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Federal Government Debt Rebalancing Strategy: Is it a Policy Path for Sustainable Debt Management?

Olumuyiwa, Yinusa, PhD
Chukwuemeka Onyimadu

Key Findings and Recommendations

- Government intends to rebalance her debt profile, favouring external borrowing to domestic borrowing.
- External borrowing is cheaper and long term, with the benefit of putting less pressure on domestic interest rates and encouraging more loanable funds for private sector investments.
- However increasing private sector investments is not automatic. There are other detrimental influences over interest rate other than government's domestic borrowing, which have to be managed.
- With regard to external borrowing, the risk of unfavourable exchange rate fluctuations increasing the external debt repayment burden (concerns on reserve management).
- Given the antecedents of past government's external debt management strategy, the use of external borrowing must be tied to projects that can either earn foreign exchange or reduce the need for foreign exchange in domestic production process. The projects must be viable and productive.
- The government may need to produce intergenerational equity report to detail the implications of the current proposed debt financing on future generations of Nigerians
- Voluntary Asset and income declaration scheme (VAIDS) and Value added Tax may be aggressively pursued as sources of tax revenue to finance government budget as against debt financing
- Recovered loots may also be utilized to finance the budget rather than domestic and external borrowing.

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I. Overview

1. One of the major challenges facing the Muhammed Buhari led Federal government like previous governments is the issue of huge budget deficit financing. The 2018 Budget just like other previous budgets is premised on oil revenue. Other sources of financing in the 2018 budget include domestic and foreign loans. The Federal government has explored the domestic debt financing sources through Domestic Bank loans, issuance of bonds as well as FGN Treasury bills. The Treasury bills are usually short term sources of debt financing with maturity period of 60 to 90 days.
2. In the budget speech presented by President Muhammadu Buhari, at the joint session of the National Assembly on the 7th of November 2017, the president indicated his regime's medium term strategy of rebalancing the country's debt profile. The strategy is to reduce the proportion of domestic debt by 60% by the end of 2019 and increase external debt by 40%. The reasons proffered for the strategy are; enhancing private sector credit, reduction of annual debt service costs as external debts are cheaper (lower interest rates) and are repaid over a longer period compared to domestic debts. In this brief, we critically appraise the implications of the government medium term debt rebalancing policy and strategy on the domestic credit market and the private sector. This is done with the view to offer possible policy paths that will ensure the government's proposed debt rebalancing strategy provides positive outcomes and sound debt management.

II. What is the Issue?

3. There exist the possibility of domestic borrowing by the government to put pressure on interest rates and reduce private sector's access to loanable funds. This is explained by the "Crowding Out" effect. Here, when government is interested in expansionary fiscal policy, the government may demand more loanable funds from the domestic economy, leaving lower amounts of loanable funds for the private sector and driving interest rates upward. Thus, Governments expansionary fiscal policy, if funded from the domestic economy, may "crowd out" investments that are private sector driven.
4. Historical data on credit to both private sector and the government clearly shows that, though credits to both private sector and government are on the increase, credit flow to the private sector is far higher than credit flow to the government, in absolute terms. Nonetheless, prior to 2015 (2010 - 2014), the average growth rate of credit to the private sector was 1.06% while the average growth rate of credit to the government was 4.15%. From 2015 onwards, this average growth rates fell significantly to 0.61% and 0.07% for private sector and government

respectively. This clearly indicates the government's intentions of reducing her borrowing from the domestic economy.

