PARLIAMENT OF KENYA

UNPACKING OF THE 2022 MEDIUM TERM DEBT MANAGEMENT STRATEGY

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MACROECNOMIC ANALYSIS & STATISTICS DEPARTMENT | PUBLIC DEBT ANALYSIS UNIT

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A. Introduction

1. Article 201 of the Constitution provides basis for prudent management of Kenya's Public Stock of Debt by requiring that burdens and benefits, of resources and public borrowing, are equitably shared between present and future generations. This creates the basis for the 2022 Medium Term Debt Management Strategy which is prepared subject to Section 64(2), and Section 33 and Regulations 184 & 185 PFM Act, 2012. The MTDS is required to indicate:
   i. the total stock of debt as at the date of the statement;
   ii. the sources of loans made to the national government and the nature of guarantees given by the national government;
   iii. the principal risks associated with those loans and guarantees;
   iv. the assumptions underlying the debt management strategy;
   v. Analysis of the sustainability of the amount of debt, both actual and potential.
2. A Medium Term Debt Strategy (MTDS) is a Public finance management tool designed to facilitate decision making based on; *i)* the evaluation and management of public debt related risks and *ii)* fiscal deficit financing through a cost-risk analytical framework. In Kenya, it is prepared by the Public Debt Management Office (PDMO) subject to Section 63 of the PFM Act, 2012. This Section mandates the office to prepare and update the annual medium term debt management strategy, in line with the Public debt management objectives such as; minimization of the cost of public debt, management debt related risks, development of domestic market institutions for government debt securities etc.

3. The 2022 MTDS proposes a borrowing strategy composed of; a) Gross financing of 25:75 for external to domestic gross borrowing respectively and, b) Net financing strategy of 32:68[1] for externa financing and domestic financing, respectively. This indicates that the domestic market will be the main source of financing for the FY 2022/23 fiscal deficit (Kshs. 846 billion). Overall, the strategy seeks to reduce cost of debt burden and reducing the refinancing risk on domestic debt by shifting borrowing towards medium and long term Treasury Bonds (Treasury bills being limited to cash management only). While the MTDS indicates the strategy will leverage on concessional financing, it is not indicated how this will take place in an uncertain international financial environment and upcoming large refinancing requirements.

4. The 2022 MTDS is prepared at a time when debt levels are historically high. As of June 2021, the international debt stock amounted to USD 296 trillion (accounting for 353% of Global GDP)[2] spurred by increased uptake in emerging economies. Kenya's debt stock on the other hand, initially driven by infrastructural expenditures, amounted to Kshs. 7.99 trillion as of September 2021 and is estimated to incur Kshs. 1.36 trillion in debt servicing expenditures (63% of FY 2022/23 total ordinary revenues). This reflects an increased constrained fiscal space and high debt burden environment.

5. A review of the MTDS indicates that costs and risks of debt burden will remain elevated primarily as a result of worsening domestic debt portfolio risk & cost characteristics[3]. As such, prudent debt

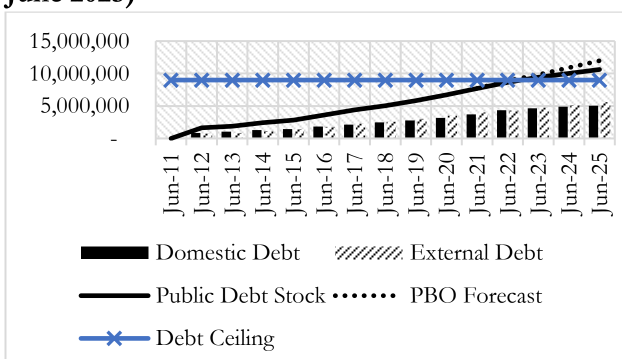
[1] Net Financing - Kshs. 275.9 billion and Net Domestic Financing – Kshs. 570.2 billion – 2022 BPS
[2] Institute of International Finance (IIF), September 2021
[3] Domestic debt in general shows a higher interest rate and refinancing risk compared to external debt portfolio.

management has never been more critical as these risks coupled with the frequency and increasing size of debt servicing, could affect medium term fiscal sustainability and slowdown the pace of economic recovery. Fiscal consolidation, enhanced transparency, increased effectiveness of resource allocation, efficiency of use of diminishing resources, fiscal discipline and fiscal commitment – should be part of the key policies for prioritization by both national and devolved governments over the long-term.

