

External Public Debt Servicing

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Introduction

Prudent external public debt service management is integral in ensuring external debt service does not place an unbearable burden on the current and future generations. It is also pivotal in informing the optimal debt strategy for mitigating or reducing exposure to foreign exchange rate risks in the medium to long-term associated with external debt repayments. Additionally, it safeguards the National Government's ability to service the external public debt without compromising the fiscal capacity to fund the provision of public services and development projects.

Kenya's external public debt stock has expanded tenfold within the last two decades from Ksh 405.35 billion in 2000 to Ksh 4.17 trillion in 2021. Further, the structure of external public debt changed with the commercial component of public debt increasing significantly since 2000. This has resulted in a tenfold expansion in the external public debt service from Ksh 34.48 billion in 2000 to Ksh 328.12 billion in 2021.¹

Kenya's external public debt repayment is serviced using major global reserve currencies, which possess a significant exchange rate and refinancing risk in the event of depreciation of the local currency. Within the last two decades, the Kenya shilling has depreciated against the major global currencies, exacerbating risks associated with external public debt refinancing. The external public debt is largely denominated in the US dollar (66%), Euro (19.4%), Japanese Yen (6.3%), Chinese Yuan (5.6%), and British Pound (2.5%), respectively.² Within the last one year, the Kenya shilling has depreciated by 9.96 percentage points against the US dollar from Ksh 111.15 in October 2021 to Ksh 121.11 in October 2022.³ In the same period, external debt service, which is transacted in US dollar, increased by Ksh 93.54 billion.

Why is External Public Debt Service Important?

The commercial component of external public debt funding in 2000 was 6.29%, while that of multilateral debt was 58.31% and bilateral 35.05%. The share of commercial debt (from syndicated loans and international sovereign bonds) has grown significantly since then to 28.7% as at June 2021. With the rise in external public debt service, significant exposure to foreign exchange rate risks cannot be wished away. There is also heightened external public debt service vulnerability, which coincides with the maturities of the Eurobonds in 2024.⁴ In 2021, Kenya's external public debt

service (as % of exports) was 25.7%,⁵ which was above the upper limit of 21 per cent external debt service threshold set by the joint World Bank-IMF Debt Sustainability Framework for developing countries.⁶ This has exerted undue pressure on the demand for hard currencies to service the external debt resulting in the appreciation of these currencies against the local currency.

Concessional loans in Kenya are priced at an average fixed rate of 1.75 per cent, with a 35-year tenor and up to a 10-year grace period. This makes them cheap and easy to service.⁷ However, the risk and cost characteristics of Kenya's external public debt portfolio have evolved over time. The key driver is the decline in development grants and concessional sources of financing following Kenya's reclassification to a lower middle-income status after rebasing in 2014. This has called for more expensive financing options, such as the commercial debt that are currently servicing the development expenditure gap. Similarly, the diversification of sources of funding because of the changing international capital markets landscapes has enabled the country to obtain commercial loans from private lenders to fund key development projects that are pivotal towards the attainment of the Kenya Vision 2030. However, the significant rise in accumulation of external debt has put pressure on the exchange rate, with implications for debt servicing.

The PFM Act 2012 section 50(6) states that public debt can be paid from the Consolidated Fund Services or any other fund that is established by an Act of Parliament. The National Treasury had put forward a bill to the National Assembly for the creation of a sinking fund to manage public debt. The creation of the sinking fund was supposed to assist in cushioning the National government in servicing public debt. External debt instruments issued with Sinking Fund carry lower costs and risks due to collateralization, hence the need for the special fund. However, the bill was rejected by the National Assembly as it had not undergone public participation.

In the recent past, the National Government through the Central Bank of Kenya has made initiatives to leverage on inward foreign remittances to boost foreign exchange reserves by creating a conducive environment for the Kenya diaspora to invest back home. Between March and May 2021, the Central Bank of Kenya did Kenya's first Diaspora Remittances Survey in a bid to enhance remittance inflows to boost private investments and Kenya's forex reserves. The average cost of sending inward financial remittances

through formal financial channels to Kenya was 4-5% of the amount sent. The cost of sending in-kind remittances is 15-27% of the item value, which is very high compared to other regions.⁸ This is a disincentive for sending money through formal channels.

