Kenya's Debt Drivers:
No Respite in Sight...

18th August 2023

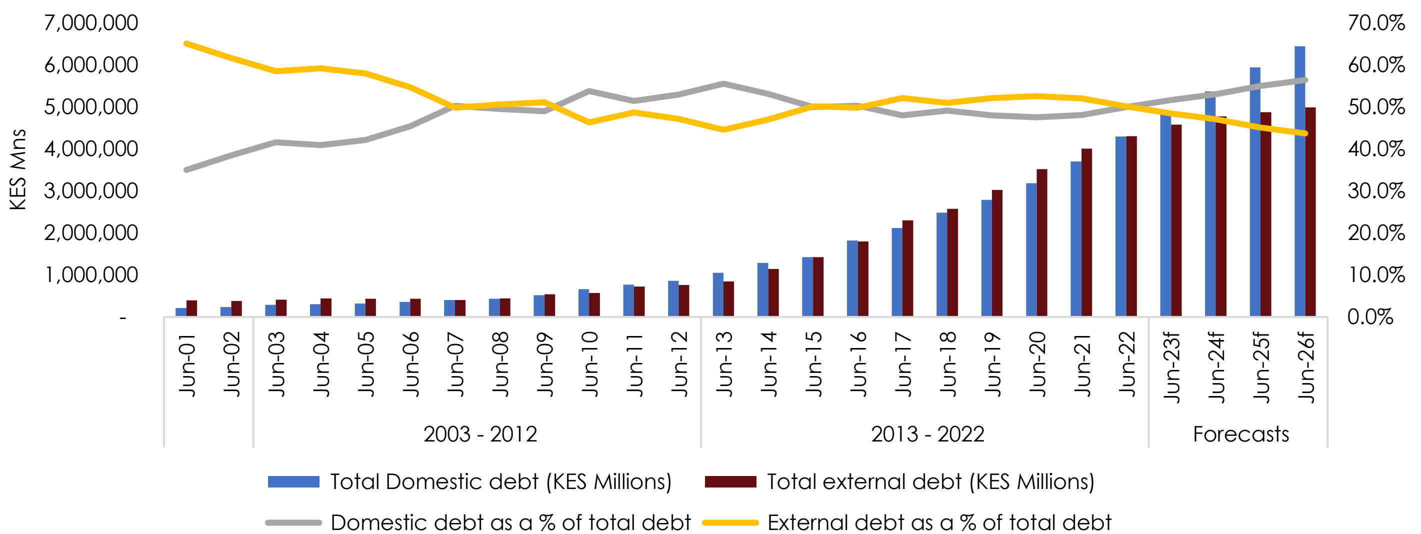
In this second part of the series, we look at the main drivers of Kenya's public debt and their implications. Understanding these drivers is crucial in assessing Kenya's debt sustainability and potential systemic risks in the long term.

The Last Decade Ended With Public Debt Externalization

Kenya's public debt has been on the rise, increasing by a 10-year CAGR of 18.3% from KES 1.9tn (June 2013) to KES 8.6tn (June 2022). Year-to-date (YTD), the public debt has grown by 5.9% to stand at KES 9.7tn (June 2023). Consequently, the debt-to-GDP ratio rose from 49.5% in June 2012 to 69.1% by the end of 2Q2022/23 (19.1% more than the IMF's recommended threshold of 50%).

As alluded to in our previous debt series report titled **Kenya's rising debt position: The lingering question on debt sustainability, dated March 10th, 2023**, the trend in the debt mix in the last decade saw an increasing externalization of public debt, with the composition of domestic debt dropping from 55.5% (2013) to 49.9% (June 2022), while that of external debt growing from 44.5% to 50.1%. The trend has not changed YTD. The composition of domestic debt dropped further from 49.0% (January 2023) to 47.1% (April 2023). However, given the current external debt market conditions, we expect to see heightened uptake of domestic debt, albeit at increasing interest rates.

