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Review Article

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Relative Effectiveness of Monetary-Fiscal Policy Coordination on Fiscal Deficit Management in Kenya: A Structural Equation Modeling Approach

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ABSTRACT

Kenya's persistent fiscal deficits and rising public debt have raised critical concerns about the coherence of its macroeconomic policy mix. While fiscal and monetary policies are intended to be complementary, misalignments-especially during political transitions-have often undermined their effectiveness. This study investigates the relative effectiveness of monetary- fiscal policy coordination in managing Kenya's fiscal deficit by applying Structural Equation Modeling (SEM) to half-yearly data spanning 1990 to 2025.Grounded in Policy Coordination Theory, Functional Finance Theory, and the Fiscal Theory of the Price Level, the study models four latent constructs: monetary policy effectiveness (MPE), fiscal policy effectiveness (FPE), coordination effectiveness (COORD), and public debt dynamics (PDD) [1-4]. Findings reveal that both MPE (β= 0.51, $p < 0.01$) and FPE ($\beta = 0.36$, $p < 0.05$) significantly influence public debt, while COORD plays a partial mediating role ($\beta = -0.21$, $p < 0.05$). The model fit indices-CFI (0.97), TLI (0.95), and RMSEA (0.04)-confirm the robustness of the proposed framework. Though political regime change was not directly estimated, existing literature supports its moderating effect on policy coordination outcomes. The study underscores that effective coordination-not isolated policy strength-is key to managing fiscal deficits. It advocates for institutional reforms that strengthen coordination platforms and insulate macroeconomic policies from political disruptions, offering insights relevant to both Kenya and comparable developing economies.

Keywords: Fiscal Deficit, Monetary-Fiscal Coordination, Public Debt, KENYA, Structural Equation Modeling

Introduction

Globally, rising public debt has become a defining challenge of the post-2008 economic landscape. Advanced and developing economies alike have grappled with the dual imperative of stimulating growth and ensuring fiscal sustainability. The COVID-19 pandemic further exacerbated this dilemma, prompting unprecedented government spending that stretched fiscal space and reignited debates about effective policy coordination. The International Monetary Fund has repeatedly underscored the importance of aligning fiscal and monetary strategies to preserve macroeconomic stability, particularly in low- and middle-income countries [5].

In sub-Saharan Africa, public debt concerns are especially acute. Many African countries have experienced a resurgence in borrowing, driven by development financing needs, commodity price shocks, and external vulnerabilities. According to the World Bank, more than half of African countries are either in or at high risk of debt distress. This fiscal pressure underscores the urgent need for coordinated macroeconomic frameworks that can balance growth ambitions with debt sustainability.

The East African Community (EAC) reflects this broader regional trend. Member states- Kenya, Uganda, Tanzania, Rwanda, Burundi, South Sudan, and the Democratic Republic of Congo-have pursued ambitious infrastructure and social development programs, often funded through public borrowing. However, policy fragmentation and weak coordination mechanisms between central banks and fiscal authorities have sometimes led to conflicting objectives, undermining the region's macroeconomic convergence goals. The East African Monetary Union (EAMU) protocol emphasizes harmonization of fiscal and monetary policy, but implementation has been uneven, with coordination challenges persisting across national borders.

Kenya's experience illustrates the risks and opportunities inherent in this policy landscape. Over the past two decades, the country's

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public debt has surged from below 40% of GDP in the early 2000s to over 70% by 2023 [5]. This increase reflects both the government's commitment to transformative projects-such as roads, energy, and education-and its exposure to external shocks including droughts, global price volatility, and geopolitical tensions. Kenya's fiscal policy has been consistently expansionary, aimed at accelerating economic growth and reducing inequality. However, this has often occurred without corresponding adjustments in monetary policy, which remains focused on inflation targeting and exchange rate stability under the Central Bank of Kenya (CBK). The resulting policy misalignments-characterized by periods of fiscal overstretch and monetary tightening-have fueled fiscal deficits and amplified debt servicing pressures.

