

## **Effect of External Debt on Economic Growth: Evidence from Nigeria**

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### **Abstract**

The study seeks to determine the effect of external debt on economic growth in Nigeria. Specifically, the study examines whether external borrowings and its major determinants like exchange rate, gross fixed capital formation and inflation rate have supported the growth of the Nigerian economy. The parameters of the model were estimated using the ordinary least squares method. The robustness of the result was enhanced using the generalized least squares technique. The result shows evidence of significant positive correlation between economic growth and the explanatory variables namely external debt, exchange rate and inflation rate. A negative correlation was however observed between economic growth and gross fixed capital formation. The regression estimates for both the ordinary and generalized least squares tests show significant positive impact of external debt, exchange rate and inflation rate on economic growth. The results also show non-significant negative effect of gross fixed capital formation on economic growth. The study concludes the external debt has significantly promoted economic growth in Nigeria.

**Keywords:** External debt, Economic growth, Exchange rate, Inflation rate, Gross fixed capital.

### **Introduction**

Debt financing is an integral part of modern economies as developed and developing nations either borrow to drive the process of economic growth and development or to support existing level of economic activities. It is a government policy of stimulating the economy by deliberately budgeting an expenditure in excess of revenue (from taxes, royalties, and sundry sources) through injection of funds to stimulate or maintain the level of economic activities, the excess being financed by borrowing. Nwankwo (2011) posits that governments all over the world engage in borrowing but explains that while developing nations borrow to finance economic and social development projects, developed nations borrow primarily to keep the economy running and making progress.

Essentially, governments borrow from internal and external sources. However while domestic borrowing has been largely criticized for its crowding-out effect on private domestic investment, external borrowing is subject to external influences such as interest and exchange rates changes as well as inflationary trends. External borrowing leads to an injection of funds (new money) into the domestic economy. Government external borrowing was justified in Nnoli (1978) who asserts that at the time of political independence, leaders considered national resources grossly inadequate and incapable of sustaining rapid economic development. Beyond the initial period of nationhood, Onosode (2004) argues that foreign capital, technological capability and know-how are required for any serious economic development. Debt financing therefore is an integral part of national existence.

There have been opposing arguments on whether external debt is actually a veritable instrument of promoting economic growth in debtor nations. Empirical findings in this area have been mixed. This paper therefore seeks to determine the effect of external debt on economic growth in Nigeria.

## **Review of Related Literature**

There is no doubt that national governments need some measure of external finance to promote economic growth and development through enhanced domestic capacity building. However, to realize the growth-inducing level of external finance, it is equally important to determine the optimum debt-to-GDP ratio. This ratio is an indicator of a country's capacity to honour debt service obligations. Sub-optimal level of external borrowing can impede growth. It can either slow down the growth process or impact growth negatively. According to Pattillo et al (2002), reasonable levels of external debt that help finance productive investment may be expected to enhance growth, but beyond certain levels additional indebtedness may reduce growth. A major challenge for many developing economies, particularly those of Sub-Saharan Africa has been the inability to determine the level of foreign debt that supports growth.

There is substantial evidence in literature that, in the short-run, external debt can assist countries increase their endowments or take advantage of additional investment opportunities without forgoing consumption smoothing while, in the long-run, it can help them undertake long-term investments without compromising current for future consumption (Essays, UK, 2013).

Okoye (2013) argues that external debt can be a driver of economic growth and development if debtor nations can prudently manage the proceeds of the loan in a manner that guarantees returns over and above the costs associated with the loan. Regrettably, countries with high incidence of external debt burden are those saddled with massive corruption, weak institutions and poor project planning and implementation. External debt acquisition therefore throws up management challenges for debtor countries. If it accumulates so much as to increase government instability or the country risk, it may lead to capital flight because foreign investors may decide to move their investments to more economically stable environments.

Also, poor external debt management creates a burden on the borrowing nation and this could be a disincentive to domestic enterprise since a disproportionate fraction of national earnings would be channeled to debt service payments thereby stifling economic growth. Proper and effective management of external debt should, among other things, accord due consideration to source and tenure of the loan as well as feasibility and viability of projects to be financed.

