

Leveraging Special Drawing Rights (SDRs) for Sustaining Economic Recovery in Kenya

Daniel Omanyo,
Hellen Chemnyongoi
and
Rose Ngugi

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By

Daniel Omanyo

Kenya Institute for Public Policy Research and Analysis

Hellen Chemnyongoi

Kenya Institute for Public Policy Research and Analysis

and

Rose Ngugi

Kenya Institute for Public Policy Research and Analysis

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List of abbreviations and acronyms

ADR	Alternative Dispute Resolution
AfCFTA	Africa Continental Free Trade Area
AfDB	African Development Bank
BETA	Bottom-up Economic Transformation Agenda
BMS	Block Management System
BoP	Balance of Payment
BPS	Budget Policy Statement
CBK	Central Bank of Kenya
ECLAC	Economic Commission for Latin America and the Caribbean
CIT	Corporate Income Tax
COVID-19	Corona Virus Disease 2019
CSD	Central Securities Depository
DCC	Debt Carrying Capacity
DSA	Debt Sustainability Assessment
DSSI	Debt Service Suspension Initiative
ECA	Economic Commission for Africa
ECF	Extended Credit Facility
EFF	Extended Fund Facility
EGMS	Excisable Goods Management System
FY	Fiscal Year
FPE	Free Primary Education
GDP	Gross Domestic Product
GFI	Global Financial Integrity
GRA	General Resources Account
HNWI	High Net-Worth Individuals
HIPC	Highly Indebted Poor Countries
ICMS	Integrated Customs Management System

IMF	International Monetary Fund
KIPPRA	Kenya Institute for Public Policy Research and Analysis
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
LIC-DSF	Low Income Country-Debt Sustainability Framework
MDRI	Multilateral Debt Relief Initiative
MSMEs	Micro, Small and Medium Enterprises
MTDS	Medium-Term Debt Management Strategy
MTRS	Medium-Term Revenue Strategy
NEER	Nominal Effective Exchange Rate
PCR	Primary School Completion Rates
PDMO	Public Debt Management Office
PPG	Public and Publicly Guaranteed
PRGT	Poverty Reduction and Growth Trust
PSTR	Primary to Secondary Transition Rates
PV	Present Value
RCF	Rapid Credit Facility
RECTS	Regional Electronic Cargo Tracking System
REER	Real Effective Exchange Rate
RFI	Rapid Financing Instrument
RSF	Resilience and Sustainability Facility
SBA	Stand-By Arrangement
SDGs	Sustainable Development Goals
SDR	Special Drawing Rights
SGR	Standard Gage Railways
SoEs	State-Owned Enterprises
TAT	Tax Appeals Tribunal
TIMS	Tax Invoice Management System
TMD	Treasury Mobile Direct
ToT	Turnover Tax
UNCTAD	United Nations Conference on Trade and Development
VAT	Value Added Tax

1. Introduction

Financing economic recovery in an era of multiple shocks

Like most countries in sub-Saharan Africa, Kenya has faced and coped with multiple shocks amid reduced fiscal headroom and increasing public debt vulnerabilities. Other than the COVID-19 global health crisis and the resulting economic effects, Kenya faced the Desert Locust Invasion in 2020, prolonged droughts in 2021 and 2022, and the accompanying high cost of living exacerbated by the spillover effects of the Russian-Ukraine war. These developments came when the economy had inadequate domestic resources to sustain the post-COVID-19 recovery momentum, and the mounting debt levels constrained the ability to raise new funding. Recent data indicate that Kenya is rated as a medium performer in terms of Debt Carrying Capacity (DCC) with a high risk of debt distress (National Treasury and Economic Planning, 2023a). The high risk of debt was primarily because of the economic effects of the COVID-19 pandemic contributing to a slowdown of economic growth. It is worsened by high inflation and supply chain disruptions due to the multiple and recurrent shocks the economy faces.

During the COVID-19 pandemic, the International Monetary Fund (IMF) supported member countries substantially. This support took multiple forms, including the Rapid Credit Facility (RCF) and the Rapid Financing Instrument (RFI), which provide emergency loans to low-income and middle-income countries facing urgent balance of payments needs. In response to the pandemic, the IMF increased the access limits for RCF and RFI loans to 100% of a member's quota and simplified the application process. Many countries used these facilities to finance their urgent health and social spending needs and address the pandemic's economic impact. The IMF also reviewed the conditionalities on various facilities, such as the Extended Credit Facility (ECF) and the Stand-By Arrangement (SBA), to provide more flexibility and support to member countries during the pandemic. These efforts allowed countries to use funds under the ECF and SBA to finance their COVID-19-related health and social spending needs (IMF, 2023; ECA & ECLAC, 2022).

With the severe impacts of the COVID-19 pandemic on global economic conditions, there were an unprecedented number of member countries seeking financial support. In response, the IMF temporarily increased annual access limits in general resources account (GRA)¹ from 145% to 245% of the quota, and under the Fund's concessional financing arm, Poverty Reduction and Growth Trust (PRGT), from 100% to 150% of the

quota. These were temporary modifications to access limits that lasted up to end of 2021, after which access limits reverted back to the initial levels before modifications. More recently, in March 2023, the IMF adjusted access limits in the GRA to 200% of the quota and the cumulative limit to 600% of the quota for a period of 12 months; this compared with the annual limit of 145% of the quota and a cumulative limit of 435% of the quota, which were last set in 2016.

Furthermore, the IMF has established the Resilience and Sustainability Trust (RST), which provides grants and concessional financing to low-income and vulnerable middle-income countries to build resilience to external shocks and ensure sustainable growth, contributing to longer-term balance of payments stability. The trust aims to support countries in addressing their urgent health and social spending needs, promoting economic recovery, and transitioning to a more sustainable and resilient economy. It is important to note that, for a country to access the resilience and sustainability facility, it must have high-quality policy reforms addressing the long-term structural challenges of climate change or pandemic preparedness. Additionally, the country must have a concurrent IMF-supported programme with upper credit tranche quality policies. At the point of accessing this facility, the country can be financing or non-financing an existing facility such as the Stand-by Arrangement (SBA) or the Extended Fund Facility (EFF), etc. Overall cumulative access cap is set at 150% of the quota or SDR one billion, whichever is smaller.

Notably, the IMF approved issuing US\$650 billion in Special Drawing Rights (SDRs) in August 2021 to help member countries supplement their foreign exchange reserves and finance their balance of payments needs during the pandemic. Data from IMF shows that about two-thirds (US\$420 billion) of the allocation went to developed economies. Further, statistics show that developing economies have a greater dependence on SDRs than developed economies, with net SDR positions showing significant differentiation in utilization rates between the two. ECA & ECLAC, 2022 noted that developing economies have an SDR utilization rate of 42.9%, while developed economies have a utilization rate of 5.9%.

The SDRs are allocated to countries based on their individual IMF quotas, which are broadly contingent on the relative economic position of the country in the world economy and computed based on a country's GDP, openness, variability, and reserves. Quotas are a key determinant of voting power in IMF decisions. Developed economies have more quotas and voting rights than developing economies, as shown by selected countries in Table 1. Globally, the United States tops with 82,994.2 million SDR quota and 831,401 votes, followed by Japan and China. South Africa, Nigeria, and Egypt lead in Africa with over 2,000 million quotas and hold over 20,000 votes. Kenya holds 542.8 million quotas with only 6,887 votes. Notably, the countries with more quotas and voting power are middle-income countries that are more developed than the low-income countries with the fewest quotas and voting rights. The low voting rights in developing countries limit their participation in the decision-making process where voting power counts. As a result, the low-income countries that need more resources and SDR allocations to address their liquidity challenges are disadvantaged.

At this moment, where the country has experienced several shocks and the government is implementing the Bottom-up Economic Transformation Agenda (BETA) to spur sustainable and inclusive growth amid the constrained fiscal space, there is a need to think boldly about new approaches and sources of funding government operations. Access to more funding is envisaged to compel higher investment in essential tenets of the BETA to bolster and sustain inclusive economic recovery. Considering limited market access, balance of payment (BoP) needs have increased, coupled with tailwinds emanating from the difficult global context. Access to additional SDRs forms a potential avenue for providing liquidity support while alleviating BoP pressures.

Table 1: Selected countries quota and voting shares

	Quotas (SDR million)	Number of votes	Percentage of voting rights
Top 5 Global Countries			
United States	82,994.2	831,401	16.50
Japan	30,820.5	309,664	6.14
China	30,482.9	306,288	6.08
Germany	26,634.4	267,803	5.31
France	20,155.1	203,010	4.03
Top 5 African Countries			
South Africa	3,051.2	31,971	0.63
Nigeria	2,454.5	26,004	0.52
Egypt	2,037.1	21,830	0.43
Libya	1,573.2	17,171	0.34
Zambia	978.2	11,241	0.22
Case Study Countries			
Ghana	738.0	8,839	0.18
Kenya	542.8	6,887	0.14
Senegal	323.6	4,695	0.09
Ethiopia	300.7	4,466	0.09

Source of data: International Monetary Fund (<https://www.imf.org/en/About/executive-board/members-quotas>)

In particular, during this period marked by recurrent economic shocks that put pressure on BoP, SDRs are one channel through which governments that have limited access to external financial markets can have liquidity support for financing operations. SDRs are international reserve assets created by the International Monetary Fund (IMF) to supplement the official reserves of its member countries. One key advantage of SDR allocations is that they can boost the foreign exchange reserves of developing countries, increasing their ability to cope with external shocks and facilitating their access to international financial markets. SDR allocations can also help alleviate liquidity shortages and support countries facing balance of payments difficulties, including those caused by the COVID-19 pandemic (IMF, 2022).

Additionally, SDR allocations can provide a stable source of financing for developing countries, as SDRs are not subject to the volatility of exchange rates and interest rates like other reserve assets such as gold or foreign currency. This stability can be precious for countries with limited access to international capital markets or facing high borrowing costs (IMF, 2022). Further, SDR allocations can provide timely and flexible support to developing countries in times of crisis, help reduce debt default risks and supporting economic recovery. Similarly, various studies have suggested that SDR allocations can help reduce global economic imbalances and support sustainable development while also providing a source of financing for low-income countries (Gallagher et al., 2020; Pforr et al., 2022; Viterbo, 2022).

Purpose of the study

This study contributes to the debate on reforms for SDR financing in sub-Saharan Africa, focusing on the Kenyan context. Specifically, the study explores the state of government balance sheet in the face of economic crises, including climate change, public debt levels, debt servicing and utilization of borrowed funds, and public debt-investments-growth nexus. The external balance, foreign exchange reserves, import cover, movements in terms of trade, and real exchange rate are also examined. Further, the study reviews SDR allocations, utilization, and accountability. Finally, the study sets a case for increased SDR allocations for Kenya in the face of narrow fiscal headroom and implications for achieving a more robust and sustainable recovery under the Bottom-up Economic Transformation Agenda. As such, the objectives of this study are three-fold: first, to review dynamics in government fiscal operations and public debt management between 2000 and 2022; second, to examine the evolution of the external position in the review period; and lastly to track SDR allocations to Kenya and their use, while providing evidence for the need for increased SDR (re)allocations.

Methodology

This study is review-based and descriptive in nature and relied heavily on desk research that involved reviewing and assessing various publications including Budget Policy Statements, Budget Review and Outlook Papers, Medium Term Debt Management Strategies, IMF Country Reports, and other publications from government ministries, departments, and agencies. Analysis of trends and patterns relied on data sourced from the Central Bank of Kenya (CBK), Kenya National Bureau of Statistics (KNBS), and the National Treasury and Economic Planning. Review of empirical literature augmented the desk research. Stakeholder's workshops with experts were also conducted and ideas and suggestions integrated in this study. The analysis period 2000-2022 is chosen because it is within this period that Kenya has benefited from general or special SDR allocations by the IMF, firstly in August 2009, then September 2009, and more recently in August 2021.

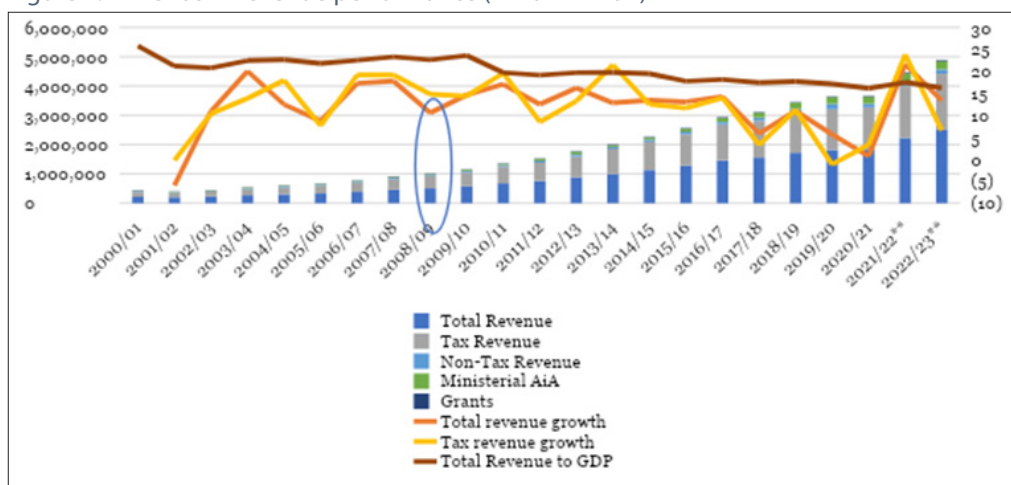
2. State of public finances in Kenya

Trends in government fiscal operations

Revenues performance

Total revenue has increased from Ksh216.4 million in FY2000/01 to Ksh2,362.1 million in FY2022/23, supported by growth in tax revenues (Figure 1). Tax revenue is the primary source of government revenue, accounting for an average of 79.9% of the total revenue, followed by ministerial A-i-A, and non-tax revenue at 9.2% and 7.4%, respectively, over the same analysis period. However, grants have remained low over the years, contributing an average of 3.4% of the total government revenue. The significant contribution of taxes to the total revenue implies that any shocks that destabilize tax performance adversely affect total revenues collected.

Figure 1: Trends in revenue performance (in Ksh million)



Note: * Preliminary.

Source of data: National Treasury and Economic Planning.

Tax revenues have increased by about 12 folds, from Ksh160.8 million in FY2000/01 to Ksh2,041.2 million in FY2022/23. The significant increase in tax revenues is partly on account of tax base expansion that aimed at netting in more taxpayers, debt collection initiatives by Kenya Revenue Authority (KRA) to enhance collection from debt programmes on non-compliant taxpayers, use of technology such as Integrated Customs Management System (ICMS), iTax, and Regional Electronic Management System as well as dispute resolution framework adopted by KRA that has enhanced revenue collection from litigation, Alternative Dispute Resolution (ADR) and Tax Appeals Tribunal (TAT). Further, the Finance Act 2023 proposed amendments, in particular tax heads to mobilize for more revenues. Therefore, implementation of the Finance Act 2023 is expected to enhance tax revenues further, especially on Value Added Tax (VAT) and income tax.

Further analysis of the revenues indicate that the annual growth rates have been above 10% over time save for the years the country experienced economic shocks (Figure 1). For example, in FY2001/02, total revenues decreased by 6.0% on account of prolonged drought that affected various sectors and change of political administration following the 2002 elections. Notably, during the electioneering period, economic activities slow down due to political uncertainties. The effects of elections were also felt in FY2017/18 when total revenues grew by 5.8% only partly due to the pro-longed electioneering period. In FY2008/09, the global financial crisis affected the domestic economy, resulting in slow growth in revenues. The COVID-19 pandemic and the effects of Russia-Ukraine war similarly affected revenue performance in the country. During the COVID-19 pandemic, the government instituted various fiscal interventions including lower tax rates to cushion citizens against the effects of the pandemic. This affected revenues in FY2019/20 and FY2020/21 as the revenues grew by 5.7% and 0.7%, respectively. The trends indicate that when the country experiences either domestic or global shocks, the revenue performance is highly affected, resulting in wider fiscal deficit that necessitates more borrowing.

Even with the increase in nominal revenues, revenue as a share of GDP has been declining from FY2001/02 to FY2022/23 (Figure 1). Notably, there was a sharp decline from 25.8% in FY2000/01 to 20.8% in FY2003/04 before a significant improvement up to 23.6% in FY2009/10. The subsequent period was characterized by a gradual decline in total revenue to GDP, registering 16.3% in FY2022/23. Some of the notable declines in revenue to GDP can be partly attributed to: the election cycle (2002/03, 2007/08, 2012/13, 2016/17), the aftermath of external shocks (global financial crisis 2008/09, COVID-19), and the rebasing of the GDP (2009, 2016).

