Rising Public Debt Profile In Nigeria: Risks and Sustainability Issues

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Abstract

The recent surge in the debt profile of the federal and state governments has echoed new concerns for policy stakeholders in Nigeria. Although debt is important for economic growth, the size of the debt is important for sustainability. Despite the “green light” signal that Nigeria has more fiscal room for accumulating more public debt, our analyses show that Nigeria's debt is fast rising and could approach unsustainable level given the low revenue and export profiles. In this Policy Brief, we traced recent trends in Nigeria's debt profile and explored the various sustainability assessment indicators to gauge the possibility of impending risks in the near term. The report sets out with the review of studies on debt and economic growth nexus and also narrows down on the implications of various issues unfolding in the public debt structure in Nigeria.

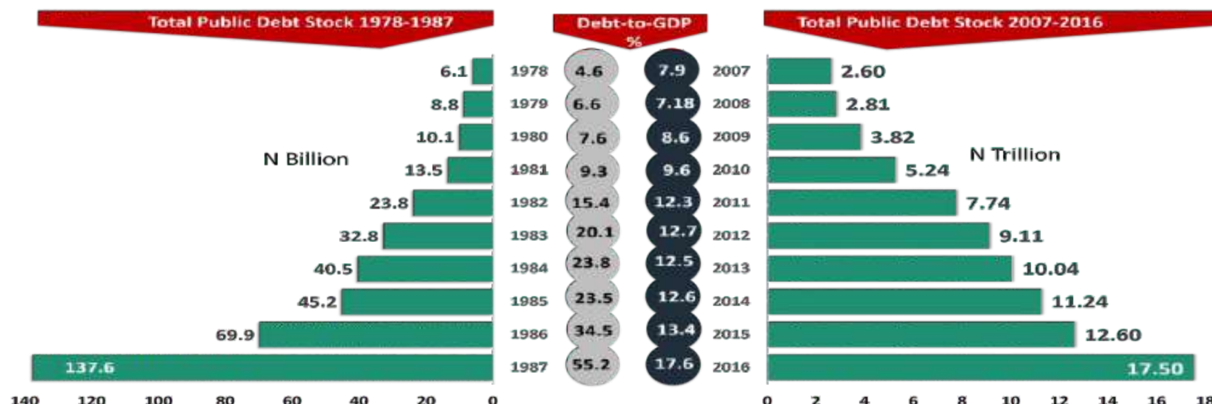
As a way forward, government should increase the share of concessional loan in external debt stock and develop Public-Private Partnership (PPP) Framework for financing infrastructure projects.

Introduction

Taking a casual look at the level of Nigeria's public debt profile, which stood at 18% of GDP, it may seem obvious that the total debt stock of N17.5 Trillion (as at December 2016) is well below tolerable threshold and that there is sufficient room in the Government's debt management strategy to cope with adverse shocks. However, it is not obvious that this relaxing mood would be sustained if the debt profile is subjected to sustainability assessments within short to medium term.

In the aftermath of debt relief deal in the 2000s, the level and composition of Nigeria's public debt have changed and are gradually picking up to historic levels. An assessment of the Nigeria's debt profile in the last decade shows how much and how quickly the structure has changed. For instance, external debt stock has jumped by almost 200%, from $3.8 billion (15% of export) in 2006 to $11.4 billion (65% of export) in 2016. Likewise, domestic debt has been increasing on steep cliff starting from the mid-2000s to reflect the substantial efforts being made by the Central Bank of Nigeria(CBN) to develop the bond market and government’s gradual shift from relying heavily on external to domestic sources of budget finance. In 2016, domestic debt was at a record high, mounting sharply to N14 trillion. Whereas in 2006, domestic debt was N1.7 trillion. One of the major transformations in the debt profile is the debt mix. The share of domestic debt to total debt stock has abruptly changed from an average of 25% in the early-2000’s to 84% between 2006 and 2016 - an effect of the debt relief deal in 2005.