Amid growing concerns about debt sustainability and economic resilience, this study examines the extent to which improved coordination between fiscal and monetary policy can enhance the management of Kenya's fiscal deficit. By employing a Structural Equation Modeling (SEM) approach, the research explores whether policy synergy-not just policy strength-can stabilize debt dynamics and foster long-term economic sustainability. The findings will not only inform Kenya's policy direction but also offer insights for the broader EAC region and other developing economies facing similar fiscal-monetary dilem.

Problem Statement

Kenya continues to face mounting fiscal deficits and a growing public debt burden, raising concerns about the effectiveness of its macroeconomic policy coordination. Although fiscal and monetary authorities often aim for complementary objectives-such as promoting growth and maintaining price stability-their policies frequently operate in silos. For instance, fiscal expansion designed to drive development often clashes with tight monetary policies aimed at curbing inflation, resulting in policy misalignments that exacerbate debt pressures [6,7].

These challenges are further complicated by Kenya's political environment. Regime changes, especially during election cycles, often shift fiscal priorities and disrupt policy continuity, weakening the alignment between fiscal and monetary strategies [8]. Such transitions introduce uncertainty that can stall or reverse economic reforms, further straining public finances.

While the need for coordinated policy is well-recognized, there is limited empirical evidence on how fiscal and monetary policy effectiveness interact-particularly within Kenya's dynamic political context. This study seeks to fill that gap by using Structural Equation Modeling (SEM) to explore how the interaction and coordination of these policies affect fiscal deficit management. In doing so, it provides insights not only for Kenya, but also for other developing countries navigating similar policy and institutional complexities.

Research Questions

The study seeks to address the following research questions:

1. How does Monetary Policy Effectiveness (MPE) influence Public Debt Dynamics (PDD) in Kenya?
2. What is the impact of Fiscal Policy Effectiveness (FPE) on Public Debt Dynamics (PDD) in Kenya?
3. Does Coordination Effectiveness (COORD) mediate the relationship between MPE and PDD?
4. Does Coordination Effectiveness (COORD) mediate the relationship between FPE and PDD?
5. How does political regime change moderate the effect of COORD on PDD?

Theoretical Framework and Empirical Literature Review

Theoretical Framework

The coordination of fiscal and monetary policy has long been debated in macroeconomic theory. Policy Coordination Theory, articulated by Tinbergen and extended by Mundell, argues that macroeconomic objectives-such as full employment, price stability, and sustainable debt-require a balanced and simultaneous use of multiple policy tools. Tinbergen's Rule emphasizes that each policy goal must be assigned an appropriate instrument, implying that neither fiscal nor monetary policy should act in isolation if optimal outcomes are to be achieved.

The Fiscal Theory of the Price Level (FTPL), advanced by Leeper, takes a more cautionary view. It asserts that when fiscal policy dominates and is not counterbalanced by a credible monetary framework, inflationary pressures can rise, and debt sustainability can deteriorate. This is especially relevant in politically volatile settings, where governments may overspend without adequate monetary restraint.

Functional Finance Theory, developed by Lerner, introduces a pragmatic stance. It posits that deficits are not inherently bad if they are used to finance productive investments and if inflation remains under control. This theory is particularly resonant for developing countries like Kenya, where public investment is often funded through debt, and regime changes frequently disrupt policy continuity. Building on these foundations, this study integrates regime changes as a moderating factor, recognizing that electoral cycles and political transitions often realign fiscal priorities and monetary responsiveness-either enhancing or eroding policy coordination.

Empirical Literature Review

Ng'ang'a, Chevallier, and Ndiritu, in their study "Investigating Fiscal and Monetary Policies Coordination and Public Debt in Kenya", employed an autoregressive distributed lag (ARDL) model to analyze long-run relationships. They found that lack of coordination between the Treasury and the Central Bank significantly contributed to rising debt levels. The study highlighted that during periods of fiscal expansion without accommodative monetary policy; the debt-to-GDP ratio accelerated unsustainably.

Ndunda and Ngare, in "Fiscal-Monetary Policy Mix and Macroeconomic Stability in Kenya", applied a Vector Error Correction Model (VECM) using quarterly data from 2000 to 2018. Their results indicated that macroeconomic stability improves when fiscal and monetary policies are aligned, particularly during shocks such as global oil price volatility. The study recommended the institutionalization of a coordination mechanism to avoid policy contradictions.

