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Managing Nigeria's External Debts: Retrospects And Prospects

by

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Introduction

A major problem of macro-economic management in most Third World countries including Nigeria has been the persistence of debt overhang. In these economies, the phenomenon is characterised by the existence of unduly high and rising debt/GDP, debt/exports and debt service/exports ratios etc. in relation to optimal levels set by the World Bank as well as prevalence of debt servicing difficulties and accumulation of debt service payments arrears. The debt overhang situation was not sudden but, had evolved through years of inefficient debt management. This was reflected in indiscriminate external borrowing largely from non-concessional, commercial sources to finance development projects most of which were hardly self-liquidating. The inefficient external resource mobilisation and utilisation loomed large among the causative factors leading to the debt crisis that had raged in the Third World since the 1980's.

It is incontrovertible, however, that external borrowing by sovereign governments to finance economic growth and development or transitory balance of payments deficit is not undesirable. The yearnings for improved standards of living had underlined the resort to such external resources. Therefore, foreign funds had indeed become inevitable for the Third World countries in their cheerless conditions of widening savings/investment gap marked by lean foreign exchange earniugs from exports arising from weak terms of trade, low productivity and tax effort, low savings rate, etc.

However, these funds became problematic where they had not been productively applied in line with the requirements of appropriate external debt management policies of the debtor countries. The resultant debt crisis led to a number of developments including economic and monetary instability as manifested in undue expansion of mouetary aggregates, high inflation and continued depreciation of the exchange rate etc. These developments are often macro-economic responses or side effects of the efforts by debt distressed country governments to manage the debt problems, without undertaking prior adjustments of their economies.

The Nigerian economy in particular continues to experience strains and stresses arising largely from debt burden and debt overhang, despite the debt management efforts put in place by the authorities since 1983 to deal with the debt problem.

The purpose of this paper is to outline the debt management strategies adopted by Nigeria so far and articulate the way forward. For ease of presentation, the paper is divided into five parts. Part I dwells on the theoretical nexus articulating the major ingredients influencing the size of the

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debt stock. Part II outlines the structure of Nigeria's external debt as well as the debt dynamics. Parts III and IV contain the analysis of the debt management strategies adopted by Nigeria thus far indicating the problems and prospects. Part V summarises some of the leading issues and concludes the paper.

PART I

CONCEPTUAL ISSUES (FRAMEWORK)

Definitions

The most widely used definition of external debt states that a gross external debt as being the amount, at any time of disbursed and outstanding contractual liabilities of the residents of a country to non-residents to repay principal, with or without interest or to pay interest with or without principal.

From this definition, some points are pertinent and hence need further elaboration. First, this definition deals with gross debt, thus highlighting the fact that gross debt is directly related to the problem of debt service. Second, it implies that debt emanates solely from contractual liabilities to the exclusion of equity participation. Third, the terms "principal with or without interest" and "interest with or without principal" suggest that loans which are interest free are included as part of external debt as well as loans of indefinite maturity, such as "perpetual" bonds. Furthermore. "contractual liabilities" criterion has to be made with non-residents to qualify a loan for inclusion as part of external debt. Thus by this phrase, it implies that external debt covers all government borrowing, and parastatal and private sector borrowing whether guaranteed by government or not as well as other financial operations of domestic economic agents, including direct investments and leasing.

However, for the purpose of debt management, a commonly used but narrow definition of external debt includes short-term public sector debt and/or private sector non-guaranteed debt (both short term and long term), all medium and long-term debt (for one year or more) guaranteed by, the public sector to non-residents.

Debt Management

Debt Management may be defined as the policy measures by the government of a debtor country, which seek to alter the stock of the debt, attain a more manageable composition/structure for the debt portfolio, and better or softer loan terms with a view to maintaining at any given time, a level of debt service payments which the economy can sustain. Put differently, Debt Management refers to the technical as well as the institutional arrangements involved in organising both domestic and the external liabilities so that the debt service burden is maintained/contained within a sustainable level.

