SPECIAL POLICY BRIEF

SPILLOVER EFFECTS OF PUBLIC DEBT CRISIS AMONG ECOWAS COUNTRIES

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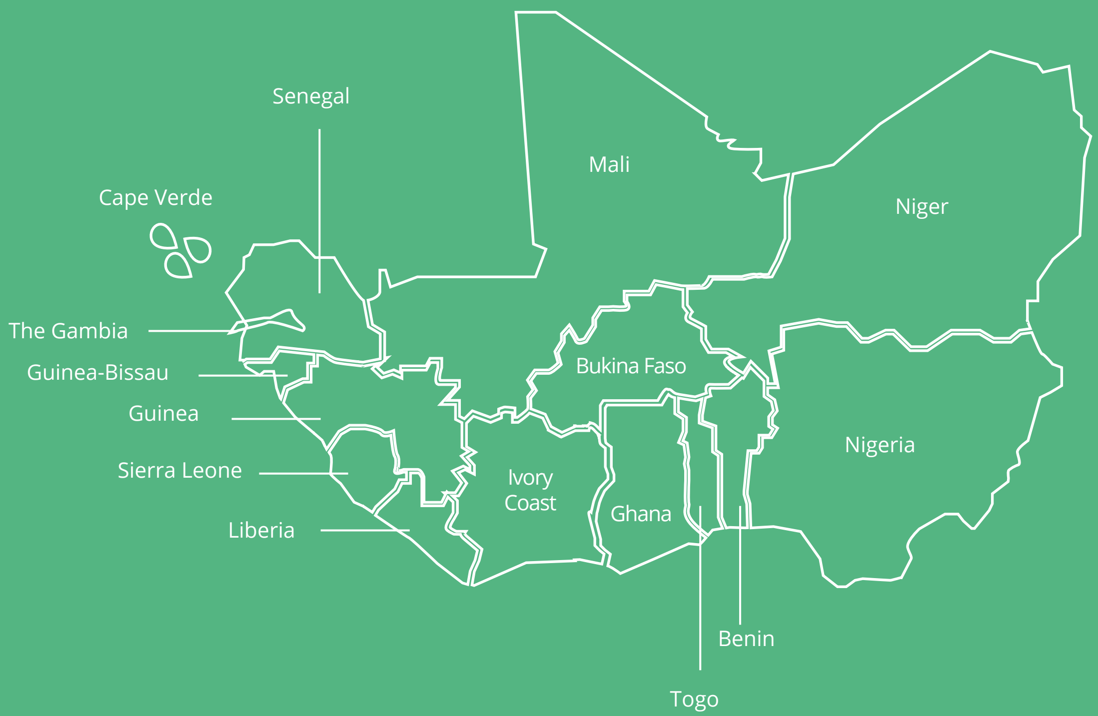

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SPILLOVER EFFECTS OF PUBLIC DEBT CRISIS AMONG ECOWAS COUNTRIES

Executive Summary

The public debt profile of all ECOWAS countries has increased tremendously, particularly following the outbreak of the COVID-19 pandemic, which lowered government revenue amidst associated spending pressure. Hence, the concerns about the pace of public debt being unsustainable for many ECOWAS countries become elevated, especially as the ability to service and repay debt becomes challenging. Whilst the accumulation of public debt is not all bad, excessive public debt over and above a certain level permissible by the economy's fundamentals could degenerate into a "Public Debt Crisis" with economy-wide implications. With the growing integration among countries, a debt crisis in one country in the region could be transmitted to neighbouring countries and cause macroeconomic instability. With Nigeria's role in the region in terms of economic size, debt component, and trade, a debt crisis in Nigeria could destabilise other countries in ECOWAS. Hence, this study assessed the spillover effects of public debt crises in Nigeria on other ECOWAS countries.

