analysis (DSA) became operational in 2002 based on IMF proposed framework that captured existing best practices in the assessment of fiscal and external sustainability analysis. DSA is basically the ability of the country to service its debt obligations as they mature. Debt sustainability assessments are considered to determine access to IMF financing, and for the design of debt limits in Fund-supported programmes. The World Bank uses it to determine the share of grants and loans in its assistance to each LIC and to design non-concessional borrowing limits. Kenya's external debt as a ratio of GDP is projected to decline over the horizon from 49.4 per cent in 2021 to 38.4 per cent in 2028 and decline further to 33.0 per cent by 2038. The sustainability indicators for Kenya are shown to improve (or decline) over time. Total public debt as a share of GDP remains well below the LIC DSA public debt benchmark. However, the DSA finds that Kenya's risk of external debt distress has increased from low to moderate due to rising refinancing risks and narrower safety margins. The framework for DSA is a comprehensive tool for analyzing the debt sustainability for a country, However, it has a few challenges that include: the DSA does not capture domestic debt as a component on its own; some of the assumptions require to be reviewed and capture Kenya's stylized facts to give room for a more realistic future projection; only provides for data on the central and general government in its public debt coverage and leaves out the county governments borrowing requirements to fulfill their budgetary operations. Therefore, an optimal or break-even point for public debt in Kenya is required to guide policy makers in the future borrowing plans.

4.1 Introduction to Debt Sustainability

The issue of debt sustainability has attracted a lot of attention in Kenya owing to the rising trends of debt stock in Kenya over the last decade. Kenya's debt has been sustainable and continues to be so based on various DSA frameworks undertaken by the World Bank and IMF beginning 2002 to the latest series of January 2022. Kenya's risk rating as of June 2022 has also declined from B+ to B (stable outlook) by the Standard and Poor's. However, the risk ratings by Fitch and Moody's were B+ (negative outlook) and B2 (negative outlook), respectively.

Debt sustainability deals with the ability of a country to service its debt obligations as they fall due. According to the IMF, a country's public debt is considered sustainable if the government can meet all its current and future payment obligations without exceptional financial assistance or going into default. Countries resort to borrowing whenever their revenues fall short of their development and recurrent expenditure needs. Debt sustainability analysis has to do with the ability to raise domestic revenue mainly through taxation, ensuring fiscal discipline and consolidation to avoid non-essential expenditures, and managing deficit financing. This chapter focusses on Kenya's debt sustainability analysis over time, making use of DSA frameworks prepared by the World Bank and IMF, offers a

discussion of the frameworks, a review of the framework for Kenya, and policy recommendations towards DSA for Kenya.

Given the importance of borrowing to help plug fiscal deficit and at the same time ensure debt is sustainable, countries are forced to make critical decisions regarding borrowing. For instance, decisions on whether the country should go for commercial vis-à-vis concessional loans, whether to go East or West for lenders, whether to take advantage of debt relief provisions, all play in arriving at debt levels that may be sustainable or not in the medium to long term. Kenya is yet to develop a debt sustainability framework that would help provide insights on her debt sustainability analysis (DSA). Given the limited domestic capacity for undertaking debt sustainability analysis, the chapter also argues for more capacity building for the debt management office and other relevant stakeholders to undertake debt sustainability analysis, and then presents a suggestion for a locally agreed Kenya DSA.

4.2 Debt Sustainability Frameworks and Analysis

This section presents a discussion on the frameworks and analysis of debt sustainability. The focus areas are: the evolution of the frameworks and debt sustainability analysis, analysis frameworks for debt sustainability by IMF and World Bank, other approaches used for debt sustainability analysis, understanding the debt sustainability framework, and the IMF assessment of Kenya's debt sustainability.

4.2.1 Evolution of the debt sustainability analysis and framework

The IMF's approach to debt sustainability analysis differentiates between market-access countries (MACs) and low-income countries (LICs). MACs are those that typically have significant access to international capital markets or have durable access to external market financing. The LICs on the other hand meet their external financing needs mostly through concessional resources. These assessments are performed through standardized templates.

Debt sustainability analysis (DSA) became operational in 2002. In the June 2002 framework, the IMF proposed a framework that builds on existing best practices in the assessment of fiscal and external sustainability based on the staff's baseline medium-term projections. However, the framework had a few limitations: the indicators used were not standardized and their interpretation was not clear and that there was need to undertake sensitivity tests in a more integrated and systematic manner (IMF, 2002). The framework was therefore refined in June 2003 (IMF, 2017).

Another framework, the joint IMF-World-Bank Debt Sustainability Framework for Low-Income Countries (LIC DSF), was introduced in July 2005. The LIC DSF classifies countries based on their assessed debt carrying capacity, estimates threshold levels for selected debt burden indicators, evaluates baseline projections

and stress test scenarios relative to the estimated thresholds, and combines indicative rules and judgements to assign ratings for risk of debt distress. This framework was further reviewed in 2006, 2009 and 2012. The 2012 framework was revised to capture country heterogeneity where applicable (IMF, 2017). Therefore, the benchmarks for present value of debt as a per cent of GDP in the 2012 review were 38 per cent for weak, 56 per cent for medium and 74 per cent for strong.

A framework for public debt sustainability analysis for advanced and emerging market economies was reformed in 2011. The 2011 framework proposed having a broad coverage as possible for public debt and adopting a risk-based approach to DSA for all market access countries. Furthermore, it proposed to integrate the assessment of debt structure and liquidity issue into the DSA (IMF, 2011).

Revised thresholds for public and publicly guaranteed external debt were later introduced in May 2013. This framework saw the revision to the benchmarks for total public debt, revised guidance on incorporating remittances, an additional "probability approach" that uses country specific information to help determine the risk of external debt distress; and a new assessment of the overall risk of debt distress (IMF, 2013). This was then followed by the publication of a new DSA template in March 2014.

The IMF Executive Board further proposed some reforms following a review of the LIC DSF. The 2017 Board reviewed the 2012 benchmarks for the present value of public debt as a percentage of GDP as 35 per cent for weak, 55 per cent for medium and 70 per cent for strong. The changes included a revised approach to the assessment of countries' debt carrying capacity based on an expanded set of variables; adjustments to the methodology designed to improve the framework's accuracy in predicting debt distress; new tools prepared to help shed light on the plausibility of underlying macroeconomic projections; tailored stress tests to help better evaluate specific risks of particular relevance for some countries; and a reduction in the number of debt thresholds and standardized stress tests. This framework became operational in 2018.

Further reforms were introduced in July 2018, which included: (i) moving away from relying exclusively on the World Bank's Country Policy and Institutional Arrangement (CPIA) to classify countries' debt-carrying capacity, and instead using a composite measure based on a set of economic variables; (ii) introducing realism tools to scrutinize baseline projections; (iii) recalibrating standardized stress tests while adding tailored scenario stress tests on contingent liabilities, natural disasters, commodity prices shock, and market-financing shock; and (iv) providing a richer characterization of debt vulnerabilities (including those from domestic debt and market financing) and better discrimination across countries within the moderate risk category (IMF, 2020).

More recently, the IMF Executive Board in 2021 approved a new framework for debt sustainability for market access countries (MAC). The refinement for DSA framework has been classified into New Public MAC DSA for lower scrutiny countries and another for higher scrutiny countries. For lower scrutiny countries, information provided relates to debt, economic and market indicators,

contribution to changes in public debt, debt-creating flows, and the composition of public debt and alternative scenarios. For the case of higher scrutiny countries, additional information is provided relating to inclusion of a heat map, debt profile vulnerabilities, and evolution of predictive densities of Gross Nominal Public Debt.

4.2.2 Analysis of debt sustainability framework by IMF and World Bank

The IMF framework for conducting public and external debt sustainability for 2002 consisted of two complementary components: the analysis of the sustainability of total public debt, and that of total external debt. Each component includes a baseline scenario, based on a set of macroeconomic projections that articulate the government's intended policies, with the main assumptions and parameters clearly laid out; and a series of sensitivity tests applied to the baseline scenario, providing a probabilistic upper bound for the debt dynamics under various assumptions regarding policy variables, macroeconomic developments, and financing costs. The paths of debt indicators under the baseline scenario and the stress tests allow to assess the vulnerability of the country to a payment crisis.

Additionally, two types of frameworks were designed: those for market-access countries and those tailored for low-income countries. Since then, these frameworks have been regularly refined mainly to enhance greater discipline to the analysis and responding to the changing economic and financial environment.

