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# IMPACT OF EXTERNAL DEBT ON INCLUSIVE GROWTH   IN NIGERIA

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**ABSTRACT**

*The study examined the impact of external debt on inclusive growth in Nigeria over the period of 1981 to 2016. This study employed Zivot Andrew unit root test with breaks to determine the order of integration of the variables used. Debt overhang and crowding out effect were used to capture the external debt, and a dummy variable was used to capture the debt forgiveness of 2005. The unit root test results show that all the variables were integrated of order zero I(0). The regression results revealed that crowding out variable has negative significant effect on inclusive growth. The results also revealed that debt relief of 2005 shows a positive and significant effect on inclusive growth. The study recommends that fiscal discipline is required, not only to reverse the excessive external debt but also to ensure that foreign debts are productively utilized to achieve inclusive growth in Nigeria.*

## 1.       Introduction

The nexus between external borrowing and economic growth has become issue of concern to both academics and policy makers. Public borrowing, either internal or external, is considered as a means of providing finance for investment in infrastructure and human capital development that will improve the living standard of the people. It is rare for any developing country to economically survive without borrowing, since internal financial resources are not sufficient to effectively implement their deficit budgets. Thus, external finance is helpful in fostering the developmental process by bridging the investment-saving gap in developing countries if properly utilized. Public debt that is not well managed could become burden, with debt crowding out investment and growth (Soludo, 2003).

Over the years, Nigeria's external debt has been on the rise even after the debt relief granted by Paris club in 2005. The country's external debt was ₦2.695 trillion in 2005 which reduced to ₦0.451 trillion in 2006 following the debt relief. The debt rose significantly to ₦1.631, ₦2.111, ₦3.478 and ₦5.787 trillion in 2014, 2015, 2016 and 2017 respectively (CBN, 2017). The Nigeria's debt portfolio has also been on the increase with external debt service payment of ₦6.6 billion, ₦8.3 billion and ₦9.13 billion in 2012, 2013 and 2014 respectively (World Bank, 2015). This has serious implications for the progress of the economy, because high debt payment reduces public investments in infrastructure that can enhance economic growth and development. The burden of debt payment becomes severe when the proceeds from the borrowed fund are not efficiently utilized to yield financial and real assets that can facilitate its repayment, liquidation of the debt and economic development of the debtor-country.

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Despite the enormous empirical studies in this area, little attention was paid to the impact of external debt on inclusive growth. Economic growth pays little or no attention to the welfare of the citizen, thus only few benefited from the increased productivity during economic boom while the majority are marginalized and bypassed, thereby making growth to be superficial and non-inclusive in nature. In the recent times, the concept of inclusive growth has received much attention in development economics. It evolved due to the sustained economic growth experienced in some developing countries over decades without significant influence on the major indicators of economic wellbeing of the people - employment opportunities, poverty reduction, quality of education and health facilities. Therefore, this study empirically examined the impact of external debt on inclusive growth in Nigeria. The study also considered the significance of structural break in external borrowing, and its effect on the inclusive growth in Nigeria. The remaining part of this paper is divided into four sections. Section 2 reviewed relevant literature; section 3 presents methodology used for the study, section 4 contains presentation, analysis and discussion of results; while the last section, section 5, concludes the study.

## 2.    Literature review

### 2.1    Conceptual issues

*External debt*: Debt is described as a liability represented by a financial instrument or other formal equivalents. When a government borrows fund, the debt is a public debt which can be either internal or external.  While internal debt concerns with fund raised internally, external debt is the one sourced outside the country. External debt is that portion of a country's debt that is acquired from foreign sources such as foreign corporate, government or financial institutions. World Bank (2005) described external debt as all unpaid portion of external finances which are needed for development purposes and balance of payment support which could not be repaid as and when due. It is also defined as the gross amount at any time of disbursed and outstanding contractual obligations of a country to non residents to repay principal with or without interest. External debt is not as bad as many people believe as long as the fund is invested in sustainable project that will generate revenue for servicing the debt.

