Financing Government Programmes in Economic Downturn: A Comparative Analysis

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I. Introduction

This paper examines the experience of Nigeria and other oil exporting countries in adjusting to lower oil prices and financing government programmes during economic downturn. The remainder of the paper is structured as follows. Section 2 discusses oil price shocks since 2014 and its impact on oil-dependent countries. Section 3 outlines government programmes and examines specific policy adjustments related to draw-down on reserves, oil revenue savings and sovereign wealth fund, exchange rate depreciation, and expenditure adjustment including oil subsidy reduction or removal. Section 4 discusses domestic budget financing sources including revenue generation, domestic debt issuance via treasury bills and bonds, and explores external financing sources such as private sector, bilateral, and multilateral. Section 5 concludes the paper.

II. Lower Oil Prices and Economic Downturn

Oil prices declined by more than 70.0 per cent from about US$115 in June 2014 to US$27 in February 2016, before recovering to the current US$42-52 price range per barrel in mid-2016. Since 1973, this level of negative oil price shock could only be comparable to those of the 1980s, when oil prices fell below US$10; and in 2008-2009, when it fell from around US$147 to about US$40. According to the IMF, futures markets predict only a modest recovery in oil prices from about US$45 a barrel at present to about US$50–US$55 o barrel by 2020. The prospect of lower oil prices for longer period is considerably influenced by a slowdown in global economic growth on the demand side, and the U.S. shale supply and Iran's return to the world oil market, on the supply side (IMF, 2016c).

The Economy and Lower Oil Prices

In oil-dependent countries, macroeconomic and financial developments are closely linked with the price of oil. Figure 1 provides a schematic view of the channels through which oil prices affect the economy. In oil-dependent

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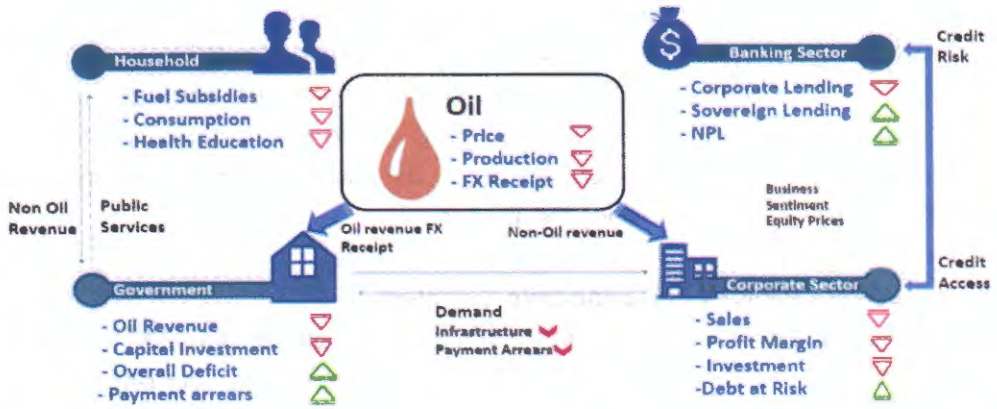
countries, public sector expenditures are negatively impacted by low oil prices as fiscal revenues from oil decline. Economic activities in the non-oil sector slow down indirectly, as lower foreign exchange inflows reduce imports for household consumption and business investment and private sector confidence weakens. In the financial sector, credit and liquidity from the banking sector are tightened as banks' balance sheets weaken due to rising non-performing loans.

