Domestic Debt Management in Kenya: Policy, Institutional and Operational Challenges

Published by
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Printed by: Doublesight Services
P.O. Box 4845-00200
Nairobi, Kenya
Tel: 0733 919024

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FOREWORD

In 2011, KENDREN commissioned a research on Foreign Debt and Development Financing in Kenya. The research was well received by the various multi stakeholders and its findings were found to be pointing to the direction of the need for a more prudent debt management system to check the exponential growth of debt in the country's macro-economic realm. A major realization in the course of this study was the reality that the domestic debt levels in country were growing at such a big magnitude and that this was to some analysts posing a greater danger for the debt sustainability levels. As such, KENDREN found it of critical and immediate urgency to carry out a study on domestic debt since this was a niche that had not been focused on greatly. As such, this study, "Domestic Debt Management in Kenya: Policy, Institutional and Operational Challenges" is the end result of this process.

At a policy roundtable side event during the World Bank /IMF Annual Meetings in Washington DC in September 2011, KENDREN together with the Harare based African Forum and Network on Debt and Development (AFRODAD) and the Malawi Economic Justice Network (MEJN) co-hosted an event, "Domestic Debt: The New Front of Debt Crisis in Africa. The Case of Kenya." Using examples

from other African countries participants and staff from the IMF noted that indeed Domestic Debt was in a sharp increase in most African countries and this indeed posed a big challenge to the issue of sustainability and management. A major highlight of this meeting was the acknowledgement that across all actors, the framework of domestic debt management was either now or was a work in progress. As such it was critical to redouble our efforts in shaping a viable framework to deal with domestic debt before it cascades to levels that out rightly undermine national development aspirations and goals.

Conversely a sharp increase in domestic debt was viewed as not only a reversal of the gains made under previous debt relief initiatives, but it was indeed a challenge to the mainstream discourse where previously much focus was on foreign debt, but now the dynamic had changed and called for a more in country process on the debt issue.

In the year 2010/2011, Kenya's total budget was close to a trillion mark resting at about Ksh 998.8 billion. The total revenue target for the same year was Ksh 688.5 billion making it about 24.9% of the GDP. In the same year, ordinary revenue was estimated at Ksh 609.6 billion. Ksh 78.9 billion was in Appropriation of Aid whereas

domestic debt redemption was at Ksh 62.5 billion as compared to external debt redemption of Ksh 20.5 billion. The overall budget deficit stood at Ksh 167.2 billion which is 6.8% of GDP. The deficit to be finance by foreign financing was Ksh 82.7 billion whereas that from the domestic market stood at Ksh 105.3 billion. Notably total donor financing stood at only 14.3% of the total budget.
These figures comprehensively capture the central role that domestic debt is increasingly playing in both the national budget process, but arguably more in informing the macro economic framework that our treasury abides by.

At the Kenya Debt Relief Network – KENDREN, the issue of a debt crisis has continued to be a poignant point of concern. In commissioning this study, we sought to assess the legal and institutional mechanisms that inform Domestic Debt management in Kenya. Who are the main actors? What are their roles and responsibilities? How are these roles and responsibilities earmarked and provided for within the constitution?

This study has endeavoured to present the framework of domestic debt, its legal and institutional frames and its role in our economic development and especially as relates to the infrastructural tangent. The policy path envisaged will govern responsible borrowing and

lending as a long term measure in handling the management of the national debt. It is therefore our collective action to make these recommendations a reality.

It is our considered hope and aspiration that this study will seek to inform and catalyze a deeper conversation and dialogue both in and across the various facets of our national policy development, implementation and coordination levels, to ensure that we indeed put in place a robust debt management policy and framework that will effectively in build a lasting and credible economic framework that unlocks the potential for our nation's development.

Yours Sincerely,

Wahu Kaara,
Executive Director

ACKNOWLEDGMENT.

The Kenya Debt Relief Network (KENDREN) owes immense gratitude and appreciation to various people whose contribution in various ways made this endeavour a resounding success.

First, we owe a great sense of appreciation to Mr. Vitalice Meja, the consultant who steadfastly carried out this research work. For his time, diligence and incisive analysis, we thank him for using his competence and expertise to point us in the right direction.

To the participants' at the validation workshop who subjected the initial draft of this research study to a rigorous analysis and critic. It is through their input that this research output became a coherent and admissible document for our consumption.

We must also thank the KENDREN staff: Programmes Coordinator; Kiama Kaara and Research Officer Tony Moturi, for their invaluable and diligent commitment to making this a success. From the inception level of the project, to every step of its management and liaison with the key actors, they have made this process less strenuous. Our Project Associates; Rita Obel and Diana Mochoge, for tirelessly running with the logistics and related coordination issues for the various stages of this project. Our Administrative department;

Hillary Andalo, Finance Officer and Samson Mutinda, Administrative Assistant for ensuring that all needs were met at the opportune time.

We are eternally grateful to our project partners, Evangelischer Entwicklungsdienst (EED) for their unwavering faith in our work and their continued and consistent support for it. It is their financial resource support that ultimately made this project a reality.

To those who played key roles and are not mentioned, it is not a deliberate omission. We take cognizant and a profound appreciation for the contribution. It is our pleasure to present this research study report to you and hope that you will find the contents of immense usefulness and timely.

