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RISING PUBLIC DEBT IN ECOWAS ECONOMIC IMPLICATIONS

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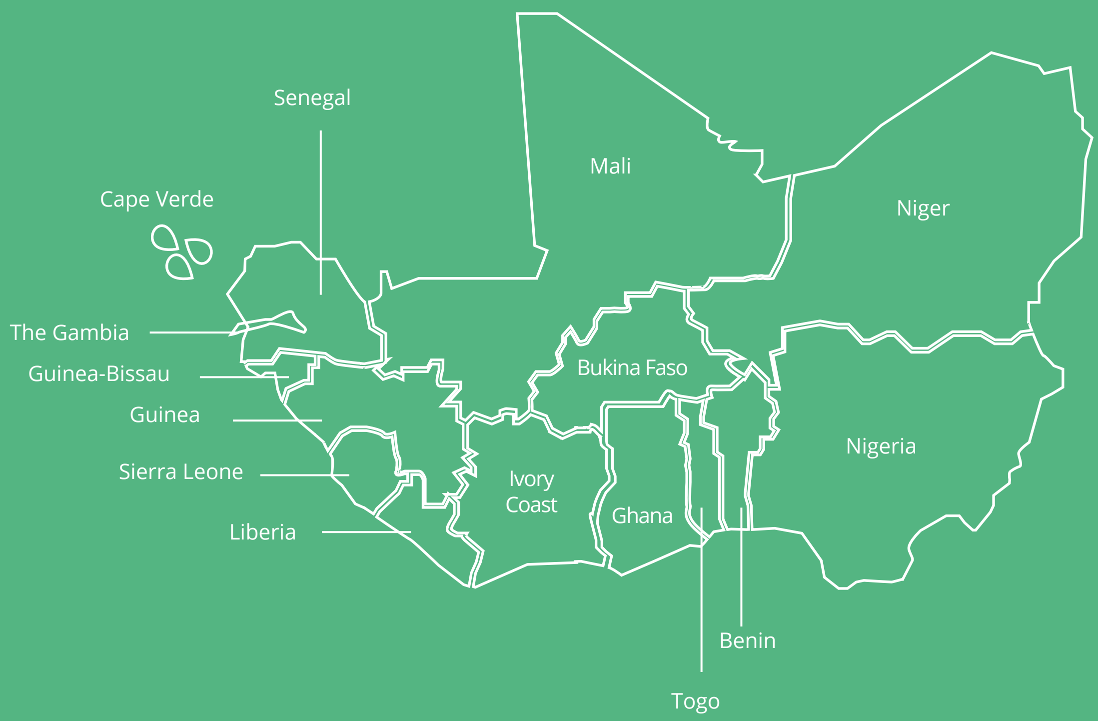

RISING PUBLIC DEBT IN ECOWAS ECONOMIC IMPLICATIONS

Executive Summary

The accumulation of public debt in ECOWAS is not a problem in itself; rather, its usage raises more concern. Theoretical postulations recognise the need for borrowing up to a certain level beyond which additional debts will be harmful to the economy. This study, therefore, provides answers to critical questions. The questions include (1) what is the impact of public debt on Economic Growth in ECOWAS; (2) is there is a non-linear relationship between public debt and economic growth in the region; (3) what are the factors that magnify the economic impact of public debt accumulation in the region?

Precisely, this study reveals that public debts have a negative impact on the ECOWAS economy, attributing this growth drag to Nigeria, which accounts for more than 50% and 67% of the region's total debt and GDP, respectively, in the region. The study also confirmed the existence of a non-linear relationship between public debt and economic growth. This suggests that an excessive rate of public debt accumulation is inimical to economic growth in the region. The key factors that magnified the negative impact of debt accumulation on the ECOWAS economy include state fragility/political instability, crowding out of private investment, resource curse and lack of compliance to fiscal rules by virtue of non-membership in a currency union. The study concludes that public debt should not be treated as an end in itself but as a means to an end. Therefore, this emphasises the need for public debt to be used judiciously and spent on revenue-generating and productive activities that would ensure debt servicing and the redemption of the debts at maturity.