*Inclusive growth:* The term "Inclusive growth" got its origin in the year 2000s when organizations such as World Bank realized that their economic predictions were not accomplished. The growth in developing countries was not reducing inequality and did not lead to increase in the living standard of people as expected (Stott, 2017). OECD (2015) defined inclusive growth as economic growth that is distributed fairly across society and creates opportunities for all. Inclusive growth is defined as the growth of output that is sustained over a period of time, which is broad based across economic sectors, creating productive employment opportunity and reduces poverty to the beeriest minimum. Inclusive growth is a concept that encompasses equity, equality of opportunity, and protection in the market and employment transition which is an essential ingredient of any

growth strategy (CGD, 2008). The equality of opportunity in the above definition implies good access to markets, resources, and unbiased regulatory environment for business and individuals. Birdsall (2007) described inclusive growth to mean pro-poor growth, which involves – increasing the size and economic strata of the middle class. The assumption here is that, growth which is beneficial for the large majority of people in developing counties, is more likely to be economical and political in nature.

## 2.2.    Theoretical review

**Debt Overhang Hypothesis:** The debt overhang hypothesis was first postulated by Stewart Myers in 1977 with his theory of company valuation in corporate finance and the effect of debt financing. He explained that high debt distorts the possibilities for companies to make optimal future investment decisions (Myers, 1977). This hypothesis opined that when the stock of debt is too large, the expected interest payments are a positive function of output. This reduces investment because their returns will be taxed away by foreign creditors and the pace of economic growth will slow down. Under such conditions, the debtor country shares partially from any increase in output and exports which could be used to augment investment and repayment of debt. Karagol (2004) indicated that there is much interest from developing countries in the link between external loan and economic development since debt overhang has an impact on investment and thus economic growth. As debt services grow, foreign creditors effectively remove many of the earnings accruable from investment within the local economy which discourages new foreign investments (Clements, Bhattacharya & Nguyen, 2004; 2005). This will, in no small measure, directly hamper capital formation, growth and living standard of people (Dijkstra &Hermes, 2001). When the effect is strong, the debtor nation is said to be on the "wrong side" of the Laffer curve, which implies that there is a limit at which debt accumulation could stimulates growth (Sichula, 2012; Pattillo, Poirson,& Ricci 2002; Elbadawi, Benno, Ndulu & Ndungu, 1997; Krugman, 1988).Koeda (2008) argued that the effect of debt overhang and the effectiveness of debt relief depend on the initial economic conditions of recipient country and the level of total factor productivity. He argued further that a country that has no effective tools to raise total factor productivity may accumulate a significant amount of concessional debt and allocate resources to consumption rather than investment.

However, Bulow and Rogoff (1991) disagreed that external debt discourages investment and reduces growth. They argued that borrower's underdeveloped was due more to their own economies mismanagement than to the burden of external debt. They concluded that debt overhang was a symptom not the cause of low growth in countries with high debt profiles.

**Dependency Theory:** The dependency theory postulates that investment is a function of savings, and that in developing countries, the level of domestic savings is not sufficient to fund the investment required for economic growth and development. Therefore, it is logical to seek the use of complementary external funds, goods and services. The acquisition of

external funds depends on the relationship between domestic savings, foreign funds, investment and economic growth. A country could seek external funds for investment and economic growth provided that such funds can generate a rate of return that is higher than the cost of borrowed foreign funds (Ajayi & Khan, 2000). Savings-investment gap often exist if the available domestic savings is less than the level necessary to achieve the target rate of growth. On a similar note, export-import exchange gap also exist if the maximum import needed to achieve the growth target is greater than the maximum possible level of export of domestic economy. The dependency theory seeks to establish the factors responsible for the development of the underdeveloped economies.

**Crowding-Out Theory:** The philosophy behind the crowding out effects concept assumes that government debts consume a greater part of the country's capital meant for investment due to increase in cost of borrowed funds. The term of trade of a country becomes worsen due to excessive interest charges on foreign credits. Crowding out effects set in at a point when only government and its agencies would be able to borrow due to excessive interest charges. Individual entrepreneurs and firms are thus unable to compete and hence crowded out of the market. Claessens, Detragiache, Kanbur & Wickham (1996) identified the decline in investment as a result of the decrease in a country's available assets for financing investment and macroeconomics activities. Reduction in nation's capability of maintaining its debt as a result of crowding out effect, seriously affects domestic investment (Patenio & Agustina, 2007).Economic growth is thus affected via the economies inability to generate enough capital for investment. In effect, debt servicing transfers wealth from the domestic arena to international arena, which creates multiplier accelerator effect that reduces the economy's capacity to develop (Metwally &Tamaschke, 1994). It can de deduced from the above that external debt may be detrimental to the growth and development of developing nations if the interest payments on the debt accumulates above the initial debt.

