Kenya's rising debt position: The lingering question on sustainability

10th March 2023

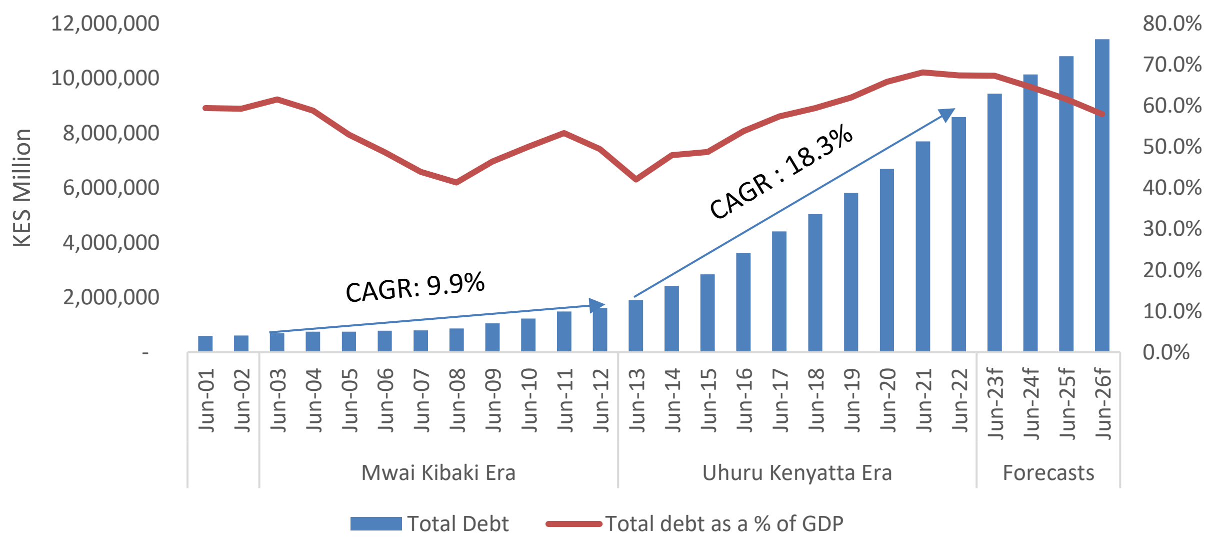
By December 2022, Kenya's public debt stood at KES 9.2tn (71.7% of GDP) and was up by 6.5% from KES 8.6tn (67.3% of GDP) in June 2022, and an 18.8% jump from KES 7.7tn (68.1% of GDP) in FY2020/21.

Debt level acceleration during the previous administration…

The public debt level has been on an upward trajectory, recording annual growth rates above 9% over the past 10 years (vs real GDP growth rates below 8%). The public debt grew at a 10-year CAGR of 18.3% (+9.9% during President Mwai Kibaki's era vs +18.3% during President Uhuru Kenyatta's Era).

The debt situation was worsened by the COVID-19 pandemic, which led to an increase in public debt by +15.2% (2020) and +15.0% (2021), and exacerbated by the rising fiscal deficit. The country's fiscal deficit rose by 17.6% in FY2020/21, inching closer to the KES 1 tn mark due to the stagnation in the growth of ordinary revenue at KES 1.8tn in FY2019/20 and FY2020/21, with government expenditure rising by 10.0% (to KES 2.6tn) and 4.6% (to KES 2.8tn) respectively. However, by the end of FY2021/22, the growth in debt level moderated (+11.6%), driven by a decrease in fiscal deficit (-15.5% to KES 784 bn) and an increase in government revenue (+21.6%) to KES 2.2tn.

Figure 1: Trend in debt level (2001-2026f)

