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POLICY BRIEF

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Sovereign debt sustainability and private sector credit growth in Kenya

Executive Summary

Typical debt sustainability metrics characterize Kenya's sovereign debt as "unsustainable" since around 2019. Further, the data show that, over time, commercial banks' private sector lending has declined while lending to the government has grown. Given these observations, this study examines whether sovereign debt has a discernible relationship with private sector credit growth and documents a characteristic negative relationship between sovereign debt and private credit growth; the negative relationship is stronger during periods when sovereign debt is arguably unsustainable. Informed by this finding, the study tests for the possible moderating influence of financial conditions on the established empirical relationship. Financial conditions have worsened considerably since around 2013 when our construct turns positive, or "restrictive". The tests show that financial conditions have a significant adverse moderating effect on the relationship between (domestic) sovereign debt and private sector credit growth. Informed by these findings, the study also tests for the possible existence of a threshold level of sovereign debt at which the negative relationship between sovereign debt and credit growth worsens: the results are mixed and inconclusive.

Several policy implications are gleaned from the findings. First, given the inconclusive threshold tests results, this paper may not recommend firm debt limits for policymakers to consider. However, the paper proposes that Kenya considers a debt limit specified as public debt as a proportion of GDP. Kenya's public debt limit is currently stated as 55% present value of debt to GDP, which is substantially higher than that of its peers in Sub-Saharan Africa (Olaoye et al (2022) find threshold levels of between 57% and 61% for a sample of Sub-Saharan African countries). Once a debt limit is established, it is important that it be hedged from arbitrary variations. Considering that fiscal policy rules in Africa have been largely ignored and hence tend to worsen debt sustainability (Abubakar et al., 2024), Kenya should consider entrenching the new debt limit in its constitution. Absent this, it would be useful for the debt statutes to provide for sanctions, with clear implementation modalities, whenever the limits are violated.

Second, based on the finding of asymmetric response between private credit growth and growth in private security holdings of banks to sovereign debt changes, in which private credit growth's response is more distinct

especially during the period regarded as exhibiting sovereign debt unsustainability. Such periods, as observed in Kenya, are often marked by fiscal adjustments. Because of their adverse effects on credit growth, fiscal adjustments induce "debt traps", which, in the long run, worsen sovereign debt sustainability. Barring its potential depreciating effect on the domestic currency value, which complicates external debt management, the country should consider employing a less restrictive monetary policy to hedge the economy from the credit growth-retarding effects of fiscal adjustments.

Third, to mitigate the adverse effects of sovereign debt on credit growth, measures to reduce public sector's debt reliance must be explored. In this regard, Kenya must consider tapping more aggressively into non-debt sources of finance, such as mobilizing private sector resources (public-private partnerships are an example) and global and sustainability focused funding opportunities like carbon finance and blended finance. Alongside this policy, the policy measures that reduce inefficient spending to create space for pro-growth outlays and discretion against shocks should be adopted.

Author: *Odongo Kodongo - Wits Business School, University of the Witwatersrand*

Context

Sovereign debt is generally considered unsustainable if the government cannot repay it without amending its contractual terms or rendering it irrelevant by defaulting, or restructuring.

By this definition, sovereign debt is unsustainable if an undesirable event such as debt default or restructuring has been occasioned by the government's attempt to settle the debt. However, for ease of interpretation, the definition of unsustainability is often linked to the flexibility of fiscal policy. If a change in fiscal policy to facilitate repayment of the debt is infeasible on social or political grounds, or because it might engender costly economic consequences (e.g., raising already high taxes or cutting essential government spending), then debt is unsustainable (Willems and Zettelmeyer, 2022). This revised definition fits the Kenyan situation neatly, where, to tackle the burgeoning sovereign debt, the government announced a package of tax increases through the Finance Act 2024, which precipitated a cost-of-living crisis that ignited street protests, forcing the government to withdraw the Act. Thus, because of its undesirable economic effects, Kenya's fiscal policy has become inflexible and may not be easily altered to facilitate debt repayment. This situation makes Kenya's sovereign debt arguably unsustainable.

Indeed, the data show that the country's sovereign debt has grown considerably since 2013 and has shown signs of unsustainability since at least 2019 when all traditional indicators of sustainability (e.g., present value of debt to gross domestic product, debt service to revenues) decisively crossed their critical levels. In such situations, credit terms for private sector borrowers deteriorate. For example, the ten-year Treasury bond yields have remained above 12% on average since 2018 and recently surged beyond 15%. Because the 10-year government bond serves as a pricing benchmark for long-term private sector credit, commercial bank lending rates have also increased. It is therefore not surprising that private sector credit appears to have fallen during the period, which coincides with arguably

unsustainable usage of sovereign debt. Given these observations, the purpose of this study was to examine the potential effects of sovereign debt unsustainability on private sector credit growth in Kenya. This is important as studies show that adverse shocks to private credit growth may engender negative real sector impacts.