Figure 1: Public Debt Stock and Debt-to-GDP Ratio



Source: CBN, DMO, World Bank

Why does this trend matter at this point? History has shown that public borrowing accelerates markedly and systematically ahead of a sovereign debt crisis. The Latin American case of the 1980s showed the adverse macroeconomic impact of not solving the debt problems at the signal of the crisis. Also, the recent case of Greece's fiscal collapse is a story of repeated underestimation of debt dynamics. With hindsight, Nigeria's current debt profile is exhibiting similar pattern as in the pre-crisis period in the 1980s. In the five years preceding the 1983 refinancing agreement of $2.1 billion and the subsequent run-up in the Nigeria debt profile, debt-to-GDP ratio averaged 16.7% and external debt stock averaged 53% of total exports. Not only do these indicators reflect current trajectory, the macroeconomic fundamentals also follows similar pattern in the pre-crisis period in the 1980s.

Yet, there are indications that debt level is just building up. In the 2016-2018 Medium Term Expenditure Framework (MTEF), the government plans to borrow N3.6 trillion. The International Monetary Fund (IMF) projects that Nigeria's debt to GDP ratio will rise to 18% by the year 2020. Without a doubt, at this point when policy priority is to stimulate economic activity and foster job creation, public debt will inevitably increase. However, the fact that the rise in the debt profile is coming at a time when government revenue has dropped creates some uncertainties that shroud the outlook for Nigeria's debt sustainability and raises concern about prudent debt level that government should be targeting.

Table 1: Nigeria's Public Debt Profile 2011 - 2016

	2011	2013	2015	2016
External Debt (US$ Billion)				
Fed. Government	3.5	6.0	7.3	7.7
State Governments	2.2	2.8	3.4	3.7
Sub-Total	5.7	8.8	10.7	11.4
Domestic Debt (N Trillion)				
Fed. Government	5.6	7.1	8.8	11.2
State Governments	1.2	1.6	1.7	2.8
Sub-Total	6.9	8.7	10.5	14.0
Grand Total (N Trillion)	7.7	10.0	12.6	17.5

Source: DMO, World Bank

Public Debt, Sustainability Threshold and The Economy

Debt is Important for Growth

Of the several reasons why countries borrow, deficit financing remains the most prominent. Borrowed funds are either channelled to public investment or used for stopgap fiscal measures applied in an economic recession. Several studies have documented how countries' debt rise in an economic downturn and how countries have efficiently utilised borrowed funds to lift output growth. To eliminate the tendency for borrowing in a recession would make the recession worse and increase inequality. Such studies also emphasised the importance of applying the right fiscal instruments, economic conditions and the timing of the debt. A country could go for foreign borrowing, as it allows for deficit financing without creating money supply-driven inflationary pressures or crowding out domestic lending to the private sector. However, the fact that external debt is typically denominated in foreign currency, it creates additional constraints on monetary policy and exchange rate management.

Due to some of the flaws identified with external debt, countries had shifted the bulk of their fiscal financing sources from external to domestic debt market. But such move weighs pros and cons of both financing sources to fine-tune the optimal mix that suits the specific need of each economy. For the reason that domestic debt is contracted in local currency, it reduces the exposure of the public debt to unanticipated movements in the exchange rate. In addition to that, developing countries where the larger share of fiscal financing is sourced from domestic debt market have been found to have broadened their investor base, increased the market depth and lengthened debt maturities. Yet, domestic debt has been found to present a significant burden to fiscal policy in terms of interest payments. Supporting this view, studies have analysed the structure of public debt in Sub-Saharan African countries and found that short-term maturity of domestic government debt is a source of rollover risk and macroeconomic instability. These studies also documented the existence of crowding out effects on private-sector borrowing.

The Size of Debt is Critical for Debt Sustainability

While debt plays a crucial role in economic growth, its size is important for effective and independent policymaking. Excessive debt levels can weigh on an economy's growth as highly indebted countries are constrained by the extent of fiscal maneuvering to play with and in most cases, they do reduce their investment and consumption. This explains why limit on debt profile are often suggested for countries. For instance, the World Bank and the IMF developed The Joint Bank-Fund Debt Sustainability thresholds for both the developing and market access countries (see table 2).

It should be noted that the case of the maximum public debt limit is not that of one-size-fits-all for countries as it is being misconstrued. Countries use debt sustainability thresholds to keep track of debt profile and guide their borrowing decisions in a way that matches their financing needs with their current and prospective repayment ability, taking into account the economic circumstances.