KENDREN SECRETARIAT

ACRONYMS

CAG - Controller Audit General

CBK - Central Bank of Kenya

CSO - Civil Society Organisation

CPI - Consumer Price Index

DMO - Debt Management Office

FDI Foreign Direct Investment

GDP - Gross Domestic Product

GoK Government of Kenya

IFIs - International Financial Institutions

IMF - International Monetary Fund

MoF - Ministry of Finance

MTDS - Medium Term Debt Strategy

NSE -Nairobi Securities Exchange

NPV - Net Present Value

PFM - Public Finance Management

EXECUTIVE SUMMARY

The rising high level of domestic debt has the potential of increasing the domestic debt burden on the Kenyans through higher interest repayment. Interest expenses on securitised debt account for about 99% of total interest payments on domestic debt. With a rising domestic debt stock, an important issue for debt management is the cost implications for the government budget. Domestic interest payments have been rising at a higher rate than growth in ordinary government revenue and GDP. Domestic interest payments, as cumulative Government expenditure on interest and other charges on domestic debt increased from Ksh 57.4 billion in the fiscal year 2010 to Ksh 69.2 billion in the fiscal year 2011.

Kenya's strategy to move away from short term instruments to longer term instruments appears to be paying off; The purpose of lengthening maturity of domestic debt is to minimise rollover risk and reduce borrowing costs associated with short term debt. In the period under review, the ratio improved in favour of bonds to bills from 74:26 in June 2007 to 81:19 in June 2008. Indeed, reflecting successes in lengthening the maturity of domestic debt, over the past 7 years the average maturity profile of outstanding Government

securities increased from 0.8 years in June 2001 to 3.9 years in June 2008.

Kenya's domestic debt levels have pushed the public debt to unsustainable levels both within its own medium term debt management strategy levels as well as the IMF's DSA framework. As a percentage of GDP, overall public debt stock increased from 49.9 percent to 51.1 percent during the period. In particular, the proportion of external debt in GDP increased from 23.0 percent to 26.3 percent, while domestic debt increased from 26.9 percent of GDP to 27.7 percent. Public debt in net present value (NPV) terms now lies above the 45 percent of GDP in nominal terms ceiling set in medium-term debt-management framework.

Kenya lacks a domestic debt management policy to guide both the institutional and systemic frameworks for debt management between the ministry of finance and the CBK; the country does not have a Debt Management Policy. Debt management rests on a Medium Term Debt Strategy (MTDS) that informs debt management. This is both for the domestic as well as external and commercial debt.

There is no legal framework to include non state actors in domestic management. Even though Kenya has a strong CSO presence in the country that can ably engage with issues of debt management. There lack a clear legal framework to guide their input to development of policy documents that guide debt management and loan contraction process.

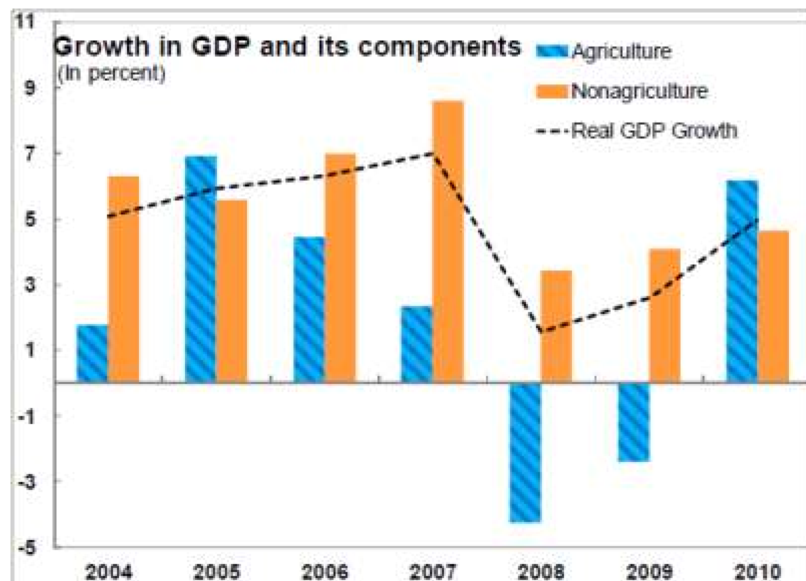
1.0 BACKGROUND

Kenya like many other developing countries is vulnerable to external shocks. The current ongoing global financial crisis has led to reduction in remittances from Kenyans in Diaspora, FDI and capital inflows, and international reserves thereby exerting pressure on the Kenya shilling exchange rate. On the fiscal front, the same exogenous shocks have fed into declining revenue and increasing expenditure needs of the government on one front, while drought has also necessitated emergency expenditures on food imports on another. On the monetary front, currency depreciation has led to inflationary pressures to pass through.

All these have led to a macroeconomic and structural vulnerability that have translated into a subdued economic performance. Real GDP growth has fallen to below 7% (Chart1). Non agricultural sectors are yet to reach their pre – 2008 levels despite the presence of 'sound neo liberal macroeconomic economic framework' in place. Furthermore the per capita GDP has not increased sufficiently to make a dent on poverty reduction efforts and reduce unemployment, and long-standing energy and infrastructure gaps remain.

Reliance on official sources of external financing has served Kenya well in the past. However, the Government has considered alternative sources of financing to accommodate higher infrastructure expenditure, consistent with Kenya Vision 2030, and to increase its independence from donor financing, which has proved volatile in the past. The Government is considering substituting external borrowing with domestic sources of financing thus putting domestic resource mobilisation squarely at the heart of economic development.