Figure 1

Economic Downturn: Learning to Live with Lower Oil Prices



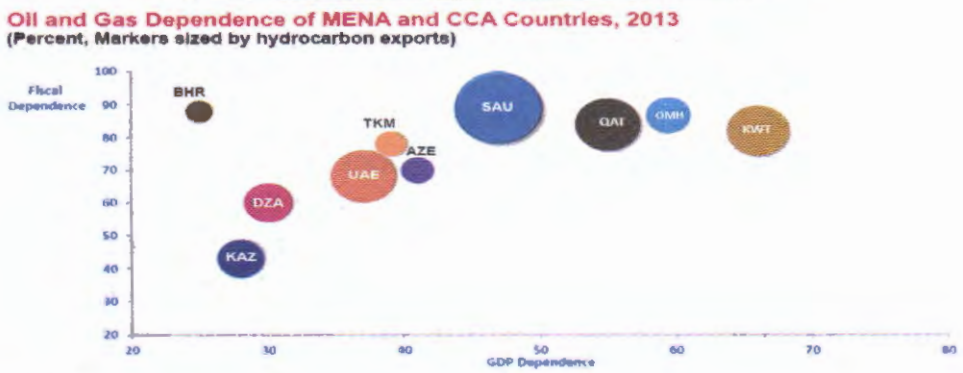
Source: Author

Jurisdictional Experiences of the MENA and CCA

Over half of the world's oil exporters are based in the Middle East and North Africa (MENA) countries (Algeria, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates), and Caucasus and Central Asia (CCA) countries (Azerbaijan, Kazakhstan, Turkmenistan). As shown in Figure 2, the fiscal revenues and gross domestic product of these countries are highly dependent on oil and other hydrocarbon resources. According to the IMF (2016c), lower oil prices reduced hydrocarbon budget receipts by more than 10.0 per cent of GDP in all Gulf Cooperation Council (GCC) countries, Algeria, and Azerbaijan between 2014 and 2015. Kuwait was one of the hardest hit, with fiscal revenue declining by a third, given that the oil sector contributes more than two-thirds to its GDP and 80.0 per cent of its fiscal revenue. In Nigeria, while the non-oil sector accounts for significant part of GDP, the oil sector plays a central role in the economy, by contributing over 70.0 per cent of government revenues until recently.

Figure 2

Oil Dependence: Nigeria: 92% exports and 10% of GDP



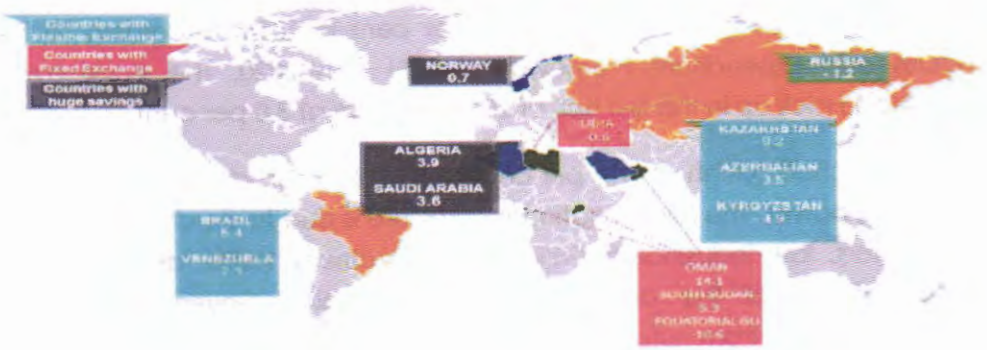
Source: IMF

Economic Slowdown

Several oil-exporting countries registered negative growth rates in 2015 (Figure 3). There is no discernible empirical evidence to suggest that operating a free floating market exchange rate or a rigid fixed exchange rate would have prevented a recession in oil-exporting countries. The following countries have not depreciated their exchange rates by much and some even maintained fixed exchange rates, but still have negative GDP growth rates according to trading economics(2015), Kuwait (-1.6 per cent), South Sudan (-5.3 per cent), Libya (-6.0 per cent), Oman (-14.1 per cent), and Equatorial Guinea (-10.6 per cent).

Figure 3

Economic Downturn in Oil Exporting Countries



Source: IMF

Russia (-1.2 per cent), Brazil (-5.4 per cent), Venezuela (-7.1 per cent), Kazakhstan (-0.2 per cent), Azerbaijan (-3.5 per cent), and Kyrgyzstan (-4.9 per cent) have significantly depreciated their currencies, but still have negative GDP growth rates year on year. With the Russian economy declining by 3.7 per cent in 2015, Sergei Guriev, an economic advisor to a former President of Russia noted on CNBC that "the Russian economy is still very dependent on oil prices. Even though Russia's central bank has moved to a floating-exchange-rate framework, Russia could not avoid the recession, given the 50.0 per cent drop in oil prices. The ruble depreciation buffered the shock but could not have shielded the economy completely" (Ellyatt, 2014). Some countries with large oil savings relative to GDP that pursued counter-cyclical policies have managed so far, to avoid a recession irrespective of their exchange rates regime. These include: Norway (0.7 per cent) with a free floating exchange rate; Saudi Arabia (3.6 per cent) with fixed exchange rate; and Algeria (3.9 per cent) with managed floating exchange rate.

Nigeria achieved a decade of robust growth, with annual real GDP growth rate averaging 6.8 per cent a year up to 2014, driven by robust oil prices, which reached a high of US$115 in July of that year, fueling high consumer demand and encouraging capital flows, as well as the rise of the services sector. From 6.3 per cent in 2014, economic growth declined significantly to 2.8 per cent in 2015; and contracted further by 0.4 per cent in the first quarter and by 2.06 per cent in the second quarter of 2016. This was due to declining oil prices which reached a low of US$27 in February, 2016, cut in oil production by more than a quarter as a result of vandalism of oil pipelines, energy and electricity shortages, and foreign exchange scarcity. Nigeria is already in a recession but is expected to reach a trough in the third quarter of 2016, with a projected positive growth in the fourth quarter. As a result, the economy is expected to register a decline of -1.3 per cent in 2016, according to the Medium-Term Expenditure Framework (MTEF) 2016-2020. The economy is expected to pick up in the first half of 2017, growing at 3.0 per cent.