## **Empirical Literature**

Literature is replete with evidence of conflicting findings on the nexus between economic growth and the exogenous variables reviewed in this study. While there exists evidence that these economic

fundamentals promote economic growth, there are also documented instances that they can be an impediment to growth. Some studies have also established that their effects on growth are non-linear.

Hagos (2011) conducted a cross country study on the effect of external debt on economic growth in Sub-Saharan Africa (SSA) based on a panel data of 44 SSA countries for a period of 30 years. The study finds that external debt and external debt service have significant negative effect on economic growth when the external debt- GDP ratio exceeds 45 per cent. The study further shows significant negative impact of external debt on human capital and also confirms the crowding out effect of external debt service payments on private investment. The study also identifies a growth maximizing level of external debt of between 25–45 per cent.

Ayadi and Ayadi (2008) examined the impact of external debt on the economic growth of the Nigerian and South African economies using annual data on real GDP, external debt stock, fixed capital stock and terms of trade. The study employed both the ordinary least squares (OLS) and generalized least squares (GLS) estimation techniques. The study shows evidence of a negative relationship between external debt and economic growth for South Africa. They also show that external debt contributes positively to growth up to a point after which its contribution becomes negative (threshold effect) in Nigeria. They however failed to establish the threshold level of external debt in Nigeria. They conclude that external debt management is better conducted in South African than in Nigeria.

Iyoha (1997), in a study on “Debt Overhang, Debt Reduction, Investment and Economic Growth in Nigeria”, confirms the “crowding out” and the: “debt overhang” effects of external debt servicing in Nigeria and concludes that both effects significantly explain the low level of investment in Nigeria.

Ashinze and Onwioduokit (1996) investigated the relationship between external debt and economic growth in Nigeria. They show evidence of non-linear effects of external debt on economic growth. Specifically, the report that external debt significantly promotes economic growth under a regime of effective utilization of external debt but also leads to decline in economic activity when external debts were not judiciously utilized.

Edo (2002) examined the problem of external debt in Africa using data from Nigeria and Morocco. The major finding of the study is that external debt severely retards economic growth. He also finds that fiscal expenditure, balance of payments and global interest rates significantly explain external debt accumulation in both economies. He recommends that privatization, sustained export promotion programme as well as restructuring and development of capital markets have the capacity to resolve the problem of external debt.

Arnone et al (2005), in a study on, “External Debt Sustainability: Theory and Evidence,” finds that large external debt stocks lead to capital flight, higher tax rates and continuous over-borrowing and therefore impacts negatively on economic growth.

Clements et al (2003) examined the relationship between external debt, public investment and economic growth in developing economies. Evidence presented in the study suggests that substantial reduction of the external debt stock could increase income per capita (per capita GDP) by about 1 per cent in those highly indebted poor countries (HIPC). They also observe that a reduction in external debt service obligations positively impacts on growth since more funds are released for public sector investment.

Ezeabasili et al (2011) investigated the effects of external debt on the growth of the Nigerian economy using annual data over the period 1975-2006, employing the methodology of econometric analysis. The error correction estimate shows that external debt is negatively related to economic growth in Nigeria. They recommend that Nigeria should closely watch the magnitude of the traditional external debt indicators (external debt to GDP ratio; external debt service to GDP ratio, etc) as they provide useful guides on debt-carrying capacity of the economy.

Elbadawi et al (1996) studied the effect of debt overhang on economic growth using data for 99 developing Countries, spanning sub-Saharan Africa, Middle East, Latin America and Asia. They find evidence of a negative effect of external debt on economic growth. Specifically, they find that external debt affects growth directly through current debt inflow in relation to GDP; accumulated debt (effect of debt over hang) outflows in respect of debt service and directly through the effects of the above channels on public sector expenditures

Sulaiman and Azeez (2012) examined the effect of external debt on economic growth in Nigeria using the ordinary least square (OLS) estimation technique. They document evidence of positive relationship between external debt and economic growth.

Cohens (1993) investigated the relationship between low investment and large LDCs (less developed countries) debt in the 1980s. He finds that external debt stock in the LDCs does not significantly explain the low level of investment. However, the finds that debt service to GDP ratio which represents actual transfers out of the economy correlates negatively with investment.