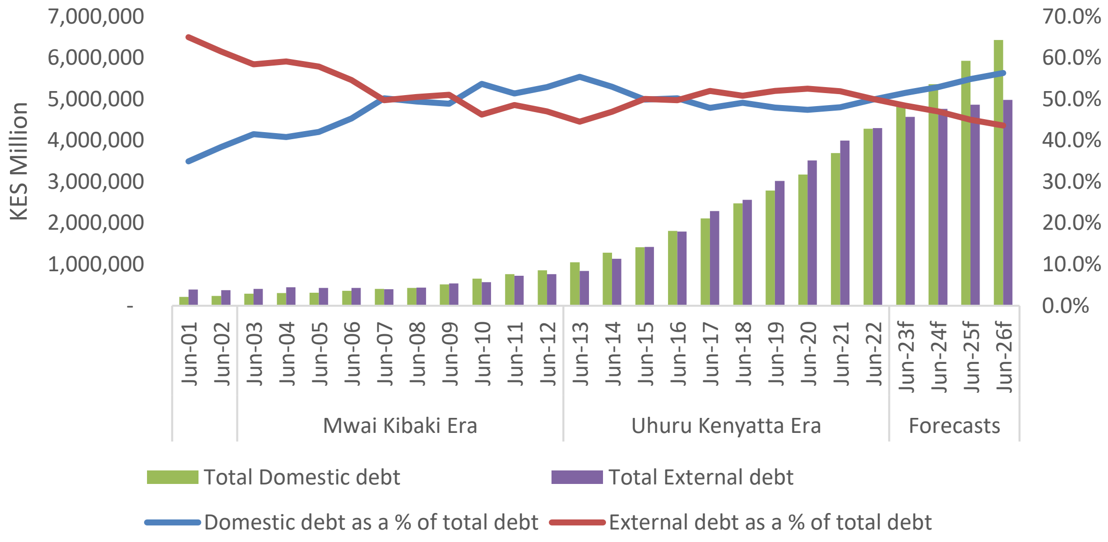


Source: National Treasury

…with externalization of the debt mix

The period 2002-2012 was characterized by a declining composition of external debt and an in-tandem rise in the composition of domestic debt. The composition of domestic debt as a percentage of total debt rose from 38.5% (FY2001/02) to 52.9% (FY2011/12). However, with the ramping up of infrastructure development, the previous administration went for external debt as a major source of funding. This resulted in the composition of external debt rising from 47.1% (FY2011/12) to 50.1% (FY2021/22).

Figure 2: External debt vs domestic debt (% of total debt) (2001-2026f)

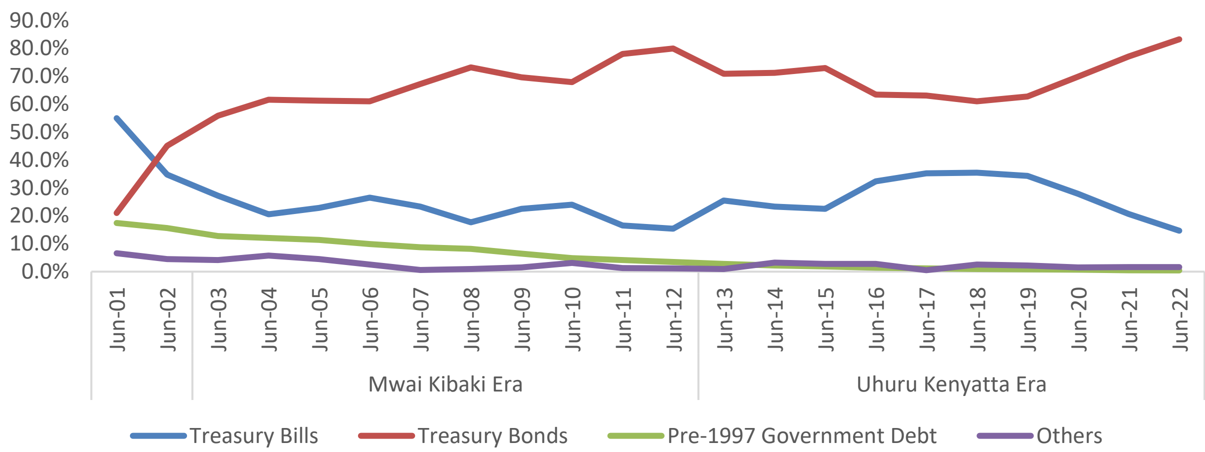


Source: National Treasury

…and a high preference for short-term securities early on as the main source of domestic funding

During the start of President Kibaki's era, the treasury bonds composition as a percentage of domestic debt began to rise and this became the trend throughout his reign. The composition of treasury bonds rose from 45.0% (FY2002) to a high of 80.0% (FY2012). President Uhuru's administration was characterized by a shift in the composition, with treasury bills picking during the early years but by mid-term, the treasury bond's composition began to rise.