## 2.3    Empirical Review

Most of the empirical studies conducted on external debt and economic growth show that there was no consensus on the link between external debt and economic growth due to social, economic and political differences in the study areas (Karagol, 2005). For instance, while some found negative effect (Asafo, Matuka & Dominic, 2019; Senadza, Fiagbe, & Quartey 2017; Reinhart & Rogoff, 2010; Were, 2001; Iyowa, 1999), others found positive effect (Matuka & Asafo, 2018; Jayaraman & Lau, 2009; Warner, 1992). Those that could not establish any relationship include: Ibiesor & Alfred (2015); Frimpong & Oteng-Abayic (2006), Cohen (1993) among others. For instance, Asafo et al (2019) examined the relationship between external debt and economic growth in a panel of 48 sub-Saharan African countries for the period 1990 – 2017 using General Method of Moment (GMM) technique. The results revealed a negative significant impact of external debt on economic growth. Senadza et al (2017) conducted an empirical assessment of external debt and economic growth relationship for 39 sub-Saharan countries for the period (1990 – 2013).

They employed a system GMM methodology, and the results revealed a negative impact of external debt on growth. They also found no evidence for a non-linear relationship between debt and growth. Sichula (2012) examined the effects of debt overhang and debt relief on economies of heavily indebted poor countries of Southern African development community. The results show that external debt has significant negative effect on economic growth. The results also revealed that Terms of trade and Capital expenditure have significant effects on private capital.

Matuka & Asafo (2018) examined the impact of external debt on economic growth in Ghana for the period 1970 – 2017. They employed Johansen co-integration and error correction model for the estimation, and the results show that external debt inflows stimulate economic growth both in the short-run and in the long-run. The results also revealed evidence of Debt overhang, Crowding out effect and non-linear effect of external debt on economic growth in Ghana.

Ejigayehu & Person (2013) analyzed the effect of external debt on economic growth of eight selected heavily indebted African countries (Benin, Ethiopia, Mali, Madagascar, Mozambique, Senegal, Tanzania and Uganda). They used ratio of external debt to gross national income as a proxy for debt overhang and debt service export ratio as a proxy for debt crowding out. Panel data covering the period 1991-2010 was used. The results showed that external debt affects economic growth through debt crowding out rather than debt overhang. Ajayi and Oke (2012) investigated the effect of the external debt burden on economic growth in Nigeria. They confirmed that external debt burden had an adverse effect on the per capita income of the nation. They concluded that external debt contributed to the devaluation of the nation's currency, increase in the retrenchment of workers, continuous industrial strike, and poor educational system. Ayadi and Ayadi (2012) comparatively studied the impact of external debt on economic growth of Nigeria and South Africa. This study confirmed the negative impact of debt (and its servicing requirements) on growth in Nigeria and South Africa. However, South Africa performs better than Nigeria in the application of external loans to promote growth. Likewise, Wamboye (2012) assessed the impact of external debt, trade and FDI on economic growth of least developed countries. The study considered the effect of public and publicly guaranteed (PPG) external debt on long term economic growth of least developed countries. Arellano-Bond GMM method was used on panel data for the period 1975 to 2010. The results show that high external debt depresses economic growth regardless of the nature of the debt. He concluded that debt relief initiatives are crucial for economic development of LDCs.

Kumar and Woo (2010) employed panel data of 36 advanced and emerging countries to assess the effect of high public debt on economic growth in the long run. They found evidence of an inverse relationship between initial debt and successive growth while controlling for other causes of growth. Moss and Chiang (2003) analyzed other costs of

high debts in poor countries in terms of their economic growth, policy dynamics and institutions. They posit that high debt ultimately contributes to adverse policy dynamic as well as impeding the sustainability of economic reform. Also, Pattillo, Helene & Ricci (2002) assessed the non-linear impact of external debt on growth using large panel data of 93 developing countries over the period 1969 to 1998. They found that the average impact of external debt on per capita GDP growth is negative for net present value of debt levels above 160-170 percent of exports and 35–40 percent of GDP. Debt also appears to have more effect on growth, via its effect on the efficiency of resource use, than private investment. They suggested that doubling the debt ratio for countries with average indebtedness, would reduce annual per capita growth by between half and a full percentage point .For countries under the heavily indebted poor country initiative, they suggested that reducing the debt ratio by half would increase annual per capita growth by 1 percent, unless constrained by other macroeconomic distortions.