Figure 1: External debt vs domestic debt (% of total debt) (2001-2026f)



Source: National Treasury

A Look Into The Key Drivers:

Some of the key drivers of Kenya's public debt include:

i. The elusive mirage of sustaining target budget deficits…

The debt burden has been primarily influenced by budget deficits, and in recent years, there has been a noticeable increase in this trend. During the 2003 -2012 period, the budget deficit averaged 2.7% of GDP. It peaked at a high of 5.9% in 2010, before moderating to 4.9% by the end of the period. During this period, the deficits were largely driven by infrastructure development and subsidies provided to various sectors of the economy, such as agriculture, education, and healthcare.

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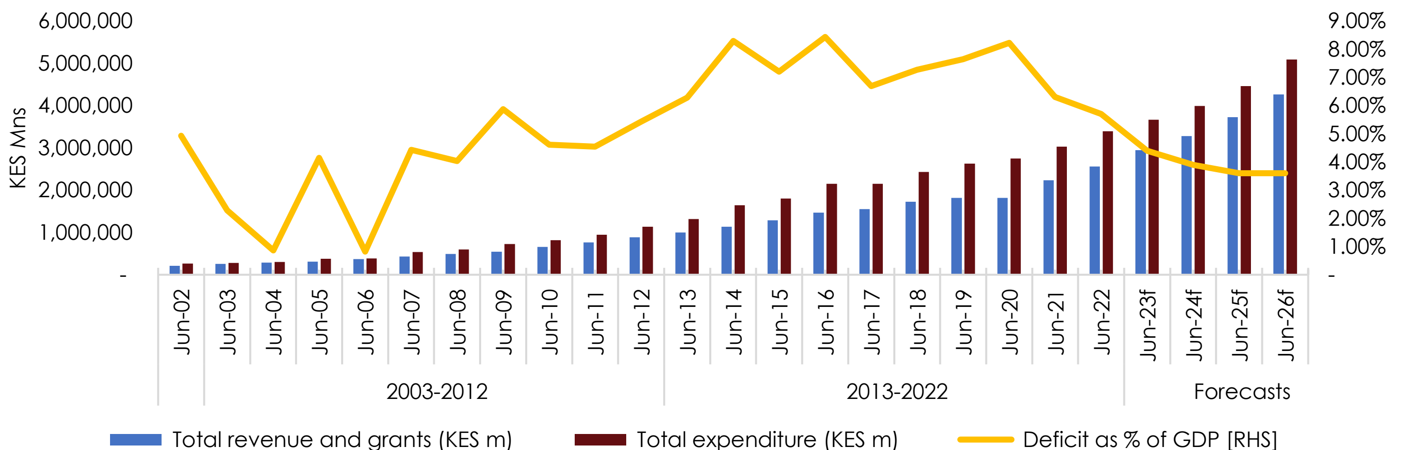
During the 2013-2022 period, the deficit averaged 7.4%. It witnessed a notable rise, increasing from 5.9% in 2013 to 8.5% in 2021, before decreasing to 5.5% in 2022. The sharp increase in fiscal deficits is attributed to increased spending on big-ticket infrastructure projects and the impact of the COVID-19 pandemic on the economy.

Going forward, the government expects a declining trend in the deficit, projecting a deficit of 4.4% (KES 718.1 bn) in FY2023/24. About KES 131.5 bn of this is expected to be financed through external borrowing and the remaining KES 586.5 bn through domestic borrowing. The projections for 2025 and 2026 stand at 3.9% and 3.6% respectively. Achieving this will largely depend on the government's ability to collect revenue. On the spending side, the government has not demonstrated the fiscal discipline to rationalize spending. This will make it challenging for the government to sustain a deficit of less than 5% in the medium term.