Figure 3: Evolution in domestic debt composition (2001-2022)

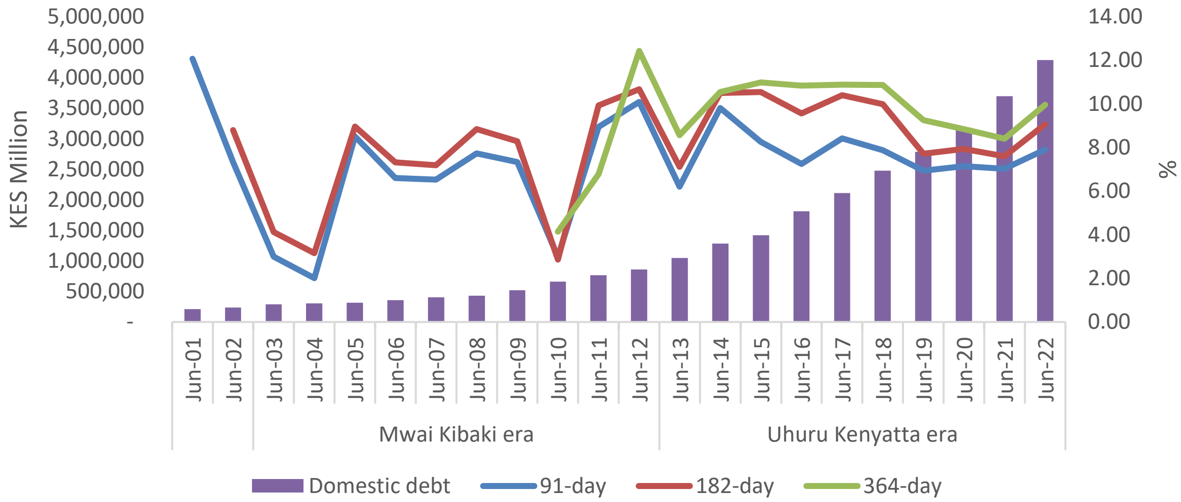


Source: National Treasury

…leading to elevated domestic interest rates

Although the general interest rate levels rose during President Kibaki's administration (averaging 6.46% for the 91-day T-bill and 7.28% for the 182-day T-bill), the rates were relatively lower compared to President Uhuru's term (when the rates averaged 7.68% for the 91-day and 9.04% for the 182-day). Since then the T-bill rates have not gone below the 6.90% threshold. During President Kibaki's era, the 10-year CAGR for domestic debt was 12.8% (vs President Uhuru's 16.9%). In our view, the accelerated ramping up of debt (including domestic debt) during President Uhuru's terms contributed to the elevated rates on Treasury securities. The rates still remain elevated and currently stand at 9.66% (91-day) and 10.12% (182-day), and we see no signs of easing in the short-to medium-term.

Figure 4: Treasury bills rates (2001-2022)

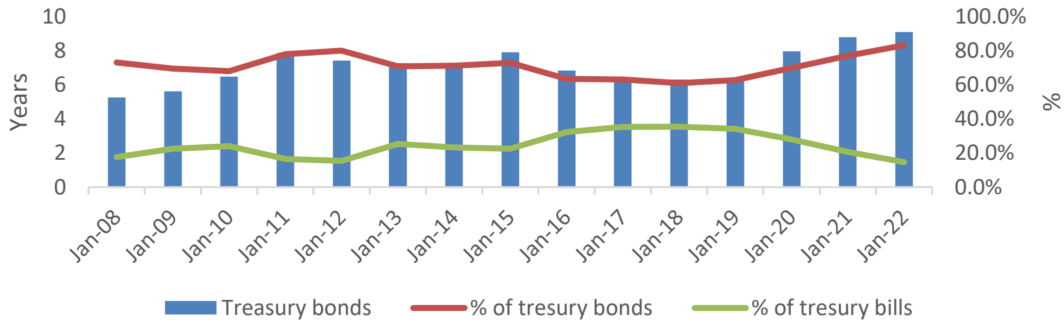


Source: National Treasury

Although there's increasing focus on longer-dated tenures…

The rise in the issuance of treasury bonds is in line with the government's objective to borrow bonds with longer tenures to increase their duration and reduce the pressure of maturing securities. The Average Time to Maturity (ATM) on treasury bonds was on an upward trajectory in the last three years, rising from 6.26 years (FY2017) to 9.1 years (FY2021[1]).