Ibiesor and Alfred (2015) examined the influence of external borrowed fund on the growth of the Nigeria economy using vector auto-regression (VAR), impulse response and variance decomposition. Their findings show that there is a weak nexus between the foreign borrowed funds and the Nigerian economy, suggesting that excessive borrowing do not significantly influence economic performance. This implies that the external borrowed fund is not a yard stick in predicting or forecasting improvement or slowdown in the Nigeria context.

The various empirical studies reviewed in this study revealed that there is dearth of studies on the impacts of external debt on inclusive growth. Most studies examined the effects of external debt on economic growth or development without considering the influence of structural break in external borrowing on inclusive growth. Thus, this study not only examined the impact of external debt on inclusive growth but also considered the significance of structural break in external borrowing on the inclusive growth in Nigeria.

## 3.    Methodology

### 3.1    Model Specification

Following Wamboye (2012), foreign direct investment, trade balance and external debt can have significant influence on economic growth. In this study, economic growth is replaced with inclusive growth and external debt is replaced with debt overhang and crowding out effect. Expressing this relationship in an equation form gives:

$$inclgrowth_t = f(fdi_t, tradebal_t, debtovang_t, crout_t,) \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (1)$$

Where;

$inclgrowth_t$= Inclusive growth at time t

$fdi_t$= Foreign direct investment at time t

*tradebal*$_t$= Trade balanceat time t

*debtovang*$_t$= Debt overhang at time t

*crout*$_t$= crowding out effect at time t

The debt forgiveness was granted to Nigeria in 2005. This could have a significant effect on inclusive growth. Using dummy variable to represent the structural break of this event and including it in the model, Equation 1 becomes,

*inclgrowth*$_t$ = β$_0$+ β$_1$*fdi*$_t$, + β$_2$*tradebal*$_t$, + β$_3$*debtovang*$_t$, + β$_4$*crout*$_t$, + β$_5$dummy + μ$_t$  ..... (2)

Where dummy = Dummy variable for the structural break 2005. It was the year that Nigeria received US$18 billion debt forgiveness (assigning 0 for periods before the break date and 1 after the break).

The a-priori expectations are β$_1$, β$_2$, β$_5$> 0 and β$_3$ ,β$_4$< 0.

## 3.2      Estimation Techniques

This study employed regression analysis to analyze the possible impact of external debt (Debt overhang and Crowding out effect) on inclusive growth. Time series often face the problem of non-stationary. A non-stationary series show a systematic pattern that is unpredictable which could produce spurious results. There are several methods of testing the presence of unit root in a series such as: Augmented Dickey-Fuller (ADF); Phillip Perron (PP); Dickey-Fuller Generalized Least Square (GF-GLS); Zivot Andrew; among others. Perron (1989; 2005) opined that failure to allow for an existing break leads to a bias that reduces the ability to reject null hypothesis. To overcome this, Perron proposed allowing for a known or exogenous structural break in unit root testing. Hence, this study employed Zivot Andrew unit root test with breaks to test the presence of unit root in time series data used in this study. Ordinary Least Square method was employed for the regression based on the results of unit root test. Principal Component Analysis (PCA) was employed to derive the inclusive growth index using per capita income, employment generation and access to infrastructure for the computation.

## 3.3      Data Measurement

**Table 1: Measurement and Sources of Data**

| Variables | Definition | Measurement | Source |
|---|---|---|---|

| *inclgrowth* | Inclusive growth index | Inclusive growth index was derived from per capita income (in Naira), employment generation (in percentage) and access to infrastructure (electricity consumption per head in khw) using Principal Component Analysis (PCA) | WDI (2016) |
|---|---|---|---|
| *debtovang* | Debt overhang | Measured as external debt/gross national income ratio. | WDI (2016) |
| *Crout* | Crowding out effect | Measured as External debt/Export ratio. | WDI (2016) |
| *Fdi* | Foreign Direct Investment | Nigeria's foreign direct investment (in Naira) | WDI (2016) |
| *tradebal* | Trade Balance | Measured as the difference between total export and total import (in Naira) | CBN (2016) |
| *dummy* | Dummy variable | Assigning 0 for periods before the break date (2005) and 1 from 2005 to 2016. | Authors' specification |

## 4.0   Presentation and Discussion of Results

The results of the Zivot Andrew unit root test suggest that all the variables were stationary at level as shown in table 2.