This study identifies four pathways via which the public debt crisis will likely spillover into other countries: trade, financial, commodity price, and policy channels. While existing data suggest ECOWAS countries are heavily exposed to other regions in Africa and the rest of the world through the channels, the largest economy in the region could generate regional economic spillovers to neighbouring countries. Using Nigeria as a utopia for the public debt crisis in the region, the results show that key regional trading partners would experience a contraction in economic growth but at low intensity. Similar effects are observed with the performance of other key macroeconomic variables such as exchange rate, inflation, imports, and exports of economies in the region.

1. Introduction

In the aftermath of the collapse of global commodities prices and the COVID-19 pandemic, the public debt profile of all ECOWAS countries has increased tremendously. In just a decade, the region's total public debt increased steadily from US$89 billion in 2010 to US$296.76 billion in 2020, with an average annual growth of 13.6%. Therefore, the public debt to GDP ratio rose from 17% in 2010 to 43.5% in 2020. The aftermath of the COVID-19 pandemic, lower government revenue amidst associated spending pressure has contributed immensely. Hence, the concerns about the pace of public debt being unsustainable for many ECOWAS countries become elevated, particularly due to ensuing challenges with repayment and debt servicing.

Whilst the accumulation of public debt is not all bad, excessive public debt over and above a certain level permissible by the economy's fundamentals could lead to a problematic situation and degenerate into a "Public Debt Crisis". The economy-wide implications of a public debt crisis include macroeconomic instability, constrained fiscal space, private crowding out effects (real sector investment and capital inflows), financial and capital market distortion; foreign exchange risk exposure; and inflationary risks. With a debt service to revenue ratio between 50% and 100%, the government has virtually nothing left to spend on the economy after debt service is deducted from revenue. This suggests the imminence of a potential public debt crisis in the ECOWAS region.

Beyond the impact on the local economy and with the growing integration among countries, the possibility of a debt crisis in one country in the region could cascade into chains of effects on the macroeconomic stability of other economies (see Robe, 2003; Berument et al., 2012). Particularly with Nigeria's role in the region in terms of economic size, debt component and trade, the fallout from a debt crisis in Nigeria could have a destabilising impact on other countries in ECOWAS. Hence, this study seeks to understand the spillover effects of public debt crises in Nigeria on other ECOWAS countries.

2. Channels of Transmission of Public Debt Crisis Shocks in ECOWAS

The relative achievement in ECOWAS drive for regional integration in trade, cross-border expansion of banks, financial markets integration, customs and monetary unions have increased the possibility of the spillover of a public debt crisis in the region. On this basis, there are four pathways that a regional or country-specific public debt crisis could spillover into other countries: trade, financial (Banking Sector or Banks' Balance Sheet, foreign capital inflow), commodity price, and policy channels.