Figure 5: Composition of T-bonds vs T-bills



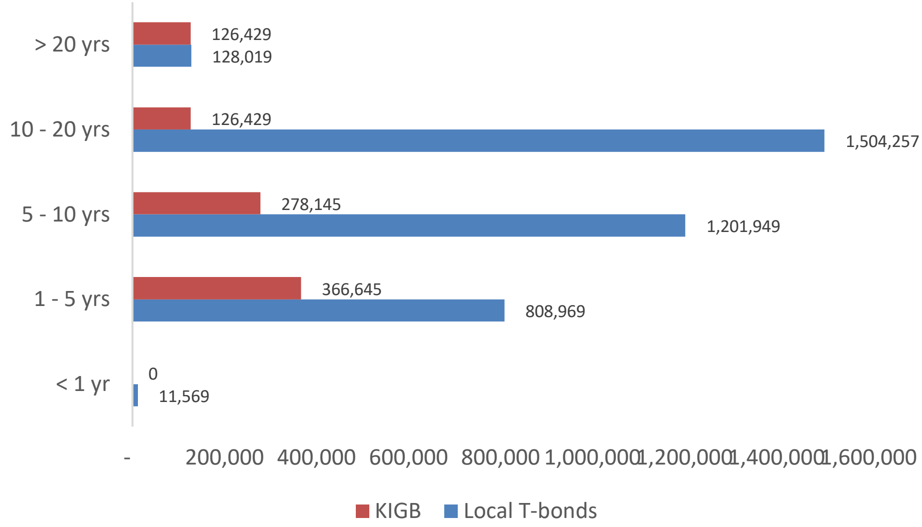
Source: National Treasury

…but we see maturity pressure in the short- to medium-term

In the next five years, total public debt amounting to KES 1.2tn (KES 820.5bn in local bonds and KES 366.6bn in external debt) is expected to mature. This is expected to put pressure on government revenue at a time when revenue collections are below target and debt markets are experiencing elevated yields.

[1] Annual Public Debt Management Report 2022

Figure 6: Expected maturities (KES m)