The DSAs focus on three core elements: an analysis of a country's projected debt burden over the next 20 years and its vulnerability to external and policy shocks; an assessment of the risk of external debt distress in that time, based on indicative debt burden thresholds that depend on the quality of the country's policies and institutions; and recommendations for a borrowing (and lending) strategy that limits the risk of debt distress.

Countries have different abilities to handle debt, based on their varying policy and institutional strengths, macroeconomic performance, and availability of buffers. In addition to the debt-carrying capacities, classified as strong, medium, and weak, there is also a composite indicator, which draws on the country's historical performance and outlook for real growth, reserves coverage, remittance inflows, and the state of the global environment. Furthermore, there is the World Bank's CPIA index. In general, countries with good macroeconomic performance and policies can handle greater debt accumulation as they will have a stronger debt carrying capacity (DCC). Table 4.1 presents the debt burden thresholds and benchmarks based on various debt carrying capacities.

Table 4.1: Debt burden thresholds and benchmarks under the DSF

Debt carrying capacity	PV of external debt in per cent of		External Debt service in per cent of		PV of total public debt in per cent of
	GDP	Exports	Export	Revenue	GDP
Weak	30	140	10	14	35
Medium	40	180	15	18	55
Strong	55	240	21	23	70

Data Source: IMF (2021) Report

Debt sustainability assessments are considered to determine access to IMF financing, and for the design of debt limits in Fund-supported programmes, while the World Bank uses it to determine the share of grants and loans in its assistance to each LIC and to design non-concessional borrowing limits.

4.2.3 Other approaches for assessing debt sustainability.

Apart from the debt sustainability analysis approaches proposed by the IMF and the World Bank, there are three other approaches as highlighted by the literature on debt sustainability. These include: the debt-stabilizing primary balance (see Ncube and Brixiova, 2014), the estimation of linear and non-linear fiscal reaction functions (see Bohn, 998), and the testing for the cointegration between government revenue and expenditure (see Hakkio and Rush, 1991).

The debt-stabilizing primary balance approach aims to identify the primary balance to achieve a chosen debt path, given the assumptions about the evolution of the real interest rate and growth. The empirical framework approach by Bohn estimates fiscal reaction functions which characterize the dynamics of sustainable debt and primary balances (Erasmo, Mendoza and Zhang, 2016). Debt sustainability also has to do with the stability of the exchange rate, particularly for public debt denominated in foreign currency. Several countries in Sub-Saharan Africa may have been pushed beyond their debt sustainability thresholds due to exchange rate volatility, which adversely affects the costs of debt servicing (IMF, 2020).

This chapter therefore argues for the adoption of additional debt sustainability analysis available in addition to the one proposed by the IMF and World Bank as a way of offering consistency checks and comparisons of the debt sustainability for countries. More research into other debt sustainability analyses is therefore vital, and also capacity building for the debt management office and other relevant stakeholders towards undertaking various forms of DSA and having a locally agreed DSA for Kenya.

4.2.4 Understanding the debt sustainability framework

The LIC DSF template is an Excel-based tool with a macroeconomic framework

which analyzes scenarios based on user inputs. The inputs consist of historical data and interrelated projections of key macroeconomic variables, known as the baseline scenario. The macroeconomic framework has both the baseline scenario and alternative scenarios. In addition is the financing strategy that is consistent with the macroeconomic framework. The aim of the LIC DSF is to support efforts by low-income countries to achieve their development goals, while minimizing their risk of experiencing debt distress. Since 2013, many countries have witnessed an increased risk of debt distress and over two-fifths of these countries are facing debt challenges. Debt Sustainability Analyses (DSAs) help to assess debt vulnerabilities by producing public and external DSAs and guide in borrowing and lending decisions.

The DSF has several interlinked sheets that have various functionalities, each aimed at providing the final debt sustainability position for a country. However, the key sheets include Basics, Debt Coverage, Macro-Debt data, External Financing, Local-debt Financing, Sheets for stress tests, Residual Financing, the Composite Indicator Summary, Realism sheets and a few Output sheets.

Reflecting on a comprehensive review of 2017, DSAs conducted under the DSF consist of:

1. Composite indicator to assess a country's debt-carrying capacity drawing on a set of country-specific and global factors (including institutional strength measured by the World Bank calculated on the CPIA score).
2. Realism tools to facilitate closer scrutiny of the baseline projections.
3. A standardized forward-looking analysis of the debt and debt service dynamics under a baseline scenario and in the face of plausible shocks, where the scale and interactions of shocks are calibrated to country experience.
4. Newly introduced tailored stress tests to better evaluate country-specific risks stemming from contingent liabilities (consistent with the coverage of public sector debt), natural disasters, volatile commodity prices, and market-financing shocks; and
5. Modules provide a richer characterization of debt vulnerabilities (from domestic debt and market financing) and better discrimination across countries within the moderate risk category.

On the basis of these thresholds and benchmark, DSAs include an assessment of the risk of external and overall debt distress based on four categories: **low risk** (when there are no breaches of thresholds); **moderate risk** (when thresholds are breached in risk scenarios); **high risk** (when thresholds are breached in the baseline scenario); and in **debt distress** (when a distress event, like arrears or a restructuring, has occurred or is considered imminent).

The DSF separately tracks the evolution of the *external liabilities* of a country (both public and publicly guaranteed (PPG) debt, and private non-guaranteed debt) and analyzes the *public sector's debts* (external and domestic) against key ratios. The DSF then assesses a country's repayment capacity over a long-term horizon by using debt ratios and conducting stress tests.

4.2.5 IMF assessment of Kenya's debt sustainability

The DSF for Kenya covers the public sector comprising of Central Government, General Government particularly social security fund, guarantees to other entities in the public and private sector, and central bank borrowing on behalf of the government. It also consists of the private sector. The framework assumes a constant discount rate of 5 per cent.

The DSA is also customizable by the user to design shocks to the main fiscal variables that determine debt dynamics for both public debt and external debt. The current DSA of 2021 provides output for external and public DSA with the actual period for 2015-2017, and projections for 2021-2041. Based on the DSA framework for Kenya (2021), the outputs for the external DSA and the public DSA are presented in Table 4.2.

Table 4.2: The IMF's external debt sustainability framework for Kenya, baseline scenario, 2019-2042

	Actual			Projections								Average	
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2032	2042	Historical	Projections
External debt (nominal) 1/	52.6	60.0	60.3	61.5	62.9	65.1	66.5	67.3	68.7	70.3	66.7	46.5	67.5
of which: public and publicly guaranteed (PPG)	30.3	35.4	34.5	35	34.4	33.6	33.1	32.6	32.7	31.8	24.0	26.0	33.0
Change in external debt	2.6	7.4	0.3	1.2	1.4	2.2	1.4	0.8	1.4	-0.2	-0.7		
Identified net debt-creating flows	0.8	3.9	-0.1	2.1	1.5	1.1	0.6	0.5	0.3	-1.2	-1.9	2.1	0.3
Non-interest current account deficit	4.0	3.6	4.0	4.3	3.6	3.6	3.4	3.3	3.4	2.8	3.1	5.5	3.4
Deficit in balance of goods and services	8.9	7.9	9.1	9.6	9.1	8.9	8.6	8.5	8.6	7.4	6.8	10.1	8.5
Exports	11.4	9.6	10.7	12	12.8	13.3	13.7	14.0	14.2	16.9	25.7		
Imports	20.3	17.6	19.8	21.6	22	22.2	22.3	22.5	22.9	24.3	32.4		
Net current transfers (negative = inflow)	-5.3	-4.9	-5.5	-5.8	-5.9	-5.9	-5.9	-6.0	-6.1	-6.2	-6.5	-5.1	-6.0
of which: official	0	0	0	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	0		
Other current account flows (negative = net inflow)	0.4	0.6	0.5	0.4	0.4	0.5	0.7	0.8	0.9	1.5	2.8	0.5	0.9
Net FDI (negative = inflow)	-0.4	-0.6	0	-0.6	-0.8	-0.9	-1.1	-1.2	-1.3	-2.0	-2.9	-0.9	-1.3
Endogenous debt dynamics 2/	-2.8	0.8	-4.0	-1.6	-1.3	-1.5	-1.6	-1.7	-1.9	-2.0	-2.2		