B. Public Debt Stock, Debt Servicing Expenditures & Fiscal Deficit Outlook

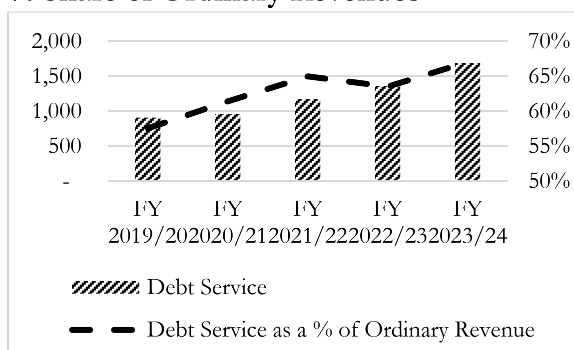
6. The stock of public debt continues to increase and with it, the level of macroeconomic effort required to maintain debt at sustainable levels. As of September 2021, the public debt stock amounted to Kshs. 7.99 trillion[4], having risen by 19% from June 2020. It is composed of Domestic Debt (48 percent) and External debt (52 percent). At the current level, debt stock accounts for 88.8% of the Kshs. 9 trillion PFM Debt Ceiling (Kshs. 9 trillion) and has a Present Value(PV) of Public Debt-to-GDP ratio of 64.2 (against a threshold of 55). In order to maintain fiscal sustainability at such high debt levels, sound fiscal policy/management should work in tandem with economic structural transformation to achieve high economic growth rate. The 10% economic growth rate target under the Vision 2030 Economic Pillar should therefore considered as a critical factor in debt management.

Figure 1: Debt Stock Growth Rate (June 2011 - June 2025)



Source: Public Debt Management Report, September 2021

Figure 2: Debt Servicing (Kshs. Billions) & % Share of Ordinary Revenues



Source: Approved Budgets & BPS

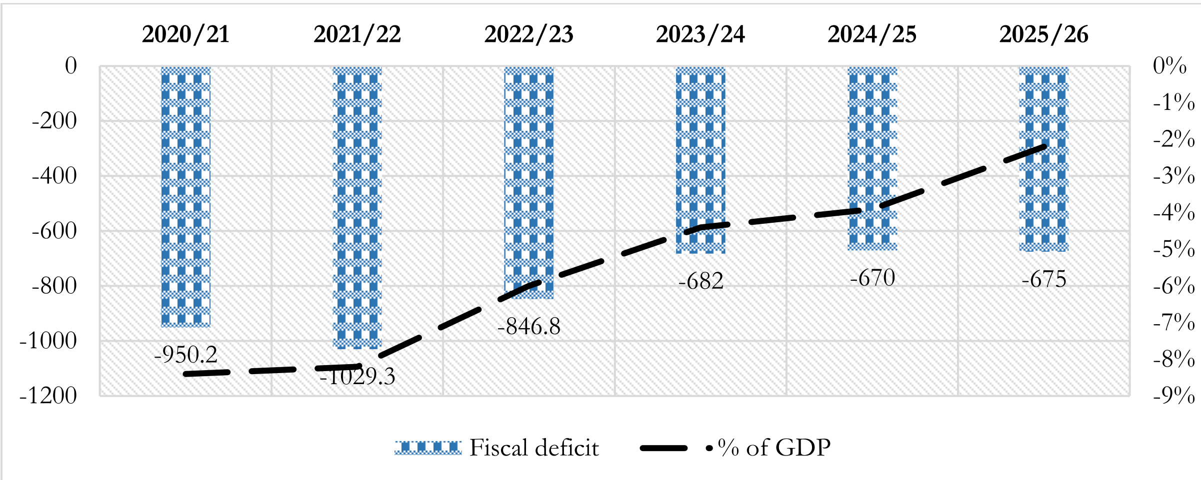
7. The debt stock is forecasted to range between Kshs. 8.6 trillion[5] and Kshs. 8.8 trillion[6] by June 2022, and cross the Kshs. 10 trillion mark by the end of 2024. Against a ceiling of Kshs. 9 trillion, this illustrates insufficiency of fiscal space to finance the fiscal deficits for FY 2022/23 (Kshs. 846 billion) and the rest of the medium term. Without the amendment of the debt ceiling and adherence to the fiscal consolidation path - fiscal policy will have to be implemented under increasingly constrained fiscal environment and the desired outcomes may not be achieved.