Chart 1 Real Growth Rates 2002 - 2010



Source Central Bank of Kenya

On the monetary policy front, inflation has increased from 3 percent to 12 percent since 2010, the shilling has lost ground, and the stock market has declined by 10 percent. Global shocks, especially the rapid rise in food and fuel prices, have added to Kenya's economic challenges. Furthermore the Kenya consumer price index (CPI) rose by 14.49 percent from 105.6 in June 2010 to 120.9 in June 2011 (Table 3.1). Taking into account price changes throughout the year, the index rose on average by 6.88 percent by June 2011 compared with an annual average increase of 5.43 percent in June 2010. All these factors have destabilised the macroeconomic framework of the country affecting the livelihood of the majority of Kenyans.

2.0 KENYA'S PUBLIC DEBT

Structure of Public Debt

Kenya's public and publicly guaranteed debt stood at Ksh 1,564.1 billion as at end September 2011. This represented a 21.7 percent increase from Ksh 1,225.7 billion held at the end of June 2010 (Table 1). The increase in the overall Government debt stock comprised Ksh 103.9 billion in domestic debt and Ksh 161.8 billion in external debt. The percentage of domestic debt in total debt declined from 53.9 percent to 48.1 percent during the period, while that of external debt increased from 46.1 percent to 48.8 percent see figure 1. As a percentage of GDP, overall public debt stock increased from 49.9 percent to 51.1 percent during the period. In particular, the proportion of external debt in GDP increased from 23.0 percent to 26.3 percent, while domestic debt increased from 26.9 percent of GDP to 27.7 percent. Public debt in net present value (NPV) terms now lies above the 45 percent of GDP in nominal terms ceiling set in medium-term debt-management framework. This is inconsistent with the debt sustainability threshold for the country.

Table 1 Size of Public Debt in Billion

Debt Category	Kshs.	USD
Domestic Debt	764.28	7.65
External Debt	799.83	8.01
Total	1,564.11	15.66

Source: Ministry of Finance

Figure 1 Structure of Public Debt

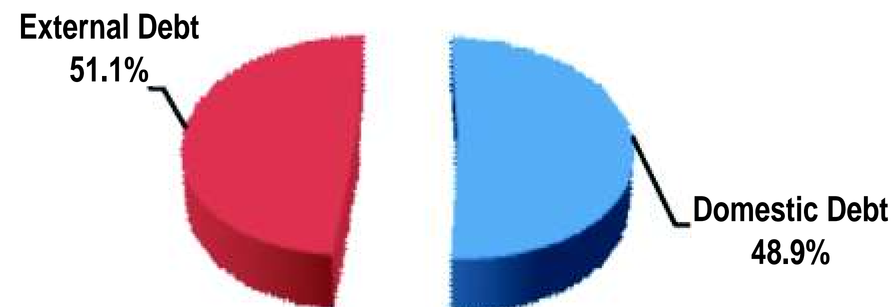


Table 1

Composition of Domestic Debt

Domestic debt in Kenya comprises central government debt incurred internally through borrowing in the local currency from residents. The government borrows from the domestic market using securities, overdrafts at the Central Bank of Kenya and advances from commercial banks. Securitised public domestic debt comprises of all government borrowings through treasury bonds, treasury bills held for fiscal and monetary policy purposes, and government long-term stocks.

Domestic debt in Kenya is contracted for various reasons. First, it is used to finance the budget deficit when the government is not able to meet its expenditure commitments using domestically raised revenue and externally sourced grants and borrowing. Second, domestic debt is contracted during implementation of monetary policy through open market operations. Third, debt instruments are important in financial markets development. In order to develop and deepen the financial markets, there is need for a steady supply of a wide range of instruments to be traded.

According to the Annual Public Central Bank of Kenya Report of 2011, securitised debtaccounted for 98.5% of overall public domestic debt in Kenya in June 2011. Just as securitised debt has been rising, its percentage in GDP rose from 26.9% in June 2010 to 27.7% in June 2011 due to a subdued growth of the economy. Domestic debt has been rising rapidly since 2008 due to reduced access to external funding and the need for domestic borrowing to finance the budgetary operations. Domestic debt, as a percentage of GDP, also increased from 26.9% in June 2010 to 27.7% in June 2011 following slowed performance of the economy see table 2.

Table 2 Domestic Debt Stock

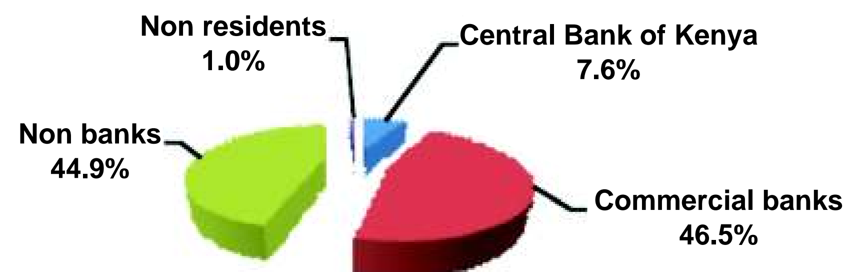
Domestic Debt	June 2009		June 2010		June 2011	
Securitised Debt	511.6	96.7	640.6	97.0	752.9	98.5
Treasury bills	150.1	29	191.3	29.0	157.3	20.6
Repo T-bills	33.3	6.4	32.2	4.9	30.7	4.0
Treasury bond	360.7	69.6	448.6	67.9	595.7	78.0
Govt stocks	0.8	0.1	0.8	0.1	0.0	0.0
Non securitised Debt	6.9	1.3	19.6	3.0	10.1	1.3
Overdraft	5.1	1.0	19.2	2.9	9.5	1.3
Others	1.8	0.3	0.4	0.1	0.3	0.0
Total	518.5	100	660.3	100	764.1	99.9
As %total of GDP	23.2		26.9		27.7	
As % of total Debt	49.1		53.9		51.2	