The contrast in the trend performance between the nominal revenues and revenues as a share of GDP may also be explained by the sectorial economic contributions, as shown in Table 2. The sectors contributing a more significant share of economic growth contribute a lower percentage of the total revenues. For example, the agriculture sector contributed an average of 20.9% to GDP from FY2017/18 to FY2021/22. However, it only contributed an average of 1.9% to total revenue over the same period.

Table 2: Sectoral contribution to GDP and total revenues

Economic Sector	Revenue (Ksh billion)					% Revenue Contribution					% GDP Contribution				
	2017 /18	2018 /19	2019 /20	2020 /21	2021 /22	2017 /18	2018 /19	2019 /20	2020 /21	2021 /22	2017 /18	2018 /19	2019 /20	2020 /21	2021 /22
Agriculture	26	30	27	29	39	1.9	2.1	1.9	1.9	2.1	20.1	19.9	21.8	22	21.1
Construction	59	63	67	71	74	4.5	4.4	4.6	4.6	3.9	5.4	6	6.3	6.9	4.2
Education	25	23	24	21	31	1.9	1.6	1.7	1.4	1.6	4.2	3.9	4.1	4	4.2
Electricity, Gas, Steam	201	224	223	271	318	15.3	15.6	15.4	17.7	16.9	2.4	2.2	2	2	1.9
Finance and Insurance	167	186	196	186	250	12.7	12.9	13.5	12.2	13.3	6.9	6.4	6.4	6.8	7
o/w banks	113	127	135	131	172	8.5	8.9	9.3	8.6	9.1					
Information and Communication	124	146	160	160	196	9.4	10.1	11	10.5	10.4	2.5	2.5	2.5	2.5	2.4
Manufacturing	262	275	265	300	364	19.9	19.1	18.3	19.6	19.3	8.4	8.1	7.5	7.2	7.2
Wholesale and Retail Trade	153	179	174	182	192	11.6	12.5	12	12	10.2	8.2	7.9	7.9	7.9	8
Professional and Technical	31	33	35	34	43	2.4	2.3	2.4	2.3	2.4	2.7	2.7	2.5	2.2	2.3
Public Administration	15	14	15	15	19	1.1	1	1	1	1	5.1	5.2	5.2	5.3	5
Real Estate	30	31	30	32	39	2.3	2.2	2.1	2.1	2.1	9.2	9.2	9	8.9	8.6
Transport and Storage	55	57	64	65	82	4.2	3.9	4.4	4.3	4.4	10.5	11.6	10.7	11	11.3
Others	170	177	170	160	238	12.3	12.3	11.7	10.5	12.6	14.5	14.4	13.9	13.2	13.9
Total	1,318	1,438	1,451	1,525	1,884	100	100	100	100	100	100	100	100	100	100

Source of data: Kenya Revenue Authority.

Similarly, the construction sector, education, transport, and storage activities contributed more than 5.0% to GDP over the same period, but each raised less than 4.0% of total revenue. However, the electricity, gas, and steam activities contributing an average of 2.1% to GDP raised 16.2% of the total revenue. The other sectors that have a lower contribution to GDP but raised more than 10% of total revenues on average include finance and insurance, wholesale and retail trade, and information and communication. The analysis shows that Kenya's economic growth is driven mainly by the agriculture sector and some service sector activities that are primarily informal. High informality has a significant implication on revenue collection and hence the need to relook at the tax structure and how to net in more of the informal sector to enhance tax revenues and reduce the fiscal deficit.

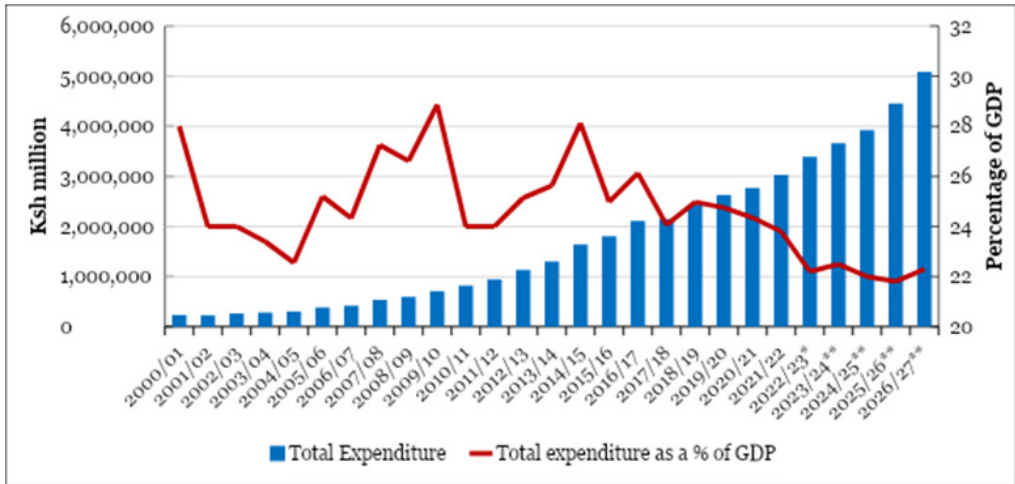
Expenditure performance

The total government expenditure has maintained an increasing trend over the years as the government carried out various projects and programmes to improve living standards. Total expenditures increased from Ksh326.6 million in FY2000/01 to Ksh3,394.1 million in FY2022/23 (Figure 2a). The increased allocation to critical economic sectors has been the primary driver of spending. The key sectors include education, health, social protection and recreation, energy, infrastructure, ICT, and environment, water, and natural resources, as well as interest payments on public debt that account for more than 60% of total expenditures, on average, over the period of analysis.

Expenditure as a share of GDP averaged about 25% during the period under consideration (Figure 2a). Notably, expenditure as a share of GDP was highest in FY 2009/10 due to fiscal stimulus package injected into the economy to support businesses and households to cope with the effects of the FY2008/09 global financial crisis. Similarly, expenditures as a share of GDP increased to 28% in FY2014/15 as the national government allocated finances to enable the establishment of the counties. However, the expenditure as a share of GDP has been on a decreasing trend since FY2015/16, in line with the government efforts on fiscal consolidation focusing on containing expenditures and mobilizing more revenues.

Expenditures on public debt have increased significantly due to increase in public debt portfolio over the years, high interest payments on domestic debt, and growth of commercial external debt. Total interest payments as a percentage of development expenditures averaged 61% between FY2000/01 to FY2022/23. Notably, in FY2001/02, FY2002/03, FY2021/22, and FY2022/23, the amount used in interest payment exceeded that used in development expenditures (Figure 2b). This underscores the resources used in interest payment at the expense of development projects intended to improve the living standards of the people. Therefore, there is a need to relook at the financial architecture to tap on much cheaper financing like SDRs.

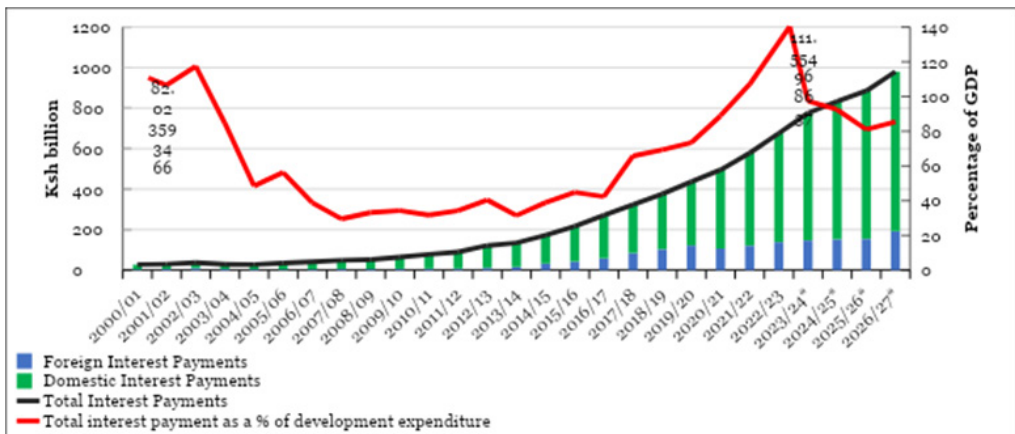
Figure 2a: Trends in the total expenditure and its share to GDP



Notes: * Preliminary, ** Projections.

Source of data: National Treasury and Economic Planning.

Figure 2b: Trends in interest payments (in Ksh billion)

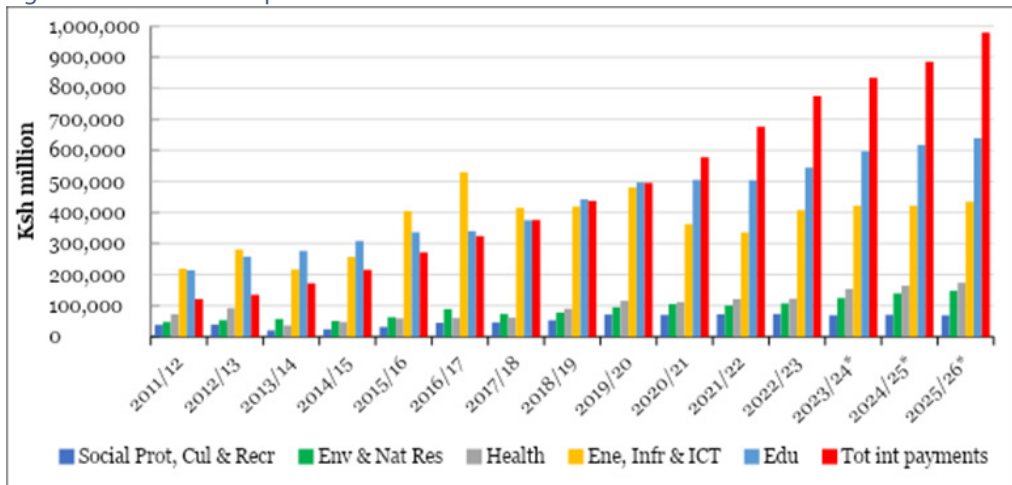


Source of data: National Treasury and Economic Planning Annual Public Debt Management Report (various issues).

Further analysis shows that interest payments on public debt increased from Ksh27.1 billion in FY2000/01 to Ksh675.8 billion in FY2022/23 and is projected to increase further to Ksh980.0 billion in FY2026/27 (Figure 2b). Notably, interest payments for external debt have remained low due to the high proportion of external debt portfolio on concessional terms. However, interest payments on domestic debt have been increasing on account of high interest rates in the domestic market and the government effort to shift from external debt to domestic debt, to mitigate refinancing risks. The challenge with increasing interest payments is that it constraints public resources for development.

The increasing interest payments similarly implies that the government disproportionately allocates a high share of its budget to fulfil its debt servicing obligations, adversely affecting spending in important social services such as health and education. Figure 2c shows that total interest payments have increased over the years and form the largest component of expenditure since FY2020/21. The increased interest payments reflect the heightened fiscal vulnerabilities due to the COVID-19 pandemic and the multiple shocks the country continues to grapple with. For example, annual interest payments between FY2011/12 and FY2022/23 exceeded the combined spending for health, social protection, culture and recreation, and environment and natural resources. Therefore, exploring other financing channels that have low interest, such SDRs, is key to supporting attainment of government development agenda.

Figure 2c: Trend of expenditure for selected sectors



Note: * projections.

Source of data: National Treasury and Economic Planning, Annual Public Debt Management Report (various issues).

Fiscal deficit

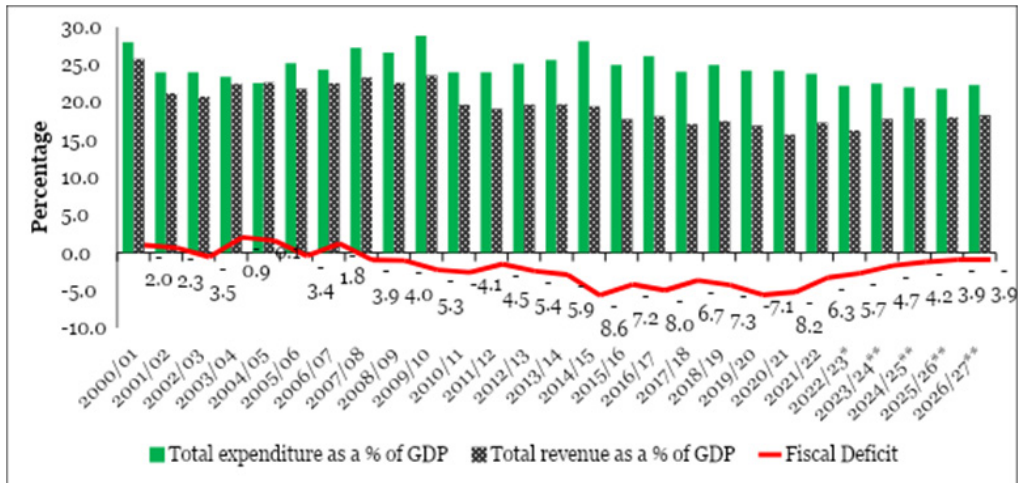
Government expenditures and revenues have increased over the review years. However, expenditures have increased more than revenues translating into a persistent deficit save for the FY2004/05 when a fiscal surplus was realized (Figure 3). The fiscal deficit widened persistently from 2.0% in FY2000/01 to 8.6% in FY2014/15 before declining slightly. Notably, the effects of COVID-19 pandemic reversed the progress made towards reducing the deficit as it affected revenue collection. This resulted to widening of the fiscal deficit to 8.2% in FY2021/22. However, fiscal consolidation efforts after the pandemic are notable in the decline of the fiscal deficit, especially from FY2021/22 to FY2022/23 (Figure 3).

Before FY2006/07, revenue collected met over 90% of government expenditures. However, the revenue collected over the last six years only met about 75% of the total expenditure. The remaining 25% of expenditure is therefore financed through

borrowing. The government’s agenda on mobilizing more resources, as stipulated in the Finance Act 2023, is timely to bridge the gap between expenditures and revenues.

The government has been implementing a fiscal consolidation plan through expenditure prioritization and enhanced revenue mobilization. Significant efforts to increase revenue collection include tax base expansion measures such as tax education, recruitment, and registration: Turnover Tax (ToT) regime, registered companies, agriculture sector, professionals, and High Net-Worth Individuals (HNWI). In addition, the revenue authority has also invested in technological transformation, data analytics, tax simplification, and other taxpayer-centric measures to enhance revenue collection. Some of the vital technological platforms include Integrated Customs Management System (ICMS), iTax, Regional Electronic Cargo Tracking System (RECTS), Excisable Goods Management System (EGMS), Tax Invoice Management System (TIMS), integration with telcos, and Block Management System (BMS).

Figure 3: Trends in fiscal deficit



Notes: * Preliminary, ** Forecasts.
Source: National Treasury and Economic Planning.

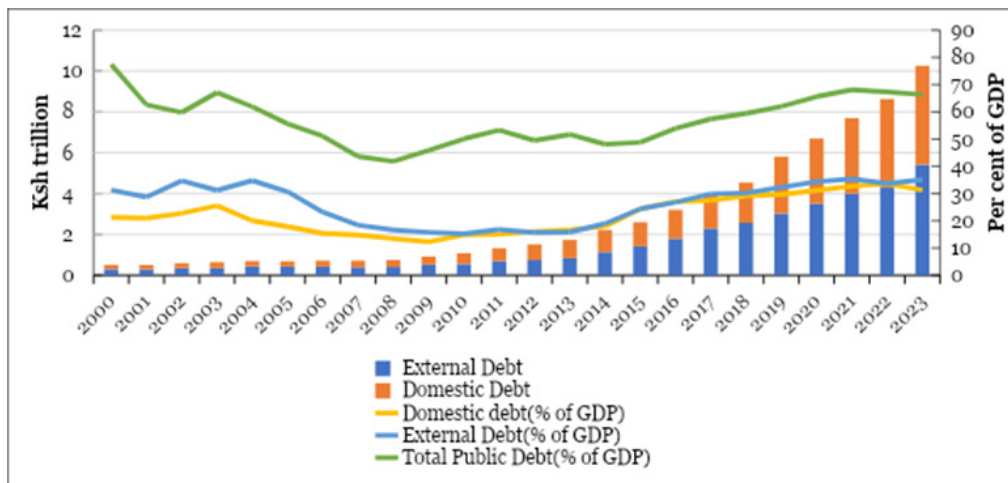
Trends in the profile of public debt

Public debt trends

Kenya’s public debt has increased significantly, primarily driven by a widening budgetary gap and increased borrowing for infrastructure projects. Public debt stock increased by more than fifteen-fold, from Ksh0.5 trillion in June 2000 to Ksh10.2 trillion in June 2023 (Figure 4). More accumulation experienced, particularly between 2008 and 2022, resulted from increased borrowing due to a widening fiscal deficit as the government increased public investment in extensive infrastructure projects such as railways and roads. Further, the COVID-19 pandemic resulted in increased domestic

and external debt accumulation by Ksh1.1 trillion and Ksh0.8 trillion between June 2020 and June 2022. In June 2023, total public debt stock stood at Ksh10.2 trillion (66.3% of GDP). Domestic debt constituted Ksh4.8 trillion (31.3 % of GDP), while external debt accounted for the remaining Ksh5.4 trillion (35.1 % of GDP).

