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EFFECT OF PUBLIC DEBT ON ECONOMIC GROWTH IN KENYA

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ABSTRACT

The study investigates the effect of public debt on economic growth in Kenya, between 1980-2013.The choices of period was guided by data availability and escalation of Kenya's public debt. The main problem is that, Kenya government has been relying heavily on public debt, aid and grants as a source of finance. This has resulted to a buildup of the level of public debt stock which has led to funds being diverted to debt servicing at the expense of economic development and domestic consumption.

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INTRODUCTION

Kenya as a Country has not attained a continuous economic growth duration for a long period of time. The Kenyan growth rate has been fluctuating from 1960s with more economic growth rates being noticed in 1960s and beginning 1970 before economic performance started declining in the mid-1970.Between 1974 and 1993, real GDP started reducing since the bilateral and multilateral aid was cut due to mismanagement of resources and shrinking of agricultural production (Osewe, 2013).

Social indicators worsened markedly between 1980s and 2002.For instance, according to Kenya Demographic and Health Survey, 2003, infant death rate increased from 96 per thousand births to 114 per thousand births in the same period and life expectancy declined from 57 years in 1986 to 47 years in 2000.I n 1993, the Government of Kenya began a major program of economic reform and liberalization. A new minister of finance and a new governor of the central bank undertook a series of economic measures with the assistance of the World Bank and the International Monetary Fund (IMF). As part of this program, the government eliminated price controls and import licensing, removed foreign exchange controls, privatized a range of publicly owned companies, reduced the number of civil servants, and introduced conservative fiscal and monetary policies. From 1994 to 1996, Kenya's real GDP growth rate averaged just over 4% a year (ROK, 2013).

In 1997, however, the economy entered a period of slowing or stagnant growth, due in part to adverse weather conditions and reduced economic activity prior to general elections in December 1997. In July 1997, the Government of Kenya refused to meet commitments made earlier to the IMF on governance reforms. As a result, the IMF suspended lending for three years, and the World Bank also put a $90 million structural adjustment credit on hold (IMF, 2013).

The Government of Kenya took positive steps on reform, including the 1997 establishment of the Kenya Anti-Corruption Authority, and measures to improve the transparency of government procurements and reduce the government payroll. In July 2000, the IMF signed a $150 million Poverty Reduction and Growth Facility, and the World Bank followed suit shortly after with a $157 million Economic and Public Sector Reform credit. In 2006 Kenya's gross domestic product (GDP) was about US$17.39 billion. The country's real GDP growth picked up to 2.3 percent in early 2004 and to nearly 6 percent in 2005 and 2006, compared with a sluggish 1.4 percent in 2003.Over the decade from 2003-2013,Kenya’s economy grew steadily from 2.9% in 2003 to 7% in 2007 due to conducive environment caused by political stability and implementation recovery strategy. However in 2008, political instability reversed the gains made and the economy dipped to 1.5%.In the following years modest growth was noted from 2009-2010 but it dipped again in 2011 due to ripple effects of the global recession. On average, the economy grew by 5% over the period 2003-2013 which is much lowered as compared to Uganda’s growth of 7%, Tanzania’s growth of 7%, Rwanda’s growth of 7.1% and EAC average of 5.9% over the same period. On the other hand the public debt rose highly over the past periods and this trend was accompanied by an expansion in the size of governments (ROK, 2013).

Global Perspective of Public Debt on Economic Growth

The impact of domestic public debt on economic growth of many nations remains a controversial issue in both academic and policy making forum (Akram, 2010). Empirical and theoretical studies try to analyze the question of whether the rising of public debt shows positive or negative effects on the growth rate of an economy.

Most broad rationalization of the adverse effect of debt is “debt overhang” effect. If there is some likelihood that in future, debt will be larger than the country’s repayment ability then anticipated debt-service costs will depress further domestic and foreign investment (Karagol, 2002). The other channel through which debt obligations affect economic growth is known as “crowding out” effect. If a greater portion of foreign capital is used to service external debt, very little will be available for investment and growth. Debt-servicing cost of public debt can crowd out public investment expenditure, by reducing total investment directly and complementary private expenditures indirectly (Karagol, 2002).