Borensztein (1990) examined the relationship between examined the relationship between external debt overhang, debt reduction and investment using annual data from Philippines. He finds that debt overhang is an impediment to private investment particularly when the debt indicator is expressed as private sector debt to GDP instead of the conventional total debt stock to GDP measure.

Ajayi and Oke (2012) investigated the effect of external debt on economic growth and development in Nigeria using data on debt service payment as proxy for external debt burden, external reserves, interest rate and Gross National Product. Employing the ordinary least squares (OLS) method of estimation, the authors find that external debt burden has an adverse effect on national output. The influence of external debt burden on national output was also found to be significant. The study also shows that the quantum of external reserves exerts a positive and significant influence on aggregate output but the influence of interest rate, though positive is quite insignificant.

Oke and Sulaiman (2012) examined the relationship between external debt, the level of economic growth and the volume of investment in Nigeria using data over the period 1980-2008. The authors adopted the ratio of external reserves to external debt, exchange rate, private investment, debt service ratio, interest rate and inflation rate as independent variables while the GDP was the dependent variable. Employing the econometric analysis technique of multiple regressions, the authors find a positive relationship between external debt, economic growth and investment. However, while the study finds that current external debt to GDP ratio stimulates growth in the short-run, private investment which they consider a measure of real and tangible development shows a decline.

Sfia (2011) investigated the relationship between external debt and economic growth in developing economies using data from 24 Countries over the period 1976-2003. The study finds that both external debt stock and external debt service ratios adversely affect economic growth.

Geiger (1990) examined the effect of external debt on economic development in Latin American using data from South American countries over the period 1974 -1986. Using a lag distributed model, he finds a statistically significant inverse relationship between external debt and economic growth.

Warner (1992), tried to establish a link between external debt crisis and investment crisis. He finds no conclusive evidence of any negative relationship between external debt and economic growth.

Were (2001) examined the impact of external debt on economic growth in Kenya using annual data for the period 1970-1995. The study could not establish evidence of any negative effect of external debt on economic growth but confirms some crowding out effects on private investment.

Schcarek (2004) investigated the relationship between external debt and economic growth in developing and industrial countries using data from 59 developing countries and 24 industrial countries over the thirty-two-year period, 1970 -2002. The study shows no evidence that external debt affects total factor productivity. However in the case of developing economies, he finds a negative relationship between external debt and economic growth. He notes that the negative relationship is accounted for by public debt stock and not private debt. Evidence of such relationship between public and private debt in relation to economic growth could not be established for the industrialized countries.

Chowdhury (1994) studied the relationship between external debt and economic growth using data from selected Asian and Pacific countries over the period 1970 -1988. He finds that external debt does not have any negative effect of economic growth.

Iyoha (1999) investigated the effect of external debt on economic growth in Sub-Saharan African Countries over the period 1970-1994. He finds a negative relationship between debt overhang, crowding out and investment. He concludes that external debt adversely affects economic growth through a disincentive and crowding out effects on investment.

Mohammed (2005) examined the impact of external debt on economic growth in Sudan using data for the period 1978 – 2002. He used real export growth rate to capture the effect of export promotion and inflation to capture the effect of macroeconomic policy. He finds that external debt and inflation adversely affect economic growth while real exports have positive and significant effect on economic growth.

Hameed et al (2008) examined the relationship between external debt servicing capital stock and labour force on economic growth in Pakistan using data over the period 1970-2003. They find evidence that external debt servicing adversely affects economic growth through its negative effect on labour and capital productivity.

Jayaraman et al (2008) studied the effect of external debt on economic growth in 6 Pacific Island countries using data for 1988 -2004. They find that external debt exerts a positive and significant influence on economic growth.

Butt (2009) examined the effect of external debt on economic growth of 27 Latin American and Caribbean countries over the period 1970 -2003. Employing the Granger Causality method of analysis, he finds evidence of causality in 13 countries but no evidence in the others.

Razazadekasalani et al (2011) examined the impact of exchange rate fluctuations on real GDP in Iran. The regression result shows significant positive impact of exchange rate depreciation gross domestic product in Iran. A similar study by Bakoulas et al (2002) which examined the effect of exchange rate fluctuations on trade flows however finds that rapid exchange rate fluctuations impede trade expansion thereby adversely affecting the growth-propelling impact of trade. Also, Eichengreen and Lablong (2003) find significant negative relationship between exchange stability and economic growth.