Contribution from nominal interest rate	1.2	1.2	1.2	1.4	1.8	1.8	1.7	1.7	1.6	1.7	1.4		
Contribution from real GDP growth	-2.4	0.1	-4.1	-3	-3.1	-3.3	-3.3	-3.4	-3.5	-3.7	-3.5		
Contribution from price and exchange rate changes	-1.7	-0.4	-1.1	...	...	...	...	...	...	...	...		
Residual 3/	1.8	3.6	0.3	-0.8	-0.1	1.0	0.8	0.3	1.1	1.0	1.2		
of which: exceptional financing	0	0	-0.5	0	0	0	0	0	0	0	0		
Sustainability indicators													
PV of PPG external debt-to-GDP ratio	...	...	27.4	26.6	26.8	26.1	25.6	25.1	25.0	24.2	17.7		
PV of PPG external debt-to-exports ratio	...	...	256.1	221.5	208.6	195.9	186.5	179.8	175.4	143.4	68.8		
PPG debt service-to-exports ratio	35.0	25.8	23.5	22.6	20.5	29.6	21.2	19.2	15.8	14.5	7.3		
PPG debt service-to-revenue ratio	23.8	15.1	15.3	15.7	15.2	22.3	16.5	15.2	12.6	13.3	9		
Gross external financing need (Million of U.S. dollars)	24,024	22,467	23,437	25,575	26,016	28,701	28,551	29,626	30,403	36,776	56,928		

Source: Kenya DSA Framework (2022)

Based on Table 4.2, Kenya's external debt as a ratio of GDP is projected to rise gradually over the horizon from 62.9 per cent in 2023 to 70.3 per cent in 2032 before declining to 66.7 per cent by 2042. The sustainability indicators, which are shown in the lower part of the table, are shown to improve (or decline) over time. In sum, the DSF baseline scenario for 2019 to 2042 points to an improving external debt position for Kenya for the 20-year projection period. The analysis for public debt sustainability over the baseline scenario for 2019 to 2042 is presented in Table 4.3 as follows:

Table 4.3: The IMF's public sector debt sustainability framework for Kenya, baseline scenario, 2019-2042

	Actual			Projections								Average	
	2019	2020	2021	2022	2023	2024	2025	2026	2027	2032	2042	Historical	Projections
Public sector debt 1/	59.1	68.0	67.8	68.6	67.0	64.9	63.0	61.1	59.6	51.0	30.0	52.0	59.7
of which: external debt	30.3	35.4	34.5	35.0	34.4	33.6	33.1	32.6	32.7	31.8	24.0	26.0	33.0
Change in public sector debt	2.6	8.9	-0.1	0.7	-1.6	-2.1	-1.9	-1.9	-1.5	-1.8	-2.3		
Identified debt-creating flows	2.3	7.8	0.6	-2.4	-2.3	-2.2	-2.0	-2.1	-2.1	-2.4	-2.8	2.6	-2.3

Primary deficit	3.4	3.8	2.7	1.4	0.3	-0.5	-0.8	-0.8	-0.9	-0.9	-1.3	3.5	-0.6
Revenue and grants	17.0	16.7	16.7	17.5	17.6	17.9	18.0	17.9	18.1	18.7	21.0	17.3	18.2
of which: grants	0.2	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3		
Primary (non-interest) expenditure	20.4	20.4	19.4	18.8	18.0	17.4	17.2	17.1	17.2	17.8	19.7	20.8	17.6
Automatic debt dynamics	-1.2	4.0	-2.1	-3.7	-2.6	-1.6	-1.2	-1.2	-1.2	-1.5	-1.4		
Contribution from interest rate/ growth differential	-0.4	2.8	-3.0	-3.7	-2.6	-1.6	-1.2	-1.2	-1.2	-1.5	-1.4		
of which: contribution from average real interest rate	2.4	2.6	1.7	-0.3	0.7	1.9	2.2	2.1	1.9	1.2	0.2		
of which: contribution from real GDP growth	-2.7	0.1	-4.8	-3.4	-3.3	-3.5	-3.4	-3.3	-3.2	-2.8	-1.7		
Contribution from real exchange rate depreciation	-0.8	1.2	0.9	...	...	...	...	...	...	...	...		
Other identified debt-creating flows	0	0	0	0	0	0	0	0	0	0	0	0	0
Privatization receipts (negative)	0	0	0	0	0	0	0	0	0	0	0		
Recognition of contingent liabilities (e.g., bank recapitalization)	0	0	0	0	0	0	0	0	0	0	0		
Debt relief (HIPC and other)	0	0	0	0	0	0	0	0	0	0	0		
Other debt creating or reducing flow (please specify)	0	0	0	0	0	0	0	0	0	0	0		
Residual	0.4	1.1	-0.7	3.1	0.7	0.1	0.1	0.1	0.7	0.6	0.5	0.7	0.7
Sustainability indicators													
PV of public debt-to-GDP ratio 2/	...	...	61.6	61.7	60	57.8	55.9	54	52.5	44	24.1		
PV of public debt-to-revenue and grants ratio	...	...	368.7	353.1	340.4	322.5	310.9	301	289.6	235.3	114.9		
Debt service-to-revenue and grants ratio 3/	57.4	54.1	55.9	52	57	62.7	54.5	49.9	43.9	39.1	17		
Gross financing need 4/	13.2	12.8	12.1	10.5	10.4	10.7	9	8.1	7.1	6.4	2.3		

Source: Kenya DSA Framework (2022)

Based on Table 4.3, Kenya's public sector debt as a ratio of GDP is projected to decline over the horizon from 68.6 per cent in 2022 to 51.0 per cent in 2032 and

decline further to 30.0 per cent by 2042. The sustainability indicators, presented on the lower part of the table, are also shown to improve (or decline) over time. For instance, the present value of public debt to GDP ratio is shown to decline from 60.0 per cent in 2023 to 44.0 per cent in 2032, and a further decline to 24.1 per cent in 2042. Therefore, as was the case with external debt, the analysis of public debt also shows an improving debt position over the projection period. Consequently, the total debt position is expected to improve.

4.3 Kenya Debt Sustainability Analysis

The Government through the National Treasury endeavors to maintain public debt and obligations at sustainable levels in line with section 15 (2) (d) of the Public Finance Management (PFM) Act, 2012. Public debt sustainability is the ability of a country to service its debt obligations as they fall due without disrupting its budget implementation. The objective of ensuring Kenya's debt is sustainable is vested under the National Treasury and Economic Planning, specifically the Debt Management Office. Furthermore, the national parliament also offers oversight on public borrowing and spending and formulating legislation that affects public debt in Kenya.

The sustainability of Kenya's public debt depends on macroeconomic performance, fiscal deficits, and stability in general prices levels (exchange rate, inflation, and interest rates). External financing on both concessional and non-concessional terms poses foreign exchange risk. The country is therefore exploring fiscal policy and monetary policy to achieve debt sustainability going forward. Specifically, the government currently aims to gradually bring down the fiscal deficit through additional revenue raising measures aimed at reducing the debt to GDP ratio. For instance, the draft 2023/24 budget submitted to Parliament proposes to further reduce the deficit from 5.7 to 4.1 per cent of GDP. On the monetary side, the monetary policy has also been tightened, with the central bank policy rate having increased by 250 basis points over the past year (IMF, 2023).

The rising interest rate environment in the international debt capital markets may increase the cost of refinancing existing maturing debt and overall cost of borrowing. Contracting new debt on short term maturities increases the refinancing risk. However, with the present fiscal consolidation efforts, the Government aims to contain the fiscal deficits and hence reduce the debt ratios. To reduce the refinancing risk, the Government's strategy is to actively restructure public loans by contracting external and domestic loans of longer-term maturities.

Total public debt as a share of GDP remains well below the LIC DSA public debt benchmark. Under the baseline and all stress scenarios, debt remains below the benchmark of 74 per cent of GDP in PV terms. This is the benchmark applicable for LICs whose CPIA score for quality of policies and institutions is assessed as strong and covers the entire public sector. In Kenya, public debt does not include legacy debts of the pre-devolution county governments (whose size is not yet fully clear) and borrowings of state-owned enterprises. In addition, public debt should include planned annuities intended to finance road construction; although the

annuity obligations may not necessarily be classified as debt under local law, they nevertheless represent public debt obligations according to international (GFS) methodology.

