Abstract

Many developing countries often acquire external debts to address their budget deficits. In Kenya, the government has over time accumulated large stocks of external debt to facilitate the provision of the essential public services and promote infrastructural development. Kenyaâ€™s external debt has been increasing, recorded at 36.4 per cent of gross domestic product as at 2022. Despite the increased external borrowing in Kenya, investment target levels have not reached the levels envisaged in the Kenya Vision 2030 development blueprint. The inflation rate has also increased over time, beyond the set threshold of 5 per cent of gross domestic product. The specific objective of this study was to investigate the effect of external debt on inflation in Kenya. The non-Ricardian Theory of Public Debt and Quantity Theory of Money were the foundations of the relationship between external debt and inflation. A descriptive research design was utilized to examine the relationship among the study variables. Annual time series data on the mentioned variables for the years 1990 to 2022 was collected using the structured data collection checklist from Kenya National Bureau of Statistics, the World Bank and International Monetary Fund websites. The research utilized the Autoregressive Distributed Lag Model. STATA software was used for data analysis. Diagnostic tests were done to ascertain that linear regression assumptions were adhered to. To test for the stationarity of data, Augmented Dickey-Fuller test was used where interest rate, GDP growth rate, exchange rate and the dummy variable were stationary at level whereas money supply, tax, external debt and inflation were stationary at first difference. The coefficient of external debt (0.4043) in the model was positive and significant, implying that 1 percentage increase in external debt would increase inflation by 0.4043 per cent. The p-value of the coefficient was 0.009. The model was a good predictor of inflation with an R2 value of 0.9973. The study recommends a robust system of debt management and mechanism to regulate the acquisition and utilization of the borrowed funds towards the earmarked projects. The study results may guide the policy makers as they formulate the fiscal and monetary policies to promote investment, while controlling inflation rate. The investors may also learn about the potential risk and benefits of investing in the country.