Inflation reached a high of 17.1 per cent in July, 2016, eroding consumers real purchasing power. The rising inflationary pressure is due to structural and cost-push factors, low industrial activities, high electricity tariffs, and the pass-through effects of the depreciation of the naira. Government's fiscal balances moved from surpluses of 2.0 – 6.0 per cent of GDP in the past decade to -1.8 per cent in 2014, and further widened to -3.7 per cent in 2015. The 2016 budget sets expenditure at ₦6.08 trillion, with capital expenditure accounting for 30.0 per cent of the total budgeted expenditure, from 10.0 per

cent in 2015, with ₦1.36 trillion for debt servicing, with a revenue projection of ₦3.86 trillion and deficit of ₦2.22 trillion. Fiscal deficits widened due to lower oil and non-oil revenues, huge fuel subsidy payments, and high debt service ratio. In 2015, export fell by 40.0 per cent and is projected to fall further by 20.0 per cent in 2016. The current account balance turned negative at -2.4 per cent in 2015. Gross international reserves declined from US$34.0 billion in 2014 to US$26.4 billion in June 2016, enough to cover 5 months of imports.

III. Adjustment as Financing Instruments

Drawdown of Reserves, Sovereign Wealth Fund (SWF) and Fiscal Buffers

Several oil exporters with fiscal buffers in oil savings and SWF used them to absorb the initial oil price shock and smoothen policy adjustment (Figure 4). The first line of defence has been to draw-down on foreign reserves, oil savings and sovereign wealth funds. The GCC countries and Algeria have a combined total of US$2.5 trillion in their sovereign wealth funds and other savings vehicles based on estimates from the Sovereign Wealth Fund Institute (SWFI). According to the IMF (2016c), several GCC and CCA oil exporters hove substantial fiscal space, with financial savings plus debt capacity exceeding 10 years' worth of projected fiscal deficits. In some other countries such as Kazakhstan, Kuwait, Qatar, the United Arab Emirates, and Turkmenistan, the estimated fiscal buffers can finance more than 20–30 years of projected deficits. Their oil savings are more than 50.0 per cent of their GDP, while that of Nigeria are less than 1.0 per cent of GDP.

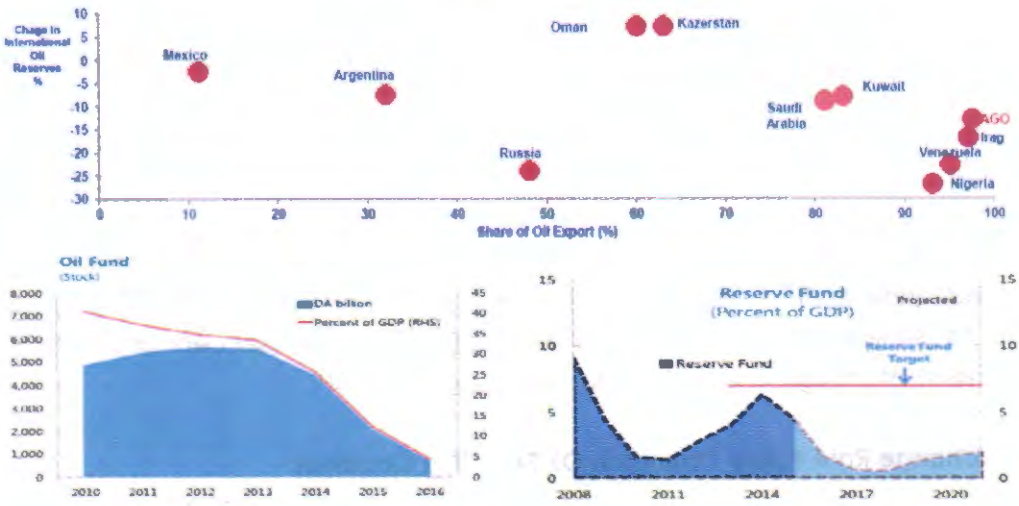
Exchange Rate Policy Options in Oil Exporting Countries

The exchange rate regimes of oil exporters vary from fixed, managed, and floating. The fixed exchange rate regime has been maintained by the GCC countries, and has provided a useful nominal anchor in most of the undiversified economies. This has been helped by the large fiscal buffers of these countries. However, fiscal adjustment measures via direct spending reduction and non-oil revenue increases will be needed to maintain the pegs in the face of a persistent adverse external shock.