In consensus with international practices, Kenya formulated a Medium-Term Debt Management Strategy (MTDS) in 2014, which will ensure the country is able to service its debt in the short, medium, and long-run without renegotiating or defaulting, and without having to undertake major policy adjustments. MTDS is tasked with responsibilities to ensure public debts are sustainable at any given time so as to install confidence on creditors that the government will be able to borrow and pay all its debts on time.

In maintaining sustainable debts, MTDS is mandated to advice the government of cheap financing options and debts levels the government should hold at income given time, through evaluation of current and future projections of total government revenue and economic growth. In the Debt Sustainability Framework (DSF), countries are classified into one of three policy performance categories (strong, medium, and poor) using the World Bank's Country Policy and Institutional Assessment (CPIA) index, which uses different indicative thresholds for debt burdens depending on the quality of a country's policies and institutions, where Kenya is rated a strong performer.

Debt sustainability analysis (DSA) utilizes three key indicators in its evaluation and include: the present value of debt as a share of GDP, present value of debt to revenue ratio and present value of debt service to revenue ratio. Through DSA, a country can gain insights on what to incorporate when designing its fiscal policy. According to Kenya's debt ratios, it shows that external debt of the country rated as a strong performer, is within sustainable levels over the medium term. This DSA for Kenya's risk of external debt distress changed from low to moderate due to rising refinancing risks and narrower safety margins, according to IMF country report 2018. Furthermore, the DSA for 2021 showed that the market financing pressures module ranks market liquidity risks as moderate (IMF, 2022).

External debt to exports and debt service-to-exports ratios, for the projected period, indicates a breach as per the set thresholds, although such breaches are temporary and marginal since they are related to bullet Eurobond repayment, against the background of Kenya's continued access to international markets and a comfortable level of official foreign reserves. In addition, the authorities are strengthening their debt management capacity to manage and prepare for large repayments on commercial borrowing. As part of this strategy, the authorities are expected to refinance loans to longer maturities and borrowing concessional loans, which have lower cost and longer maturity period vice verse non-concessional loans, which are expensive to maintain due to high interest rates and short period tenure. If the country must borrow non-concessional loans, they should only be limited to finance projects with high social and economic returns.

Table 4.4: Kenya's external debt sustainability

Indicators for medium DCC	Thresholds	2020	2021	2022	2023	2024	2025
PV of debt–to-GDP ratio	**40**	27.1	28.2	27.2	26.9	25.9	25.6
PV of debt-to-exports ratio	**180**	280.1	278.5	241.7	225.6	207.5	198.8
PPG debt service-to-exports ratio	**15**	24.7	21.6	23.7	19.5	28.8	17.4
PPG debt service-to-revenue ratio	**18**	14.6	13.6	16.0	13.3	20.0	12.2

Data Source: IMF Country Report No. 21/275, December 2021 and Republic of Kenya (2022)

Other than external debt, the key indicators show that total public debt is also sustainable in the medium term. Table 3 tabulates the key parameters (present value of public debt to GDP ratio, present value of public debt to revenue ratio and public debt service to revenue ratio) that are used to analysis public debt sustainability by the IMF. As at 2023, Kenya failed to meet three thresholds; these were: PV of debt-to-GDP ratio, PV of debt-to-exports ratio, and PPG Debt service-to-revenue ratio, which were at 26.9, 225.6 and 13.3 against thresholds of 40, 280.1, and 18, respectively. However, the thresholds for PV of debt-to-revenue ratio and PPG Debt service-to-exports ratio were met.

Analysis of Kenya's public debt sustainability indicates that total public debt as a proportion of GDP peaks in 2022 (due to expenditure on infrastructure) and gradually decreases over the medium term. High debt levels were driven by higher execution of debt financed projects that are expected to raise growth in output and exports in the long term, both of which will support Kenya's public debt sustainability.

Under the baseline, public debt remains below the benchmark of 74 per cent of GDP in PV terms, while the path of the public debt-to-revenue and public debt service-to-revenue ratios are projected to decline in the longer term with public debt service-to-revenue ratios above the threshold of 30 per cent of revenue in PV terms. Going forward, the authorities will need to remain committed to their medium-term plans of gradual adjustment since public debt service to revenue and exports ratios might grow out of bound resulting from uncontrolled public debt stock.

Table 4.5: Kenya's public debt sustainability

Indicator	Threshold	2020	2021	2022	2023	2024	2025
PV of public sector debt to GDP ratio	**55**	60.3	61.7	62.2	61.2	59.2	56.3
PV of public sector debt to revenue ratio	**300**	362.8	375.5	364.5	343.7	323.9	300.8
Debt service to revenue and grants ratio	**30**	53.7	51.8	58.2	56.0	58.1	46.8

Data Source: IMF Country Report No. 21/275, December 2021 & Republic of Kenya (2022)

Table 4.5 also shows that whereas Kenya is still achieving the thresholds for public debt sustainability on the three indicators shown, the projections to 2025 appear to decline and hence narrowing closer to the thresholds. For instance, by 2025, if the projections are to be achieved and thresholds remain unchanged, the country's PV of public sector debt to revenue ratio will just be at the threshold. However, given the current administration's demonstration of debt sustainability and fiscal consolidation, and if this is sustained for the medium term, it is expected that the projections going forward might improve for Kenya, if the IMF Analysis was to be done for 2023 and beyond.

More recently, beginning June 2022, the IMF has adopted the Sovereign Risk and Debt Sustainability Framework (SRDSF), which replaces the Debt Sustainability Framework for Market Access Countries. The SRDSF introduces improvements in organization, methodology, transparency, and communication when analyzing public debt issues in countries that mainly finance themselves with market-based debt. The SRDSF will hence become the Fund's principal tool for assessing public debt sustainability. It will also help to support the Fund's surveillance and lending functions and incorporates several tools that analyze debt risks at various times (IMF, 2022). This means that there is need for capacity building for country staff involved in debt issues to enable them to better understand debt issues and how to conduct debt sustainability analysis.

4.4 Kenya Debt Payment Obligations and Relief Measures

Debt payment is an obligation that an indebted country should undertake as its debts fall due. If the country is unable to finance its debt obligations, it is said to have defaulted. Kenya has not defaulted on its debt obligations, and the current administration under President William Ruto has reaffirmed its commitment to make good its debt obligations as they fall due. While payment of debt obligations comes along with limited fiscal space for the country, it is an important move to prevent the country being rated even much lower in terms of credit worthiness and which may also lead to debt distress. Beginning 2023, Kenya is facing a strain

of servicing debt obligations, since most of its debt, especially domestic debt were falling due at the same time (IMF, 2023).

Historically, countries have sought debt relief and other debt restructuring measures to help them deal with their debt crisis problems. The two key debt relief measures were the Highly Indebted Poor Countries (HIPC) introduced by the World Bank in 1996, and its complementary, the Multilateral Debt Relief Initiative (MDRI) introduced in the IMF in 2005. In addition, the Catastrophe Containment and Relief Trust (CCRT) adopted by the IMF in 2015 was created to offer grants for debt relief for the poorest and most vulnerable countries hit by catastrophic natural disasters or public health disasters. As of January 2023, 36 countries were in the post-completion point, 2 countries were between decision and completion point (or interim countries), while 1 country (Eritrea) was in the pre-decision point. However, Kenya has not yet benefited from debt relief measures under HIPC, MDRI nor CCRT. Furthermore, the country has no intentions of restructuring her debt, given the nature of negotiations involved towards debt restructuring.

Another aspect that could help improve a country's debt sustainability position are the special drawing rights (SDRs). The SDR is an interest-bearing international reserve asset created by the IMF in 1969 to supplement other reserve assets of member countries. The SDRs became particularly useful during the recent COVID-19 pandemic, which saw many countries requesting for more allocations from the IMF to help them effectively deal with the pandemic. However, the SDR allocations are awarded based on quotas to IMF member countries and are determined by the Fund. SDRs do not change any country's net wealth, but they represent a sizable injection of liquidity into the economy, thus supplementing public revenues. Furthermore, SDRs can be converted into cash and the cash used to pay down debt (Kharas and Dooley, 2021).

