



The impact of external debt on Economic Growth in Somalia

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Somalia

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Abstract: This study examines the impact of external debt on economic growth in Somalia using secondary data from 1991 until 2020. Somalia, a developing country with history, political instability and economic challenging, in the period of study and the topic is crucial in Somalia context. However the consequences of relied on the external debt on economic growth have been subject to debate. In regression results, the OLS method was used to analyze the short run relationship between the explanatory variables and indigenous variable so the study found that independent variables are positively impact to the dependent variable, means that one (1) unit increase in FA cause GDP will increase 0.11 units like that one (1) increase in export brings 153.3 increases in GDP so at the side of the probability there is statistically significant as p-value is less than 5 %.

To examine the long run relationship between external debt and economic growth, the study is done using Johansen system co-integration test and results are In Null-hypothesis (H_0) Thus, the study suggested some recommendations and policy implications such as The loans taken from foreign participate in the growth of the national economy, the study would suggest that government makes effort to make easier to get loan. At the end of the Somali debt relief process conducted by the Somali government and the IMF, it is necessary to be very careful about the money collection system, if the money is received, it can cause financial instability. Ensuring that borrowed funds are used effectively and that debt sustainability is maintained to support long –term economic growth.

Keywords: External debt, Economic Growth, Gross domestic product, Agricultural export, foreign direct investment, foreign aid , least developed countries

1. INTRODUCTION

To achieve long run economic growth is favorable in any country but in developing countries to achieve this goal needs strategic decision to simplify desired level of growth, so this study will focus on the impact on economic growth in Somalia. The 1950s and 1960s have been referred to as “golden years” for developing countries, when the least developed countries (LDCs) increased their investment with less dependence on external resources. However, in the 1970s, these countries began to rely more heavily on external investment, which also led to debt growth (Boboye, 2012). The external debt of developing countries like Somalia is, at least in part, due to borrowing from developed economies to improve the performance its industry, security, and agricultural sectors. Foreign borrowing for a country is especially required if the borrowed resources are used to fund economic development. Despite this, too much borrowing will lead an increase in the external debt, which will negatively affect the economy (Sheikh Ali et al., 2018).

In Africa, external indebtedness expanded phenomenally for the period 1990 to 2016. For instance, Africa’s external debt stock grew rapidly, by 10.2 percent per year in 2005-2015, compared with 7.8 percent per year in 2006-2009. The annual average growth rate of Africa’s external debt stock exceeded 10 percent in eight heavily indebted poor countries and 13 non-heavily indebted poor 2 countries (IMF, 2015). In 2005-2015, the external debt stock grew most rapidly in Mozambique (average by, 30 percent per year), Cameroon (26 percent per year) and Gabon, Nigeria, Rwanda and Seychelles (24 percent per year each). The concessional share of total external debt was less than 50 percent on the average in only seven of the heavily indebted poor countries in Africa, namely Côte d’Ivoire (27 percent), Zambia (39 percent), the Sudan (40 percent), Liberia (40 percent), the Central

African Republic (43 percent), Ghana (45 percent) and the Democratic Republic of the Congo (48 percent). In contrast, as of December 2015, this concessional share of total external debt in the period 2011-2013 was less than 50 percent for 11 of 16 non-heavily indebted poor countries. The weighted share of concessional debt in total external debt in Africa fell from 42.4 percent in 2006-2009 to 36.8 percent in 2011-2013(Personal & Archive, 2020).

The main objective of this paper is to examine the influence of a change in external debt on economic growth in the HIPC countries over the period 1970 to 2007 using recent developments in time series and cross-sectional analysis. Standard growth accounting process by decomposing the sources of economic growth will be employed for this purpose. In addition, the paper will analyze the extent to which the external debt held by heavily indebted poor countries has impacted on their economic growth. This will involve an analysis of various debt ratios over time(Siddique, Abu, E.A Selvanathan, 2015).

Thus, since Somalia was in a situation of statelessness and civil conflicts for almost three decades, there was no functional central government to monitor and control the external debts received from foreign countries and institutions, which made Somalia fall in the debt trap and remained the frontrunners of the Heavily Indebted Poor Countries initiative. Consequently, this study examines the level of the external debt stock in Somalia and its effects on the economic growth rate of the country for the period 1990-2016. The outline of the paper is presented as follows: following the introduction Section 1, Section 2 provides a review of existing literature(Personal & Archive, 2020).