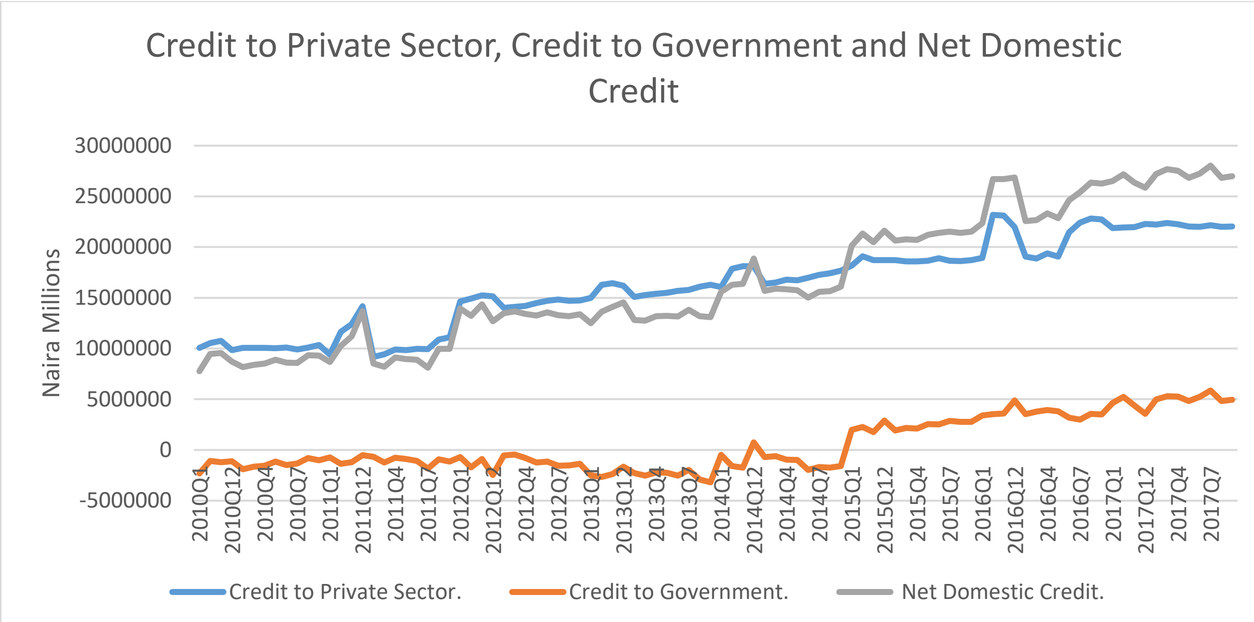

Figure 1: Credit to Private sector, Credit to the Government and Net Domestic credit
Source: Central Bank of Nigeria.

5. Rebalancing governments borrowing from domestic sources to external sources, implicitly implies that there should be more loanable funds for the private sector, which is expected to induce private sector driven investments and put less pressure on the domestic interest rates. However, this process is not automatic. Availability of loanable funds as well as access to these loanable funds are important factors in boosting credit to the private sector. High cost of credit can be detrimental in encouraging credits to the private sector. Deposit Money Banks (DMBs) as a convention, use the monetary policy rate (MPR) plus a mark-up as a basis for determining their lending rates to the private sector. The value of this mark-up determines how high the lending rates will be. Currently, prime lending rates are 371 base points higher than the MPR and the maximum lending rate is 1699 base points higher than the MPR (figure 2).

6. The data on lending rates clearly show that, the dispersion between MPR, prime lending rates and maximum lending rates does not depend on the movements of the MPR. For example, in table 1 we show that large movements by base points (bp) in the MPR do not have corresponding movements (both in direction and magnitude) for both prime lending rates and maximum lending rates. In 2015Q10 – 2015Q11, the MPR fell

by 200bp, and the prime lending rate and maximum lending rates increased by 14bp and 1bp respectively. On the other hand, in 2016Q2 – 2016Q3, the MPR increased by 100bp, and the prime lending rate and maximum lending rates increased by 10bp and 20bp respectively. The movements in both prime lending rates and the maximum lending rates clearly show that other extraneous factors, apart from the MPR and governments borrowing from the domestic economy serve as important determining factors. It is these extraneous factors that contribute to the high dispersion between the MPR and lending rates, thereby making access to credits by the private sector expensive.

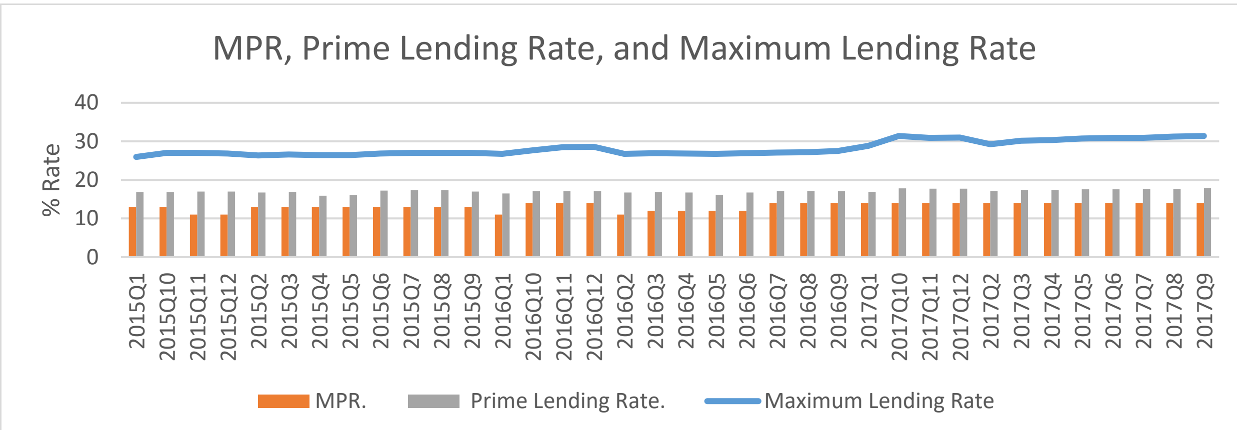

Figure 2: Trend in Monetary Policy Rates
Source: Central Bank of Nigeria.