Figure 2: Trend in fiscal deficits



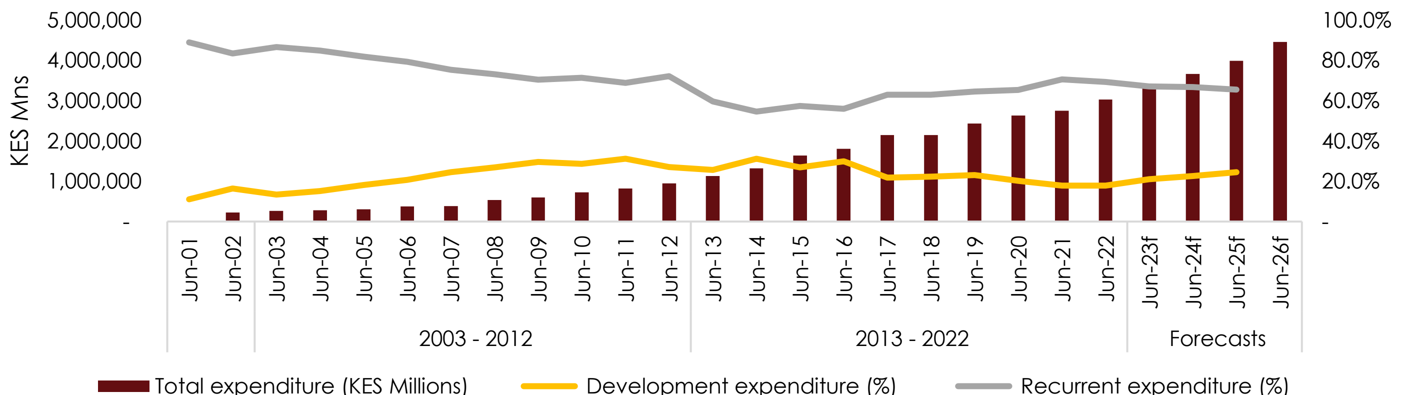
Source: National Treasury

As of June 2022, the total debt service as a percentage of revenue was estimated at 47.9%. This leaves only 52.1% of the tax revenue to finance an ambitious government development program in an economy experiencing high budget deficits necessitating further borrowing in a recessionary global environment.

During the 2003-2012 period, revenue and grants grew at a CAGR of 15.4%, from KES 210.8bn to KES 763.8bn. However, revenue growth decelerated to a CAGR of 10.8% (887.5bn to 2.2tn) in the 2013 – 2022 period.

The total public expenditure grew at a CAGR of 15.2% from KES 264.1bn (2003) to KES 945.3bn (2012). Most of this growth was channeled toward development expenditure, as depicted in the chart below. However, during the period 2013-2022, public expenditure slowed down to a CAGR of 11.6% (from KES 1.1tn to KES 3.0tn). Interestingly, most of the funds were consumed by recurrent expenditure.

Figure 3: Trend in key public expenditure components



Source: National Treasury

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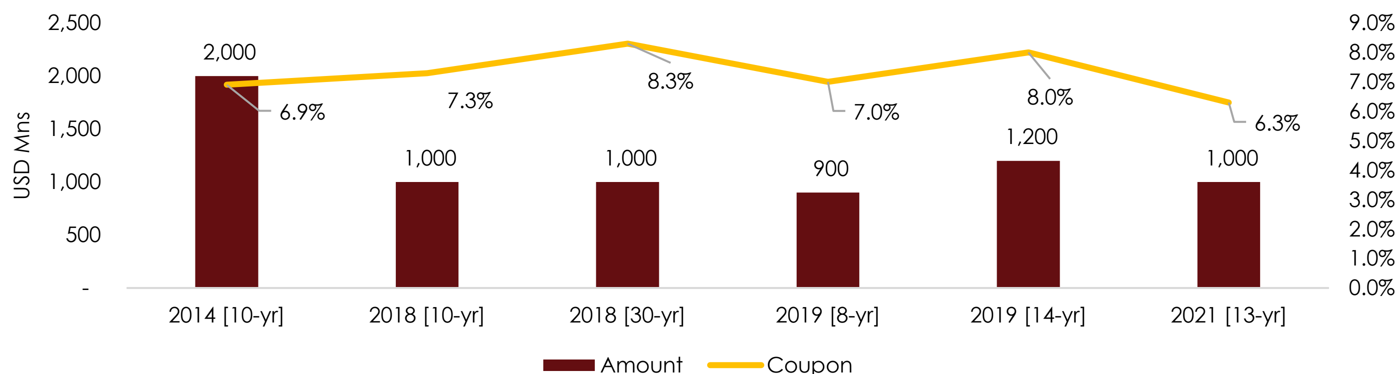
ii. …necessitating the issuance of sovereign bonds

External borrowing grew briskly during the 2013-2020 period as the government waded into the Eurobond market, drawn by competitive financing terms with coupon rates in the 7-8% range. It has been reported that Eurobonds were issued to fund infrastructure projects, repay maturing debt, and cover the fiscal deficit. The chart below shows the current outstanding Eurobonds.