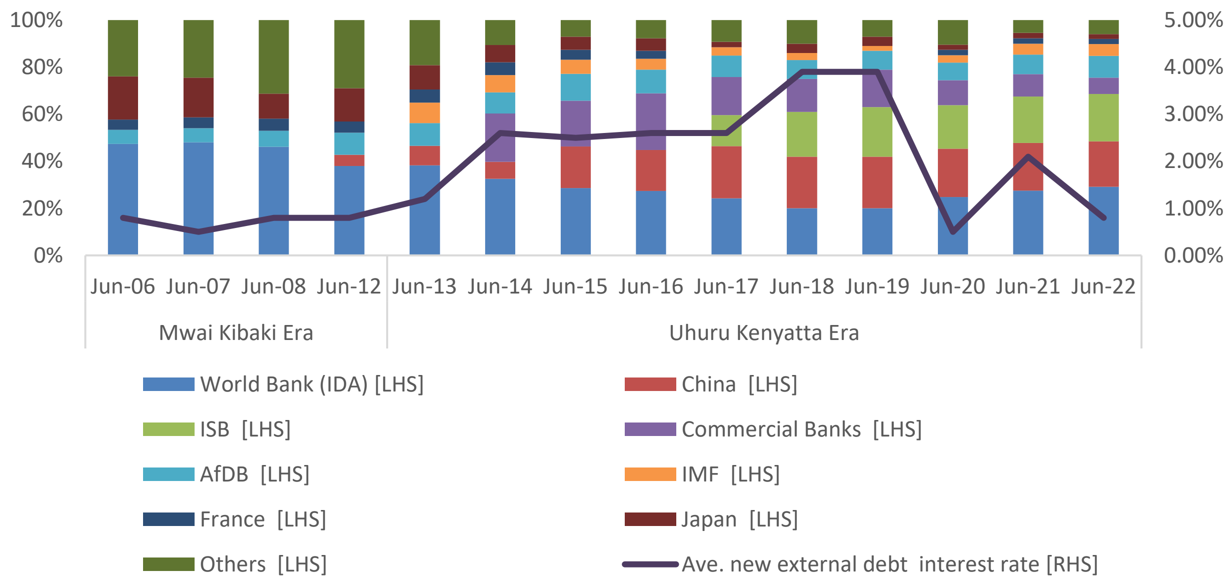


Source: Bloomberg

From relatively cheap to more expensive debt…

Kenya was categorized as a lower middle-income country in 2014, following the rebasing of its national accounts. At the time, it was still within the International Development Association (IDA) concessional funding window as its Atlas Gross National Income (AGNI) per capita was below the IDA's cut-off threshold of USD 1,215. However, has since grown to levels of 1,303 (2015) and 2,080 (2021) according to the World Bank. This contributed to President Kibaki's administration heading East for new sources of funding. As a result, cheap debt (which often comes with various conditions) began to shrink. President Uhuru's administration further diversified sources of external debt to even more expensive sovereign bonds and commercial bank debt. Although by the end of FY2021/22 the largest external lender was still International Development Association (IDA), their composition in the debt mix had shrank to 29.1% (from 47.4% in 2006). This was followed by International Sovereign Bond (ISB) holders at 20.1% (from 0% in 2006) and China at 19.4% (from 0% in 2006). The other top multilateral and bilateral lenders were AfDB (9.3%) and IMF (5.0%).

Figure 7: Evolution in external debt composition by creditor vs average interest rate-(2006-2022)

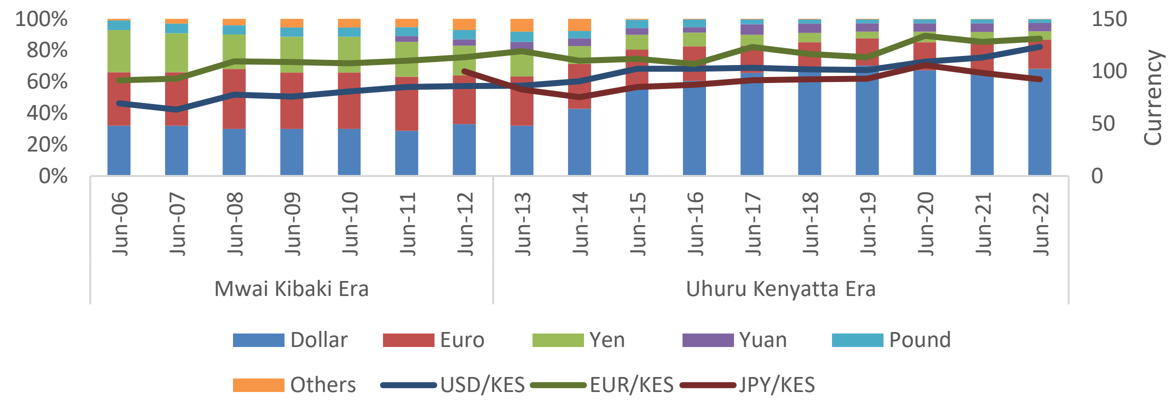


Source: National Treasury

…with the current currency exposures adding to the debt pressure situation

With the increased externalization of the public debt came an increasingly higher exposure to various global currencies. President Kibaki's administration saw an increase in exposure to the Yuan (0% in FY2006 to 4.0% by FY2012), and other various currencies (1.0% to 7.0%). However, during President Uhuru's terms, exposure to the US dollar shot up to 68.2%, the Yuan rose marginally to 5.3% while exposure to the Euro dropped from 31.0% to 18.6%, Yen from 19.0% to 5.4% by the end of FY2022. The general increase in the level of external debt has exposed the country to foreign exchange rate risk. Based on the data available, during the period FY2004 – FY2012, the Kenya shilling depreciated by +11.2% against the dollar (vs +43.4% during the 2012-2022 period), +7.8% against the Euro (vs +15.6% during the 2012-2022 period), and appreciated by -6.7% against the Sterling pound (vs depreciation of +6.8% during the 2012-2022 period). The shilling continues to be on a sliding path against the US dollar. It has depreciated by 2.5% YTD from KES 123.7 (30 Dec 2022) to KES 126.43 (24 Feb 2023).

Figure 8: External debt composition by currency and trends in exchange rates-(2006-2022)