Source CBK 2011

Domestic Debt Instruments by holder, in Kshs billion

Commercial banks hold the largest proportion of the outstanding Government debt securities amounting to Kshs 355.02 billion or 46.5 percent as shown in Table 9 and Chart 3. Government debt securities worth Kshs 8.07 billion or 1.0 percent were held by non residents who invest through nominee accounts in the local banks. Kshs 58.13 billion held by Central Bank of Kenya comprises of Repo Treasury Bills used for execution of monetary policy. The non banks held 44.9 percent of the outstanding Government paper, mostly Treasury Bonds as illustrated in Chart 5. The non banks category comprises non bank financial institutions, National Social Security Fund (NSSF), parastatals, insurance companies, building societies, pension funds and individuals.

Figure 2 Domestic Debt by Holder



Source Treasury 2011

Kenya can boast of a fairly wide investor base in its domestic market, see figure 2. This could have contributed to reduced monopoly by one player in the market as well as reduced the cost of borrowing. Furthermore by compiling the securitised debt by instrument type, investor type and maturity structure provides the government with an opportunity to formulate effective strategies of managing the macroeconomic risks associated with domestic borrowing. There is however little evidence to show that the government has capitalised on this gain it has made.

While there is clear evidence to promote the participation of foreign investors in the domestic debt market with a view of promoting

competition, and increasing efficiency in the domestic debt market through financial technology and innovation, efforts to encourage and motivate ordinary citizens participation in domestic market remain weak and limited only to the elites of the society. Requirements for participation are not only cumbersome but also make the participation of the private domestic investor an exclusive affair.

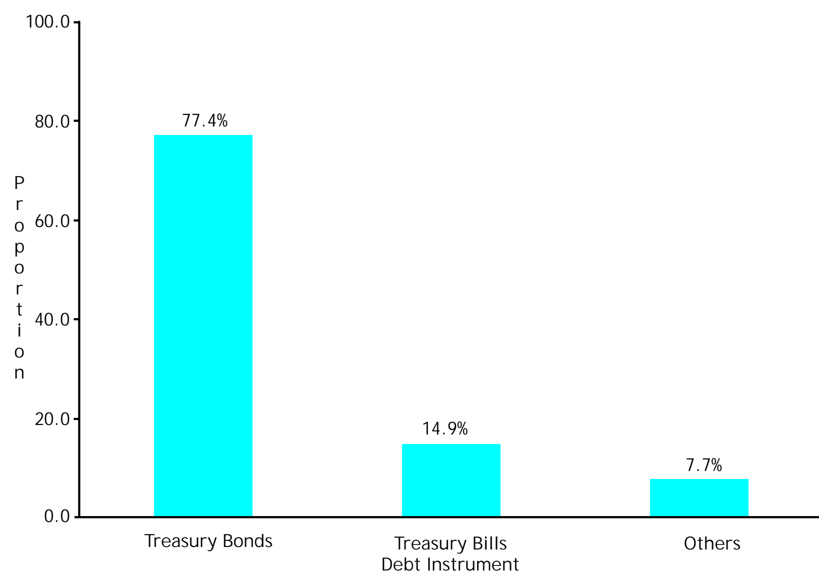
Furthermore there is a need to improve the adequacy of data on non-resident investment in government securities to enhance monitoring of foreign direct investment in the country. The study established that commercial banks invested in government securities on behalf of individuals or institutions such as pension funds. Since these funds are part of what commercial banks declare as their own investments, statistics on holdings of government securities by banks could be overstated, while those on holdings by individuals could be understated. Therefore, making it statutory for the banks to declare these holdings to the CBK would increase the accuracy of statistics on holders of the debt.

Domestic Debt by Instruments

Treasury Bonds comprises of 77.4 percent of Government domestic debt, 14.9 percent in Treasury Bills while the balance is mainly the overdraft at the Central Bank of Kenya. The structure of the holding is consistent with the debt strategy of holding more domestic debt on longer dated instruments to minimise refinancing risk and promote development of domestic markets for Government debt.

In being consistent with its debt management strategy, in June 2008 the Government launched a debut 20-year Treasury Bond following successful Treasury Bonds issues with maturities of more than 10 years. The purpose of lengthening maturity of domestic debt is to minimise rollover risk and reduce borrowing costs associated with short term debt. In the period under review, the ratio improved in favour of bonds to bills from 74:26 in June 2007 to 81:19 in June 2008. Indeed, reflecting successes in lengthening the maturity of domestic debt, over the past 7 years the average maturity profile of outstanding Government securities increased from 0.8 years in June 2001 to 3.9 years in June 2008. In the period under review, average maturity has increased from 3.1 to 3.9 years. As a reflection of improved liquidity in the secondary bonds market at the Nairobi Stock Exchange (NSE),

turnover rose from Ksh 62,575 million in 2006/07 to Ksh 77,376 million in 2007/08. In addition, the corporate bonds market recorded increased activity with six (6) new corporate bonds listed at the NSE.