Figure 4: Outstanding Eurobonds – amounts, coupons, and maturities



Source: National Treasury

These bonds have helped to diversify Kenya's sources of external financing, but they have also increased the country's exposure to international financial market conditions. As a result, external debt servicing costs are expected to record a sharp rise in the next five years driven primarily by the external principal repayments that are expected in FY2023/24 (USD 2bn), FY2026/27 (USD 900m), and FY2027/28 (USD 1bn). Further, the erosion of the shilling against the US dollar will increase the debt repayment burden. We expect the government's ability to tap into the external debt markets at favorable rates to be challenging in the short to medium term, a situation that is likely to pile more pressure on rates in the domestic debt market.

iii. …and uptake of commercial syndicated loans

Since 2012, Kenya has actively pursued commercial syndicated loans from various financial institutions, including Standard Chartered Bank, Citi Bank, Africa Export-Import Bank, and the Trade and Development Bank. These commercial syndicated loans have been used to finance major infrastructure projects, such as the construction of the Standard Gauge Railway (2nd phase). Between 2018 and 2019, loans amounting to USD 6.5bn at variable interest rates were taken from Trade and Development Bank. The loans are repayable from April 2020 until 2029. On 6th, July 2023, the government secured a USD 500m syndicated loan from Citi Group, Standard Chartered Bank of the United Kingdom, the Afrexim Bank, Standard Bank SA, and Rand Merchant Bank SA. The terms of the loan, which comes in two tranches (a 3-year and a 5-year) were not disclosed.

However, these loans often come with higher interest rates and shorter repayment periods than bilateral or multilateral loans, which has contributed to the strain on the government's debt-servicing capacity. During the 2003 – 2012 period, the average tenor of new loans to Kenya was 15.3 years compared with 10.5 years during the 2013 – 2022 period. Conversely, interest rates on loans have been rising in recent years. The average interest rate on new loans stood at 5.3% during the 2003 – 2012 period compared with a rate of 6.0% during the 2013 – 2022 period.

Given the government's current debt levels and obligations, the fiscal structure, and the macroeconomic environment, it has very little wiggle room to negotiate for better terms. In line with this, it has been forced to go back to relying on institutions such as the IMF and the World Bank, a dependency that also comes with stringent conditions. As a result, we expect to see some major structural changes in the macroeconomic environment which will have significant long-term implications. In the meantime, the expected heavy borrowing in the domestic market and refinancing will come at relatively high rates. Notably, the YTD rate on the benchmark 91-day T-bill has risen by 374bps to 13.11% (8th August), pointing to higher financing and refinancing costs in the domestic market.