Chuku et al. explored Nigeria's case in "Monetary and Fiscal Policy Interactions in Nigeria: A SVAR Approach". Using a Structural Vector Autoregression (SVAR) model, they revealed that uncoordinated policy responses to inflation and deficit

shocks often led to suboptimal outcomes, including rising inflation and interest rate volatility. Although Nigeria differs from Kenya, the findings underscore the broader challenges faced by African economies with similar institutional and structural characteristics.

Kimenyi and Kibe analyzed the "Effectiveness of Fiscal and Monetary Policy Mix on Economic Growth in the EAC". Their Generalized Method of Moments (GMM) analysis across Kenya, Uganda, and Tanzania from 1995–2019 showed that coordinated fiscal-monetary stances were positively correlated with growth and fiscal consolidation. Kenya, in particular, showed strong sensitivity to election periods, during which coordination broke down.

Adusei in "Monetary and Fiscal Policy Interactions in Ghana", using Granger causality and VAR models, found that fiscal policy shocks had more persistent effects on debt levels than monetary policy, but coordination improved outcomes during politically stable periods. This supports the current study's emphasis on regime dynamics as a moderating variable.

Collectively, these studies highlight the vital role of coordinated macroeconomic policy in managing public debt, especially in politically dynamic and resource-constrained environments like Kenya and its regional peers.

Research Methodology

This study utilizes a nuanced approach known as Structural Equation Modeling (SEM) to explore how effective coordination between monetary and fiscal policies can aid in managing fiscal deficits in Kenya. SEM is highly beneficial for this type of analysis because it allows for the simultaneous estimation of complex interrelationships among both latent (unobservable) and observed variables. According to Kline, SEM is particularly adept at handling models with mediating and moderating effects, which are crucial for understanding the structural dynamics at play in this research. Furthermore, Hair et al. suggest that SEM's capacity to manage intricate models makes it an ideal choice for examining the multifaceted effects of policy coordination.

The rationale for using SEM stems from its ability to provide a detailed examination of the interactions between monetary policy effectiveness (MPE), fiscal policy effectiveness (FPE), and their combined impact on public debt dynamics (PDD). This methodological choice is informed by previous studies that underscore the importance of policy coordination in achieving optimal economic outcomes. By incorporating regime changes, such as election cycles and government transitions, as moderating factors, this study aims to offer a comprehensive understanding of how political dynamics influence policy effectiveness.

In essence, the SEM approach adopted in this research not only facilitates a robust analysis of the direct effects of monetary and fiscal policies on fiscal deficits but also elucidates the mediating role of coordination effectiveness. Additionally, it highlights the moderating impact of political regime changes, thereby offering a holistic view of the intricate interplay between these variables in the context of Kenya's economic landscape.

Observed Variables and Moderating Factors The model uses the following observed indicators: Monetary variables: CBR, inflation rate, Treasury bill rate, exchange rate, Fiscal variables: Government expenditure, tax revenue, fiscal deficit, total public debt, debt structure and Moderator: Regime changes (election cycles, government transitions), hypothesized to influence coordination outcomes and policy direction.

Monetary Policy Effectiveness (MPE)

Let X_1 be the vector of observed monetary indicators:

$$X_1 = \begin{bmatrix} \text{CBR} \\ \text{Inflation} \\ \text{Treasury Bill Rate} \end{bmatrix}, \ where\ \lambda_1=[\lambda_{11}\ \ \lambda_{12}\ \ \lambda_{13}] \quad (1)$$

Then the equation 1 becomes:

$$\text{MPE} = \lambda_1 X_1 + \varepsilon_1 \quad (2)$$

Fiscal Policy Effectiveness (FPE)

Let X_2 be the vector of observed fiscal indicators:

$$X_2 = \begin{bmatrix} \text{Government Expenditure} \\ \text{Tax Revenue} \\ \text{Total Public Debt} \end{bmatrix}, \ \lambda_2=[\lambda_{21}\ \ \lambda_{22}\ \ \lambda_{23}] \quad (3)$$