SDRs can be a mechanism to replace more expensive debt with cheaper debt, improving country creditworthiness. For instance, 55 countries (including Angola, Argentina, Bangladesh, Côte D'Ivoire, Dominica, Ecuador, Egypt, Iraq, Pakistan, Samoa, and Tunisia) have opted to finance their debt service obligations to IMF with SDRs worth US$ 6.5 billion (Arauz and Cashman, 2022). Several countries have, however, made proposals to the IMF to improve its SDR allocation quotas since they tend to benefit developed countries more, at the expense of developing and low-income countries which are in more need. For example, the African continent received SDR worth US$ 34 billion dollars against a global injection of US$ 660 billion. As of 30th April 2023, Kenya had a cumulative net allocation of SDR 779.9 million and holdings of SDR 409.86 million.

During the recent COVID-19 pandemic, countries throughout the world sought debt relief measures to enable them have resources aimed at fighting the pandemic. The IMF and World Bank, under the G20 common framework, introduced the Debt Service Suspension Initiative (DSSI) in May 2020. The DSSI was meant to offer temporary relief to poor countries for debt service payment obligations. By the expiry of DSSI in December 2021, DSSI had benefitted 48 of the 73 eligible countries

helping them to concentrate their resources towards fighting the pandemic. The initiative suspended US$ 12.9 billion in debt service payments owed by participating countries to their creditors (IMF, 2023). Kenya participated in the DSSI with an estimated potential DSSI savings between January and December 2021 of US$ 1,189.5 million. Furthermore, the Paris Club creditors provided debt rescheduling options and debt service relief options to their member countries. In 2021, the Paris Club approved Kenya's request for 6-months debt relief worth Ksh 32.9 billion. It also received debt service suspension from China worth Ksh 27 billion.

More recently, the IMF has developed the Resilience and Sustainability Trust (RST), which is aimed at helping countries to tackle the challenges of climate change, build resilience to external shocks, and ensure sustainable growth (IMF, 2022). As of 18th April 2023, a total of SDR 25.1 billion, or equivalent to US$ 33.8 billion have been made as contributions to countries, with 11 countries so far as beneficiaries. Beneficiary countries so far are Australia, Canada, China, France, Japan, Korea, Lithuania, Netherlands, Spain, Estonia, and Germany. Rwanda is the latest country to receive RST, the first country from Africa (IMF, 2023).

In sum, Kenya continues to make payments for its debt obligations as they fall due, and this is vital for improving its credit worthiness and ratings. Although the country did not benefit from initial debt relief measures such as HIPC, MDRI, and recently CCRT, it has received debt service suspension under the DSSI, the Paris Club creditors, and has also received SDRs for financing its expenditure needs. There is, however, need to join hands with other African countries to seek for additional SDRs allocation from the IMF, and request for other innovative debt relief measures instituted by IMF and World Bank, such as the recent Resilience and Sustainability Trust (RST).

4.5 A Review of DSA Framework (DSF) for Kenya

While the DSF is an important and comprehensive tool for analyzing the debt sustainability for Kenya, it has some few challenges that can be considered to enhance the robustness of the framework. Most significantly, the DSF does not capture domestic debt as a component on its own, given that it only focuses on external debt and total public debt. This section offers a review of the DSA framework, based on the Excel-based DSA framework, and on the literature reviewed.

A review of underlying assumptions and data updating: It has been noted that some of the assumptions require to be reviewed and capture Kenya's stylized facts to give room for a more realistic future projection. Since the projections are long term in nature going beyond 30 years, a solid assumption is required particularly on prices and discount rates. This will also include having accurate and up to date data that consist of a more refined baseline for the projections. The macro indicators utilized require to be elaborate and capture Kenya actual stylized facts and official statistics. With regard to macro data, there is need to ensure that populated data are conceptually consistent with those in debt description. The nominal GDP is in US dollars where the main concern is the exchange rate that

was used for conversion, whether it is average or for a specific period. Also notable is that the real GDP is presented in Kenya shilling in the same framework. Data consistency is required to generate a stable sustainability framework and a fair sustainability conclusion.

Debt definition and coverage: The debt definition is taking a different dimension and should reflect the debt as per the MTDS documents from the National Treasury in both external and domestic debt. The description of public debt coverage in terms of sectors needs to be as accurate as possible to yield an efficient sustainability analysis. The debt coverage at the national level is still usually lower in scope than the internationally agreed statistical definition (IMF, 2020). Based on the Excel DSA framework, public sector debt comprises of debt from several different sub-sectors. Thus, coverage of public debt includes public enterprises and local governments. The public sector is defined as central, state, and local governments, social security funds and extra budgetary funds, the central bank, and public enterprises. The second is private sector debt guaranteed by the public sector. However, the law in Kenya defines public debt as all financial obligations attendant to loans raised or guaranteed and securities issues or guaranteed by the national government (Constitution of Kenya, Article 214). Therefore, the coverage of public debt in DSA is at variance with the definition in the country's law. Additionally, the magnitude of shock used for contingent liability tailored stress tests, has the guaranteed debt allocated a default shock of 2 per cent of GDP. This is supposed to be zero per cent since the Kenyan government captures all the guaranteed debt and therefore no default shock at all. The same applies to the PPP default shock, which is set at 35 per cent of GDP. In Kenya, the PPPs is a very small component to even have any significant default shock. It is also indicated that a PPP shock is only applicable when the PPP capital stock is larger than 3 per cent of GDP. Since the size for Kenya is below one per cent, then the default shock should be zero per cent and not the 35 per cent indicated. This calls for a careful review of all the default shocks allocations for Kenya in the sustainability framework.

The interest rates phenomenon: There is inconsistency in terms of the interest rate used for computing the debt servicing levels for domestic and external debt. The interest rate specified for external debt is in nominal terms while that for domestic debt is in real terms. A clear harmonization is required for better and fair treatment of debt at all levels. This harmonization will yield a better and consistent forecast for long-term analysis. There is need to correctly capture the assumptions on borrowing terms on new PPG debt and on debt conditionalities. . More specifically, the terms of the new PPG external debt disbursements by creditor groups have specified the interest rate in nominal terms. The financing of domestic debt, however, assumes the real interest rate. It is thus not very clear as to why the two types of debt have different interest rates applied for them. Given that real interest rates are lower than nominal interest rates as they factor in the inflationary component, then the interest rate growth differential (r – g) is lower when using real interest rates. It is also known that a government can stabilize or reduce their debt ratio even in the presence of budget deficits when a lower interest rate growth differential is sustained. Thus, the motivation for using real

interest vis-à-vis nominal interest rate for external debt financing is an aspect that needs to be well elaborated.

County government borrowing not factored in: Another gap identified with the Excel-based framework is the fact that it only provides for data on the central and general government in its public debt coverage. This leaves out the second level of government, the county governments, which have borrowing requirements to fulfill their budgetary operations and finance their development projects. As county governments increasingly demand for consideration to be allowed to borrow both locally and externally, a framework that can factor the sub-national level of government would be a better framework. A framework that includes borrowing by sub-national governments, as is the case with the examples of Nigeria and South Africa, would offer better insights for Kenya in terms of her debt sustainability framework.

Uniform application of a 5 per cent discount rate: Application of a uniform 5 per cent discount rate for all countries is also considered as another limitation of the DSA framework. The integer-based discount rate is calculated based on the six-month average of the U.S. dollar commercial interest reference rate (CIRR) and includes a margin to reflect a term premium for long-term loans (worldbank.org/content/dam). The discount rate has a direct effect on the debt burden; when the discount rate is too high, it underestimates the debt burden and risks, and vice versa. Furthermore, a staff proposal for reforms was made in 2013 to move to a uniform discount rate linked to the 10-year average level of the U.S. dollar CIRR published by the OECD, as this would allow for greater stability and predictability in concessionality calculations and protect the present value of debt from cyclical fluctuation (IMF, 2013a).

Impacts of exogenous shocks: DSAs have also been criticized for downplaying the impact of exogenous shocks, unpredictable aid flows, the institutional capacity and resource constraints in LICs, and for using inappropriate measures to assess institutional and policy environments as a cause for debt distress (Nissanke, 2013). According to Caliari (2006), DSAs also ignore the human dimension to development. More specifically, they ignore the fact that debt financing is critical to providing basic needs when examining debt sustainability and the cost of servicing debt. In this vein, DSAs do not consider the fact that debt may be used to fund the SDGs and other critical infrastructure for a country. It has therefore been recommended that future DSAs consider the implications of longer-term structural challenges faced by African countries and other LICs (Rustomjee, 2018). The framework also needs to consider the country's poverty reduction plans and provisions for social protection.