**Table 2: Result of Zivot Andrew Unit root Test and Order of Integration**

| Variable | Zivot Andrew Unit root Test | | |
|---|---|---|---|
| | P-value | Remark | Order of Integration |

| | | | |
|---|---|---|---|
| *inclgrowth* | 0.034 | Stationary | I(0)** |
| *Fdi* | 0.009 | Stationary | I(0)* |
| *Tradebal* | 0.01 | Stationary | I(0)** |
| *debtovang* | 0.029 | Stationary | I(0)** |
| *Crout* | 0.098 | Stationary | I(0)*** |

Source: Researchers' *Computation from Eviews (2017) *. **, *** indicate significant at 1, 5 and 10 percent levels respectively*

Based on the unit root results presented above, all the variables were stationary at levels. Thus, the study employed Ordinary Least Square method (OLS) for the estimation. The regression results, as presented in table 3, revealed that all the explanatory variables conformed to expected signs except trade balance. The adjusted R-square of 0.897 indicates that the explanatory variables explained about 89.7 percent changes in the dependent variable (inclusive growth). The variables that are not included in the model explained for the remaining 10.3 percent variation in the dependent variable. Thus, the goodness of fit of this model is adequate with high predictive power.

Foreign direct investment came out with expected sign and statistically significant at 1 percent significance level. This implies that FDI is a major determinant of inclusive growth in Nigeria. A unit rise in foreign direct investment induces 12.5 percent increase in inclusive growth, which suggests that inflow of FDI into Nigeria can lead to substantial improvement in living standard of people. The estimates of both debt overhang and trade balance were negative and statistically insignificant. This suggests that debt overhang, measured as external debt-GDP ratio, does not significantly influence inclusive growth in Nigeria. This finding contradicts the findings of Ajayi and Oke, (2012), and Ayadi and Ayadi, (2012). Besides, the trade balance variable came out with positive sign but does not have significant effect on inclusive growth, which could be due to the prolonged unfavourable balance of payment in the country.

**Table 3: Regression Results**

| Model | Inclusive growth (ig) | | Expected Sign |
|---|---|---|---|
| | Coefficient | P-value | |
| *fdi_t* | 0.1254 | 0.0006* | + |

| tradebal$_t$ | -3.9816 | 0.9304 | + |
|---|---|---|---|
| debtovang$_t$ | -2.8733 | 0.1869 | - |
| crout$_t$ | -0.4730 | 0.0184** | - |
| *Dummy* | 1.1660 | 0.0011* | + |
| Constant | -1.4212 | 0000* | |
| Adjusted R square | 0.897 | | |
| Prob (F-statistic) | 0.0000 | | |

Source: Researchers' *Computation from Eviews (2017). * & ** indicate significance at 1 &5 percents respectively*

The crowding out effect variable was negative and statistically significant at 5 percent level. This means that 1 percent increase in external debt service export ratio (crowding out) induces about 47.3 percent fall in inclusive growth. This implies that as more quantity of incomes from export leaves the economy through foreign debt servicing, the saving-investment gap would be more expanded and economic advancement becomes more challenging. However, the negative and significant coefficient of the crowding out further confirmed the presence of revenue crowding out in Nigeria as in most developing economies and in line with other studies (Asogwa &Chetachukwu, 2013; Paiko, 2012; Obi & Abu, 2009; Emran &Farazi, 2009).

Also, the dummy variable employed to assess the significance of external debt forgiveness on inclusive growth is positive and significant at 1 percent, which suggests that the Paris club debts forgiveness of 2005 exerts significant impact on inclusive growth. This suggests that debt forgiveness can accelerate the inclusive growth in Nigeria.

The implication of these findings is that revenue crowding out is a major impediment to inclusive growth in Nigeria due to increase in external debt stock even with debt forgiveness.

## 5.    Conclusion and recommendations

The study examined the impact of external debt on inclusive growth in Nigeria using Zivot Andrew unit root test with break to determine the order of integration of all the variables used in the study. The study revealed that all the variables were integrated of order zero I(0) and the regression results show that crowding out effect had more impact on inclusive growth in Nigeria than debt overhang. The result of the dummy variable employed shows that the Paris club debts forgiveness of 2005 exerts a significant effect on inclusive growth. This indicates that debt forgiveness can accelerate the inclusive growth drive Nigeria. This is because the money accrues from debt servicing can be used to achieve the Sustainable

Development Goals for the betterment of the populace. The study therefore, recommends that fiscal discipline is required in Nigeria not only to reverse the excessive external debt but also, to ensure that foreign debts are productively utilized. The Government should also place restrictions on external borrowings by the federal and state governments except in cases where such loans are explicitly acknowledged to be for viable projects that will have positive impact on the welfare of the citizens.

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