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Thinking Policy Together

Public Borrowing with Multiple Shocks: Status and Policy Options

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Key Highlights

Public borrowing is one of the sources of financing fiscal deficit. This Policy Brief focuses on public borrowing during a period of multiple shocks that hit the country since 2020, including COVID-19 pandemic, severe prolonged drought, and the effects of the Russia-Ukraine war; and provides policy options. The key highlights include:

(i) The effects of COVID-19 pandemic led to an unexpected increase in government expenditure in responding swiftly to safeguard lives and livelihoods. This was followed by a severe drought situation and the Ukraine-Russia war, which exerted more fiscal pressures.

(ii) Economic activities were severely disrupted during the COVID-19 period adversely affecting households' income and government revenues. With the drought, the food prices rose further, and this had a negative impact on households' disposable income. Moreover, the Ukraine-Russia war caused a disruption of the global supply chain especially in the oil market, which further worsened the already existing predicaments.

(iii) To safeguard lives and livelihoods while cushioning the economy from recession, the Government sought enhanced funding externally. This led to an increase in the country's public debt from Ksh 6.3 trillion in March 2020 to Ksh 6.7 trillion (65.8% of GDP) in June 2020 and further to Ksh 7.7 trillion (68.1% of GDP) in June 2021. Further borrowing resulted in a debt increase to Ksh 8.6 trillion in 2022 and to Ksh 10.2 trillion as of 30th June 2023.

(iv) To cushion the country from adverse shocks, it is important for the Government to strengthen the fiscal buffers by sustaining fiscal consolidation. The Government is already working towards this through tax reforms to increase revenue collection with a target to grow tax revenue to above 18 per cent of the GDP. Moreover, the Government is keen to reduce its expenditure to below 22.3 per cent of the GDP, by ensuring efficiency in public spending through the removal of low-priority expenditures, removal of unsustainable subsidies, reducing tax exemptions, and use of public-private partnerships to finance projects. Going forward, the Government should consider expediting the finalization of the Public Finance Management Regulations, 2022 that established the Disaster Management Fund. This will help in ring-fencing funds for shocks that can adversely affect the economy.

Introduction

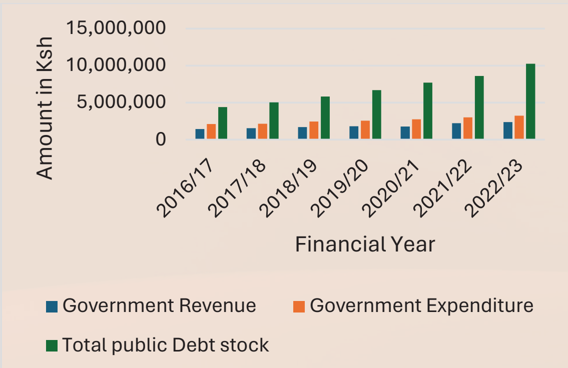
Kenya has faced a couple of shocks since 2020, which mainly include the COVID-19 pandemic in 2020, drought in 2021, and the Russia-Ukraine war that began in February 2022. These have had implications on government expenditures as the Government worked towards safeguarding the lives and livelihoods of citizens against the adverse effects.

The COVID-19 pandemic not only posed a serious risk to public health but also interrupted international supply chains, affecting trade and the domestic economy. At the same time, persistent droughts have put a burden on the nation's agricultural sector, causing a shortage of food and water and endangering the livelihoods of many Kenyans. Additionally, the Russian-Ukraine crisis had implications across the globe, altering geopolitical dynamics and the stability of the world, largely affecting commodity prices internationally and domestically. These concurrent shocks highlight the interconnection of world affairs and the need for Kenya to navigate difficult times while ensuring that the citizens are cushioned from adverse effects.