1. Introduction

Against the backdrop of insufficient capital to finance developmental projects targeted at economic growth and future revenue growth, ECOWAS countries have resorted to exploring alternative financing sources deeply rooted in borrowing. But then, the level of debt accumulated by these countries have only landed most of them in debt distress, leaving them with no option but to seek debt re-negotiation and resolution. Following the debt relief initiative enjoyed by ECOWAS countries in 2005-06, the growth rate in debt accumulation is quite alarming. The region's public debts grew sharply from US$58.5 billion in 2005-06 to US$296.8 billion in 2020 – a fourfold increase in less than two decades. This is associated with an increase in the debt to GDP ratio from 26.3% in 2015 to 43% in 2020.

The fiscal environment in the region has been in an uninterrupted fiscal deficit for over a decade. Additionally, the COVID-19 pandemic occasioned an unprecedented budget deficit to a tune of 6.8% of GDP in 2020, against ECOWAS convergence of 3%. The anticipated impact of increased public spending on growth and future revenue has often been cited as the purpose for escalated borrowing. Though the economic growth reality across ECOWAS countries has been divergent, the general macroeconomic space has not reflected the upsides of the growing debt for most countries. Hence, there is a need to assess the impact of growing public debt on the economy of ECOWAS. This will provide more guidance on the extent to which debt accumulation has been beneficial to the region and its member-states.

2. How does Public Debt Impact the Economy of ECOWAS?

The conventional wisdom suggests that public debts promote growth to the extent that a country does not exceed its debt-carrying capacity. Otherwise, excessive debt accumulation would serve as a tax on future investment returns, creating a disincentive for investment in a highly indebted country (Adekunle et al., 2021). Though there is no direct link between debt (external or domestic) and growth, a possible transmission mechanism has been identified through the investment channel (see Pattillo et al., 2004; Adekunle, 2018).

Empirical evidence from a standard growth regression revealed that debt accumulation constitutes a key driver of economic growth in ECOWAS . Nevertheless, debt accumulation has a negative impact on growth in the ECOWAS region. This is as suggested by the dominating influence debt to GDP, external debt to GDP and external debt to export ratios among the five debt indicators. The results indicate that every 10 percentage point increase in public debt to

GDP, external debt to GDP and external debt to export ratios reduces regional growth, on average, by 0.4, 0.48 and 0.01 percentage points, respectively. By implication, uncontrolled accumulation of public and external debts is inimical to regional growth, particularly when such debts are not put into productive use.

These findings do not directly translate to the fact that public debt is bad, given that ECOWAS countries have often attributed their debt accumulation to increased public investment in infrastructural development, which should support growth. The findings suggest the need for ECOWAS countries to conduct a reassessment of the value-added from debt accumulation and the associated macroeconomic implications and efficiency of the resource management system in each country. The findings further suggest that the region has a debt carrying capacity, which varies across member countries, given some characteristics specific to each country. The downside macroeconomic impact of debt level way above the debt carrying capacity could rub off on the gains from the extra debt incurred. Hence ECOWAS countries need to be wary of compounding fiscal and economic burden by indiscriminately expanding public debt.

3. Does Non-linearity Matter in the Way Public Debt Impact the Economy of ECOWAS?

A number of studies have investigated the validity of two recurring theories in the development economics literature: debt overhang theory and the crowding-out effect hypothesis. The debt overhang theory suggests a non-linear relationship between public debt and economic growth, indicating that public debt enhances output growth at lower levels but has a contractionary effect if accumulated excessively beyond an optimal level (Jarju et al., 2016). The optimal level of debt is the maximum debt carrying capacity of a country beyond which it experiences investment cuts and consequently a shortfall in output growth. On the other hand, the crowding-out effect hypothesis holds that large debt accumulation may stifle economic growth through lower investment. In this way, debts would be beneficial to investment to a certain threshold, beyond which excessive leverage will start to constrain the gross capital formation or the rate of capital accumulation (Banayed et al., 2015).