Figure 4: Trend of public debt stock (as of 30th June)²



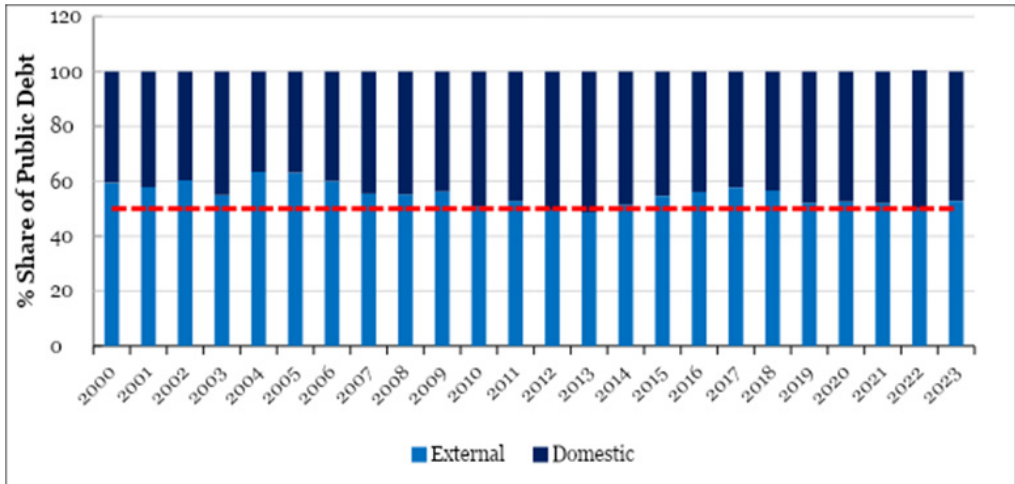
Source of data: National Treasury Annual Public Debt Management Report (various issues).

As a share of GDP, public debt was high in the 1990s and peaked at 77.4% of GDP in June 2000 (Figure 4). After that, public debt declined to 41.8% of the GDP in June 2008, partly attributed to faster economic growth experienced especially during the implementation of the Economic Recovery Strategy 2003-2007. However, from 2009 public debt as a percentage of GDP rose steadily to 66.3% in June 2023 due to increased borrowing and slower economic growth. Notably, public debt stock has been growing relatively faster, averaging 18% annually between 2008 and 2022, compared to GDP growth that averaged 4.5% over the same period. Therefore, the government’s agenda of mobilizing more revenues to finance the expenditures is timely as it will reduce the public debt burden.

Composition of public debt stock

Historically, Kenya’s public debt comprises mainly external debt, although there has been a notable shift towards domestic debt since 2010 (Figure 5). The ratio averaged 58% external and 41% internal between 2000 and 2009. However, as the government focused on domestic borrowing, the ratio changed to 53% external and 47% domestic between 2010 and June 2023. The upward trend in the share of domestic debt stock from 2010 indicates 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 aimed to reduce vulnerability to fluctuations in foreign exchange rates.

Figure 5: Composition of Kenya’s public debt stock (as of 30th June)

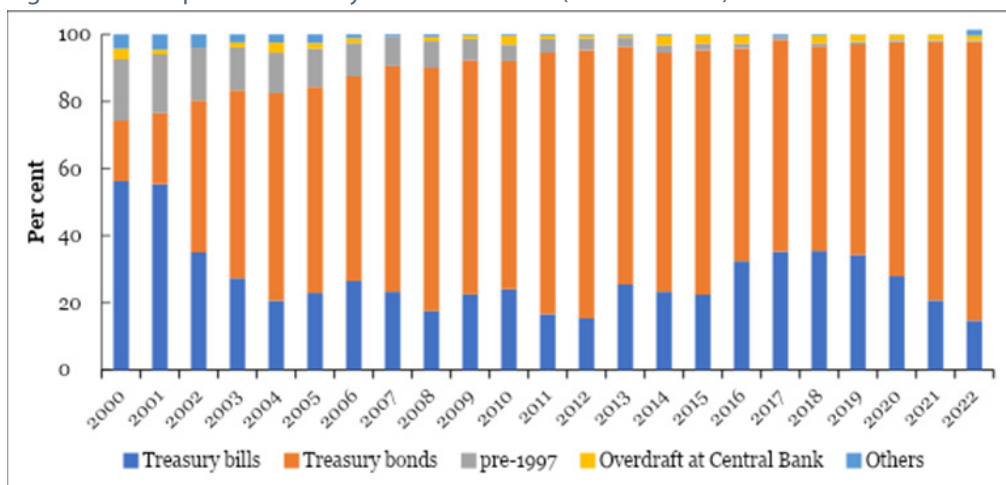


Source of data: National Treasury; Annual Public Debt Management Report (various issues).

Composition of domestic debt

The composition of domestic debt in Kenya has over the years shifted from Treasury bills to Treasury bonds as the government took a deliberate move in 2001 to reduce the proportion of short-term securities in favour of long-term securities (Figure 6). In 2000 and 2001, domestic debt was mainly held in Treasury bills accounting for an average of 73%, whereas Treasury bonds accounted for only 26%. 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. The composition of domestic debt between Treasury bonds and Treasury bills improved from 24:76 in June 2000 to 85:15 in June 2022, attaining the desired targeted mix set by the domestic debt strategy of 80:20. 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 6: Composition of Kenya's domestic debt (as of 30th June)

Source of data: National Treasury; Annual Public Debt Management Report (various issues).

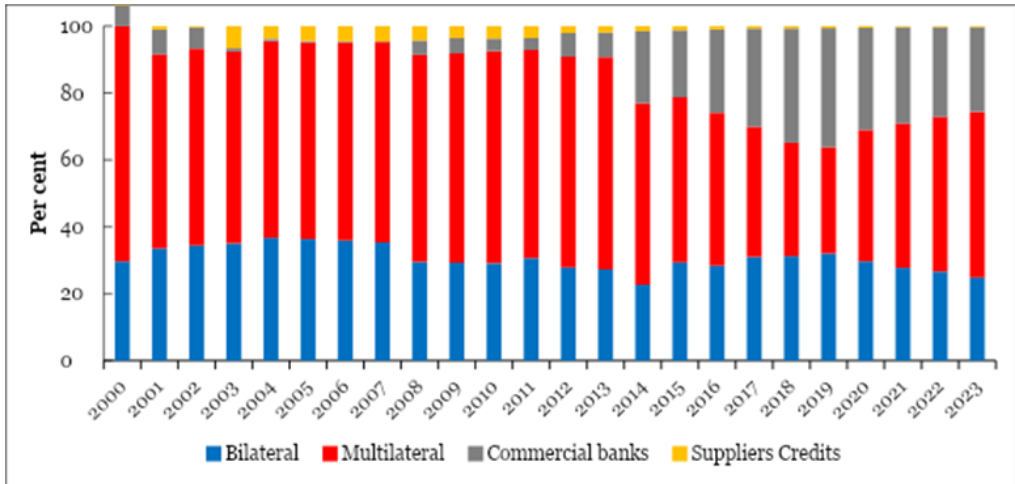
Composition of external debt

Kenya's external debt stock has been on the rise since 2000, partly driven by the issuance of sovereign bonds, commercial syndicated loans, increased bilateral credits, and foreign exchange rate fluctuations. The composition of external debt indicates that between June 2000 and June 2013, multilateral debt accounted for the largest share of external debt before declining from June 2014 (Figure 7). Specifically, in June 2000 multilateral debt accounted for 70.3% of total external debt before declining to 47.5% as of June 2023. This was occasioned by the shift towards commercial debt from 2014 when Kenya transitioned to Lower Middle-Income Country. Accessing concessional window begun to shrink in 2014 when Kenya was elevated to the Lower Middle-Income Country, and hence the shift to commercial debt. Further, by World Bank and IMF standards, Kenya could no longer access concessional loans meant for the lower income countries, necessitating the country to go for the commercial loans which have little conditionalities as compared to the multilateral loans.

The share of commercial debt in external debt has increased from 6.3% in June 2000 to a high of 28.8% in June 2021 (Figure 7) on account of issuance of Eurobonds between 2014 and 2021 to support the government budget and finance infrastructure projects. Whilst commercial debt comes with limited conditions, it also comes with higher interest loans and shorter repayment periods. This has resulted in increased debt service costs and downgrade in the country's credit ratings, while increasing risk of debt distress. Considering this, the shares of commercial debt decreased to 25.3% of the external debt as of June 2023, as borrowing strategy shifted towards more concessional borrowing due to the risks associated with increase in commercial financing such as exchange rate fluctuations and rising yields on Kenya's Eurobond reducing the access to commercial financing.

The share of bilateral debt, on the other hand, remained relatively stable between June 2000 and June 2023. It accounted for 35.0% in total external debt in June 2000, but has relatively declined to 24.9% as of June 2023.

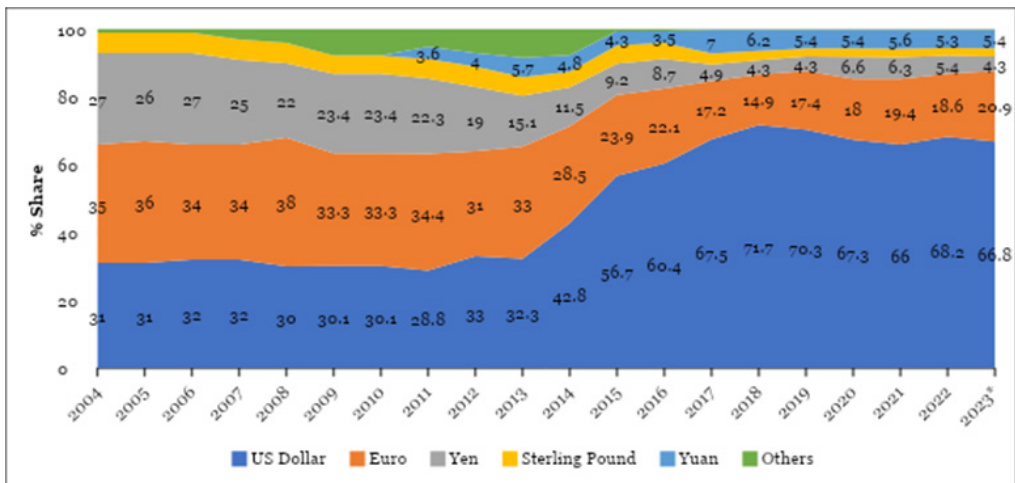
Figure 7: Composition of external debt (as of 30th June)



Source of data: National Treasury; Annual Public Debt Management Report (various issues).

Kenya’s external debt is primarily denominated in US dollars and the euro, exposing the country to exchange rate risks (Figure 8). The euro dominated the external debt portfolio between June 2004 and June 2013 before declining steadily to 20.9% by June 2023. Notably, from June 2014, the proportion of external debt held in US dollar has significantly increased from 32.3% to 66.8% as of June 2023.

Figure 8: Kenya’s external debt composition by currency (%), as of 30th June



Note: * as of April 2023.

Data Source: National Treasury, Annual Public Debt Report (various issues).

The shares of Japanese yen and sterling pound decreased to 4.8% and 2.4%, respectively, in June 2022, compared to 27% and 6.0% in June 2004. On the other hand, the share of Chinese yuan increased from 3.6% in June 2011 to 5.4% in June 2023. 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 when Kenya shilling (Ksh) depreciates against the US dollar. For example, the Kenya shilling against the US dollar depreciated by 91.7% from Ksh73.77 in 2004 to Ksh141.45 as at July 2023.

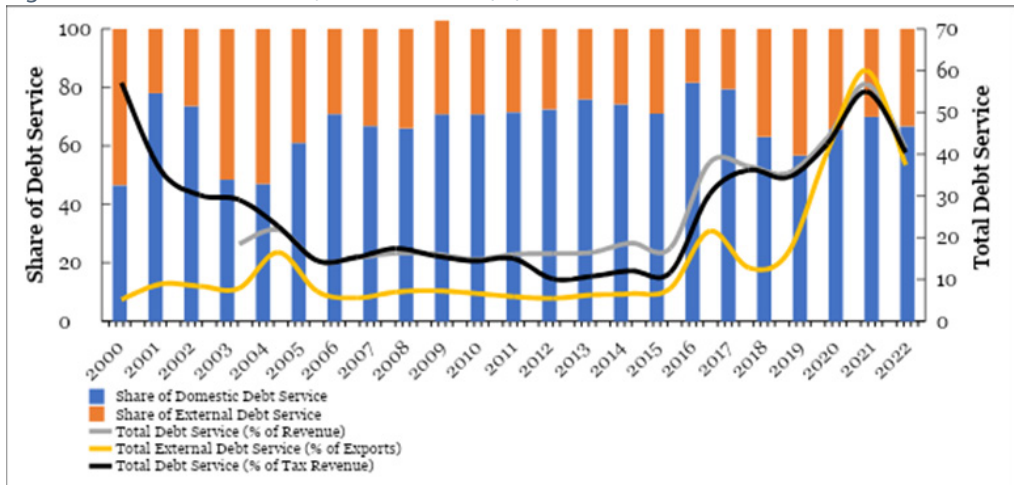
Public debt service

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 9). The share of domestic debt service increased steadily from 46.5% in June 2000 to a high of 81.6% in June 2016 on account of increased utilization of Treasury bills which are short-term in nature. However, from June 2017 the share of domestic debt service in total debt service exhibits a decreasing trend as the government shift towards long-term debt.

The share of external debt service to total revenue increased significantly from 18.5% in June 2019 to a peak of 56.8% in June 2023 partly on account of increased uptake of commercial loans over the period. During the same period, the total external debt service as a proportion of exports rose from 5.2% to 60.1%. The increase in 2019 can be attributed to substantial principal payments made to commercial creditors and sovereign bond holders, particularly for the five-year bond issued in 2014, which matured in 2019. To mitigate the rising costs, it is important for the government to pursue more opportunities for restructuring commercial debts to minimize fiscal pressures and provide fiscal space, while lifting the uncertainties around repayment obligations.

The total debt service as a share of tax revenues declined significantly from 57.1% in June 2000 to 11.7% in June 2014. However, it surged to 30.4% in 2015 and reached a peak of 55.0% in 2019, before slightly decreasing to 50.4% 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 FY2019/20 due to reduced debt service obligations for the FY2019/20 following the COVID-19 pandemic, as well as 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 9: Public debt service, as of 30th June (%)



Data Source: National Treasury, Annual Public Debt Report (various).

Public debt sustainability

Public debt remains sustainable, though rated at high risk of distress. The assessment of Kenya’s debt sustainability indicators shows that the Present Value (PV) of external debt-to-export and Public and Publicly Guaranteed (PPG) of debt-service-to-export indicators were within the required thresholds in the years before 2020 but breached the thresholds in the period 2020-2022 (Table 3). Further, the projections indicate that both indicators will remain above the thresholds over the medium term on account of slowdown in exports (National Treasury and Economic Planning, 2023a). This calls for implementation of development policies aimed at improving Kenya’s export sector to enhance exports.

The liquidity position for public debt as indicated by the debt-service-to-revenue ratio shows that Kenya has the capacity to service its debts as the ratio is below the IMF threshold. The ratio stood at 15.7% in 2022 and was below the threshold of 18% (Table 3). However, it is projected to increase to 22.3% in 2024 due to the maturing US\$2 billion Eurobond and the rollover of external commercial loans coming due in 2025. Thereafter, it is expected to decline and remain within the threshold in the medium term.

Table 3: External debt sustainability analysis

Indicators	Thresholds	2016-2020	2021	2022	2023*	2024*	2025*	2026*	2027*
External Debt Sustainability Analysis									
PV of PPG external debt-to-GDP ratio	40.0		28.2	26.6	26.8	26.1	25.6	25.1	25.0
PV of PPG external debt-to-export ratio	180.0	226.0	278.5	221.5	208.6	195.9	186.5	179.8	175.4
PPG debt-service-to-export ratio	15.0	20.4	21.6	22.6	20.5	29.6	21.1	19.2	15.8
PPG debt-service-to-revenue ratio	18.0	14.1	13.6	15.7	15.2	22.3	16.5	15.2	12.6
Public Debt Sustainability Analysis									
PV of debt-to-GDP ratio	55.0	60.3	61.7	61.7	60.0	57.8	55.9	54.0	52.5

Note: * Projections.