8. The fiscal deficit, which facilitates the accrual of public debt, is estimated persist but decline into the medium term. Amounting to Kshs. 846 billion in FY 2022/23, it estimated to decline to Kshs. 675 billion by the end of the medium term[7]. Whilst initially, the fiscal deficit prompted by large

4 Quarterly Economic and Budgetary Review, November 2021
5 2022 BPS
6 PBO Forecast
7 2022 Budget Policy Statement

infrastructure related expenditures, the increase in debt servicing expenditures alongside critical expenditures (such as implementation of the economic recovery strategy, national election related expenditures), is expected to play a greater role in the stickiness of the fiscal deficit over the medium term, and determine the pace of debt stock growth.

Figure 3: Fiscal Deficit, 2020/21 and the Medium term



Source: 2021 MTDS

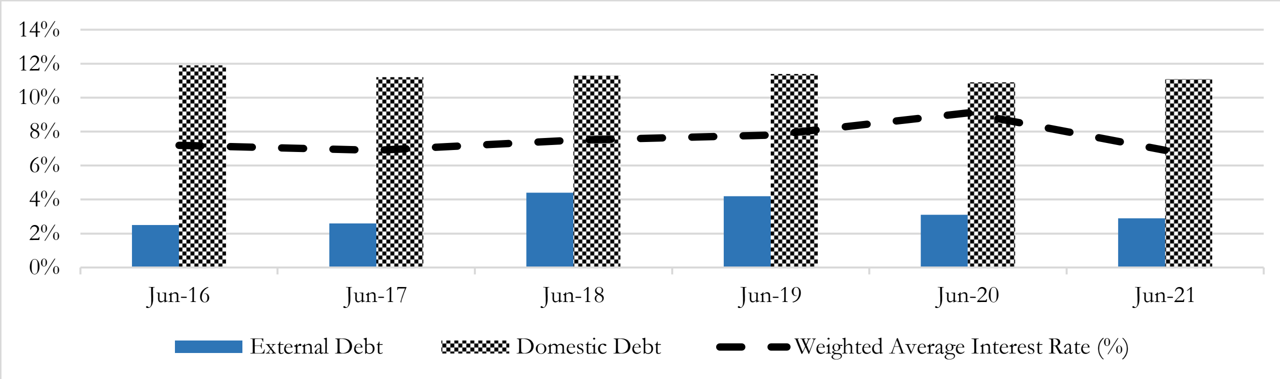
C. Cost and Risk Profile

9. Domestic debt risk characteristics continues to worsen and the overall risk profile of the stock of debt is dependent on favorable external debt risk profile. The domestic debt portfolio has a higher refinancing risk and interest rate risk exposure, despite shifting borrowing from short-term debt instruments to using medium term to long-term instruments. This is illustrated by: i) domestic debt having a much lower Average Term to Maturity (6.9 years) compared to External debt (10.8 years), ii) a higher rate of debt maturing in within one year (25.9%) compared to for external debt (5.2%), and iii) a higher Weighted Average Interest Rate (at 11.1%), compared to that of the external debt portfolio (2.9%).

i. Interest Rate Risk

10. Between June 2020 to June 2021 Weighted Average Interest Rate (WAIR) of the debt portfolio improved from 9.1% to 6.9%. This was on account of concessional financing for external borrowing that reduced the external debt stock WAIR from 3.1% to 2.9% thus keeping interest rate risk exposure on the downside. Domestic debt WAIR on the other hand, increased from 10.9% to 11.1% indicating a rising cost of borrowing from the domestic market and any given strategy based on domestic market financing will have an incremental impact on total debt interest servicing.

