Determinants and Analysis of Domestic Debt in Nigeria: 1970-2015

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Abstract: The problem of debt overhang is becoming intractable in Nigeria. It is believed that the rising trend of domestic debt is determined by some factors. The paper empirically investigates the variables influencing domestic debt. Prior literature on debt had focused on external debt. Literature on domestic debt had just examined its impact on economic growth. Multivariate vector error correction framework was used to analyze data obtained from Central Bank of Nigeria, World Bank National Accounts Data and Debt Management Office between 1970 and 2015. Domestic debt investor base swings between the deposit money bank and the non-bank public. Lagged values of budget deficit, external debt and GDP growth rate explains current domestic debt in the short run. There exist bi-directional granger causalities between domestic debt and budget deficit, domestic debt and external debt and domestic debt and GDP growth rate. The study recommends reasonable budget cut, redirection of fiscal deficit into productive capital expenditure, eliminating recurrent fiscal financing and thereby utilizing rising domestic debt. The study contributes to existing knowledge on domestic debt and affirmed that budget deficit, financial deepening of an economy, external debt, interest rate and GDP growth rate has a long run relationship with domestic debt in Nigeria.

Keywords: Domestic debt; Budget deficit; External debt; Gross domestic product growth rate; Interest rate.

JEL Clasiffication: H6; H63

1. Introduction

Public debt has raised major concerns among international financial institutions and bilateral lenders, resulting in several initiatives from international financial institutions to ease the debt burden that was threatening to cripple the Nigerian economy. The initiatives range from measures to ease the debt burden through debt rescheduling to outright debt forgiveness. These initiatives, however, have concentrated on addressing the external debt burden and also led to the substitution

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(partial) of external debt with domestic debt. It would be recalled that after the exit from the Paris and London Club debts, there was a strategic imperative to develop the domestic debt market for a number of benefits: to establish an alternative source of funding for government to avoid compelling dependence on only external sources and to develop a complete capital market (FMoF, 2014).

However, domestic debt remains one of the fundamental economic issues confronting the Nigerian economy. An escalating debt profile presents serious obstacles to a nation's path to economic growth and development. The cost of servicing public debt (domestic and external) may expand beyond the capacity of the economy to cope, thereby impacting negatively on the ability to achieve the desired fiscal and monetary policy objectives (Sanusi, 2003).

The Federal Ministry of Finance earlier in the year 2014 reported that a sharp rise in government domestic borrowing occurred in 2010 when borrowing rose to N1.36 trillion (from about N524 billion in 2009) to finance salary increases. Also saying that the rise in domestic debt stock was directly attributable to the growth in the annual fiscal deficits, which grew explosively between 2007 and 2012.

With all these remarks, it is a known fact that the debt profile of Nigeria has been experiencing what could be called a partial shift from external debt to domestic debt and most recently it has been on the increase. Domestic debt profile has been rising astronomically and if not controlled could create some unfavorable consequences as crowding out private sector investment, poor GDP growth etc, Okonjo- Iweala, (2011) as cited in Onyeiwu (2012).

In spite of the attendant effects of domestic debt, literature on domestic debt in Nigeria is still relatively scanty, with the vast literature on debt mostly focused on external debt. The available ones have focused on motivations of domestic debt, its costs, and extensively on its impact on economic growth: Aminu, Ahmadu & Salihu (2013), Okon, Maji & Denies (2013). Literature on public debt has neglected domestic debt based on but not limited to the fact that domestic debt only transfers resources within the country. Whereas when these resources are left idle without productive activity, meaningful results in terms of growth and development might not showcase. One objective of borrowing is revenue gap, but in Nigeria's case, where oil price has been increasing and the revenue profile is also rising and at the same time, public borrowing is going on unabated, there is a need for investigation.

The objective of the study is to analyze Nigeria's domestic debt while examining the trend and pattern of domestic debt and its relationship with external debt, the composition of domestic debt in terms of its sources and instruments and the determinants of rising domestic debt.