Flexible exchange rate regime, allows for depreciation of the exchange rates, and can help smoothen fiscal and external adjustment, especially in countries with more diversified economies. However, there are odverse effects associated with higher inflation ond financial stability risks due to currency mismatches and unhedged borrowers especially in the context of dollarised economies. While Algeria has adopted a managed exchange rate and Kazakhstan has introduced substantially more foreign exchange flexibility,

Turkmenistan and Uzbekistan have managed their currencies more tightly through interventions and administrative controls. With a flexible exchange rate, currency depreciation raises the local-currency value of oil and other exports and thereby boost short-term fiscal revenues. However, these revenue gains can be negated by a proportional rise in government spending, especially public wages. Nominal depreciation can also be offset by inflationary pressures, which have been observed in Azerbaijan and Kazakhstan. Overall, the losses of foreign exchange reserves have been smaller in the CCA region than in the GCC and Algeria, which allowed flexible exchange rates as shock absorbers (IMF, 2016c).

Figure 4



Source: IMF Algeria, Angola and Russia Article 4 Consultation Report
Note: 1st Line: Fiscal Buffers: Drawdown your reserves, oil savings and SWF; Nigeria's SWF 0.5% of GDP Vs. 40% in Algeria (GCC have $2.5 Trillion in Savings > $1 Trillion of Projected Deficits)

The CBN had used various instruments in an attempt to meet multiple objectives. The Bank has used both quantitative measures and exchange rate adjustment in response to foreign exchange scarcity following the fall in oil price since 2014. Some of the measures include restrictions on commercial banks' FX trading, closing of the official FX auction window, and banning of 41 items from the official window. In September 2015, J.P. Morgan excluded Nigerian domestic bonds from its local currency government bond indexes due to FX liquidity issue. In order to stimulate the slowing economy, the CBN expanded special intervention schemes while easing monetary policy rate

and the cash reserve ratios implemented in November 2014 and May 2015 (IMF, 2016a).

In essence within the monetary policy trilemma, the CBN sacrificed inflation and price stability for liquidity and growth, and exchange rate stability for capital flows. As a result, foreign capital flows dried up and inflation rates rose to 17.1 per cent. At its July 2016 MPC Meetings, the CBN made a 360-degree change towards favouring capital flows while sacrificing growth with greater exchange rate flexibility, hike in interest, and short-term interest rate measured by the yields on Treasury Bills rising above 20.0 per cent.

Nigeria had devalued the naira twice in this oil down cycle, but has maintained an official exchange rate since the first half of 2015. Following the adoption of a flexible exchange rate by the Central Bank Nigeria (CBN) in June 2016, the inter-bank rate of the naira depreciated by two-thirds from ₦197 to US$1 to ₦316 to US$1 and stood at US$384 at the parallel market as at 2nd August, 2016. Demand for foreign exchange at about US$5.0 billion per month far outstripped by five times the supply of only US$1.0 billion.

Will a further devaluation by itself address the recession and current account gap? The IMF estimates that Nigeria faces a current account gap of 1.5 to 2 per cent of GDP and a real exchange rate gap of about 15.0 - 20.0 per cent. According to the IMF (2016), over half of the gaps could have been closed if other macroeconomic policies, other than exchange rate adjustment, had been at their desirable settings. "This provides a measure of the component of the estimated overvaluation that would ideally be addressed by other policy levers, leaving the remainder to be addressed through real exchange rate adjustment, or, in the medium term, structural policies to improve competitiveness. These dynamics are illustrated by the inability of the 2014-15 devaluations to significantly alter the real effective exchange rate, which points to the need for a package of supportive macroeconomic policies to restore external sustainability" (IMF, 2016).

IV. Government Ambitious Programmes and Limited Fiscal Space

In 2014, most MENA and CCA countries implemented fiscal stimulus measures, including through off-budget vehicles. In 2015, fiscal expenditures slowed substantially, and with sizable fiscal adjustment plans of 4-6 per cent of non-oil GDP for 2016. Over time, all MENA and CCA oil exporters are expected to adjust to the new reality of lower oil prices for longer, with fiscal adjustment of 5-7.5 per cent of GDP (IMF, 2016c). In terms of balancing fiscal budgets, GCC

countries and Algeria, on average, require spending cutbacks by about one-third, while CCA oil exporters need about one-quarter.