Figure 4: weighted average interest rate, June 2016 – June 2021



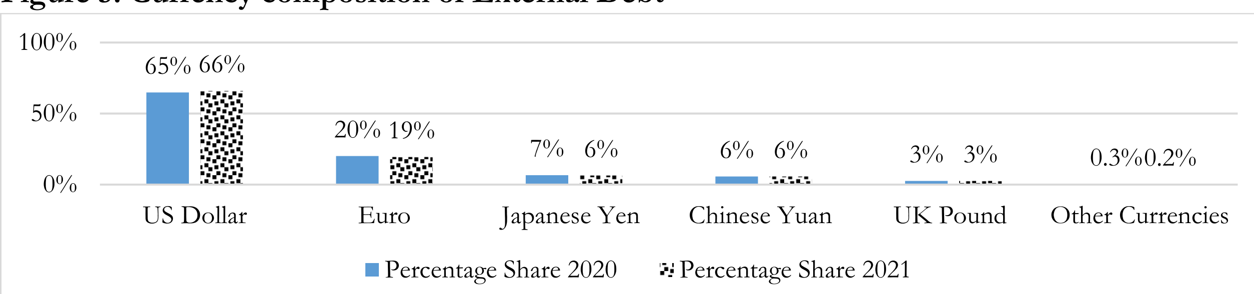
Source: 2022 MTDS

11. For the total debt portfolio, the proportion of debt to be refixed in one year improved, from 27.1% to 25.4% while average time to re-fixing fell marginally from 8.4 years to 8.3 years. The percentage of total debt on fixed rate also increased from 86.9% to 87 .7%. This indicates a reduced exposure of debt stock to interest rate volatility. The domestic debt portfolio accounts for the biggest amount of debt refixing in a year, at 25.9% (owing to treasury bills), compared to 24.9 % for external debt. 77 % of external debt is fixed rate, while 23% is variable rate. Therefore, the control of interest rate risk exposure related to short-term domestic instruments will be critical to lowering overall interest rate risk impact.

ii. Exchange Rate Risk

12. Exchange rate risk relates the impact of exchange rate fluctuation on external debt. The exposure depends on the amount and currency composition of external debt. External debt accounted for 51.3% of total debt stock as of June 2021, and changed on marginally (from 51.2% - June 2020), indicating relative stability. The top currencies include; USD 66%, Euro and Japanese Yen at 66%, 19% and 6% respectively, and is as a result of reliance on certain creditors and/or market segments. It is the movements of the exchange rates related to these three currencies that have the highest impact on the composition of external debt stock and also the in-year external debt servicing.

Figure 5: Currency composition of External Debt



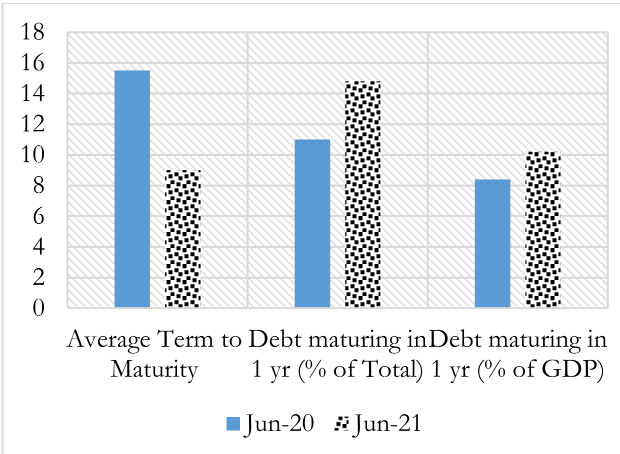
Source: 2021 MTDS

iii. Refinancing Risk

13. Public debt refinancing provides the highest risk exposure due to deteriorating of risk indicators and will be the cause liquidity concerns in the medium term. The 2022 MTDS indicates that there is a decline in the Average term to maturity a from 15.5 years to 9 years and a subsequent increase debt maturing in 1 year (both as a share of total debt stock from 11% to 14.8%). This is primarily