1.1. problem statement

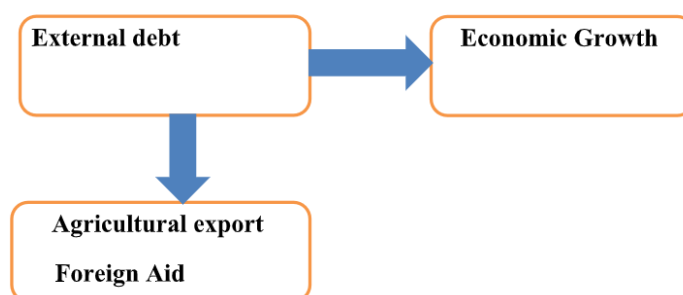
In 2015 Somalia owed an estimated \$5.3 billion to multilateral and bilateral creditors. It owes \$1.5 billion (28 percent) to international financial institutions, mainly the World Bank, the IMF, and the Arab Monetary Fund. Of this amount, \$1.2 billion is accumulated arrears. Somalia also owes \$3.8 billion to bilateral creditors accrued during the Cold War era, mainly the United States and the Russian Federation; \$2.3 billion to Paris Club members (mainly the United States, the United Kingdom, the Russian Federation, France, Italy, and Japan); and \$1.5 billion to non-Paris Club countries (including the United Arab Emirates, Saudi Arabia, and China)(ABDISAMAD MOHAMED FARAH2019).

Due to lack of saving and international investment many developing countries suffer economic problems such poverty, unemployment and Somalia is among those countries, especially Somalia is one of those countries and there is no relent study in the last five years so the study will examine the impact of external debt on Economic growth in Somalia from 2000 to 2022.

1.2. Specific objectives of the study

- To examine the impact of external debt on economic Growth in Somalia from 2000 to 2022, To assess the current status of agricultural export on Economic growth from 2000 to 2022.
- To investigate the effect of foreign aid on economic growth in Somalia between 2000 to 2022.

1.3. Conceptual Framework



2. LITERATURE REVIEW

2.1 concepts of external debts

Sánchez-Juárez and García-Almada (2016) used dynamic econometric models and panel data for 32 US states for the period 1993–2012. The results show that external debt is positively correlated with

public investment and this, in turn, generates economic growth. Similarly Maghyereh (2002) examined the effects of external debt on the performance of the Jordanian economy, using new econometric techniques to determine its optimum level. The results show that the optimal level of foreign indebtedness is roughly 53 percent of GDP. This implies that as the foreign debt surpasses this level, it has an inverse effect on the performance of the Jordanian economy (Saney Dalmar et al., 2018).

The need for external debt could be evaluated by weighing two factors: social usefulness and economic consequences for the country. Debt creates an unsustainable liability for countries once the charges outweigh the benefits. These advantages and expenses are determined by the creditor government's capability to progress in welfare programs. According to Panizza (2008), Emerging economies have accumulated enormous foreign debt over several years while having a low standard of living, inadequate reserves, poor tax structures, and a poor revenue collection system. Regardless of the actual earnings on borrowed funds, an external loan always contains flat charges, including interest (Jimale, 2022).

The issue of external debt has been at the forefront of international discourse since the 1979 world oil crisis, which plunged several developing economies into a recession and previous extensive literature has been conducted the determinants of external debt. There has been a rise in academic interest in foreign debt in recent years, especially in developing economies. Murwirapachena & Kapingura (2015) suggested that an increase the foreign reserves of a nation could also help decrease its foreign debt. Low and unreliable foreign exchange reserves on the economic fronts will raise several other problems. Reducing imports and growing exports is one way that South Africa can raise foreign reserves. Some of the previous studies examined the macroeconomic determinants of foreign debts, such as Al-Fawwaz (2016), who confirmed that there is a negative, statistically significant, long-term GDP per capita. Similarly, Awan, Anjum, & Rahim (2015) introduced the macroeconomic determinants of foreign debt in Pakistan; the study found that when Pakistan's debt load rises, the trade openness, exchange rate and fiscal deficit are statistically significant determinants of foreign debt (Mohamed Omar & Isse Ibrahim, 2021).