Source: National Treasury, Medium Term Debt Management Strategy (various).

Overall, the public debt sustainability indicators are projected to improve in 2026 after settlement of major maturities in 2024, 2025, and 2026. This will be supported by anticipated recovery in exports sector as global economy recover from 2020 COVID-19 pandemic effects and shocks to global supply chain, as well as implementation of the ongoing fiscal reforms under the EFF/ECF programme.

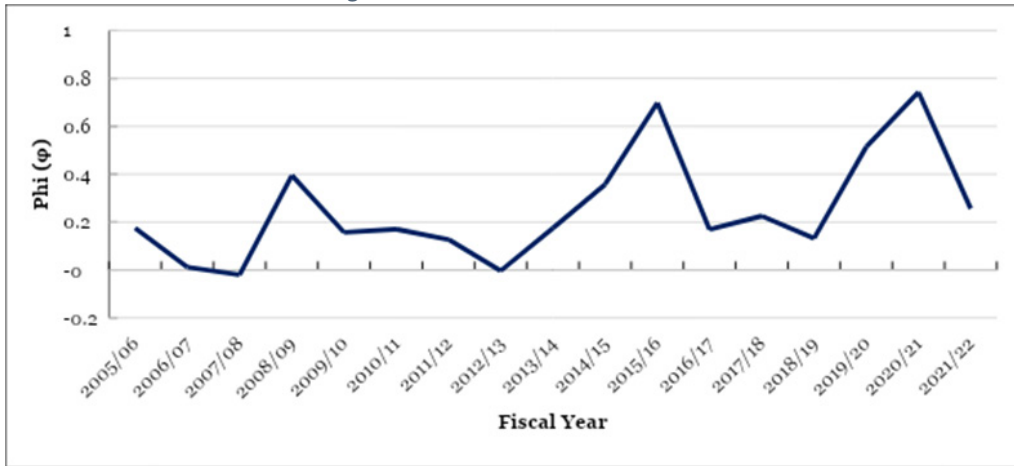
The PV of total debt-to-GDP ratio remains above the 55% threshold though projected to decline steadily from 2024 to below the threshold by 2026 (Table 3). Kenya debt sustainability is vulnerable to exogenous shocks such as exports and exchange rate. However, as the economy recovers from global shocks and fiscal consolidation continues, Kenya's debt indicators are expected to improve in the medium term.

A country's economic performance has a direct effect on debt sustainability. Poor performance of the various sectors of the economy deteriorates debt indicators leading to debt sustainability challenges and vice versa. Cognizant of this, the government focused on reviving the economy following the COVID-19 pandemic and the Russia-Ukraine war shocks through the Bottom-Up Economic Transformation Agenda. The agenda is geared towards economic transformation and inclusive growth aimed at increasing investments in the various sectors of the economy. Successful implementation of the agenda is expected to stimulate economic recovery to 6.1% growth in 2023 from 4.8% registered in 2022.

To support economic transformation, the government in 2023 Budget Policy Statement outlined its plan to increase revenue collections to Ksh3.0 trillion in FY2023/24 and Ksh4.0 trillion in the medium term through a combination of both tax administrative and policy reforms. Therefore, the current implementation of the 2023 Finance Bill is timely to support resource mobilization for economic transformation. On the expenditure side, the government focus on improving efficiency in public spending through eliminating nonpriority expenditures, retiring expensive and unsustainable consumption subsidies, reducing tax exemptions, and scaling up the use of Public Private Partnerships financing for commercially viable projects, among others (National Treasury and Economic Planning, 2023b). The reforms in the revenue and expenditure side are envisaged to reduce fiscal deficit from Ksh833.9 billion (5.7% of GDP) in FY2022/23 to Ksh720.1 billion (4.4% of GDP) in FY2023/24. The government strategy to revive the economy and its commitment to fiscal consolidation will lead to improvement of the debt ratios and thereby boosting the country's debt sustainability position.

In addition to the IMF-World Bank Low Income Country-Debt Sustainability Framework (LIC-DSF), this study also applied intertemporal government budget constraint model for an open economy with access to external financing as explored by Reddy (2006) and Ryan and Maana (2014); see details in notes³. Public debt is generally considered to be sustainable if $\phi < 1$ and unsustainable if $\phi > 1$. We find that during the 2005-2022 period, public debt in Kenya remained sustainable with debt increasing in fiscal years 2014/15 and 2015/16, and 2018/19 through to 2020/21.

Figure 10: Measuring public debt sustainability using phi (φ_t) in the debt equation
 Source: Authors' computations based on data from KNBS, the National Treasury and Economic Planning, and CBK.



Increased debt vulnerability in fiscal years 2014/15 and 2015/16 reflect the uptake of Kenya 24, the US\$2,000 million Eurobond that matures in June 2024, the increased government financing needs due to the implementation of the devolved governance system, and the construction of the standard gage railways (SGR) which is Kenya’s largest infrastructure project since independence. In fiscal years 2018/19 through to 2020/21, besides increased uptake of Eurobonds totalling US\$5,100 million, the economy faced multiple shocks including the COVID-19 pandemic, effects of Russia-Ukraine war, and six consecutive failed rain seasons which adversely affected economic growth together with supply-related inflation pressures that picked up post-COVID period. While Kenya’s debt has remained sustainable over the period, it is important to note that public debt sustainability remains vulnerable to shocks on economic growth such as those posed by pandemics and climate change.

Using steady-state debt equation⁴, the study examined the impact of export growth on public debt sustainability and debt-carrying capacity. The maximum debt-carrying capacity at steady-state or at a level where debt stops growing over time was derived, which is the simple definition of sustainable debt. Using data from KNBS, CBK, and the National Treasury and Economic Planning for fiscal years 2005/06 and 2021/22, the average primary balance of government budget as a ratio of exports of goods and services is about 31.47%, long-term annual growth of nominal value of exports and services is approximately 7.73%, while the average interest paid on external total debt is approximately 2.06%. The computation using these long-term parameters indicates that Kenya could reach a maximum threshold when external debt to exports ratio reaches 528.8%, much higher than what is proposed by the current Debt Sustainability Assessment (DSA) framework. Based on the debt equation (in the footnotes), as the difference between interest rate and nominal growth in exports diminishes, the

debt dynamics equation suggests that debt will accumulate indefinitely. Moreover, higher growth rate in nominal exports compared to interest rate will help to lower the threshold needed to reach optimal debt and vice versa. For example, to reach the 180% threshold needed by the current DSA, Kenya's exports would have to grow by about 12.9% or make significant headways in reducing primary balance deficit to increase the debt-carrying capacity of the economy.

Risk rating of sovereign debt

Major international sovereign rating agencies, including Fitch, Standard and Poors, and Moody's play a key role in assigning rating scores to sovereigns and corporates. The scores influence the terms of funding from capital markets and the investment decisions of lenders in the international markets. Kenya has received relatively stable ratings over the last decade from the three rating agencies (Table 4). In 2006, Kenya received its first rating of B+ from Standard and Poors (S&P) and a similar rating in 2007 from Fitch Rating agency. Moody's assigned Kenya a B+ equivalent of B1 rating in 2012, which is the only rating agency to upgrade Kenya's sovereign rating to B2 in 2018. Currently, the ratings stand at B (stable outlook), B+ (negative outlook) and B2 (negative outlook) by Standard and Poors, Fitch, and Moody's, respectively. Despite the effect of the COVID-19 pandemic, the country has remained resilient, being downgraded only by Standard and Poors from B+ (negative outlook) to B (stable outlook) on 5 March 2021. The variations in the credit rating scores of the three agencies shows the influence of subjectivity and the perceptions generated in the qualitative analysis. Therefore, it is important for Kenya to have an independent audit of the rating process to substantiate the findings by the agencies.

Key drivers of Kenya's sovereign risk rating have been the following:

- a. Governance exposure from weak fiscal policy effectiveness, high levels of corruption, and weak rule of law.
- b. Exposure to social risks from high levels of poverty, health and safety risks, high unemployment rates, and limited access to basic services.
- c. High debt and interest burden that poses financing risks driven by slow implementation of fiscal consolidation. The debt service to tax revenue ratio has increased from 17.5% in 2014 to 50% in 2021.
- d. Increased fiscal risk posed by deteriorating financial performance by large state-owned enterprises (SoEs) through budget support and contingent liabilities.
- e. High exposure to environmental risks posed by climate events on the economy and government finances.
- f. The country continues to face liquidity risk due to high gross financing needs.

Table 4: Kenya's credit rating

Date	Agency	Rating	Outlook
Sep 08 2006	Standard and Poors	B+	Stable
Dec 12 2007	Fitch	B+	Stable
Jan 30 2008	Fitch	B+	Negative
Feb 04 2008	Standard and Poors	B	Negative
Mar 10 2008	Standard and Poors	B	Stable
Aug 04 2008	Standard and Poors	B	Positive
Jan 16 2009	Fitch	B+	Stable
Nov 19 2010	Standard and Poors	B+	Stable
Nov 08 2012	Moody's	B1	Stable
Jul 17 2015	Fitch Rating	B+	Negative
Oct 16 2015	Standard and Poors	B+	Negative
Oct 14 2016	Standard and Poors	B+	Stable
Oct 02 2017	Moody's	B1	Under Review
Feb 09 2018	Fitch	B+	Stable
Feb 13 2018	Moody's	B2	Stable
May 07 2020	Moody's	B2	Negative
Jun 19 2020	Fitch	B+	Negative
Jul 14 2020	Standard and Poors	B+	Negative
Mar 05 2021	Standard and Poors	B	Stable
Aug 25 2022	Standard and Poors	B	Stable
Dec 14 2022	Fitch	B	Stable
Feb 28 2023	Standard and Poors	B	Negative
May 12 2023	Moody's	B3	Under Review
July 20 2023	Fitch	B	Negative

Source: National Treasury; Monthly Debt Bulletin.

Public debt and growth nexus

The recent escalation in public debt has become a significant concern for governments of many countries across the globe. However, there is evidence that an increase in debt is growth-enhancing, at least at the early stages of growth and development (Asravor et al., 2023; Beshears et al., 2022; Asteriou et al., 2021). Moreover, empirical research shows that debt-growth dynamics are not linear but rather an inverted U-shape relationship indicating a positive impact below the debt threshold and a negative impact above (Augustine and Rafi, 2023; Reinhart and Rogoff, 2010). For Kenya, a study by KIPPRA found that public debt hurts economic growth in the short run but stimulates it in the long run. The study further established that the growth-optimizing debt level in Kenya is 68% of GDP, beyond which debt accumulation hurts

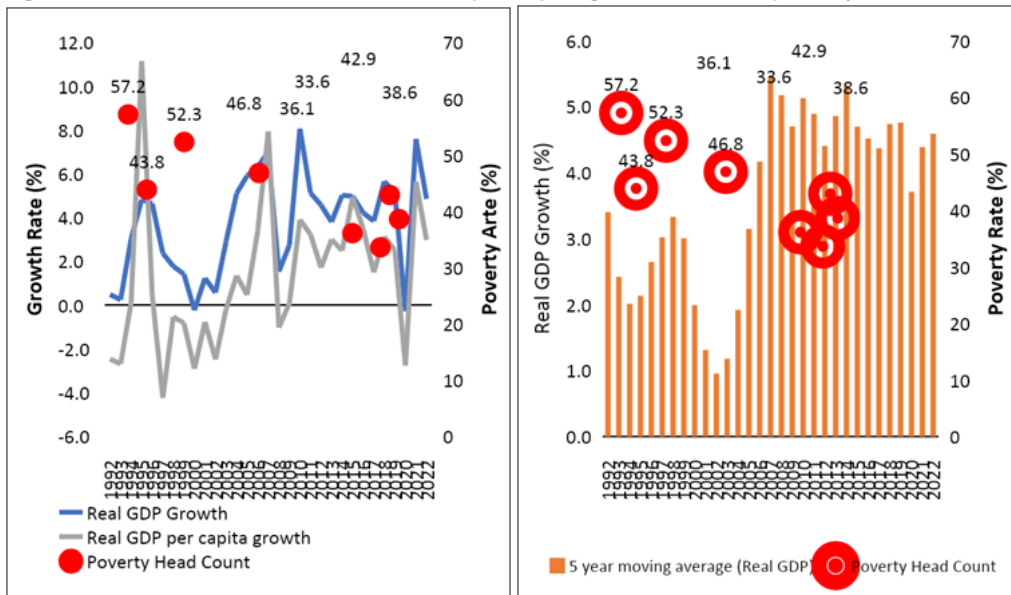
the economy.

Over the years, the exchequer has constantly grappled with an ever-expanding need for spending owing to financing government development programmes⁵ as espoused in the medium-term plans and budgets, episodes of catastrophic droughts and floods, and impacts of global financial crises. More recently, the COVID-19 fiscal stimulus packages and the need to meet the Sustainable Development Goals (SDGs) by 2030 have put pressure on government spending. Conversely, the rise in government revenue to match the expenditure needs is constrained by concerns about the distortionary effects of taxation (especially when the cost of living is already high) and the limited scope to expand the tax base due to a vast informal sector. Subsequently, the government has had to escalate its dependence on debt financing to bridge the revenue-expenditure gap.

To a more significant extent, debt accumulation has enabled the government to set the economy to growth take-off by investing in critical mass infrastructure projects and the social sectors. The real gross domestic product (GDP) has nearly tripled from Ksh3.9 trillion in 2000 to Ksh9.9 trillion in 2022. Additionally, looking at extended data from 1992 to 2022, it emerges that the 2006-2022 period is the period of take-off and sustained⁶ growth with an average five-year moving average growth of 4.7%. In contrast, 1992-2005 is the last decade when the average five-year moving average growth rate was 2.3%. Kenya's economic growth rate is commensurate with real GDP per capita growth, implying that enhanced economic activity is essential for improving incomes and economic welfare. During the period of sustained growth, incomes increased as well; for example, real GDP contracted by an average of 0.25% between 1992 and 2002, marking the slow growth phase. In contrast, real GDP per capita recorded an average growth of 207% over the same period (Figure 11).

The growth momentum in the post 2006 period and the accompanying government investment efforts has improved several socioeconomic indicators. Overall national poverty rates have declined steadily and significantly from 57.2% in 1992 to 33.6% in 2019. However, the COVID-19 pandemic interrupted this trend. Aside from massive job losses and economic contraction for the first time since 1998, the country recorded an increase in poverty rates. The national poverty rate increased to 42.9% in 2020 before declining to 38.6% following the relaxation of COVID-19 restrictions on movements and the ensuing rebound in economic activity. It is important to note that the government responded to the pandemic with large social spending programmes to mitigate the COVID-19 economic shocks and keep businesses and families afloat. A budget of Ksh44.8 billion, equivalent to 0.46% of GDP, was allocated for increased healthcare spending and COVID-19 monitoring costs and enhanced social protection, cash transfers, and food relief programmes.

Figure 11: Annual real GDP and real GDP per capita growth rate and poverty rates



Source of data: KNBS, Various Economic Surveys and Integrated Household Budget Surveys.

Kenya has also recorded commendable improvements in the education and health sectors. Besides advances in physical infrastructure and human resources, education has also seen improvements in access, equity, and inclusion. For example, in primary education, gross enrolment rates have steadily remained above 100%, while net enrolment rates have been above 90% since the free primary education (FPE) programme began in 2003. Likewise, primary school completion rates (PCR) and primary to secondary transition rates (PSTR) have steadily increased. In 2004, PCR was 78.4%, while PSRT was 56.0%. Due to increased government spending in the education sector and the accompanying institutional, legal, and policy reforms, 2022 PCR and PSRT were 87.8% and 78.6%, respectively. Gender disparities in access to education have also declined. In 2004, the gender parity index for enrolment in primary school was 0.94, against 0.97 and 0.96 in 2018 and 2020, respectively. As of 2020, about 97% of primary schools were connected to electricity; about 25.7% of these schools had access to functional internet.

Even though there are numerous gaps in health outcomes, over the study period, several health indicators have improved because of government investment in the sector and efforts toward attaining universal access to healthcare services. Under-5, infant and neonatal mortalities per 1,000 live births were 41, 32, and 21 in 2022 compared to 115, 77, and 28 in 2003, respectively. Moreover, 39% of live births were attended by skilled medical personnel in 2003 compared to 88% in 2022. Over 80% of children aged two years and below had received all the basic immunizations in 2022 compared to 52% in 2003. Morbidity cases have also declined, with life expectancy

rising from 55 years in 2003 to 63 years in 2022.