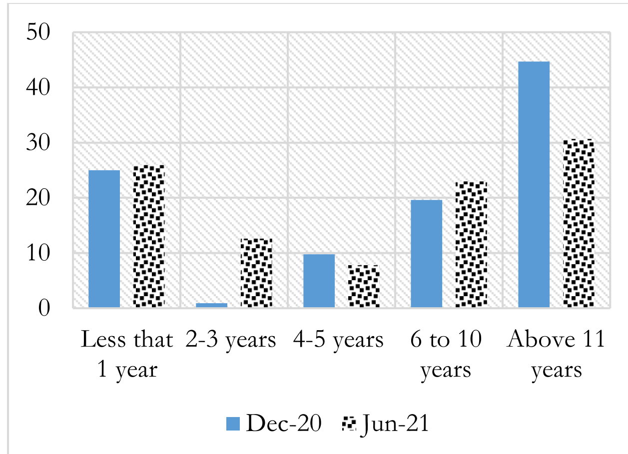
as a result of deterioration of domestic debt redemption profile whose debt maturing in 1 year is increasing from 25% to 25.9% and accounting for 81.5% of total debt amortization. External debt redemption profile remained low, owing to its concessional composition and the role of Debt Servicing Suspension Initiative[8]. This indicates an increased levels debt repayment expenditures and expected repayment shocks[9] raising liquidity risk to medium term budget implementation and fiscal sustainability.

Figure 6: Refinancing Risk Indicators, June 2021



Source: 2021 MTDS

Figure 7: Domestic Debt maturity profile, June 2021



Source: 2021 MTDS

D. 2022 MTDS - Borrowing Strategy

14. The optimal medium term debt strategy is based on the macroeconomic assumptions under the 2022 budget policy statement. These include; i) projected growth rate of 5.9% for FY 2021/22 owing to reopening of the economy (facilitated by uptake in covid-19 vaccines) and implementation of the economic recovery strategy, ii) inflation target of 5± is 2.5 percent, iii) fiscal consolidation path that will bring primary balance to a surplus of 0.9% of GDP surplus, among other assumptions.

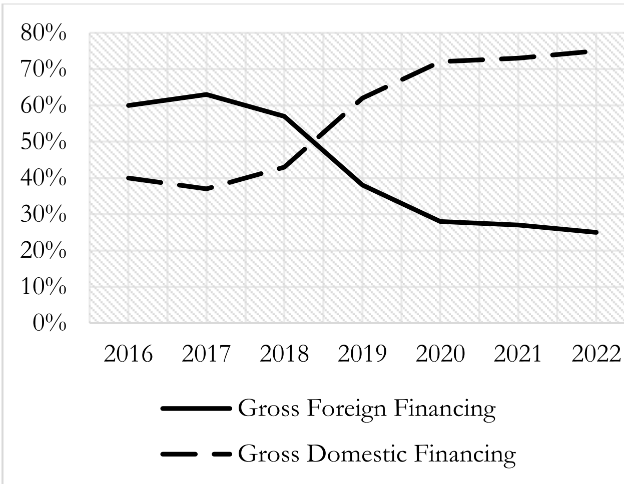
15. In order to finance the Kshs. 846 fiscal deficit for FY 2022/23, the MTDS recommends a cost and risk strategy based on a mix of external and domestic sources as follows:
    i. Gross foreign financing and Gross domestic financing ratio of - 25:75
    ii. Net foreign financing and net domestic financing ratio of - 32:68

16. The domestic market is therefore expected to remain the pillar for deficit financing in FY 2022/23 despite the increased risk characteristic of the domestic debt portfolio. Whilst gross financing strategy remained relatively constant, there was a complete shift of net financing of the strategy. The ratio of net foreign financing to net domestic financing shifted from 57:43 (whereby net financing was depended on external financing) under the 20210 MTDS, to 32:68 (whereby domestic financing will be the main source of fiscal deficit financing) under the 2022 MTDS.

[8] According to the MTDS, between January to June 2021, the DSSI yielded debt servicing suspension of Kshs. 46.5 billion to be paid over 6 months.

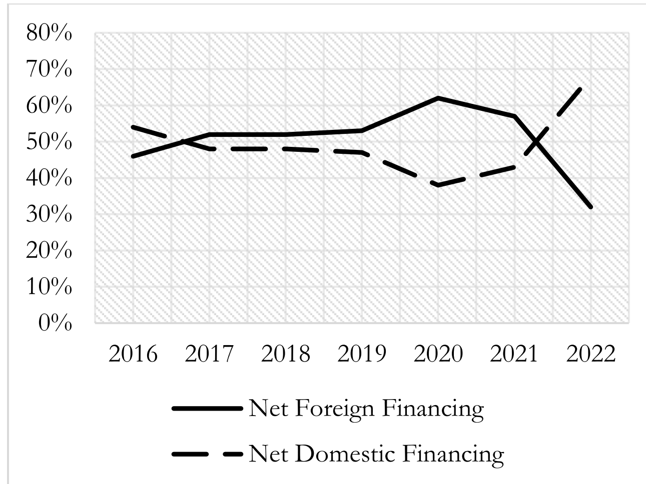
[9] Refinancing spikes are expected in 2024, 2028 and 2048 due to maturing international sovereign bonds