Considerations may border on the growth, interest rate, foreign reserves and the previously observed capacity of governments to react to rising debt. Irrespective of country-specific circumstances, developing countries

have been found to be exposed to the debt crisis phenomenon than the developed economies. While developing economies debt threshold is in a range of 30% to 50% of GDP, the suggested thresholds for emerging markets and developed economies are 70% and 85% respectively. The concept of debt sustainability threshold does not suggest that countries should dare to approach the indicative limits, as the risk of debt distress can occur below the thresholds. For instance, even with the 70% debt-to-GDP threshold stipulated for emerging markets, it has been found that more than half of debt defaults in those economies occur below the threshold.

Table 2: The Joint World Bank-IMF Debt Sustainability Framework for low-Income and Market-Access Countries

	Low-Income Countries *(Categorised base on Policy Ratings)*			Market-Access Countries	
Country Grouping	Weak Policy	Medium Policy	Strong Policy	Advanced Economies	Emerging Markets
Threshold Indicators					
Debt (as % of GDP)	30	40	50	85	70
Debt (as % of Exports)	100	150	200		
Debt (as % of Revenue)	200	250	300		
Debt Service (as % of Export)	15	20	25		
Debt Service (as % of Revenue)	18	20	22		
Bond Spreads				400 - 600	200 - 600
Change in Short-term Debt				1 - 1.5	0.5 - 1.0
Foreign Currency Debt (% of Total Debt)					20 - 60
Non-Resident-Held Debt (% of Total Debt)				30 - 45	15 - 45
External Financing Requirement (% of GDP)				5 - 15	17 - 25

Source: International Monetary Fund

The Evolving Issues on the Nigeria's Debt Profile

Nigeria's Public Debt is no Longer at Low Risk of Distress

For an economy facing revenue shortfall such as Nigeria's, borrowing is a healthy option as long as the government can repay its debt. Looking at the total public debt to GDP in 2016 at 17.3% and averaging 13.8% in the last five years, it appears government debt burden has more room to go higher as recently projected in the debt sustainability assessments. But peeking below the surface, other indicators of debt sustainability reveal that while Nigeria's public debt might still be at the moderate level, its trajectory is highly vulnerable to revenue shocks given the low revenue base and high debt service burden. As at 2016, debt-to-revenue was 360% and debt-to-export was 223%. These are pointers suggesting that debt crisis is possible if the current trends continue and that the harmful effects of debt on the fragile economic growth

are likely to kick in well before 30% debt-to-GDP threshold.

More worrisome is the rising debt service payments in the past few years. Between 2008 and 2016, the government has spent close to c.N6.9 trillion on debt servicing. The sum is almost 75% total budgeted capital expenditure within the same period and equivalent to the total capital funding requirement projected in the 2017-2019 MTEF. In 2017 budget, the debt service jumped significantly to 33% of revenue following its gradual build-up from 4% in 2008. This is far above the 22% threshold for developing economies. These are the effects of weak revenue base in the face of rising debts and servicing costs.

Excessive Domestic Borrowing in the Debt Structure is Creating Macroeconomic Distortions

The financing costs are sharply higher for domestic than external debt.

The financing costs of domestic debt in Nigeria has been more expensive than external financing. From 2008, the average yield on 10-year FGN bond has moved between 9% and 18%. At the current level of 15.9%, the FGN bond is perhaps the highest in the world and yet it is above rates obtainable in the US (2.4%), UK (1.1%), the Euro Area (0.45%), China (3.2%), Brazil (10%), Kenya (14.0), South Africa (8.7%) and Japan (0.9%). Not even a high-risk market as Venezuela, which has a 10-year bond yield of 10.4% could match up with Nigerian bond yield. The federal government has been unable to issue long-term securities at a reasonable interest rate at the Nigeria bond market. This has resulted in maturity mismatch for development projects, even far worse than currency mismatch that would have been created if the bulk of debt burden was external loan.

Table 3: Nigeria's Debt Sustainability Ratios

Indicators	Threshold	2008	2012	2014	2015	2016
Debt Stock						
Total Debt (% of GDP)	30-50	7	13	13	13	18
Total Debt (% of Exports)	100-200	27	60	87	142	223
Total Debt (% of Revenue)	200-300	36	85	112	182	361
External Debt (% of Oil Revenue)		7.6	12.7	24.0	55.1	144.6
Debt Service						
Debt Service (% of Export)	15-25	2.8	5.1	7.1	12.2	17.5
Debt Service (% of Revenue)	18-22	3.7	7.2	9.2	15.6	28.2
Debt Terms						
Ave. Grace Period on New External Debt (years)		9.8	8.0	4.9	4.9	
Ave. Maturity on New External Debt (years)		40.2	29.5	21.5	20.5	

Source: NESG Research and World Bank

...and given Nigeria's macroeconomic policy constraints, it is difficult to control rates in the debt market.

