Debt-servicing and economic growth in Kenya

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Abstract

Foreign debts are a priority claim on the foreign exchange earnings and international reserves. They reduce the scope for manoeuvrability for financing development and meeting balance of payments needs. Also, being part of the complex web of international economic relations and foreign policy, foreign debts have wide reaching repercussions which put the debt crisis at the top of the government's agenda. It has been argued that debt servicing in Kenya poses a real burden on the economy since a large proportionof exports is devoted to this servicing and thus watering down the impact of growth in exports on economic growth. The need to service a large amount of external debt by an economy not strong enough to withstand the pressure can discourage both the domestic and foreign investment as well as adversely affect economic performance through crowding out effects. Kenya'sdebt stock stood at US $ 5.1 billion as of December 2001, with the biggest proportion (97%) being officialdebt (60% multilateral and 37% bilateral) and the remaining 3% being commercial. According to the 2001 Economic Survey, the debt service as a percentage of GOP and export of goods and services stood at 4.4% and 16.5%, respectively by the end of year 2000. In spite of debt servicing consuming a largeproportion of the country's resources it is argued that Kenya's debt is sustainable. This is one of the reasonswhy the country does not qualify for the Heavily Indebted Poor Countries (HIPC) relief. This study is therefore an effort to explore the effect of external debt-servicing on economic growth. Specifically,the study tests the hypotheses that debt servicing has a negative effect on economic growth and that economicgrowth rate influences debt-servicing. In doing this, the study uses a single-equation model that has the real GOP growth rate as a function of debt servicing among other factors and later a simultaneous-equationmodel consisting of several structural equations. In the latter model, the aim is to test whether economic growth rate influences debt-service ratio through feed-back effects. The study employs annual Kenyan data from 1970 to 2000 and the results of both models indicate that there is indeed a negative relationship between debt-servicing and economic growth rate. However, the results of the simultaneous equation model show a break down in the feed-back effects of economic growth rate on debt-servicing and hence the second hypothesis of the study is not confirmed.