Period	MPR (%)	Base Point Changes	Prime Lending Rate (%)	Base Point Changes	Max. Lending Rate (%)	Base Point Changes
2015Q10	13	Reduced by 200 base points	16.84	Increase by 14 base points	27.01	Increase by 1 base point
2015Q11	11		16.98		27.02	
2016Q2	11	Increase by 100 base points	16.72	Increase by 10 base points	26.73	Increase by 20base points
2016Q3	12		16.82		26.93	
2016Q6	12	Reduced by 200 base points	16.78	Increased by 36 base points	26.93	Increased by 13 base points
2016Q7	14		17.14		27.06	

Table 1: Base Point changes for MPR, Prime Lending Rates and Maximum Lending Rates for selected years.
Source: CBN and Author's computation.

7. Most of the money deposit Banks could not provide low priced credit to the private sector particularly small and medium size businesses in the manufacturing sector that has capacity to generate jobs. The reason for the high cost of credit is not far fetch. It stems from the harsh business environment where banks operate that is

characterized with high risk, high operational cost couple with high inflation rate. Businesses in the private sector would not be able to thrive under this kind of condition and new businesses may not have access to finance from the formal financial sector to kick start their businesses. The current tightening monetary policy by the CBN is equally capable to depress aggregate demand and adversely affect credit delivery and heightened the already weak investment climate and non-performing loans.

III Should Government Continue to Borrow Externally Despite Rising External Debt Stock?

8. With government's intentions of leaning more towards external borrowing, it is expected the Nigeria external debt stock may rise significantly. There are no strong evidence and indications that suggest that past external government borrowings have been deployed for productive use. Borrowed funds may be easily mismanaged due to corrupt practices, poor institutional quality and presence of extractive institutions that promote corruption Investments in projects that were not viable and yield inadequate returns may also account for poor performance of external debt by government. An indication of mismanaged external borrowing may be evidence in the continuous increase in the external debt stock overtime. The data on external debt stock and growth rates of external debt stock clearly shows rising external debt stock position of Nigeria. We divide the data on external debt stock into two periods; 2000 – 2004 and 2006 – 2017. We ignore the periods 2005 and 2006 due to the experience of debt forgiveness.

9. The trend in both external debt stock clearly show that Nigeria's external debt is increasing. Since after the debt forgiveness in 2005 and 2006, Nigeria's external debt stock has increased by 14.7% (figure 3).

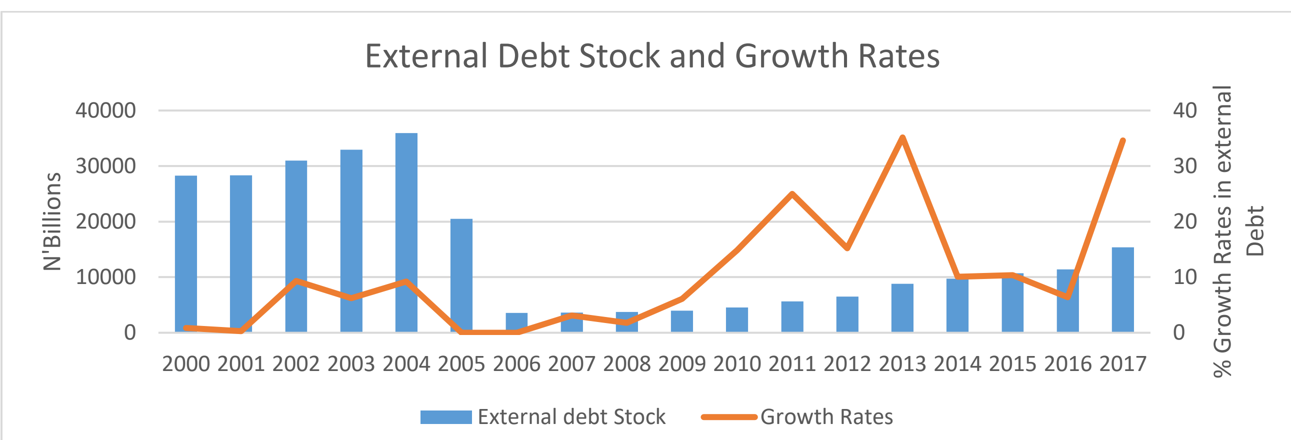

Figure 3: Trend in External Debt Stock and Growth Rates, 2000 – 2017

Sources: Debt Management Office.