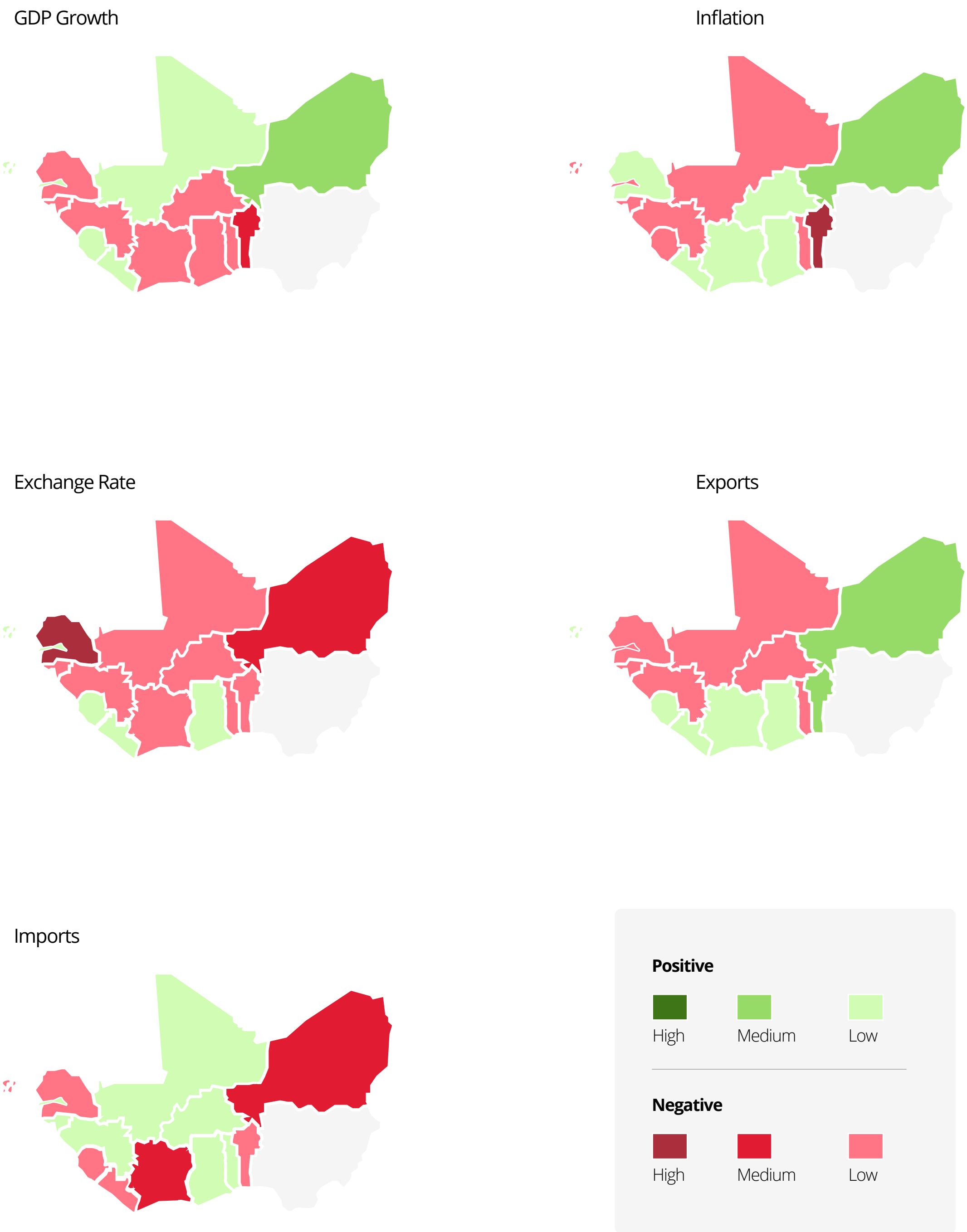
2.1 Trade Channel

Trade plays a pivotal role in the economic development and regional integration in Sub-Saharan Africa and is an important channel for transmitting macroeconomic shocks, especially growth spillover (Kose and Riezman, 2001; Norris et al., 2015; Arizala, 2018). However, existing data indicated that ECOWAS countries are heavily exposed to other regions in Africa and the rest of the world through trade (IMF, 2021). Notwithstanding, Forbes and Chinn (2004) confirm the possibility of regional economic spillovers from the largest economy in the region to neighbouring countries. Hence, an economic crisis in Nigeria would create a significant rip-off on the macroeconomic performance of close neighbours such as Niger, Togo, Benin Republic and key trading partners like Ghana, Cote d'Ivoire, and Senegal.

The contagion effects of a public debt crisis in Nigeria will trigger macroeconomic fluctuations in the region except for Guinea and Cabo Verde. Although, it appeared that most WAEMU countries are exposed to Nigeria. This is due to the significant reliance on Nigeria for imports of crude oil and other petroleum products, and these products top the trade list of most countries in WAEMU. Similar effects are anticipated if public debt crisis induced macroeconomic fluctuations occur in Senegal, Ghana, Cote d'Ivoire and Togo. Thus, a transmitted macroeconomic shock from the strongest economies and topmost trade partners in Nigeria, Ghana, Senegal, and Cote d'Ivoire would create significant changes across the region. This is especially the case with WAEMU countries with a high intra-trade connection with one another.