Domestic borrowing brings benefits only in the presence of an effective institutional and macroeconomic policy framework. Leaving it to provide 80% of deficit financing shows some dysfunctions in the debt management strategy. On the first note, considering that the CBN's monetary policy rule has always been anchored on inflation targeting, it may be difficult to control the rates in the domestic bond market. Besides, the current macroeconomic fundamentals cannot cope with distortions that domestic debt market has been creating. Indeed, countries with debt profiles worse than Nigeria's, but with clear macroeconomic policies will pay less attention to debt limits. For instance, Japan's debt is about 230% of its GDP, far beyond the 85% threshold set for market access countries. The domestic debt component has the largest share of the debt but different factors explain why it works out for Japan: The

Central Bank of Japan has kept the interest rate close to zero for a long period; debt is held by Japanese investors, especially public pension reserve funds; and not foreigners and the net financial asset position of the country is large.

On the second note, activities at the Nigerian bond market have been crowding out loanable funds to the private sector. By statutory provision, Nigerian banks are the biggest players in the local bond market. At such a lucrative rate that the Nigerian bond market offers, banks are incentivised to direct funds to the debt market. Undoubtedly, this is profitable for the banks, but only at the expense of lending to local businesses and improving financial inclusion.

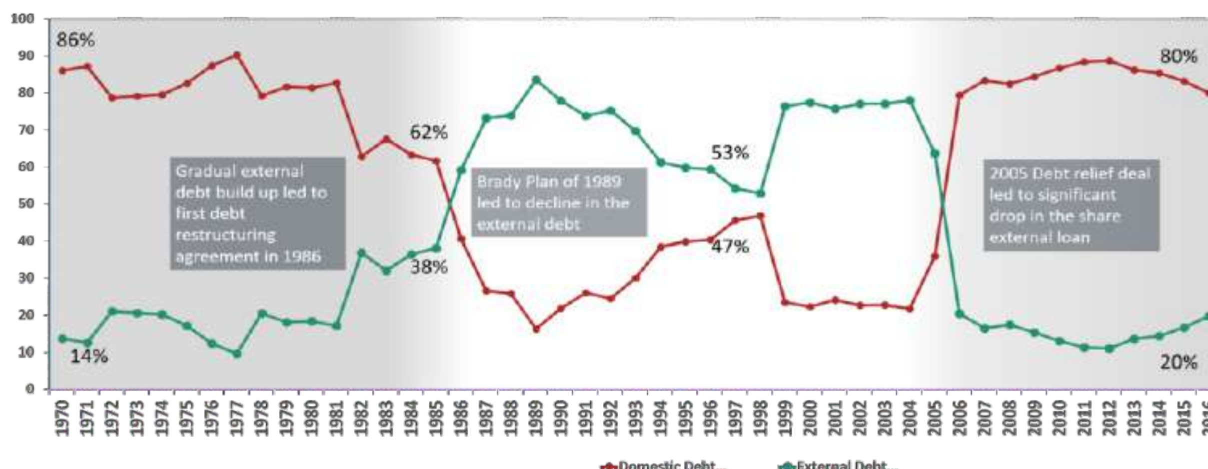
Increasing the share of external loan in the bulk of deficit financing requires cautious steps

Considering the high relative cost of domestic debt to that of the external debt market, the idea of rebalancing Nigeria's debt portfolio to have more share of external debt component is a welcome development from the government. Such initiative from the government would trigger double-barrelled effects on both the foreign exchange liquidity and cheaper source of deficit financing. Based on the analogy of the Two-Gap Model and considering the current realities of the Nigerian economy, reducing exchange rate premium is a dominant factor for Nigeria's economic recovery and growth. Addressing such constraint will have far-reaching impact on the economy faster than correcting the high cost of borrowing and misapplication of domestic savings created by the domestic bond market.