Source Treasury 2011

Treasury Bills

As shown in Table 3.4, the stock of Treasury bills declined from Ksh 94,882 million in June 2007 to Ksh 76,293 million in June 2008. The amount of Treasury bills held by commercial banks declined from

Ksh 45,051million (47.5 percent of total) in June 2007 to Ksh 28,483 million (37.3 percent) in June 2008. Insurance companies and pensions funds scaled up their holdings from Kshs.13,673 million (14.4 percent) to Ksh 32,389 million (42.5 percent) during the period under review.

Table 3 Treasury Bills

Holders	2008		2009		2010		2011	
	Amount	%	Amount	%	Amount	%	Amount	%
Banks	69.4	62.4	108	78.3	167.2	87.4	119.4	75.9
Central Bank	43	38.6	33.3	24.2	33.2	17.4	31.7	20.1
Commercial Banks	26.4	38.6	74.6	54.2	133.8	70.0	87.7	55.8
NBFIs	0	0	0.0	0.0	0.2	0.1	0.0	0.0
Insurance companies	17.0	15.3	17.0	12.4	8.4	4.4	4.7	3.0
Parastatals	7.2	6.4	2.3	1.7	1.9	1.0	3.2	2.1
Pension Funds	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Building Society	1.1	0.9	0.0	0.0	0.0	0.0	0.0	0.0
Others	16.7	15.0	10.5	7.6	13.8	7.2	30.9	19.6
Total	111.3	100.0	137.8	100	191.3	100	157.3	100

Treasury Bonds

Outstanding Treasury bonds increased from Ksh 272,200 million in June 2007 to Ksh 315,190 million in June 2008 as observed in Table 3.5. Holdings by pension funds, parastatals and building societies recorded declines of 11.5, 1.7 and 4.4 percentage points respectively while holdings by both commercial banks and insurance companies remained relatively unchanged at 51 percent and 10 percent of the total holdings respectively. Holdings in the ‘other’ category which includes individual investors recorded a significant increase of 18.8 percent.

Table 4 Outstanding Treasury bonds

Holders	2008		2009		2010		2011	
	Amount	%	Amount	%	Amount	%	Amount	%
Banks	156.1	49.8	176.8	49.0	211.7	47.2	290.9	48.8
Central Bank	0.0	0.0	0.0	0	0	0	0	0
Commercial Bank	156.1	49.8	176.0	48.8	208.9	46.6	288.4	48.4
NBFIs	0.1	0.2	0.8	0.2	2.8	0.6	2.5	0.4
Insurance companies	31.9	10.1	38.3	10.6	53.8	12.0	74.7	12.5
Parastatals	29.5	9.4	31.4	8.7	38.0	8.5	23.7	4.0
Building Societies	0.9	0.5	0.1	0.4	0.1	0.3	0.3	0.1
Pension Funds	11.3	3.6	15.8	4.4	20.1	4.4		
Others	96.0	30.5	113.8	31.5	124.7	27.8	206.1	34.6
Total	315.2	100	360.7	100	448.6	100	595.7	100

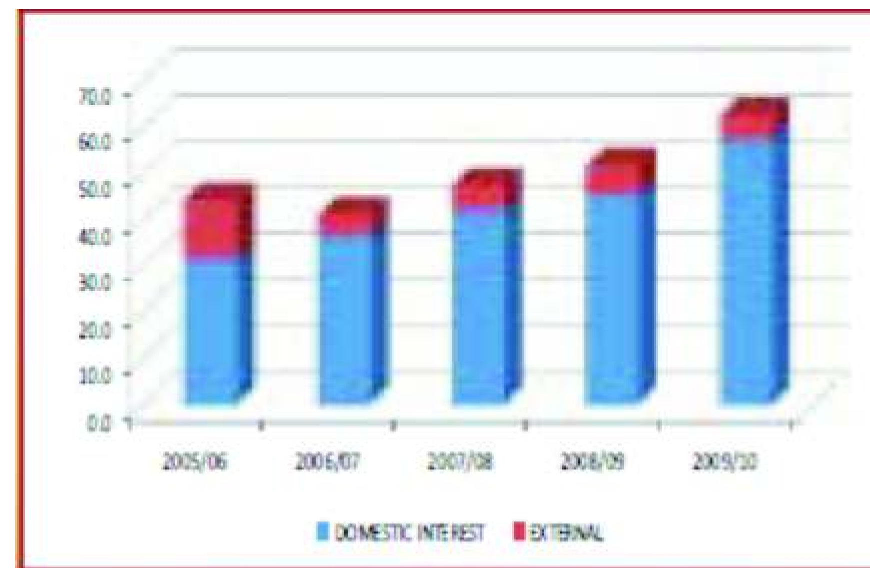
Source CBK

The shift in the composition of domestic debt in favour of the longer-dated instruments followed a deliberate government initiative in May 2001 to restructure public domestic debt and develop the domestic debt markets. This was to restructure domestic debt from the short-dated Treasury Bills to the long-dated Treasury Bonds in order to minimise the risks of short-term borrowing, as well as develop a secondary market for government securities.