The rest of the paper is structured into five sections; section two looks into the concepts, review of theoretical and empirical literature. Section three covers the

trend of domestic debt profile, composition of domestic debt in terms of sources and instruments. Section four entails modelling, result presentation and discussion. Section five and six contains the findings and recommendations respectively.

2. Literature Review

2.1. Conceptual Issues

Likita (2000) cited in Aminu et al (2013) defined debt as a contractual obligation of owing or accumulated borrowing with a promise to payback at a future date. Domestic debt is defined as debt denominated in local currency. There are some factors that evolve around and determine the conceptualization of domestic debt. First, currency in which the debt is issued. Second, the residence of the creditor. Third, place of issuance and the legislation that regulates the debt contract (Panizza, 2008).

Some of the reasons often advanced for government domestic debt include: budget deficit financing, monetary policy implementation and to deepen the financial sector (Alison, 2003). Monetary policy has also been influenced by the open market operations such as the sales of treasury bills of the government. In deepening the financial sector, there needs to be a steady supply and range of financial instruments to be traded. Financial market deepening can be achieved by offering longer dated instrument with different interest rate structures, that is, fixed and floating rate (DRI, 2001).

Increasing domestic debt could crowd out private investment because government will tend to struggle with the private sector for the limited resource that should be available for investment, thereby reducing investment. When issuing domestic debt, governments tap into domestic private savings that would otherwise have been available to the private sector. This is normally followed by an increase in domestic interest rates if these are flexible, adversely affecting private investment (Christensen, 2004). Even where interest rates are controlled, domestic borrowing can lead to credit rationing and crowding out of private sector investment (Easterly & Fischer, 1990 as cited in Christensen, 2004). An investor base that is dominated by commercial banks may worsen the abovementioned effect. The crowding out effect may, therefore, be more pronounced in the absence of nonbank investors, such as pension funds and retirement funds, to which the government could sell its debt without necessarily crowding out private sector credit (Christensen, 2004). Hence, a diverse investor base prevents excessive reliance on commercial bank funds and thereby reduces the risk of crowding out (World Bank and IMF, 2001as cited in Christensen, 2004).

Incessant increase of domestic debt can have serious effect on the economy. Domestic debt service can consume a significant part of government revenues, especially given that domestic interest rates are higher than foreign ones. The interest cost of domestic borrowing can rise quickly along with increases in the outstanding stock of debt, especially in shallow financial markets (Christensen, 2004).

2.2. Theoretical Literature

2.2.1. Liquidity Constraint Hypothesis

The liquidity constraint is captured as a "crowding out" effect, by which the requirement to service debt reduces funds available for investment and growth. A reduction in the current debt service should, therefore, lead to an increase in current investment for any given level of future indebtedness (Cohen, 1993 as cited in Okon et al., 2013). Theoretically, the process of crowding-out arises from the fact that once the government borrows heavily from the domestic market, a shortage of funds arises prompted by increased demand for investible funds which drives interest rates up leading to the reduction of private borrowing and hence limiting private investment (Maana, Owino & Mutai, 2008).

2.2.2. Profligacy Theory

The profligacy thesis attempts to correct the weakness of growth – cum debt theory by focusing on the institutional arrangement under which a loan was contracted. The profligacy thesis, a component of the system stability theory, recognizes that the debt crisis arose from weak institutions and policies that have wasted resources through unbridled official corruption and damaged living standards and development. These policies led to distortions in relative prices and encouraged capital flights – as seen in substantial external liquid funds of private citizens of debtor countries in foreign banks (Nyong, 2005).

2.3. Empirical Literature

Christensen (2004) estimated a single panel data model regressing private sector lending on domestic debt (both variables were in percent of broad money) for 27 sub-Saharan countries including Nigeria over the period 1980–2000. The results from the regression found significant support for the crowding out hypothesis; on average across countries; an expansion in domestic debt of 1 percent relative to broad money causes the ratio of lending to the private sector to broad money to decline by 0.15 percent.

