Economic and Financial Review

Volume 53
Number 4 *Proceedings of the seminar on “Financing Government Programmes in Economic Downturn -The Role of Central Bank of Nigeria?", for CBN Executive Staff at Golden Tulip Hotel, Lagos, September 5th – 8th, 2016*

Article 6

12-1-2015

Financing government deficit during economic downturn: options for consideration

O. Ajakaiye
African Center for Shared Development Capability, Ibadan

Recommended Citation

Ajakaiye, O. (2015). Financing government deficit during economic downturn: options for consideration, CBN Economic and Financial Review. 53(4), 59-69.

Financing Government Deficit during Economic Downturn: Options for Consideration

Olu Ajakaiye[*]

I. Introduction

Economic downturn is said to commence when the rate of economic growth is slowing down. If economic downturn, continues up to a point where the growth rate turns negative for two consecutive quarters, the economy is generally deemed to be in recession. The immediate cause of economic downturn can be a reduction in expenditure by households, firms, government, reduction in export earnings or a combination of these causes. The root cause of recession is, however, a reduction in income of households, firms, government and the major trading partners or a combination.

An economic downturn triggered by a reduction in export earnings, for example, will result in loss of income by firms. Firms respond by retrenching workers resulting in rising unemployment and dwindling household incomes (wage and non-wage incomes). During economic downturn, therefore, government revenue falls. A passive government may reduce its expenditure on goods and services, while transfers component of its expenditure relating to unemployment benefits, pension and other social protection programmes may have to rise. Accordingly, during recession, government budget, invariably, runs into non-discretionary deficit.

An active government that seeks to pursue counter-cyclical fiscal policy may also embark on discretionary budget deficit thus, magnifying the budget deficit. In such situation, government discretionary budget deficit arises from government investment (capital) expenditure. Passive governments (like EU and UK until recently) tend to adopt austerity measures thereby avoiding discretionary budget deficit.

The upshot of the foregoing is that during economic downturn or outright recession, non-discretionary budget deficit is inescapable. Experience, however, suggests that during economic downturn, most governments tend to pursue counter-cyclical fiscal policy requiring a discretionary budget deficit.

The conventional approaches to financing budget deficit are the issuance of government bonds. In this paper, we examine the efficacy of the

[*] Professor Olu Ajakaiye is of the African Center for Shared Development Capability, Ibadan. *The usual disclaimer applies.*

conventional approach to financing budget deficit during economic downturn in Nigeria. We also consider other (unconventional) options for financing budget deficits during economic downturn in Nigeria.

The rest of the paper is, therefore, organised as follows. Section II presents key features of the current economic downturn in Nigeria. This is followed, in Section III, by a review of the current methods of financing budget deficit in Nigeria. Section IV presents additional options for financing budget deficit that can be considered in the contemporary Nigerian situation.

II. Features of Current Economic Downturn in Nigeria

As mentioned earlier, economic downturn manifests when GDP growth rate starts to decline. A look at Figure 1 shows that the current economic downturn in Nigeria actually commenced from the second quarter of 2014 and by the first quarter of 2016, the growth rate had turned to negative (-0.36 per cent). The second quarter GDP growth rate of -2.06 per cent along with a double digit inflation rate since June 2016 suggests that the Nigerian economy is in a recession accompanied by rising inflation, unemployment, interest rates on loans and government debts.

Meanwhile, it is significant to note that the downturn started immediately the international price of crude oil decelerating from June 2014 (see Figure 2). Specifically, the root cause of the current economic downturn in Nigeria is the reduction in export earnings, occasioned by the deceleration in international crude oil prices. This has been accentuated by the disruption in oil production by the various groups in the Niger Delta Region.

In the Nigerian context, therefore, the immediate effect of reduction in export earnings is reduction in oil revenue (government income) and reduced inflow of foreign exchange. The associated reduction in capacity to import also affects a major component of revenue, namely customs duties. Given the high import dependence of production and consumption activities in Nigeria, the VAT, CIT and payroll taxes would eventually decline. In sum, the reduction in export earnings arising from the fall in international crude oil prices and reduction in oil output had a ramifying immediate effect on all components of government revenues leading to escalated non-discretionary budget deficit in the economy.