2.1.1 Agricultural Export on Economic growth

The importance of the instability of exports in less developed countries is due to three factors: First, less developed countries specialize in the production and export of primary commodities. Second, less developed countries' exports are concentrated in a small group of goods. Third, less developed countries' exports concentrate on a small group of markets, which are often traditional markets (Abu-lila M Ziad et al., 2021).

The impact of exports on economic growth, focusing on empirical evidence of Pakistan. The study is based on how exports influence economic growth in Pakistan consisting of 43 years of annual data from 1972 to 2014. Gross domestic product (GDP) is employed as the dependent variable while exports and other factors are used as independent variables such as imports, consumer price index, and terms of trade as independent variables in the study. The autoregressive distribution lag model (ARDL) and error correction model (ECM-ARDL) were employed for the long-run and short-run relationships in the study. ECM empirical estimations found out that equilibrium is fairly fast and restored (Mohamud Hussein & Abdi Ali, 2022).

The causal relationship between export and economic growth in developing countries. Panel data from 73 countries were used. Granger causality and co-integration tests were also used. The study divided these countries into two groups oil-dependent and non-oil-dependent countries. The results indicate that there is bidirectional short-run causality between export and GDP growth for non-oil developing countries, where, for oil countries, there is no short-run causality relationship between exports and economic growth (Ali et al., 2018).

2.1.2 Foreign Aid on Economic Growth

Foreign aid is also known as official development assistance (ODA) and consists of the transfer of resources from developed to developing countries via concessional loans. There is an intense debate on the effect of foreign aid on the evolutionary processes of developing nations. Foreign aid is a significant topic, given its links to poverty reduction in developing countries. In Somalia, foreign aid

has been increasing in recent years while foreign direct investment has been declining (Sheikh Ali et al., 2018).

Entrepreneurship is seen as one of the strongest determinants of local economic strength. Small and medium-sized enterprises (SMEs) have played a critical role in the economic growth of both underdeveloped and developed countries. Small and medium-sized enterprises (SMEs) are, in particular, the engines that drive economic growth. Businesses account for almost 90% of enterprises in both the leading and developing economies through job formation, jobs, tax provision and a contribution to the Gross Domestic Product (Muriithi, 2017). While local output is poor, the strength of new and small firms is a key component of local competitiveness and therefore affects the country's economic performance (Maow, 2021).

In the developing world, small and medium-sized companies are one of the biggest economic boosters, with SMEs accounting for 51% of US GDP and 25% of UK GDP (Burns, 2016; Longenecker, Moore, Petty & Palich, 2005). Like the United States and the United Kingdom, SMEs contribute 80% of urban jobs and 60% of GDP to China (Sham & Pang, 2014). Studies in Africa confirm that SMEs contribute about 50% of GDP (Kamunge, Njeru & Tirimba, 2014). For example, in Kenya, SMEs contribute 40% of GDP, 70% of Nigeria's industrial jobs and 70% of Ghana's total workforce (Muriithi, 2017; Mwarari & Ngugi, 2013). In Sub-Saharan Africa, as Kauffmann (2005) stated, due to SMEs simple approach in responding to the majority of African needs by providing affordable goods and services on fair terms and prices, a source of income and jobs has become available to the sector (Maow, 2021).

2.3 Concepts of Economic Growth

Economic growth is an increase in the capacity of an economy to produce goods and services, compared from one period of time to another. It can be measured in nominal or real terms, the latter of which is adjusted for inflation. Traditionally, aggregate economic growth is measured in terms of gross national product (GNP) or gross domestic product (GDP) (Mohamud Hussein & Abdi Ali, 2022). The examined the economic growth in China. The direction of the long-run and short-run causal relations was assessed using a modified Granger causality test, and the long-run relationship is determined using the autoregressive distributed lag (ARDL) approach. Annual time series data from 1978 to 2009 were used. The findings support the long-term bidirectional relationship between exports and imports, as well as between economic growth and exports. The authors drew the conclusion that the external deficit for China is manageable based on these data, which also supported the validity of the hypotheses of growth-led exports, growth-led growth, growth-led imports, and growth-led growth. Effects of export and technology on economic growth in a few selected emerging Asian economies were researched (Sultanuzzaman et al., 2019). The study used the Generalized Method of Moments (GMM) method using panel data covering the years 2000 to 2016. The findings showed that export and technology have a positive and significant impact on the economic growth of emerging Asian economies (Aden Mohamed & Shire Mohamud, 2023). The economy grew at an estimated rate of 2.9 percent in 2019, on par with population growth, and was projected to grow at 3.2 percent in 2020. Increased confidence in the economy; a higher than normal Dyer rainfall season, which facilitated a productive season in the agricultural sector; operationalization of reforms in the financial and telecommunication sectors; and small-scale investments and entrepreneurial activities in urban areas all contributed to a growth recovery before the COVID-19 crisis. Somalia also reached a milestone in March 2020 when the World Bank and the International Monetary Fund (IMF) announced that Somalia had reached the HIPC Decision Point, meaning that it could begin receiving debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative ("Somalia Econ. Updat. June 2020," 2020).

