IMPACT OF EXTERNAL AID ON ECONOMIC GROWTH IN, KENYA 1970-2007

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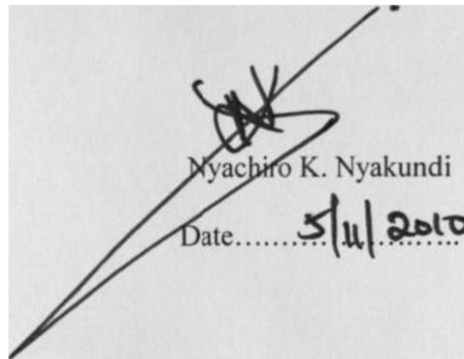
A Research Project Submitted in Partial Fulfillment of the Requirements for the Award of the Degree of Master of Arts in Diplomacy and International Relations at University of Nairobi

Declaration

This research project is my original work and has not been submitted for examination for a degree in any other university.



This research project has been submitted for examination with my approval as university supervisor.

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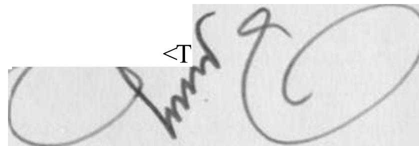

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Senior Lecturer

Date.

Dedication

Dedicated to my wife Margaret and children Kerry. Keturah and Esther for their support, encouragement, sacrifice and love.

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List of Abbreviations

AERC	Africa Economic Research Consortium
AfDB	African Development Bank
BOP	Balance of Payment
CBK	Central Bank of Kenya
DAC	Development Assistance Committee
DFID	Department for International Development
EAC	East African community
EU	European Union
EDT/GNP	Total External Debt as a Ratio of GNP
EDT/XGS	Total External debt as a Ratio of Exports of Goods and Services
ERS	Economic Recovery Strategy Paper for Wealth and Employment Creation
ESAF	Enhanced Structural Adjustment Facility
GDI	Gross Domestic Income
GNI	Gross National Income
GDP	Gross National Product
GNP	Gross National Product
GoK	Government of Kenya
IMF	International Monetary Fund
INT/GNP	Interest Payment as a Ratio of GNP
ITN/GNP	Interest Payment on Debt as a Ratio of Exports of Goods and Services
KIPPRA	Kenya Institute of Public Policy Research and Analysis
Kshs.	Kenya Shillings
LDCs	Less Developed Countries
MDGs	Millennium Development Goals
NARC	National Rainbow Coalition
NDC	National Defense College
NEPAD	New Partnership for Africa's Development
ODA	Overseas Development Assistance
OECD	Organization for Economic Cooperation and Development
SAL	Structural Adjustment Loan
SAPs	Structural Adjustment Programmes
SDR	Special Drawing Rights
SSA	Sub-Sahara Africa
TDS/XGS	Total Debt Service Payment as a Ratio of Goods and Services
ToT	Terms of Trade
UK	United Kingdom
UN	United Nations
US	United States of America
UNCTAD	United Nations Conference on Trade and Development
UNCTAD	United Nations Conference on Trade and Development
SILIC	Severely Indebted Low Income Country
HIPIC	Highly Indebted Poor Country
KenGen	Kenya Generating Company

Abstract

This study used time-series data and scatter plots to investigate the effect of external aid on economic growth in Kenya. The study shows that aid has small but significant positive effect on GDP growth through filling domestic savings and foreign exchange gaps. However, the contribution of foreign aid is weakened by the indirect diversion of aid funds to non-productive activities, shift of domestic resources to consumption purposes that would otherwise be used for productive purposes. The study also argues that external aid supports the growth rate in consumption, and makes it easier to avoid hard policy choices such as heavy taxation on income and consumption.

The study also shows a negative side of external aid of causing disruptive effects on the economy that can be overcome through policy initiatives. In this regard it is imperative that Kenya enhance savings and encourage foreign direct investment as well as portfolio investments, especially in the productive sectors in order to increase productivity and reduce reliance on external aid.

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CHAPTER ONE
EXTERNAL AID AND ECONOMIC GROWTH: THE RESEARCH DESIGN

The Contention in the Relationship between Aid and Growth

The contribution of external aid in the economic development of Third World countries is a contentious subject in both academia and practice.' One argument is that external aid is an impetus for economic growth and development. Specifically, external aid can contribute to filling the resource gaps in the national economy. This is evident as most donors provide resources to spur development in the productive sectors such as infrastructure and agriculture. An alternative argument has it that whereas external aid complements domestic resources, it tends to be detrimental to economic growth and development and results in fragile economies. Reliance on external aid tends to be a perpetual feature characterizing the economic life of developing countries. This has resulted in accumulation of external debt thereby increasing the countries" debt burden and accentuating the mismatch between their government revenue and expenditure flows. Indeed, developing countries registered a decline in both output and economic activity by the middle of 1980s despite increased aid flows." These poor results bring to question the effectiveness of external aid.

A dilemma thereby emanates out of the situation calling to question the wisdom of continued borrowing to meet short- term budgetary objectives as opposed to opting to forego these funds in order to avoid medium to long-term negative effects on growth and development. Despite the dilemma most developing countries often opt to borrow more external aid even though this has proved unsustainable and has led to debt overhang and a dependency syndrome.[3] The dilemma is also evident in the

[1] Manundu, M. (1984) The Development of Kenya's External Debt, Paper Presented at a Workshop Organized by Iriedrich Ebcrt Foundation, Nairobi
[2] Kiarie. A. (2005) Effects of Donor Funded Projects in Rural Development in Kenya. Unpunished Paper, NDC
[1] Corbridge, S. (1993). *Debt and Development,* Blackwcll Publishers, Oxford, U.K, 1993

Kenyan context where it has remained the subject of debate for many governments. However, the chapter will first examine the conceptual issues in external aid.

The post independence Kenyan Government inherited debt servicing obligations worth about US$ 5.6 million, representing a debt-servicing ratio of about 2 percent.[4] Exports grew at a remarkable rate of 13 percent per annum in the first ten years of independence, but the debt-servicing ratio began to rise slowly reaching 4 percent in 1972.[5] Several factors explain this initial increase in debt burden. First, the country's external debt increased after independence due to pension and other payments to expatriates who were leaving. Second, the external debt was increased by loans granted to the Government for the purchase of foreign-owned farms to resettle the landless. Third, the poor rains of 1965/66 and the resulting food shortages necessitated significant assistance from the USA in form of food aid. Fourth, due to a policy shift on the dawn of independence, the Kenya Government had to take over all defense expenditure for the country that was previously borne by the British Government. Other reasons include the rapid deterioration of the security situation in the North Eastern Province in the 1960s, necessitated the rapid build-up of the country's defense force, facilitated through external borrowing mostly from the United Kingdom. In addition, there was increased external borrowing to provide much-needed foreign capital to facilitate general development in the country.[6]

The debt-servicing ratio in the country was by 1970, too low to cause concern. For example, while the debt-servicing ratio for African countries as a whole was over 10 percent in 1972, in Kenya it was merely 4 percent.[7] This increased to about 13 percent in 1982 for Kenya while it was over 22 percent in all African countries taken

[4] Government of Kenya: Statistical Abstract various issues. Government Printer, Nairobi, Kenya
[5] World Bank (1987c), World Development Report 1987 (New York: Oxford University Press)
[6] Manundu. M (1984). The Development of Kenya's External Debt, Paper Presented at a Workshop Organized by Friedrich Ebert Foundation, Nairobi
' IMF (2002). International Financial Statistics CD-ROM. Washington DC, IMF.

together.[8] However, the oil crisis of 1973/74 triggered severe BOPs problems for Kenya as the balance of trade accounts began posting large deficits due to the escalating oil import bill. The Government resorted to heavy external borrowing to meet the soaring BOPs deficit. [9] Nevertheless, the Kenyan debt burden has been increasing considerably fast, with the debt-servicing ratio presently, registered as approximately 30 % of GDP, higher than it was in the 1970s and earlier 1980s.[10]

The coffee boom of 1976/77 led to an abrupt increase in the country's export earnings. As a result there was a temporary drop in the servicing ratio from 5 percent in 1971 to 2 percent in 1977." However, the coffee boom was followed by sharp deterioration in world commodity markets, Kenya's export earnings stagnated and the debt-servicing ratio began to increase. This increase in the debt servicing-ratio was temporarily stabilized in 1979 as the UK had written off the outstanding debt, and extended future economic aid in form of grants rather than loans. However, the debt servicing-ratio continued to grow due to other compelling reasons. First, amortization payments on external loans were overdue. Secondly, the country had to depend heavily on external aid to meet persistent food deficits, beginning in the 1980s.[12] Third, the country had borrowed substantially and at high interest rates to alleviate the BOPs crisis. Finally, the country increased defence loans from multilateral sources as from 1979.

The concerns enumerated in the foregoing paragraph, point to the significance of external aid to any economy under conditions of stress, but demonstrate that

[8] **opcit**
[9] World Bank (1987c), World Development Report 1987 (New York: Oxford University Press).
[19] Government of Kenya (2003) Economic Recovery Strategy for Employment and Wealth Creation. Kenya. Nairobi: Government Printer
'[1] Manundu. M. (1984) The Development of Kenya's External Debt, Paper Presented at a Workshop Organized by Friedrich Ebert Foundation, Nairobi.
[1:] These deficits were reinforced by an industrialization policy which relied heavily on imported inputs and was biased against exports. The deficits were largely covered by long-term capital inflows which mainly composed of loan capital.

external indebtedness can also be harmful to economic growth. It also shows that the debt problem in Kenya has been growing steadily over the years.

Objectives of the Study

This study aims to assess the relationship between external aid and economic growth in Kenya under a shifting policy environment. Specifically, the study seeks to answer one main question: Does the external aid contribute to economic growth or does it negate growth? Secondly, does growth change at all in the face of changes in policy orientation with regard to external aid?

Conceptual Framework

The literature on the subject of aid and growth isolates four issues that have significant relevance to the present study, namely; external stock, debt service, balance of payment and economic growth. The definition of the four concepts is presented below.

External Stock

External debt stock is the total amount of bank debt owed by debtor nations to foreign lenders and creditor banks. The IMF has defined external stock as "the outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/or interest by the debtor at some point(s) in the future and that are owed to non-residents by residents of an economy."[13]

Debt Service Ratio

Debt service ratio is the ratio of debt service payments of a country to that country's export earnings over a given period of time. External debt is normally subject to repayment in form of interest on the loans and amortization payments on the loans. Interest payment and amortization payments constitute the cost of servicing the

[15] IMF Country' Report No. 05/11, 2005.

debt. Since external debt has to be repaid in foreign exchange, the cost of servicing is a call upon the country's foreign resources.[14] A country's international finances are healthier when this ratio is low ranging between 0 and 20% for most countries.[15]

Balance of Payment

Balance of Payments (BOPs) sheet is an accounting record of all monetary transactions between a country and the rest of the world. These transactions include payments for the country's exports and imports of goods, services, and financial capital, as well as financial transfers. The BOP summarizes international transactions for a specific period, usually a year, and is prepared in a single currency, typically the domestic currency for the country concerned. Sources of funds for a nation, such as exports or the receipts of loans and investments, are recorded as positive or surplus items. Uses of funds, such as for imports or to invest in foreign countries, are recorded as a negative or deficit item. After all components of the BOP sheet have been entered, they must balance - that is, the BOPs sheet must sum to zero - there can be no overall surplus or deficit. For example, if a country is importing more than it exports, its trade balance will be in deficit, but the shortfall will have to be counter-balanced in other ways - such as by funds earned from its foreign investments, by running down reserves or by receiving loans from other countries.[16] This can result in surplus countries accumulating hoards of wealth, while deficit nations become increasingly indebted.