The realism tools in the framework also need to be revised to make them more consistent in line with the country's economic fundamentals. The DSA framework has four realism tools to help examine the realism of the medium-term macroeconomic projections under the baseline scenario, which include checking the realism of: the drivers of debt dynamics, planned fiscal adjustment, growth and fiscal adjustment, and public investment and growth relationship. For the case of Kenya, it would be expected that the relationship between public investment and

growth would be made stronger given the recent large-scale public investments undertaken by the government. This means that the realism tools need to be revised in line with recent dynamics and adjust the framework to accommodate the changes.

Validity of sustainability assessment: Debt sustainability is an essential attribute of good macroeconomic policies, but its precise definition is elusive, and its assessment is even more challenging. The IMF has developed a sophisticated approach, but it must be recognized that because the future is unknown, any debt sustainability assessment is only valid within the bounds of the underlying guesses. There is no support for the view that added complexity allows for more precise assessments. Consequently, policy conclusions drawn from debts sustainability exercises must be considered with care. Sacrificing growth – in the short and even in the long run – to imprecisely known risks can be very costly.

Because debt sustainability is a forward-looking concept, it cannot be assessed with certainty: In that sense, debt sustainability analysis (DSA) is impossible. At best, following the DSA procedures, one can make educated guesses, but it is important to recognize at the outset that these are just guesses, no matter how sophisticated they may be. DSA can only provide probabilities. In some extreme cases, it can be 0 per cent or 100 per cent, but generally it will be somewhere in the middle; i.e., relatively not informative. Put differently, DSA is rarely black-and-white and therefore a poor guide to policy that cannot solely be guided by an event that may, or may not, happen (Wyplosz, 2007).

The Emerging Markets Bond Index (EMBI) spread is utilized in the framework, with a spread of 350 basis points for Kenya. This is a spread that is computed by J.P. Morgan. The spread is measured as the difference between the yield on a dollar-denominated bond issued by the government and a corresponding one issued by the U.S. Treasury. It would also be meaningful to understand the determination of this spread, how domestic monetary and fiscal policies affect the EMBI spread, and the interaction between the domestic exchange rate and interest rates to the EMBI spread. Most importantly, however, is the need to understand how the EMBI spread affects the cost of debt service.

The external risk rating in the DSA is assigned by comparing the projected evolution of the four PPG external debt burden indicators, both under the baseline and stress scenarios to their respective thresholds (IMF, 2018). These thresholds are set based on the countries' debt carrying capacity. The debt carrying capacity is an important parameter for setting the debt thresholds. In addition, the ability of the country to absorb the debt and utilize it may need to be considered as well in determining the thresholds for borrowing. In addition, although the DSA framework is universal, whether the framework is similar for all countries or has features that vary by country is also not clear, as this will allow countries to customize their frameworks to suit their characteristics.

Finally, **rising interest rates increase the debt burden** and reduce the probability of debt sustainability. A disturbing aspect of this linkage is that interest rates on public debts, whether in domestic or foreign currency, include a risk premium. The risk itself is related to the probability of default; i.e., to sustainability. The result is the possibility of a vicious circle that goes from a fear

of debt non-sustainability to higher interest rates and to a higher probability of non-sustainability. What makes this observation disturbing is the possibility that the mere fear of non-sustainability makes non-sustainability more likely. Debt distress can be self-fulfilling. Improper or incorrectly interpreted DSA may have a deleterious effect on debt sustainability (Wyplosz, 2007).

Conclusion and Key Messages

Debt sustainability analysis is crucial for a country, including Kenya, to ensure that debt is taken based on the country's carrying capacity and repayment ability. The IMF and World Bank have developed a DSF for Kenya, which can be improved through addressing the critique to the framework as highlighted in this chapter and making provision for county government borrowing. By ensuring that borrowed funds are used for the purpose they were borrowed for and enhancing transparency and accountability, debt can effectively be used to achieve the development goals and other macroeconomic objectives of the country. Most importantly is the issue of political goodwill and commitment. For example, the case of Botswana which ensures adherence or compliance to its debt ceilings. Similarly, although Chile struggled with debt problems in the 1990s, political good will, fiscal council, and fiscal rules have played an important role to get back to overcome her debt problems. For Kenya, the establishment of debt-rules, revenue-rules, and balanced budget rules, are a step in the right direction, and therefore focus should be turned to ensuring implementation of the rules and the need to strengthen the country's capacity to undertake DSA.

The optimal or break-even point for public debt in Kenya is also an exercise that can guide policy makers in the borrowing plans. As it is now, it is still not known what the debt optimal point is. This would be made possible by establishing a public debt data repository in addition to the debt figures reported by the Kenya National Bureau of Statistics (KNBS). The repository would help to provide additional information related to how debt money has been used and the effect of debt repayment on economic growth. It would also be used to state the debt ceilings beyond which a country cannot borrow. Through the repository, it would be necessary to also inform on how the country's borrowing is impacting on key macroeconomic variables and the ability of the Central Bank of Kenya to effectively undertake its monetary policy objectives or management.

More recently, beginning June 2022, the IMF has adopted the Sovereign Risk and Debt Sustainability Framework (SRDSF), which replaces the Debt Sustainability Framework for Market Access Countries. The SRDSF introduces improvements in organization, methodology, transparency, and communication when analyzing public debt issues in countries that mainly finance themselves with market-based debt. The SRDSF will therefore become the Fund's principal tool for assessing public debt sustainability. It will also help to support the Fund's surveillance and lending functions and incorporates several tools that analyze debt risks at various times (IMF, 2022). This means that there is need for capacity building for country

staff involved in debt issues to enable them better understand debt issues and how to conduct debt sustainability analysis.

Kenya continues to make payments for its debt obligations as they fall due, and this is vital for improving its credit worthiness and ratings. Although the country did not benefit from initial debt relief measures such as HIPC, MDRI, and recently CCRT, it has received debt service suspension under the DSSI, the Paris Club creditors, and has also received SDRs for financing its expenditure needs. There is, however, need to join hands with other African countries to seek for additional SDRs allocation from the IMF, and request for other innovative debt relief measures instituted by IMF and World Bank, such as the recent Resilience and Sustainability Trust (RST).

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Annexes

Annex 1: Public debt conceptual framework

Public debt management is a very critical aspect of fiscal policy, which calls for strict adherence to fiscal prudence as prescribed in the various sections of Public Financial management Act of 2012. The objectives of implementing these policies are mainly to support faster economic growth, restructure public debt towards external concessional borrowing, which is cheaper than domestic debt, and the continued deepening of the capital markets. The ongoing rationalization of recurrent expenditure is an important step and necessary in the medium-term as it will ensure that public debt remains on a sustainable path. To strengthen the impact of these policies in the economy, it will be imperative to include measures meant to improve the trade deficit to reduce the vulnerability to external shocks, increase the relative share of development expenditure in the budget, enhance the absorption of development funds, and promote domestic revenue mobilization.

The tenets of public debt management in Kenya are enshrined in the Constitution and the Public Finance Management (PFM) Act (2012) and the Public Finance Management Regulations. The legal framework is meant to promote prudent and sound debt management practices for both national and county governments with the aim of enhancing public finance effectiveness and transparency in management of public resources. The National Treasury is implementing fiscal consolidation with a view to improving the balance between public revenues and expenditures aimed at reducing the rate at which Kenya accumulates debt. Under the fiscal consolidation programme, fiscal deficit is projected to narrow to 3.0 per cent of GDP over the medium term. Implementation of fiscal consolidation will ensure that public debt remains within sustainable levels. It is important to ensure that public debt remains low and affordable, and the risks of public debt stock are actively monitored and managed. In addition, there is need to diversify fiscal funding sources and the mix of currencies to manage currency risks, while at the same time lengthening the maturity profile of public debt to reduce refinancing risks.

A sustainable debt provides confidence that the government will be able to borrow and pay potential creditors. Unsustainable debt levels, on the other hand, present risks to government expenditures on development and social programmes since a large proportion of tax revenue would be diverted to debt service. The concept of sustainability of debt has evolved from the definition based on meeting a group of indicators and thresholds, to a more general approach where it is conceived as a process (Foncerrada, 2005). The process comprises a series of actions and functions aimed at sustaining the debt flows and then the borrowing and consequential debt service. It identifies the minimum aspects that are critical to the debt sustainability process as: existence of a legal framework and institutional structure for debt management, a framework for coordination among the key players in the debt and communication of debt management activities, market

development structure, and a staffing with requisite skills and necessary analytical tools.