Domestic Interest Payments

As shown in Table 5, domestic interest payments increased from Ksh 36,860 million in 2006/07 to Ksh 42,181 million in 2007/08. However, as a proportion of GDP, the interest payments remain relatively unchanged at 2.0 percent of GDP during the period under review due to higher GDP growth rate. The ratio of domestic interest payments to domestic revenue, expenditure and as a percentage of total interest payments (domestic and external) also declined over the period.

Chart 4 interest payments on domestic debt



Source CBK

3.0 DOMESTIC DEBT AND ITS IMPLICATION ON DEVELOPMENT

While for a long period of time there has not been a clear alignment of domestic debt instruments to a particular development project, the trend is currently changing, with government issuing project specific bonds to facilitate its infrastructural development program under the Vision 2030.

While the government contracts domestic loans to meet shortfalls in the budget, it continues to advance money or take over loan obligations from State Corporations. The loan obligations and the exact circumstances under which they were contracted are not clear. In some cases, the loan contracts are not even availed to the Controller and Auditor General (CAG) during audits. For example Treasury was called upon to settle a debt of about 15 million shillings owed by the Nzoia sugar company to a local bank in 1997. The CAG, in his report for 1997/98 states that he did not see any loan agreement between the lender and the loanee and that it appeared that no proper loan agreements had been made. He also doubted whether Nzoia Sugar Company would ever repay the money to Treasury

considering that the company was in financial difficulties. (Oyugi and Meja :2010)

Interest expenses on securitised debt account for about 99% of total interest payments on domestic debt. With a rising domestic debt stock, an important issue for debt management is the cost implications for the government budget. As shown in Chart 4 above, domestic interest payments have been rising at a higher rate than growth in ordinary government revenue and GDP. Domestic interest payments, as cumulative Government expenditure on interest and other charges on domestic debt increased from Ksh 57.4 billion in the fiscal year 2009/10 to Ksh 69.2 billion in the fiscal year 2010/11. The rise is attributed to weak revenue performance in the period.

Due to higher interest rates and rising domestic debt, the interest cost on domestic debt accounted for the largest proportion of total government interest expenditure during the period.

Excessive domestic borrowing could also crowd out private sector investment as the government competes with the private sector for private savings. This is more so in developing countries like Kenya

where national savings are quite low compared with those of developed countries. Increased demand for limited financial resources from commercial banks and other non-bank investors' driving interest rates up. This increases the cost of borrowing and hence reduced credit to domestic private sector investor which eventually undermines private investment.

In longer-term nominal debts contracts, they enhance political accountability and help governments build a track record to access international capital markets. Increasing the reliance on domestic financing may help mitigate the problem of external borrowing, which has been found to crowd out institutions by weakening the State's dependence on its citizenry and hence severing the accountability channel that forces domestic institutional reform.

Since Kenya spends a large portion of its budget on debt service, a factor that leads to cutting on other critical human development sectors this has obvious implications for development. If the government can spend almost 3% of its GDP on servicing debt, it is a clear indication of how prudent management of debt can free up resources for development.

The government could allocate more funds to health, education and other development programs if it were not for the net loss of capital outflows in terms of debt services and interest payments.

The large amount of capital outflows through domestic debt servicing and interest payments in Kenya could have had an adverse impact on the country's ability to develop. Government expenditures on education, health and other social sectors have to be cut in order to meet conditions of donor countries and international lending institutions.

4.0 LEGAL AND INSTITUTIONAL FRAMEWORK

Legal Framework

Kenya is currently undergoing a landmark reorganizing of its governance structure. With the promulgation of the new constitution in August 2010, a new governance model that will impact greatly on the social, political and economic framework of the government is underway.

Towards this end, the Ministry of Finance (The Treasury) has developed a draft Public Finance Management Bill for consideration in light of the new devolved structures. Whereas, the debate and discourse on the ensued proposed framework is ongoing, and elicits intense and diverse opinions, it is greatly recommended that all voices be heard in this regard if Kenya is to come through with a concrete framework of financial and economic management that will reinforce and cement its devolved structures.

Conversely speaking, Kenya does not have a Debt Management Policy. As such it rests on a Medium Term Debt Strategy (MTDS) that informs debt management. This is both for the domestic as well as external and commercial debt. In operationalizing this, there exist key features that inform the domestic debt scenario in Kenya.

There are no legal requirements for an inclusive procedure for domestic debt management especially in the monitoring, evaluation and regulatory levels. Nonetheless, some corrective measures at the institutional level have been undertaken.

As regards the management of domestic debt, this can be broken down into two core pillars, namely: The Legal Framework and the Institutional Framework. It is these two frameworks that guide and inform the overall management structure of domestic debt.

Within the legal framework, currently, there exist four different but related Acts of Parliament governing public debt management in Kenya, namely: the External Loans & Credits Act (Cap 422), Internal Loans Act (Cap 420), Guarantee Loans Act Cap 461 and the Central Bank of Kenya Act (Cap 491).