3. METHODS AND MATERIALS

There are many empirical and theoretical literature that display methods to increase the inflow of external debt and in this study, we focus to test the macroeconomic variables that has high capacity to influence the inflow, so in this study employed timeseries data of External debt in Somalia. In this research of paper was entirely dependent on secondary data from major data of World Bank, African development bank, SISRIC and country reports which published by Central bank of Somalia. In this research paper is based on time series data of the external debt, agricultural export, foreign aid and

economic growth over the period of 1991 up to 2020 in Somalia. The data covers the period of 32 years from 1990 to 2022. The study chose this period because of the country's economic situation changed due to lack of strong government and monetary institutions along this period.

3.1. Model Specification

The main objective of this model is to build econometric model that describe the equation of variables. The model contains variables such as explanatory variables and indigenous variables, so the variables that specify independent variables are external debt, foreign aid and agricultural export while dependent variable is economic growth. These variables are shown in the following equation.

$$GDP_t = \alpha + \beta_1(ED) + \beta_2(FA) + \beta_3(EXP) + \epsilon_t \dots\dots\dots(1)$$

Where GDP is the abbreviation of Gross domestic product. α is the intercept term. ED is the external debt, FA is the foreign aid, EXP is the agricultural export, ϵ_t is the error term.

3.2. Empirical Strategies

For the effectiveness of this study, both descriptive and analytical techniques were used. For the analysis of the time series data, certain statistical techniques were employed. This includes multiple regression analysis of a single – equation model based on method of Ordinary Least Squares (OLS). The analysis of Variance (ANOVA) was utilized to test the difference between means for hypothesis one ($H_0 \#1$).

3.2.1 STATIONARITY

“For any long run economic analysis, it is important that variables in the regression equations be stationary” (Gujarati, 2009). Therefore, before estimating a model, we should test for stationary of each of the time series variables to be included in our model to avoid estimating spurious regressions and making Type I or Type II errors. After estimation and stationary is found in the series at level form, then the estimation of a long-run equation would give reliable slope parameters and standard errors, otherwise the standard errors will not give reliable parameters for making any t-statistic test or inference. Also, the stationary of all variables within the system of equations helps identify any possibility of long run connection between the systems of equation. For instance, if all the variables are integrated of 1st Order after 1st differencing, i.e. $I(1)$, it means the series would have been transformed to their short run movements, there would be much possibility that they all converge in the long run.

3.2.2 UNIT ROOT TEST

The first step involves testing the order of integration of the individual series under consideration. Researchers have developed several procedures for the test of order of integration. The most popular ones are Augmented Dickey-Fuller (ADF) test due to Dickey and Fuller (1979, 1981), and the Phillip-Perron (PP) due to Phillips (1987) and Phillips and Perron (1988). Augmented Dickey-Fuller test relies on rejecting a null hypothesis of unit root (the series are non-stationary) in favor of the alternative hypotheses of stationary. The tests are conducted with and without a deterministic trend (t) for each of the series. The null hypothesis (H_0) is rejected when time series data is stationary $\rho = 0$ and it do not rejected when time series data is non-stationary $\rho < 0$.