Figure 1: Quarterly GDP Growth Rate, 2011Q1-2016Q1

Source: National Bureau of Statistics (2016) National Accounts of Nigeria (NBS, Abuja)

Figure 2: Monthly Brent Crude Oil Price US$/Barrel, 2010-2016

Source: World Bank (2016) Global Economic Monitor (World Bank, Washington DC)

Another pertinent feature of the current economic downturn is that the government budget has been in deficit for some time. For example, a look at Table 1 showed that prior to the onset of economic downturn, government has been running budget deficit. It seems reasonable to consider the deficits prior to 2015 to be largely discretionary, while the 2015 budget deficit is a combination of discretionary and non-discretionary deficits [3]. Clearly, the

[3] When the difference between revenue and recurrent expenditure is positive (negative), i.e., development budget is non-zero (negative) the budget deficit can be deemed to be discretionary (non-discretionary).

2016 Federal Budget is a combination of discretionary and non-discretionary deficits [4].

Table 1: Federal Government Fiscal Balances 2011-2015

Budget Heads/Ratios	2011	2012	2013	2014	2015
Federal Government Retained Revenue (N' billion)	3348.12	3154.86	3362.19	2518.84	3602.96
Total Expenditure (N' billions)	4484.74	4130.58	4522.15	3030.29	4357.96
Budget Deficit (N' billion)	-1136.62	-975.72	-1159.90	-511.45	-755.00
Primary Deficit (N'billion)	-641.52	-296.44	-325.33	191.38	188.00
Total Fiscal Deficit (per cent) of Revenue	-42.80	-30.93	-25.29	-20.30	-20.95
Primary Deficit (per cent) of Revenue	-19.16	-9.40	-9.68	7.60	5.22
Total Fiscal Deficit/GDP per cent	-3.09	-2.85	-1.85	-0.64	-0.79
Primary Deficit or surplus /GDP per cent	-1.7	0.74	0.70	0.2	0.2
GDP (N'billions)	37543.70	39904.30	46714.30	80,222.13*	95843.16

Source: National Institute of Legislative Studies (2016) Review of 2016 Appropriation Bill (NILS. Abuja)

A related issue is the rather high debt service payments. For example, as shown in Table 1, between 2011 and 2015, an average of 25.0 per cent of Federal Government revenue has been devoted to debt service. Moreover, Table 2 revealed that actual debt service has always exceeded the budget in recent times. Now that the economy is in recession, it is pertinent to manage debt service payment with a view to releasing the much needed government revenue for use in addressing the burning social and economic development challenges which the economic recession would have accentuated. Accordingly, the next section is devoted to examining the efficacy of the conventional approaches to financing budget deficit in a recession.

Table 2: Budget and Actual Debt Service Payments, 2013-2015

Items	Jan-Dec, 2013			Jan-Dec, 2014			Jan-Sep 2015		
	Budget	Actual	Variance	Budget	Actual	Variance	Budget	Actual	Variance
Debt Service Payments	591.76	834.56	242.79 (41.03 per cent)	712.00	941.67	229.67 (32.2 per cent)	715.21	908.91	193.7 (27.0 per cent)

Source: National Institute of Legislative Studies (2016) Review of 2016 Appropriation Bill (NILS. Abuja),

[4] For 2016, the federal government retained revenue is N3.85 trillion, recurrent expenditure is N 4.6trillion implying that up to 50% of the total deficit of N2.2trillion can be considered non-discretionary.

Notes: The values in parentheses show the percentage of variations of Actual from Budgeted values. *the actual values for personnel cost, pensions and gratuities and overhead costs and service wide votes in 2014 are as at October.