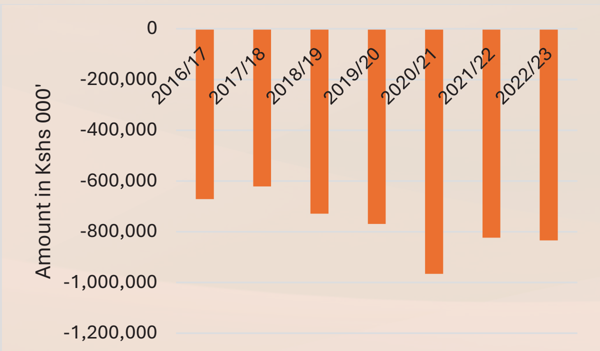
Furthermore, the COVID-19 pandemic led to an unexpected increase in government expenditure. It resulted in unprecedented health challenges, which meant that the government had to act swiftly to minimize and contain the infection rates, morbidities, and mortalities arising from the pandemic. Related to this was the loss in economic activities following the lock downs, travel restrictions, and closure of schools and learning institutions, among others, aimed at curbing the spread of the disease. In addition, the government introduced various stimulus programmes that were aimed at cushioning citizens and the economy at large from the adverse effects of the pandemic. This included a reduction of PAYE from 30 per cent to 25 per cent, a reduction of turnover tax from 3.0 per cent to 1.0 per cent for all MSMEs, 100 per cent tax relief for those earning less than Ksh 24,000, temporary suspension of listing on the Credit Reference Bureau, lowering of the Central Bank Rate, and lowering of the Cash Reserve Ratio (CRR), among several other programmes.

With the COVID-19 pandemic, revenues grew much slower than expenditures, which saw the government increase its borrowing to bridge the revenue gap. Specifically, government revenue decreased by 1.0 per cent between 2019/20 and 2020/21 whereas government expenditures grew by 6.7 per cent during the same period (Figure 1a). Gross operating balance as a percentage of revenue also worsened from - 27.4 per cent in 2018/19, to - 37.3 per cent in 2019/20 and further deteriorated to – 41.1 per cent in 2020/21. Further, fiscal deficit widened from Ksh 767.8 million in 2019/20 to Ksh 965.7 million in 2020/21 but has since decreased to Ksh 833.9 million in 2022/2023. The lower revenue achievements vis-à-vis increased expenditures to contain the pandemic, therefore necessitating more borrowing by the government.

Figure 1a: Trends in fiscal indicators



(a) Trends in revenues, expenditures, and debt in Ksh Million



(b) Trends in fiscal deficit in Ksh Million

Data source: National Treasury (Annual public debt reports and quarterly economic budget reviews)

Further, the country was affected by a severe drought which saw the government cushion the affected people through social protection schemes, distribution of food and water, treatment for acute malnutrition, livestock offtake and livestock feed and enhanced school meals programme. The government also introduced various subsidies amounting to Ksh 80.7 billion [1]in 2021/22 to minimize the impact of drought. They included subsidizing pump prices, reduction in electricity tariff by 15 per cent to lower the cost of power, granting waiver of import duty for maize, subsidizing fertilizer to farmers, reduction of the VAT rate on liquefied petroleum gas from 16 per cent to eight (8) per cent, and subsidizing maize flour. The subsidies, therefore, reduced the revenue collected. In addition, the government allocated Ksh 850 million to enhance drought resilience and sustainable livelihood, Ksh 178 million towards Ending Drought Emergencies in Kenya and an additional allocation of Ksh 421 million for the Livestock and Crop Insurance Scheme to reduce the vulnerabilities of Kenyan farmers to diseases and natural disasters in the 2023/24 budget. To protect the vulnerable, the government allocated Ksh 500 million to the National Drought Emergency Fund.

The outbreak of the Russia-Ukraine war saw the recovery efforts disrupted, putting on more fiscal pressure. The war disrupted the grain and oil markets, which led to a rise in the prices of corn, wheat, and crude oil. This pushed inflation up and spiked a rise in the cost of living, thus triggering the introduction of subsidies by the government to cushion the economy from extreme shocks caused by the price changes. The doubling of fertilizer prices due to the disruption of the fertilizer market – with Russia being the leading exporter of fertilizer in the world – caused the government to introduce subsidies on fertilizer to farmers. These subsidy programmes have been a contributor to government spending, which has in turn triggered more borrowing for the government and an increase in taxation measures to net in more revenue through taxes to finance the deficit.

The government sought financial assistance during the period with shocks to cushion the citizens from adverse effects and provide budgetary control. This Policy Brief, therefore, focuses on public borrowing during the period of multiple shocks including COVID-19, severe drought, and disruptions of the global supply chain with the Russia-Ukraine war while providing policy options.

Status of Kenya's borrowing during the COVID-19 pandemic period

(i) Public debt levels

The public debt stock stood at Ksh 6.3 trillion (65.6% GDP) in March 2020. With the borrowing following the outbreak of the COVID-19 pandemic, the debt stock increased to Ksh 6.7 trillion (65.8% of GDP) in June 2020 and further to Ksh 7.7 trillion (68.1% of GDP) in June 2021. Notably, external debt grew by 24.5 per cent from Ksh 3.2 trillion as of March 2020 to Ksh 4.0 trillion in June 2021, whereas domestic debt stock grew

[1] World Bank (2022)

by 20.4 per cent from Ksh 3.1 trillion to Ksh 3.7 trillion during the same period.