Economic Growth

Economic Growth is a positive change in the level of production of goods and services by a country over a certain period of time. The most persuasive model for

[14] Adams. M (1989), Aid coordination in Africa: A Review, *Developing Policy Review,* 7, 185-192.
[15] Heller, S.P. (1975). "A model of public fiscal behavior in developing countries: Aid, investment and taxation" *American Economic Review, vol.65, no.3.*
[16] Killick, T. (1991). "The Developmental Effectiveness of Aid to Africa" .World Bank WPS 646.

understanding economic growth is the Harrod-Domar model. The model explains the rate of economic growth based on the level of saving and productivity of capital.[17] Growth depends on the quantity of labour and capital that is, more investment leads to capital accumulation that in turn generates economic growth.[18] The model applies to less economically developed countries as well. In these countries, labour is in excess supply but physical capital is limited which slows economic progress due to insufficient average incomes to enable high rates of saving. Accumulation of the capital stock through investment is therefore low.[14]

The Harrod-Domar model of growth with the use of economic theory, discusses possible government policies to promote economic development. The model suggests that high levels of savings support growth as savings provide funds, which can be borrowed for investment purposes. The rate of economic growth therefore depends on the level of saving and the productivity of investments. Aid provides a one-for-one increment to the capital stock which, by operating thorough the Harrod-Dommar mechanism, leads directly to a higher growth rate.

Determinants of Economic Growth

Investment, external aid and foreign trade are the three commonly suggested determinants of economic growth. Other determinants include human capital, technological advancement, government expenditure, taxes, population growth, inflation, rule of law, governance and democracy, education, and size of government, among others.

" Harrod. R.F. (1939). "An Essay in Economic Theory", *Economic Journal,* Vol 49, No.l.
" Domar. D. (1946), "Capital Expansion, Rate of Growth and Employment" *Economelrica,* Vol, 14
[19] Boone. P. (1994). "The Impact of Foreign Aid on Savings and Growth " Mimeo, London School of Economic, London, 1994

According to Levine *el al* (1992), investment is an important determinant of economic growth both in the short and long term.[20] While, high investment ratios may not necessarily lead to rapid economic growth, its effectiveness is contingent upon a number of factors, namely; the quality of investment, productivity, existence of appropriate investment policies and political stability. Private investment, according to the neo-liberal logic is the engine that drives a country's growth, while public investment provides the necessary infrastructure.[21] Public investment may crowd in or out private investment. Public investment in human capital such as health, education, law and order, research and development, and social and economic infrastructure leads to the creation of positive externalities that in turn improve the productivity of private investment. Thus, a positive relationship can be discerned between public investment and economic growth, a relationship that if well executed leads to increased government revenues, and less need for external aid as there are adequate resources to fund the national budget.

The second determinant of economic growth is external aid. External assistance relaxes the investment constraints[22] and creates positive impact on economic growth through the following mechanisms: (i) increases investment (ii) increases the capacity to import capital goods or technology (iii) does not have an adverse impact on investment and savings (iv) increases the capital productivity and promotes endogenous technical change. In addition, aid received in the form of foreign exchange and therefore permits a higher level of capital imports. As Papanek

Levine. R *el al.* (1992), 'A sensitivity Analysis of Cross-country regressions'. *American Economic Review,* 82 (4): 942-963.

[2'] Government of Kenya (2002). Budget Speech, 2002/2003, Nairobi, Government Printer.

[22] Bacha, E.L. (1990), 'A Three-gap Model of Foreign Transfers and the GDP Growth rate in Developing Countries', *Journal of Development Economics,* No. 32: 279 - 296.

(1973) explains, "aid, unlike domestic savings, can fill the foreign exchange gap as well as the savings gap."[23]

Foreign trade can influence private investment and economic growth. According to the neo-classical school of thought, open trade has many advantages such as efficiency gains that come with specialization and competition from international trade; embodied technological transfer through imported inputs; economies of scale arising from expanded markets; and diffusion of ideas through global interaction. However, under-developed countries such as Kenya's domestic industries get exposed to competition from subsidized imports, and their exports are often exposed to unreliable world markets.

Among other factors that influence investment and in turn economic growth are human capital, technological advancement, government consumption expenditure, taxes, population growth, inflation, rule of law, governance and democracy, education, and size of government expenditure. However, in any study, the time series approach cannot incorporate all these factors as some are not measured annually, while others change very slowly over time and would thus be incapable of explaining annual growth which can vary significantly.

Hypothesis of the Study

External aid constrains economic growth.

Literature Review

A substantial amount of literature can be found on different aspects of economic growth. Studies have attempted to justify external aid for developing countries while others suggest that reliance on foreign aid is harmful to the recipient

Papanek. G. (1973). "Aid, Foreign Private Investment. Savings and Growth in Less Developed Countries." Journal of Political Economy 81. pp. 120-130

economies. [:J] These studies also reveal that it is not only the opponents but also the proponents of aid who have been troubled by the widely acknowledged theoretical possibility of aid being convertible. External aid is usually associated with official development assistance, which in turn is a subset of the official development finance, and normally targeted to the poorest countries (World Bank, 1998).

How does external aid affect the economic growth of developing countries? This is a question which has drawn the attention of many scholars over time. Papanek (1972) finds a positive relation between aid and growth. Fayissa *et al* (1999) show that aid positively affects economic growth in developing countries. Singh (1985) also finds evidence that foreign aid has positive and strong effects on growth when state intervention is not included. Snyder (1993) shows a positive relation between aid and growth when taking country size into account. Burnside *et al* (1997) claim that aid works well in the good-policy environment, which has important policy implications for donors community, multilateral aid agencies and policymakers in recipient countries.

Sachs (2005) argue that foreign aid is necessary to fill the deficit between domestic savings and foreign exchange earnings on the one hand and resource demand to finance investment for economic growth and development, especially the attainment of Millennium Development Goals (MDGs).[2^] For example, NEPAD estimates that for Africa to achieve MDGs a sustained 7% annual growth rate is needed to achieve the resource gap of 12% of GDP or US$64 billion is required by 2015.[26] The World Bank and IMF (2005) estimated that additional ODA that Africa could use effectively in both infrastructure and human development ranges from US

"Muhammad Ishfaq, (2004) "Aid Effectiveness. Debt Capacity and Debt Management in the Economy of Pakistan". Quaid-i-Azam University, Pakistan

[25] Sachs, ***J. el*** a/(2004) Investing in Development-A Practical Plan to Achieve the MDGs. UNDP New York.

[26] Sanjcev Gupta el al (2006), Macroeconomic Challenges of Scaling Up Aid in Africa: A checklist for practitioners. IMF Washington DC page I.

$!4billion to US $l8billion per annum over the period 2006-2008, and US $24 billion to US $28billion by 2015 in order to achieve a sustained economic growth.

The Monterrey Consensus urged developed countries to make concrete efforts towards the target of 0.7% of GNP as ODA to developing countries.[27] Major advances have occurred in the development of growth theory, but the conceptual understanding of the link between aid and growth is still rooted in the two gap model, first developed by Chenery *el al.*[2S] The analytical framework is based on a Harrod-Domar growth model where savings are needed to fund investment required to attain a target growth rate, conditional on the productivity of capital.

Recent research by the World Bank on aid effectiveness and the implication for the allocations of the donor aid has prompted vigorous debate. This debate has featured mainly the impact of aid on growth, conditionally, selectivity and the implications for poor performers. Two opposing viewpoints have emerged. According to one debate, aid works only when government policy is good and more selective allocation of aid to "good-policy" countries will lead to larger rate of growth. The other debate suggests that aid effectiveness is not conditional on policy and the implication of decisions for more selective aid allocations are treated with concern.[29]

Empirical evidence suggests a bi-directional causality between external debt and growth. Higher external debt lowers growth but at the same time low growth increases indebtedness.[30] Higher debt operates through a strong negative effect on physical capital accumulation and on total factor productivity.[31] Lower growth

Final Outcome of the International Conference on Financing for Development, adopted by acclamation at the Summit Segment of the International Conference on Financing for Development on March 22, 2002 in Monterrey Mexico

Chenery, H B et al (1966) "Foreign Assistance and Economic Development," America Economic Review, LVI, 4.

" World Bank (1988b); *Adjustment Lending: An Evaluation of Ten Years of Experience* (Washington. DC: World Bank)

[50] ibid

" Ibid

reduces revenues and primary surpluses and without adjustment, a debt ratio explodes. Reducing debt levels would therefore, contribute to growth by boosting both capital accumulation and productivity growth. Lowering debt alone, however, may not be sufficient to jump-start growth in the absence of structural reforms that address the key bottlenecks to growth.

Persistent fiscal gaps in the economy have specific adverse effects on growth. Bacha (1990) has argued that fiscal deficits suppress private sector investment to a level below what the available national savings would permit.[32] The study, thus identified three constraints; limited investment due to low domestic savings, limited ability to import investment goods if export earnings are low, and the unfavorable fiscal policies on investment. By relaxing these constraints, external aid can affect growth through increased investment.

Developing countries have consistently depended on external aid. World Bank studies indicate that enormous resources have been spent in developing countries. Studies undertaken in Botswana and the Republic of Korea in 1960s, Indonesia in 1970s, Bolivia, Ghana, Uganda and Vietnam in the 1980s indicated that external aid has had spectacular success/' These countries have emerged from crisis to rapid growth and development. The external aid has in particular been felt much in agricultural innovation, investment and policies that created the Green Revolution, thereby improving the lives of millions of poor people around the globe. This has had a positive impact on rural development in those countries because these programmes have improved incomes, reduced diseases and improved access to schools, clean water, sanitation, electric power, health clinics, irrigations and roads.

[32] Bacha, E.L. (1990) "A Three - Gap Model of Foreign Transfers and the GDP Growth Rale in Developing Countries" Journal of Development Economics. 32, pp 279-296

[33] World Bank. World Debt Tables 1989-90 VOI.I Washington, DC.

However, evidence emerging mostly in the second half of 1990s shows that high external indebtedness in many developing countries hampers economic growth and development. Pattillo *et al* (2004) argues that low levels of public debt tend to enhance economic growth. This study further argues that beyond a certain threshold additional debt impacts negatively on growth. This argument suggests that a country cannot borrow without limit.[34] Gomanee *et al* (2005) argue that aid has a beneficial impact on growth in Sub-Saharan African countries through financing public investment, although the impact on growth is small because productivity is low.[35] Other literature on external aid such as Nikbabakht *et al* (1984) claims that foreign aid has no effect or has largely harmful effects on recipient countries.'[6]

Chenery *et al* (1966) have argued that external finance contributes to growth by filling the domestic savings and foreign exchange gaps. Developing countries, particularly in Africa, have continued to accumulate external debt without realizing that they were falling behind schedule in repayment arrangements, a condition that have resulted in high external debt arrears, which make it increasingly difficult for these countries to direct adequate resources to the productive and social sectors. If external aid is to be used to ease these constraints, it should be positively correlated with investment and growth.

