

## Domestic Debt and the Nigerian Economy

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**Abstract:** The study investigates the empirical relationship between domestic debt and economic growth in Nigeria. Using OLS regression techniques and the time series data from 1986 – 2005, the study explored the relationship between domestic debt and economic growth in Nigeria. Our result shows that domestic debt has affected the growth of the economy negatively. In the light of the findings, the study recommend that Government domestic borrowing should be discouraged and that increasing the revenue base through its tax reform programmes should be encouraged.

**Key words:** Budget deficit, debt profit, domestic debt, economic growth and public expenditure

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### INTRODUCTION

The beginning of the existing market for government borrowing in Nigeria is the financial reforms introduced by the colonial government in 1958. These reforms saw to the creation of the Central Bank of Nigeria (CBN) and the creation of Marketable Public Securities to finance fiscal deficit. According to paragraph 35 of the Central Bank of Nigeria (CBN) Ordinance 1958, the bank shall be entrusted with the issue and management of Federal Government Loans publicly issued in Nigeria upon such terms and conditions as maybe agreed within the Federal Government and the Bank.

Since the early 1960s, the ratio of domestic government to Gross Domestic Product (GDP) increased. A decade later by 1974 this ratio went up slightly to 6.9% of GDP. But by 1984, the domestic debt to GDP ratio was over 40%. Although it declined slightly in the 1990s, it has since 2000 moved upward, Asogwa (2005). He further opined that, Nigeria has not been alone in experiencing escalating levels of government domestic indebtedness, but in comparison to other countries in sub-Saharan Africa, Nigeria's domestic debt to GDP ratio is clearly on the high side.

One can analyze the evolution of the domestic debt from its size or by considering its different components. The stock of government debt is measured relative to national output. This is shown by the size of the domestic debt structure both in nominal terms as a percentage of total debt has grown tremendously from ₦0.23 billion at inception and it stood at ₦1.86 billion as at 1980. It was in 1986, at the inception of the Structural Adjustment Programme (SAP) that the level of external debt for the first time becomes larger than the level of domestic debt. Ever since then, the stock of external debt has consistently been larger than domestic debt.

Alison *et al.* (2003) revealed three theoretical reasons often advanced for government domestic debts. The first,

is for budget deficit financing, secondly, is for implementing monetary policy (buying and selling of treasury bills in the open market operation) and the third is to develop the financial instruments so as to deepen the financial markets.

In Nigeria, several factors have been advanced to explain the changing domestic debt profile between the 1960s to date. The major factors include – high budget deficits, low output growth, large expenditure growth, high inflation rate and narrow revenue base witnessed since the 1980s. Output growth declined as it recorded annual average values of 5.9% in 1980-1984, 4% in 1990-1994 and 2.8% in 1998-1999 period respectively. However, growth was recorded in 2003. It is usually expected that as countries expand their output, they also tend to rely more heavily on domestic public debt issuance to finance growth. There is thus a strong cross-country relationship between economic growth and the total size of the debt market.

Public expenditure as a percentage of GDP increased from 13% in the 1980 – 1989 period to 29.7% in the 1990-1994 periods. This increased public expenditures to GDP ratio resulted from fiscal policy expansion embarked upon during the oil boom era of the 1970s.

However, as the oil boom declined in the 1980s, priorities of government expenditure did not change. Consequently, the fiscal operations of the federal government resulted in large deficits from the average of 0.8% of GDP in the 1970 – 1979 period, the level of deficit increased persistently averaging 5.1% in 1980 – 1989 and 10.0 in 1990 – 1994. A very remarkable feature of the government fiscal expansion was the financing of the excess expenditures from domestic sources averaging 79.2% between 1980 – 2002, since foreign loan was difficult to obtain.

Gross – country relationship between fiscal deficits (as percentage of GDP) and the size of government debt markets confirms that countries with larger fiscal deficits

have issued more government securities in domestic markets.

Generally, declines in government revenue were met by borrowing from the Central Bank through the instrument of ways and means advances. These advances were never defrayed by the Federal Government but refinanced by the floatation of treasury bills and treasury certificates are rolled over by issuing new ones to pay holders of maturing debt instrument contributing to the continue growth of the debt stock. The research therefore, set out to investigate the effect of rising domestic debt on the Nigerian Economy.