Kenya's current account deficit has widened with rising value of imports, which are outpacing the rate at which exports leave the country. As a result, the demand for hard currencies to pay for imports—which compete with external debt service—has increased. Kenya's destination markets for exports have remained narrow, with 13 countries accounting for over 70% of total exports on a global scale. The product base has also been equally narrow, with 5 broad categories of products accounting for 56% of total exports.⁹ The National Government has developed the National Trade Policy¹⁰ and National Industrialization Policy¹¹ in earnest, encouraging Kenya to leverage the opportunities that lie in a diversification of the export base. Prospects for these transformative policies lie in opportunities in the domestic market and in the regional and global markets, where Kenya's share remains reactively low. However, there is immense unexploited trade potential in sectors in which Kenya has both a comparative and competitive advantage. This includes targeting the untapped value addition options in the agricultural and livestock production and manufacturing sector. Also, the policies encourage the country to create a conducive environment to tap the wealth of unexploited natural resources in minerals, the blue economy and the diverse services sector. Effective implementation of these policies is vital in boosting exports to increase foreign exchange reserves, which are pivotal for external debt service.

Policy Recommendations

Thus, in ensuring that the servicing of external debt does not give undue fiscal burden, the following is recommended.

- (i) At present, Kenya's external public debt service is paid from the Consolidated Fund Services (CFS). The CFS also covers other obligatory payments by the State remuneration and pension of civil servants. The National Treasury and National Assembly are encouraged to create, operationalize, and implement a Sinking Fund in compliance with the Public Finance Management (PFM) Act 2012. The sinking fund will be essential in alleviating any

external debt rollover risks. It will also play a pivotal role in debt restructuring and ring-fencing resources to ensure timely service of maturing external public debt.

- (ii) Incentivize inward remittances from the diaspora to boost foreign reserves by lowering the cost of alternative remittance channels and establishing innovative investment vehicles that attract diaspora remittances.
- (iii) A preference for loans in concessional terms is encouraged since it is extended under favourable terms (longer grace periods and lower interest rates). This offers convenience in the form of leeway in allowing the projects to be completed and pick up before repayment in addition to the lower external public debt service. Further, is exploring other sources of financing infrastructure development including from domestic sources and local currency dominated bonds.
- (iv) Promote the diversification of the export base by targeting unexploited natural resources in the blue economy and extractive sector, the untapped value-addition possibilities in agriculture and livestock production, and the growth of the manufacturing sector.

Endnotes

1. KNBS Economic Surveys <https://www.knbs.or.ke/>
2. The 2022 Medium-Term Debt Management Strategy <https://www.treasury.go.ke/medium-term-debt-management-strategy/>
3. The Central Bank of Kenya Weekly Bulletin <https://www.centralbank.go.ke/releases/weekly-bulletin/>
4. The National Treasury <https://treasury.go.ke/wp-content/uploads/2021/02/Joint-World-Bank-IMF-Review-May-2020.pdf>
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6. Joint World Bank-IMF Debt Sustainability Framework <https://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/16/39/Debt-Sustainability-Framework-for-Low-Income-Countries>
7. The 2022 Medium Term Debt Management Strategy <https://www.treasury.go.ke/medium-term-debt-management-strategy/>
8. Kenya Diaspora Remittance Survey <https://www.centralbank.go.ke>
9. Kenya Integrated National Export Development and Promotion Strategy <https://www.tralac.org/documents/resources/by-country/kenya/2057-kenya-integrated-national-export-development-and-promotion-strategy-july-2018/file.html>
10. Kenya National Trade Policy https://www.trade.go.ke/sites/default/files/Kenya%20National%20Trade%20Policy%20%282016%29_0.pdf
11. National Industrialization Policy <https://www.industrialization.go.ke/index.php/policies/124-the-national-industrialization-policy>

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