The sustainability of public debt should also be assessed by the ability of a government to meet thresholds set on a group of indicators (IMF, 2003). These indicators ensure that countries remain solvent such that they can meet their debt obligations on time without constraining their growth objectives. The ratio of the budget deficit to GDP is one such measure, since it is a proxy for fiscal sustainability. In more recent times, the accumulated debt liabilities and the cost of servicing them has been expressed as a ratio of GDP, of sustainable revenues, and of government expenditures.

Debt sustainability analysis should also include an assessment of the institutional development and monitoring (IMF, 2004). One of the main measures of the quality of a country's policy environment is the World Bank's Country Policy and Institutional Assessment (CPIA) Index. The CPIA rates countries against a set of criteria grouped in four clusters: economic management; structural policies; policies for social inclusion and equity; and public sector management and institutions. The rating influences the parameters and international perception of a country's sovereign debt risk. Other rating agencies such as Standard and Poor's, Moody, and Fitch use a broader set of indicators to influence potential investors in debt instruments.

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. A country's historical fiscal performance helps to inform the assessment of what constitutes an optimal public debt policy (Oviedo and Mendoza, 2004). The size and structure of public debt in Kenya has increased and changed over time, necessitated by the need to source for affordable loans with less risks to finance development projects to meet the country's long-term development goals. Analysis of the current composition of the public debt and its maturity structure is relevant to access the vulnerability of a country to a debt crisis (World Bank, 2007) and in turn determines the optimal public debt policy given the cost and risk of the public debt portfolio.

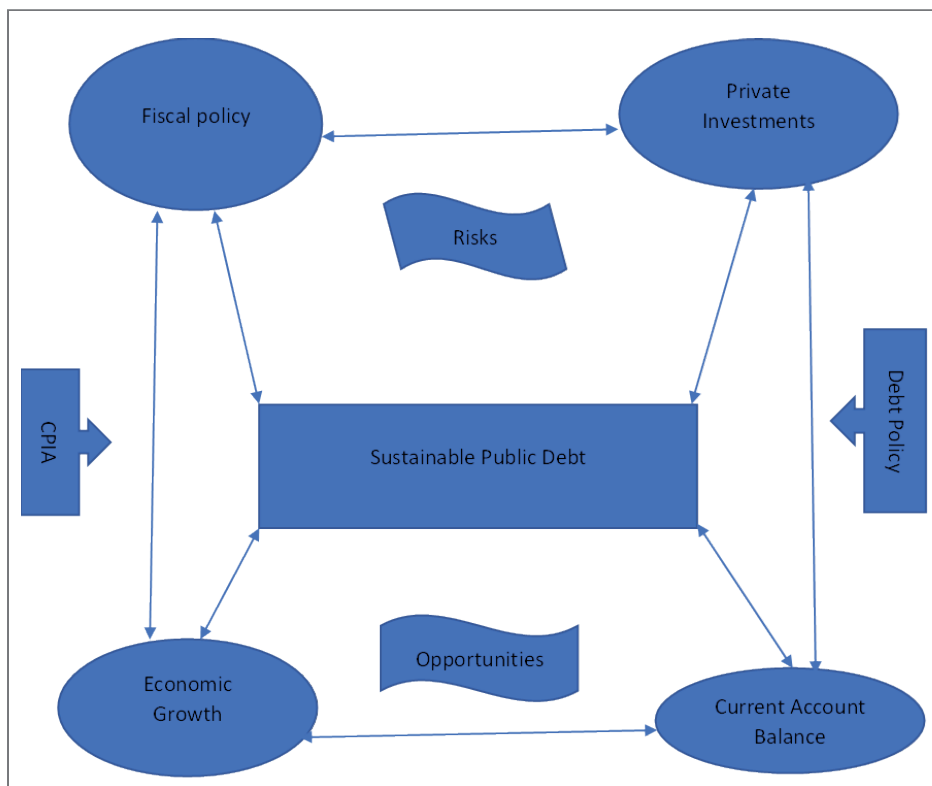
The PFM Act 2012 and the PFM regulations state that all external borrowing should be channelled to development projects in the country. This, therefore, provides a very important opportunity for the country to make great strides in economic development using relatively cheap external financing. Debt management provides an avenue to drive this country's development agenda and should prevent debt resources from debt fungibility issues that normally occur in a political economy such as Kenya.

Debt stabilization is an indicator of the effectiveness of the policies implemented by the Government. A large and growing debt increases the risk of speculative attacks against a country's debt, which can be viewed by investors as if the government is on the verge of a default leading to speculation in the economy (Sardoni, 2013). The increase in public debt is still projected to continue with major capital projects especially in infrastructure and energy slated for implementation

under the Vision 2030. The increasing debt levels have been characterized by the continuous upward revision of the country's debt limits.

To stabilize the debt levels and subsequently put it on a declining path, the government needs to generate a sufficiently large fiscal surplus over an extended period. Stabilization of public debt depends on macroeconomic performance and the government's fiscal policy stance, but with Kenya's rising fiscal deficit, it is difficult to prevent the debt levels from rising. The government could therefore prepare good policies that will stabilize the public debt levels.

Figure A1: Conceptual framework for debt analysis in Kenya



Source: Authors computation 2023

Annex 2: Public debt per cent of GDP

Country	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Angola	31.4	56.3	37.2	29.6	26.7	33.1	39.8	57.1	75.7	69.3	89.0	95.0
Benin	18.3	18.7	21.0	21.9	19.5	18.5	22.3	30.9	35.9	39.6	41.0	40.9
Botswana	7.7	17.9	20.4	20.4	19.2	17.4	17.3	17.2	15.6	13.4	12.1	12.3
Burkina Faso	25.9	29.1	31.2	27.6	28.4	29.1	29.9	35.6	39.2	38.4	42.9	42.9
Burundi	102.5	25.7	46.9	42.7	41.4	36.1	35.8	45.3	48.4	51.7	58.4	63.5
Cabo Verde	57.6	64.1	72.5	78.5	91.1	102.5	115.9	126.6	128.4	127.2	124.5	123.5
Cameroon	11.7	12.0	14.7	15.7	15.4	18.2	21.5	32.0	32.8	37.6	39.1	40.5
Central African Republic	35.8	20.3	19.9	19.7	31.5	51.8	62.2	59.8	53.9	50.3	49.9	44.5
Chad	19.9	31.6	30.1	30.6	28.8	30.5	41.5	43.9	51.5	49.8	48.3	44.7
Comoros	33.4	31.8	30.4	27.3	25.0	10.5	13.5	14.3	16.9	18.4	21.0	24.3
D.R Congo	87.8	91.3	30.6	25.0	21.8	19.1	16.8	17.0	21.7	19.1	15.3	13.5
Republic of Congo	79.4	86.7	46.3	36.2	39.0	43.3	53.6	102.9	118.6	117.5	87.8	78.5
Côte d'Ivoire	70.8	64.2	63.0	69.2	45.0	43.4	44.8	47.3	48.4	49.8	53.2	52.7
Equatorial Guinea	0.5	4.3	7.9	7.2	7.1	6.3	12.6	33.6	43.4	38.0	43.3	45.4
Eritrea	259.7	207.1	201.7	165.3	160.1	194.6	143.4	190.3	170.1	196.2	174.3	165.1
Eswatini	14.2	10.3	13.8	14.2	14.4	14.7	13.8	17.7	25.0	27.5	35.2	40.9
Ethiopia	38.5	35.2	39.6	45.3	42.2	47.5	47.6	54.5	55.8	58.6	61.0	59.1
Gabon	20.1	26.0	21.3	21.4	21.4	31.1	34.1	44.7	64.2	62.6	60.7	56.4
The Gambia	39.5	38.9	42.9	49.2	49.5	58.2	71.1	69.4	80.9	87.0	86.6	80.9
Ghana	24.9	27.0	34.6	31.4	35.6	43.2	51.2	54.8	57.1	57.3	59.3	63.8
Guinea	58.5	61.3	68.8	58.1	27.2	34.0	35.1	41.9	42.5	40.6	38.2	45.4
Guinea-Bissau	163.3	159.0	68.3	51.7	53.5	57.1	65.0	61.7	62.5	57.2	64.3	69.2
Kenya	41.5	41.1	44.4	43.0	43.9	44.0	48.6	51.4	54.5	55.2	60.1	61.6
Lesotho	44.9	34.1	31.8	33.7	37.0	38.5	38.8	43.2	37.0	37.1	44.5	45.9
Liberia	201.9	113.4	21.8	19.3	17.6	17.9	21.7	25.9	28.3	34.0	39.9	45.5
Madagascar	35.2	39.2	37.0	35.0	35.5	42.5	34.7	35.7	47.1	46.0	45.7	46.5
Malawi	36.2	35.6	29.6	30.6	43.9	59.3	54.7	61.2	61.3	61.5	62.9	65.1
Mali	20.2	21.9	25.3	24.0	25.4	26.4	26.9	30.7	36.0	36.0	37.3	37.6
Mauritius	49.4	57.6	55.1	55.7	55.1	57.5	60.6	65.0	65.0	64.3	66.2	68.7
Mozambique	36.3	41.9	43.3	38.0	40.1	53.1	67.2	94.2	129.9	100.5	99.8	108.8
Namibia	18.8	15.5	16.0	26.2	23.7	24.2	26.3	39.9	42.6	41.0	45.8	49.2
Niger	19.0	21.6	20.6	20.1	24.6	26.0	29.0	39.9	44.6	54.4	53.8	55.8