The Internal Loans Act (Cap 420) provides the legal framework for the Minister for Finance to borrow on behalf of the government from the domestic market through issuance of Treasury Bills and Treasury Bonds. According to this Act,

"the government sets a target for domestic borrowing annually through the budget and has the option of revising the figure through the revised budget in the second half of the fiscal year.".. (GoK 2009)

The Act also allows the Government access to an overdraft at the Central Bank of Kenya (CBK) when there is a mismatch between revenue receipts and expenditures. As a measure of checking inflationary pressures resulting from use of the overdraft facility, the Act sets a limit to the use of the overdraft to a 5 percent level of the latest audited Government revenue. 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 does not have a limit in law. This is different from external borrowing where the External Loans and Credit Act, limits the total indebtedness in respect of principal amount to Ksh 800 billion or such higher sum as the National Assembly may by resolution approve. (GoK 2009)

The minister of Finance, according to the Act, is required by provisions of the Internal Loans Act to;

"…report to the National Assembly in writing, the amount of indebtedness outstanding at the end of each financial year in respect of each manner of borrowing specified in section 3 of the Internal Loans Act."

This, however, is hardly done promptly and with the necessary regularity.

Institutional Framework

In terms of the Institutional Framework, Section 45 of the Central Bank of Kenya (CBK) Act provides the legal framework for the central bank to manage public domestic debt on behalf of the government. This includes contracting domestic debt through sale of Treasury Bills and Bonds, extending overdraft facilities to the Government, maintaining domestic debt register and making payments of domestic debt. As a banker to the Government, the Central Bank of Kenya effects payments to external creditors on specific instructions from the Treasury. Whereas this is the case in terms of the structure a more nuanced and clear separation of duties and responsibilities becomes imperative in order to benefit from a highly rationalised and articulated policy framework.

Key players within the institutional framework of domestic debt management are:

- The Attorney General's Office: Principal legal adviser to Government and is responsible for reviewing draft loan agreements to ensure conformity with the relevant legislation.
- Accountant General's Department: Responsible for cash management and in particular the use of the Government

overdraft facility at CBK. The institution could benefit from increased institutionalization in order to put paid to the image of a one-man-show syndrome.

- Controller & Auditor General: Responsible for issuance of authority to debit the Consolidated Fund Service account to settle Government debts. It undertakes periodic audits of public debt.

In terms of the main principles of government debt management, the overall objective of Government debt management strategy is to meet the central Government's financing requirements at the most optimal borrowing costs with a prudent degree of risk. It also aims at facilitating the Government's access to the financial markets as well as supporting development of a well functioning domestic financial market.

The strategy of domestic debt issuance is reviewed on a continuous basis and agreed upon between the Treasury and CBK. To ensure transparency and credibility of the Government debt policy, the annual net domestic borrowing target is announced in the Budget Speech each year in June.

The Central Bank of Kenya issues Treasury Bonds and Bills as determined by the Government's current revenue and expenditures. To meet temporary shortfalls in cash-flows, the Government may access the overdraft facility at the CBK up to the statutory set limit of 5 percent of the latest audited Government annual ordinary revenue.

Information Dissemination

An important element of Government debt management is to promote transparency in its operations. To this end, the Government publishes various reports in its efforts to disseminate information to the public on debt management operations. A wide range of information is currently published in the CBK's *Monthly Economic Review* and *Weekly Bulletin, MoFs Annual Public Debt Management Report, Monthly Debt Bulletin, Quarterly Budget Review, Budget Outlook Paper and Budget Strategy Paper* and in the *Annual Economic Survey* published by the Kenya National Bureau of Statistics. This information may also be downloaded from the respective websites.

5.0 THE ROLES AND RESPONSIBILITIES OF DIFFERENT ACTORS IN DOMESTIC DEBT MANAGEMENT

Domestic debt management remains a preserve of the Central Bank of Kenya under the close supervision of the Ministry of Finance. There seems to be little room to involve the non state actors in the process. While on the one hand it is seen as a monetary policy instrument, on the other it is a financing instrument for the government in meeting its obligations on the national budget. In managing monetary policy and financing the national budget, parliament, civil society organisations and private sector participation is important. This is not only to enhance ownership of the domestic debt as tax payers but also as beneficiaries of the outcomes of the domestic debt.

i) Parliament

Parliament is a vital democratic institution serving as a bridge between State and society by carrying out its legislative, oversight and representative functions in a way that strengthens the good governance values of accountability, transparency and participation.

The Kenyan Parliament has traditionally been ineffective in monitoring how the Executive borrows, expends and services public debts and this can be attributed to the then existing constitution that limited the role of parliament with regard to approval and authorisation of domestic borrowing. This gave too much leeway for Treasury to commit the country into borrowing without recourse to parliament for approval.

Over the years, parliament through legislation, has taken measures that have increased its oversight role in finance management. In 2008, Parliament passed the Fiscal Management Act, that increased their level of participation in budget formulation where the Finance Minister is required to lay before the House the budget policy statement that contains an assessment of the current financial year and the projected state of the economy for the succeeding three years including the domestic debt and external borrowing and debt servicing charges and loan repayments for the succeeding financial year.[1]

This role has been enhanced under the Constitution of Kenya 2010 where the National Assembly is required to pass a law that will prescribe the terms on which the government may borrow and impose reporting requirements thereof.[2]

Under the new dispensation, parliament therefore can move motions that have financial implications including matters related to contracting public debt and ensuring there is inter-generational equity in sharing public borrowing between current and future generations.

ii) CSOs

Kenya has a strong CSO group that can ably engage with issues of debt management. However, over the years the CSO has had a minimal role in the management of domestic debt and it has been consigned to being consumers of statistics of public debt. Their input to development of policy documents that guide debt management and loan contraction process is non-existent. This sorry state can be attributed to the following factors:

i) Lack of an enabling legislation towards access to information and this has been a great impediment in accessing timely information; and,

ii) The limited opportunities for CSOs engagement on debt issues.