**Conceptual framework:** Oshadami (2006) Defined Domestic Government debt as debt instruments issued by the Federal Government and denominated in local currency. In principles, state and local government can also issue debt instrument, but limited in their ability to issue such. Debt instrument consist of Nigerian Treasury certificates, Federal government development stocks and treasury bonds. Out of these, treasury bills, treasury certificates and development stocks are marketable and negotiable while treasury bonds; ways and means advances are not marketable but held solely by the central Bank of Nigeria. Odozi (1996), in his opinion sees domestic debt as the gross liability of Government, and properly considered should include Federal, State and Local governments transfer obligations to the citizens and corporate firms within the country. Consequently, the Central Bank of Nigeria (CBN) as banker and financial adviser to the Federal Government is charged with the responsibility for managing the domestic Public debt.

Lipsey (1986) Defined economic growth as the positive trend in the nations total output overlong period of time. This implies a sustained increase in Gross Domestic Product (GDP) for a long time. Schiller (1999) opined that economic growth is an increase in output (real GDP), an expansion in product possibility curve. Schiller (1999) view was not different from that of Dolan and Lindsey (1991) who sees economic growth as most frequently expressed in terms of increase in Gross Domestic Product (GDP), a measure of the economy's total output of goods and services. This GDP as a measure of economic growth, like any other economic quantitative must be expressed in real terms. That is, it must be adjusted for the effects of inflations as for it to provide a meaningful measure of growth overtime.

**Literature:** The need to finance rising government expenditures has been identified to be responsible for the rapid increase in the stock of Nigeria's domestic debt. Gbosi (1998), opined that borrowing by government from the domestic economy became the main source of financing government expenditure due to the collapse in prices of oil in the international market. He asserts that despite the various efforts made by the government to rationalize public expenditure, much success has not been

achieved in reducing its spending and this has continuously raised the size of the domestic debt.

Christensen (2004) employed a cross country survey of the role of domestic debt market in sub-saharan African based on a new data set of 27 sub-saharan African countries during the 20 year period (1980 – 2000), he finds out that domestic debt markets in these countries are generally small, highly short term and often have a narrow investors base. He also discovered that domestic interest rate payment present a significant burdens to the budget, despite much smaller domestic debt than foreign indebtedness. He did not stop at that, he further revealed that, the use of domestic debt is also found to have significant crowd out effect on private investment.

Asogwa (2005), employing a more comprehensive technique in investigating the effect of domestic debt on economic growth concluded that domestic government debt in Nigeria has continued to suffer form of confidence crisis as market participants have consistently shown greater unwillingness to hold longer maturities. The government has only been able to issue more of short-term debt instrument.

In the words of Gurley and Shaw (1956), mounting volume of public debt is a necessary feature of a strong and healthy financial structure of an economy. Therefore some secular increase in public debt should be planned by every government of a market – oriented economy. However, it appears that no government plans a long term increase in debt. The volume of public debt has tended to increase in response to compulsions of the moment. We must note here the false view that a country that borrows is automatically immersed in the debt burden. This false conclusion was clarified by Queientin (1984) that indebtedness amounts to a problem, if a country couldn't afford to repay its debt. To him, the key is the cost of debt servicing which includes the repayment of principal and interest due on the loan. He justified borrowing as arising from increased government expenditure on development programmes without generally an additional income to finance it.

Ajayi (1989) traces the origin of Nigeria's debt problems to the collapse of the international oil price in 1981 and the persistent suffering of the international oil market and partly due to domestic lapses. As a result of the debt problem, credit facilities gradually dried up, which led to a number of project getting stalled. He advocated the revival of the economy growth as the best and most durable solution to the debt burden. The needed growth, however, is disturbed by two factors, which include, limitation imposed by inappropriate domestic policies and the external factors, which are beyond the control of the economy.

Sanusi (1988), was of the view that faulty domestic policies which ranges from project financing mismatch, in appropriate monetary and fiscal policies was responsible for domestic borrowing problem. He believes that some of the policies were of little significance because of the

perceived temporary effect of the external shocks. The expansionary policies, he believes, led to stupendous macroeconomic fallout, which encourage import and discourage export production.

Ahmed (1984) reflected the causes of debt problem as related to both the nature of the economy and the economic policies put in place by the government. He articulated that the developing economies are characterized by heavy dependence on one or few agricultural and mineral commodities and export trade is highly concentrated on the other. The manufacturing sector is mostly at the infant stage and relies heavily on imported inputs. To him, they are dependent on the developed countries for supply of other input and finance needed for economic development, which made them vulnerable to external shocks.

James (2006) opined that public debt has no significant effect on the growth of the Nigeria economy because the fund borrowed were not channeled into productive ventures, but diverted into private purse. He suggested further, that, for the gains of the debt forgiveness to be realized the War Against Corruption should be fought to the highest.