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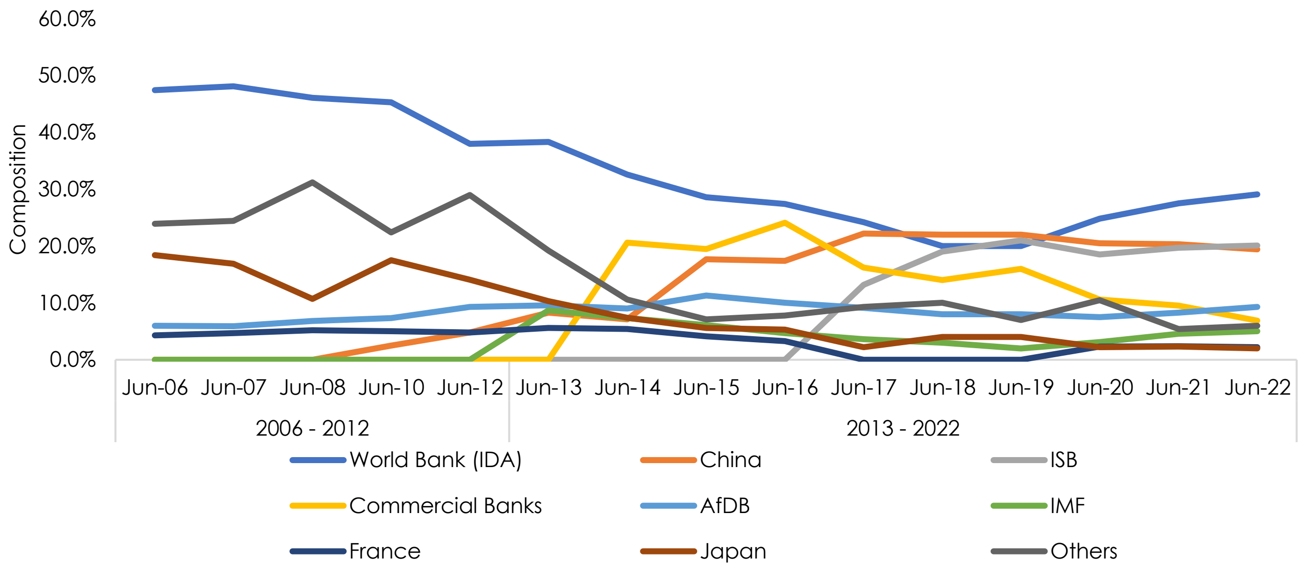
Figure 5: Trend in the composition of external debt by holder

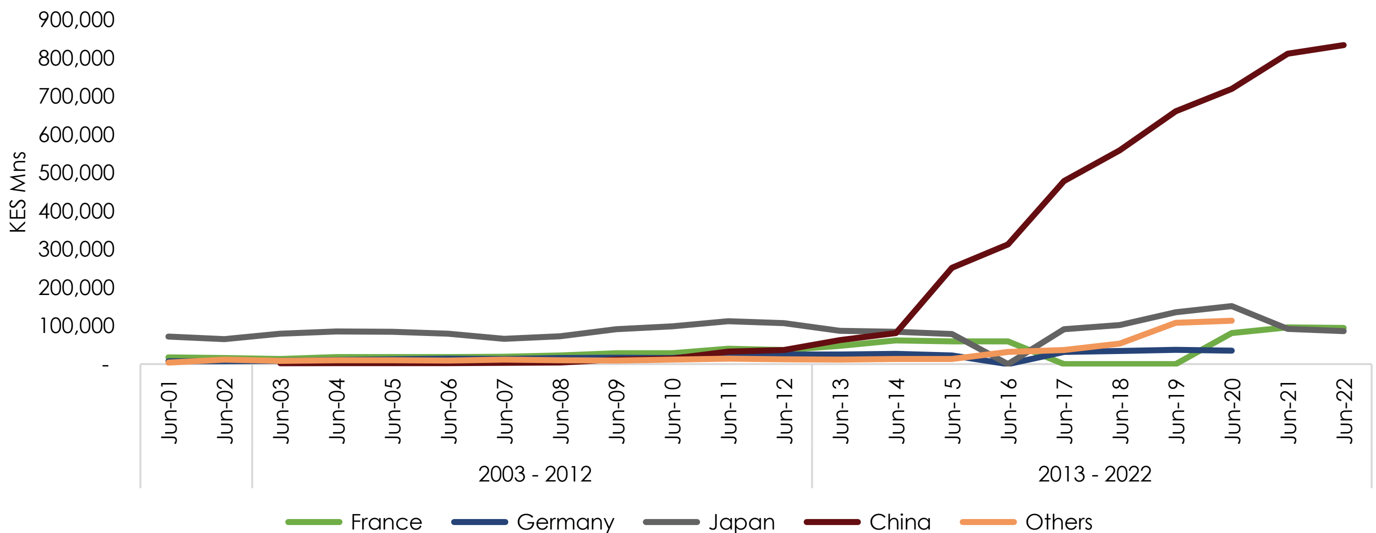


Source: National Treasury

iv. ...and looking to the East for bilateral loans

Bilateral lending has grown significantly in recent years, accounting for 25.7% of Kenya's external debt in 2022. According to the data from the National Treasury, China was the largest bilateral lender to Kenya in 2022, with outstanding loans amounting to KES 787.5bn (~73% of total bilateral debt).