In going forward, the new Constitution of Kenya 2010 has come up with provisions that will make it easier for the CSOs and the general

public to access any information held by the State and it goes further to compel the Government to publish and publicise this information to the general populace.[3] This will therefore enhance the oversight role of the CSOs in the domestic debt management.

The Ministry of Finance has drafted a Public Finance Management Bill and this offers the CSOs an opportunity to meaningfully contribute and influence the development of legal framework on loan contraction and debt management. This will be key in promoting national ownership of the process as well as receiving alternative views that neither the government nor the financial institutions have, given their practical experience with policy impact at the grass root level.

The CSOs could also play a key role in assessing the suitability of projects funded by loans sourced locally as well as assist in monitoring and evaluating the impact of the various loan projects to the community.

A closer collaboration with the government is necessary as this could provide the much needed momentum for resolving the currently stalled repayments of arrears of suspicious security based loans. CSOs could campaign for their total and unconditional cancellation.

Whereas the new constitution has allowed the CSOs to actively engage on policy issues such as the budget making process, their contribution to the management of domestic debt is non-existent as this is a preserve of the Ministry of Finance and the Central Bank of Kenya and their role is only be limited to oversight one.[4]

iii) The Private Sector

The Kenya private sector has over the years substantially contributed to the country's economic development process.

They have no direct role in as far as management of domestic is concerned. They only do business with government by participating in domestic debt auction that is done through the Treasury Bonds and Treasury Bills. They lend money to government.

Despite lack of a direct function in domestic debt management, the private sector just like CSOs can utilise the access to information provisions in the law to play an important role in improving transparency and accountability on the part of the executive and also parliament. This will increase their oversight role and provide policy alternatives.

iv) International Financial Institutions- IFIs

The International Financial Institutions including the World Bank and the International Monetary Fund have played an important role in providing technical assistance to the government to establish the debt management department. This assistance has focused most recently on policy advice in the context of an update to the authorities' Medium-Term Debt Strategy.[5]

The Fund and the Bank were also responsible for the debt management capacity assessment of the government and provided a loan of US$1.5 million to establish the debt management office and to strengthen the domestic debt market.

The government has also benefited from the support of Macroeconomic and Financial Management Institute for East and Southern Africa (MEFMI). Some of the areas these institutions have assisted the government with include:

- Establishment of a comprehensive and reliable public debt database supported by an effective back office.
- Consolidation of debt management functions currently spread within MoF and CBK under one unit, the DMO.
- Capacity building

- Preparation of debt objectives and strategies to guide the operations of DMO.
- Develop a legal framework for public debt management.

While the initiatives the government has taken to strengthen its debt management system through the International Financial Institutions, it is important that the government takes the lead in ensuring the sustainability of the debt management reform process. In this regard, entrenching an internal capacity building program for the department, preparation of debt objectives and development of legal framework for public debt management should be internally driven through consultation with broad stakeholders from within rather than through technical assistance from the international financial institutions.

6.0 CONCLUSIONS AND RECOMMENDATIONS

The study concludes that domestic debt plays a big role in the Kenya's economy and how it is managed has the potential to catalyse and revamp the economy on the one hand and increase the debt burden to the citizens of the country to the unsustainable level on the other. High interest rates, coupled by subdued economic performance, dwindling external support and increased government expenditure continue to push domestic debt to levels not previously envisioned under the country's medium term debt strategy remain an area of concern for creating a domestic debt crisis and by extension public debt crisis.

Domestic debt data is not comprehensively disaggregated. Commercial banks investors use fed nominee accounts registers such investments as their own. This clearly overstates their investment in the domestic debt market while understating the private individual investor participation in the domestic debt market. Furthermore the lack of an inclusive approach to domestic management, where civil society and parliament are excluded with regard to domestic debt financing, calls into question the constitutionality of domestic debt

borrowing. It is with this in mind the study recommends the following;

i) Link domestic to development outcome; Domestic loans linked to the national budget or specific development project must have clear measurable development outcome. This will ensure prudent and effective use of resources. Domestic loans towards infrastructural projects particularly must be able to not only show development impact for the people of Kenya but must also demonstrate the ability to service the debts in themselves without additional burden on the public coffers.

ii) Develop a Domestic Debt management Policy; Domestic debt management policy is important if the country is to be able to manage its domestic debt prudently. The need for legal, institutional and regulatory framework to guide domestic debt contraction, its management, recording, and servicing is not only key in ensuring the integrity of the loan contraction process but also provides frameworks for monitoring and accounting of the relevant structures to the general public. It also enhances not only the professionalism in

the process but also eliminates political interference from the executive in its management.

iii) Create a Legal framework for domestic debt contraction that is inclusive; The current framework of domestic debt management is untenable under the current institutional framework. The desire for people participation in public policy and institutional reforms demand that legal framework for domestic debt contraction must include the views of non state actors including the civil society, private sector and the parliament. This facilitates ownership and enhances the demand and consumption of citizen accountability with regard to domestic debt commitments.

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