Oshadami (2006) in her own study concluded that the growth of domestic debt has affected negatively the growth of the economy. This situation is premise on the fact that majority of the market participant are unwilling to hold longer maturity and as a result the government has been able to issue more of short term debt instruments. This has affected the proper conduct of monetary policy and affected other macroeconomic variables like inflation, which makes proper prediction in the economy difficult.

## MATERIALS AND METHODS

**An Overview of Domestic Government Debt in Nigeria:** Domestic government debt instruments play an important role in any economy be it capitalist, socialist and mixed economy. They provide economic agents with alternative options to banking for allocating their savings accordingly. It is a key part of the collateral used in financial markets, and as such plays an important role in monetary policy implementation.

The situation of Nigeria domestic debt shows that treasury bills constitute the main component of government debt accounting for 77.4% of total domestic debt in 1960, decline to 51% by 1970 but went up to 62% 2003. The decline in the percentage share of treasury bills in the mid 1970s happened as revenue from the oil sector improved substantially, Okunrounmu (1992). The growth in the level of treasury bill also reflected the practice of roll over of matured securities and continuous recourse to conversion of ways and means advances outstanding at the end of the year to treasury bills as a way of funding the fiscal deficits.

Treasury certificates, which were first issued in 1968, constituted one of the largest securities between 1983 and

1988. It even surpassed treasury bills issued to further deepen the domestic money market by increasing short – term investment option available. In 1995, the federal government of Nigeria decided to further reduce the debt service obligations on domestic debt. A treasury certificate was therefore abolished in 1996.

In 1989, the monetary authorities at the inception of the action bid system for flotation of treasury bonds as another instrument in the portfolio of domestic debt. The objective was to minimize the service obligation on domestic debt arising from the liberalization policies thus in 1989, N20 million worth of treasury bills representing 58.6% of treasury bills outstanding were converted to treasury bond.

Development stocks were apparently the first government instruments to be issued. It floated largely to provide development finance either directly to meet the needs of the federal government or as loan on lent to the state government. The development stocks were first register debt stocks 1956/61. The stock outstanding increased between 1960, 1987 and 1988. This stock is traded in the secondary market of the Nigeria stock exchange.

**The Trends in Nigeria's Public Domestic Debt:** Total domestic debt was N28,440.2 million in 1986 but, rose to N36,790.6million in 1987, showing an increase of N8,350.4 million between the two periods. Similarly, in 1990, domestic debt increased to N84,093.1 million from N47,031.1 million in 1988, showing an increase in N37,062.0 million between the two periods. It is pertinent for us to note that the increase in domestic debt between 1989 and 1990 is greater than that in the period 1986 and 1987 by N28,711.6 million. The reason for this increase is that more money was needed by the government to finance its deficit budget (Table1).

In 1996, domestic debt outstanding arose astronomically to N343,674.1 million, increasing by almost five – fold to N84,093.1 million in 1990. By 2000 domestic debt had grown to N898,253.9 million showing an increase of N554,579.8 million between 1996 and 2000 (Table1).

The high rate of domestic debt continue to increase till 2004 to N1,016,994.0 million, N1,166,000.7 million, N1,329,692.7 million and N1,370,325.2 million in 2001, 2003 and 2004 respectively (Table1).

In absolute terms, Nigeria's domestic debt had grown sky – rocketedly over the decades with the effect that her domestic debt consumes a larger chunk of her Gross Domestic Product (GDP) thereby tending to decline in total output of goods and services (Table1).

**Sources of Data:** This study relied basically on Secondary data sourced from the CN publications, Journals, Reports, related textbooks and FOS review of the economy for various years.

Table 1:Trends of real GDP(Y) and domestic debt outstanding

Year	Real GDP	Domestic Debt Outstanding
1986	69063.3	28440.2
1987	94905.0	36790.6
1988	80123.1	47031.1
1989	81605.8	47051.1
1990	93680.8	84093.1
1991	96.836.8	116200.2
1992	113249.0	161900.2
1993	92249.4	261093.6
1994	76893.0	259360.9
1995	95662.0	248774.5
1996	105655.0	343674.1
1997	101513.1	359029.1
1998	90080.5	537490.9
1999	102460.2	794806.6
2000	135532.1	898253.9
2001	129480.0	10167974.0
2002	130670.0	1166000.7
2003	113874.5	1329692.7
2004	105488.0	1370325.2
2005	14610880.0	1525906.6

Source: CBN Statistical Bulletin Vol: 16, December 2005

**Method of Analysis:** The method of study adopted in this study is both descriptive and analytical. The descriptive tools consist of the use of table and percentages. The analytical tool used is the ordinary least square regression analysis.