As of February 2022, when the effects of the COVID-19 pandemic were fading and the Russia-Ukraine war broke, total public debt stock stood at Ksh 8.4 trillion. In June 2023, total public debt stock stood at Ksh 10.2 trillion (66.3% of GDP). Domestic debt constituted Ksh 4.8 trillion (31.3% of GDP), while external debt accounted for the remaining Ksh 5.4 trillion (35.1% of GDP). With the rising public debt, the recent government's agenda of mobilizing more revenue to finance the expenditures is timely as it will reduce the public debt burden.

In addition to the country's borrowings during the pandemic, there was also a change in external debt stock by creditors during the same period as shown in Table 1. The largest of this change was by the IMF, whose debt stock increased from Ksh 110.61 billion in 2019/20 to Ksh 804.6 billion in 2022/23, representing a change in the stock of Ksh 693.99 billion. Other changes witnessed were by the World Bank and Commercial loans.

Table 1: Change in external debt stock by creditors between 2019/20 and 2022/23 (Ksh billion)

Creditor	2019/20	2020/21	2021/22	2022/23	Change in stock
World Bank	921.43	1,126.13	-	-	204.70
IMF	110.61	178.22	402.60	804.60	693.99
Commercial loans	1,102.29	1,187.44	1,181.33	1,357.17	254.88

Data source: The National Treasury and CBK

The increased public debt stock also exerted pressure on the debt ceiling set at Ksh 9.0 trillion in 2019 when Parliament scrapped the debt ceiling pegged to GDP. This led to Parliament revising the debt ceiling to Ksh 10.0 trillion in June 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.

In October 2023, Parliament replaced the 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 numerical public debt ceiling constrained public funding of projects while not considering the effects of external shocks on the economy. The debt ceiling set at 55 per cent of GDP 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.

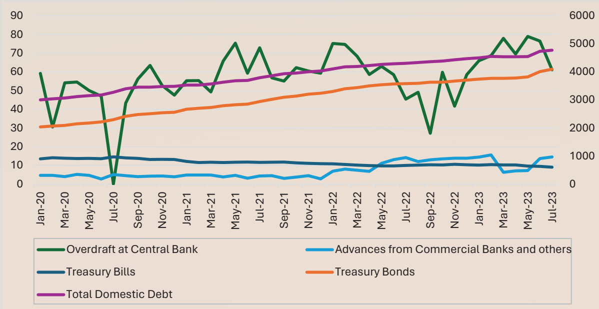
(ii) Public debt structure

Domestic debt

During the COVID-19 period, the stock of domestic debt maintained an increasing trend, growing from Ksh 3.1 trillion in March 2020 to Ksh 4.2 trillion in February 2022 and Ksh 4.8 trillion in June 2023 (Figure 2). The increase was mainly due to an increase in the stock of Treasury bonds, which contribute 84.7 per cent of the total domestic debt.

The stock of Treasury bonds increased from Ksh 2.1 trillion in March 2020 to Ksh 3.4 trillion in September 2021. By June 2023, the stock of Treasury bonds was at Ksh 4.01 trillion. On the contrary, the stock of Treasury bills declined over the period of analysis. Specifically, it declined by 31.4 per cent from Ksh 921.7 million in March 2020 to Ksh 631.9 million in June 2023. The decline was aligned 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.

Figure 2: Trends of domestic debt by instruments (January 2020 to July 2023)



Data source: Central Bank of Kenya, Monthly Economic Indicators

Borrowing from the IMF

In April 2020, Kenya sought emergency financial assistance under the IMF's Rapid Credit Facility (RCF) exogenous shock window to address the shocks related to the COVID-19 pandemic. This led to a single disbursement of US$ 739 million (SDR 542.8 million) to help in financing the budget and balance of payment deficit. In addition, Kenya requested for additional funding for budget support under a three-year programme of Extended Credit Facility (ECF - US$ 577.26 million) and Extended Fund Facility (EFF - US$ 1,770.09 million) arrangements in March 2021. This led to the first installment disbursement of US$ 307.5 million in April 2021 aimed at supporting the country in addressing debt vulnerabilities and supporting response to the COVID-19 crisis. The second disbursement was made in June 2021 of US$ 407 million (about SDR 285 million). In July 2023, the IMF's Executive Board successfully concluded the fifth review under both the EFF and ECF arrangements for Kenya. This completion led to an immediate disbursement of US$ 415.4 million (SDR 306.7 million), adding to the total disbursements under these arrangements, which stood at approximately US$ 2.04 billion (SDR 1.51 billion as of July 2023 (Table 2).