Figure 8: Gross Financing, 2016 - 2022



Source: MTDS

Figure 9: Gross Financing, 2016 - 2022



Source: MTDS

17. This is to cushion budget financing from uncertain flow of external debt financing and enhance development of domestic market. Already, there is a heavy dependence on the domestic market for government financing as can be illustrated by deviations from annual strategies in favor of domestic financing[10]. Whilst this is critical for domestic market sustainability, if it is not coupled with adequate market reforms, could exert pressure on the domestic financial market and increase borrowing costs. On the external side, there are no measures provided on how the incurrence of commitment fees will be halted[11] and how uncertainties from international financial markets are taken into consideration.

18. Similar to previous MTDS indicates a series of reforms to be undertaken. However, there is no information provided relating to the status of implementation of previous reforms (Annexes-Table 1). 2022 MTDS indicates that the following domestic market reforms will be undertaken:

   i. Enhance market infrastructure through automation of processes and deployment of a new central securities depository system by the CBK
   ii. Publication of auction rules and guidelines for government securities market
   iii. Enhancement of treasury bonds benchmark program
   iv. Setting up of over-the-counter trading platform to complement the Nairobi Securities Exchange
   v. Sustained stakeholder engagement and collaboration

[10] 2022 MTDS

[11] According to annual public debt management reports, a total of Kshs. 14.3 billion has been incurred between June 2016 and June 2021

E. Public Debt Sustainability Analysis

19. Debt sustainability analysis, compares debt burden indicators to thresholds over 20 -year projection period, if a debt burden indicator exceeds its indicative threshold then it would suggest that a risk of experiencing some form of debt distress exists. The objective of Debt Sustainability Analysis (DSA) is to evaluate a country's capacity to finance its policy agenda, and service the ensuing debt without unduly large adjustments that may compromise its macroeconomic stability and/or that of its economic partners. The DSA framework consists of two complementary assessments of the sustainability of the following; i) Total public sector debt DSA and ii) Total external debt DSA.

i. Public Sector Debt DSA

20. The overall DSA indicate that Kenya's debt (public & publicly guaranteed debt) totaling to Kshs. 7.99 trillion, is gradually moving towards breaching the all sustainability thresholds, indicating increasing likelihood of debt distress in the future. Breached thresholds include, i) PV of Public Debt-to-GDP ratio, ii) PV of Public debt-revenue and grants ratio, iii) PV of PPG External Debt-to-Exports ratio, iv) PPG debt service-to-exports ratio. This indicates that both solvency and liquidity sustainability ratios are presumed to be permanently breached and will require concerted effort of fiscal consolidation to bring them back to sustainable levels.

Table 1: Debt Sustainability Analysis

	Threshold	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2031**	**2041**
PV of Public Debt-to-GDP ratio	**55**	**62.4**	**63.0**	**64.2**	**63.4**	**62.9**	**61.1**	**59.5**	**45.4**	**22.6**
PV of Public debt-revenue and grants ratio	**300**	**360**	**372.6**	**370.8**	**348.**	**339.2**	**324.0**	**309.3**	234.8	110
PV of PPG External Debt-to-GDP ratio	**40**	28.7	28.7	28.3	27.3	26.3	25.7	25.2	22.7	16.8
PV of PPG External Debt-to-Exports ratio	**180**	**288.3**	**255.8**	**239.20**	**219.8**	**204.2**	**193.6**	**188.5**	151.5	79.8
PPG debt service-to-exports ratio	**15**	**26.5**	**19.1**	**22.70**	**20.1**	**29.7**	**18.4**	**17.1**	**16.1**	7.9
PPG debt service-to-revenue ratio	**18**	15.50	13.00	15.80	14.00	**21.00**	13.10	12.10	12.70	8.30

Source: IMF – March 2021

21. Furthermore, the public debt stock is estimated to amount to Kshs. 8.6 trillion – Kshs. 8.8 trillion by the end of FY 2021/22. This indicates that up to 98% of the Kshs. 9 trillion PFM Act, 2012, debt ceiling will have been exhausted by the end of FY 2021/22. As such, given it is estimated that only up-to Kshs. 200 billion of the FY 2022/23 fiscal deficit is financed. Without an amendment to the ceiling, it would imply that the fiscal deficit for FY 2022/23 is naturally capped at the remaining fiscal space provided by the ceiling and balanced budgets have to be maintained over the medium term.

