Fundamentals

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Macroeconomic update | Nigeria's 1Q2022 public debt stock

The dose makes the poison

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IN BRIEF

- Warren Buffet opined that chains of habit are too weak to be felt until they are too strong to be broken. This has been the case with Nigeria's public debt as the country continues to pile into more debt despite its lingering fiscal concerns.
- While borrowing is a global norm, and it is in itself not a sin, the capacity to pay back is the underlining factor amid the rising cost of sovereign debts.
- Countries incur debt to finance key development projects. But, taken too far, the burden of debt repayment can overwhelm a country's finances – at worst leading to default.
- Although, Nigeria may not be drowning in a sea of debt just yet like the most recent domino (Sri Lanka) that fell in the face of global threats, the ingredients of unsustainable debt are increasingly becoming conspicuous.
- Dwindling reserves, unproductive government expenditure, rising import bill, a weakening local currency, and a growing budget deficit all pose downside risks to Nigeria's fiscal balance in the near term.
- Therefore, taming Nigeria's burgeoning debt stock with its increasingly asphyxiating service obligations is cardinal to averting a possible high risk of debt distress.
- Everything must be done to repel an unsustainable debt scenario.

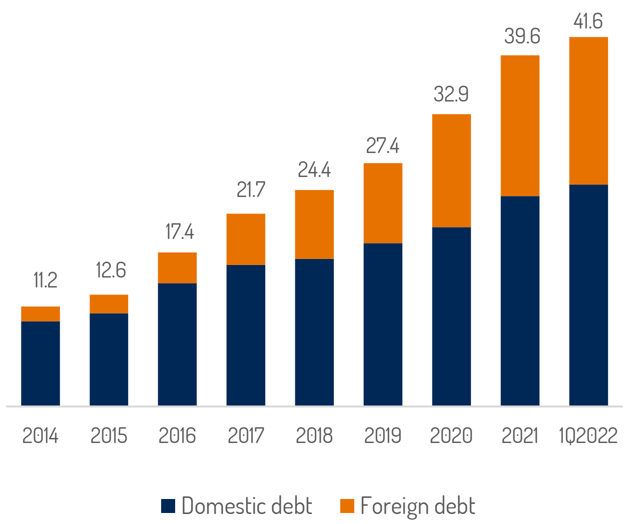
In 1Q2022, Nigeria's public debt stock rose by NGN 2.0trn to NGN 41.6trn (USD 100.1bn), with NGN 876.7bn (USD 2.1bn) worth of debt service obligations. With a debt-GDP ratio of between 23%-24%, the country is far below the 55% threshold advised by the International Monetary Fund (IMF) for countries with moderate risk of debt distress.

However, many factors go into assessing how much debt an economy can safely carry – including its ability to mobilise domestic revenue. Nigeria's public debt bag begs the question: how long will the country remain in the safe corridor, amid its myriad expenditure needs and revenue constraints?

The massive debt behemoth

The continuous increase in Nigeria's debt load is going to remain a major cause for concern amid its perennial revenue shortfalls. In 1Q2022, the country's public debt stock rose by 5.2% q/q (around NGN 2trn) to NGN 41.6trn (USD 100.1bn). The burden of debt paints an even grimmer picture when we factor in the around NGN 19.0trn (USD 45.7bn) – which is not captured in the published public debt figures – that is owed to the Central Bank of Nigeria (CBN) by the Federal Government of Nigeria (FGN) via overdrafts referred to as Ways and Means (W&M).

Nigeria's public debt stock (NGN'trn)



Source: Nigeria's Debt Management Office

Nigeria's debt Gordian knot is a direct consequence of lofty budget assumptions, i.e. spending plans that are as large as a barge and Barmecidal government revenues. Pandemic-related emergency expenditure, and an ever-increasing petrol subsidy bill pumped up the state budget in recent years, while the failure to meet its crude oil production quota robbed the country of the potentially huge revenue accruing from higher oil prices in the global market. A person in debt is likened to a wounded patient whose first line of treatment should be stopping the bleeding, but the Nigerian government is bent on holding on to the hook.