According to Abbas (2007), the higher interest rates increase the cost of financing new private investment " crowding – out " and hence limit economic growth. The higher interest rate may also have an adverse effect on the trade balance which is an important parameter of economic growth. Since the government assets become more attractive to foreign investors, so the demand for local currency will increase which tends to push up the price of domestic currency in terms of other currencies, the imports will rise and the exports tend to decline (it become more expensive), hence large trade deficit will ensue which ultimately hinder the economic growth However, various authors (Pattillo, Poirson Ricci, 2004) are unable to find evidence of a significant crowding out effect; while others (i.e. Chowdhury, 2004, Clements, Bhattacharya & Nguyen., 2003,) find that both debt burden and debt service obligations have reduced the investment and economic performance. (Ochieng, 2013).

Public Debt Level and Economic Growth in Kenya

The Internal Loans Act (Cap 420) provides the legal framework for the cabinet secretary to National Treasury to borrow on behalf of the government from the domestic market through issuance of Treasury bills and Treasury bonds. The government overdraft at the Central Bank of Kenya is the only aspect of domestic debt borrowing that seems to be limited by law. Domestic borrowing through Treasury bills and bonds do not seem to have a limit in law. This is different from external borrowing where the External Loans and Credit Act, CAP. 422 of the laws of Kenya limits the total indebtedness in respect of principal amount to Kshs 500 billion or such higher sum as the National Assembly may by resolution approve (Ochieng, 2013).

The evidence of highly increasing level of debt producing a negative impact on economic development was noted in the first United Nations Development Decade Even though the developing nations attained the minimum target of annual growth of GDP of 5 percent easily by 1970s, nearly about half of official foreign exchange receipts were used for the purpose of repaying debt to official lenders. The reduction in official government cash flows during the period made debt servicing very difficult thereby necessitating debt rescheduling for the governments. The continuous reduction in official assistance and increasing level of multilateral assistance in the poorer and developing nations especially in the sub-Sahara Africa together with a rapid increase in the private sector liquidity because of expansion of the Eurodollar market during the beginning of 1970s resulted into an increase in private sector borrowing by a number of rapidly developing countries (Osewe, 2013).

The 1990s witnessed a steady decline in development assistance to Kenya occasioned by a perception of poor governance and mismanagement of public resources and development assistance. Other factors include the end of the cold war and the collapse of the Soviet Union. This led to a debt crisis in the country in the early 1990s which turned Kenya into a highly indebted nation. The debt problem was exacerbated by macroeconomic mismanagement in the 1990s such as the Goldenberg scandal which fleeced Kenyans billions of shillings leading to a reduction of donor inflows. The government thus resorted to occasional debt rescheduling and expensive short-term domestic borrowing to finance its expenditures (Putunoi & Mutuku, 2013). Public borrowing is inevitable and not reprehensible phenomenon of economic growth. It is a way to stimulate economic growth by injecting money from foreign investors (external debt) into it as well as distributing assets (internal debt) among those who has more than they can use at the moment and those who lack assets for developing economic initiative or other needs (Osewe, 2013).

However the persistent increase in the stock of public debt has negatively impacted on private investment levels in Kenya. It has reduced the current and future investment through increases in the cost of capital (borrowing by the private sector). It has also affected the current flow of resources available in the economy when domestic debt is used to service external debt (Karazijiene & Saboniene, 2009). Public debt has distorted the economy and complicated macroeconomic management causing poor social and economic status for Kenyan citizens. The debt problem has been exacerbated by increasing fiscal and balance of payment deficits; slow export growth, over reliance on primary export; overvalued exchange rates and negative real interest rate have also contributed to a rise in public debt which is estimated to be 53% of GDP (RoK, 2007).

Conclusions and Recommendations and Policy Implications

This study concludes that high level of public debt deters economic growth in Kenya and government should use it as a last resort to finance its economic developments since it is causing the crowding out effect problem in the Country. A debt overhang problem might be experienced in the long run since the domestic debt is affecting the GDP negatively meaning that in future external debt will be used to service domestic debt if the level of borrowing is not contained.

This paper recommends that public borrowing (government) from international markets and internal borrowing needs to be contained even though there was no problem of debt overhang since it leads to high interest rates and crowding out of the private sector from investment. Close monitoring of government borrowing through the domestic market is necessary since it affected the GDP negatively. The reduction in the domestic real interest rates is also necessary to encourage private sector investment and thereby substantially contribute to real growth. There is need for proper management of resources of the economy as a whole since it determines the volume and servicing of external debt and domestic debt, as well as the credit rating. Availability of public finance should be consistent with a policy framework that is credibly maintained (inflation policy, exchange rate policy, interest rate policy, pricing policy, etc.).

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