While the technical aspect focusses attention on determining the required level of debt which the economy can sustain and ensuring that loans contracted are on favourable terms and conditions which are commensurate with the future debt service capacity of the country, the institutional aspect deals with the administrative, organisational, legislative, accounting and monitoring aspects of managing both new borrowings and the total stock of debt. In both aspects, more attention is given to reducing the debt service burden or keeping it stable, rather than merely focussing on the

streams of debt service payments being made. The most widely used measure of debt service burden is debt service payments as a proportion of exports earnings by a country in a given year (debt service ratio). In order to ensure an efficient management of the debt, the debt service burden must be linked with some standard macro-economic indicators, while the performance of the debt, using analythical tool, is then measured relative to the established benchmark for comparison. There is a simple and universally accepted macro-economic model which enables a derivation of a broad macro-economic condition that should be met in order for the debt service ratio to be stable.

Analytical Framework for Debt Management

The analytical framework attempts to bring out clearly in measurable terms those determinants of debt service ratio which would ensure that the debt service burden is kept either stable or at a desirable level. The framework is presented as follows:

$$d = F/(Px) \quad \text{.. .. ..} \quad (1)$$
$$F = rD+A \quad \text{.. .. ..} \quad (2)$$
$$(dD)/(dt)/P = I-S+rD/P \quad \text{.. .. ..} \quad (3)$$
$$I = k(dY/dt) \quad \text{.. .. .. ..} \quad (4)$$
$$S = sY \quad \text{.. .. .. ..} \quad (5)$$

Where:

d = ratio of debt service to exports
F = debt service
D = outstanding external debt in nominal prices
A = amortization
r = average nominal interest rate
P = price level
X = exports in real terms
I = gross domestic capital formation in real terms
S = gross domestic savings in real terms
k = incremental capital output ratio
Y = gross domestic product in real terms
s = average savings rate.

In this model, the debt service ratio can be re-written as:

$$d = (F/D)\ D/PY)\ Y/X) \quad \text{.. .. .. ..} \quad (6)$$

and,

$$F/D = r + a \quad \text{.. .. ..} \quad (7)$$
$$Y/X = I/x \quad \text{.. .. ..} \quad (8)$$

Where:

a = average amortization
x = relative share of exports to GDP.

Substituting (7) and (8) into (6) gives:

$$d = [(r+a)/x)] (D/pY) \qquad (9)$$

Equation (9) indicates that developments in the debt service ratio will depend ultimately on those in the debt/GDP ratio, assuming that the terms of external debt and the export/GDP ratio remain unchanged. This implies that the debt service ratio will stabilize at a certain level only if the debt/GDP ratio stabilizes over the medium term.

Specifying dynamic movements in the debt/GDP ratio over time, we have:

$$d(D/PY)/dt = (dD/dt)/pY - (g+h) (D/pY) \qquad (10)$$

Where:

g = (dY/dt)/Y : growth rate
h = (dP/dt)/P : inflation rate.

Using equations (3), (4) and (5),

(dD/dt) PY can be given by:

$$(dD/dt)PY = (kg-s) + r(D/PY) \qquad (11)$$

Substituting equation (11) into (10) gives the following dynamic equation for the debt/GDP ratio:

$$d(D/PY)dt = (kg-s) +[r-(g+h)] (D/PY) \qquad (12)$$

Given equation (12), the debt/GDP ratio will stabilize at long-run equilibrium only if the following condition is satisfied:

$$(g+h)-r > 0 \qquad (13)$$

or

$$g - i < 0 \qquad (14)$$

Where:

i = r-h : average real interest rate.