Elbadawi (1999) argues that in Sub-Saharan Africa foreign aid causes exchange rate appreciation thereby dampening growth of exports and thus economic growth. Overdependence on external aid can impose disruption to the domestic

"Pattillo C, *et al* (2004). *What are the Channels through which External Debt Affects Growth*? IMF Working Paper.

"Gomanee, K., S. *et al* (2005), 'Aid and Growth in sub-Saharan Africa: Accounting for Transmission Mechanisms', *Journal of International Development,* 17(8), 1055- 1076.

Nikbabakht, E. (1984). *Foreign Loans and Economic Performance. The experience of the Less Developed Countries,* Praeger Publishers

[17] Chenery, H B. *et al* (1966). "Foreign Assistance and Economic Development," America Economic Review, LVI, 4 pp 679-733

economy, particularly if the flow of aid is not smooth. * Aid can cause the price of non-tradable goods to rise relative to that of tradable goods bringing about a change in real exchange rate which causes a decline in competitiveness through appreciation of the real exchange rate and a parallel decrease in exports. Domestic borrowing tends to increase during reduced flow, and real exchange rate appreciates during heavy flow. If the economy is able to deal with the increase in external aid in a manner that stirs economic growth, then its impact will be positive. However, considering the imperfect nature of capital markets in most developing economies, reversal in relative prices associated with the reduction in aid flows hampers the optimal shift of resources back to the traded goods sector. This would imply a total reduction in economic growth similar to a recession after a boom.

Other studies however show that aid can have a positive impact in the economy. According to the World Bank's 1998 report. *Assessing Aid,* countries with good monetary, fiscal and trade policies registered high positive effects as a result of aid. A good policy environment is determined by certain aspects of the donor or recipient country such as whether recipient countries spend donor funds on intended purposes.'[9] Levy (1987) while using time series data in individual countries found no significant diversion as countries spend external aid funds on the designated purposes. This differs with findings by Njeru (2003).[40] Further findings indicate that donors' decision to give external aid to different countries is based on a variety of reasons.[4']

Feyzioglu *ei al* (1998) while using cross country data from 14 developing countries found that external aid is not fungible at aggregate levels in smaller samples,

" Elbadawi, 1 A. (1999). "External Aid: Help or Hindrance to Export Orientation in Africa." *Journal of African Economies* 8(4):578-616

[39] Levy, V. (1987). "Anticipated Development Assistance, Temporary Relief Aid, and Consumption Behaviour of Low-Income Countries" *Economic Journal, vol.97, no.* 6

[4"] Njeru. J. 2003. The Impact of Foreign Aid on Public Expenditure. A Case Study of Kenya, Nairobi, AERC Research Paper 135.

[41] Such as economic, social, cultural, commercial and political which influence the impact of external aid.

but that increasing the number of countries makes aid fungible.[42] Aid money increased government expenditures on a roughly one to one basis for the smaller samples. Increasing the sample to 37 countries changed the results; a dollar's worth of aid led to significantly less than a dollar's worth of government expenditure. On the other hand, Pack and Pack (1990) concur with Feyzioglu *et al* (1998) in the case of Indonesia and Sri Lanka that strong disruptions do occur on concessional loans but results differ with data from the Dominican Republic.[4']

Devarajan *et al* (1998) have argued that most aid over 90 percent boosted government expenditure with no significant evidence of tax relief.[44] About half of the total aid was used to service external debt; one quarter financed investments; while the other quarter was used to offset current account deficits. On the other hand, Swaroop *et al* (2000), while focusing on the effects of external aid on expenditure decisions of the Central Government of India, found that external aid merely substitutes for already earmarked government spending; with the central government devoting funds freed by aid on non-development activities. This suggests that government expenditure choices are largely unaffected by external sources of finance. Therefore, aid merely softens the government's budget constraints.[45]

In an analysis of Kenya's fiscal response to temporary trade shocks, Bevan *et al* (1993) argued that the coffee boom of 1977/78 induced massive increases in public expenditure in excess of the increase in public revenue associated with the boom.[46] The government spent much of the boom revenue on consumption rather than

[42] Feyzioglu, ct al (1998). "A Panel Data Analysis of the Fungibility of Foreign Aid" .*World Bank Economic Review.*
[43] Pack, H *el al* (1990). "Is foreign aid fungible? The case of Indonesia." *Economic Journal, vol. 100* no.3:188 - 94.
[44] Devarajan S.A *el al* (1998). "What does aid to Africa finance?"AERC/ODC Project on Managing a Smooth Transition from Aid Dependence in Africa, Washington, D.C.
[45] Swaroop, V. J *el al* (2000). "Fiscal effects of foreign aid in federal system of governance: The case of India" *Journal of Public Economics, vol.* 77. no.2000:307 - 30.
[46] Bevan, D P *el al* (1993). "Anatomy of temporary trade shocks: The Kenya coffee boom of 1976 - 9" *Journal of African Economies, vol.1, no.2:27/* - 305.

investment, which adversely affect investment. The relative irreversibility of the rise in public spending made it difficult for the Treasury to cut expenditure as some ministries refused to reduce their spending and instead requested supplementary reallocations of resources.[47] This result corroborates that of Heller (1975) suggesting that governments treat drastic changes in external aid flow as temporary shocks.[48]

There are indications that the Third world debt crisis is worsening.[4"] Bird (1989) has argued that the expectation that the problem would be cured by economic expansion in the industrial world or by adjustment within developing countries had not been realized. In an effort to address debt crisis, the study recommends that these economies must first forecast debt, assess risk default, define clear roles of the public and private sectors in an economy, develop a strong and sound financial sector, and analyze the effects of political instability before seeking external aid. The study further poses three questions, namely; why debt problems arise, how have they been handled in the past, and how they are likely to be handled in the future? The study further elaborates that while it is tautological to say that the acquisition of debt is a pre-condition for the emergence of the debt problem, it is important to note that debt acquisition need not lead to problems. Indeed, in many respects, borrowing is an entirely rational and welfare enhancing activity representing an inter-temporal redistribution of living standards. Provided that the rate of discount exceeds the rate of interest, welfare will be raised by borrowing now and paying later.

Investigations on the effect of external debt on economic performance in Sub-Saharan Africa using a simulation approach for the period 1970-1994 by Iyoha, (1996) revealed that external debt has significant implications on economic

^ ibid
'* Heller. S.P 1975 "A model of public fiscal behavior in developing countries: Aid. investment and taxation" .*American Economic Review, vol.65, no.3.*
" Bird, G,, (ed) (1989), *Third World Debt. The Search for a Solution.* Edward Elgar Publishing Ltd, England, 1989

performance.[50] The significance of debt overhang variables affected investment, suggesting that mounting external debt depresses investment through both a "disincentive" effect and a "crowding out" effect. Other studies using the non-linear effects of debt on economic growth have empirically demonstrated that the probability of debt rescheduling which depends on external indebtedness significantly lowers growth. For example Cohen (1997) revealed that debt becomes excessive when it reaches levels of the order of 50 percent of GDP or 200 percent of exports.^

Were (2001) has attributed causes of debt in Kenya to both internal and external factors which revealed a negative relationship between external debt accumulation growth and investment in Kenya.[52] These findings recommend that prudent management of the economy as a whole since it determines the volume and servicing capacity of external debt and further supports the argument for Kenya to be considered for comprehensive debt relief measures. The argument additionally demonstrates the increasing role that the government could play in stimulating the economy if the resources obtained from the debt relief initiative were channeled to productive public investments with the resultant crowding in effects on private investment, and social spending for the poor.

Corden (1989) has demonstrated that the channels for debt overhang effects on growth may not only come through low volumes of investment, but also through lowering productivity. [3] The debt overhang theory is advanced since any activity that requires incurring costs today for the sake of increased output in the future will be discouraged, as part of the proceeds will be taxed away by creditors. The government may have less incentive to undertake difficult policy reforms with initial high political

lyoha, M.A (1999). External Debt and Economic Growth in Sub-Saharan African Countries: An Econometric Study. Nairobi, AERC Research paper no. 90.

[M]Cohcn, D. (1997), *"Growth and External Debt: A New Perspective on the African and Latin American Tragedies,"* Centre for Economic Policy Research Discussion paper, No. 1753

Were M. (2001) The Impact of external Debt on Economic Growth in Kenya. United Nations University

" Corden, W.H. (1989). "Debt Relief and Adjustments Initiatives". In J.A. Frenkel, M P.

and economic costs, as the poorer policy environment could contribute to lower productivity growth.

Similarly, other literature such as Serven. (1997) has stressed on the uncertainties created by high debt stocks, implying that debt constrains growth through either the capital accumulation or productivity channel. Particularly, in low income countries with debt servicing difficulties, there are uncertainties over what proportion of the debt will actually be serviced using the countries' own resources. The highly uncertain environment may also lead to misallocation and poor quality investment projects that subsequently slow productivity growth.[54]

Further research casts doubt on the relationship between aid, investment, and growth. Easterly's (2001), while evaluating what donors have actually achieved by granting aid to poor countries for more than 40 years established that there is no tangible benefit linked to external aid.[55] In another study, Easterly (1999) analyzed the link between aid, investments and growth in 88 countries between 1965- 95 and found that only six countries registered a significant and positive effect of foreign aid on investment.[56] Two of these countries, Hong Kong and China, had small amounts of aid, but the remaining four were countries with relatively substantial inflows of external aid. These were Tunisia, Morocco, Malta and Sri Lanka. Easterly then analyzed the short-run relationship between investment and growth in 138 countries, and found only four countries that passed the test of a significant and positive relationship. The four countries were Israel, Liberia, La Reunion and Tunisia.

[M] Servin, L. (1997), *"uncertainty. Instability, and Irreversible Investment: Theory, Evidence, and Lessons for Africa*, "World Bank Policy Research Working Paper.
Easterly, W (2001). The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics. Cambridge, MA: MIT Press Pp 330
[54]. . . . .(1999). "The Ghost of the Financing Gap: Testing the Growth Model Used in the International Financial Institutions." *Journal of Development Economics* vol. 60, pp 423- 438.

Similar conclusions were reached by Boone (1996) when using data from 97 recipient countries over a 20 year period (1975-1995).[5'] The results indicated no significant correlation between aid and poverty reduction and no evidence that aid improves mortality rates, primary school enrolment or life expectancy in recipient countries. Like Easterly (1999), Boone tested the link between aid and growth and found no evidence of relation between the volume of aid and growth.[58] The overall explanation for Boone's conclusions is that external aid intended for investment may very well have been used for investment but, if it was, the recipient governments simultaneously lowered their own investment and transferred resources to additional consumption. Boone also found a strong correlation between the volume of aid and public consumption.

Generally, most studies tend to confirm that a heavy debt burden acts to reduce investments through debt overhang and the "crowding out" effect. Nonetheless, this empirical evidence mainly focuses on evaluating the impact of external aid on investments rather than on economic growth *per se.* These studies are also mainly based on data across countries and disregard each country's uniqueness and diversity. This study therefore concentrates on the impact of external aid on economic growth in the Kenyan and performs sub-sector analysis which forms the point of departure from similar studies.