Despite the relatively good performance in social-economic wellbeing, supported by government borrowing, numerous gaps remain and could potentially limit the country's achievement of some of the Sustainable Development Goals (SDGs). The limited financial resources and the acute debt burden coupled with the impacts of climate change continue to threaten the path to delivering better living standards to the citizen and attaining the SDGs targets.

Debt reprofiling and resolution with creditors

The IMF and World Bank, under the G20 common framework, introduced the Debt Service Suspension Initiative (DSSI) in May 2020 as countries sought debt relief during the COVID-19 pandemic. The DSSI was meant to offer temporary relief to poor countries for debt service payment obligations to help them concentrate their resources towards fighting the pandemic. Kenya benefited from the DSSI with an estimated potential savings of US\$1,189.5 million between January and December 2021. During the COVID-19 pandemic, the Paris Club creditors also provided debt rescheduling options and debt service relief options to their member countries. Kenya, similarly, benefited through the approved request of 6-month debt relief worth Ksh32.9 billion by the Paris Club in 2021. The country also received debt service suspension from China worth Ksh27 billion.

The IMF has also 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. As of 18 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. Rwanda is the latest country to receive RST, the first country from Africa.

On the external front, Kenya is in the process of undertaking liability management operations with the intention of easing pressure on debt service repayments. Kenya has a Eurobond of US\$2 billion maturing in June 2024. The following can be considered:

- a. Full repayment with multi-tranche Eurobond.
- b. Part buy-back part repayment with multi-tranche Eurobond.
- c. Part swap part repayment with multi-tranche Eurobond.

Other options being considered include refinancing major portions of the Eurobond using one or a combination of syndicated loan proceeds or bilateral loan proceeds. Issuance of a Sukuk bond or Samurai bond is also another option under consideration.

On the domestic scene, Kenya has endeavoured to reduce the stock of Treasury bills as shown in Figure 6 while at the same time lengthening the maturity of the Treasury bonds. This has seen the ratio of Treasury bonds to Treasury bills stand at 85:15 as desired, thereby reducing the refinancing risk.

Recent developments and country approaches for debt management

Kenya is in the process of amending the Public Finance Management Act and its attendant regulations with an aim of amending the debt ceiling from a numerical number to a debt anchor pegged at 55% of GDP in Present Value. A debt anchor is a desired level of public debt as a ratio of GDP that is supportive of economic growth and development. The amendments also seek to define the term financial obligations as envisaged in the Kenya Constitution, harmonize the definition of public debt in the regulations to be consistent with the constitution. This, in turn, will enhance transparency and accountability in the management of public debt.

The fiscal policy stance over the medium term, through fiscal consolidation plan, aims to reduce the annual growth in public debt and implement an effective liability management strategy. The overall goal is to have a convergence towards the fiscal targets under the East Africa Community Monetary Union Protocol that sets a ceiling of fiscal deficit of 3% of GDP (including grants) and 6.0% (excluding grants). To achieve this, the government, in the Budget Policy Statement for 2023, outlined specific measures to grow tax revenues above 18% of GDP while reducing expenditures to 22.3% of GDP in the medium term.

A combination of both tax administrative and tax policy reforms would be undertaken to mobilize more financial resources. On tax administration, the government focus through KRA is to reduce the Value Added Tax (VAT) gap from 38.9% to 19.8%, expand the tax base in the informal sector, reduce the Corporate Income Tax (CIT) gap to 30% from the current 32.2%, and roll out of measures at the Customs and Border Control, leveraging on technology and enhanced data analytics to enhance revenue per unit, among others. On tax policy, the National Tax Policy is being finalized to enhance administrative efficiency of the tax system, provide consistency and certainty in tax legislations and management of tax expenditure. The government is also developing the Medium-Term Revenue Strategy (MTRS), which will provide legal, administrative, and policy measures to reform the tax system and increase tax revenues over the medium term. To improve efficiency in public spending, the government focus on eliminating nonpriority expenditures, retiring expensive and unsustainable consumption subsidies, reducing tax exemptions, and scaling up the use of Public Private Partnerships financing for commercially viable projects. The combined measures are expected to narrow down the fiscal deficit and hence slow down the annual growth of public debt.

The Public Debt Management Office (PDMO) similarly is in the process of developing a strategy paper on credit rating. The strategy paper is aimed at explaining the common methodologies employed by the major sovereign rating agencies to assign rating scores to countries which in turn determine the cost of external commercial credit demanded by investors lending to the sovereign. This will guide in proposing a strategy to improve Kenya's sovereign credit rating score as part of efforts to lower the cost of public debt as required by the Public Finance Management Act, 2012.

The domestic market for government securities has seen the following developments:

- a. Publication of the auction rules and guidelines for government securities market in the Central Bank of Kenya (CBK) website: The initiative was aimed at enhancing primary market transparency and market confidence, contributing to increased price stability and lower overall debt cost.
- b. Stability of the yield curve: Kenya has a well-established and stable yield curve that extends to 25 years. Issuance of large size bonds through re-opening of benchmark tenors continues to increase market liquidity, reduce market fragmentation, and firm-up the yield curve.
- c. Enhancement of the Treasury Benchmark Bonds Programme: To strengthen secondary market liquidity and reduce the debt cost, there has been sustained issuance of large size bonds through re-opening of benchmark tenors (5, 10, 15, and 20 years), increasing market liquidity, reducing bond market fragmentation, and helping maintain a well-priced stable yield curve as a result.
- d. Automation of market operations: To enhance efficiency of operations, the Central Bank of Kenya (CBK) launched the Treasury Mobile Direct (TMD) targeting retail investors as well as the Internet Banking (IB) platforms for institutional investors, to enhance access to the government securities market.
- e. Upgrade of the Central Securities Depository (CSD): To further develop the market, the CBK is in the process of implementing a new Central Securities Depository (CSD) system as part of key market infrastructure that will promote market liquidity and deepening. The CSD system is expected to improve market liquidity distribution, enhance operational efficiency in the domestic debt market, reform financial market infrastructures, promote capital market growth, and position Kenya as the preferred financial hub in the region.
- f. Market engagement: The government has enhanced coordination in debt management and market development initiatives. Further, CBK continues to spearhead consultations with the market players through market forums, an initiative that started in 2001, which has been instrumental in developing one of the fastest growing bond markets in Africa.

In sum, government revenues and expenditures have increased significantly over the years. However, the expenditures have increased more than the revenues, resulting in a persistent fiscal deficit, and hence increased public debt. Increased

public debt further constraints the fiscal space as significant financial resources is channelled towards repayment obligations arising from high interest rates. This crowds out resources from critical sectors that are essential in enhancing economic development and reducing poverty.

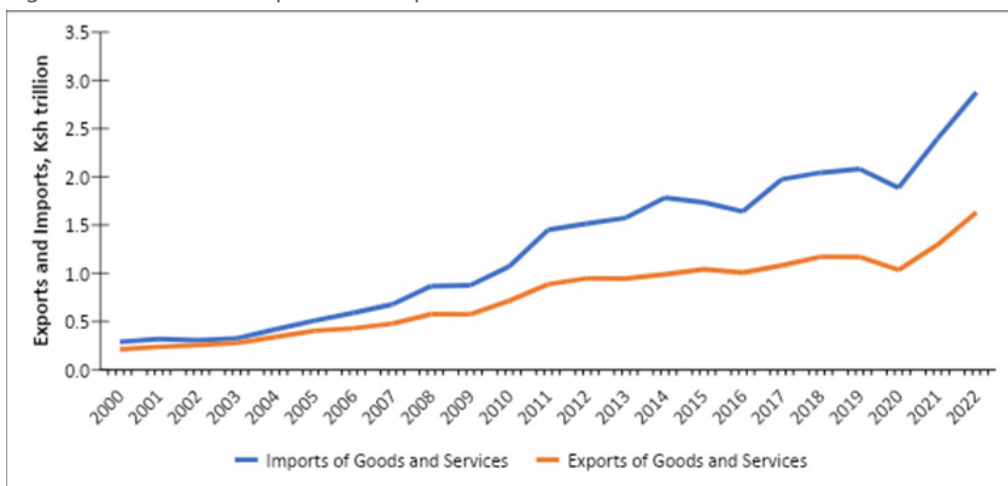
Nevertheless, the government continues to make payments for its debt obligations as they fall due, and this is vital for improving its credit worthiness and ratings. Although the country did not benefit from initial debt relief measures such as Highly Indebted Poor Countries (HIPC) and Multilateral Debt Relief Initiative (MDRI), 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) to support economic development.

3. External balance

Current account balance

Developments in the external sector indicate that exports have never exceeded the Ksh2 trillion level between 2000 and 2022, at a time when the country is a heavy importer of goods and services, reaching Ksh2.9 trillion in 2022 and further widening the gap between both exports and imports (Figure 12). Between 2009 and 2022, exports have doubled to reach about Ksh1.6 trillion in 2022, while imports have more than tripled, increasing from Ksh0.9 trillion in 2009 to Ksh2.9 trillion in 2022. This has translated into a huge gap between exports and imports, and recurrent merchandise trade balance and current account deficits. When grouped together, exports and imports appear to be diverging quite significantly over time (Figure 12).

Figure 12: Trends in imports and exports

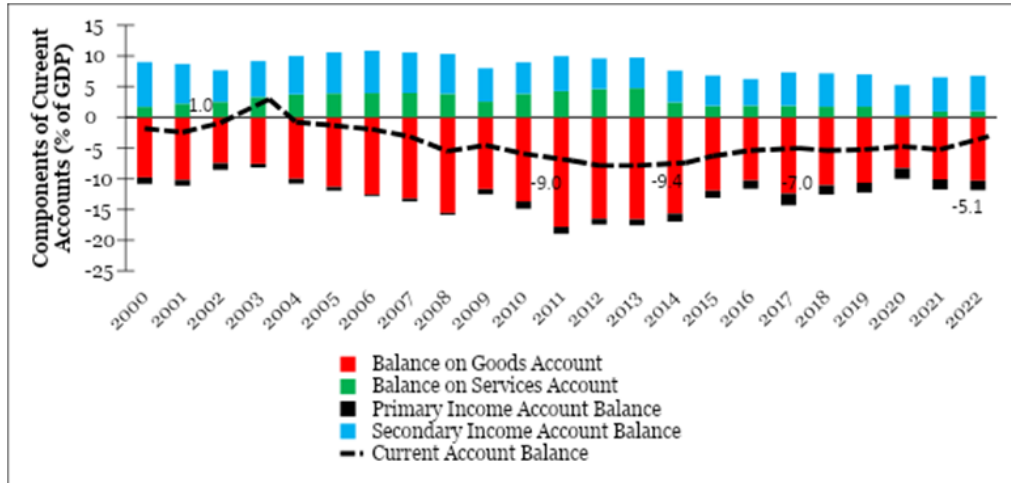


Data source: KNBS, Economic Survey (various reports).

Subsequently, the country experienced persistent current account deficits during the analysis period. Importantly, in 2003, the current account recorded a surplus of about 1.0% of GDP, occasioned by increased tourism earnings and grants inflows from abroad. Thereafter, the current account balance has widened from a deficit of

0.8% of GDP in 2004 to 9.4% of GDP in 2014 before narrowing to 7.0% of GDP in 2018. The persistence of the current account deficit has been on account of an increase in imports of goods and services relative to exports and a widening primary income account. Figure 13 shows that, over the years, the major drivers of current account are balance on goods account and secondary incomes. The deficit in goods account has largely improved due to growth in exports and slowed rate of importation.

Figure 13: Trends in the components of the current account (% of GDP)

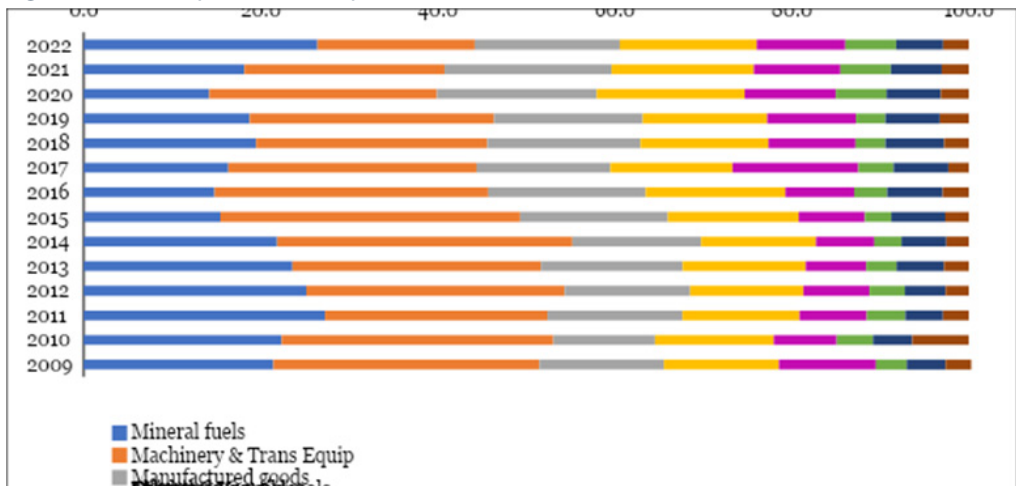


Data source: KNBS, Economic Survey (various reports).

A significant proportion of merchandise imports is geared toward capital investment and intermediate production (Figure 14). Notably, the share of machinery and transport equipment in total imports averaged 27.8% from 2009 to 2022. This was followed by mineral fuels, which averaged 20.4%, manufactured goods (15.9%), and chemicals (14.3%) over the same period. The bulk of the imports have been used for infrastructure development such as Standard Gauge Railway (SGR), roads construction and port expansion, spurring growth and development. Food imports have increased over the period, largely on account of weather-related shocks. The imports averaged 9.0% of the total imports over the same period, with a surge recorded in imports of wheat, maize, rice, and sugar.

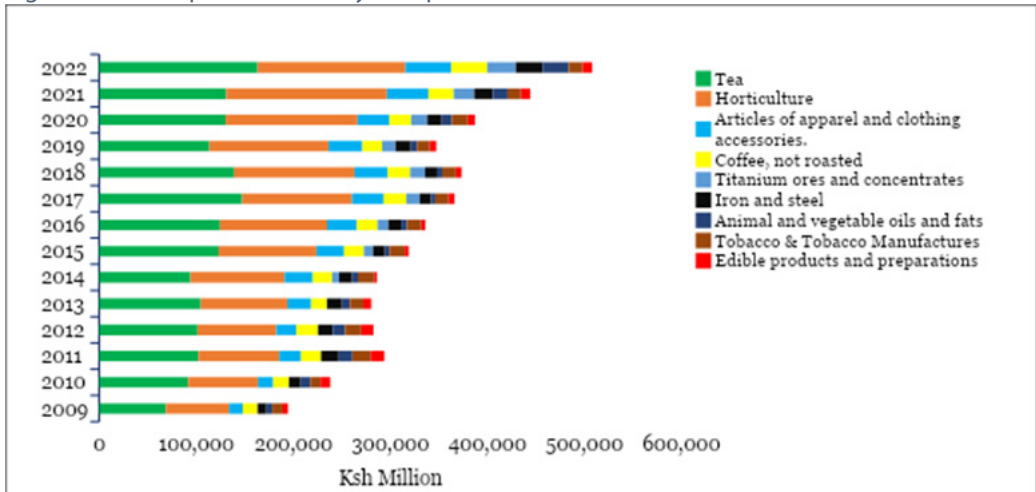
Kenya’s merchandise exports largely remained unchanged. Tea and horticulture are the leading export earners, accounting for an average of 43.5% of total exports over the years (Figure 15). This is followed by earnings from exports of articles of apparel and clothing accessories (5.6%) and coffee (4.2%). Production of tea, horticulture, and coffee are highly susceptible to weather changes, thereby affecting the export earnings. This calls for policy interventions to diversify the exports products. The exports market for tea, horticulture, and coffee is Europe and Middle East. Therefore, there is need to leverage on regional integration initiatives such as the Africa Continental Free Trade Area (AfCFTA) to diversify the market for Kenya’s exports while maintaining the traditional markets. Exports of some commodities such as fluorspar has ceased, while the trends in exports of soda ash and cement have been somewhat suppressed.

Figure 14: Composition of imports



Data source: KNBS, Economic Survey (various reports).