Findings from an empirical analysis suggest ECOWAS runs a high risk of debt overhang problem . The findings support the existence of the debt Laffer curve, which shows an inverted U-shaped relationship between debt accumulation and economic growth with respect to debt service to revenue ratio. Though the non-linear effect is not significant, the adverse impact of uncontrolled debt accumulation by ECOWAS countries on regional growth cannot be overemphasised, considering the weak local resource mobilisation across ECOWAS countries. The insignificance of the non-linear effect term could be partly due to considerable progress that some member states have made in tax revenue mobilisation. However, others still find it challenging to improve tax collection in their domains. For instance, Nigeria accounts for over half of ECOWAS' total debt portfolio in the region but has the lowest revenue mobilisation capacity of about 6.3% revenue to GDP ratio in 2020.

Besides, the susceptibility of most ECOWAS economies to commodity price volatility and terms of trade shocks magnifies their debt repayment risks with huge pressure on their meagre resources. This particular finding is a clarion call on member states to be conscious of their solvency thresholds or debt distress level so that they would not be immersed in a debt trap and debt overhang problem going forward.

Furthermore, the debt overhang theory is validated for 9 out of the 15 ECOWAS members . This, therefore, proves the point that regional growth is indeed a decreasing function of the level of debt. By implication, uncontrolled debt accumulation would only streamline development projects in many member countries as their revenues would be otherwise spent on servicing their growing debt stock.

[1] NESG (2022). Debt Management, Restructuring and Sustainability in ECOWAS. See Appendix 1

[2] The list includes but is not limited to Pattillo et al. (2002; 2004), Clements et al. (2003), Schclarek (2005), Osinubi and Olaleru (2006), Checherita and Rother (2010), Tuffour (2012), Dogan and Bilgili (2014), Forgha et al. (2014), Mupunga and Roux (2015), Jarju et al. (2016), Omotosho et al. (2016), and Ebi and Imoke (2017), Adekunle (2018).

4. Factors that Magnify the Negative Impact of Public Debts on the ECOWAS Economy

Empirical findings from this study contradict the conventional wisdom that public debts should promote growth. The findings affirm the existence of the debt Laffer curve for ECOWAS, which suggests ECOWAS countries have debt-carrying capacity. Beyond this level, the impact of an additional debt become negative on the economy. The following factors potentially magnify the negative impact of debt on the ECOWAS economy. Also, these factors are responsible for the hastening the attainment of negative marginal returns additional debts.

» ***Debt accumulation substantially crowds out private investment in ECOWAS.*** This study revealed that uncontrolled debt accumulation would lead to a reduction in gross capital formation in ECOWAS. This is because prospective creditors and investors price down the sovereign and investment ratings of highly leveraged member states. Estimates show that every 10 percentage point increase in external debts (% of GDP) and external debts (% of exports) slows down regional growth by an average of 0.03 and 0.01 percentage points, respectively, via the investment channel . This is corroborated by the weak positive correlation between gross capital formation and each of the five debt indicators .

» ***The group of middle-income class countries plays a crucial role in reinforcing the adverse growth effects of debt accumulation in ECOWAS.*** Middle-income class ECOWAS economies (especially Nigeria) constitute a drag on regional growth due to their relatively large economic sizes; however, they have a weak country-specific growth trajectory. Empirical findings from this study showed that debt accumulation ignites a deceleration in regional growth while accounting for middle-income class status in the debt-growth regression.

» ***The Resource-curse phenomenon has taken its entire course in ECOWAS, with resource dependence magnifying the region's negative growth impact of debt accumulation.*** This study offered evidence of a resource-curse hypothesis, as resource dependence constitutes a drag on the rate of acceleration of regional growth . This finding cannot be dissociated from the huge presence of Nigeria's economy as the largest crude oil exporter in ECOWAS. Also, Liberia is one of the region's largest exporters of gold, iron ore and rubber. This suggests the urgency for economic diversification in resource-dependent ECOWAS economies , as the debt-growth nexus in these countries are tied to the performance of resource sectors.

