Nigeria Economic Alert:

2017 Budget: Debt sustainability under fiscal constraints

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Summary

Nigeria plans for the 2017 fiscal year with a budget of NGN7.3trillion (USD23.9billion), a 20.4% y/y increase, targeted at restoring the economy to the path of sustainable and inclusive growth. In our view, the budget performance would be strongly impacted by the level of revenue accretion, as oil and non-oil revenues are largely susceptible to downside risks. Delivering on this target of economic recovery will require a huge political will to rein in wasteful expenditure, a sustainable debt financing strategy as well as a focus on developmental Capital Expenditure (CAPEX). This brings us back to the urgent need to implement critical reforms that will encourage private sector participation to help bridge the funding gap.

Debt sustainability in focus

The Federal Government's debt has increased at a CAGR of 16.2% over the last 5 years to about USD42.1billion[1] (NGN13.8 trillion) in 2016. Going by the borrowing plans for 2017, the debt stock could increase by as much as 20% y/y to USD54.4billion (NGN16.6trillion) with debt to GDP rising to 17% (2016e: 15%) which remains benign relative to emerging market average of 42% and a threshold of 56%[2] under joint IMF and World bank Debt Sustainability Framework.

Nonetheless, Nigeria's debt profile reveals some vulnerabilities. The debt service to revenue ratio has risen from 9.5% in 2009 to 30.9% in 2015, above the country specific threshold of 28%. In 2016, this spiked further to about 50%, driven by unfavorable financing terms and weak revenue growth (*See figure 1*). By our estimate, average interest rate on domestic debt in 2016 was c.13.2%, up from 10.8% in 2015.

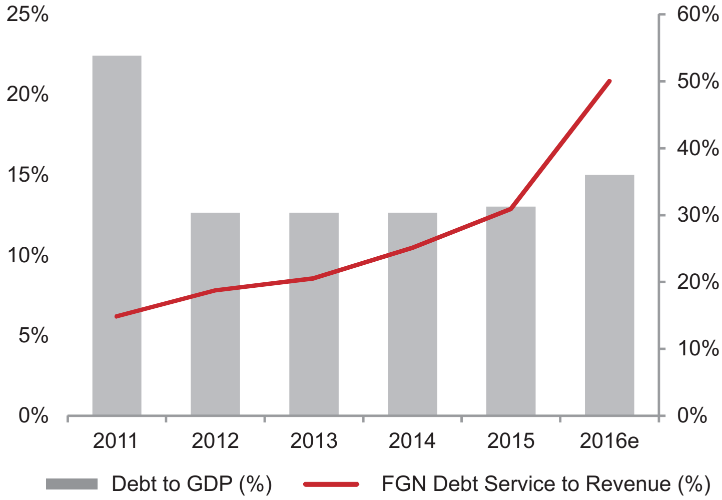
Going forward, significant additions to debt would likely increase the debt service charge, most especially in the domestic market with the risk of crowding out private investment, as investors price in higher yields for rising risk. More so, the outlook of a tighter monetary policy stance could worsen debt refinancing conditions, as c.35% of existing domestic debt matures in less than twelve months.

Interestingly, Nigeria's recently issued USD1billion Eurobond at 7.9%, represents 28.6% of the 2017 external borrowing plan. However, rising uncertainty in the global financial markets and stringent conditions for accessing concessionary debt still pose a concern for bridging the shortfall in budget. In addition, accretion to the Excess Crude Account (ECA) has slowed, leaving limited options for deficit financing.

Estimates are based on NGN305/USD exchange rate

1- *Debt Management Office (2016)*
2- *IMF (2013), "Staff Guidance Note on the DSF for LICS*
3- *World Bank 2014 estimate*
4- *AFDB (2013) High level policy dialogue: Infrastructure and structural transformation in Nigeria*

Figure 1: Debt sustainability indicators



Source: Debt Management Office, CBN, PwC Analysis

Yet, Nigeria's tax collection is one of the lowest in the world with tax to GDP at 2%, relative to global average of 14.8%[3]. Thus, implementing tax reforms that can raise revenues is imperative for closing the budget deficit and reducing borrowing costs.

Developmental Capital Expenditure vulnerable to revenue shocks

Nigeria's infrastructure deficit is estimated at USD3 trillion[4] for the next 30 years, implying that the 2017 budget allocation for infrastructure spending is marginal at less than 3% of required annual funding (USD300 billion). More so, the budget is largely vulnerable to revenue shocks, and precedence suggests revenue underperformance would likely constrain developmental CAPEX, since recurrent expenditure is deemed non-discretionary. Implementation of CAPEX over the past 5 years has averaged 60.0% relative to the 99.0% implementation of recurrent expenditure.

Given the government's budget constraint across all levels, private sector involvement has become increasingly important in delivering economic and social infrastructure. However, investment has remained sluggish in recent times due to unpredictable polices and the challenging business environment. According to NBS, foreign direct investment declined 27.8% y/y to USD1.0billion in 2016, the lowest level since 2011.

In the near term, there is an urgent need to provide clarity on the policy environment by implementing key reforms that will promote a convergence of business and development interests, toward a common goal of inclusive prosperity.

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