On 23rd August 2021, the IMF offered the fourth and largest allocation of SDR 456.5 billion (equivalent to US$ 650 billion). Of that allocation, Kenya received SDR 520.2 million (about US$ 740 million or approximately

Ksh 80.84 billion), equivalent to the 542.8 million SDR quota Kenya has at IMF. The 2023 Budget Policy Statement (BPS) noted that part of the IMF's SDR allocation of about Ksh 40.8 billion formed part of government borrowing and was utilized in financing the fiscal deficit in 2021/22. The SDR allocation thus funded about 28.6 per cent of the government's foreign financing. These funds were used to cushion the poor from the adverse effects of the COVID-19 pandemic and formed critical interventions, including the purchase of COVID-19 vaccines, social protection, education, and health.

Kenya was among the first African countries to benefit from the new IMF Resilience and Sustainability Facility (RST)[2]. It was approved by the IMF in July 2023 and aims at boosting resilience to the effects of climate change. Additionally, this is expected to strengthen macroeconomic stability during the transition to renewable energy. The reform measures with the IMF include incorporating climate risks into fiscal planning and investment framework; mobilizing climate revenue while strengthening climate spending efficiency; and enhancing the effectiveness of Kenya's existing frameworks to mobilize climate finance and strengthening disaster risk reduction and management. The IMF's RSF financial support to Kenya amounts to SDR 407.1 million (75% of quota; about US$ 551.4 million). The disbursement is based on meeting the agreed reform measures over the 20-month period of the RSF programme.

Borrowing from the World Bank and African Development Bank (AFDB)

In May 2020, the World Bank and AfDB also approved US$ 1.0 billion (comprising of US$ 750 million credit from the International Development Association (IDA) and a further US$ 250 million loan from the International Bank for Reconstruction and Development (IBRD) and EUR 188 million, respectively targeting reforms that help advance the government's inclusive growth agenda, including in affordable housing and support to farmers' incomes and budget support. Towards the close of the financial year in June 2021, the World Bank approved US$ 750 million for development policy financing to support policy reforms that would strengthen transparency and accountability in public procurement and promote efficient public investment spending. Around the same time, in June 2021, the AfDB Board of Directors approved a US$ 95 million loan to Kenya. The funds were for boosting the government's economic recovery efforts under the Competitiveness and Economic Recovery Support Programme (CERSP). The efforts included the adoption of an electronic government procurement system to encourage transparency and efficiency, strengthen industrial development, and enhance social and economic inclusion. In July 2022, the AfDB approved EUR 89.0 million to support economic recovery and a further EUR 63.0 million to support cereals and oil seeds production. In May 2023, the World Bank authorized US$ 1.0 billion to Kenya through the Development Policy Operation (DPO) window. This substantial financial support aims to offer low-cost budget financing while concurrently aiding key policy and institutional reforms. The allocation serves Kenya's immediate agenda of fiscal consolidation and aligns with its over-arching aspiration for sustainable, inclusive growth with a focus on environmentally friendly practices.

Borrowing from the International Financial Market

The National Treasury further successfully raised US$ 1.0 billion through the issuance of a 12-year Eurobond in the international financial markets, following a successful three-day virtual Eurobond Roadshow. The bond was over-subscribed with over US$ 5.4 billion offered by investors. It was listed on the London Stock Exchange. Table 2 provides a summary of the borrowings.