» ***State fragility undermines the growth effects of debt accumulation in ECOWAS.*** This study found that the region's conflict zones impose huge constraints on regional growth relative to politically stable members. Uncontrolled debt accumulation to wage war against terrorism and incessant civil conflicts would rather rob these countries of resources that could have been put into productive uses. Hence, there is a negative growth impact of debt accumulation through the conflict channel. The study showed that a 10 percentage points increase in regional debts would slow down average growth in ECOWAS by -0.75 to -0.16 percentage points.

» ***Currency union membership plays a key role in enhancing the growth impact of debt accumulation in ECOWAS.*** While accounting for the role of a monetary union (the 8 members' West African Monetary Union - WAEMU), the estimates from this study showed that a 10 percentage points increase in regional debts would push up average growth in ECOWAS up by 0.32 to 0.66 percentage points . This result suggests that some fiscal rules and convergence criteria unconditionally bind WAEMU member states to ensure efficient fiscal management and improve debt outcomes in the bloc relative to the non-WAEMU bloc.

[3] NESG (2022). Debt Management, Restructuring and Sustainability in ECOWAS. See Appendix 2

[4] NESG (2022). Debt Management, Restructuring and Sustainability in ECOWAS. See Appendix 9

[5] NESG (2022). Debt Management, Restructuring and Sustainability in ECOWAS. See Appendix 3

[6] The coefficients of correlation between gross capital formation (i) and public debt (% of GDP); (ii) and external debt (% of GDP); (iii) and external debt (% of exports); (iv) and total debt service (% of exports); and total debt service (% of revenue) are estimated at 0.26, 0.20, 0.01, 0.13 and 0.14, respectively (Source: STATA 2015 Output).

[7] NESG (2022). Debt Management, Restructuring and Sustainability in ECOWAS. See Appendix 4

[8] NESG (2022). Debt Management, Restructuring and Sustainability in ECOWAS. See Appendix 5

[9] Other resource-dependent countries in ECOWAS are Burkina Faso, Ghana, Guinea, Mali, Niger and Sierra Leone.

[10] The countries in question are Côte d'Ivoire, The Gambia, Guinea, Guinea-Bissau, Mali, Sierra Leone and Togo.

5. Conclusion

Due to finance deficiency for developmental projects targeted at economic growth and future revenue growth, ECOWAS countries have borrowed heavily, with debts now at unsustainable levels. Hence, Hence, this study set out to assess how growing public debt impacts the ECOWAS economy. Against conventional wisdom, this study found that debt accumulation constitutes a key driver of economic growth in ECOWAS; however, debt accumulation has a negative impact on growth in the ECOWAS region. This suggests that public debt accumulation in the region has not been supportive of growth. Worthy to note that the findings do not directly translate to public debt is bad; rather, ECOWAS countries need to reevaluate the value adds from additional debt accumulation alongside the macroeconomic implications. Also, the findings revealed that ECOWAS exhibit non-linearity in the debt-growth relationship; as such, uncontrolled debt accumulation would only magnify the negative outcome from growing debt. In addition, this study identified factors such as the crowding-out effect, resource-curse hypothesis, state fragility, among others, as the magnifiers of the negative debt-growth relationship. Hence, ECOWAS countries need to pay critical attention to the progression and management of their debt to ensure the additional debt is not yielding a negative outcome for the economy. There is the need for public debt to be used judiciously and spent on revenue-generating and productive activities that would ensure timely debt servicing and redemption at maturity.

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[11] NESG (2022). Debt Management, Restructuring and Sustainability in ECOWAS. See Appendix 6.

[12] NESG (2022). Debt Management, Restructuring and Sustainability in ECOWAS. See Appendix 7. Also, the WAEMU countries include Benin, Burkina Faso, Côte d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo. The non-WAEMU countries, on the other hand, are Cabo Verde, The Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone.

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ABOUT THE DMR

The Debt Management Roundtable (DMR) on debt restructuring and social financing was instituted in March 2021 by the Nigerian Economic Summit Group (NESG) with the support of the Open Society Initiative form West Africa (OSIWA). The Roundtable is expected to provide insights, evidence and recommendations on debt management and sustainability, with a view to engaging policymakers on debt restructuring and social financing in the West African region, using Nigeria as a case study. Public debts in ECOWAS have spiralled upwards more than four folds since the debt relief period (2005-2006).

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