Maana et al. (2008) analyzed the economic impact of domestic debt on Kenya's economy. The authors examine the impacts of domestic debt on private sector lending by applying ordinary least square technique using annual data over the period 1996 to 2007. Their model was specified as $pi = \alpha + \beta Di + \varepsilon$. The study finds

that domestic debt does not crowd out private sector lending in Kenya during the period due to substantial level of financial development in Kenya. The study also examines the effects of domestic debt on real output by using a modified Barro growth regression model. The results indicate that increase in domestic debt has a positive but insignificant effect on economic growth during the period. The study suggests that government should employ wider reforms that promote investment in treasury bonds and encourage institutional investors.

Adofu and Abula (2009) investigated the effects of rising domestic debt on the Nigerian economy by applying OLS technique using time series data from 1986-2005. The findings of the study revealed that several factors responsible for rising domestic debt in Nigeria are high budget deficit, low output level, increased government expenditures, high inflation rate and narrow revenue base. The analysis shows that domestic debt has negatively affected the growth of the economy and recommends that government should made efforts to resolve the outstanding domestic debt.

Abbas and Christensen (2007) examined the role of domestic debt markets in economic growth: an empirical investigation for low-income countries and emerging markets using panel econometric techniques to examine the endogeneity of domestic debt and its impact on growth with a view to obtaining a sense of the optimal size and quality of domestic debt. They found the following, among others: higher private savings increase the scope for domestic debt issuance while a larger supply of domestic debt instruments provides incentives to increase private savings. But, financial depth had a surprisingly weak causal contribution to income and the growth contribution of domestic debt is higher if it is marketable, bears positive real interest rates and is held outside the banking system.

Asogwa (2005) employing risk measures for domestic debt instrument investigated the effect of domestic debt on economic growth concluded that domestic government debt in Nigeria has continued to suffer some 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.

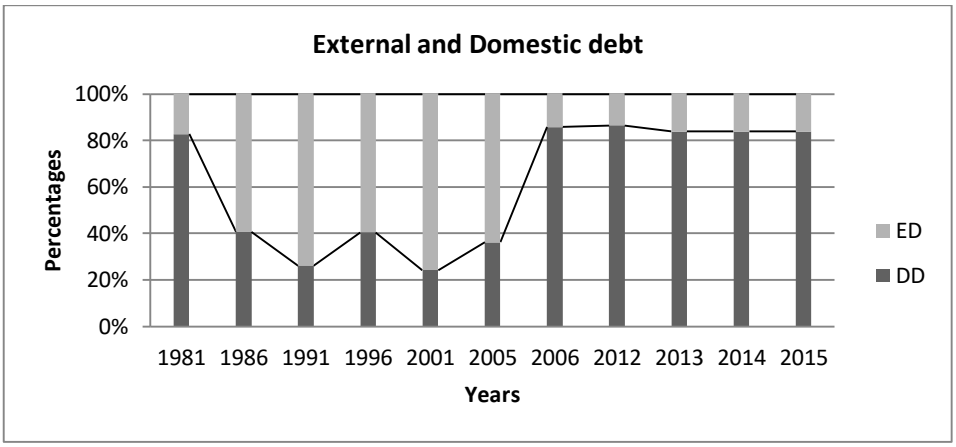
Oshadami (2006) cited in Adofu and Abula (2009), concluded that the growth of domestic debt has affected negatively the growth of the economy. This situation is premised on the fact that majority of the market participant are unwilling to hold longer maturity and as a result the government has been able 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.

Putunoi (2013) investigated the effects of domestic debt on economic growth in Kenya using quarterly data spanning 2000 to 2010. Augmented Dickey-fuller, Johannes Cointegration and error correction model were used. The study shows that

domestic debt expansion in Kenya has a positive and significant effect on economic growth.

3. Nigeria Domestic Debt Profile

Figure 1. Percentage Distribution of public Debt in Nigeria for some selected years



Source: Underlying data were obtained from the CBN Statistical Bulletin, 2012 and 2015

The year 2006 all through 2015 saw a great shift from excessive reliance on external debt to domestic debt, rising over 80percent leaving less than 20percent for external debt. The change in the structure may be due to the debt forgiveness or stringent conditionalities attached to foreign debt.