Methodology

This study involved the use of both quantitative and qualitative analysis. The quantitative analysis involved in this study was the analysis which was represented using charts such as scatter plots. Further analysis was conducted using a bivariate

[57] Boone. P (1996). 'Politics and the Effectiveness of Aid.' *European Economic Review* vol. 40, pp. 289- 329. Boone also tested the results for reverse causality, i.e. aid is channeled to countries in crisis and with poor growth, but that did not change the results.
". . . . .(1994) *The Impact of Foreign Aid on savings and Growth.* Mimco. London School of Economics.

analysis whereby external aid and growth in GDP was plotted on a scatter plot to assess the impact of aid. A sectoral analysis was conducted to find out the impact of external aid on different sectors to establish how important these variables are in driving GDP growth in Kenya.

Qualitative analysis was also conducted based on target interviews with individuals with technical knowledge on the Kenyan experience in external aid and economic performance. Purposive sampling technique was used to select respondents and organizations with required information. These respondents and organizations included World Bank, IMF, EU Country offices; Ministries of Finance, Planning, Agriculture, Forestry, Transport, and Energy; current and former Permanent Secretaries and Ministers of Finance among others. Interviews comprised seven questionnaires that were designed in consultation with the supervisor. The questionnaires were emailed to the selected interviewees in advance, after which the researcher visited the interviewees for personal discussions.

The study used time series data for the period 1970 to 2007. Much of the data required for this study is contained in policy and technical documents held in different organizations. The documents include Government of Kenya annual printed estimates, the economic surveys, statistical abstracts, the annual budget reports; treasury circulars and previous study reports and Central Bank of Kenya publications. The World Debt Tables and reports, OECD/DAC annual reports, and International Financial Statistics Year Books were also valuable sources of data. Data was also utilized to analyze the impact of aid on various sectors.

Chapter Outline

The first chapter of this study deals with issues such as the contention, objectives of the study, conceptual framework, determinants of economic growth,

hypothesis of the study, literature review, and methodology. The chapter lays the foundation, states the problem that is to be investigated and outlines the specific objectives. The conceptual framework and associated hypothesis lays particular emphasis on concepts like external stock, debt service ratio, balance of payment and economic growth relationship between and among variables. It also describes data and methodology.

The second chapter looks at policy trends regarding aid and growth, role of external aid in Kenya, debt policy framework in Kenya, legal framework, aid flow to Kenya; structure, type and composition of external debt; size and magnitude of external debt in Kenya; external aid freeze, general economic growth, and finally the neo-liberal reforms. The chapter analyses policy, external shocks on economic growth trends and their effects on aid flow in size, magnitude. It also looks at aid freezes and their effects. The chapter reviews the Kenyan experience in external aid flows and the policy that helps to explain the compelling desire for aid.

The third chapter presents analysis ofexternal aid and economic growth and its effects of various sectoral performance, debt overhang and qualitative analysis. The detailed analysis provides the empirical evidence on the impact of external aid on economic growth and related sector.

The conclusion is presented in chapter four and relationship between aid and growth in the Kenyan experience.

Chapter Two

Effects of External Aid on Economic Growth in Kenya

Introduction

This chapter aims to review the Kenyan experience in external aid flows and the policy that helps to explain the compelling desire for aid. The chapter will attempt to answer two specific questions: First, to what extent has the government relied on external aid in pursuit of its objective to realize economic growth? Second, does government policy assign any significance to aid type and amounts? The section is organized in three sections. The first section examines policy trends, the second section aid flow and third section growth.

Policy Trends Regarding Aid and Growth

At independence, the government committed to addressing illiteracy, disease, and poverty.[59] All development efforts were therefore geared towards ensuring elimination of these three vices. These efforts were carried out through five year development plans, which were implemented through annual budget processes. Involvement of both the government and the private sector were meant to create ownership and aid in allocation and distribution of resources.

Kenya's economy grew by about 6 % during the first decade of independence.[wi] The nature and general magnitude of this development can be seen in the changing average real GDP growth rates between 1964 -1986.[61] Agriculture was boosted by the ability of African farmers to acquire fertile agricultural land at low cost from departing European settlers while industry made hesitant steps from import-

[59] The ideals of the First Republic arc well articulated in Sessional Paper No 10 of 1965 on African Socialism and its Application in Kenya.

Government of Kenya Economic Survey various issues. Government Printer, Nairobi, Kenya

" See World Bank(l989) tablel.l, p.3 1950-59(6.1%); 1960-69(5.9%); 1970-75(10%); 1975-80(5.9%; 1980-86 (34%)

substitution towards export-orientation through its discovery of new markets in the neighboring countries.

It is noteworthy that as an open economy, Kenya has always been vulnerable to external shocks. Nevertheless, the Kenyan economy was experiencing a gradual decline in its potential throughout the late 1970s. The decline was mostly serious in agriculture as it grew at 0.3 %, in spite of the stimulus occasioned by the tea and coffee boom. The cause of this decline was however, not a shortage of overall investment; rather, it was a decline in the productivity of investment. In the industrial sector, the incremental capital-output ratio deteriorated by more than 50% between the early 1970s and early 1980s.[6:] One aspect of this which caused concern for development agencies, pre-eminently the World Bank, was that the rate of return on their own projects was falling as well. Within the Bank's portfolio, the average *ex post* realized rate of return on projects fell from 16.8% between 1976-79 to 11.2% between 1980 and 1983.[63]

The oil crisis of 1974-75 slowed down the growth rate and gave rise to the first inflationary experience in Kenya's history.[64] This negative shock was quickly filled by the stimulus of the coffee and tea boom of 1976-77, to which the government responded in the pro-cyclical fashion, allowing the benefits to come through to the private sector.[65] Kenya appeared at this time to be graduating rapidly from low-income to middle-income status. The government, however, continued to borrow heavily on the international capital markets, partly through 'hard' World Bank loans.

[62] World Bank (1988a) , *Report of the President to the Executive Directors on a Proposed Industrial sector Adjustment Credit* (Washington, DC: World Bank) p.2

ibid

[M] For the details of this episode, see Killick (1984a), pp. 182-9

[65] This is criticized by Killick(1984a) and defended but Collier et al. (1988) on the grounds that the rural stallholders who were the main beneficiaries of the boom had such a high propensity to save as to stabilize the boom automatically

Kenya economy was hit by a sharp fall in the price of coffee and by a doubling in the price of imported oil by late 1979.[66] Its first response to the consequent BOPs problem was to seek assistance from the IMF, as it had previously done on two occasions since 1975. Terms for a new stand-by agreement (conditional on the observance of ceilings for domestic credit creation, government borrowing and an 'understanding' with the Fund on exchange policy) were concluded in August 1979, but disbursements were delayed for a year. The delay left the Kenya government in urgent need of quickly available, low-interest programme Finance: precisely the functions which the World Bank's Structural Adjustment Lending Programme (SAPs) was intended to fulfill.

However, the period 1979-2002 was characterized by a key development paradigm policy shift to increasingly open the economy to international competition and reduce the government's involvement in economic functions, which could otherwise be efficiently performed by the private sector.[67] The key reforms were carried out through the SAPs. This notwithstanding, the development goals remained much the same as underlined in the development agenda that is elimination of illiteracy, disease and poverty.[68]

In 2003 the new government promised to re-engineer the economy by taking firm and focused actions that could guarantee wealth and employment creation thereby reducing poverty. This called for actions that were to bring about comprehensive political and economic changes. The changes in policy were documented in the NARC manifesto and the Economic Recovery Strategy (ERS)

[44] By 1980, net imports of fuels were absorbing 20 % of the country's net export earnings by comparison with less than 1% in 1973.
[47] The ideals of the opening up the economy are well articulated in the Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth,
".bid

Paper.[6g] The government put forward a comprehensive blueprint, the ERS, which was intended to guide the economy up to 2007. The growth plan put emphasis on rapid economic growth, strengthening of the institution of governance, rehabilitating and strengthening the physical infrastructure and investment in human capital.[70]

Role of External Aid in Kenya

Official Development Assistance (ODA) is a common means of defining and measuring external aid. The Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD) uses ODA consisting of grants and loans that a government or a multilateral organization gives to a developing country to promote economic development and welfare. The assistance is usually granted on concessional terms, whereby in the case of a loan, at least 25 percent is in form of grants.[71] Loans can either be advanced in "soft" or "hard" form. "Soft" loans are normally at a lower interest rate or no interest and have long repayment periods. "Hard" loans are repaid over a short period of time and at high interest rates. Soft loans are normally provided by governments and multilateral agencies such as the World Bank while hard loans are from Commercial International Finance Institutions.

Conventional knowledge indicates that the main objective of external aid is to promote economic growth in poor countries in order to improve the welfare of the people. The idea dates back to John Maynard Keynes who in the 1930s argued that governments could stimulate development by financing investments.[72] Keynes' idea for the domestic economy was taken up by a new school of development theorists who

[69] The ideals well articulated in NARC manifesto and Economic Recovery Strategy Paper 2003
[10] Op.cit
[71] O' Bnen. F.S *elal.* (1999). "Aid and reform in Africa: Kenya case study". *World Bank project on Aid and Reform in Africa.* Washington. D.C.pp 6.
[n] Chenery, H B. *et al* (1966). "Foreign Assistance and Economic Development," America Economic Review, LVI, 4 pp 679-733.

argued that investment in Less Developed Countries (LDCs) could be stimulated through injection of funds from overseas.

Since attainment of independence in Kenya in 1963, the economy has depended on approximately 70 percent of external aid in form of loans and grants to supplement domestic resources in its quest to achieve higher economic growth and improve social welfare. The world economic situation in the 1960s constituting lower interest rates, better prices for primary commodities, low prices for manufactured goods, readily available inputs and investment capital and goodwill of donors provided a favorable environment for Kenya to pursue its post-independence development goals and helped realize high growth rates of over 6 percent the 1960s and 1970s.[73]

Today, external resources constitute an integral part of development expenditure in most countries in Sub-Saharan Africa (SSA) especially Kenya. This source of finance supplements low savings, low export earnings, and thin tax bases. These countries sometimes face significant budget constraints and capacity to use foreign resource inflows to cover any deficits is low.[71] Nevertheless, with fiscal problems and the change in political focus by the donor community, external aid flow has drastically reduced in the past as donors make aid conditional on fiscal discipline and good governance policies.[?>] This has had adverse ramifications for the budget process of highly aid-dependent countries. Governments that do not conform to aid conditionalities suffer penalties, especially aid freeze from donors.

[7J] Government of Kenya (1965). Sessional Paper no 10 of 1965 on "African Socialism and its Application to Planning in Kenya. Nairobi: Government Printer
[u] Levy, V. (1987). "Anticipated development assistance, temporary relief aid. and consumption behaviour of low-income countries" *Economic Journal, vol.97, no.* 6:446 - 58.
[75] Feyzioglu, et al (1998). "A panel data analysis of the fungibility of foreign aid". *World Bank Economic Review, vol.65:429* -445.

