FDC Economic Bulletin

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Rising public sector debt, a ticking time bomb

FGN seeks securitization and restructuring of debt backlog

As Nigeria attempts to prevent a further blemish to its credit rating, the finance ministry on the authority of the Federal Executive council (FEC) wants to securitize and restructure some long dated (1994) existing financial obligations of approximately N2.7trn ($8.8bn).

History of FGN unwillingness to settle financial obligations

Nigeria has a reputation of chronic indebtedness and financial delinquency dating as far back as the 1970s, when Nigerian debt was ruled as sub-standard by the London Club of Bankers. The cement armada and defaulting on confirmed irrevocable Letters of Credit was the first time the government of Nigeria became a documented defaulter in the international arena. The accumulation of arrears on trade finance resulted in a rescheduling of trade and payable debts in the 1980s. The cumulative effect of the piecemeal and unstructured approach to debt servicing (accounts for 66% of recurrent income) resulted in a choking debt trap. In the end, Nigeria's accumulated external debt reached a level of $36bn (HIPC – Heavily Indebted Poor Countries). A combination of deft negotiation and a payment of $18bn comprehensive debt forgiveness were achieved in 2005.

On the domestic front, delays and default in payment for Bona fide transactions such as the JV cash calls have strained the financial reputation of the FGN. The securitization of debt through promissory notes is a step taken by the government to address debt to 'helpless creditors' of the government such as FGN contractors and suppliers, pension and salary arrears and state governments. The arrears to be targeted date as far back as 1994.

Debt profile[1]

Debt Category		Outstanding in USD ('000, 000)	Outstanding in NGN ('000, 000)
A	External Debt Stock (FGN + States)	13,807.59	4,229,955.20
	Domestic Debt Stock (FGN Only)	39,077.32	11,971,336.53
B	Domestic Debt of States	9,985.16	2,958,517.43

Cost overrun and project inflation by contractors

Many multinational contractors blacklisted Nigeria because of its tarnished payments record. The others who had no choice had to inflate the contracts to reflect the additional default risks. The hedge against delays or possible defaults resulted in project cost inflation at the expense of the tax payers.

Banking system fragility in a recessionary environment

The Nigerian banking system has been vulnerable to commodity price and currency volatility shocks. However, one of the weaknesses of the sector has been the high default rate of debtors. Non-performing loans are now believed to be approximately 16% of total risk assets. Last year, Fitch Ratings reduced the Support Rating Floors of 10 Nigerian banks to "No Floor" on the backdrop of rising foreign debt and lack of institutions to cushion these banks in the event further shocks to the system. Major contributors to the asset quality problem of the sector are government contractors. The banks now shun more loan requests by government and public sector contractors. In the past two rounds of bank distress, government delinquency has been a major catalyst of bank failure.

Impact analysis

To put the proposed securitisation of N2.7trn in context, it is roughly $8.9bn and 29.3% of gross external reserves and 12.3% of money supply. The impact of this proposed debt scheme transcends through key variables such as interest rates, exchange rates, asset quality and monetary stability.

[1] Source: DMO for the period ending 31st of March 2017

Banking system, sink or swim?

The banking system could gain a sense of respite through increased liquidity. Many of the loans obtained by contractors affected by FGN default had been written off as non-performing loans by these banks leading to many rating agencies questioning the strength of the banking system in withstanding further shocks. Most of the banks also sustained significant losses to their share values and as such increased liquidity is to facilitate a tapering in the speculation of a banking crisis.

Monetary stability and the enigma that is inflation

In regards to monetary stability, an inflow of liquidity is expected, regardless of how much discounting is imposed on notes. Currently M2 is approximately N22trn and the average opening position so far in July is N9.88bn short.[2] Hence, the expected increase in liquidity is welcomed especially by manufacturers and investors. However, price stability is threatened as an increase in money supply coincides with an increase in the price level. Currently inflation sits at 16.1%, well above the CBN's target of 11% by year end.

Interest rate policy and the singing doves

Inflationary conditions will factor into monetary policy as calls for a more accommodative interest rate environment might cease. This is because of the anticipated money supply impact of cashing in notes. Worst case scenario might lead to considerations of further tightening as the CBN's primary goal is price stability above all other objectives, such as economic growth.

Exchange rate, how bleak is the future?

The exchange rate is likely to be negatively impacted from this debt scheme. It makes rational sense to assume that many contractors who cash out their notes will go straight to the forex market. Increased demand of that magnitude with little or no corresponding supply on the part of the CBN could undermine past interventions by the apex bank and force the value of the naira down. Therefore CBN policy in the FX market will have to be intensified in order to offset anticipated exchange rate losses.

[2] Review period is from the 1st to 14th of July 2017


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Why now? In politics, timing is everything

Apart from the catalytic impact of the securitization on growth and its stimulus effect on the recovery from recession, the timing of the programme has raised eyebrows. Some analysts fear that the scheme could be abused for political purposes. In the past, the judicial process had been abused to create fictitious debts that had no genuine transactions. As we slowly go into the electoral cycle, it is feared that political favours could be extended to friends and supporters to fund political campaigns. With both leading political parties in dire need of funding, sceptics fear that the temptation of fiscal abuse is high.

Going Forward

The Federal Government needs to exercise discipline in the execution of this proposed debt scheme. The crux of the current issue about default and delay in payment dates back to the culture of allowing arrears to build up in the first place. Brokerage abuse and unethical practices between banks and government, lead to the culture of using funds set aside for settling contractors and suppliers to trade for extra profit. Therefore, to break the cycle of bad governance and negligence, which has brought the nation to this point, ethical execution from screening contractors to issuing the notes and payment at maturity, is required.