F. Matters Arising

i. PFM (Sec. 33) requires that the Stock of Debt stated under the MTDS should be at the date of the statement (September 2021, total debt amounted to Kshs. 7.99 trillion) – 2022 MTDS debt status is as of June 2021 (Kshs. 7.7 trillion). This could indicate a possible under estimation of debt risks by the MTDS.

ii. In order to maintain fiscal sustainability at such high debt levels, sound fiscal policy/management should work in tandem with economic structural transformation to achieve high economic growth rate. The 10% economic growth rate target under the Vision 2030 Economic Pillar should therefore considered as a critical factor in debt management.

iii. Achieving and sustaining a GDP growth rate target of 10% should be undertaken by focusing on sectors that are critical for revenue growth such as manufacturing, finance & Insurance, Information and communication. This will accelerate the fiscal consolidation process.

iv. It is anticipated that the Debt ceiling (Kshs. 9 trillion) will be exhausted by the end of the FY 2021/22. There should be an immediate determination of the actual stock of debt and review of the debt ceiling (Kshs. 9 trillion) if the Kshs. 846 billion FY 2022/23 fiscal deficit is to be fully financed.

v. Without an amendment to the ceiling, it would imply that the fiscal deficit for FY 2022/23 is naturally capped at the remaining fiscal space provided by the PFM Act Debt ceiling and that balanced budgets have to be maintained over the medium term.

vi. Debt servicing expenditures are expected to continue to cause liquidity hitches and affect implementation of the anticipated fiscal stimulus and other critical government programs. This is indicated by the high interest risk and refinancing risk exposures.

vii. The 2022 MTDS puts the domestic financial market the core of its deficit financing strategy despite the domestic debt portfolio ready having an elevated interest rate risk and high refinancing risk characteristic.

viii. It is noted that there are recurrent deviations from the annually approved debt strategies and that these carry cost and risk implications that are not adequately evaluated. Furthermore, the deviations imply that the MTDS has limited influence over medium term perspective and therefore no impact on long-term public debt management.

ix. There has been no recommendation on measures to enhance loan disbursement and curtail incurrence of commitment fees annually.

x. Given the high level of stock of debt, enhancement of debt transparency and accountability initiative in line with Principles of public finance (Art. 201 of the Constitution) is required. The following should be undertaken:

   a) Full quantification of Kenya's Public debt stock as defined under Article 214 and to include debt disbursed and debt commitments already entered
   b) Quarterly submission of the debt register to Parliament for scrutiny
   c) Progress reporting on projects indicated under the debt register to enhance oversight

ANNEXES

Table 1: Achievement of MTDS Reforms (FY 2018/19 – 2022/23)

Reform	FY 2018/19	FY 2019/20	FY 2020/21	FY 2021/22	Indicated Achievement
Separation of institutional investors and retail investors in the primary market to facilitate full automation of securities auction and shortening of primary cycle	✓	✓	✓	✓	None
Regular publication of issuance calendar	✓	✓	✓	✓	None
Regular market engagement	✓	✓	✓	✓	None
Restructuring of horizontal repo transactions	✓	✓	✓	✓	None
Establishment if over the counter trading platform aimed at fostering transparency and efficiency in secondary securities trading	✓	✓	✓	✓	None
Issuance of fewer but large size benchmark bonds to enhance market liquidity and attract capital flows	✓	✓	✓	✓	None
Issuance of a portion of external debt in local currency in order to reduce the impact of exchange rate risk and change currency composition of Kenya's debt portfolio.			✓		None
Diversify market financing instruments to include zero coupon bonds, indexed bonds and undertake periodic liability management operations such as bond exchanges			✓		None
In undertaking market based debt restructuring, to undertake the diversification of government securities to include non-plain vanilla instruments, undertake liability management operations such as bond exchanges				✓	None
MAkiba					None

Source: 2020 MTDS