Dependence on external debt is not necessarily harmful to economic growth nor does heavy external debt inevitably lead to slow economic growth.[76] For example, during a recession, borrowing can be an important mechanism for avoiding high taxes that would otherwise send the economy into a deeper recession. Similarly, during a national emergency such as a natural disaster or a terrorist attack, debt can be a helpful instrument for shoring up revenue without having to disrupt the rest of the economy through massive tax increases or deep spending cuts to other important programmes. The problem is the ill-informed decision to use debt to fund non-emergency programs that have a fixed place in the budget. In the long-term, borrowing for the year-to-year operations of these types of programmes will accumulate and become unsustainable.[77] This will be detrimental for many LDCs whose inability to meet current debt obligations due to insufficient domestic resources. Inadequate information on the kind, structure and magnitude of the debt compounds the problem. The issue of external aid and its servicing assumed critical importance since Mexico declared in 1982 that it could not service its debt obligations.

Therefore, there are fundamental reasons for making Kenya a focal point for discussion. In the first place, Kenya has had unbroken record of large-scale and varied economic assistance from abroad. Secondly, Kenya provides a good illustration of economic growth in the face of serious economic, social and political obstacles, and with acute problems still remaining unresolved. Kenya also has a long tradition of overall planning, based on a mix of private and state initiatives. However, the external debt situation in Kenya imposes serious limitations on the extent to which additional external borrowing can be undertaken. In particular, it underlines the need for such expenditures to be devoted as far as possible to those projects likely to

[16] Were M. (2001).The Impact of external Debt on Economic Growth in Kenya. United Nations University.
[77] Congressional Budget Office, "Monthly Budget Review," September 7, 2007, at www cbo.gov/ ftndocs/ 86xx/doc8607/09-2007accessed on 5.12.2008

enhance the country's ability to repay the debt and develop faster. In addition, project finance should cover both capital as well as running costs to ensure project success.

External Aid and the Debt Policy Framework in Kenya

The primary objective of Government debt management policy is to cover the government financing requirements at the lowest possible long-term borrowing costs, subject to a prudent degree of risk. The other objective is to deepen the domestic market for Government securities. A significant proportion of the Government budget allocation is to service public debt, leaving inadequate financial resources for pro-poor development programmes. The need to strengthen public debt management is critical not only to lowering the cost of debt service to the Exchequer, but also to the development of Kenya's capital markets. Over the last three decades, the Government experienced major lapses in systems and controls related to management of external supplier credit loan contracts.

Kenya's external debt and Foreign Aid policy framework is built around the following policies: maintaining external debt sustainability to ensure Kenya does not become a Highly Indebted Poor Country (HIPC) or Severely Indebted Low income Country (SILIC) by ensuring only concessional borrowing is contracted to minimize servicing costs and maximize the grant element of borrowing; implementing a Foreign Aid policy that harmonizes donor practices along the lines proposed in the Rome Declaration of February 2003 and minimizing the transaction costs related to external aid; and ensuring that foreign aid is aligned to the national budget, the national development priorities and implementation based on best practice principles.[78]

" IMF Country Report No. 05/11, 2005

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 External Loans & Credits Act empowers the Minister for Finance to negotiate the terms and conditions for contracting external loans and credits for the country. The current ceiling for the stock of external debt is Ksh 500,000 million, which was set by Parliament in 2000 and is subject to review. The Act requires the Minister for Finance to report to Parliament details of any new borrowing.

The Internal Loans Act empowers the Minister for Finance to borrow on behalf of Government directly from the domestic market through issuance of Treasury bills and bonds. The Act allows the Government access to an overdraft at the CBK when there is a mismatch between revenue receipts and expenditures. However, to check inflationary pressures resulting from use of the overdraft facility, the CBK Act limits the overdraft level to 5 percent of the latest audited Government revenue.

Guaranteed borrowing by Government enterprises and local authorities is contracted under the Guarantee Loans Act. The current ceiling for guaranteed borrowing as set by Parliament in 1993 is Ksh 80,000 million. Parliamentary approval is required for issuance of a Guarantee to a public enterprise and local authority.

Debt Management Objectives

The Government borrows mainly to cover its financing requirements. In addition, the Government borrows from the IMF for balance of payments purposes. The *adhoc* strategy of the Government has been to borrow as much as possible from external lenders on concessional terms while domestic borrowing is only used to cover the

remaining resource gap. The strategy ensures that the debt portfolio is divided into two distinct sub-portfolios from a cost and risk perspective. External debt is long term in nature and is characterized by low interest rates while domestic debt is relatively short term with higher interest rates. The emerging risks on the debt portfolio are mainly related to the currency exposure for the foreign debt and the rollover risk on the domestic debt.

The *ad hoc* debt management strategies employed by the Government of Kenya are: ensuring that both the level and the rate of growth of Kenya's public debt are fundamentally sustainable over time, seek more debt relief on a bi-lateral basis to release resources to core poverty programs, encourage debt for development swaps option, contract new concessional foreign loans from multilateral and bilateral sources, foreign borrowing must have a grant element of at least 35 percent and will be used to finance core poverty programs, external borrowing must be contracted from internationally credit rated commercial banks and financial institutions, debt portfolio continually reviewed and restructured to minimize debt-servicing costs, domestic borrowing and monetary policies are closely coordinated so as to ensure that the government raises required resources from the financial market without destabilizing interest rates and consequently crowding out the private sector, efforts are made to lengthen Treasury bond maturity to promote development of the capital markets, and outstanding external debt stock is within the limit authorized Parliament.

However, it should be noted that the policy of borrowing from abroad does not mean, that Kenya can relax the efforts to promote domestic savings and raise tax surpluses. Indeed, it is only to the degree that Kenyans are successful in these efforts that they can in the near future attract more capital from abroad to raise the rate of

growth; and ultimately succeed in reducing over reliance on foreign capital and increase their share in the ownership of productive assets.

Aid **Flow to Kenya**

This sub-section of the chapter shows aid flows to Kenya based on the policy changes before the debt crisis across in 1970s, during the debt crisis in mid 70s - 80s, during and post SAPs. As indicated on table 1 below there has been a strong, steady build-up in nominal aid flows to Kenya over this period. Gross ODA inflows increased from an annual average of US$2195.5 million in the 1970s to over US$670 million in the 1980s and to slightly over US$ 1070 million in 1990-99 rising to US$ 1440 million in 2000-2007. At the peak in 1990-91, net ODA inflows were equivalent to 14 percent of GDP and to approximately 45 percent of the government budget.[79]

[79] Government of Kenya Economic Surveys various issues and World Bank Tables

Table 1 : Total Aid Flow to Kenya (in USD Million) 1970 - 2007

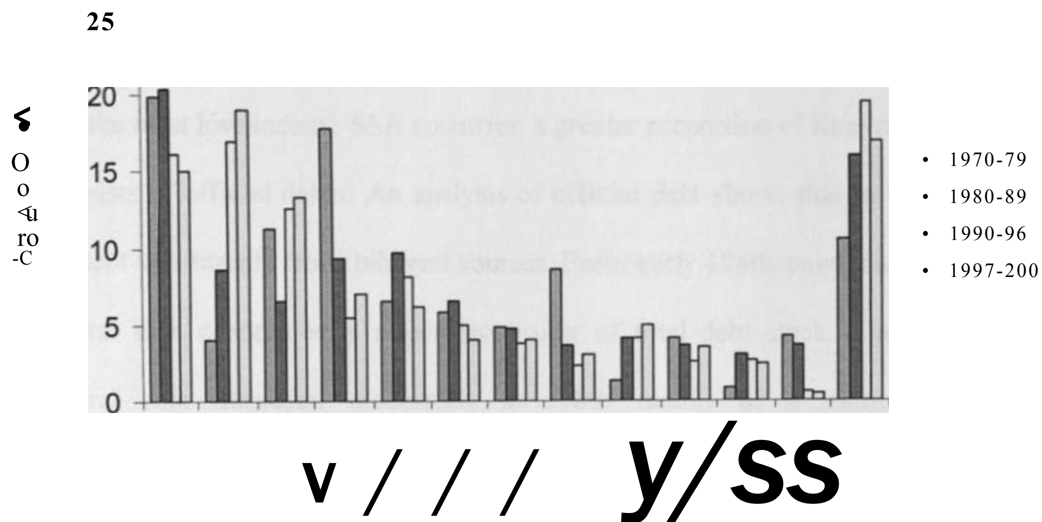
Year	Loans	Grants	Gross ODA	Debt Relief	ODA-DEBT Relief	Net ODA
1970	35.5	30.6	66.1	-	-	57.5
1971	42.2	37.8	80	-	-	67
1972	55.7	85.8	141.5	-	-	72.3
1973	87.1	54.1	141.2	-	-	95.8
1974	77.8	72.9	150.7	-	-	119.4
1975	98.2	89.4	187.6	-	-	130.6
1976	148.8	10.9	258.7	-	-	160
1977	139.9	113.7	153.6		-	165.2
1978	168.8	174.6	343.4	-	-	242.5
1979	213.1	218.9	432	-	-	350.6
1980	232.1	248.8	480.9	-	-	396.5
1981	237.1	298.7	535.8	-	-	449.3
1982	317.8	260.2	578	-	-	484.9
1983	242.6	277	519.6	-	-	397.3
1984	373.5	282.1	655.6	-	-	411.1
1985	215	311.5	525.5	-	-	438.3
1986	287.9	349.2	637.1	14	623.1	458
1987	352.5	400.1	752.6	60	692.6	572
1988	387.3	567.1	954.4	13	941.4	809
1989	538.3	553.6	1091.9	433	658.9	967
1990	429.7	1185.3	1615	84	1531	1054
1991	461.2	640.9	1102.1	66	1036.1	873
1992	327.5	659.6	987.1	30	957.1	894
1993	317.6	552.1	869.7	-	-	911
1994	227.5	503.8	731.3	-	-	677
1995	557.5	463.4	1020.9	-	-	732
1996	342.8	400.5	743.3	-	-	606
1997	475.9	695.7	1171.6	-	--	959.5
1998	491.6	722	1213.6	-	-	994.7
1999	507.2	748.3	1255.6	-	-	1030
2000	522.9	774.6	1297.6	-	-	1065.2
2001	538.6	800.9	1339.6	-	-	1100.4
2002	554.3	827.2	1381.6	-	-	1135.6
2003	570	853.5	1423.6	-	-	1170.9
2004	585.7	879.8	1465.6	-	-	1206.1
2005	601.4	906.1	1507.6	-	-	1241.3
2006	617.1	932.4	1549.6	-	-	1276.5
2007	632.8	958.7	1591.6	-	-	1311.8

Source: World Bank Debt Tables various issues

Figure 1 below provides a breakdown of aid disbursements to Kenya according to their multilateral and bilateral sources from 1970-2007. The share of multilateral aid increased moderately in the 1980s, primarily due to the large disbursements of World Bank adjustment lending, but the bilateral share rose again in the 1990s with the decline in new adjustment lending after 1991. While the overall

share of multilateral and bilateral aid sources have not changed markedly over time, there have been significant changes within the two categories.

Fig 1 : % Share of Major Lenders in ODA to Kenya from 1970-2007



Source: Computed from World Bank Debt Tables and various Economic Surveys

From figure 1 the World Bank, which accounted for 20 percent of total flows in the 1970s and 1980s, has seen its share of total disbursements reduced to 16 percent in the 1990s, due to the growing importance of certain bilateral/donor assistance with significant reduction in disbursements for BOPs support since the early 1990s, and shrinking portfolio of project loans. The other principal multilateral agencies, the AfDB and the European Union (EU), have each contributed a much smaller share to Kenya's ODA.