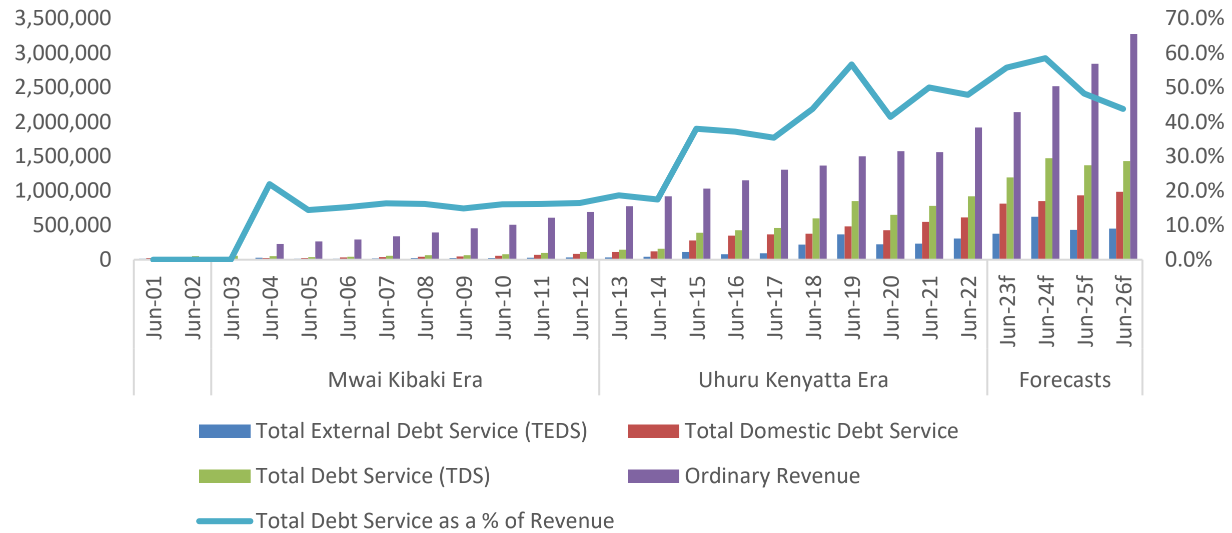


Source: National Treasury/CBK

Rising debt service obligations… where will the funds come from?

During the period 2004 – 2012, the total debt service as a percentage of revenue averaged 16.4%. However, these jumped to levels of 38.6% during the period 2013 – 2022. By the end of the financial year FY2021/22, KES 917.8 bn (47.9% of revenue) was expensed for debt servicing (KES 612.1 bn on domestic debt and KES 305.7 bn on external debt). This was 17.6% higher compared to KES 780.6 bn (50.0% of revenue) expensed in FY2020/21.

Figure 9: Debt servicing by the government (2001-2026)



Source: National Treasury

Although the projected total debt service to revenue percentage is expected to decline from 47.9% (FY2021/22) to 43.8% (by FY2025/26) due to a projected increase in revenue, the projected debt service, in absolute terms, is expected to rise to KES 1.4 tn (FY2025/26) from KES 917.8 bn (FY 2021/22). Most (KES 612.1bn or 66.7% of total debt serviced) of the debt servicing was on domestic debt with about KES 456.9 bn spent on interest payments and KES 155.3 bn on treasury bond redemptions.

During FY2021/22, KES 305.7 bn was spent on external debt servicing compared to KES 234.6 bn in the previous period. The rise was due to an increase in bilateral debt servicing attributed to the end of the Debt Service Suspension (DSSI) extended to Kenya in 2021. The servicing of external debt is expected to record a sharp rise in the next five to six years driven by the external principal repayments that are expected to grow and peak in FY2023/24 and FY2027/28 due to the expected payments on the two 10-year Eurobonds.

Going forward, the ability to comfortably service debt will largely depend on the ability of the government to collect revenue (on the domestic front) and grow FX-earning capacity (on the international front).

The question of sustainability will linger on for sometime

During the pre-pandemic period, Kenya's debt-to-GDP ratio levels were above 50% and inching towards 60%. By FY2021/22 the ratio had gone up to 67.3%. According to the International Monetary Fund (IMF), the country was ranked 17th in Sub-Saharan Africa in 2021 based on the high debt-to-GDP ratio up from 18th in 2020[2]. Based on the Joint World Bank-IMF Debt Sustainability Analysis in 2021[3], Kenya's debt was considered sustainable thanks to the fiscal consolidation through the IMF-supported program. The position remained the same in 2022 and the IMF, in its Country Report No. 22/232, indicated that the country's public debt is still sustainable.

By February 2023, out of the three major rating agencies, two of them had a negative outlook on the country's rating.

Figure 10: Kenya's Sovereign Credit Ratings (February 2023)

Source: Respective company website

It is also projected that the present value[4] of total public debt to GDP will remain above the 55% benchmark up to 2025.[5] According to the IMF, the sustainability threshold for the debt to GDP ratio is 55%. Currently, Kenya has surpassed it by more than 10%. In addition, the threshold for the present value of external debt to GDP is 40% and Kenya is currently in a safe zone at 33.7%. According to the National Treasury's Medium-Term Debt Strategy, the ratio is expected to go below 27% between 2023 and 2025.