A cross-country contagion of the public debt crisis from Nigeria shows that key regional trading partners would experience a contraction in GDP growth but at low intensity. However, the impact intensity would be higher for the Benin Republic, whose real sector is closely tied to the Nigerian economy. Also, countries within the Gulf of Guinea will be negatively impacted directly or indirectly via the trade channel.

Figure 1: Illustrative Impact of Public Debt Crisis in Nigeria on Other ECOWAS Via Trade Channel



Source: NESG Research

2.2 Financial Channel

Financial linkage is also an effective transmission channel of a public debt crisis among countries in the same region. Although, financial spillovers are opined to be small among ECOWAS countries. This position may be due to the relatively underdeveloped financial system of many economies in the region. There are three potential financial linkages that a public debt crisis could be transmitted among countries: banks' balance sheets, remittance and foreign capital spillover channels.

The increasing cross-border expansion of banks in the region has deepened the economic integrations and likelihood of macroeconomic spillover among ECOWAS countries (Beck et al., 2014; Claessens and van Horen, 2014). Also, there is an increase in the cross-border capital market listing for commercial banks such as ECOBANK, Stanbic IBTC and others. This will increase the intensity of financial shock transfers among economies in the region, especially from Nigerian banks with footprints and a significant share of banking industry assets in ECOWAS (see Box 1). Nigeria is the country of origin of many regional banking groups in ECOWAS, except for Ecobank, with headquarters in Togo but the largest operation and shareholding still in Nigeria.

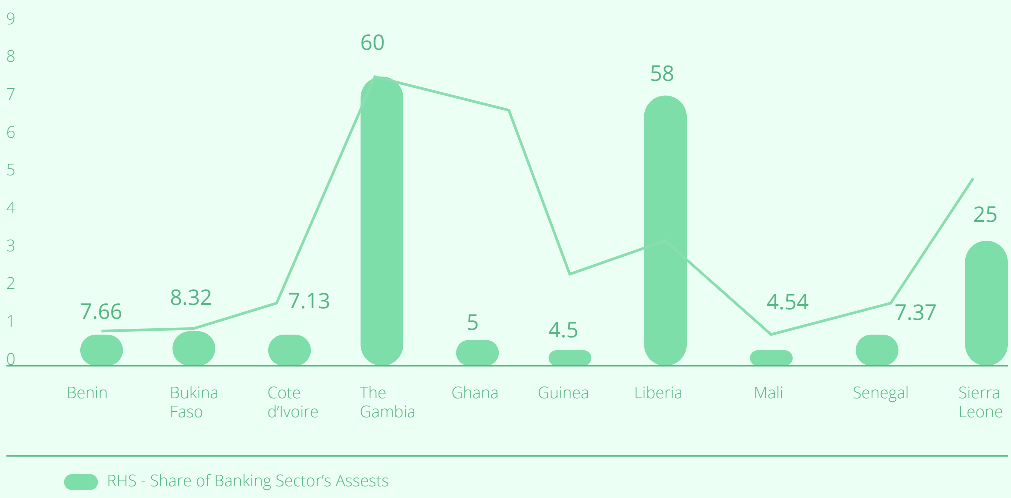
A public debt crisis in Nigeria would occasion a bank crisis and erode the quality of most banks' balance sheets. These effects are transmitted to other countries in the region through the regional banks, where they have operations. Since banks have a strong tie with the real sector of countries where they operate, a banking crisis in the banks' country of origin, which restrains the supply of credit to the private sector, would adversely affect growth in other countries. In summation, a public debt crisis in Nigeria would result in a banking crisis which would adversely affect Gambia, Liberia, and Sierra Leone as Nigerian banks account for a substantial share of these countries' banking sector's assets and deposits. WAEMU countries such as Benin, Burkina Faso, Cote d'Ivoire, Senegal, and Togo will also experience mild public debt-induced shocks from Nigeria. Ghana and Guinea would also experience similar spillover effects.