Akpokodje (2009) investigated the impact of volatile exchange rate on import-import trade flows in selected African countries from 1986 to 2006. The study focused on Non-Communate Finnciere Africaine (Non-CFA) countries. The result shows that exchange rate volatility has significant negative effect on import-export trade flows.

Ogunleye (2009) examined the effect of foreign exchange volatility on the inflow of foreign direct investment in Sub-Saharan Africa. The study focused on Nigeria and South Africa. Employing the technique of two-stage least squares, the study finds that exchange rate volatility significantly impedes foreign direct investment. However, the degree of impact is stronger in Nigeria than in South Africa largely due to prevalence of weak institutions in Nigeria.

Aliyu (2009) analyzed the effect of exchange rate movements on non-oil export trade flows in Nigeria over the period 1986-2006. The study shows significant negative impact of exchange rate volatility on Nigerian non-oil export flows. Another study by Aliyu (2011) which investigated the effect of oil price shocks and exchange rate volatility on macroeconomic growth in Nigeria however shows that exchange rate appreciation has significant positive effect on economic growth.

Yaqub (2010) studied the effect of exchange rate changes on the output performance of the agricultural, manufacturing and services sectors of the Nigerian economy. Data for the period 1970-2007 were analyzed using the modified IS-LM (goods market-money market) framework, estimating the behavioural equation as a system using the seemingly unrelated regression estimation (SURE) technique. The model for agricultural sector has  $GDP_A$  (dependent variable) as proxy for agricultural output while real effective exchange rate (REER), foreign income, money supply and government expenditure are the independent variables. Also, the model for the manufacturing sector has  $GDP_M$  (dependent variable) as proxy for manufacturing output, while REER, foreign income, money supply, government expenditure (defined as expenditure on social and economic service) imports are the independent variables. For the services sector,  $GDP_S$  was used as the dependent variable and REER, foreign income, money supply, government expenditure and imports were the independent variables. The results indicate that exchange rate has significant contractionary effects agricultural and manufacturing sectors while it has an expansionary effect on the services sector.

Berman et al (2012) examined the reactions of manufacturers to changes in exchange rate over an 11-year period, 1995-2005 using very rich French firm-level dataset with destination – specific export values and volumes. They find that high performance firms react to depreciation by increasing significantly their mark-up and at the same increasing less their export volume. The implication of the finding is that not only is there an increase in output price but there is also a contraction of production capacity.

Adeniran et al (2014) examined the effect of exchange rate fluctuation on economic growth in Nigeria over the period 1987- 2013 using the technique of the ordinary least squares. They find non-significant impact of exchange rate movements on economic growth.

Arize et al (2000) examined the effect of exchange rate movements on the flow of foreign trade using quarterly data from thirteen less developed countries (LDCs) covering the period 1973 to 1996. Estimates of the co-integrating relationships are obtained using the Johansen and Juselius (1990) procedure. Estimation of the short-run dynamics is obtained for each country using the error-correction technique. The study shows that high volatility in the behaviour of exchange rate, approximating exchange rate uncertainty exerts a significant negative effect on export flows in both the short-run and the long-run in each of the 13 LDCs. This implies a reduction in the output of export industries.

With regard to inflation-growth nexus, Sarel (1996) conducted a study of 87 countries over the period 1970-1990. The study shows non-linear effect of inflation on economic growth. Specifically, the study reveals an inflation threshold of about 8 per cent, an indication that inflation stifles growth only when it exceeds the identified threshold. Kremer et al (2009) introduced a new dimension to the inflation-growth nexus. Their study which covered 63 countries shows a threshold of 2 per cent and 12 per cent for industrialized and non-industrialized nations respectively.

Studies by Ahmed and Mortaza (2005), Li (2005), Bassey and Onwioduokit (2011), Khan and Sanhadji (2001), Bawa and Abdulahi (2012), Mubarik (2005), Hussain (2005), Singh (2003), Hussain and Malik (2011), Fabayo and Ajilore (2006), Frimpong and Oteng-Abayie (2010), Doguwa (2012), among others also support the threshold effect of inflation on economic growth. One striking revelation of these studies is the lack of consensus on what constitutes the threshold for developed and developing nations. Equally disturbing is the finding of different thresholds for the same country (see Bassey and Onwioduokit, 2011; Bawa and Abdulahi, 2012; Fabayo and Ajilore, 2006; Doguwa, 2012).