Expenditure reduction is an important part of fiscal consolidation in several oil exporting countries partly due to prior pro-cyclical policies with significant increases during the episode of high oil prices. Algeria, Azerbaijan, and Saudi Arabia have announced sizable cuts in public investment spending, while Qatar continues to spend on key infrastructure ahead of the FIFA 2022 World Cup (IMF, 2016c). The United Arab Emirates has reduced transfers to public sector entities, subsidies, and grants. Kuwait is cutting recurrent expenditure, while maintaining capital spending. Protecting public employment and wages remains a major priority in most countries.

Subsidy and Energy Price reforms

Several oil exporters have adopted subsidy and energy price reform, with increases in fuel and electricity charges from very low levels in these countries. Saudi Arabia plans further price increases over time. the United Arab Emirates, Oman, Qatar went further by introducing energy price adjustment mechanisms that will align movement in domestic prices with international benchmarks.

Non-oil Revenues

GCC countries do not have personal income taxes and are not planning to introduce them any time soon. However, a GCC-wide value added tax (VAT) has been announced and other fees, charges, and excises have been introduced. Bahrain has started increasing a number of fees including healthcare services while Oman has increased corporate taxes and fees.

Government delayed policy responses, especially those relating to adjustment to the low oil price, which should have started from the fourth quarter of 2014. The oil and gas sector has been marred by corruption, inefficiencies, and fuel scarcity with long queues at petrol stations all over the country. An announcement on subsidy removal was made in May of 2016. The 2015 budget was submitted within the electoral cycle and did not achieve much. The Federal Government provided some fiscal relief for the state governments. The 2016 budget was delayed by more than six months, although it has the goal of stimulating the economy, while laying the foundations for sustainable growth and development. The 2016 Budget proposals of the Federal Government had ₦6.08 trillion in spending, with a revenue projection of ₦3.86 trillion, resulting in a deficit of ₦2.22 trillion. A sum

of ₦300 billion was budgeted for Special Intervention Programmes (FGN 2016 Budget Speech).

Capital expenditure: In 2016, capital expenditure was allocated 30.0 per cent (₦1.8 trillion) of the budget, compared to less than 15.0 per cent (₦557.0 billion) in 2015, but implementation take off has been slow, starting essentially from the second half of the year. Significant resources have been committed to critical sectors such as Works, Power and Housing – ₦433.4 billion; Transport – ₦202.0 billion; Special Intervention Programmes – ₦200.0 billion; Defence – ₦134.6 billion; and Interior – ₦53.1 billion. (FGN 2016 Budget Speech)

Recurrent Expenditure: The budget proposed a 9.0 per cent reduction in non-debt recurrent expenditure, from ₦2.59 trillion in the 2015 Budget to ₦2.35 trillion in 2016, while budgeting ₦300 billion for Special Intervention Programmes. The Efficiency Unit was set up, which along with the effective implementation of Government Integrated Financial Management Information Systems (GIFMIS) and Integrated Payroll and Personnel Information System (IPPIS), is expected to reduce overheads by at least 7.0 per cent, personnel costs by 8.0 per cent and other service wide votes by 19.0 per cent.

The MTEF and Budget: An average growth rate of 4.37 per cent was envisaged for the economy in 2016, and was expected to increase to 4.8 per cent in 2017 and 5.2 per cent in 2018. The GDP growth rate was predicated on an oil price benchmark of US$38 in 2016, and an average of US$49 in 2017-2018, as well as oil production of 2.2 million barrel per day (mbpd) in 2016 and an average of 2.27 mbpd for 2017-2018. The GDP growth rate was expected to come from the non-oil sector with agriculture, including agro-allied business, growing by 8.0 - 15.0 per cent over the period. In light of the weak macroeconomic outturns described above, the GDP growth rate was revised in the new MTEF to -1.3 per cent for 2016 and 3.0 per cent in 2017, with an average growth of 4.4 per cent during 2018-2020. The new MTEF Oil price benchmark of US$38 was maintained for 2016, but revised for 2017 and 2018 from US$42 and US$48 to US$48 and US$50, respectively. Oil output was revised down to 1.7 mbpd for 2016 and 2.2 mbpd for 2017.

VI. Domestic and External Financing

Debt issuance: In several oil exporting countries, budget deficits are being financed with a mix of asset drawdowns and debt issuance. Many governments withdrew some of their deposits from the local banking system, central bank, or sovereign wealth funds. In some cases, governments also

borrowed from local banks. The use of international bonds (for instance, in Bahrain, Kazakhstan, Qatar, and the United Arab Emirates—Abu Dhabi) and syndicated loans (Oman, Qatar, and Saudi Arabia) have been less frequent until recently.

After significant withdrawal of financial savings last year, some countries may issue more debt this year. The exact composition of financing is highly uncertain, but if policymakers decided to finance half of their deficits by issuing debt, the total issuance would reach close to US$100.0 billion, given the sizable projected deficits (IMF, 2016c).