III. A Review of the Current Approaches to Deficit Financing in Nigeria

The conventional approach to financing government budget deficit is through domestic and/or external borrowing. Domestic borrowing is typically effected through issuance of interest-bearing government debt instruments like treasury bills and bonds. These instruments can be purchased by the central bank, deposit money banks, other financial institutions, pension funds and the non-bank public. An accumulation of these instruments results in rising public debt. Also, financing budget deficit through interest-bearing domestic debt can cause interest rates to rise leading to rising debt service as well as the familiar crowding-out effect and possible Ricardian equivalence.

Table 3: FGN's Domestic Debt by Holder Category as at end-December, 2015 (₦' Billion)

Instruments	Central Bank	Banks	Non-Bank Public	Sinking Fund	Amount Outstanding
FGN Bond	550.66	2,237.14	3,020.34	-	5,808.14
Treasury Bonds	93.79	-	-	162.20	255.99
NTBs	232.85	1,046.87	1,493.15	-	2,772.87
TOTAL	**877.30**	**3,284.01**	**4,513.49**	**162.20**	**8,837.00**
Per cent of Total	9.93	37.16	51.07	1.84	100.00

Source: Annual Report and Statement of Accounts, 2015 (DMO, Abuja)

Available data from Debt Management Office presented in plotted Figures 3 and 4 showed that Nigeria's total debt stock and debt service have been rising. Figure 3 showed that the increase in total debt stock has been driven, mainly, by domestic debt, indicating that the bulk of the deficit has been funded through domestic borrowing.

Table 3 showing the distribution of domestic debt by category of holders revealed that over half of the total debt stock at end-December 2015 was held by non-bank public, while the banks held about 37.0 per cent. The relatively small holding by the Central Bank is consistent with the twin objective of the domestic debt management strategy of DMO, namely, to finance budget deficit and also deepen the bond market (DMO, 2015:11).

As shown in Figure 3, Nigeria's external debt stock is relatively small, but rising. Figure 4 also showed that external debt service is quite small. It is also noted that 82.2 per cent of the external debt stock is made up of concessional loans. It is encouraging to note that Nigeria has been meeting its debt service obligations promptly such that it received a waiver in 2015. These explained the relatively low external debt service. During recession, it is important to maintain these attributes to prevent the stock and debt service payments from escalating.

Figure 3: Composition Nigeria's Debts Stock, 2011-2015

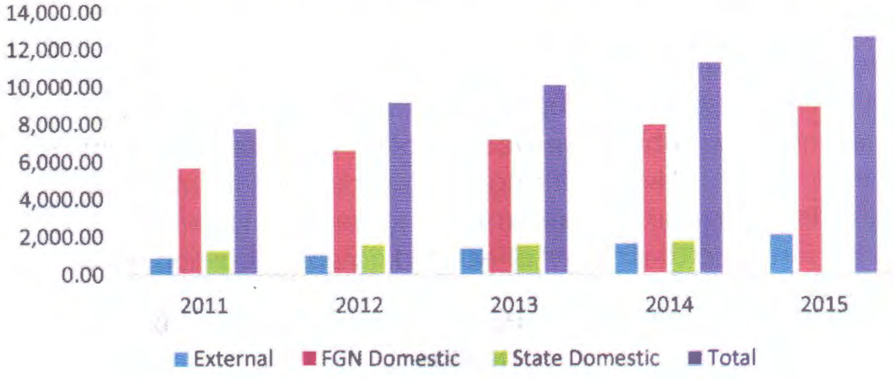
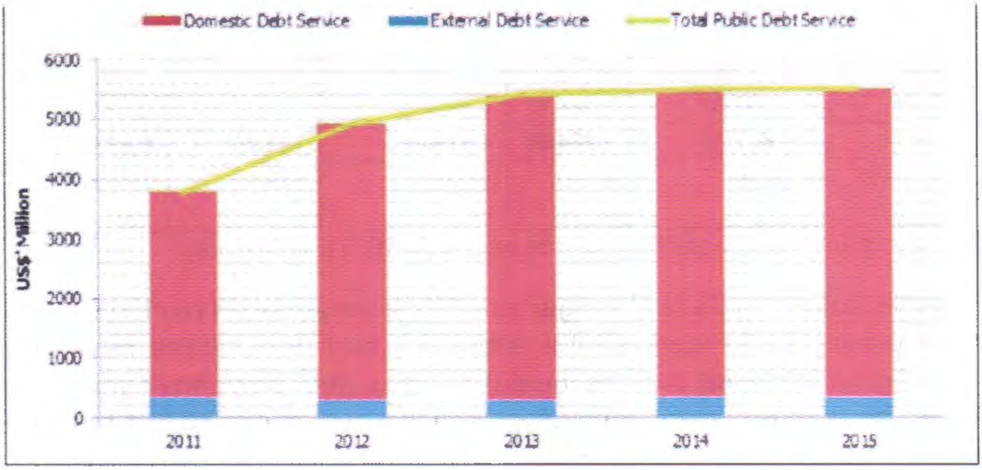