Some studies however have produced evidence of either positive or negative effect of inflation on economic growth regardless of level. For instance, Umaru and Zubairu (2012) examined the effect of inflation on economic growth in Nigeria. The result shows non-significant positive impact of inflation on output growth in Nigeria. Faria and Carneiro (2001) conducted a similar study for Brazil but found negative impact of inflation on the growth of the Brazilian economy. Studies by Paul et al (1997) and the Central Bank of Nigeria (1974) which examined the inflation-growth nexus across a number of countries show mixed results. While the studies show evidence of positive impact of inflation for some countries, they also report negative impact for some others.

## Methodology

This study is based on non-survey research design and the study data were collected essentially from the publications of the Central Bank of Nigeria for the period of the study (1981-2015).. Ordinary least square (OLS) and generalized least square (GLS) regression methods were used to analyze the data using SPSS statistical software.

### *Model Specification*

The study adopts GDP as proxy for economic growth as the dependent variable and exchange rate, external debt, inflation rate and gross fixed capital formation as the explanatory variables. The implicit form of the relationship between the dependent and explanatory variables is presented as:

$$\text{OUT} = f(\text{EXD}, \text{EXR}, \text{GFCF}, \text{INF}) \dots\dots\dots (i)$$

This economic relationship is explicitly presented as:

$$\text{OUT} = \beta_0 + \beta_1 \text{EXD} + \beta_2 \text{EXR} + \beta_3 \text{GFCF} + \beta_4 \text{INF} + \varepsilon_{it} \dots\dots\dots (ii)$$

Where:

OUT = Output or GDP growth, proxy for economic growth.

EXD = External debt, measured as ratio of external debt to GDP.

EXR = Exchange rate, measured as change in exchange rate over successive periods.

GFCF = Gross fixed capital formation, proxy for infrastructure.

INF = Inflation rate.

$\beta_0 \dots \beta_4$  = Parameters to be estimated.

$\varepsilon_{it}$  = Stochastic variable or error term.

### *A priori Expectations*

Following from the dual gap theory, external debt ( $\beta_1$ ) is expected to enhance domestic production capacity. It is therefore expected to bear a positive sign. Exchange rate ( $\beta_2$ ) is expected to bear a negative sign partly because it is highly volatile and partly because it has depreciated for a major part of the period leading to high cost of production inputs. Gross fixed capital formation ( $\beta_3$ ) is expected to bear a positive

sign because increased capital stock promotes infrastructural development required to support domestic production. Inflation rate ( $\beta_4$ ) is expected to bear a negative sign because inflationary pressures fuel higher prices of production inputs and distort production and consumption patterns and thereby impede output growth. The above expressions can be mathematically represented as  $\beta_1 > 0$ ,  $\beta_2 < 0$ ,  $\beta_3 > 0$  while  $\beta_4 < 0$ .

## Results and Discussions

This section presents the estimates obtained from the ordinary and generalized least squares methods. The results are discussed below, starting with the preliminary tests.

**Table 1: Philip Perron (PP) Unit Root Analysis**

Variable	PP Te @ Levels	PP Critical values @ 5%	Test @ First Difference	PP Critical values @ 5%
LOUT	0.427128	-1.171814	-3.247129	-2.247125
LEXD	1.924161	-2.457801	-2.789241	-2.247125
LEXR	1.024816	-1.546811	-3.895741	-2.247125
LGFCF	-2.974157	-2.987147	-1.897412	-2.247125
LINF	0.724167	-1.245781	-3.598746	-2.247125

*Stationary trend at 5% level of significance*

The result of the unit root test based on Philip Peron method shows that none of the variables show stationary trend at 5 per cent level of significance. However, at their first difference, all the variables became stationary thereby reducing the chances of spurious estimates when subjected to regression analysis.