The Sovereign Credit Ratings (SCR): The SCR of several oil exporters, including Bahrain, Kazakhstan, Oman, and Saudi Arabia have been revised down by credit rating agencies, although most GCC countries still have ratings similar to those of the best performing advanced economies, while their debt ratios are typically below advanced economy peers. Azerbaijan and Kazakhstan also have low debt ratios. In spite of rating downgrade, banks in most countries have tapped foreign sources of funds. According to the IMF (2016), in the GCC countries (excluding Saudi Arabia) and CCA oil exporters, the increase in net foreign liabilities was about 5.0 per cent of GDP in 2015. In Qatar, the increase was almost 10.0 per cent of GDP. Several countries, notably Saudi Arabia, are also exploring partial privatisation of government holding of public corporate assets as o temporary source of financing during adjustment. Oman has raised US$1.0 billion loan and US$2.5 billion Eurobond in spite of its fixed exchange rate and negative GDP growth of 14.0 per cent, while Qatar has raised US$9.0 billion triple-tranche bond.

Nigeria's fiscal deficit, equivalent to 2.16 per cent of GDP, brings the overall debt to GDP ratio to 14.0 per cent of our GDP, well within acceptable fiscal limits, but debt servicing at one-third of revenue is quite high. Government is targeting fiscal deficits to GDP ratio of 1.3 per cent by 2018, with revenue increases and overheads reduction. The 2016 deficit is planned to be financed by domestic borrowing of ₦984 billion, and foreign borrowing of ₦900 billion totalling ₦1.84 trillion.

In 2016, oil and gas revenues are estimated at ₦820 billion. Non-oil revenues would bring in ₦1.45 trillion. Non-oil revenues, which include Income Tax (CIT), Value Added Tax (VAT), Customs and Excise duties, and Federation Account levies, have been below peers at about 30.0 per cent of total revenues and 5.0 per cent of GDP. The efficiency ratio of VAT collection is also below peers

(Figure 5). The contributions of independent revenues from MDAs are projected up to ₦1.51 trillion. The NNPC is exploring alternate funding models that will enable it honour its obligations in Joint Ventures (JVs) and deep offshore fields and to lower the burden that the traditional cash calls have imposed on fiscal budget and foreign currency cash flows.

Figure 5

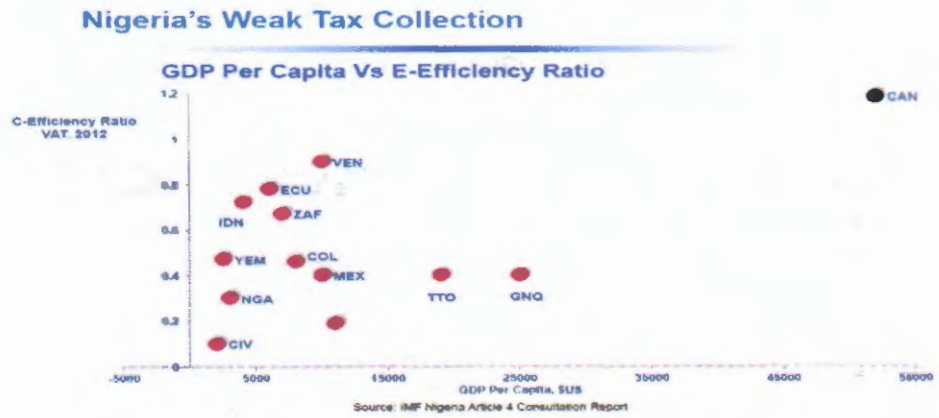
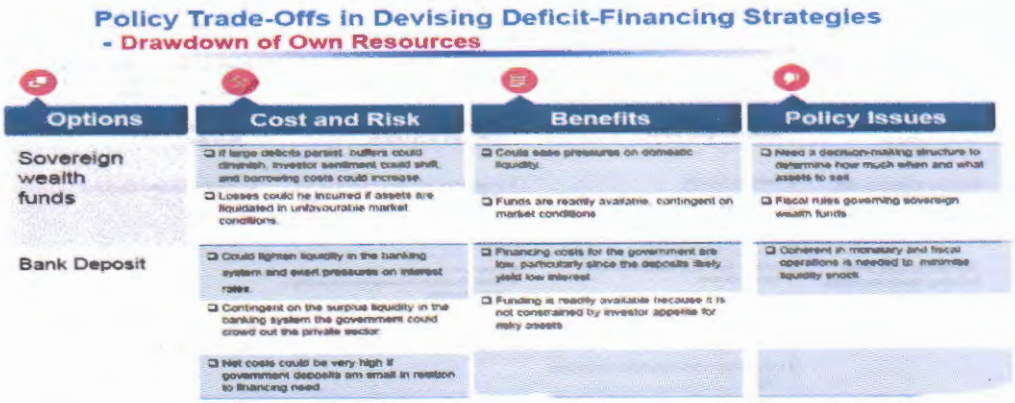