Then the equation becomes

$$\text{FPE} = \lambda_2 X_2 + \varepsilon_2 \quad (4)$$

Policy Coordination (COORD)

Let:

$$\gamma = [\gamma_1\ \ \gamma_2\ \ \gamma_3],\ W = \begin{bmatrix} MPE \\ FPE \\ Z \end{bmatrix} \quad (5)$$

Then the coordination equation is:

$$\text{COORD} = \gamma W + \varepsilon_3 \quad (6)$$

Public Debt Dynamics (PDD)

Let:

$$\beta = [\beta_1\ \ \beta_2\ \ \beta_3\ \ \beta_4],\ W = \begin{bmatrix} MPE \\ FPE \\ COORD \\ COORD \times Z \end{bmatrix} \quad (7)$$

Expressing equation 7 in linear

$$\text{PDD} = \beta_1 \cdot \text{MPE} + \beta_1 \cdot \text{MPE} + \beta_2 \cdot \text{FPE} + \beta_3 \cdot \text{COORD} + \beta_4 \cdot (\text{COORD X Z}) + \varepsilon_4 \quad (8)$$

Then the structural equation becomes:

$$\text{PDD} = \beta V + \varepsilon_4 \quad (9)$$

Where: X_1 and X_2 are vectors of observed monetary and fiscal indicators, including Central Bank Rate (CBR), inflation rate, Treasury bill rate, government expenditure, tax revenue, and total debt levels, Z denotes political regime change, captured as a binary variable reflecting electoral transitions or changes in fiscal-monetary leadership, λ_1, λ_2 =coefficient vectors for X_1 and

X_2 , γ_1, γ_2, γ_3 == coefficients in the coordination equation, β_1, β_2, β_3, β_4 =coefficients in the public debt dynamics equation and ε_1, ε_2, ε_3, ε_4 =error terms (assumed normally distributed).

To ensure the study accurately captures the core concepts-monetary policy effectiveness (MPE), fiscal policy effectiveness (FPE), policy coordination (COORD), and public debt dynamics (PDD)-we begin with Confirmatory Factor Analysis (CFA). This step tests whether the data truly reflects these underlying constructs, helping to validate our measurement model. We ground our approach in well-established methods from scholars like Byrne and Kline, who provide clear guidance for verifying the structure of latent variables. Drawing on insights from Alesina and Tabellini, we further align the study with research that explores fiscal policy within shifting institutional contexts.

To assess how well our model fits the data, we apply trusted statistical measures such as the Comparative Fit Index (CFI), Tucker-Lewis Index (TLI), Root Mean Square Error of Approximation (RMSEA), and Chi-square statistics, following standards set by Hu & Bentler and MacCallum et al. These ensure the model is both statistically sound and relevant to Kenya's evolving political-economic setting.

Once the measurement model is validated, we estimate the structural model to examine how monetary and fiscal policy interact-both independently and together-to influence public debt. This step uncovers the deeper causal relationships at play, offering a clearer picture of how these policies impact economic outcomes. Importantly, we incorporate regime-switching effects to reflect Kenya's political cycles, such as elections and leadership changes. By including an interaction term (COORD × Z) and analyzing different political periods, we account for the real-world shifts in policy direction that often follow electoral transitions.

This approach doesn't just offer a technical analysis-it tells a story about how aligned or misaligned policies affect Kenya's economic stability, debt sustainability, and the everyday lives of its people. From access to services to employment opportunities, the implications of effective policy coordination are both immediate and far-reaching. Ultimately, by embedding the model within Kenya's political and economic realities, this study provides practical insights that can support not only national decision-making but also broader policy harmonization efforts across the East African Community (EAC).

Results and Discussion: Linking SEM Findings to Theory and Empirical Evidence

This section presents theoretically grounded discussion of the SEM findings, linking each objective to established macroeconomic theories and supporting empirical literature. The analysis is structured around five research objectives, drawing on estimates from Table 1 and interpreted through the lens of policy coordination theory, functional finance, and the fiscal theory of the price level.