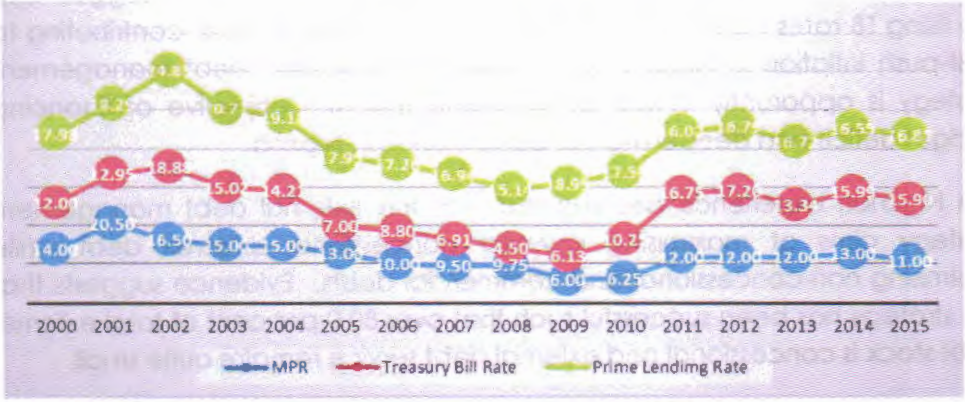
Figure 4: Trend in Debt Service, 2011-2015



Source: DMO

Figure 5 showed clearly that TBR and Prime lending rate tracked remarkably. Causality test also suggested that the causality runs from TB rate to prime lending rate implying that raising the TBR in order to attract investors to patronise government interest-bearing debt instruments crowds out the private sector and stokes cost-push inflation. See Ajakaiye and Babatunde (2015) for further analysis of the relationship between lending rate and inflation in Nigeria.

Figure 5: Trends in MPR, TBR and Prime Lending Rate, 2000-2015



Source: CBN

It would be recalled that most of the external debt overhang from which Nigeria managed to extricate itself in 2006 were accumulated during the economic downturns of the 1980s and 1990s. The commercial debts have a way of starting small, but growing very fast. Also, there is always pressure by the commercial loan 'merchants' to encourage developing country governments to take their loans, especially during a recession. It is important to avoid these temptations during this recession so as to prevent a re-emergence of debt overhang in the future.

It is noted that so far, a large proportion of external debts are allocated to economic sectors (see DMO, 2015:28). During economic recession, government may be tempted to contract non-concessional and commercial external debt for social protection programmes, especially in view of the massive needs for resettlement of the internally displaced persons. The prevailing strategy of patronising concessional loans for this purpose should be sustained. If commercial loans must be contracted, they should be allocated to projects that will generate foreign exchange high enough to meet the interest and capital payment obligations.

Evidently, Nigeria has adopted the conventional approach to deficit financing from domestic sources, namely issuance of government debt instruments. In keeping with the text books (Krugman and Wells, 2009 Ch. 13) and in recent literature (Wood, 2012; Ajakaiye, 2002; and Ajakaiye and Babatunde, 2015; Turner, 2015; and McCulley and Pozsar, 2013), this conventional approach tends to raise interest rates, crowd-out the private sector from the credit market and could stoke inflation.