Figure 6: Composition of bilateral lenders as of June 2022



Source: National Treasury

Some of China's loans have been used to finance projects such as the Standard Gauge Railway (~KES 857bn), the Lamu Port South Sudan Ethiopia Transport corridor (~24bn), and the 27.1km Nairobi Express Way (~KES 88bn).
Although these projects have contributed to the expansion of transportation infrastructure and trade, they have come at a very high cost, which implies a longer time horizon to start generating net positive returns to the economy. In addition, while bilateral loans may offer favorable terms and longer repayment periods than syndicated loans, they also come with risks such as exposure to political pressure from the lending countries.

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v. But some exogenous shocks showed up…

The high debt level has also been driven by exogenous shocks, such as the 2008 financial crisis, a ravaging drought, locust invasion, the COVID-19 pandemic in 2020, and the onset of the war in Ukraine in February 2022. These shocks have negatively impacted the economy, leading to a decline in government revenues, increased external borrowing, steep commodity prices, and a depreciation of the shilling.

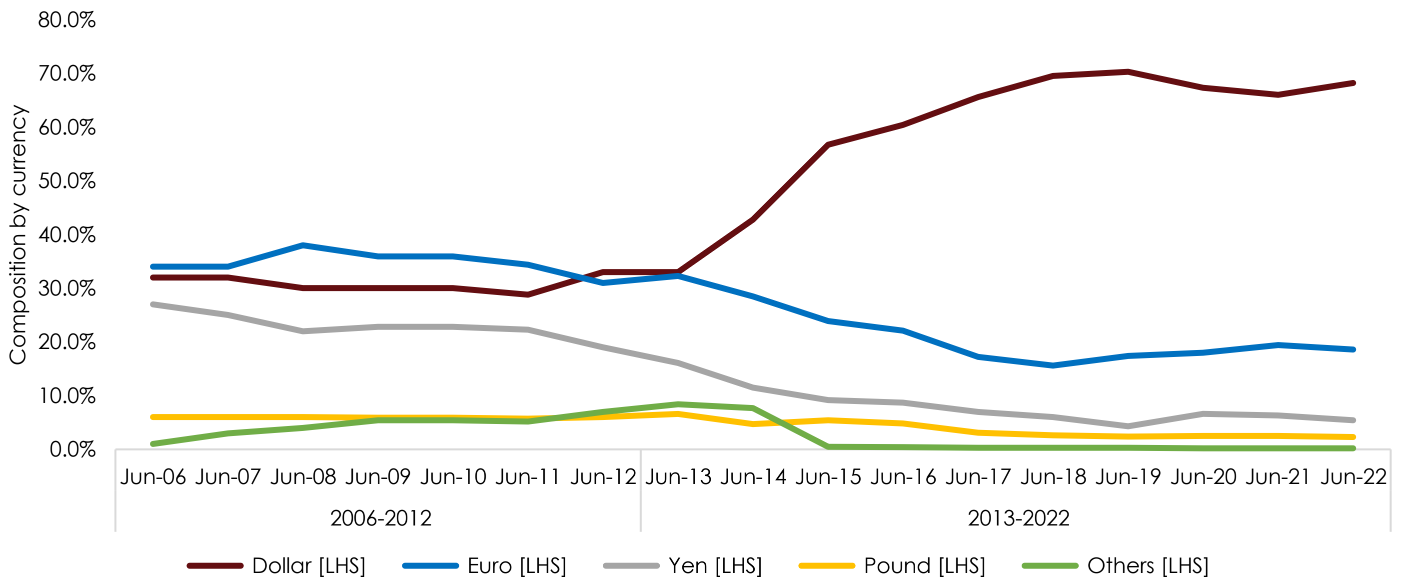
In 2008, Kenya borrowed USD 508m in external debt and USD 53m in domestic debt to mitigate the effects of the financial crisis leading to an increase of 6% in total debt. In February 2023, it was reported that the country received USD 140m as credit from the World Bank for drought mitigation efforts and USD 126m from United States Agency for International Development. The impact of the COVID-19 pandemic saw the country experience weakening fiscal buffers at a time when fiscal injection was required to stimulate aggregate demand which led to an increase in external borrowing in 2020 as the government sought to finance its response to the pandemic.