Over the same period, Japanese aid increased from 4 percent of gross ODA in the 1970s to 17 percent in the 1990s. Another significant trend has been the declining share of many medium-sized donors, including the Scandinavian countries, Canada and the Netherlands. Sweden's aid has actually fallen in nominal terms, from an average of 8.5% in the 1970s to 3.5% in 1992-96 with a marginal increase of 4.5% in 1997-2007. The trend is even more pronounced for Norway (with which Kenya broke

diplomatic relations during 1990-95) whose aid disbursements fell from 4.5% in the 1980s to about 1% in 1992-96. However, countries classified as 'others' have continued to increase their ODA share to Kenya especially in the period 1997-2007. This is true as in the case of countries such as China.

Structure, Type and Composition of External Debt

Like most low-income SSA countries, a greater proportion of Kenya's external debt consists of official debts. An analysis of official debt shows that in the 1970s, official debt was mainly from bilateral sources. From early 1980s onwards, however, multilateral debt constituted a major proportion of total debt stock. The share of multilateral debt increased moderately in 1980s mainly as a result of large disbursements of adjustment lending from the World Bank.*[0] Since early 1990s, the proportion of concessional debt has been rising; from 20 per cent in 1979 to 34 per cent in 1989 and to 63 per cent in 1999, respectively. The concessional loans have also increased from 67% in 2000 percent to 90 percent in 2007. This has given Kenya the advantage of contracting loans on soft terms.

Size **and Magnitude of External Debt in Kenya**

The size of Kenya's stock of external debt and debt service payments for the period 1970-2007. The total nominal debt stock rose from US$ 477.5 million in 1970 to US$ 4 million in 1995 to US$10711.8 million in 2007 while total debt service payments rose from US$ 50 million to US$ 901.4 million and US$1143 million in the same period. However, the stock of debt and debt service payments declined to US$ 6.561.5 million and US$ 716.0 million in 1995 to 1999 respectively and seems to have increased to US$11423 million in 2007 from US$ 941 million in 2000. The decline

[0] Were M. (2001).The Impact of external Debt on Economic Growth in Kenya. United Nations University

could be attributed to donor confidence in the government due to better financial management systems introduced.

Despite the magnitude of external debt characterizing the 1980s, Kenya was able to service its debt without rescheduling. This is also reflected by the fact that there was zero or negligible accumulation of arrears in 1970s and a better part of 1980s. However, by early 1990s, the debt burden became so acute that Kenya had to reschedule its debt in 1994 for the first time. With the aid freeze the government began to accumulate arrears on official debt. There was a significant accumulation of arrears in the early and late 1990s notwithstanding the debt relief the government received in 1986-1992.

Further analysis on Table 2 below shows that over the entire period 1970 to 2007, external debt accounted for the highest share of public debt. In 1970, while it stood at 17% of GDP the domestic debt on the other hand stood at 10 % of GDP. It is also evident that the structure of the public debt has been changing over time with a gradual decline in the share of external debt to GDP and a rise in the domestic debt. For example, while in 1990 the external debt stood at 52% of GDP declining to 33.2 % in 2005 and a further decline to 27.9% of GDP in 2007, the domestic debt, on the other hand, stood at 10 % of GDP in 1970 rose to 26.5 % in 2000 but declined marginally to 23.2 % in 2007. The share of public debt to GDP increased from 27 per cent in 1970 reaching a high of 77.4 per cent in 2000 before declining to 51.1 per cent.

Table 2 : Debt Stock as % of GDP

Year	**1970**	**1980**	**1990**	**2000**	**2005**	**2007**
Public External Debt	17	19	52	50.9	33.2	27.9
Public Domestic Debt	10	13	23	26.5	23.4	23.2
Total Public Debt	27	32	75	77.4	55.6	51.1

Source: Government of Kenya. Various Economic Surveys

External Aid Freeze

Kenya was among the first African countries to receive structural adjustment funding from the World Bank and later the Enhanced Structural Adjustment Facility (ESAF) loan from the IMF. However, the country has experienced stand-offs with the donor community that has sometimes led to aid freeze due to dissatisfaction in the way the government implements aid conditionalities. For example, the World Bank withheld the release of the second tranche of US$50 million in July 1982, citing laxity in policy reforms. The Bank did not resume funding until 1984 when new agreements were drawn, partly attributed to the humanitarian gesture of providing large volumes of food aid in response to the devastating drought during that year.[81]

The flow of aid continued to increase as the World Bank and IMF supported the reform programmes outlined in Sessional Paper No.l of 1986 on Economic Management for Renewed Growth. In addition, the government benefited from re-scheduling and canceling of debt, a trend that did not last long as the donor community focused its attention on corruption, good governance and democratization, found Kenya's performance unsatisfactory and resolved to withhold any commitments in fiscal year 1990/91.[82] The withholding of funds in addition to increased expenditure to finance multi-party elections in 1992 affected the Kenya government's budgetary position immensely as it led to an increased budget deficit. The government resorted to domestic borrowing, which increased debt by 59% during the 1990/91 financial year.[8j]

Although major donors withheld their funds to Kenya in 1982; 1991; 1992 and 1997, aid for ongoing projects, technical assistance and emergency relief from some

[11] Njcru, J (2003). The impact of Foreign Aid on Public Expenditure. A case Study of Kenya, Nairobi AERC Research Paper 135 ppl I

Opcit pp 15

" Ibid pp 15

donor agencies continued to flow in except the Norway Development Agency, which froze all aid. As a result, at a Consultative Group meeting between officials of the Government of Kenya and the IMF/World Bank held in 1997, the IMF suspended the ESAF programme amounting to about US$200 million. The World Bank and the African Development Bank also withheld their budget support programme loans. This negatively affected the government's fiscal performance in 1997/98.[S4]

However, Kenya undertook a new policy direction in 1986 in an effort to fulfill the independence development policies and cushion the public from effects of poor economic performance.[8^] Furthermore, domestic resources were found inadequate for implementation of development programmes and policies in an effort to achieve higher economic growth and prosperity. The possibility of external aid once again took high priority on the policy agenda to fill the resource gap.[86]

General Economic Growth Performance Since 1970s

The general information available on aid and economic growth in Kenya over the last 30 years indicates that foreign aid as a percentage of Gross National Income (GNI) grew continuously between 1970 and 1995, starting at around 5 per cent in 1970 and peaking to around 18 percent in 1995. The percentage of aid as a proportion of GDP was relatively low during the 1970s while GDP per capita growth was high. The proportion of aid grew dramatically but GDP per capita growth fell and was even negative for several years after the oil price shocks of the late 1970s" The percentage of aid dropped to 14 % in 2000 from 17 % in 1998 which led to a subsequent fall in the growth rate.

[14] Ministry of Finance. Debt Management Division.(Various Reports), Nairobi, Kenya
"Government of Kenya, (1986). *The Sessional Paper No. 1 of 1986 "Economic Management for Renewed Growth,* Government Printer, Nairobi.
[u] Njeru, J. (2003). The Impact of Foreign Aid on Public Expenditure. A Case Study of Kenya, Nairobi, AERC Research Paper 135 ppl I
[11] World Bank (1989c) *Sub-Saharan Africa: From Crisis to Sustainable Growth* (Washington, DC. World Bank).

Neo-Liberal Reforms

Kenya was among the first country to sign a Structural Adjustment Loan (SAL) programme with the World Bank in the early 1980s, and the first country to receive a conditional loan from the IMF. It was almost by accident that Kenya came to the World Bank for quick-disbursement of funds.[88] Although severe structural distortions were building throughout 1970s, the critical trigger point was the financial imbalances created by the terms of trade shocks and fiscal indiscipline. The essential novelty of this instrument was that it combined quick-disbursing programme lending with explicit policy: conditional loans, pegged to certain reform agenda. This new form of lending grew rapidly in the early 1980s, went through various refinements in mid-decade, and as a part of a broader category of loans called 'adjustment lending' still constituted between one-quarter and one-third of the Bank's new lending at the end of the decade.[89]

The initial stages of Kenya's SAP brought about dramatic changes: the institution of an auction market for foreign exchange, the abolition of commodity marketing boards; and the elimination of import license requirements. These were soon to be followed by comprehensive review and reform of the import tariff and exercise tax system. Further reforms were expected to ensue, such as the privatization or commercialization of parastatals and further restructuring of the financial sector. The SAPs were to be implemented from 1986, although this has not been feasible. Therefore the progress in reforming Kenya's economic policies has continued with varying degrees of success.[90] Arguably, the two Structural Adjustment Lending

"World Bank. (1994). In Isharal Husain and Rashid, F. (ed.) Adjustment in Africa: *Lessons from Country Case studies,* Washington. D C: World Bank

[w] Adams, M (1989), Aid coordination in Africa: A Review. *Developing Policy Review,* 7, 185-192.

* World Bank (1987c), World Development Report 1987 (New York: Oxford University Press).

programmes in the 1980s only slowed down the trend of rising tariffs and the increased use of quantitative restrictions through import licensing.

Although, the economy stabilized between 1982 and 1984, little or no progress was made towards structural adjustments due to poor design and timing. The unsatisfactory implementation led to aid freeze. Given the limited implementation capacity of the government, and in the hope of building a greater consensus, it was decided that adjustment should proceed on a sectoral basis with support from the World Bank, and the IMF monitoring the macroeconomic balances.

Conclusion

In the foregoing chapter we have analyzed the Kenyan experience on external aid flows and the policy that helps to explain the compelling desire for aid. However, caution is advised that overreliance on external aid leads to dependency syndrome. In the long-run. however, it is our aim to maintain a rapid rate of growth with less dependence on foreign sources of capital.

Chapter Three

External Aid and Economic Growth: A Correlation Analysis

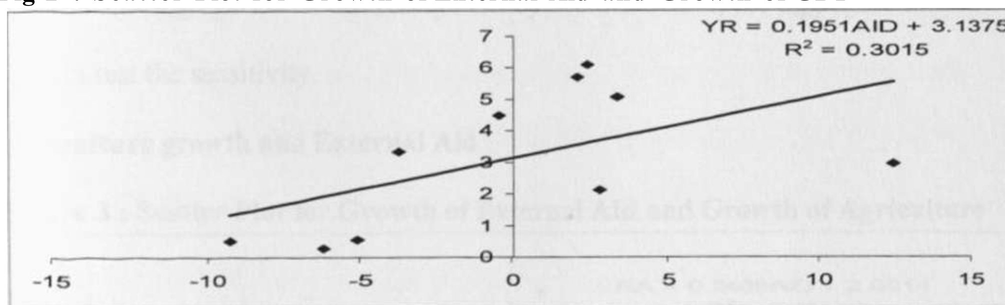
Introduction

The previous chapter analyzed the changing formal policy regarding the use of external aid in national economic development. The chapter also examined changes in aid flows since independence, including the explanations for the changes, and trends in economic growth during the same period. This chapter seeks to advance the argument through assessment of the impact of external aid flow on economic growth in Kenya. The analyses were conducted using scatter plots which help to unveil relationships between economic growth and other variables. Also, a qualitative analysis is done based on the primary data collected from target respondents in an effort to discern a casual relationship between aid flows and economic growth.

Analysis of External Aid and Economic Growth

The relationship between the rate of change of external aid and economic growth in Kenya since 1970-2007 is presented in Figure 2 below.