Nigeria	7.3	8.6	9.6	17.6	17.7	18.6	17.5	20.3	23.4	25.3	27.3	29.8
Rwanda	19.2	18.0	19.0	16.3	18.6	20.8	26.6	29.7	32.9	36.5	40.7	49.1
São Tomé and Príncipe	58.5	72.4	79.5	78.0	81.0	71.2	69.5	85.8	95.3	91.7	74.5	77.2
Senegal	18.9	26.9	28.3	32.7	34.2	36.8	42.4	44.5	47.5	61.2	61.6	63.3
Seychelles	192.1	106.1	82.2	82.5	80.1	68.2	72.7	67.0	69.0	63.2	56.9	53.8
Sierra Leone	42.4	48.1	46.8	44.8	36.8	30.5	35.0	44.9	55.5	57.9	63.0	64.5
South Africa	26.5	30.1	34.7	38.2	41.0	44.1	47.0	49.3	51.5	53.0	56.7	59.9
South Sudan	n/a	n/a	n/a	0.0	8.9	17.6	38.3	60.3	85.7	63.2	42.2	34.4
Tanzania	21.2	24.0	27.0	27.4	28.7	30.0	32.6	35.9	36.4	36.6	37.3	37.7
Togo	92.7	80.6	46.3	47.3	48.0	57.2	62.8	72.1	81.4	76.0	76.2	72.6
Uganda	20.3	19.2	22.4	23.4	24.5	27.8	30.7	34.3	37.1	39.7	41.4	43.6
Zambia	19.2	20.5	18.9	20.8	25.4	27.1	36.1	62.3	60.7	61.9	78.1	91.6
Zimbabwe	61.1	62.0	49.6	41.4	37.2	38.6	40.3	41.8	54.2	52.9	37.1	17.7

Annex 3: Institutional framework

A clear legal framework is necessary for making appropriate institutional arrangements for public sector borrowings. This should cover legislation for borrowings by the government (for its own use or on-lending), state enterprises and Central Bank and for regulating and/or monitoring the external borrowings of the private sector. There are, as stated, several agencies of the government that have responsibility for a part of or the whole loan cycle relating to domestic and external borrowings and debt management functions. The National Treasury and Central Bank would be the main agencies involved in loan operations. In some instances, an autonomous Public Debt Management Office may be set up with special responsibility for public debt either by legislation or administrative order.

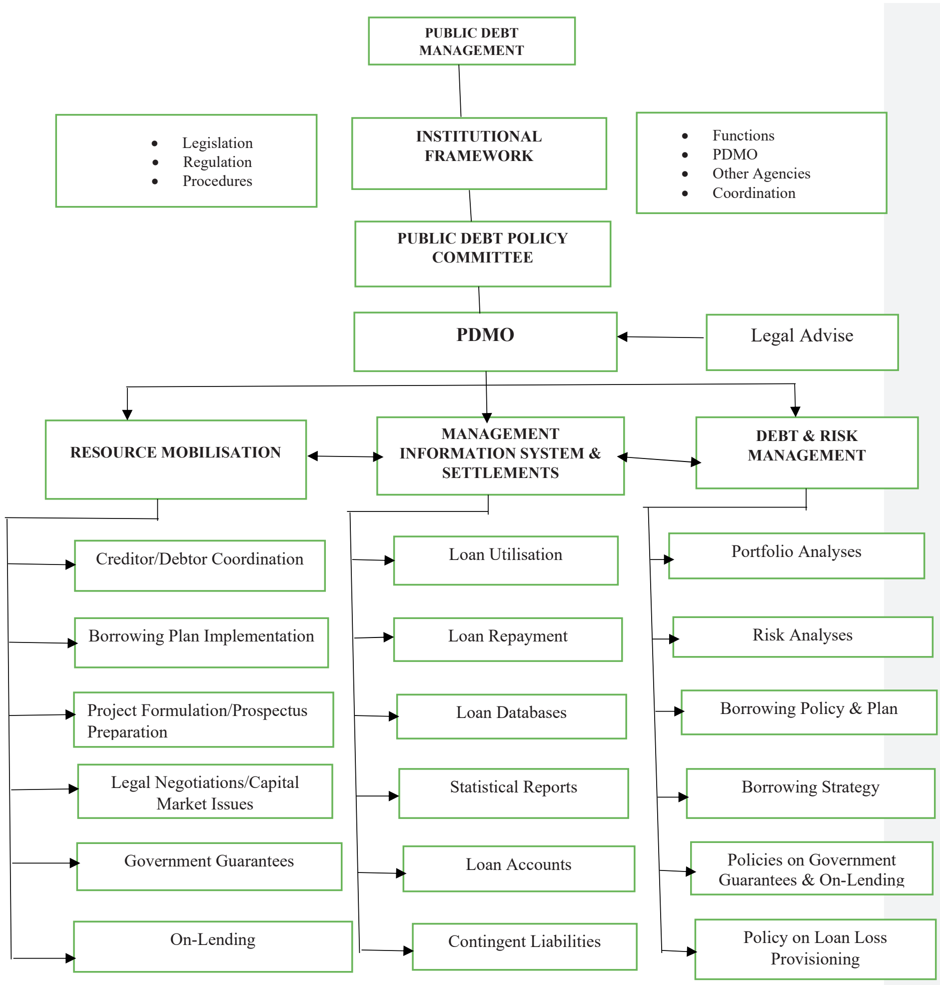
A well-defined organizational arrangement and transparent coordination mechanism between all the different agencies are required for effective public debt management. The institutional framework adopted by a country should facilitate the borrowing and the effective utilization of borrowed funds. According to United Nations Institute for Training and Research (2002), the functional organization for public debt management could be like that of an investment institution. They propose that three operational offices could be set up to correspond to the three categories of debt management functions. These are referred to in this paper as the Front, Middle and Back offices.

The Front Office would be responsible for resource mobilization and make the major decisions on foreign and domestic borrowings based on the approved borrowing plan. It would also take responsibility for on-lending and guarantee operations and hedging and derivative transactions of the government. The Middle Office would be responsible for debt and risk analysis. It should undertake portfolio analyses, develop a risk management strategy, and develop borrowing scenarios and compare the emerging debt indicators with agreed benchmarks. This would enable sustainable levels of public sector borrowings to be estimated and a borrowing policy and plan for public sector borrowing to be prepared. The Front Office could formulate a strategy for implementing the borrowing plan by mobilizing resources from domestic and foreign sources with the assistance of the Middle Office. The Back Office would be responsible for the management information system and settlements. It would make debt service payments based on creditor invoices that are crosschecked with its own database and be responsible for monitoring loan utilization and the preparation of accounting and other reports required by creditors and the government.

Linking all three offices could be a legal group whose principal function would be to support the activities of the Front and Back offices. The three offices would be interdependent and exercise checks and balances over each other in the interests of transparency and accountability. The organizational structure for public debt management could include a Public Debt Policy Committee.

The organizational structure suggested for a PDMO is illustrated below, and sets out the institutional framework that is necessary for public debt management. It corresponds to the three groups of debt management functions that were

identified in the preceding section. It is the ultimate structure that should emerge in a PDMO when all the functions are brought under one office instead of being scattered among different agencies of the government.



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