POLICY BRIEF

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THE SPILLOVER EFFECTS OF GLOBAL SHOCKS ON KENYA'S DEBT SUSTAINABILITY AND FISCAL RESILIENCE

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Introduction

Kenya's economy has exhibited resilience in recent years as characterized by a strengthening currency, marked improvements in trade balances and steadily declining inflation.

The country's ability to navigate economic challenges is reinforced by the narrowing current account deficit, surging exports and remittances, and enhanced foreign exchange reserves. Meanwhile, inflationary pressures have eased, reinforcing a more stable investment climate.[1] Despite these gains, the country remains highly susceptible to persistent global external shocks. Geopolitical conflicts, such as the Russia-Ukraine war and instability in the Middle East, have disrupted global fuel and food supply chains, driving up import costs for Kenya, which remains heavily reliant on petroleum and cereals.[2]

Monetary policy tightening in advanced economies like the U.S. has raised global interest rates, increasing Kenya's external borrowing costs and triggering capital outflows.[3] At the same time, protectionist trade policies and supply chain disruptions have weakened Kenya's export competitiveness, constrained access to concessional financing, and delayed critical infrastructure inputs.

These developments have exposed structural weaknesses: high public debt levels, narrow export diversification, dependence on external financing, and inadequate fiscal buffers. Consequently, Kenya is struggling with limited fiscal space for development, rising debt service obligations, which currently consume nearly a third of domestic revenue and heightened macroeconomic volatility. Without decisive reforms to address these fragilities, Kenya risks undermining its economic recovery and long-term fiscal sustainability.

This policy brief presents targeted recommendations to bolster Kenya's fiscal resilience and debt sustainability amid persistent global shocks. These include the following:

- Reform and broaden the tax base, with a targeted focus on high-growth sectors like the digital economy.
- Reduce import dependence by investing in local manufacturing and agro processing.
- Strengthening regional trade integration and South-South cooperation to diversify markets.
- Adopt counter-cyclical fiscal frameworks, including a stabilization fund and independent fiscal council.
- Enhance shock-responsive social protection systems through early warning and digital delivery tools.
- Secure strategic reserves for food, fuel, and key agricultural inputs to reduce exposure to global price shocks.

Key Global Shocks & Policy Recommendations

One of the key fiscal challenges Kenya faces today stems from global monetary tightening, particularly by the United States and the Eurozone, which resulted in increased global interest rates. These developments, coupled with Kenya's high risk of debt distress, have made it more expensive for Kenya to access external credit markets and reduced the availability of concessional financing. As a result, the country has become increasingly reliant on expensive domestic borrowing to finance its fiscal needs. This shift has significantly elevated debt servicing obligations, now consuming nearly a third of domestic revenue, thereby reducing the fiscal space for priority development investments.[4]

To address this, consistent with the call to reform and broaden the tax base to high-growth sectors, Kenya must strengthen its domestic revenue mobilization strategy by expanding taxation to under-taxed areas such as the digital economy. The rapid evolution of this sector has outpaced existing tax frameworks, making it difficult to identify taxable activities, enforce compliance, and avoid double taxation. Digital platforms, spanning e-commerce, content streaming, and digital financial services, have created a large and growing revenue base that remains underutilized because of being difficult to tax under conventional frameworks due to the absence of physical presence.

Although Kenya introduced a 1.5% Digital Service tax in 2021, challenges remain in identifying taxable digital activities, enforcing compliance and avoiding double taxation, thereby requiring technical capacity building and international cooperation.

Kenya's dependence on imported food, fuel, and fertilizer has proven to be a major vulnerability during recent global shocks. The Russia-Ukraine war and instability in the Red Sea due to the Israeli-Hamas conflict disrupted global supply chains, driving up the cost of essential commodities.[5] In 2022, these supply constraints triggered domestic inflation, which forced the government to introduce costly fuel and food subsidies.[6] While necessary to ease hardship faced by consumers, these subsidies strained the national budget and diverted funds from long-term development goals.

To safeguard the economy from future disruptions, Kenya should ensure investments in local production capacity. Improving domestic food security and reducing dependence on volatile international markets can be achieved by strengthening agro-processing industries, boosting climate-smart agriculture, and expanding irrigation infrastructure. In addition, developing local fertilizer production will help stabilize input prices, while post-harvest losses would be reduced through investment in storage and distribution logistics. These measures will improve price stability and build resilience across the production chain.

Kenya's export sector has been adversely affected by growing trade protectionism policies, which include trade tensions such as the U.S.-China tariff wars. These trends have disrupted access to critical markets and created uncertainty around investment and supply chain stability. Kenya's exposure to geopolitical and economic shocks has been heightened by overreliance on a narrow set of external trade partners, limiting export earnings and stifling industrial growth.

Kenya should strengthen regional trade ties through deeper engagement with the African Continental Free Trade Area (AfCFTA) and expansion of the South-South cooperation to counter these effects. Smoother intra-African trade can be facilitated by harmonizing customs and product standards, investing in regional transport infrastructure and removing non-tariff barriers. In addition, pursuing bilateral trade agreements with emerging economies will diversify Kenya's export destinations and enhance resilience. Expanding trade options not only reduces vulnerability but also encourages industrial upgrading and the transfer of technology.