Condition (14) indicates that in order for the debt service ratio to stabilise at a particular level and for a country to be able to maintain liquidity and solvency in the long-run, **the economic growth rate should be higher than the average real interest rate.**

If this stability condition is met, the debt/GDP ratio converges at:

$$(D/PY)^* = (kg-s)/(g-i) \quad .. \quad .. \quad .. \quad (15)$$

Substituting (15) into (9) gives the following long-run debt service ratio:

$$d^* = [(r + a)(kg - s)]/[x(g - i)] \quad .. \quad .. \quad (16)$$

Equation (16) indicates that the long-run debt service ratio is positively related to the rate of interest and the average amortization rate and negatively to the domestic saving rate. The equation also indicates that the long-run debt service ratio depends on how borrowed funds are used. For example, the use of loans that promotes the expansion of the export sector relative to GDP and an improvement in the use of capital as indicated in a decline in the incremental capital-output ratio would greatly alleviate the debt service burden in the long-run.

Besides the need for stability in the debt service ratio, there is the need to keep the ratio at an appropriate level. It is difficult, however, to determine a priori the most appropriate level of debt service for an individual country. It all depends on the potential constraint that a high debt service ratio may impose on monetary and economic stability. In general, a high debt service ratio implies that a debtor country will face a severe debt service burden, particularly where the export sector is weak.

Characteristics of Efficient Debt Management

1. The critical level defined by the World Bank for debt servicing capacity, beyond which the debt situation is regarded as problematic is 30 per cent. An efficient debt management would result in debt service ratio that is kept stable at between 20-25 per cent. However, it should be noted that a country's ability to sustain any particular debt service ratio depends on several factors including the outlook for the country's exports, reserve level and flexibility of the country in adjusting its policies and economic structures.

2 An efficient debt management would entail the prevalence of stable economic and monetary system.

3. The structure of debt reflects an adequate spread of maturities and diversification of sources of debt. Loan maturities almost always match the pay off period of investments so that there is no bunching of maturities nor rolling over of short-term borrowing.

4. Too often, external borrowing to finance investments is limited to the point where the marginal product of capital is equal to the cost of borrowing. This is because borrowing to finance investments whose rate of return falls short of the cost of borrowing leads to a decline in the growth rate of GDP, a situation in which the debt burden becomes unsustainable.

5. The ratio of Debt stock to GDP is often kept at a very low level, as a high ratio would suggest that the country is at a great risk. If the level is high, there is an increased reliance on foreign borrowing which would lower the growth rate of the GDP even if the marginal product of

capital exceeds the world interest rate. Moreover, an excessive rise in the ratio of Debt stock to GDP may increase the perceived probability of future debt-servicing difficulties, thus raising expectations about increased taxation, inflation or currency depreciation or capital flight.

It is observed that in countries where external debt is efficiently managed and the debt judiciously used in improving the productive sector of the economy, under appropriate economic policies, the ratio of Debt stock to GDP tends to decline as the growth rate of the GDP increases.

6. In countries where external debt is efficiently managed, the growth rate of the debt does not persistently exceed the growth rate of the country's exports or the GDP.

7. Efficient debt management also places emphasis on full and adequate computerisation of debt management functions.

PART II

STRUCTURE OF NIGERIA'S EXTERNAL DEBT

External debt can be broadly classified into private and official debts. The private debts constitute uninsured short term trade debt arrears that were contracted through the medium of bills for collection, open account, etc. and the commercial banks' debts contracted through loans and/or letters of credit (often referred to as the London Club debts). On the other hand, the official debt comprises Paris Club debts, (that is, the debts insured by exports credit agencies of Paris Club members), Multilateral debts which are debts owed to regional and international financial institutions such as the ADB, EIB, the World Bank, etc. Other official debts referred to as non-Paris Club bilateral debts are those debts owed to country governments which are non-members of the Paris Club group of creditors, such as Russia.