A review of the Nigerian experience prior to the onset of economic downturn revealed that domestic public debt stock and debt service have been rising very fast, and an average of 25.0 per cent of government revenue has been devoted to debt service between 2011 and 2015 and evidence suggest that the rising TB rates contributes to rising bank lending rate, thus, contributing to cost-push inflation in Nigeria. Meanwhile, the domestic debt management strategy is apparently aimed at achieving the twin objective of financing budget deficit and deepening the bond market in Nigeria.

The Nigerian experience also showed that the external debt management strategy aims at maximising low-cost concessional external debt while minimising non-concessional and commercial debts. Evidence suggests that this strategy has been successful such that over 80.0 per cent of total external debt stock is concessional and external debt service remains quite small.

Now that the Nigerian economy is in recession triggered, mainly, by falling crude oil revenue and characterised by high inflation, high unemployment, and depreciating exchange rate in an import dependent production and consumption system, it is imperative to reconsider exclusive reliance on the conventional approach to deficit financing and explore options that are unlikely to raise interest rates, raise debt service and stoke cost-push inflation. The next section therefore explores these options.

IV. Additional Options for Financing Nigerian Government Budget Deficit during Economic Downturn

IV.1 Monetary Financing of Budget Deficit

Evidently, continuing the exclusive reliance on issuance of interest-bearing debt instruments as a strategy for deficit financing from domestic sources in Nigeria will escalate debt service, cause interest rates to rise and crowd-out the private sector. Moreover, pursuing the other objective of deepening the bond market in Nigeria during economic recession may be unaffordable. Data showed that at end-2015, CBN held less than 10.0 per cent of total interest-bearing domestic debt stock. Therefore, financing budget deficit by issuing irredeemable fiat non-interest bearing monetary liabilities of government by the CBN should be seriously considered (Wood, 2012; Citi Economic 2012; and Turner, 2015).

This approach, which has been dubbed Overt Money Finance, has the benefit of stimulating the economy without raising interest rates and crowding out the private sector as well as stoking cost-push inflation. The approach, however, requires the CBN and Ministry of Finance to coordinate their activities and work in concert to stimulate the economy at lower direct costs (Turner, 2015; Wood, 2014). In this regard, the monetary authorities may have to give greater consideration to economic revival (growth and employment revival) and be ready to accept higher inflation while the recession lasts. The risks of abusing this approach have been significantly reduced as the fiscal authorities comply with the Fiscal Responsibility Act which prescribed 3.0 per cent deficit GDP ratio.

IV.2 Co-Financing Arrangements with Pension Funds

At the moment, Pension Funds regulation discourages the PFAs from investing in long-term risky projects. Therefore, they patronise treasury bills and minimise long-term bonds in their portfolio. However, if capital projects are packaged in ways that they will yield reasonable returns, Pension Funds could be encouraged to enter into co-financing arrangement with government. Examples could be highway projects with tolls similar to those in Lagos State. This way, the countercyclical development enhancing capital projects could be financed without issuing interest-bearing instruments and, indeed, non-interest bearing government bonds.

IV.3 Issuance of Project-Tied Bonds

It has been mentioned that the external debt management strategy aimed at minimising the external debts stock and debt service is suitable for an economy in recession and should be sustained. It is quite possible that concessional external loans may be insufficient to meet the external components of budget deficit. In such case, government, in concert with the Central Bank, should consider issuing project-tied bonds and market them among the Nigerians in Diaspora. Experience of countries that successfully issued such bonds suggests that an appropriate Diaspora Policy guaranteeing participation of the diaspora in political, social and economic development of their home country is a pre-requisite. The Diaspora Policy of Ethiopia can be a useful guide in this regard. Successful diaspora bonds can be instrumental in formalising remittances and making them available to fund capital projects.