Figure 6 presents the cost and risk profile of existing public debt of the Federal Government of Nigeria (FGN) as at the end of 2015. Figures 7, 8 and 9 show the composition of domestic debt in terms of instruments and the sources of external financing and their respective percentage share as at the end of 2015. According to the DMO (2016), the implied interest rate (i.e., weighted average cost of debt) was high at 10.77 per cent, due mainly to the higher interest cost on domestic debt. The portfolio is further characterised by a relatively high share of domestic debt falling due within the next one year.

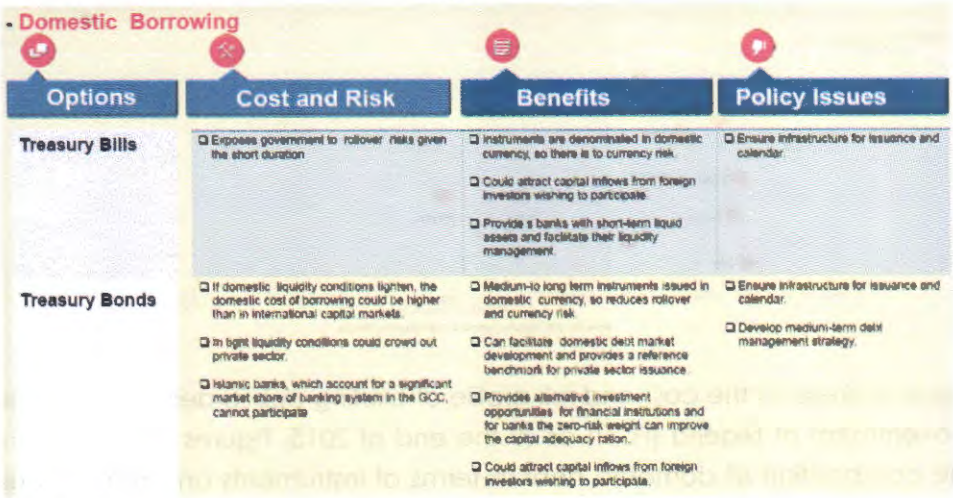
Figure 6



Source: IMF

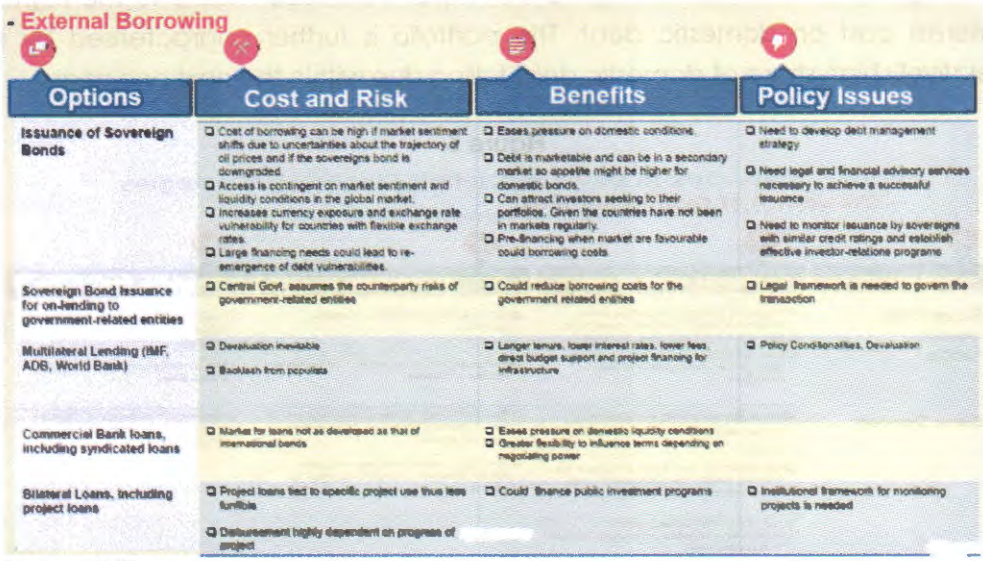
Interest rate risk is high, since maturing debt will have to be refinanced at market rates, which could be higher than interest rates on existing debt. The foreign exchange risk is relatively low given the predominance of domestic debt in the portfolio. A rise in short-term interest rates would increase the cost of domestic debt, while further pressure in the foreign exchange market and the resultant volatility would threaten the prospects of external financing and capital inflows in the immediate term (DMO, 2016).