Structure

In the period 1983-94, the private debt outstanding witnessed a very significant change. It amounted to US$9,965 million or 56.1 per cent of the total debt stock outstanding in 1983, declining marginally and later sharply to US$9,121 million or 52.6 per cent , and to US$7,815 million or 41.3 per cent in 1984 and 1985, respectively. Although the private debts increased in absolute terms in 1986 compared with the figure for 1985, nevertheless, its percentage share in the total debt stock remained relatively stable at 41.4 per cent. It, however, declined gradually to US$10,770 million or 35.1 per cent and US$10467 million or 31.0 per cent, in 1988 and 1991, respectively. Private debt dropped further to US$5,366 million, or 19.5 per cent in 1992, and to US$5,235.96 million or 17.8 per cent in 1994. (See Tables 1 (a), 1(b), 3 and 4.

In the same period under review, the official debts also witnessed very significant changes. In 1983, the official debts as a proportion of the total debt outstanding accounted for 43.9 per cent. It then trended upwards monotonically accounting for 47.4, 58.6, 67.6, and 80.5 per cent in 1984, 1986, 1989 and 1992, respectively. It peaked at its highest level in 1994 when it absorbed 82.2 per cent of the total debt stock outstanding.

Debt Dynamics

In terms of the debt burden and debt servicing capacity, the trend in some external debt indicators for the period 1983-1994 is indicative. The debt service ratio at the end of 1986 increased to 29.4 per cent from 16.6 per cent in 1983. It, however, declined to 19.3 per cent in 1987, but then rose to 29.1 per cent in 1991. Between 1991-94 it declined to 25.9, 16.4, and 17.2 per cent in 1992, 1993 and 1994, respectively. (See Table 2)

Similarly, the external debt outstanding to real GDP increased from only 20.5 per cent in 1983 to 62.3 per cent in 1986. It then rose sharply to 158.9 per cent in 1987 through 294.2 per cent in 1990, before declining through 196.8 and 79.0 per cent in 1991 and 1992, respectively to 69.2 per cent in 1994. For most of the period under review, the ratio of Debt Stock to GDP is over and above the 50 per cent critical level established by the World Bank. Also, at 148.9 per cent in 1983, the Debt Stock to Exports ratio peaked at 418.3 per cent in 1988. Though it declined through 227.6 and 261.3 per cent in 1990 and 1992 to 292.1 per cent in 1994, this situation is indicatiive of the country's debt servicing difficulties.

However, the above debt burden indicators should be interpreted with caution, as they suffer the limitations endemic to ordinal measurement. The apparently low debt service ratio, contrasted to far below the critical level of 30 per cent, needs cautious interpretation for two reasons. Not only was the cost of closing the London Club deal ($2.4 million) excluded from the debt service figure, as much as US$4.5 billion and US$6.8 billion of external debt service obligations stood as arrears as at the end of 1993, and 1994, respectively.

Also, the observed low ratio of Debt Stock to GDP may not be sufficient indicator to conclude that there are no apparent debt servicing difficulties. This is because a country may have a low ratio of Debt Stock to GDP, but may still have an unsustainable external debt if exportables comprise a very small portion of the GDP. Also, the Debt Stock to GDP is influenced by the exchange rate; depreciation of the domestic currency can raise the Debt Stock to GDP ratio measured in terms of the market exchange rate even while physical output and the Debt Stock remain unchanged. Another salient point to note while interpreting external debt indicators is the fact that the ratios of Debt Stock to GDP and Debt Stock to Exports do not reflect the terms under which loans were contracted and the mix of concessional and the non-concessional portion of the debt. Yet these factors have a crucial impact on the magnitude of the debt service payments during any year. Furthermore, many debt ratios are strongly affected by inflation.

Nevertheless, debt indicators are relied upon for measuring the sustainability of debt. However, the limitations of the indicators are not such as to attenuate the severity of the debt situation in Nigeria.

In order to prevent a breakdown of world economic and financial system in an increasingly interdependent world of economic relations, creditor groups and international financial institutions took initiatives to evolve measures or strategies designed to address the debt problem. Debtor countries on their part have had to strive to adopt some of those strategies. The following is a narration of Nigeria's efforts at managing her external debt under the aegis of some of those strategies.