Fig 2 : Scatter Plot for Growth of External Aid and Growth of GDP



Where YR is the growth rate of GDP and AID is the growth rate of external aid. Figure 2 indicates the relationship between GDP growth and the rate of growth of external aid to the country over the period 1970-2007. From the figure it appears that there is a positive relationship between external aid flow and GDP, which in this regard suggests that a 1 percent change in external debt leads to a 0.3 percent change

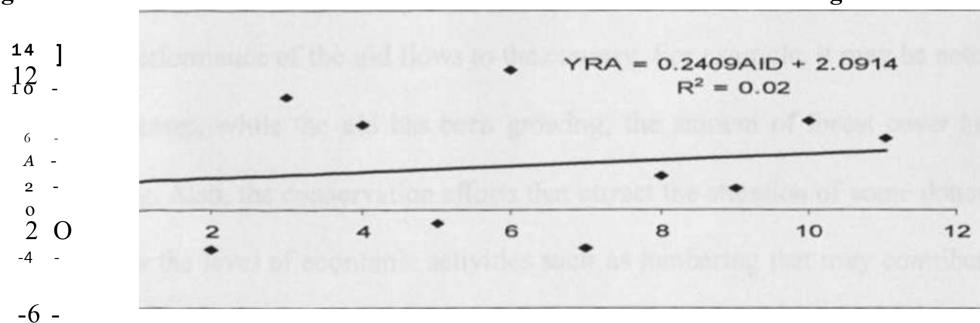
in GDP growth. Essentially this finding supports a pool of literature that argues that economic growth is positively related to external aid flows. In Kenya therefore, it may be suggested that full potential growth cannot be achieved without input from foreign sources which comes in the form of loans and grants that are channelled to specific sectors of the economy.

Sectoral Analysis on Economic Growth and Aid

In order to investigate the role of external aid on the sectoral GDP, a bivariate analysis involving growth of foreign aid to the GDP to the sectoral GDP is analysed in this section. This section seeks to show which sectors of the economy are more responsive to changes in external borrowing. This is motivated by the fact that most of the bilateral and multilateral donors give sector specific aid. In some cases one finds that almost the entire development expenditure of some ministries emanates from foreign resources. This is also more evident when analysing the sectors that are major recipients of foreign aid. In this regard we seek to investigate the sensitivity of growth of some specific sectors in relation to the growth of aid. This will be done without regard to desegregation of the foreign aid by sector. Rather, the aggregate aid flow is used to test the sensitivity.

Agriculture growth and External Aid

Figure 3 : Scatter Plot for Growth of External Aid and Growth of Agriculture



Where YRA is the growth rate of the agriculture sector GDP as indicated in figure 3. From the scatter plot it appears that there is a strong association between the

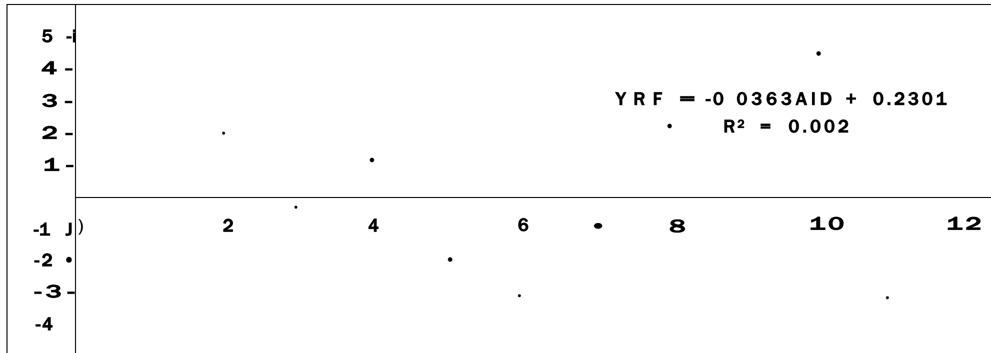
growth of the GDP associated with the agriculture sector and the growth of aid. The positive correlation between these variables therefore suggests that higher levels of foreign aid are associated with higher levels of growth of the agriculture sector. An R^2 of 0.2 percent and the coefficient of the external aid at 0.24 percent suggest that a 1 percent change in aid will lead to a 0.24 percentage change in the same direction. This finding is consistent with the amount of foreign resources that are channelled to the sector to improve the performance of the agriculture sector in the less developed countries. In Kenya, for example, a large proportion of external resources are channelled to the agriculture sector to improve the performance of the sector. This therefore suggests that the agriculture sector is sensitive to the performance of aid flows with rapid growth of the external debt being associated with higher performance of the agriculture sector.

Forestry and External Aid

The forestry sector is also analysed and the associated scatter plot is shown in figure 4 below, where YRF is the growth rate of the forestry sector GDP. From the scatter plot it appears that there is a very weak but negative relationship between the growth of the GDP associated with the forestry sector and the external aid. This finding therefore suggests that the forestry sector is not a major recipient of foreign resources. This may be taken to mean that the growth of the forestry sector has little to do with the performance of the aid flows to the country. For example, it may be noted that in most cases, while the aid has been growing, the amount of forest cover has been declining. Also, the conservation efforts that attract the attention of some donors tend to reduce the level of economic activities such as lumbering that may contribute to the growth of the sector. All these suggest that external aid which may have a

strong impact on conservation efforts tend to reduce the level of economic activity in this sector.

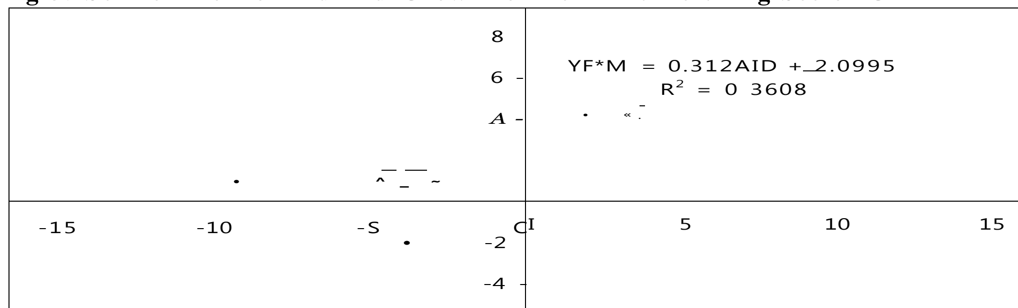
Fig 4 : Scatter Plot for Growth of External Aid and Growth of the Forestry GDP



Manufacturing and External Aid

The impact of external aid on the manufacturing sector is shown in the figure below. From figure 5, where YRM is the growth rate of manufacturing GDP, it appears that there is a positive association between the level of foreign aid flows and the GDP generated from the manufacturing sector. The R: of 0.36 is an indication of the strength of this association between manufacturing and aid. Furthermore it is evident that when the level of external aid increases by 1 per cent the GDP generated from the manufacturing sector increases by 0.3 per cent.

Fig 5: Scatter Plot for Aid and Growth of the Manufacturing Sector GDP

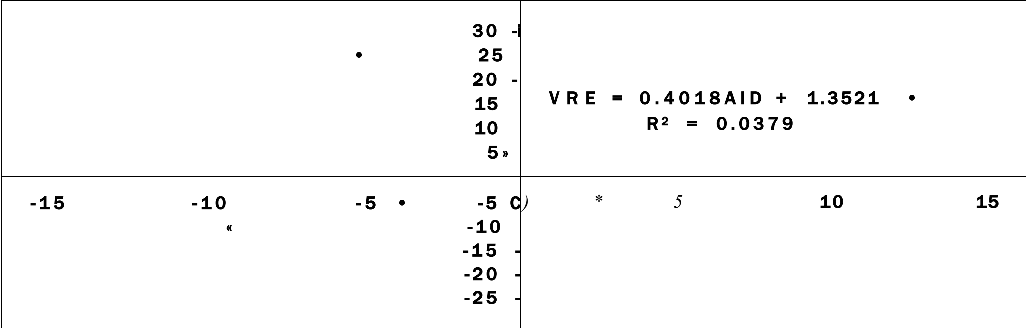


Electricity Sector and External Aid

The energy sector more particularly the electricity sub-sector makes a large contribution to the growth of the GDP. Evidence from the energy sector shows that

the sector has been receiving large inflows of foreign resources. For example, the Kenya Power and Lighting Company and KENGEN are receiving large amounts of resources in the effort to reform the sector. This may have contributed to the better performance of the sector and therefore the GDP generated from the sector may have increased. The figure below shows the relationship between the growth of the GDP generated from the electricity sector and the growth of the external debt.

Fig 6 : Scatter Plot for External Aid and Growth of the Electricity Sector GDP

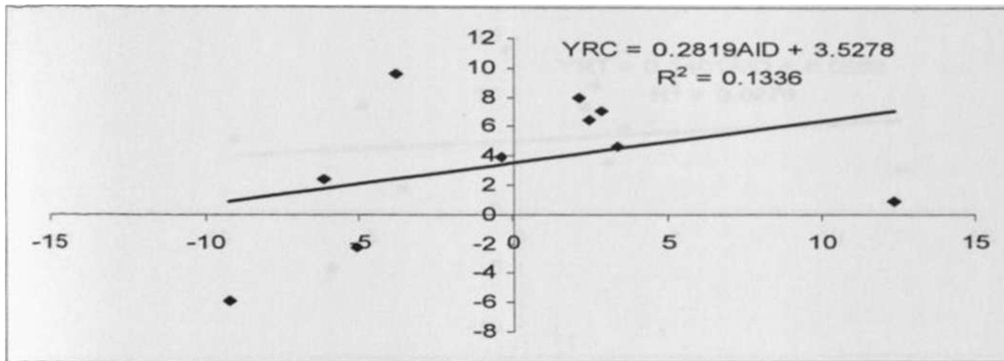


From the scatter plot figure 6, where YRE is the growth rate of the electricity sector GDP, it appears that there is a weak but positive relationship between the growth of GDP that is generated from electricity sector and the flow of external aid. An R^2 of 0.03 is further evidence of the weak relationship. However, it is pointed out that 1 per cent change in external aid will lead to a change of the GDP generated from the electricity sub-sector by 0.4 per cent.

Construction and External Aid

The construction sector is considered a major recipient of foreign aid. The construction sector includes roads and building sub-sectors which tend to attract large foreign resources. From the scatter plot figure 7 below, where YRC is the growth rate of the GDP from the construction sector above, it is evident that there is a positive relationship between the growth of aid and the GDP generated from the construction sector.