Figure 15: Composition of Kenya's exports

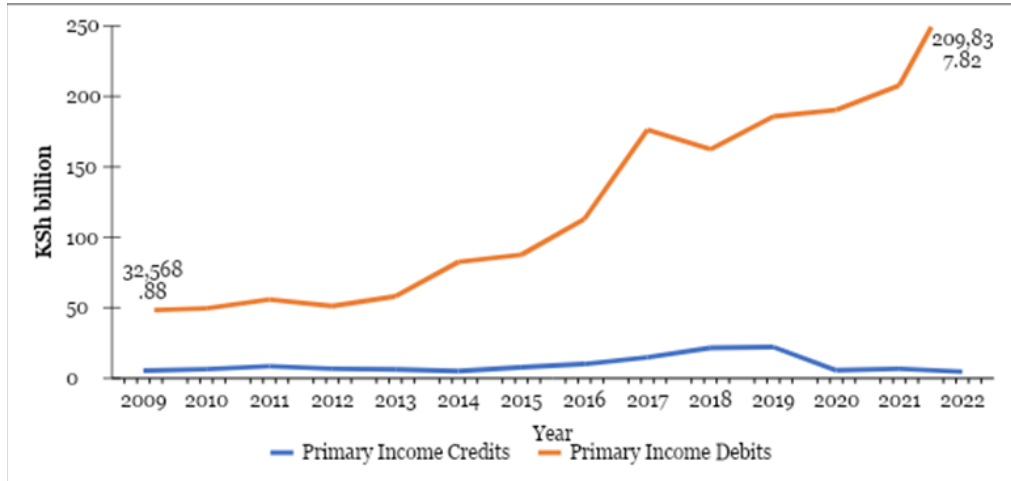


Data source: KNBS, Economic Survey (various reports).

In terms of services, transport, technical, trade-related, and other business services account for most imports of services. On the contrary, receipts are mainly from travels, telecommunications, transport, financial services, and government goods and services. Service receipts have been relatively stable over time. However, in 2020 the services receipts declined by 31.9% to Ksh388.8 billion on account of the effects of COVID-19 pandemic on travel and transport services.

The primary income debits have increased significantly from Ksh32.6 billion in 2009 to Ksh209.8 billion in 2022. This has been occasioned by increased interest payments following accumulation of government external debt. However, the primary income credits have remained relatively constant over the same period. This has led to the widening of the balance in the primary income account from a deficit of Ksh27.1 billion in 2009 to Ksh205.2 billion in 2022 (Figure 16).

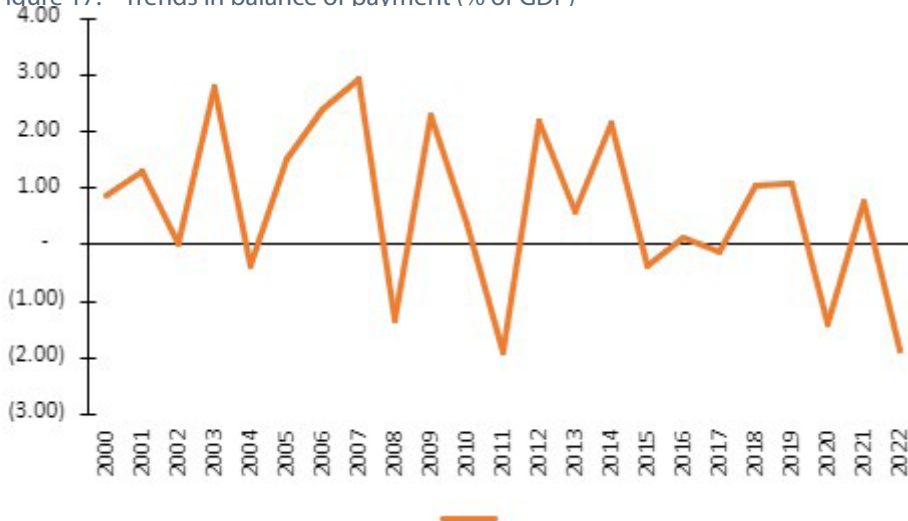
Figure 16: Trends in primary incomes



Data source: KNBS, Economic Survey (various reports).

Despite the recurrent current account deficits, Kenya has relatively maintained a surplus in its capital and financial account, supported mainly by dynamic banking system which has attracted significant bank deposits from the diaspora, as well as foreign capital seeking investment in Kenya’s Treasury bonds. The continued capital and financial account surpluses have offset the recurrent current account deficits and translated into no significant balance of payments (BoP) deficits over the period under consideration. Important to note however, that during crisis period such as the 2008 post-election violence and the global financial crisis, 2011 drought events and the Euro crisis, the 2020 COVID-19 pandemic, and the 2022 prolonged droughts, Kenya suffered significant balance of payment deficits triggering external borrowing and IMF support in SDRs that supported the BoP position in subsequent years.

Figure 17: Trends in balance of payment (% of GDP)



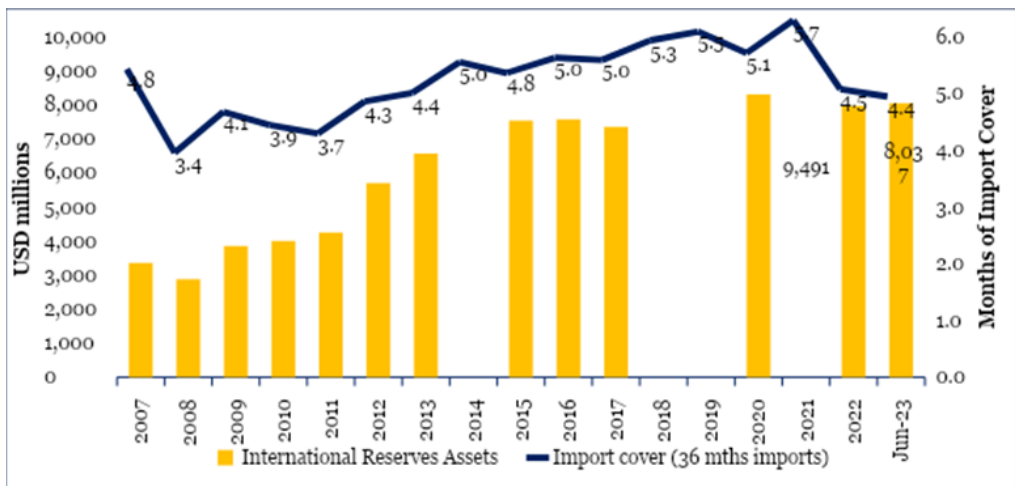
Data source: KNBS, Economic Survey (various reports).

International reserve assets

International reserve assets are the external assets that are readily available to and be controlled by monetary authorities. Their main purpose is to meet the balance of payments financing needs, intervention in the exchange markets, maintaining confidence in the currency and the economy, as well as serving as a basis for foreign borrowing (IMF, Balance of Payment Manual 6). The components of reserve assets include monetary gold, SDR Holdings, reserve position in the fund, and other reserve assets which constitute currency and deposits, securities, financial derivatives, and other claims.

Kenya’s official reserve assets have increased over time to peak at US\$9,491 million (5.7 months of import cover) as at end of 2021 (Figure 18). The increase was generally supported by government disbursements, majorly Eurobond and World Bank proceeds, the 2021 SDR allocations from the IMF, as well as resilient earnings from tea, horticulture, travel receipts, and remittance inflows. The stock of Eurobond amounted to Ksh875.95 billion (US\$7,850 million) at the end of 2022. However, the official reserve assets declined to US\$8,037 million (4.4 months of import cover) as at end of June 2023, partly on account of scheduled debt repayments. The official foreign reserves meet the statutory requirement of 4 months of import cover.

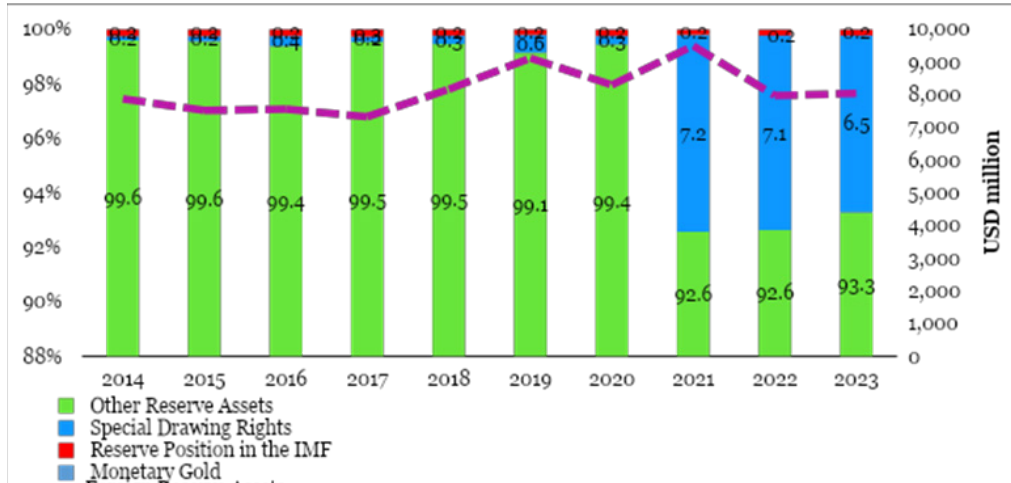
Figure 18: Kenya’s official foreign reserve assets



Source: Central Bank of Kenya.

Other reserve assets were US\$7,497.26 million (93.3%) as at end of June 2023 and accounted for the largest share of Kenya’s official reserve assets (Figure 19). The other reserve assets are invested in securities, current account, and time deposits. In 2021, Kenya received SDR allocation amounting to US\$740 million, thereby boosting the SDR holdings in the reserve assets as shown in Figure 18. Kenya’s reserve position in the fund has remained relatively constant over the period averaging US\$18.56 million. The denomination of official reserve assets is largely in US dollars, accounting for over 80%.

Figure 19: Composition of Kenya’s official reserve assets

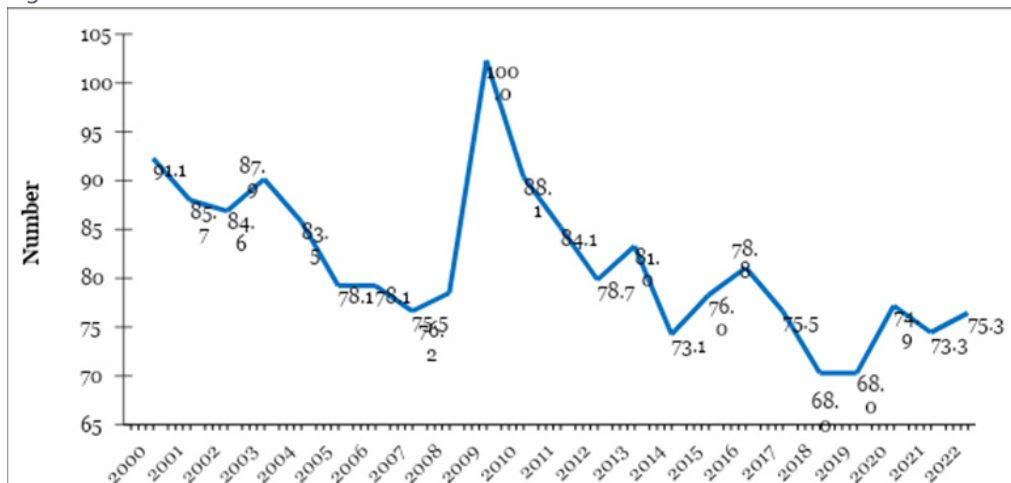


Source: Central Bank of Kenya.

Movements in terms of trade

Kenya’s terms of trade have worsened over the years, largely attributed to the faster growth in merchandise imports relative to exports. The terms of trade index worsened to 68.0 in 2019 from 88.1 in 2010. However, the index gradually improved to 75.3 in 2022, attributable to increase in tea exports on account of higher international commodity prices. The generally decreasing terms of trade implies that the relative prices of Kenya’s exports declined compared to the prices of its imports. In other words, Kenya is receiving less value for its exported goods and services in comparison to the value of the goods and services it is importing. This is caused by exporting unprocessed goods while importing manufactured goods which attract higher prices. The implication of dwindling terms of trade on borrowing is that Kenya’s foreign reserves decline making it difficult to make debt repayments.

Figure 20: Trend in terms of trade

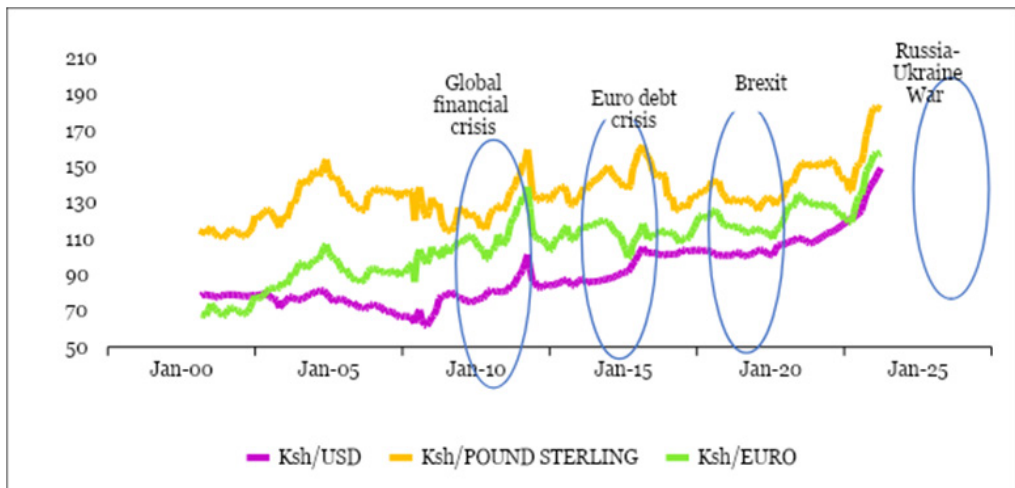


Data source: KNBS, Economic Survey (various reports).

Movement of real exchange rate

Kenya has operated a flexible exchange rate policy which is determined by demand and supply of foreign exchange since October 1993. The trends in the Kenya shilling exchange rate are largely explained by domestic and external factors. Kenya shilling remained resilient in the period after the COVID-19 crisis. However, it has weakened against the major trading currencies since 2021 partly due to tightening of the monetary policies in the advanced economies and the effects of the Russia-Ukraine war.

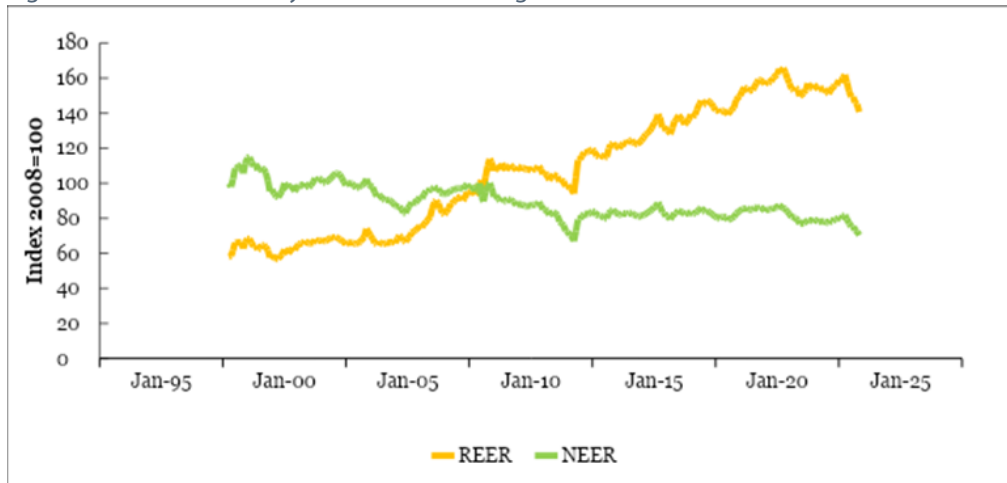
Figure 21: Trends in Kenya shilling nominal exchange rate



Source: Central Bank of Kenya.

The real effective exchange rate (REER) is a measure of a country’s price competitiveness. The REER index is computed by measuring a country’s currency against a basket of trading partner currencies, and their relative price index. Kenya’s main trading partners include Burundi, Uganda, Tanzania, Rwanda, South Africa, USA, UK and the Euro, China, India, and Japan⁷. The REER index has appreciated over the years, partly attributed to relatively lower inflation rates of the trading partners, implying the country’s trade competitiveness has weakened. On the other hand, the Nominal Effective Exchange Rate (NEER) has remained relatively stable over the years.