3.2.3 CO -INTEGRATION TEST

When variables in a given vector are non- stationary in levels and integrated of the same order; one or more than one a test of co-integration can be implemented to determine the number of long-run equilibrium relation(s) among the variables. This study employs Johansen (1988) approach to test for co-integrating relations among variables. Juselius (1990) and Johansen (1991) parameterized the VAR model in equation (3) to yield the following tests equation:-

$$LGDP_t = \rho(LGDP_{t-1}) + u_t \dots\dots\dots - 1 \leq \rho \leq 1 \dots\dots\dots (2).$$

Once a unit root has been confirmed for a data series, the next step is to examine whether there exists a long run equilibrium relationship among variables. The existence of long-run equilibrium (stationary) relationships among economic variables is referred to in the literature as co-integration which is very significant to avoid the risk of spurious regression. The Johansen procedure will be employed to examine the question of co-integration and provide not only an estimation methodology

but also explicit procedures for testing for the number of co-integrating vectors as well as for restrictions suggested by economic theory in a multivariate setting. Engel and Granger (1987) pointed out that a linear combination of two or more non-stationary variables may be stationary. If such a stationary combination exists, then the non-stationary time series are said to be co-integrated. The VAR is based on co-integration test using the methodology developed in Johansen (1991, 1995).

3.2.4 ERROR CORRECTION MODEL

The co-integrating regression so far considers only the long-run property of the model, and does not deal with the short-run dynamics explicitly. Clearly, a good time series modeling should describe both short-run dynamics and the long-run equilibrium simultaneously. For this purpose we now develop an error correction model (ECM). Although ECM has been popularized after Engle and Granger, it has a long tradition in time series econometrics dating back to Sargan (1964) or being embedded in the London School of Economics tradition. To start, we define the error correction term by the following equation:

$$\epsilon_t = \text{L GDP}_t - \alpha - (\text{LED}) - (\text{LFA}) - \beta_3(\text{EXP}) \dots \dots \dots (3)$$

Where ϵ_t is white noise error Term.

4. RESULTS AND DISCUSSIONS

4.1. Test for Unit root

This involves testing for the stationary of the individual variables using both the Augmented Dickey Fuller (ADF) and Phillips – Perron (PP) tests to find the existence of unit root in each of the time series. An augmented Dickey–Fuller test (ADF) tests the null hypothesis that a unit root is present in a time series sample the alternative hypothesis is different depending on which version of the test is used, but is usually stationary or trend-stationary. It is an augmented version of the Dickey–Fuller test for a larger and more complicated set of time series models.

Table: 4.1 Unit Root Test

Variables level

	C	C & T	C
Export	0.8435	0.0000	
FA	0.9721	0.9678	0.0000
GDP	0.8265	0.0046	

All the variables were not found stationary at levels and intercept but most of the variables are stationary at level of trend and intercept except foreign aid that became stationary at 1st difference of intercept so null hypothesis is rejected.

4.2. Regression Results

Regression analysis generates an equation to describe the statistical relationship between one or more predictor variables and the response variable.

Dependent Variable: GDP				
Method: Least Squares				
Date: 08/09/23 Time: 04:01				
Sample: 1991 2020				
Included observations: 31				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	6.61	86323851	7.652165	0.0000
FA	0.115198	0.041700	2.762534	0.0099
EXPORT	153.2692	31.07034	4.932975	0.0000
R-squared	0.750805	Mean dependent var		1.20E+09
Adjusted R-squared	0.733619	S.D. dependent var		2.32E+08
S.E. of regression	1.20E+08	Akaike info criterion		40.13164
Sum squared resid	4.17E+17	Schwarz criterion		40.26906

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Log likelihood	-639.1063	Hannan-Quinn criter.	40.17719
F-statistic	43.68739	Durbin-Watson stat	0.79061
Prob(F-statistic)	0.000000		

In the above table shows that all independent variables are positively impact to the dependent variable, means that one (1) unit increase in FA cause GDP will increase 0.11 units' like that one (1) increase in export brings 153.3 increases in GDP so at the side of the probability there is statistically significant as p-value is less than 5 %.

Thus the result of R-squared shows that how much independent variable is predicted to the dependent variable so the explanatory variables are predicted 75% to Indigenous variable.

4.3. Co Integration Test For Long Run Relationship

Co-integration tests identify scenarios where two or more non-stationary time series are integrated together in a way that they cannot deviate from equilibrium in the long term. The tests are used to identify the degree of sensitivity of two variables to the same average price over a specified period of time.