Table 2: Summary of external borrowings between 2019/20 and 2023/24

Time	Creditor	Amount
IMF Loans		
April 2020	IMF-RCF	US$ 739 million
April 2021	IMF-ECF-EFF (1st Tranche)	US$ 307.5 million
June 2021	IMF-ECF-EFF (2nd Tranche)	US$ 407.0 million
August 2021	IMF SDR Allocation	US$ 650.0 billion
December 2021	IMF-ECF-EFF (3rd Tranche)	US$ 258.1 million
July 2022	IMF-ECF-EFF (4th Tranche)	US$ 235.6 million
December 2022	IMF-ECF-EFF (5th Tranche)	US$ 447.39 million
July 2023	IMF-ECF-EFF (6th Tranche)	US$ 415.4 million
World Bank, AfDB and Eurobond		
May 2020	World Bank (budget support - COVID-19 Response)	US$ 1.0 billion
June 2021	World Bank (Development Policy Operation -DPO)	US$ 750.0 million
March 2022	World Bank (DPO - economic transformation)	US$ 750.0 million
May 2023	World Bank (DPO)	US$ 1.0 billion
May 2020	AfDB (COVID-19 response)	EUR 188.0 million
June 2021	AfDB-CERSP	US$ 95.0 million
November 2021	AfDB (for infrastructure)	US$ 217.0 million[3]
July 2022	AfDB (economic recovery)	EUR 89.0 million
July 2022	AfDB (seeds production)	EUR 63.0 million
June 2021	Commercial (12-year Eurobond)	USD 1.0 billion

Data source: The National Treasury, IMF, World Bank

(iii) Debt service payment arrangements

Kenya participated in the Group of Twenty (G20) Debt Service Suspension Initiative (DSSI), which was facilitated by the World Bank and IMF in November 2020 to free some resources to mitigate the impact of COVID-19. This resulted in a six-month debt service suspension from the Paris Club and China worth Ksh

2 IMF Staff Report, July 2023

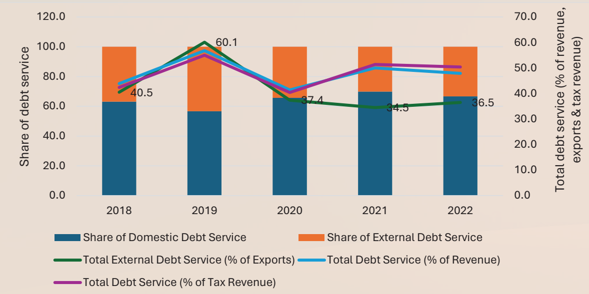
3 On the AfDB Loan, USD 75 million was non-concessional while US$ 142 million was concessional.

32.9 billion and Ksh 27 billion, respectively. The Paris Club extended the DSSI relief to the end of December 2021, as agreed by the G20 in April 2021. The freed cash was expected to be used to mitigate the impact of the COVID-19 pandemic. In addition, a temporary suspension of debt servicing was envisioned to offset the increase in public debt servicing.

Nevertheless, the public debt service in Kenya has been on the rise mainly driven by the dominance of domestic debt service, which carries relatively higher costs (Figure 3). The share of external debt service to total revenue increased significantly from 43.9 per cent in June 2018 to a peak of 56.8 per cent in June 2019. During the same period, total external debt service as a proportion of exports rose from 40.5 per cent to 60.1 per cent. The increase in 2019 can be attributed to substantial principal payments made to commercial creditors and sovereign bondholders, particularly for the five-year bond issued in 2014, which matured in 2019. Further, total debt service as a share of tax revenue increased to 55.0 per cent in 2019, before slightly decreasing to 50.4 per cent in 2022.

High total debt service as a share of tax revenue implies high public debt and related costs leaving scarce resources for development. Notably, total debt service declined significantly in 2019/20 due to reduced debt service obligations for the 2019/20 following the COVID-19 pandemic, 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 3: Public debt service, as of 30th June (%)



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

Policy Options for Improving Public Borrowing during Emergencies

To manage public borrowing during emergencies and pandemic periods, the government can consider the following recommendations:

(i) Ensure adequate fiscal buffers all the time

The government should build adequate fiscal buffers that can sustain fiscal pressures, with natural disasters and other unforeseen shocks. This can be achieved through finalizing the setting up of the National Disaster/ Emergency Fund. Adequate fiscal buffers would reduce dependence on uncertain external donations, ensure quick disbursement for recovery and relief efforts, minimize disruption of pre-existing spending plans on health, education, and infrastructure, and provide flexibility in addressing post-disaster liquidity needs.

ii) Establish an institutional framework for distributing emergency funds

An effective institutional framework is necessary to ensure the effective utilization of emergency funds, especially natural disaster funds, and enhance transparency and accountability of the funds. In view of this, a well-designed framework needs to first be consolidated with budget information to allow the assessment of the overall fiscal situation; at a minimum, the fund balance should appear in financial statements. Secondly, there ought to be a standing appropriation that allows for spending immediately after a certain trigger event, such as a declaration of a disaster emergency by the Executive. Lastly, the fund should generally apply normal Public Finance Management (PFM) rules and be limited to responding to disasters with large fiscal impacts.

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KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

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