Fig 7 : Scatter Plot for Aid and Growth of the Construction Sector GDP

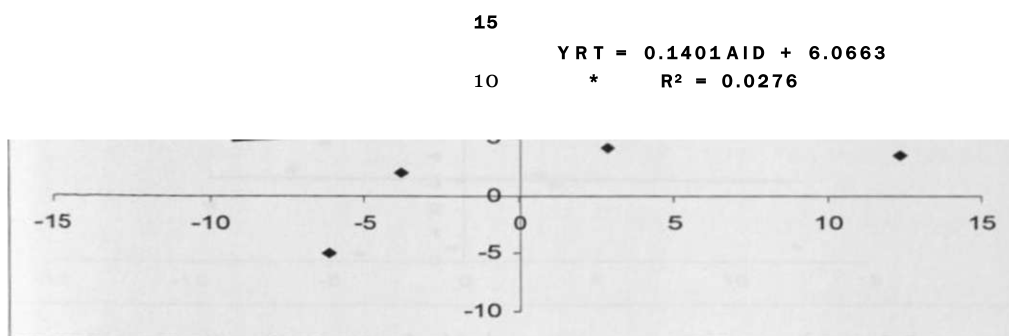


Transport and External Aid

The transport sector involves the activities of the ministry of transport which include both the road, air and water transport. This sector has received large stocks of external resources to finance a number of activities. In the air transport sector large inflows of foreign resources are channelled towards the modernization of airports, the road transport and water transport sectors. This suggests that the growth of the sector largely depends on external resources. The association between the growth of the GDP of the transport sector and the external resource flows is represented below.

From Figure 8 where YRT is the growth rate of the GDP of the transport sector, there appears to be a weak positive relationship between the changes in GDP generated from the transport sector and the foreign aid growth. This means that a I percent change in external debt leads to a 0.14 growth in the GDP from the transport sector. This is therefore a strong indication that the transport sector is dependent on external Financing for its growth.

Fig 8: Scatter Plot for Aid and Growth of the Transport Sector GDP

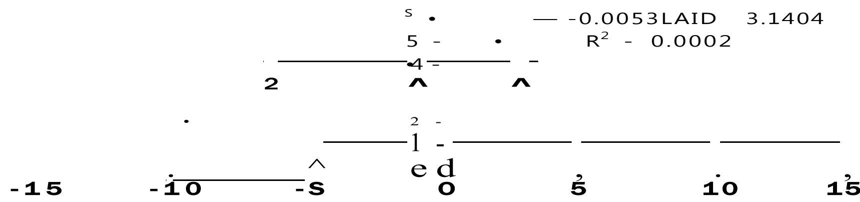


Debt Overhang and Economic Growth

As argued in the literature reviewed, external aid will have a strong impact on the growth performance of the economy. In this regard it is argued that because of high repayment costs in terms of interest payments and the accumulated principal debt will starve the other sectors of the economy of the much needed resources, thus retarding economic growth of the economy. To test this proposition we investigate the behaviour of the relationship between lagged foreign debt growth and current growth rate of the GDP. The graphical illustration of the relationship is in figure 8 below.

Figure 9, where LAID is the growth rate of the lagged external aid, shows the relationship between the growth rate of GDP and the growth rate of lagged external aid in Kenya over the period 1997- 2007. From the scatter plot it appears there is a very weak relationship between the growth of the economy and that of the lagged external aid. The R^2 appears to be very insignificant and the estimated coefficient of the foreign aid appears negative but very small in magnitude. The existence of a negative relationship between these variables is a sign that accumulation of external debt will have a negative effect on economic growth. However in the Kenyan context, this association seems to be very weak implying that Kenya does not have major problems with external debt.

Fig 9 : Scatter Plot for Lagged Aid and Growth of the GDP



This implies that external aid does not seem to have enhanced the growth prospects of Kenya during this period. The lack of a strong relationship at the overall level calls for an investigation of the sources of the GDP over the period to determine which sectors are more responsive to external aid.

Qualitative Analysis

In order to compliment the quantitative analysis reported above, I proceed to discuss the main findings of the qualitative assessment. This is the process of interpreting data collected during the course of qualitative research. In this assessment we found the following:

Achieving Economic Growth

The respondents attested to the null hypothesis that external aid has a positive impact on growth. The respondents suggest that aid makes a positive contribution to growth only in cases where policy formulation and implementation is strong. If policy on external aid is inadequate, aid is ineffective. Respondents concurred that in the absence of aid flows, growth would be lower. The other issue the responded agreed on is poor data storage on aid. The other effect is lack of mechanism to coordinate donor funding to the country as some resources are channeled to NGOs directly rendering utilization ineffective and inefficiency.

Chapter Four
External Policy and Economic Growth in Kenya

Introduction

The purpose of this study was to investigate the impact of external aid on the growth in Kenya under different policy regimes. Basic quantitative and qualitative analysis was employed to establish the impact of external aid on economic growth in Kenya. The quantitative analysis was conducted using scatter plots while the qualitative analysis was conducted by way of interviews targeting key policy makers in the country. Furthermore, a review was done regarding debt matters such as the quantity and the structure of external debt in Kenya during the same period. The study shows that official policy on external aid is unfavourable, the flow of aid was on the increase but sometimes decreasing rate, and economic growth rate was directly proportional to the rate of flow of external aid. This chapter will present the synopsis of key findings of the study under each of the sub-themes.

Policy on Aid

In Chapter 3 of this study, we evaluated the effectiveness of external aid on economic growth in Kenya. The main finding of this evaluation is positive. The study shows that aid has a small but positive and significant effect directly or indirectly to GDP growth in Kenya. This would be attributed to the possibility of leakage into non productive expenditure in the public sector and the transmission of negative effects to the private sector. However, external aid's potential adverse consequences do not mean that it is necessarily a bad thing. The requirement is to use appropriate policy measures to minimize the undesirable aspects of aid macro impact. This result shows that although Kenya has achieved relatively high growth rates in income and consumption since 1970s, external aid made it easier to avoid hard policy choices. Kenya has lived beyond its means specifically in the 1980s and the 1990s, and has

been fortunate to bridge the gap between domestic savings and current income transfers from abroad.

While discussing the external aid management policies pursued in Kenya, it is suggested that the capacity to repay requires a series of coordinated actions. Productivity somewhere in the economy must be raised by the results of the aid. Resources must be allocated to increase the savings rate along with a decrease in capital-output ratio. In the long-run, there is need to plan that savings exceed investment and exports be greater than imports which may lead to gaining independence from foreign aid. If the country's loans are to be repaid or amortized without new loans coming in, Kenya will have to transfer capital outwards rather than inwards.

Flow of Aid

In the study, we have observed that domestic savings are insufficient to fill the budget constraint gap which compels Kenya to borrow from external sources. Thus, during the 1970s, 1980s and 1090s net external borrowing remained positive. An obvious implication of this pattern is that the external debts have continued to rise during the period of analysis. The economic theory suggests that a transfer of external resources enables Kenya to fill the budget and trade gap. However, continuation of substantial resource transfer requires adjustments in the structure of domestic production. Once these budget and trade deficits are Filled with external aid and a growth process is established, then changes in the economic structure in the direction of increased savings and exports are required to reduce the dependence on external aid. The role of external aid in Kenya is therefore determined by the extent to which aid flows encourage, or alternatively retard, these processes.

Economic Growth

From the results it appears that there is a positive relationship between external aid and GDP growth in Kenya by filling domestic savings and foreign exchange gap. This supports our null hypothesis. The ineffectiveness can be attributed to indirect diversion of aid funds to non-productive activities and inefficiency in resource allocation especially in public sector associated with the easy availability of aid as the recipient government simultaneously lowers their own investment and transfers resources to additional consumption. The study also argues that external aid has been instrumental in supporting the growth rate in consumption that otherwise would not have been possible. Furthermore external aid made it easier to avoid hard policy choices such as heavy taxation of income and consumption. However, over reliance on external aid is unsustainable as it brings about disruptive effects on the economy unless efforts are made on continuous basis, to overcome the basic weaknesses in the economy. Kenya will need to carefully monitor the growth of its external funded debt, especially the growth of the debt servicing debt ratio, so as to avoid crippling indebtedness. Kenya must improve its savings rate by investing in productive sectors; in order to reduce on wasteful expenditure.

Association between External Aid and Growth

From the results it appears that there is a positive association between the growth of the GDP associated with the agriculture sector and the growth of the foreign debt. The positive correlation between these variables therefore suggests that higher levels of aid are associated with higher levels of growth of the agriculture sector. There is a very weak but negative relationship between the growth of the GDP associated with the forestry sector and the external debt which suggests that the forestry sector is not a major recipient of foreign resources. This might imply that the

growth of the forestry sector has little to do with the performance of the aid flows to the country. This is because conservation efforts that attract the attention of some donors tend to reduce the level of economic activities such as lumbering that may contribute to the growth of the sector.

The impact of the external aid on the manufacturing sector shows that there is a positive association between the level of aid flows and the GDP generated from the manufacturing sector. Empirical evidence from the energy sector shows that the sector has been receiving large inflows of foreign resources. The relationship between the growth of the GDP generated from the electricity sector and the growth of the external debt shows a weak but positive relationship between the growth of the GDP generated from the electricity sector and the flow of external aid.

Evidence from the construction sector shows a positive relationship between the growth of external aid and the GDP generated from the construction sector. The association between the growth of the GDP of the transport sector and the external resource flows shows there a weak positive relationship between the changes in GDP generated from the transport sector and the foreign aid growth which is an indication that the transport sector is dependent on external financing for its growth.

In this study, we have investigated the relation between external on economic growth in Kenya. Overall, external aid is found to be significantly and negatively correlated with growth. The second issue which the thesis addressed has been how the relation between aid and growth varies across sectors. Aid to the various sectors has had an adverse effect on growth though the economic performance remains fairly poor. This shows that large amount of aid does not necessarily guarantee growth. What really matters is the quality of aid. From donors' side, it requires the appropriately designed programs, timely and sufficient disbursement, good

conditionally and strict penalty upon deviation or violation etc. From the recipients' side, it requires good macroeconomic management policies and institutions. These actually are problems, with which Kenya is facing now. Therefore, aid programs should be designed in such a way that they support countries to build their own capacity in management. Policymakers training, intensive human capital investments and better partnership between donor community and local governments should be first priorities. Needless to say, fighting against corruption and aid dependency is extremely important.

The general conclusion emerging from our analysis can be summarized as follows: when aid is used productively (unproductively) it has, *on average,* a positive (negative) effect on growth while its respective volatility has a negative (positive) growth effect. From a policy perspective, these results seem to suggest that the scope for a higher effectiveness of aid on stimulating growth is a responsibility that lies with all sides from the wide spectrum encompassing the process of resource transfers, i.e., both recipients and donors. Taking them literally, our results propose that recipient countries should allocate the aid they receive on the most productive uses, while donors should make sure that aid provision is the least erratic possible. The findings are that aid unto itself is not intrinsically bad or good but rather, it is the way it is utilized that matters.

The policy implication here is that for Kenya, the money aid is necessary but the idea aid is even more important. It would be more sustainable if aid supports the policymakers training or education and then nurtures institutional reforms initiated by these well-trained policymakers. Put it another way, aid better be "the midwife of a good policy". Aid could be more effective to finance the overseas education of young

and potential leaders in order to build capacity. However, this is a very long-term human capital investment, of which the outcomes will be felt later.

By and large, there are many things that need to be improved by both donors and recipients. For recipients, the policy and institutional environment must be improved with willingness and a strong commitment to reform. For donors, better assessment criteria and conditionality must be applied, i.e. better designed programs, more efficient coordination and cooperation and last but not least, the reforms of aid agencies. Based on the findings the Government of Kenya must give priority to the following activities in order to address the debt management problem: continue focusing on timely and accurate settlement of public debt; maintain a reliable and up to-date public debt database; disseminate debt information on a timely basis; and continuously review External Debt Regulations policy to effectively manage external debt in accordance with the provisions of the External Loans and Credit Act.

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