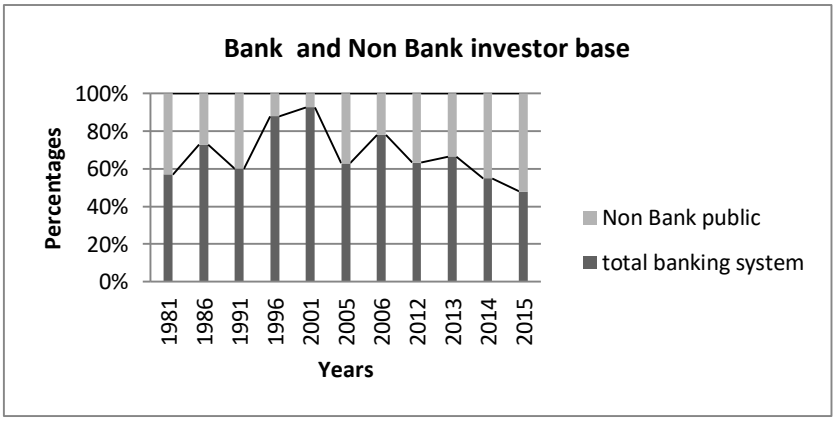


Figure 2. Percentage Distribution of bank and non-bank debt source for some selected year

Source: Underlying data were obtained from the CBN Statistical Bulletin 2012 and 2015

Categorizing the investor base into banking system and non- banking system, it was discovered that throughout the selected years except 2015, total banking system investor held more than fifty percent of the domestic debt instrument.

The figure below shows the composition of domestic debt by instruments. The instruments are development stocks, treasury bonds, Federal government of Nigeria (FGN) bonds, treasury bills, treasury certificates and /or promissory notes. For this study and this figure, development stocks, treasury bonds, FGN bonds and treasury bills were used. It was discovered that FGN bonds had the largest share of the component of domestic debt throughout the selected years. It was also observed that FGN bonds and treasury bills were crowding out treasury bonds, which has been reducing in percentage. Development stock is infinitesimal with its impact not even showing on the figure, meaning it is not up to 1%.

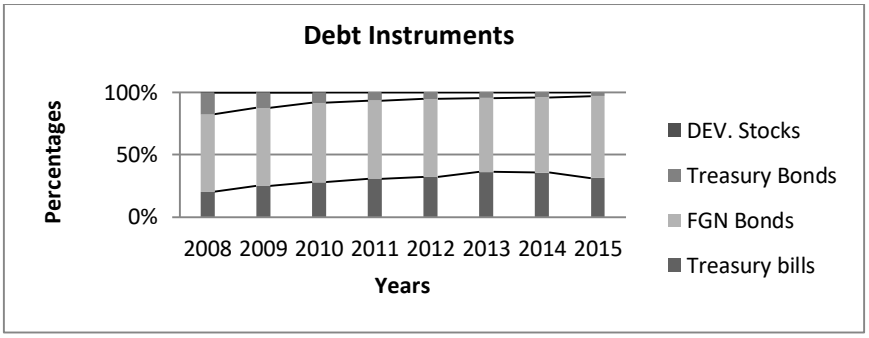


Figure III. Percentage Distribution of domestic debt by instruments (selected years)

Source: Underlying data were obtained from CBN Statistical Bulletin 2012 and 2015

4. Model, Result Presentation and Discussion

The study employed time series data ranging from 1970 to 2015 obtained from Central Bank of Nigeria Statistical Bulletin various issues, World Bank National Accounts Data and OECD National Account Data files. Philip Perron unit root tests were used to establish the stationarity and order of integration of the series. Johansen co-integration procedure was applied to determine whether a long-run equilibrium relationship exist amongst the variables after testing for stationarity. Vector error correction estimate and granger causality test were also employed so as to draw meaningful deductions from the series.