Figure 7



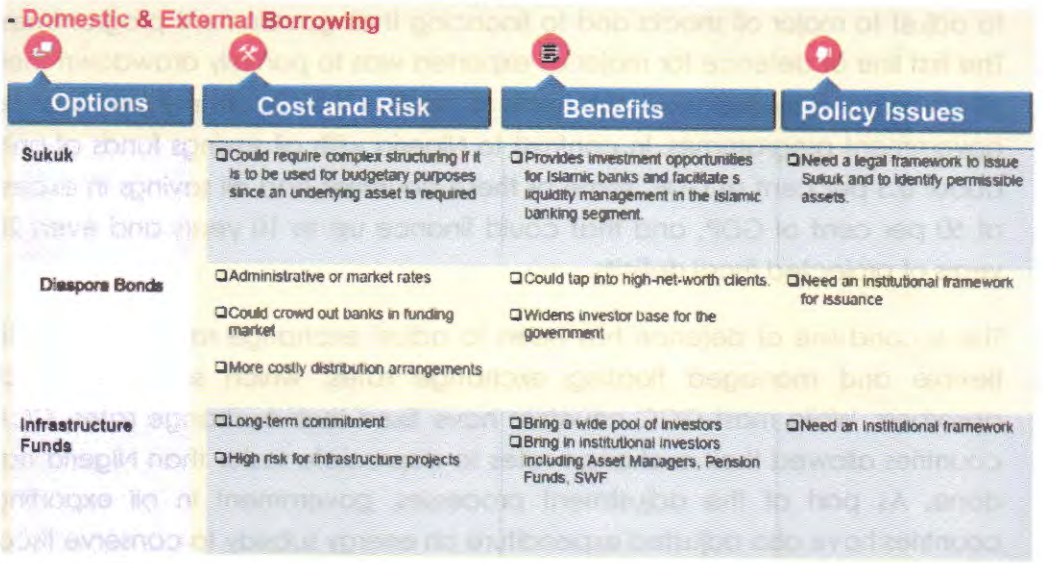
Source: IMF

Figure 8



Source: IMF

Figure 9



Source: IMF

The newly approved Debt Management Strategy prepared by the DMO and approved by the Federal Executive Council (FEC) plans to introduce new debt instruments. Retail bond, inflation-linked bond and Domestic Sukuk are planned for the Domestic Bond Market, while Diaspora Bonds and International Sukuk are envisaged for the International Capital Market.

The Debt Strategy for 2016 to 2019 period favours rebalancing the public debt portfolio in favour of long-term external financing with the objective of reducing debt service cost and extending the maturity profile of debts. The debt portfolio composition is, therefore, targeting a ratio of 60:40 for domestic debt and external debt, as against the 84:16 as at end 2015. The foreign exchange rate risks that may arise will be mitigated by prioritising long-term concessional borrowing for infrastructure projects. The debt strategy is also aiming at a domestic debt mix of 75:25 for long and short-term debts from the current 69:31 as at end 2015 to reduce the cost of debt service and roll-over risk (DMO, 2016).

V. Conclusion

The economies of Nigeria and other oil exporters have been hit by lower oil prices with serious consequences for fiscal and current account balances, economic growth and financing of government programmes. This paper examined the experiences of other oil exporters in adjusting and financing government ambitious programmes. These experiences were compared and contrasted with the experience of Nigeria.

Oil exporters in the MENA and CCA regions have used a variety of instruments to adjust to major oil shocks and to financing their government programmes. The first line of defence for major oil exporters was to partially drawdown their oil savings and sovereign wealth funds to stabilise their economy and finance government programmes. In contrast to Nigeria with oil savings funds of only about 0.5 per cent of GDP, some of these countries had oil savings in excess of 50 per cent of GDP, and that could finance up to 10 years and even 20 years of projected fiscal deficits.

The second line of defence has been to adjust exchange rate policies with flexible and managed flooting exchange rates, which serve as shock absorbers. While most GCC countries have fixed their exchange rates, CCA countries allowed their exchange rates to depreciate faster than Nigeria has done. As part of the adjustment processes, government in oil exporting countries have also adjusted expenditure on energy subsidy to conserve fiscal resources. Some countries have also announced privatisation programmes to raise revenues. GCC countries do not have personal income taxes; and are not planning to introduce them any time soon, although a GCC-wide value added tax (VAT) has been announced, and other fees, charges, and excises have been introduced. Beyond these monetary and fiscal measures, governments in oil exporting countries are borrowing both domestically and externally from commercial sources, via Euro-bonds and other sources to finance public sector programmes.

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