Refences

Adebiyi, M. A. and Babatope-Obasa, B., (2004). Institutional Framework, Interest Rate Policy and the Financing of the Nigerian Manufacturing Sub-Sector. African Development and Poverty Reduction: The Macro-Micro Linkage. Forum Paper, 13-15. Lord Charles Hotel, Somerset West, South Africa.

Adebiyi, M. A. (2001). "Can High Real Interest Rate Promote Economic Growth Without Fuelling Inflation in Nigeria?" *Journal of Economics and Social Studies*, Volume 1, Number 1, Pp. 86- 100.

Ajakaiye, D. O and Babatunde, M. A., (2015). The Future of Banking System and Economic Development in Nigeria. *Annals of the Social Science Academy of Nigeria.*

Ajakaiye, D. O. (2002) Banking Sector Reforms and Economic Performance in Nigeria. In: Deregulation and the Banking Crisis in Nigeria. A Comparative Study. Eds. H. Stein, O. Ajakaiye and P. Lewis. Palgrave Publishers Limited.

Ajakaiye, D. O. and Ojowu, O., (1991). Exchange Rate Depreciation and Structure of Sectoral Prices in Nigeria Under Alternative Pricing Regimes, 1986-89, *Final Research Report*, Presented to AERC, Nairobi, December.

Ajakaiye, D. O. and Omole, D. A., (1991). Contributions of Rising Lending Rates to Inflation in Nigeria: An Empirical Assessment, 1987-1989. An Invited Paper by the Program Committee for the First Biennial International Conference on African Economic Issues (Lome, Togo).

Ajakaiye, D. O. and Odusola, F. A., (1995). "Real Deposit Rates and Financial Savings Mobilisation in Nigeria: An Empirical Test", *Journal of Economic Management*, Vol. 2, No.2, October.

Babatunde, M. A. and Shuaibu, M. I., (2012). "An Empirical Analysis of Bank Lending and Inflation in Nigeria", *Indian Economic Journal*. Volume 59 Number 3.

Citi Economics (2012). What More Can Central Banks Do To Stimulate the Economy? (Global Economic View, Citi Investment Research and Analysis).

Debt Management Office (2015). 2015 Annual Report and Statement of Accounts (DMO, Abuja)

Epstein, G. (2006). Central Bank As Agents of Employment Generation (UNDESA Working paper No. 38, June)

Feltenstein A. and Iwata, R., (2002). "Why is it Hard to Finance Budget Deficit? Problems of a Developing Country", *Journal of Asian Economics*, 13 pp. 531 - 44

Krugman P. and Wells, R., (2009). Macroeconomics Ch. 13 (Worth Publishers New York)

Lenza, M., H. Pill and Reichlin, L., (2010). Monetary Policy in Exceptional Times in Economic Policy, April pp. 295-339

McCulley, P. and Pozsar, Z., (2013). Helicopter Money: Or How I Stopped Worrying and Love Fiscal-Monetary Cooperation (Global Society Fellows of Global Interdependence Centre, Washington DC)

National Institute for Legislative Studies (2016). Review of 2016 Appropriation (NILS, Abuja)

Roley, V. V. (1981). "The Financing of Federal Deficits: An Analysis of Crowding Out", *Federal Reserve Bank of Kansa City Working Paper.*

Turner, A. (2015). The Case for Monetary Finance – An Essentially Political Issue (Paper Presented at the 16th Jaques Polak Annual Research Conference, November 5-6, hosted by IMF, Washington DC)

Vit, K. (2003). "The Possibilities of Budget Deficit Financing", *University of Economics Working Paper*, Praque, Czech Republic.

Wood, R. (2012). "The Economic Crisis: How to Stimulate Economies Without Increasing Public Debt", *CEPR Policy Insight No. 62* August.

Wood, R. (2012). Delivering Economic Stimulus, Addressing Rising Public Debt and Avoiding Inflation, *Journal of Financial Economic Policy*, Vol. 1 No. 1 pp4-24.