**Research Domain:** This investigation into the effect of rising domestic debt on the Nigerian Economy was conducted in Kogi State Nigeria. It covers the period o 1986 – 2005.

**Model Specification:** Our model was developed to access the effect of Domestic Debt on real Gross Domestic Product (GDP) between 1986 – 2005. To achieve robust statistical analysis, other variables like domestic credit and interest rate which are related to domestic debt have been included in our model. We therefore specified our regression model as follows:

$$GDP = b_0 + b_1 DDO + b_2 DC + b_3 INT + U$$

Where

GDP = Real Gross Domestic Product

DDO = Domestic Debt Outstanding

DC = Domestic Credit

INT = Interest Rate

U = Stochastic Error Term

### RESULTS AND DISCUSSION

$$GDP = - 708540 - 0.428DDO + 0.943DC + 0.010 INT$$

(-0.416) (-2.670) (5.835) (0.072)

$$R^2 = 0.67$$

$$DW = 2.159$$

T-Values in Parenthesis

The regression coefficient of domestic debt in the estimated regression line presented above is – 0.428, which implies that domestic debt has led to 42.8%

decrease in Gross Domestic product within the period under study. The calculated t – statistics for the parameter estimate of domestic debt is- 2.670. The tabulated t–statistics is 2.13. In the regression, the value of the calculated t-statistics for domestic debt is less than the value of the tabulated t – statistics. The findings indicate that, the relationship between Gross domestic product and domestic debt is not statistically significant.

The regression co-efficient of domestic credit in the estimated regression line is 0.943, which implies that a 100 percent point increase in domestic credit during the period under review led to a 94.3 percentage point increase in gross domestic product. The calculated t–statistics for the parameter estimate of domestic credit is 5.835 and the tabulated t – statistics is 2.13. The value of the t – calculated is greater than the value of the t–tabulated. These findings indicate that, the relationship between gross domestic product and domestic credit is statically significant at 5% level of confidences.

The regression coefficient of interest rate in the estimated regression line is 0.010, which shows that a 100percent point increase in interest rate led to 1 percentage point increase in gross domestic product. The calculated t-statistics for the parameter estimate of interest rate is 0.072 and the t – tabulated is 2.13. The value of the – calculated is less than the value of the t – tabulated. These findings indicate that, the relationship between gross domestic product and interest rate is not statistically significant at 5% level of significances.

The Durbin Watson statistic showed the presence of serial autocorrelation because the Durbin Watson test was not approximately 2, but 2.159.

### CONCLUSION AND RECOMMENDATION

In our attempt to investigate the effect of rising domestic debt on the Nigerian Economy, three theoretical facts has emerged as the reason advanced for government domestic debt. The first is budget deficit financing the second is implementing monetary policy (buying and selling of treasury bills in the open market) and the third is developing the financial sector (supplying tradable financial instruments so as to deepen the financial market). But in Nigeria, several factors have been advanced towards explaining the changing domestic debt profit. Some of those factors are high budget deficit, low output level, increased government expenditure, high inflation rate and narrow revenue base. Our findings in this study suggest that the increasing domestic debt profile has affected the growth of the economy negatively.

To alleviate the effect of domestic debt on the economy, the study make the following policy prescription.

Effort should be made by the government to settle the outstanding domestic debt. This will give room for proper conduct of monetary policy in the economy.

It will be healthy if the government strive to finance budget deficit by improving on the present revenue base rather than resulting to domestic borrowing. This can be achieved by improving its revenue sources and efficient pursuit of tax reforms.

The rise in domestic debt profile in Nigeria is attributed to government extra budgetary activities, which most often are not used for the intended project. Commitment to budget should be encouraged for fiscal discipline on the part of the government and its agencies.

The government and the Debt Management Office (DMO) should drawn up guidelines to limit the growth of future domestic debt. In this regard, debts service ratio must not exceed 40percent of allocation from the federation account. Effective mechanism should be put in place to ensure that any new borrowing is judiciously utilized to contribute to economic growth.

The place of corruption in public debt in Nigeria is central. Most often, borrowed fund are either misapplied or embezzled. In this regard, government effort at curbing corruption should be sustained. It is good news that the corruption perception index of Transparency International has shown positive improvement in Nigeria standing. This should be sustained.

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