The gainers from a public debt crisis in Nigeria would be Attijariwafa and Standard Bank Group, with their major operations outside the region but with an extensive foothold across ECOWAS countries. The other two linkages – remittance and foreign capital spillover channels appear less significant and negligible. Intra-regional FDI flows are estimated to be below 5% of the total foreign capital inflows into the region (ECOWAS, 2019). A similar situation applies to remittance inflows among countries in the region.

BOX 1: Cross- Border Expansion of Nigerian Bank across ECOWAS countries

Nigeria is an important market destination for the purchase of goods and services for many businesses and households in neighbouring countries in the region. As a result, there are substantial trade financing and payment opportunities for Nigerian banks, and these are some of the reasons for the increasing cross-border expansion in recent times. Thus, many Nigeria-based banks are systematically important to the financial system of these countries, and a shock to the Nigerian financial system would be transmitted via impacts on these banks' balance sheets.

Figure 2: Nigerian Banks in Other ECOWAS Countries – 2019



N:B Countries in the figures greater than 2 percent and above are considered to have a high trade exposure to region
Source: BCEAO & other Central Banks Annual Reports; NESG research

2.3 Commodity Price Channel

Empirical studies and trade statistics on West Africa have shown that most countries are net importers of manufactured goods. Interestingly, there is a strong cross-border trade link among ECOWAS countries, especially trade in grains, livestock, and other primary products such as refined petroleum products. In effect, inflation spillover via changes in commodity prices is significant among countries in the region. Also, inflation problems resulting from public debts could cause spillovers to neighbouring countries (World Bank, 2014). For illustration, a substantial proportion of refined petroleum products consumed in Benin Republic, Niger, and other Central African Countries like Chad and Cameroun are imported from Nigeria (World Bank, 2014). Also, landlocked countries - Mali and Gambia, rely heavily on manufactured imports from neighbouring countries (UNCTAD, 2019).