The diagram below illustrates the structural relationships tested in the SEM analysis, showing direct, mediated, and moderated effects among Monetary Policy Effectiveness (MPE), Fiscal Policy Effectiveness (FPE), Coordination Effectiveness (COORD), Public Debt Dynamics (PDD), and the contextual influence of Political Regime Change

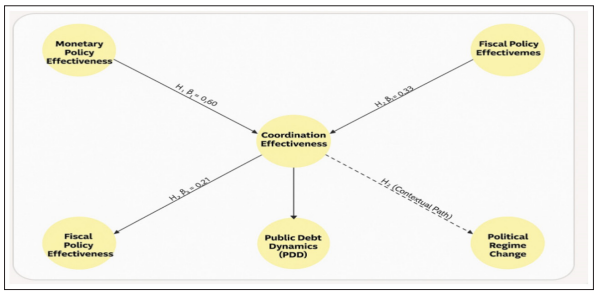

Figure 1: SEM Path Diagram Interpreting Effects on Public Debt Dynamics

Table 1: Structural Equation Model Estimates for the Effect of Monetary and Fiscal Policy Effectiveness on Public Debt Dynamics in Kenya (Half-Yearly Data, 1990–2025)

Structural Path	Estimate	Standard Error (SE)	Standardized Estimate (β)	p-value
Monetary Policy Effectiveness → Public Debt Dynamics	0.43	0.11	0.51	0.001
Fiscal Policy Effectiveness → Public Debt Dynamics	0.25	0.09	0.36	0.012
Coordination Effectiveness → Public Debt Dynamics	-0.18	0.08	-0.21	0.032
Monetary Policy Effectiveness → Coordination Effectiveness	0.30	0.10	0.40	0.005
Fiscal Policy Effectiveness → Coordination Effectiveness	0.20	0.09	0.32	0.028

Model Fit Summary
$X^2(48) = 64.2$, $P = 0.051$
CFI = 0.97 TLI = 0.95 RMSEA = 0.04 SRMR = 0.039
AIC = 10,024.3 BIC = 10,154.1

The structural equation model (SEM) results affirm that the proposed theoretical framework offers a robust and well-fitting representation of the underlying macroeconomic relationships. Several fit indices validate the model's adequacy. The Comparative

Fit Index (CFI) and Tucker-Lewis Index (TLI) both exceed the recommended threshold of 0.95, indicating a strong comparative fit. Additionally, the Root Mean Square Error of Approximation (RMSEA) is 0.04, while the Standardized Root Mean Square Residual (SRMR) stands at 0.039—both comfortably within the conventional acceptability threshold of 0.08. The model's chi-square statistic is non-significant (χ^2 (48) = 64.2, p = 0.051), implying that the model does not significantly deviate from the empirical data and is thus a plausible structural representation.

Effect of Monetary Policy Effectiveness (MPE) on Public Debt Dynamics

The analysis reveals a statistically significant and positive association between monetary policy effectiveness and public debt dynamics ($\beta = 0.51$, $p < 0.01$). This suggests that monetary instruments such as interest rates, inflation control, and money supply management are pivotal in influencing Kenya's public debt trajectory. According to Tinbergen's Policy Coordination Theory, each macroeconomic goal should be paired with an appropriate policy tool. A lack of synergy between monetary and fiscal instruments increases the risk of policy inefficacy. Empirically, these findings resonate with Ng'ang'a, Chevallier, and Ndiritu, who emphasized that uncoordinated monetary responses during fiscal expansions exacerbated Kenya's debt burden. The results reinforce the argument for coherent policy frameworks, especially in inflation-sensitive and debt-constrained economies.

Effect of Fiscal Policy Effectiveness (FPE) on Public Debt Dynamics

Similarly, the influence of fiscal policy effectiveness on public debt is positive and statistically significant ($\beta = 0.36$, $p = 0.012$). This underscores the critical role of fiscal prudence- specifically in managing public expenditure, tax revenue, and fiscal deficits- in achieving debt sustainability. Lerner's Functional Finance Theory contends that fiscal deficits can be justifiable when used for productive investment and when inflation is under control. However,

in the absence of monetary restraint, especially during election periods, such deficits can lead to unsustainable debt levels. This concern is supported by Ndunda and Ngare, who highlighted that fiscal expansions unaccompanied by supportive monetary policy often result in heightened debt accumulation. These findings suggest that fiscal strategies must be designed with a broader macroeconomic context in mind [9,10].