Beyond the initial focus on the sovereign-debt—credit-growth nexus, the paper also attempted to establish if a threshold level exists beyond which sovereign debt affects credit growth more adversely. That is, if, for example, sovereign debt affects private credit growth and unsustainable sovereign debt affects private credit more, it is a useful policy exercise to establish the point at which this transition occurs. Knowledge of the threshold level would facilitate evidence-based formulation of fiscal policy rules such as sovereign debt limits. This is particularly important for Kenya, where the public debt limit has been set haphazardly over time. The threshold analysis is underpinned by the literature that asserts that different levels of sovereign debt impose different intensities of effect on the real sector (e.g., Assoum and Alinsato, 2023), implying that there is a threshold level of sovereign debt at which it becomes unsustainable.

From the tests conducted, the study reports interesting findings. The results show a characteristic negative relationship between sovereign credit and banks' private sector lending, reminiscent of a phenomenon known as the "crowding-out" effect. These effects are stronger for loans and advances to customers than for private security holdings of banks – which can potentially be explained by risk asymmetry between private bank borrowers and security issuances of firms. Unlike private loans, which are directly negotiated with customers (firms and individuals) and are replete with contractual frictions such as higher moral hazard, security issuances, whether directly placed to banks and other institutional lenders in the private debt markets (e.g., commercial paper) or sold in public

debt markets (e.g., bonds and notes), allow for collective monitoring by all creditors through a trustee and the use of restrictive covenants, both of which may reduce contractual frictions. Thus, where banks must choose between private security investments and direct credit to firms and households especially in times of sovereign borrowing-induced liquidity constraints, they are likely to prefer the safer security holdings option, resulting in crowding out of direct lending. The results further show an unambiguous, and stronger negative effect of domestic sovereign borrowing on private credit growth. However, domestic borrowing does not appear to have a statistically significant effect on bank's private sector-issued security holdings.

During 2019–2023, when public debt is considered unsustainable, the results report a more significant effect on private credit growth than the earlier period of sustainable usage of sovereign debt, indicating stronger effects of sovereign debt on the real sectors. Further, when the moderating role of financial conditions is considered, tests results show that financial conditions significantly moderate the effect of domestic sovereign debt on private credit growth while, expectedly, having no effect on private sector security holdings. Specifically, the results show that tighter financial conditions worsen the ability or willingness of banks to lend to the private sector. For example, in times of restricted money supply growth (tight liquidity), banks may tighten their credit scoring when evaluating loan applicants or require higher collateral or interest rates on loans advanced to successful loan applicants, which lower the credit demand. Alternatively, banks may shift their supply of loans to the less risky public sector, given the finding that excessive usage of sovereign debt may induce banks to shift their preference to the less-risky government securities.

Understanding Sovereign Debt Sustainability

Definition: *Sovereign debt becomes unsustainable if repayment requires restructuring, default, or extreme fiscal policy changes that cause undesirable economic effects.*

Kenya's Context: *Tax increases in the Finance Act 2024, aimed at addressing sovereign debt, led to a cost-of-living crisis and protests, highlighting fiscal inflexibility and debt unsustainability.*

Indicators of Unsustainability

Rising Debt Levels: *Kenya's sovereign debt has grown substantially since 2013, surpassing critical sustainability indicators like debt-to-GDP and debt service-to-revenues by 2019.*

Impact on Private Borrowing: Treasury bond yields exceeding 15% have driven up commercial lending rates, contributing to a decline in private sector credit growth.

Sovereign Debt and Private Credit

Crowding-Out Effect: *High sovereign borrowing leads banks to prefer safer government securities over riskier private sector loans, reducing private sector credit growth.*

Differentiated Impact: *Loans to customers are more adversely affected than banks' private security holdings due to differences in risk and monitoring mechanisms.*

Threshold Analysis

Importance: *Identifying a tipping point where sovereign debt transitions from sustainable to unsustainable helps guide fiscal policy and debt limit setting.*

Kenyan Example: *The absence of a structured debt limit exacerbates the negative effects of sovereign debt on credit growth.*

Key Findings (2019–2023)

Stronger Effects: *During the period of unsustainable debt, the adverse impact on private credit growth intensified compared to earlier years.*

Role of Financial Conditions: *Tight financial conditions amplify the negative effects of domestic borrowing on private credit, as banks favor government securities over private lending.*

Policy Implications

Several policy suggestions can be gleaned from these findings as follows:

1. Kenya operates with fiscal policy rules such as sovereign debt limits, which have often been set haphazardly. This may be because the threshold level of sovereign debt has not been empirically established for the country. Although this study attempts to establish the sovereign debt threshold level for optimizing private credit growth, the results are not conclusive. Thus, we are unable to prescribe a firm public debt limit that the government could consider. However, the study shows a clear negative linkage between sovereign debt and private sector credit growth, with the negative relationship being stronger during the periods when debt usage is arguably unsustainable. Because private sector credit is important for financing investments, the results of this study suggest that excessive usage of sovereign debt would be harmful to real output growth and other facets of the real economy.