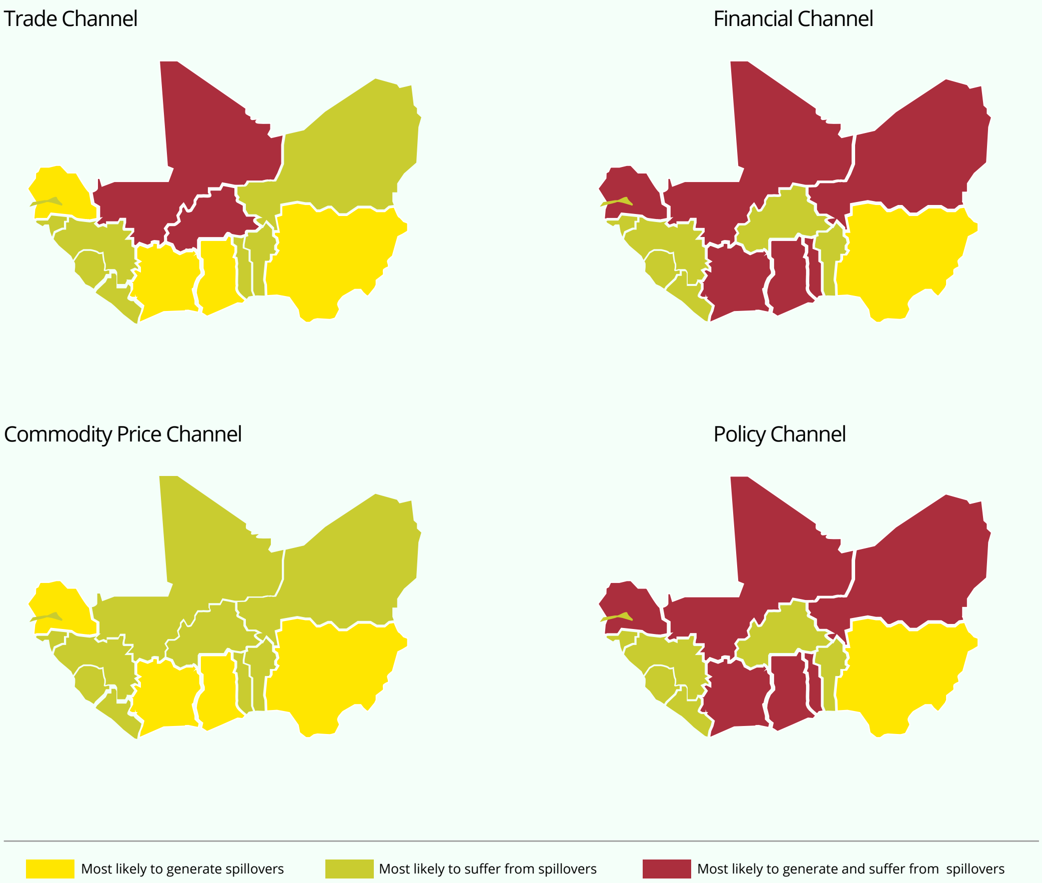
2.4 Policy Channel

In Custom, Currency, and Monetary Unions like ECOWAS, many empirical studies have established the transmission of monetary and fiscal policy shocks. Also, regional and international shocks or spillover from domestic spending and monetary policy impulses on growth and other macroeconomic indicators are positive and persistent in the short-term, mostly peaking in the second year (Corsetti and Muller, 2013; and Faccini et al., 2016). During a public debt crisis, budgetary spending and monetary policy adjustments usually generate significant externalities for other countries

Following a debt crisis, fiscal and monetary policy austerity measures are directly felt by countries in the WAMZ economic bloc and all countries sharing borders with the country, such Niger, Benin Republic, and others. For example, Nigeria's recent border closure resulted in poor export and heightened inflation in countries such as Ghana, Togo, Benin Republic, and Niger. In case of a public debt crisis, more stringent monetary policy and fiscal policy decisions may hurt the economic activities of countries in the region, especially in countries sharing borders with Nigeria. In addition, Nigeria's adoption of protective trade policies to limit the impact of the debt crisis will hurt the domestic economies of countries in the region. The price level will rise, and production will diminish as exports and entreport to Nigeria reduce. Thus, disturbing these countries' trade and financial sectors.

The foregoing validates the possibility of a public debt crisis transmission from one country to another in the ECOWAS region. Also, there are three categories of countries concerning shock transmission in the region. The first category includes countries likely to generate spillover effects – Nigeria, Ghana, Senegal, and Cote d'Ivoire. Some countries would suffer from the spillover effects. Meanwhile, the last category can suffer and generate spillover effects. Figure 3 presents a schematics of transmission of shocks among ECOWAS countries, with Nigeria only able to generate spillover across all channels.

Figure 3: Channels of Public Debt Crisis Spillover in ECOWAS



Source: NESG Research

3. Conclusion

With the growing integration among ECOWAS countries, the possibility of a debt crisis in one country could impact the macroeconomy of other economies. Hence, this study seeks to analyse the spillover effects of public debt crises in Nigeria on other ECOWAS countries. This study identified four channels of transmission of a public debt crisis in Nigeria to other ECOWAS countries: trade, financial, commodity price, and policy channels. While trade data suggest ECOWAS countries trade more with other African regions and the rest of the world, there is a possibility of regional economic spillovers from the largest economy, like Nigeria, to neighbouring countries through trade. The increasing cross-border expansion of banks and capital market listing of commercial banks has increased the intensity of financial shock transfers among economies in the region. With Nigeria being the major oil exporter and other re-exportation to ECOWAS countries, inflationary shock from a public debt crisis could trigger macroeconomic instability among ECOWAS countries. Likewise, policy actions in response, especially with austerity, to debt problems could also transfer shock from Nigeria to other countries in the region. But then, the trade and financial channels are the most vital transmission channels of a public debt crisis in the region.

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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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