However, the country is not on the safe side in terms of external debt service to revenue. The IMF threshold is 15% while the country recorded 15.9% in 2022 and it is expected to rise to 17.7% and 24.7% in 2023 and 2024.

[2] IMF. Regional Economic Outlook – Sub Saharan Africa, October 2022

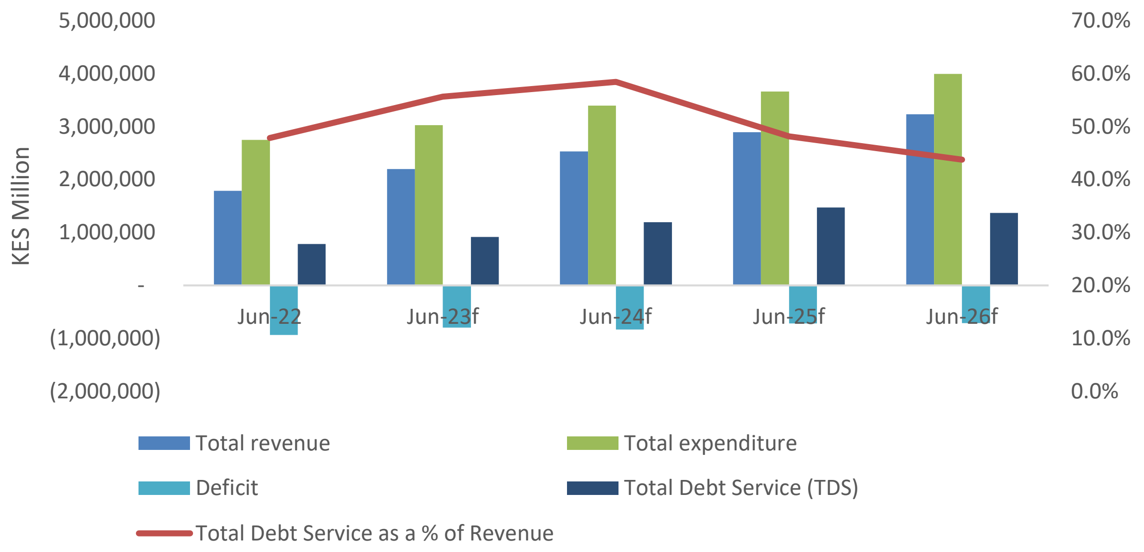
[3] Kenya - Joint World Bank-IMF Debt Sustainability Analysis, April 2021

[4] Present value of total public debt: According to IMF, it is the sum of short-term external debt plus the discounted sum of total debt service payments due on public, publicly guaranteed and private non-guaranteed long-term external debt over the life of existing loans

[5] Annual Public Debt Management Report 2022

Upon further assessment of the projected revenues and total debt service levels, there may be revenue pressure to cover for various expenditure and debt service. Based on government's projections, the total debt service-to-revenue is expected to increase and reach a high of 58.4% in 2024. It is then expected to decline to 43.8% by 2026. However, based on IMF's report, the ratio is expected to reach a high of 79.3% in 2024 then decline to 69.8%. Based on both debt service projection, next year (2024), may turn out to be another challenging year for the government. Although the deficit is not expected to be as large as recorded in 2021 (KES 934 bn) it is expected to range between KES 700 bn and 800 bn between 2023 and 2027 which we deem is still relatively high.

Figure 11: Revenue, expenditure, fiscal deficit and total debt service (2022-2026f)



We see a potentially high risk of debt distress, if the debt build-up is not matched with an accelerated rate of sustainable revenue generation. By the end of FY2022, the growth in the debt level had moderated, the fiscal deficit declined, government revenues grew significantly and the composition of external debt vs domestic debt dropped. On the flip side, the country's domestic debt service rose, treasury bill rates increased, the Kenyan shilling depreciated further, dollar debt composition rose, and the country's credit ratings worsened. Among other things, the government must keep an eye on debt sustainability by increasingly focusing on tenure elongation, improving FX-earning capacity, improving domestic revenue collection and efficiently managing public resources. In our next report, we will discuss further the main drivers of Kenya's debt, both external and domestic.

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