4.1. Model Specification

Adopting Cuddington (1996) and Jibao, Schoeman & Naraidoo (2012) model,

$$B_t = B_{t-1} + I_t B_{t-1} - P_S \qquad 4.0$$

Where; B_t denotes current debt of government in time t

B_{t-1} denotes outstanding debt at period t-1

I_t denotes domestic interest rate in period t

P_S denotes primary surplus

The above model is modified to accommodate for some factors (budget deficit, financial deepening, external debt, interest rate and economic growth) that have been advanced to explain the burgeoning domestic debt profile in Nigeria from empirical literature. The regression model is therefore specified as follows:

DD= f (BD, FD, ED, IR, GR) i)

Where;

DD= Domestic Debt stock at time t

BD= Budget Deficit/surplus at time t

FD= Ratio of credit to private sector to GDP proxy for financial deepening

ED= External Debt stock at time t

IR= Interest rate at time t

GR= Gross Domestic Product growth rate at time t

In econometric form,

$$DD = \alpha_0 + \varphi BD + \delta FD + \theta ED + \gamma IR + \omega GR + U_t \quad \text{ii)}$$

Where α_0 is an intercept. φ, δ, θ, $\gamma$and ω are coefficients to be estimated. μ_t is the error term.

A prior expectations are φ >0, δ>0, θ <0, γ>0 and ω<0.

The vector error correction model is specified below:

$$\Delta DD_t = \alpha_1 + \sum_{i=1}^{n} \beta_i \Delta DD_{t-i} + \sum_{i=1}^{n} \varphi_i \Delta BD_{t-i} + \sum_{i=1}^{n} \delta_i \Delta FD_{t-i} + \sum_{i=1}^{n} \theta_i \Delta ED_{t-i} + \sum_{i=1}^{n} \gamma_i \Delta IR_{t-i} + \sum_{i=1}^{n} \omega_i \Delta GR_{t=i} + ECT_{t-i} + U_{1t} \quad \text{(iii)}$$

$$\Delta BD_t = \alpha_2 + \sum_{i=1}^{n} \varphi_i \Delta BD_{t-i} + \sum_{i=1}^{n} \beta_i \Delta DD_{t-i} + \sum_{i=1}^{n} \delta_i \Delta FD_{t-i} + \sum_{i=1}^{n} \theta_i \Delta ED_{t-i} + \sum_{i=1}^{n} \gamma_i \Delta IR_{t-i} + \sum_{i=1}^{n} \omega_i \Delta GR_{t=i} + ECT_{t-i} + U_{2t} \quad \text{(iv)}$$

$$\Delta FD_t = \alpha_3 + \sum_{i=1}^{n} \delta_i \Delta FD_{t-i} + \sum_{i=1}^{n} \varphi_i \Delta BD_{t-i} + \sum_{i=1}^{n} \beta_i \Delta DD_{t-i} + \sum_{i=1}^{n} \theta_i \Delta ED_{t-i} + \sum_{i=1}^{n} \gamma_i \Delta IR_{t-i} + \sum_{i=1}^{n} \omega_i \Delta GR_{t=i} + ECT_{t-i} + U_{3t} \quad \text{(v)}$$

$$\Delta ED_t = \alpha_4 + \sum_{i=1}^{n} \theta_i \Delta ED_{t-i} + \sum_{i=1}^{n} \beta_i \Delta DD_{t-i} + \sum_{i=1}^{n} \delta_i \Delta FD_{t-i} + \sum_{i=1}^{n} \varphi_i \Delta BD_{t-i} + \sum_{i=1}^{n} \gamma_i \Delta IR_{t-i} + \sum_{i=1}^{n} \omega_i \Delta GR_{t=i} + ECT_{t-i} + U_{4t} \quad \text{(vi)}$$

$$\Delta IR_t = \alpha_5 + \sum_{i=1}^{n} \gamma_i \Delta IR_{t-i} + \sum_{i=1}^{n} \theta_i \Delta ED_{t-i} + \sum_{i=1}^{n} \beta_i \Delta DD_{t-i} + \sum_{i=1}^{n} \delta_i \Delta FD_{t-i} + \sum_{i=1}^{n} \varphi_i \Delta BD_{t-i} + \sum_{i=1}^{n} \omega_i \Delta GR_{t=i} + ECT_{t-1} + U_{5t} \quad .(vii)$$