Between 2020 and 2021, it received financial support to the tune of over USD 4.2bn from partners including the IMF, World Bank, and AfDB. This contributed to the 17.3% growth in the external debt stock from KES 3.2tn (March 2020) to KES 3.8tn (March 2021). The war in Ukraine has piled pressure on the stock and servicing of external debt, through the weakening of the shilling and an escalated cost of risk. Kenya canceled an intended USD 1bn Eurobond in mid-2022 owing to a surge in yields. This is making it challenging for the government to raise additional debt or refinance through the external debt market.

vi. …an additional burden from currency depreciation

Kenya's external debt has also been affected by the weakening of the shilling against the major currencies. In the recent past, the external stock of debt has been predominantly USD and Euro-denominated.

Figure 7: Composition of debt by currency



Source: National Treasury

The shilling has generally been depreciating against the US dollar since 2005. During the 2005-2012 period, it depreciated by 10.5% (from KES 76.2/USD to KES 84.2/USD). It maintained the same trend during the 2012-2022 period, weakening further by a significant 37.0% (from KES 86.0/USD to KES 117.8/USD). YTD (as of August 17th), the shilling had depreciated by 16.87% against the USD to 144.2/Euro.

The shilling recorded a 15.0% depreciation against the Euro during the 2005-2012 period (from 92.1/Euro to 106.0/Euro). It depreciated by a further 10.6% during the 2013-2022 period (from 112.1/Euro to 124.0/Euro). YTD, (as of August 17th), it had depreciated by 15.14% to 156.9/Euro.

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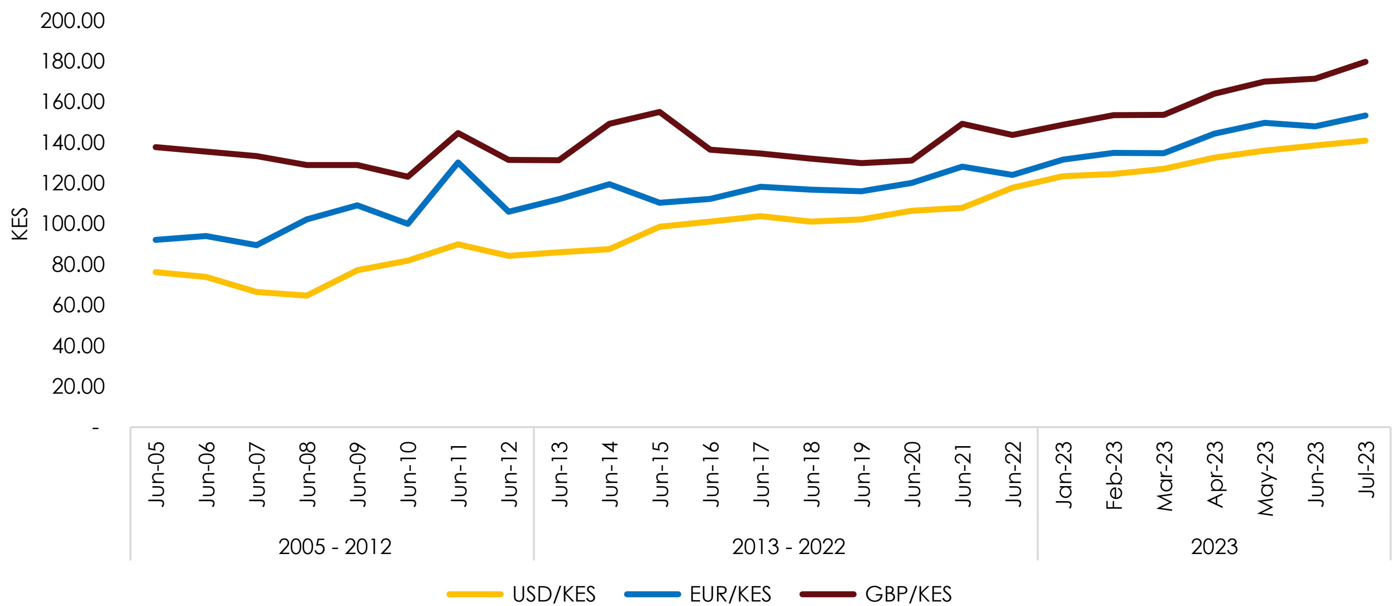
Figure 8: Trend in the exchange rate