Global financial markets are unstable due to rising interest rates and investor uncertainty, exposing the weaknesses in Kenya's fiscal structure. Sharp capital outflows, currency depreciation, and the rising cost of debt have left the government with limited room to respond effectively to economic downturns. Kenya's fiscal response has been largely reactive, resulting in unsustainable borrowing and the curtailment of public investments.

Introducing adaptive and counter-cyclical fiscal frameworks is critical to breaking this cycle. Kenya should establish a stabilization fund that saves surplus revenue during economic booms and provides fiscal support during downturns. In addition, an independent fiscal council can reinforce accountability, monitor compliance with fiscal rules, and ensure transparency in budget execution. Kenya could borrow from Ghana, which established an independent Fiscal Council in 2019 under its Fiscal Responsibility Act. Ghana's Independent Fiscal Council advises the government on fiscal policy, assesses adherence to legislated fiscal rules and publishes independent reports on fiscal performance.[7]

In 2025, Ghana further strengthened this Council through amendments to its Public Financial Management Act, which granted it legal autonomy and assigned it a formal mandate to monitor compliance with fiscal rules and recommend corrective measures in cases of breaches. These reforms also introduced sanctions and penalties enforced by the Ministry of Finance through the PFM Compliance Desk and Enforcement Committee, with the Attorney-General handling prosecutions where necessary. Though the sanctions and penalties are not exercised directly by the Fiscal Council, they support its oversight role. Establishing a similarly empowered institution in Kenya would significantly strengthen fiscal governance while institutionalising credible and independent fiscal oversight. Formal fiscal rules that link spending and borrowing to sustainable thresholds will help cushion the economy from external shocks and rebuild investor confidence.

The global food and energy crises triggered by supply disruptions and currency depreciation disproportionately affect Kenya's low-income households. As inflation surged, many vulnerable families struggled to afford basic necessities. The absence of scalable and responsive social protection mechanisms limited the government's ability to provide timely and targeted relief which amplified hardships and risked social unrest.

Kenya should build a robust shock-responsive social protection system to ensure a more equitable response to future crises. Scaling up cash transfers through mobile platforms and biometric ID verification will improve delivery efficiency. Integrating early warning and disaster risk monitoring systems will enable the government to activate support before a crisis escalates. Additionally, linking social protection programs to services such as health, education, and agriculture, among others, will reduce long-term vulnerability and promote sustainable livelihoods.

The rise in global fuel and food prices between 2022 and 2023 highlighted Kenya's limited preparedness to manage external commodity shocks. Disruptions caused by the Russia-Ukraine war and Red Sea shipping instability led to sharp increases in the cost of fuel, fertilizer, and staple foods. Without adequate strategic reserves to cushion these shocks, the government resorted to emergency subsidies to lower prices for consumers. While these subsidies provided short-term relief, they placed a heavy and unplanned burden on the national budget, diverting resources from long-term development needs. This reactive approach is not sustainable and leaves the country exposed to similar disruptions in the future.

To build resilience, Kenya should invest in establishing and maintaining strategic reserves of essential commodities. Key actions include modernizing the National Cereals and Produce Board to function as a reliable food reserve agency, expanding national fuel storage infrastructure, and supporting local production of fertilizer to reduce import dependence. Transparent management of these reserves, through regular audits, clear replenishment schedules, and strong governance, will ensure they are effective when needed. Well-managed reserves can stabilize prices during crises and give the government greater flexibility to respond without undermining fiscal stability.

Conclusion

Kenya's economic resilience is evident in its ability to navigate global challenges, but persistent shocks continue to expose structural vulnerabilities that threaten fiscal sustainability. The rising cost of external borrowing, supply chain disruptions, and protectionist trade policies have constrained Kenya's economic flexibility, amplifying macroeconomic volatility. To safeguard long-term growth, Kenya must implement strategic reforms that prioritize domestic revenue mobilization, fiscal adaptability, and economic resilience.

Expanding the tax base, particularly in high-growth sectors like the digital economy, will enhance domestic revenue mobilization and reduce reliance on costly external financing. Strengthening regional trade integration and South-South cooperation will diversify export markets, improving economic stability amid shifting global dynamics. Investments in local manufacturing, agro-processing, and climate-smart agriculture will mitigate import dependency, fostering self-sufficiency in critical sectors. Furthermore, adopting counter-cyclical fiscal frameworks, including the establishment of a stabilization fund and an independent fiscal council, will help Kenya manage economic downturns more effectively.Enhanced shock-responsive social protection systems, such as digital cash transfers and early warning mechanisms, will provide timely support to vulnerable populations, reducing socioeconomic disparities.

Additionally, securing strategic reserves for food, fuel, and key agricultural inputs will protect Kenya from global price volatility and ensure sustainable crisis response mechanisms. Kenya can build a resilient foundation for sustainable growth while navigating continued global uncertainty, reinforce its economic stability and mitigate external risks by proactively addressing these structural weaknesses and adopting adaptive policy mechanisms.

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