**Table 2: Co-integration Analysis**

Hypothesized No of CE(s)	Eigen Value	Trace Statistic	0.05 Critical Value	Prob **	Max Eigen Statistic	0.05 Critical Value	Prob **
None	0.699541	99.7413	75.174	0.0021	34.1271	32.6987	0.0321
At Most 1	0.523518	75.2645	61.2571	0.2546	25.6512	29.2112	0.0024
At Most 2	0.458715	60.4571	54.6988	0.3245	20.1226	25.359	0.1657
At Most 3	0.346974	42.3214	44.2655	0.0457	18.2351	19.3688	0.2457
At Most 4	0.224578	32.1247	34.2135	0.3245	15.2479	11.2587	0.3589

The result of the Johansen co-integration test is analyzed based on the estimates of the trace and Max-Eigen statistics. From the trace statistics, there is evidence of at most 2 co-integrating equations while the Max-Eigen statistic shows at most 4 co-integrating equations. Evidence of co-integration is an indication that the variables do not have a tendency to drift apart. Hence the model can be deployed to resolve economic problems.



**Table 3: Correlation Matrix**

	OUT	EXD	EXR	GFCF	INF
OUT	1				
EXD	0.487*	1			
EXR	0.214*	0.457*	1		
GFCF	(0.122)*	0.459*	0.3547*	1	
INF	0.772*	(0.781)*	0.485*	(0.398)*	1

\* denotes 5% level of significance

The correlation estimate presented in table 3 shows that national output growth has significant positive relationship with external debt, exchange rate, and inflation rate. The result also shows significant negative correlation between output growth and gross fixed capital formation.

**Table 4: Regression Analysis**

Explanatory Variables	OLS			GLS		
	$\beta$	t-stat	p-value	$\beta$	t-stat	p-value
Constant	-2.145	0.021	0.871	-9.119	1.74	0.207
EXD	0.214	2.076	0.003*	1.211	2.658	0.001*
EXR	0.124	2.253	0.011*	0.321	2.095	0.002*
GFCF	-0.775	0.759	0.399*	-1.473	0.651	0.243*
INF	0.529	1.954	0.004*	0.166	2.398	0.001*
R <sup>2</sup>	64%			67%		

Adj. R <sup>2</sup>		51%				56%		
P-Value		0.003				0.001		
F-Value		0.001				0.000		
R <sup>2</sup> : Within	0.7641	0.5784						
Between	0.5545	0.4901						
Overall	0.5547	0.6779						
* significant at 5% respectively								

The regression result shows that the ordinary and least squares estimations are consistent. Both estimates show significant positive impact of external debt, exchange rate and inflation rate on economic growth as well as non-significant negative effect of gross fixed capital formation on the growth of the Nigerian economy during the period of this study.

The positive impact of external debt on economic growth implies that as more external debts are procured, internal production capacity is enhanced, obviously through increased importation of necessary production inputs. Domestic production in Nigeria is characterized by high import content. This result aligns with *a priori* expectation and it is consistent with the findings in Ashinze and Onwioduokit (1996), Sulaiman and Azeez (2012), Oke and Sulaiman (2012), Jayaraman et al, (2008), etc. but it is at variance with the outcome of studies like Hagos (2011), Ayadi and Ayadi (2008), Ezeabasili et al (2011), Sfia (2011), Hameed et al (2008), Ajayi and Oke (2012), Mohammed (2005), etc.

Also, the positive impact of exchange rate dynamics suggests in part that stable exchange rate management practices enhance economic growth. It is also an indication that exchange rate devaluation in Nigeria has supported the growth of domestic output. Though contrary to *a priori* expectation, it goes to show the high level of dependence of domestic production on the external sector.

## Summary of Findings and Conclusion

Evidence emanating from the study shows that economic growth, proxied as GDP growth has significant positive association with external debt, exchange rate and inflation rate. A negative correlation was however observed between economic growth and gross fixed capital formation. The regression estimates for both the ordinary and generalized least squares tests show significant positive impact of external debt, exchange rate and inflation rate on economic growth. The results also show non-significant negative effect of gross fixed capital formation on economic growth.

Following from the above results, the study concludes the external debt has significantly promoted economic growth in Nigeria. Government should therefore engage external borrowing to augment domestic financial resources in this drive to achieve rapid growth and development of the economy.

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