

**EFFECT OF EXTERNAL DEBT ON INFLATION AND INVESTMENT IN
KENYA**

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DECLARATION AND RECOMMENDATION


Declaration


This thesis is my original work and has not been presented for conferment of a degree or any other award in any other university.


Signature.......... Date.....12/10/2024.....
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Recommendation

This thesis has been examined, passed and submitted for examination with our approval as university supervisors.

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DEDICATION

The work is dedicated to my parents and the entire Kagotho's family.

ABSTRACT

Many developing countries require external debt to bridge the gap in government's expenditure budget. In Kenya, the government has over time accumulated large stocks of external debt to facilitate the provision of the essential public services and promote infrastructural development. Kenya's external debt has been increasing, recorded at approximately 45.5 billion U.S. dollars as at 2023. Despite the increased external borrowing in Kenya, public investment target of 10 per cent of gross domestic product and private investment target of 24 per cent of gross domestic product towards fulfillment of vision 2030 has not yet been achieved. The inflation rate has also increased over time, beyond the set threshold of 5 per cent. This study focused on the effect of external debt on inflation and investment in Kenya. The specific objectives of this study included; to investigate the effect of external debt on public investment in Kenya, to determine the effect of external debt on private investment in Kenya and to investigate the effect of external debt on inflation in Kenya. The relationship between external debt and investment (private and public) was based on Debt Overhang Theory augmented with Accelerator Theory whereas non-Ricardian Theory of Public Debt was the foundation of the relationship between external debt and inflation. A causal research design was utilized to examine the relationship among the study variables. Yearly time series data on the mentioned variables for the years 1990 to 2022 was collected using the structured data collection checklist from Kenya National Bureau of Statistics and World Bank. The research utilized the Autoregressive Distributed Lag Model. Stata software was used for data analysis. Diagnostic tests were conducted to ascertain that linear regression assumptions are adhered to. To test for the Stationarity of data, Augmented Dickey-Fuller test was used where interest rate, GDP growth rate, exchange rate and the dummy variable were stationary at level whereas private investment, money supply, tax, public investment, external debt and inflation were stationary at first difference. The long-run coefficient of external debt (0.1423) in model 1 was positive and significant, implying that 1 percentage increase in external debt would lead to a rise in public investment by 0.1423 per cent. The long-run coefficient of external debt (-0.0891) in model 2 was negative and significant, implying that an increase in external debt by 1 per cent would decrease the private investment by 0.0891 per cent. Lastly, the coefficient of external debt (0.2063) in model 3 was positive and significant, implying that 1 percentage increase in external debt would increase inflation by 0.2063 per cent. The p-values of the corresponding coefficients were 0.040, 0.006 and 0.026 respectively. The models were good predictors of public investment, private investment and inflation with R^2 values of 0.9682, 0.9890 and 0.9973 respectively. The study recommends a robust system of debt management and mechanism to regulate the acquisition and utilization of the borrowed funds towards the earmarked projects. The policy makers may use the study results to guide the government on how to sustainably acquire external debt while enhancing macroeconomic stability. The investors may also learn about the potential risk and benefits of investing in the country.