$$\Delta GR_t = \alpha_6 + \sum_{i=1}^{n} \omega_i \Delta GR_{t=i} + \sum_{i=1}^{n} \gamma_i \Delta IR_{t-i} + \sum_{i=1}^{n} \theta_i \Delta ED_{t-i} + \sum_{i=1}^{n} \beta_i \Delta DD_{t-i} + \sum_{i=1}^{n} \delta_i \Delta FD_{t-i} + \sum_{i=1}^{n} \varphi_i \Delta BD_{t-i} + ECT_{t-i} + U_{6t} \quad (viii)$$

Δ is the difference operator and ECT is the error correction term. Equation (iii) was used to determine the determinants of domestic debt and was used to test causation of the independent variables to domestic debt.

Table 1. Unit Root Test for Variables

Variables	Test	t-statistic	Prob	Order of Integration
DD	PP	-7.714952	0.0000	I(1)
BD	PP	-15.46269	0.0000	I(1)
FD	PP	-6.668745	0.0000	I(1)
ED	PP	-16.38866	0.0000	I(1)
IR	PP	-9.549667	0.0000	I(1)
GR	PP	-14.29980	0.0000	I(1)

Source: Authors Computation, 2017

From the table above, Philip Perron unit root test shows that all the variables are stationary at first difference. For getting optimal lag length for Cointegration, Akaike information criterion suggested we use leg length of 3.

Table 2. Optimal Lag Order Criteria

Lag	Log L	LR	FPE	AIC	SC	HQ
0	-2341.776	NA	1.07e+40	109.1989	109.4446	109.2895
1	-2238.046	173.6874	4.67e+38	106.0486	107.7689	106.6830
2	-2152.240	119.7286*	5.08e+37	103.7321	106.9268*	104.9102*
3	-2110.206	46.92142	5.06e+37*	103.4515*	108.1207	105.1733

* indicates lag order selected by the criterion. LR: Sequential modified LR test statistic, FPE: Final prediction error, AIC: Akaike information criterion, SC: Schwarz information criterion, HQ: Hannan-Quinn information criterion

Table 3. Result of Johansen co-integration Value

Hypothesized No of Cointegrating Equations	Trace Statistic	Trace Statistic 5% Critical Value	Prob
None*	204.9239	95.75366	0.0000
At Most 1*	114.1871	69.81889	0.0000
At Most 2*	57.06931	47.85613	0.0054
At Most 3*	33.27045	29.79707	0.0191
At Most 4	12.18605	15.49471	0.1482
At Most 5*	4.953929	3.841466	0.0260

Source: Authors Computation, 2017

Trace statistics indicate 4 cointegrating equations at 5% significant level which implies that long run relationship exist among the variables. The cointegrating equation from the normalized cointegrating coefficient is:

Table 4. Normalized cointegrating coefficients table: Domestic Debt (DD) dependent variable

DD	BD	FD	ED	IR	GR
1.000000	25.62430	306874.6	-0.552572	871.6793	424653.4
	(4.14207)	(41707.8)	(0.17185)	(22086.3)	(47958.8)

Source: Authors computation, 2017

From the cointegrating equation, BD, FD, GR and IR which represents budget deficit, ratio of credit to private sector to GDP proxy for financial deepening, GDP growth rate and interest rate are positively related with DD in the long run while ED which represents external debt is negatively related with Domestic Debt in the long run. All the variables are in consonance with aprior expectation except GDP growth rate.

4.2. Vector Error Correction Method

This was used to establish short run equilibrium relationship among the variables after testing for the existence of long run equilibrium relationship. It was also used to cover for the lagged values of the dependent and independent variables. It was discovered from the VECM and Wald test that there is a short run causality running from lagged values of budget deficit, external debt and GDP growth rate to domestic debt. With the error correction term negative and significant coefficient, the VECM affirmed long run causality running from all the independent variables to domestic debt. The coefficient of the error correction term of domestic debt variable carries negative sign and it is statistically significant at 5 % with the speed of convergence to equilibrium of 62%. Thus in the short run, domestic debt adjusted by 62% of the past year's deviation from equilibrium.