However, there is the need for government to be cautious about the type and terms of the external loan deal. Going for external loans is important. Yet the terms of external loan deals are also important. We notice that some of the recent external loan deals are veering more into commercial loans with high financing costs and short maturity. A review of new loan commitments of Nigeria's debt in recent years has shown that the average grace period on new external debt commitments in Nigeria has slipped to 5 years in 2015, from 10-year grace period just after debt relief deal in 2007. Whereas, an assessment of the sectoral allocation of external loan between 2011 and 2015 reveals that the bulk of external loans were used for long-gestation public infrastructure and social service projects ranging from Electricity (16% of total external loan), Road Transports (8.8%), Agriculture (9.8%), Rail Transport (8.8%), Education (6.0%) and water supply (5.8%).

Likewise, the sovereign bond has been popular with the Nigeria's external debt pursuit in recent years. The fact that the recently issued $1 billion Eurobond was oversubscribed is a good pointer to the interest of international investors in the Nigerian economy. Yet offering such bond at 7.8% would likely constitute a huge fiscal burden on Nigeria for the next 15 years – a step that defeats the purpose of securing the external loan. Also, not only do investment funds trail after high return on investment, sound macroeconomic fundamentals are also put into consideration. Assets prices have remained low in developed and emerging markets compare to the lucrative rate of 7.8% Nigeria had offered in the international bond market. If policy rate edges up in the global markets in the near term, it may be difficult for Nigeria to meet its external financing requirement, as the bulk of funds will be redirected to more safer markets.

Figure 2: Share of Domestic and External Debt



Source: CBN, Budget Office and NESG Research

Alternative Options to Deficit Financing

Despite the fact that Nigeria's debt sustainability assessment ratios are still below thresholds, government should avoid approaching them. This does not imply that government should actively pursue debt reduction policies. More importantly, Nigeria should avoid premature tightening of deficit financing to the possible extent, as any retrenchment of public debt could prolong the lingering economic recession. Even as government budget is facing revenue shocks, the financing needs will not decline. The scale of infrastructure and industrial development funds needed to diversify the economy underscores the level of loan capital flows expected in the economy. Nigeria's infrastructure deficit has been put at $3 trillion for the next 30 years. This suggests that N2.2 trillion allocated to capital expenditure in 2017 budget is a scratch in the surface of annual infrastructure investment. As an alternative to accumulating debt proportionally, it is imperative to exploit complementary financing option to fund development projects and get more mileage out of fiscal intervention.

The following are the imperative policy options

Increase the share of concessional loan in external debt stock

Given the high cost of domestic debt, seeking external financing at commercial rates may be harmful to the economy. Currently, 69% of the bulk of the Nigeria external debts are contracted on commercial terms, while the concessional loans hover around 31%. To avoid the risks of debt service overhang, a key initiative for Debt Management Office will be to find a way of contracting larger share of the external debt on soft terms. Multilateral and Bilateral loans are contracted far below market interest rates and are usually placed with long maturity periods. In recent time, both the federal and state governments have been enjoying some levels of infrastructure development partnerships on bilateral agreement basis. Such deal could be scaled up to fund the infrastructure projects. For instance, China Investment Corporation recently announced it will use about 40% of its

$200 billion overseas sovereign wealth fund to broaden its infrastructure investment in the US. Such opportunities could be considered to close the infrastructure gap in Nigeria.

In addition to rebalancing the public debt portfolio, it is imperative for government to reduce excessive refinancing of domestic debt. Given the recent improvement in government revenue, paying off domestic debt at maturity would achieve significant reduction in debt stock and improve the maturity profile of debt.

Develop Public-Private Partnership (PPP) Framework for financing infrastructure projects

The Nigerian government has not recognised the importance of harnessing PPP Model into development projects. Given the daunting limitations on government budget across all levels, private sector participation has become necessary in the delivery economic and social infrastructure without losing the essence of social value. There is no legislation which sets out the framework of collaboration between public and private sectors for infrastructure investments. The federal government can develop such policy framework, with clear guidelines on how the PPP model could be put into practice. With such intentions, the clause for PPP financing could take a certain share of deficit financing in the annual budget of Nigerian governments and the bulk of private capital chasing ailing government revenue with exorbitant interest rates in the capital market could be redirected to infrastructure funding.

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