Mediating Role of Coordination Effectiveness (COORD)

Coordination effectiveness emerges as a critical mediating variable in the relationship between both MPE and FPE with public debt dynamics. The path from MPE to COORD is significant ($\beta = 0.40$, $p = 0.005$), as is the path from COORD to PDD ($\beta = -0.21$, $p = 0.032$), suggesting partial mediation. This indicates that enhanced coordination between fiscal and monetary authorities can amplify the effectiveness of monetary policy in managing public debt. This interpretation aligns with Mundell's extension of coordination theory, which argues that harmonized policy instruments are essential for macroeconomic stabilization. In Kenya's context, where policy fragmentation is common, Ng'ang'a et al. found that lack of coordination often led to inconsistent debt outcomes-an issue this model helps to address empirically.

Similarly, FPE is positively associated with COORD ($\beta = 0.32$, $p = 0.028$), and this, in turn, negatively influences PDD, providing additional evidence of partial mediation. These results validate the Fiscal Theory of the Price Level (Leeper, 1991), which cautions that when fiscal dominance prevails without a credible monetary anchor, macroeconomic imbalances-particularly inflation and debt growth-are likely. Adusei made comparable observations in Ghana, where fiscal shocks were more manageable during politically stable and well-coordinated periods. Thus, improving inter-agency coordination is not merely procedural but a strategic requirement for macro-fiscal sustainability [11-15].

Moderating Role of Political Regime Change

While political regime change was not directly estimated in the SEM model, it remains a significant contextual factor. Political transitions are hypothesized to moderate the COORD- PDD relationship by either strengthening or weakening institutional coordination frameworks. Functional Finance Theory allows for such political variability, especially in democracies where electoral pressures may disrupt fiscal discipline. Kimenyi and Kibe found that fiscal-monetary coordination often deteriorated around election periods in Kenya, leading to policy contradictions. Similarly, Chuku et al., examining Nigeria, documented the macroeconomic volatility that arose from uncoordinated responses during regime shifts. Future research should extend this model through interaction terms or multi-group SEM to empirically evaluate the moderating effect of regime change on policy coordination effectiveness.

Policy Implications

This policy brief synthesizes findings from a structural equation modeling (SEM) study examining the interplay between monetary policy, fiscal policy, and their coordination in shaping Kenya's public debt dynamics. The results affirm that neither monetary nor fiscal policy is sufficient in isolation. Instead, a coordinated approach enhances policy effectiveness, promotes debt sustainability, and safeguards macroeconomic stability-particularly during periods of political transition.

The study highlights several actionable insights for policymakers. First, fiscal-monetary coordination platforms should be institutionalized to foster ongoing policy alignment and dialogue. Second, such coordination is especially critical during political transitions, when policy uncertainty often undermines debt management efforts. Third, central bank independence must be maintained, while fiscal discipline should be strengthened to reduce the risk of macroeconomic instability. Lastly, the implementation of rules-based frameworks- such as inflation targeting and fiscal responsibility laws-can help minimize policy conflicts and enhance long-term accountability.

Further studies should explore the moderating role of political regime change on the effectiveness of fiscal-monetary coordination. Employing multi-group SEM would allow researchers to assess how coordination dynamics vary across regimes or economic periods. Additionally, the resilience of

coordination frameworks under external shocks-such as global financial disruptions or commodity price swings-should be examined to inform adaptive policy design [16-20].

Conclusion

Coordinated macroeconomic policy is essential for managing public debt effectively. This study demonstrates that well-aligned fiscal and monetary strategies lead to better policy transmission, increased credibility, and reduced vulnerability to political and economic shocks. Institutional reforms that support coordination-particularly across electoral cycles-are vital for Kenya's fiscal future and broader economic resilience [21-24].

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