Table 5. Summary Results from VECM

	ΔDD	ΔBD	ΔFD	ΔED	ΔIR	ΔGR
Constant	-215195.7	68859.76	-0.215565	-478043.1	2.744125	7.832798
	(-1.486805)	(1.77524)*	(-0.147944)	(-1.473042)	(1.254603)	(2.473883)**
ECT	-0.626240	-0.061043	3.92E-06	-0.297727	2.11E-06	-3.52E-06
	(2.440039)**	(-0.887383)	(1.516548)	(-0.517371)	(0.544302)	(-0.627188)
R^2	0.967639	0.919845	0.786441	0.957705	0.501039	0.783747
Adjusted R^2	0.930168	0.827035	0.539163	0.908732	-0.076705	0.533348
SE of Regression	303514.8	81350.74	3.055494	680537.7	4.586672	6.639541
F-stat	25.82370	9.910996	3.180385	19.55576	0.867234	3.129997

( ): t-statistic, ***: 1% significance level, **: 5% significance level, *:10% significance level

Source: Authors computation, 2017

4.3. Granger Causality

In order to analyse the short run causal relationship among the variables for each equation in the VECM, the granger causality test was examined. Budget deficit, external debt and gross domestic product growth rate causes domestic debt. It was discovered that domestic debt causes budget deficit, external debt and GDP growth rate. Therefore, there exist bi-directional granger causalities between domestic debt and budget deficit, domestic debt and external debt and domestic debt and GDP growth rate.

Table 6. Summary Results from VEC Granger Causality Test

Dependent Variable: D(DD)			
Excluded	**Chi-sq**	**df**	**Prob**
D(BD)	20.45609	3	0.0001
D(FD)	2.539801	3	0.4681
D(ED)	12.14031	3	0.0069
D(IR)	5.074245	3	0.1664
D(GR)	16.95700	3	0.0007
ALL	**215.5715**	**15**	**0.0000**
Dependent Variable: D(BD)			
Excluded	**Chi-sq**	**df**	**Prob**
D(DD)	40.66970	3	0.0000
Dependent Variable: D(ED)			
Excluded	**Chi-sq**	**df**	**Prob**
D(DD)	24.51265	3	0.0000
Dependent Variable: D(GR)			
Excluded	**Chi-sq**	**df**	**Prob**
D(DD)	13.84251	3	0.0031

Source: Authors computation, 2017

5. Findings

i. Nigerian government has been incurring more domestic debt than external debt after the external debt forgiveness of 2005;

ii. Domestic Debt investment base has not seen much diversity as it has been swinging between the deposit money banks and non-bank public. The provision for sinking fund has not been robust;

iii. FGN bonds are the most patronize debt instrument amidst the domestic debt instruments;

iv. Long run relationship exists among domestic debt, budget deficit, financial deepening indicator, external debt, interest rate and GDP growth rate;

v. Lagged values of budget deficit, external debt and GDP growth rate explain variations in current domestic debt in the short run;

vi. Lagged value of domestic debt explains variations in budget deficit, external debt and GDP growth rate in the short run;

vii. There exist bi-directional granger causalities between domestic debt and budget deficit, domestic debt and external debt and domestic debt and GDP growth rate.

6. Recommendations

i. Increasing domestic debt should be redirected into productive capital expenditure, thereby eliminating recurrent fiscal financing;

ii. Other long term maturity structure debt instruments like treasury bonds and development stock should also be made attractive for investors by reducing their maturity period which is averagely longer than FGN bonds, the most patronize instrument;

iii. Instituting reasonable budget cut that will not hamper economic growth;

iv. Since all the variables explained the variations in domestic debt in the long run, they should all be held in considerable amount so as to checkmate the rising domestic debt profile.

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