Figure 22: Trends in Kenya's effective exchange rate



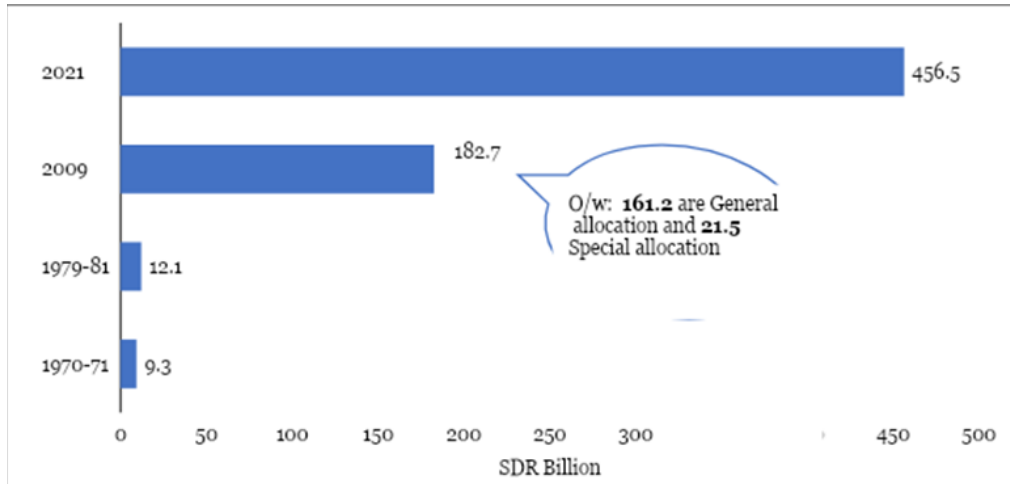
Source: www.bruegel.org

4. Special Drawing Rights allocations

SDRs⁸ were created by the IMF in 1969, and allocated to members to supplement the existing official reserves. Allocation of SDR creates unconditional liquidity under certain conditions prescribed in the IMF Articles of Agreement. These conditions include meeting long-term global needs to boost reserve buffers and bolster international economic resilience; assist mitigate risk of economic and social fragility; minimize spillovers and enhance the stability of the international monetary system; and to avoid economic stagnation and deflation, as well as excess demand and inflation in the world.

The SDR allocations should have the broad support of the member countries, and it requires 85% majority of the total voting power of the member countries. Since its inception, the IMF has made only four general SDR allocations and one special allocation as shown in Figure 23. In 1970–1971, SDR 9.3 billion was allocated in annual instalments; in 1979–1981, SDR 12.1 billion was issued in annual instalments; on August 28, 2009, SDR 161.2 billion was issued. A special one-time transfer of SDR 21.5 billion, known as the Fourth Amendment special allocation, went into effect on 9 September 2009. The general allocation done in 2009 aimed to support global liquidity following the global financial crisis, while the special SDR Allocation in 2009 aimed at equitable allocations particularly for countries that joined IMF after 1981. In the history of IMF, the August 2021 general allocation of SDR 456.5 billion was the largest. It aimed at boosting global liquidity and supporting countries respond to the COVID-19 pandemic and its impacts.

Figure 23: IMF SDR allocations (SDR millions)

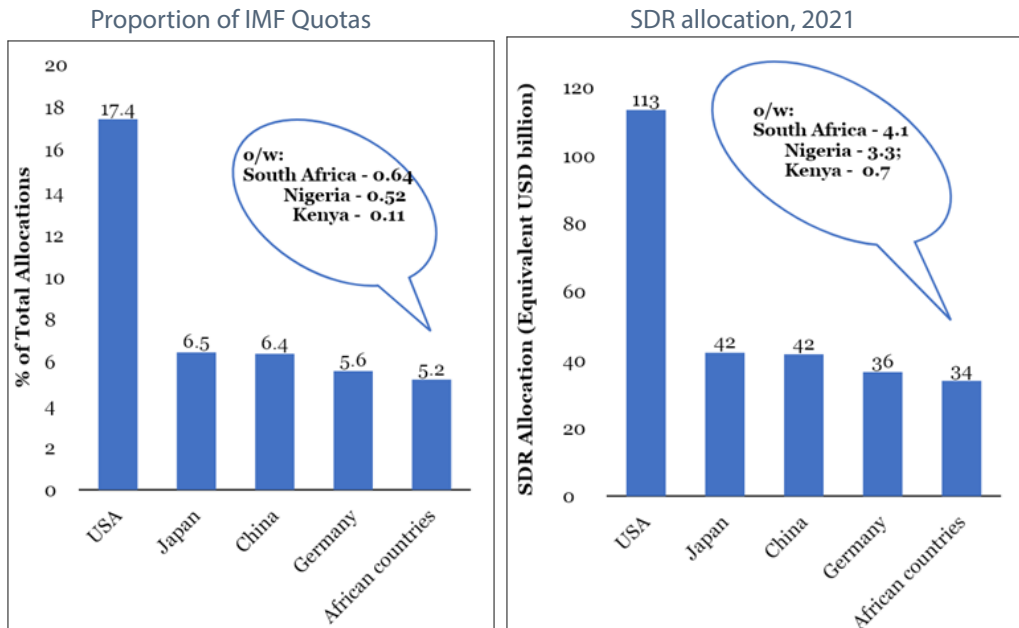


Source: IMF.

SDR allocations to members are based on their relative shares in the IMF (Quotas). The quotas are assigned broadly based on country's relative position in the world economy.⁹ This implies that they are allocated inversely to needs. Notably, African countries account for relatively small share (5.2%), while a larger proportion is assigned to the developed and emerging economies (Figure 24).

The small share of Africa quotas in the IMF has led to little allocation of SDR, which is not commensurate to the needs of the continent. In 2021, the SDR allocation to Africa with a population of about 1.4 billion people was equivalent to about US\$34 billion, while that to Germany with a population of 83.2 million people was equivalent to about US\$36 billion (Figure 24). The US\$34 billion allocated to African countries was highly beneficial, but only accounted for less 10% of the US\$345 billion finance gap that they faced from 2020 through to 2023.¹⁰ African countries had drawn down US\$4.3 billion as of the end of January 2022, accounting for 13% of their US\$34 billion allotment. This accounted for roughly 30% of the entire US\$14.8 billion (of the US\$650 billion SDR allotment) exchanged internationally.

Figure 24: IMF Quotas and SDR allocations 2021



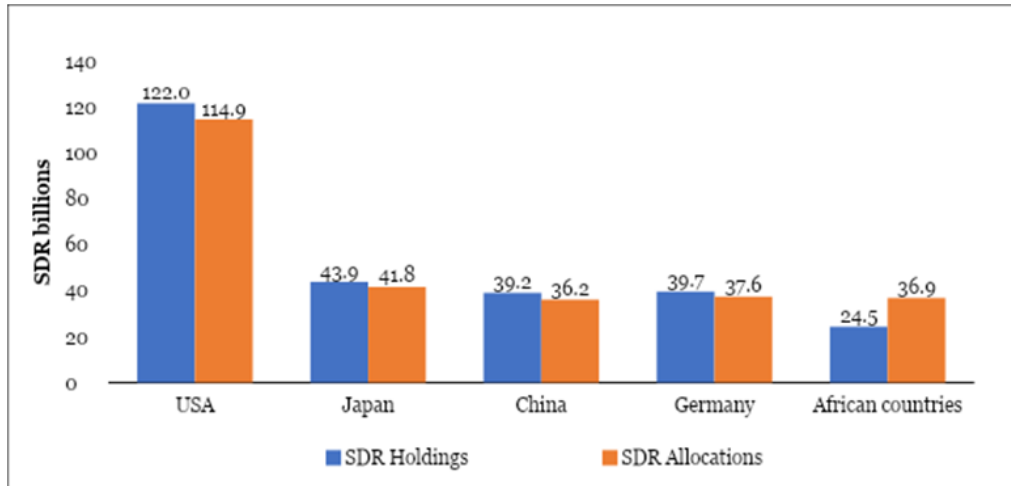
Source: IMF.

Trends and patterns in SDR utilization

The SDR allocation is cost free, but use of SDR is not free. Holdings of SDRs by an IMF member are recorded as an asset, while the allocation of SDRs is recorded as the incurrence of a liability of the member receiving them (because of a requirement to repay the allocation in certain circumstances, and interest accrues). This means that when IMF allocates interest-bearing reserve asset, SDR holding increases and a corresponding increase in long-term liability, SDR allocation, which attract charges¹¹. Additionally, there are net charges on the difference between cumulative SDR allocations and SDR holdings.

As shown in Figure 25, the SDR allocations to advanced economies have remained unutilized as the SDR holdings remains relatively higher than SDR allocations. This implies that these economies did not need the SDR allocated to them. In contrast, the African countries SDR holdings are lower than SDR allocations, which implies higher utilization and demonstrate they needed these resources.

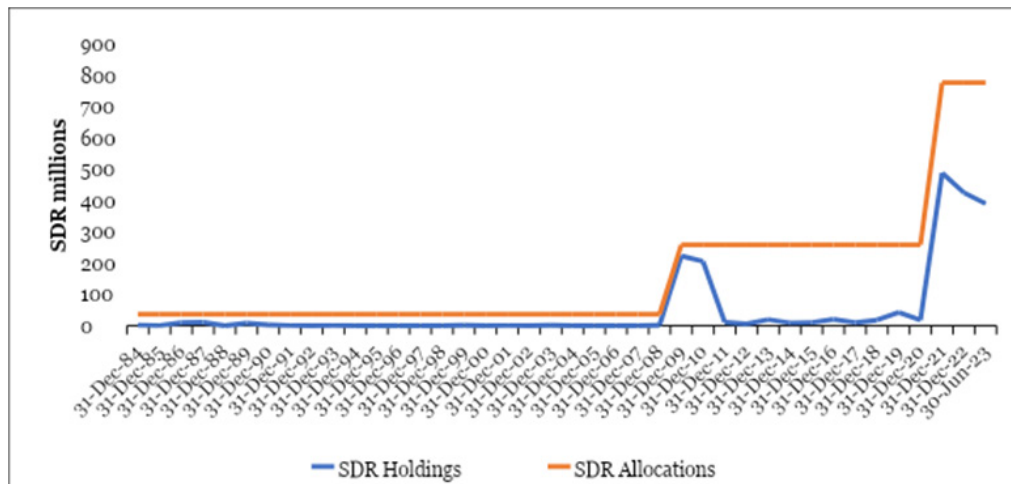
Figure 25: SDR allocations and holdings (SDR billions)



Source: IMF.

In Kenya, the increase in SDR allocations and holdings were more pronounced in 2009 and 2021 supported by the IMF SDR allocation following the global financial crisis and COVID-19 pandemic, respectively. In 2021, Kenya received SDR allocation equivalent to US\$740 million, which provided budget support and build-up of official reserves. Kenya SDR holdings are relatively lower than allocations arising from use of SDR or exchange for freely usable currencies (Figure 26). Consequently, Kenya pays net charges on the difference between cumulative SDR allocations and SDR holdings.

Figure 26: Kenya’s SDR allocations and SDR holdings, 1984-2023



Source: IMF.

The National Treasury and Economic Planning 2023 Budget Policy Statement (BPS) reports that the IMF's SDR allocation of Ksh40.8 billion formed part of government borrowing, and was utilized in financing the fiscal deficit in FY2021/22. The SDR allocation thus funded about 28.6% of government foreign financing. These funds were used to cushion the poor from the adverse effects of the COVID-19 pandemic and formed critical interventions including purchase of COVID-19 vaccines, social protection, education, and health.

Resilience and Sustainability Facility (RSF)

Kenya is among the first African beneficiaries of a new Resilience and Sustainability Facility towards building resilience to climate change. The new IMF facility was supported by resources arising from the voluntary pledges from the SDR allocation by members. Kenya's 20-month RSF¹² was approved by the IMF in July 2023, and aims at enhancing the capacity to address challenges emerging from climate change as well as boosting resilience to climate change and adaptation. Additionally, this is expected to strengthen macroeconomic stability during transition towards renewable energy. The reform measures with the IMF include:

- i. Incorporating climate risks into fiscal planning and investment framework.
- ii. Mobilizing climate-revenue while strengthening climate-spending efficiency.
- iii. Enhancing effectiveness of Kenya's existing frameworks to mobilize climate finance.
- iv. 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-months period of the RSF programme (Table A1 in the appendix).

Instruments for enhanced SDR reallocations

SDR allocations form an important part of financial resource to the vulnerable countries, particularly during periods of extreme external shocks as evidenced during the global financial crisis and the COVID-19 pandemic. However, these resources have not been sufficient to meet the financing needs, particularly for African countries. This situation has been exacerbated by the inability to access the global financial markets for fiscal financing since 2021, due to volatility in the global financial market and monetary policy tightening measures by the advanced and emerging market economies to contain inflationary pressures. In addition, when African countries, including Kenya, access the global financing markets, they are faced with exorbitant interest rates. In this regard, there is need for review of the funding mechanism

by the multilateral institutions aimed at enhancing the availability of funding and at reasonable costs for the vulnerable countries, particularly during periods of pronounced impact of climate change.

The IMF allocation and current distribution mechanism based on the relative quotas continue to disadvantage the vulnerable countries, which are in dire need of these financial resources. At the same time, the advanced and emerging market economies continue to benefit more from the distribution of SDR allocation, and yet they do not need them as evidenced by unutilized allocations. In view of this, there is need to:

- i). Review the distribution mechanism beyond the quota shares to take into consideration the countries that need them most and are more vulnerable.
- ii). Enhance the voluntary rechanneling mechanism of SDR allocations by member countries to help vulnerable countries, especially African countries. This includes exploring modalities for rechanneling of the SDR allocations through Multilateral Development Banks such as the African Development Bank to increase utilization by the vulnerable countries.
- iii). Expand IMF's capacity for concessional financing, particularly scaling up of Poverty Reduction and Growth Trust's (PRGT) loan resources¹³ (currently lent at zero interest rate) through voluntary rechanneling of SDR allocations to increase resources available to the vulnerable countries.

From the foregoing, it is clear that Kenya, like most developing countries, receives little in SDR allocation while the needs are dire. Recurrent external and internal shocks continue to put pressure on the balance of payments position as a result of substantial trade imbalance, high external debt payments, and limited foreign exchange reserves. Consequently, the BoP deficits are putting pressure on the country's foreign exchange reserves and making it difficult to meet external financial obligations.

The current account balance has persistently remained in deficit due to entrenched trade imbalance as depicted by the decreasing terms of trade over the years. Imports constitute a significant portion of essential goods and raw materials, such as oil, machinery, and consumer goods, while export base, even though diverse, does not generate enough foreign exchange to cover the import bill.

Over 50% of debt is external with a substantial amount being commercial. The limited fiscal space and the tighter international markets have made it difficult to access additional funding. Furthermore, the weakening of the shilling against the US dollar has increased the debt stock and the resultant servicing. With limited access to new debt, the high debt servicing costs are straining the country's foreign exchange reserves and reducing its ability to allocate resources to other development priorities.

Given these challenges, more access to SDRs is critical for liquidity support, debt sustainability, and crisis preparedness. Firstly, additional SDR allocations could provide Kenya with a much-needed injection of foreign exchange reserves. These reserves could

be used to cover import costs, service external debt, and stabilize the country's external financial position. Secondly, the increased foreign exchange reserves from SDRs could help alleviate the pressure on Kenya's external debt servicing thereby reducing the fiscal deficit and in turn improve the overall debt sustainability and reduce the risk of default. Thirdly, accessing additional SDRs could enhance the ability to respond to future economic shocks or crises, providing a buffer to help manage external vulnerabilities.

Fourthly, reallocating SDRs would accelerate progress towards key developmental goals in the country. The Bottom-Up Economic Transformation Agenda (BETA) has prioritized some sectors as key in enabling the government meet service delivery. The key sectors in delivery of BETA include health; education; energy, infrastructure and ICT; environment protection, water and sanitation; agriculture, rural and urban development; and transformation of MSMEs. Hitherto, these sectors have suffered reduced allocations at the expense of interest payments.

The priority projects highlighted under the BETA require an estimated Ksh2.7 trillion (Ksh473 billion, Ksh516.5 billion, Ksh537.1 billion, Ksh559.9 billion, and Ksh583.8 billion, respectively, for every financial year between the FY2022/23 and 2026/27). Furthermore, the medium-term budget indicates that, inclusive of the BETA programmes, these critical sectors will require Ksh5.9 trillion between FY2022/23 and FY2025/26 to project the economy on a sustainable growth path. Notable projects the government aims to implement under the BETA include:

1. Agriculture Sector, where the focus is on deployment of modern agricultural risk management instruments, transitioning of two million farmers into agricultural surplus producers, extension support for farmers, raise productivity of key value food chains and other value chains, reviving underperforming and collapsed export crops. The government plans to spend Ksh75.6 billion for the FY2023/24 and the sectoral expenditure is targeted to increase to Ksh91.6 billion by the FY2026/27.
2. Transforming MSMEs, where the focus is on providing access to affordable finance; establishing Business development centres, incubation centres and industrial parks; and revising and rationalizing all business licenses. The budgetary allocation for FY2023/24 under the sector is Ksh12.9 billion and is expected to grow to Ksh23.6 billion by the FY2026/27.
3. Housing and Settlement, aiming to fund rural resettlements and increase the number of mortgages. Ksh25.6 billion has been allocated for the FY2023/24 and is targeted to increase to Ksh31.6 billion by the FY2026/27.
4. Under Healthcare, the target is to initiate community health workers programme, employ 20,000 healthcare workers, provide medical scheme for retired health workers, and co-funding for strategic programmes. The budgetary allocation for FY2023/24 for the Health Sector is Ksh154 billion and is set to increase to Ksh173.8 billion by the FY2026/27.