The key policy derivative from this finding is two-fold:

- a. A sovereign debt limit should be established at a level consistent with those of economies considered Kenya's development peers for which such thresholds have been established. In this regard, the recent study of Olaoye et al (2022) which find threshold levels of between 57% public debt to GDP (in respect of exchange rates) and 61% (in respect of inflation) for a sample of Sub-Saharan African countries that includes Kenya is germane.
- b. Once a debt limit is established, it is

important that it be hedged from arbitrary alterations. Considering that fiscal policy rules in Africa have been largely ignored and therefore tend to worsen debt sustainability (Abubakar et al., 2024), Kenya could consider imbedding the established debt limit in the constitution. Currently, public debt limits are governed by legislation: Section 52(2) of the Public Finance Management Act gives discretion to the national assembly to periodically set the limit with advice of the Public Debt Management Office. Yet, as recent practice shows, such flexibility in the legal framework can be abused. If the rules cannot be written in the constitution, it would be useful that the statutes specify sanctions, with clear modalities for implementation, whenever the limits are violated.

2. The establishment of firm fiscal policy rules, such as a debt limit with sanctions for violation, restricts government spending without imposing similar constraints on expenditure needs. For example, because a close linkage has been established between public infrastructure investment and economic growth in Africa (Kodongo and Ojah, 2016), African governments are advised to focus closer attention to infrastructure types such as energy, which have direct effects on economic activities like manufacturing, and telecommunications, which heavily impact the services sectors. However, where fiscal policy rules such as those recommended above impose constraints on capital spending, governments should still be able to finance such investments using nontraditional approaches. In this regard,

- a. Kenya needs to consider availing itself of innovative sources of finance by tapping into private sector resources (public-private partnerships are a good example) and global and sustainability focused funding opportunities such as carbon finance and blended finance.
 - b. Alongside the foregoing suggestion, fiscal policy measures should be adopted that reduce inefficient spending (e.g., that reduce public sector wage bill and remove subsidies while reducing taxes to caution citizens against the resulting higher prices of the previously subsidized goods) to create space for pro-growth spending (e.g., SMMEs support) and discretion against shocks (Ncube and Brixiová, 2014).
3. This study finds an asymmetric response in which private sector credit growth is more responsive to sovereign debt than private security holdings of banks. As argued, negative effects on private sector credit have a cascading effect on investments and output. However, Kenya arguably has a high monetary policy space relative to the typical advanced economy which it could use to ease the adverse effects on investment and output of fiscal adjustment measures imposed by excessive debt. Because of their adverse effects on credit growth and investments, fiscal adjustments induce “debt traps”, which, in the long run, deteriorate sovereign debt sustainability. Barring its potential effect on the domestic currency value, which complicates external debt servicing, Kenya could consider employing a less restrictive monetary policy to hedge the economy from the credit growth-retarding effects of fiscal adjustments.
 4. The study finds that the effect of government debt, particularly domestic debt, on bank

investment in private securities is muted. This is likely because the country’s corporate bond market is not as vibrant as the treasury bond market due to the corporate bond market’s small and illiquid nature, implying that the market avails limited investment opportunities to banks and other institutional investors. Thus, most of the institutional investors on the corporate bond market, particularly banks, are likely to do so for precautionary purposes. By their nature, precautionary investments are infrequently traded, making them generally insensitive to endogenous shocks such as changes in the volume of offerings of the relatively low-risk Treasury assets.

To encourage broader and more robust bank participation in the corporate bond market, policies that encourage deepening of the corporate debt/bond market should be enacted. A vibrant corporate bond market benefits the economy by availing an expanded pool of lower-cost long-term financial resources to corporate borrowers and facilitating banks and other institutional investors seeking relatively safe assets with higher yields than Treasury assets for their excess liquidity.

Policies for deepening the corporate bond market may include:

- a. Strengthening disclosure requirements for bond issuers.
- b. Encouraging more market makers to enter the market to provide liquidity to bond traders wishing to liquidate their positions (e.g., through a policy framework that incentivizes entry of new players).
- c. Promotion of greater respect for market autonomy (e.g., repealing or amending laws that impose stringent requirements on pension funds’ portfolio holdings).

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Kenya Bankers Association

13th Floor, International House, Mama Ngina Street
P.O. Box 73100– 00200 NAIROBI
Telephone: 254 20 2221704/2217757/2224014/5
Cell: 0733 812770/0711 562910
Fax: 254 20 2221792
Email: research@kba.co.ke
Website: www.kba.co.ke



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