Source: National Treasury

The sustained depreciation of the shilling continues to put pressure on the government's ability to finance external debt. By the end of April 2023, the stock of external debt stood at KES 4.9tn (USD 34.5bn). Holding all factors constant, if the shilling is to depreciate by a further 5.0%, it would pile an additional KES 242.6bn in the current stock of external debt. In addition, the external debt servicing costs stood at KES 378.3bn (KES 137.2bn in interest and KES 241.1bn in principle) in FY2022/23. This is expected to shoot up by 64.2% to KES 621.3bn (145.7bn in interest and KES 475.6bn in principle). A 5.0% depreciation of the shilling from current levels would increase the external debt servicing cost by an additional KES 31.1bn (~2.6bn monthly).

vii. Oh! There's the burden of cash strapped State-Owned Enterprises (SOEs)

State-owned enterprises in Kenya have a long history of financial difficulties, which has contributed to the rise in domestic debt. Many of them have turned to borrow money under government guarantees as well as directly. During the FY2018/19, the government paid KES 1.4tn as called-up guaranteed debts owed by public enterprises that were in financial distress, including East Africa Portland Cement (EAPC), Tana and Athi River Development Authority (TARDA), and Kenya Broadcasting Corporation (KBC), which accounted for 25.6%, 20.5% and 53.9% of the payments made during that year, respectively.

In FY2021/22, Kenya Airways defaulted on a USD 841.6 m loan (guaranteed and non-guaranteed portions) from the American Exim Bank for the purchase of aircraft out of which the government guaranteed USD 525m. There are plans, with a push from the IMF to privatize the company. In the same year, Kenya Power's debt stood at KES 95.9 bn. The company has struggled with financial mismanagement, alleged corruption, and a high level of non-payment by customers, which has contributed to its debt burden.

By the end of June 2022, the amount of publicly guaranteed loans stood at KES 145.4bn. In addition, out of the 260 state corporations, 19 had non-guaranteed public debt amounting to KES 99.3 bn (0.8% of GDP, an increase from 0.1% in 2021) out of which 15.2% is held in domestic currency obtained from local banks.

Unless privatized or restructured, we expect the trend of SOEs accumulating debt to continue, given the financial difficulties many of them face. According to the Auditor General's report for FY2019/20, many SOEs have negative working capital and are unable to meet their financial obligations, which puts them at risk of defaulting on their loans.

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Still No Light At The End of The Tunnel

The country's total debt stock has been on an upward trajectory in recent years. Drivers such as increased fiscal deficits, issuance of sovereign bonds, shilling depreciation, exogenous shocks, and debt held by cash-strapped SOEs have contributed significantly to the growing debt burden.

The government finds itself in a quagmire - a rising interest rate environment, a huge and growing public expenditure, inflationary pressures, and a depreciating currency. To meaningfully manage the rising debt pressure, it is critical that the government cuts wastage, reduces the level of corruption, and instills fiscal discipline across ministries, departments, and agencies. Unfortunately, we are yet to see that level of commitment.

Based on the recently signed Finance Bill, it is clear that the government has chosen the easier route of revenue mobilization by introducing a raft of new revenue sources. In our view, this may not yield much if the operating environment continues to be challenging for both households and businesses. We expect interest rates and inflationary pressures to remain elevated in the short- to medium term. Consumption levels will drop drastically and job creation and salary increment in the private sector will be muted. Overall, achieving meaningful inclusive economic growth in the medium term will be almost impossible.

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