5. Education Sector, the focus is on building of more TVETs, improve capacity of day schools, establishing National Skill and Funding Council, bridging the teacher shortage, increasing the amount allocated to school feeding programmes, and paying for in-service teacher training. The sectoral allocation for the FY2023/24 is Ksh597.2 billion and is projected to increase to Ksh639.4 billion by the FY2026/27.
6. Environment and Climate Change Sector has its priority projects as establishing five million acres of agroforestry in dryland areas, support scaling up of clean cooking technologies, and supporting waste separation infrastructures/sites. The government has allocated Ksh124.6 billion for the FY2023/24 and is targeted to increase to Ksh147.7 billion by the FY2026/27.

Reallocating SDRs would be a strategy for Kenya to address her increasing development finance gap and accelerate progress towards key developmental goals. By focusing on infrastructure, healthcare, education, poverty reduction, climate action, and economic stability, SDR reallocation can help Kenya build a brighter and more prosperous future while strengthening the bonds of international solidarity. However, given the sheer size of financing needs, a new allocation based on the current IMF quota would only be a fraction of the country's needs. The US\$740 million that Kenya received in 2021 could only cover a small proportion of the financing needs in the medium term. This entrenches the need for reallocation of SDRs based on needs.

5. Institutional challenges

Capital flight

Africa is a source of large-scale capital flight (AfDB and GFI 2013; Boyce and Ndikumana 2012; Ndikumana and Boyce 2011). It is estimated that US\$88.6 billion of Africa's GDP leaves the continent in the form of capital flight (United Nations Conference on Trade and Development [UNCTAD], 2020). This has amounted to over US\$2 trillion dollars in the last three decades. Africa receives her financial inflows through foreign direct investment, exports, foreign aids, and external borrowing; but some of it ends up being siphoned out of the continent through various channels of capital flight, such as corrupt dealings in form of kickbacks from foreign contracts, misinvoicing, tax evasions, and setting up of tax havens with the help of foreign banks, among others. The factors that contribute to capital flight in Africa include but not limited to macroeconomic elements such as inflation, taxation, exchange rates, GDP growth, fiscal deficits, political stability of a country, and corruption (Muchai and Muchai, 2016; Mwangi et al., 2019; Asongu & Nnanna, 2020; Boyce and Ndikumana, 2012).

Cumulatively, Kenya lost US\$4.9 billion from 1970 to 2010 through capital flight (Boyce and Ndikumana, 2012). Further, Kar and Spanjers (2014) estimated that Kenya's capital flight between 2003 and 2012 was US\$860 million. The key factors that contribute to capital flight in Kenya include external debt, taxation, exchange rate, and expenditure practices under different regimes (Muchai and Muchai, 2016; Wujung and Mbella, 2016; Mwangi et al., 2019). To avert capital flight, the government ought to continue managing public resources prudently as studies found that fiscal discipline is a significant factor in deterring capital flight. Secondly, efforts need to be made towards minimizing external debt as research indicated that external debt fuels capital flight in Kenya. Further, Muchai and Muchai (2016) established that tax incentives directed towards capital attraction were found not to attract investments and hence taxation policies need to be implemented cautiously with a focus on the general tax rate in the economy.

On corruption, Wujung and Mbella (2016) established that there was no significant relationship between corruption and capital flight in Kenya. This supports the government's effort to fight corruption. The country has improved based on the 2022 Corruption Perceptions Index from a score of 19 in 2000 to 32

in 2022, on a scale from 0 (highly corrupt) to 100 (not corrupt). The efforts made by the government are bearing fruits and therefore the institutions mandated to fight corruption need to sustain the efforts to help avert capital flight through the corruption channel.

Tax mobilization effort

Tax revenues contribute the largest share of government's revenues and hence tax effort is crucial in indicating the extent to which a country has exploited its tax capacity. The effort is determined by the degree of taxpayer compliance, the quality of tax administration, and the nature of the tax regime (Le et al., 2016). The quality of tax administration and policies influence the levels of tax effort and, therefore, it is essential for a country to have a strong tax administration system.

The country, over the study period, collected less tax revenues as compared to its target, save for FY2021/22 when the revenue collected surpassed the target by Ksh66.4 million following recovery of economic activities after COVID-19 pandemic. This is mainly attributed to non-compliance by some taxpayers, low taxpayer morale, and huge informal sector that contribute a lot to the economy but less in terms of tax revenues. Further, some traders under-declare their tax obligations whereas others smuggle goods into the country leading to loss of tax through evasion of customs. Statistics from the Kenya Revenue Authority (KRA) show that, of the 759,164 companies registered in Kenya, only 504,036 of them filed annual returns for the FY2021/22. Of these, only 84,428 firms (16% of the total) declared and paid corporate tax, implying that 84% of companies are either loss making businesses or inactive. This raises concerns of tax evasion among the tax filers.

To this end, the government has stepped up efforts to strengthen its tax administration structures and policies through digitization: Introduction of iTax for online tax filing and ETR and eTIMS for VAT registration to crack down on the rampant cases of tax evasion and fake invoicing for VAT reimbursement and reduction. The government has also made concerted efforts to expand its tax base by tapping into the large-to-tax sectors which are largely informal through the introduction of the turnover tax. The digitization efforts are aimed at enhancing taxpayers' identification and monitoring capacity thus streamlining tax processes and making them more transparent and inherently reducing the cost of compliance. Moreover, efforts have been made to integrate the KRA tax system with the telecommunication companies to curb tax cheats in businesses. There has also been an upscaling of the technical capacity of KRA through skills, technology, and additional staffing. Additionally, the government granted a tax amnesty for interests and penalties on tax debt effective from 1 September 2023 to 30 June 2024 enacted through the Finance Act 2023 to encourage tax compliance and increase tax revenues.

Public expenditure in the provision of public goods

Public finance and government expenditure is one area that efficiency needs to be used as a guiding principle. This implies that finances ought to be used sparingly with minimal or no wastage at all. The role of public expenditure is to spur an equitable and inclusive economic growth and also plays a crucial role in investments and savings through fiscal and human capital formation over time. As such, there is need for efficient and effective expenditure on the productive sectors of the economy.

The National Treasury in August 2018 released public investment management guidelines intended to streamline the use of public resources on projects as part of reforms in the public sector's financial management. The guidelines outline the process of project identification and planning, feasibility and appraisal, project selection for budgeting, implementation, monitoring, evaluation, and reporting as well as project closure, sustainability, and impact assessment. This will promote efficient project management and prevent projects that have not been well verified and valued from being entered into the budget and subsequently avert cases of stalled projects.

Inefficient public expenditure manifests in various ways. For example, some of the weaknesses that have been revealed by compliance audits include irregular procurements and use of non-competitive procurement practices, abuse of low-value procurement method, unapproved over-expenditures, unauthorized allowances, idle cash in bank accounts, unbudgeted expenditures, lack of or poorly maintained fixed assets registers, stalled/incomplete projects, and delays in completion of projects (The Auditor General, 2023).

The Auditor General (2023) report indicated that the government has continued to incur huge expenditure on stalled and incomplete projects, with some even attracting penalties due to delays in completion while others have been revised to amounts higher than the original contract sum leading to cost escalation. Therefore, stalled or incomplete projects provide no value for money on public funds as they provide no services to the public. Moreover, the amount spent on these projects, which is Ksh77.4 billion as of 30 June 2022, is a sunk cost since no development has been achieved from them. To address the challenge of stalled projects, The National Treasury in the Budget Policy Statement 2023 committed to review government projects and consider deferment of new projects by one year while ensuring adequate counterpart funding to provide finances for stalled projects before finalization of budget estimates.

6. Policy lessons and implications

Public debt is essential for improving socioeconomic wellbeing. However, there is a threshold beyond which debt hurts the economy. For Kenya, the growth-optimizing debt level is 68% of the GDP. Through accumulation and prudent utilization of public debt, the Government of Kenya has, not only put the economy on a take-off phase of development, but also has improved living standards among the populace. Careful management of public debt remains vital to ensure that borrowing is channelled into productive investments while avoiding excessive accumulation that could lead to future economic instability. Implementing effective debt management strategies, monitoring debt levels, and adhering to the identified growth-optimizing threshold of 68% of GDP is crucial.

Notwithstanding, Kenya, like most countries in Africa, has faced a multitude of economic shocks, including the COVID-19 pandemic, climate change impacts, and global events. These shocks have strained fiscal space, increased public debt vulnerabilities, and negated two-decade gains of sustained growth and poverty reduction. SDRs rechanneling presents a valuable tool for financing government operations at low interest and achieving inclusive economic recovery. SDR allocations can strengthen foreign exchange reserves, alleviate liquidity shortages, and provide stable financing sources for developing countries. Strategically leveraging SDR allocations will support economic recovery under the BETA and address fiscal challenges posed by shocks. It is critical to prioritize using SDRs to boost foreign exchange reserves, enhance liquidity, and fund critical sectors such as healthcare, social protection, and infrastructure development.

The utilization of SDR allocations varies among countries. Some advanced economies have relatively higher SDR holdings than allocations, suggesting they did not urgently require these resources. In contrast, African countries have lower SDR holdings than allocations, indicating higher utilization due to their pressing financial needs. The challenge lies in ensuring efficient and effective utilization of SDRs, especially in countries where these resources are vital for development.

SDR allocations have proven valuable during global crises, but the current allocation and distribution mechanism can be enhanced. To address financing gaps, particularly in the face of climate change impacts, reforms are needed to broaden the reach and impact of SDRs. Importantly, reviewing distribution mechanisms, voluntary rechanneling options, and bolstering concessional financing to support vulnerable countries' development and climate resilience.

Capacity building and technical assistance should be provided to countries, especially those with limited experience utilizing SDRs effectively. This includes guidance on integrating SDRs into fiscal planning, investment frameworks, and development strategies, ensuring that these resources contribute optimally to sustainable development and climate resilience.

At the international level, fostering global collaboration and partnerships is imperative to maximize the impact of SDR allocations. Encourage cooperation between international organizations, development banks, and donor countries to leverage SDRs for targeted and coordinated interventions, addressing pressing challenges such as climate change adaptation, poverty reduction, and health crises.

Notes

1. The General Resources Account (GRA) is the principal account in the General Department and handles the largest part of transactions between the IMF and its membership, most notably payments to the IMF for quota subscriptions, purchases (drawings) and repurchases (repayments), receipt of periodic charges (analogous to interest) on the use of IMF resources, and disbursements for remuneration on remunerated reserve tranche positions. <https://www.elibrary.imf.org/display/book/9781557757593/ch002.xml>
2. The period 30th June refers to end of each Financial Year in Kenya's fiscal calendar.
3. See Ryan and Maana (2014) -

$$d_t = \varphi_t d_{t-1} - pb_t$$

Where, $\varphi_t = \frac{[1+i_t^w + \alpha_{t-1}\varepsilon_t(1+i_t^f)]}{(1+g_t)(1+\pi_t)}$. Variables are defined as: i_t^w is the weighted average of total domestic and external debt nominal interest rate; α_{t-1} is the share of external debt in total public debt at period $t-1$; ε_t is the rate of nominal exchange rate depreciation at period t ; i_t^f is the interest rate on foreign debt at time t ; g_t is the growth rate of real GDP at time t ; while π_t is the inflation rate of GDP deflator at time t .

4. See Abebe (2021)– “A note on the dynamics of Ethiopia’s exports and its implications to external debt sustainability”.

$$d^* = \frac{1 + \bar{g}}{g - \bar{r}} \times \overline{pb}$$

In the above equation, variables have been normalized using nominal exports instead of GDP such that steady-state is driven by growth in exports and primary balance as a share of exports.

5. Budget Policy Statement 2023 - Substantial amount of government spending is on education (21.7%), physical infrastructure (19.2), public administration and international relations (16.8%), national security (8.4%), environmental protection, water, and natural resources (5.1%), social protection, culture and recreation (3.5%), and agriculture, rural and urban development (3.3%).

6. Following Berthélemy and Söderling (2001), extended period of solid growth is defined as an uninterrupted period of ten years or more, during which time the five-year moving average of annual GDP growth exceeds 3.5%.
7. <https://www.bruegel.org>
8. SDRs are held only by the monetary authorities of IMF members and a limited number of international financial institutions that are authorized holders. SDR is a unit of accounting for IMF and its value is based on a basket of five major international currencies (US dollar, euro, Chinese renminbi, sterling pound, and Japanese yen), which are reviewed every five years.
9. The current formula for calculation of Quotas consists of GDP, degree of openness, economic variability, and international reserves, with a weight of 50%, 30%, 15%, and 5%, respectively.
10. Harcourt, S. (2021, March 23). <https://www.one.org/international/blog/sdrs-global-economic-recovery-what-are-they/>
11. SDR interest earnings on SDR holdings and charges on SDR allocations are based on the SDR interest rate posted weekly by the IMF. The SDR interest rate is calculated based on a weighted average of representative interest rates on 3-month debt in money markets of SDR basket currencies. The SDR interest rate was about 4.033% as at 2 August 2023.
12. IMF Staff Report, July 2023.
13. During the COVID-19 pandemic, IMF mobilized PRGT loan resources amounting to about US\$24 billion, of which about US\$15 billion was from use of SDRs.

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Appendix

Table A1: Kenya's RSF reform measures and proposed disbursement schedule by the IMF

Reform Measure (RM)		Timelines for RM	Available Loans Under RSF (SDR Million)
Reform Priority 1: Incorporating Climate Risks into Planning and Investment Framework			
RM2	National Treasury to conduct long-term fiscal sustainability analysis under different climate change scenarios and publish the results in the Fiscal Risk Statement starting in FY2024/25.	April 7, 2024	45.2333
RM5	National Treasury to (i) develop a standardized climate change and disaster risk methodology to be integrated in project appraisal, (ii) include climate considerations in project selection criteria, and (iii) reflect the use of the analysis in project concept notes, feasibility studies, and the publication of the project selection criteria.	September 30, 2024	45.2333
RM8	National Treasury to implement a prototype of climate budget tagging in key climate sensitive sectors, develop guidelines (applied to all sectors) in the FY2024/25 MTEF circular for budget preparation with a clear definition of climate-related expenditure and publish the results.	February 15, 2025	45.2334
Reform Priority 2: Mobilizing Climate-Revenue and Strengthening Efficiency			
RM3	Subject to Parliamentary approval, National Treasury to implement carbon pricing in line with IMF recommendations to better reflect the externalities of fossil fuel consumption and to achieve emissions reduction targets in line with the updated NDC.	April 7, 2024	45.2333

continued next page

Table A1 Continued

Reform Measure (RM)		Timelines for RM	Available Loans Under RSF (SDR Million)
Reform Priority 2: Mobilizing Climate-Revenue and Strengthening Efficiency			
RM6	National Treasury to adopt priority fiscal incentives in agriculture, water, and land management sectors, as listed in the draft National Green Fiscal Incentive Policy Framework.	September 30, 2024	45.2333
RM7	Cabinet to approve net metering regulation, electricity market, bulk supply, and open access regulations, including rates determination methodology to promote energy efficiency, electricity wheeling, and distributed renewable power generation in the residential, commercial, and industrial sectors, including Special Economic Zones and Industrial Parks.	September 30, 2024	45.2334
Reform Priority 3: Enhancing Effectiveness of Existing Frameworks to Support Climate Finance			
RM4	CBK to develop a draft green finance taxonomy adapted to Kenya's updated NDC and circulate the draft for stakeholder consultation.	April 7, 2024	45.2333
RM9	CBK to (i) adopt a green finance taxonomy adapted to Kenya's updated NDC and reflecting stakeholders' comments, (ii) issue guidelines for the implementation of climate related disclosures for the banking sector in line with international best practices, and (iii) introduce time-bound targets for the implementation of climate disclosure requirements.	February 15, 2025	45.2334
Reform Priority 4: Strengthening Disaster Risk Reduction and Management			
RM1	Cabinet to adopt the National Framework for Climate Services to enable dissemination of a digital early warning system platform for a multi-sector climate-related information to most vulnerable counties, including ASAL and coastal regions.	October 7, 2023	45.2333
Total			407.1000

Source: IMF Staff Report on Kenya, July 2023.



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Nairobi 00200, Kenya
Tel: +254 (0) 20 273 4150
communications@ercafrica.org