Date: 08/09/23 Time: 23:57				
Sample (adjusted): 1991 2020				
Included observations: 30 after adjustments				
Trend assumption: Quadratic deterministic trend				
Series: GDP FA EXPORT				
Lags interval (in first differences): 1 to 1				
Unrestricted Cointegration Rank Test (Trace)				
Hypothesized				
No. of CE(s)		Eigenvalue	Trace Statistic	0.05
			Critical Value	Prob.**
None *		0.565693	46.42448	35.01090
At most 1 *		0.411403	21.40434	18.39771
At most 2 *		0.167619	5.503961	3.841466
Trace test indicates 3 cointegrating eqn(s) at the 0.05 level				
* denotes rejection of the hypothesis at the 0.05 level				
**MacKinnon-Haug-Michelis (1999) p-values				
Unrestricted Cointegration Rank Test (Maximum Eigenvalue)				
Hypothesized				
No. of CE(s)		Eigenvalue	Max-Eigen Statistic	0.05
			Critical Value	Prob.**
None *		0.565693	25.02014	24.25202
At most 1		0.411403	15.90038	17.14769
At most 2 *		0.167619	5.503961	3.841466
Max-eigenvalue test indicates 1 cointegrating eqn(s) at the 0.05 level				
* denotes rejection of the hypothesis at the 0.05 level				
**MacKinnon-Haug-Michelis (1999) p-values				

In Null-hypothesis (Ho) , there is no co-integration means that there is no long run relationship between independent variable and dependent variable , so if the p-value is less than 5% so there is statistically significant and null-hypothesis is not accepted

4.4 Multicollinearity Test

Multicollinearity occurs when independent variables in a regression model are correlated. This correlation is a problem because independent variables should be *independent*. If the degree of correlation between variables is high enough, it can cause problems when you fit the model and interpret the results.

Variance Inflation Factors			
Date: 08/01/23 Time: 01:29			
Sample: 1991 2020			
Included observations: 32			
Variable	Coefficient	Uncentered	Centered
	Variance	VIF	VIF
C	8.65E+15	19.25092	NA
EXPORT	965.3660	27.68599	1.753404
FA	0.001739	3.936937	1.753404

In the above table shows that there is no Multicollinearity since all centered VIF is less than 10.

4.5. Heteroscedasticity Test

Heteroscedasticity is a systematic change in the spread of the residuals over the range of measured values. Heteroscedasticity is a problem because ordinary least squares (OLS) regression assumes that all residuals are drawn from a population that has a constant variance (homoscedasticity).

Heteroskedasticity Test: Breusch-Pagan-Godfrey			
F-statistic	25.83099	Prob. F(2,27)	0.15000
Obs*R-squared	19.70278	Prob. Chi-Square(2)	0.2000
Scaled explained SS	33.91622	Prob. Chi-Square(2)	0.1000

In the above results shows that probability of Chi-square is greater than 5% so it is statistically insignificant.

5. DISCUSSIONS, CONCLUSIONS AND RECOMMENDATION

The study found that all variables were found stationary at levels of trend and intercept so null hypothesis is rejected. In the regression table shows that all independent variables are positively impact to the dependent variable, means that one (1) unit increase in FA cause GDP will increase 0.11 units' like that one (1) increase in export brings 153.3 increases in GDP so at the side of the probability there is statistically significant as p-value is less than 5 %.

Thus the result of R-squared shows that how much independent variable is predicted to the dependent variable so the explanatory variables are predicted 75% to Indigenous variable.

In Null-hypothesis (Ho) , there is no co-integration means that there is no long run relationship between independent variable and dependent variable , so if the p-value is less than 5% so there is statistically significant and null-hypothesis is not accepted . In Multicollinearity table shows that there is no Multicollinearity since all centered VIF is less than 10.In this paper of the study explores the impact of external debt on economic growth in Somalia for the period 1991-2020. The finding results of external debt, foreign aid influence on growth indicate that they have significance and positive effect on economic growth in Somalia.To enhance the whole system of the economy in developing countries especially Somalia, we would recommend the following hints: Since the loans taken from foreign participate in the growth of the national economy, the study would suggest that government makes effort to make easier to get loan. At the end of the Somali debt relief process conducted by the Somali government and the IMF, it is necessary to be very careful about the money collection system, if the money is received, it can cause financial instability. Ensuring that borrowed funds are used effectively and that debt sustainability is maintained to support long –term economic growth.

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Mr. Liban Omar Sagal is a graduate of a Bachelor of Business Administration in 2012 and later pursued a Master of Business Administration in 2014, both from University of Somalia. In 2019, I further enhanced expertise by completing a Master's degree in Leadership and Governance at Jomo Kenyatta University. Currently, I hold the position of Lecturer at the University of Somalia, where I teach in management to undergraduate students.

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