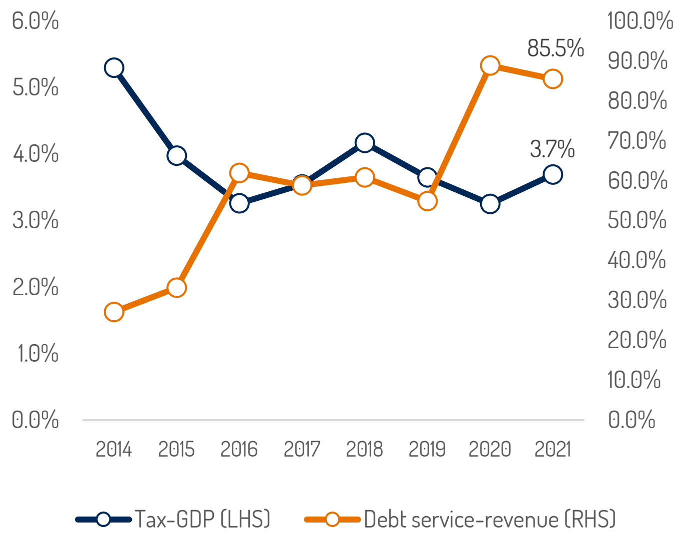
In 2022, the government continued to bleed red ink by incurring an average loss of NGN 236.9bn monthly from January to April because of its involvement in fuel importation and subsidy provision. On the other hand, Nigeria's crude oil production capacity has stagnated at 1.2mbpd despite higher production quotas from the Organisation of Petroleum Exporting Countries (OPEC). This means the country is barely able to cover its under-recovery costs with oil receipts and is left to finance a sizeable fraction of its budget with borrowed funds that mostly carry commercial rates of interest.

Debt mark-up heading towards a fiscal cliff

Due to the negative spill overs from the European war, the Nigerian government's fiscal space is poised to thin out further, leaving it with more limited options and resources to service its existing financial obligations. Likened to termites that remain undetected - silently eating off wooden furniture - until irreparable damage has been done, Nigeria's debt service obligations have risen significantly in recent years limiting the budgetary room available to accommodate discretionary spending.

The IMF confirmed that Nigeria spent 86% of its revenue on debt servicing in 2021, and the ratio is poised to worsen in 2022 as the burden of subsidising petrol is limiting the accretion of petrodollars to the government's coffers. Nigeria's fiscal tightrope reflects low revenues from petrodollars and taxes, as well as higher rates of interest demanded by the country's creditors. For instance, South Africa's USD 273.9bn public debt stock - almost three times the size of Nigeria's – is being serviced by around 20% of its revenues, thanks to outperforming revenues from taxes and the metals windfall.

Nigeria's tax-GDP vs debt service-revenue (%)



Source: Federal Inland Revenue Service, Nigeria's National Bureau of Statistics, Central Bank of Nigeria, IMF

Nigeria's 10-year Eurobond z-spread

Source: Bloomberg

In addition, investors demanding a relatively higher mark-up for Nigeria's issues to compensate for the country's risky environment, are adding to the financing pressure. A case in point is Nigeria having to pay a rate of interest of 8.4% on the 7-year Eurobond it issued in March, while South Africa is paying a 5.9% rate of interest on its 10-year Eurobond issuance that happened only a few weeks apart.

The low revenue state of play is worsened by the fact that the general polls are less than 10 months away, and pressure is building up on the government to deliver on previous election promises at a time when it is not politically expedient to increase taxes or remove subsidies. Combine this with the fact that Nigeria is an import-dependent economy with an NGN 20.8trn (USD 49.5bn) import bill in 2021, and external reserves currently at USD 38.5bn, then the outlook for debt servicing also paints a grim picture. Little wonder the IMF projects that Nigeria could be using more than 100% of its revenues to service its debts by 2024 if domestic revenue mobilisation strategies are not intensified.

Feeling the pinch of rising interest rates

The steep path to higher interest rates in the global financial market is pushing Nigeria close to the edge when it comes to covering its financing costs, and this is likely to further shake concerns about the country's sovereign debt manageability – especially as its external borrowing costs continue to rise. Year-to-date, the yield on Nigeria's 10-year maturing Eurobond has risen by 483bps to 12.8%, while its z-spread has increased by more than 40% from the end of last year. A higher z-spread denotes a higher risk associated with holding the instrument, for which investors demand a higher premium.

Given the high yield environment, the calculus for investing in countries with high debt and/or debt service obligations, and external reserve accretion constraints is now very different, and investors may be reluctant to finance subsequent large debt piles without an increase in debt premiums. This could put Nigerian bonds under renewed pressure. Irrespective of this, we are of the opinion that Nigeria's debt situation is worrisome, but not dire. However, markets could overreact intermittently as debt sustainability alarm bells continue to chime.

Conclusion

Debt is like any other trap: easy to get into, but difficult to get out of. Although Nigeria may still be miles away from a debt implosion, its debt bag leaves it on shaky ground. In addition, the recourse to tapping the CBN's W&M window could have adverse implications on monetary policy to the detriment of domestic prices and exchange rates. This could intensify the credit risk associated with the country's foreign borrowings, which currently account for around 40% of its debt portfolio.

Therefore, debt sustainability alarm bells are likely to continue chiming as Nigeria's interest payments rise along with government borrowing, shrinking its fiscal space. Risk also remains high on increasing fuel subsidies, which could weigh heavily on the country's fiscal balance.

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