10. We also looked into the data by categorising the data into periods; 2000 – 2004 representing periods that can be categorise as high mismanagement of external debts, 2006 – 2011 representing debt forgiveness and periods of high crude oil prices, and 2012 – 2017 representing change in the structure of the economy (specifically a change in government and recession). The data shows that the growth rates of external debt stock prior to debt forgiveness was 5.17% which is far lower than periods after debt forgiveness. If mismanagement of external debt gives rise to growth in external borrowing, then there is concern with current external debt growth rates which stand at 10.20% and 18.60% for 2006 – 2011 and 2012 – 2017 respectively.

Year	2000 - 2004	2006 -2011	2012 - 2017
Average Growth	5.17%	10.20%	18.60%

Table 2: Growth Rates in External Debt Stock for Specific Period.
Source: Authors computation.

The rising external debt stock indicate that past external borrowing by government may not be productive, it only increase the debt stock of the country. This implies that external debt financing needs to be reassess. The role of the National Assembly is very crucial in the reassessment process to achieve sustainable debt management.

IV. Legislative Actions requires of the National Assembly for Nigeria to achieve sustainable Debt Management?

The debt rebalancing strategy by the Federal government seems to gear towards providing optimal debt financing portfolio that can help reduce debt service cost and ease the domestic debt market such that private sector actor can access more credit rather than being crowd out by government credit. External borrowing from international capital market may have several benefits and advantages. Despite the benefits, it is crucial that the National Assembly assess critically the short run and the long run implications of the debt rebalancing strategy of the federal government. The National Assembly should do the following:

(1) Invite the Ministers of Finance and Budget & planning for serious engagement session. The session should be to require that both Ministers provide intergenerational equity report and consequences of the current debt rebalancing proposal as suggested in the 2018 budget proposal. This may be very important considering the fact that future generations may likely pay for some of these debt. The benefits

that are accruable to them now and the future should be conspicuously highlighted in the intergenerational equity report.

(2) The National Assembly may need to engage the Federal Inland Revenue service on various challenges and problems constraining FIRS on Tax revenue generation and mobilization. This is very important considering the fact that government needs to do more in the area of mobilization of non-oil revenues to bridge the fiscal deficit. There is room for more tax mobilization. Nigeria's non-oil tax to GDP stood at 2.3% in 2016 which is well below the average of 16% among Sub-Saharan Africa countries. The National Assembly may require FIRS to reassess possibility of generating more revenues from Value Added Tax (VAT) which contributed the highest non-oil-revenue in 2016 and has the potential to generate more tax revenue for the government. Considering the high consumption level in Nigeria and huge population, the VAT may be very strategic as a major source of non-oil revenue that can be employed to finance capital projects rather than borrowing externally.

(3) The National Assembly may request that the FIRS provide data on number of VAT payers for over specific years say five years and potential VAT payers may be enumerated and capture in the FIRS database. The issue of exemptions in the VAT law may need to be reconsidered at this crucial time of lean Budget funding. Equally the FIRS may be required to provide VAT audit reports generated in the last five years and the feasibility of conducting VAT audit with the intention to recover more revenue from VAT. Apart from tax revenue from VAT, tax revenue sources such as presumptive tax from informal sector and property tax may need to be explored to finance the budget rather than Federal government pursuing external borrowing .The current efforts to generate tax revenue through the voluntary Asset and income declaration scheme is a right step in the right direction. The National Assembly should support FIRS and Ministry of Finance to ensure the full success of VAIDS.

(4) The National Assembly may also need to engage and interact with the Economic crime and financial commission on the progress made so far to recover looted funds. The engagement with the EFCC may also involve the Minister of Planning and Minister of Finance. This is important because the financing of the 2018 Budget is to some extent dependent on recovered looted fund apart from revenue from oil and non-oil sources. The engagement should result to possibility of the Federal government to use recovered looted funds to finance the budget. This may reduce or eliminate huge domestic and external debt financing by the Federal government.

(5) The National Assembly through it oversight function should appraise the utilization and productivity of the debt stock over the years before further approval is given for more debt financing by government.

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Contact
National Institute for Legislative and Democratic Studies (National Assembly)
14/18 Danube Street, Off IBB Way, Maitama
Abuja, Nigeria.
Email: info@nils.gov.ng
Website: http://nils.gov.ng/
Tweeter: @nilsnigeria