NIGERIA'S EXTERNAL DEBTS: A LEGAL APPRAISAL OF THE IMPACT ON THE NATION'S ECONOMY*

Abstract

External borrowing serves as one of the critical economic instruments adopted by governments to stimulate and sustain economic growth. Upon receipt, external loans transition into debt, which, if not effectively serviced, can accumulate and transform into what is often termed as "hangover debt." This phenomenon is particularly prevalent among underdeveloped and developing nations, where external debt is frequently relied upon as a strategic means to finance infrastructure, stimulate investment, and accelerate economic development. This study provided a comprehensive examination of external debt, exploring its definition, various classifications, and the multifaceted effects it imposes on national economies. Employing a doctrinal research methodology, the study meticulously examined the role of external debt in economic growth, weighing its potential benefits against its inherent risks. The findings reveal that while external debt can indeed serve as a powerful catalyst for economic expansion, its effectiveness is highly contingent upon the country's ability to service and manage the debt responsibly[1]*. Mismanagement or failure to service external debt can lead to severe economic constraints, including increased debt burdens, reduced fiscal space, and heightened vulnerability to external shocks. Furthermore, the research highlights the dual-edged nature of external debt, emphasizing that while it can provide necessary capital for development, it also carries the risk of plunging a nation into a debt trap if not managed prudently. In light of these findings, the study strongly recommends that governments pursuing external borrowing as an economic strategy should establish robust debt management frameworks, implement comprehensive economic reform policies, and ensure that all borrowings are secured on sustainable terms. These measures are crucial to mitigating the risks associated with external debt and ensuring that it contributes positively to long-term economic growth.*

Keywords: External Debts, Nigerian Economy, Impact, Legal Appraisal

1. Introduction

External debt, also called foreign debt is a type of public debt and has become one of the tools adopted by developing countries to foster and drive economic growth. If these external debts are being utilized for capital investments as against recurring expenditures by the borrowing country, they will rarely face any form of economic instability and most likely will experience economic growth. High level of debt burden on developing nations has been one of the fundamental development policy issues since the start of the twentieth century. Most developing countries usually channel their financial resources to fund capital projects and recurring expenditures in their national budget based on revenue projections. These projected revenues in most cases are not realized and therefore there will be deficit and to be able to finance the deficit, the government will have to resort to external borrowing to finance their budget as the financial resources needed may be inadequate locally due to the underdevelopment of the capital market and low productivity.

In a situation where a substantial amount of a nation's budget is used to service public debt, the economic growth of that nation will most likely be hindered as a result of the consequential burden on domestic production and capital investments. The financial resources used to service debt in a nation will most definitely hinder meaningful economic growth activities as the resources which ought to be utilized for the nation's economic growth-oriented policies are being channeled to service debts. High level of debt servicing is a great challenge to any nation of the world and creates an extra problem for the nation by increasing fiscal deficit in financing the nation's budget. High level of debt servicing is a great threat to a nation's economic growth as a considerable amount of its public revenue is channeled to principal and interest payments.[2]

2. Conceptual Clarification

External Debt

External debt is the liabilities governments usually owe foreign lenders, such as international financial institutions, foreign governments, and commercial banks. Governments resort to external debt for different purposes, like meeting additional expenses, building infrastructure, etc. External debt can also be referred to that portion of a nation's debt borrowed from foreign institutions/governments. Governments and companies may not prefer taking on this type of

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[1] Ibrahim F.I. Shihata, 'The World Bank Legal Papers' Brill, 2001.

[2] Otiko, 'Debt Servicing and Economic Growth in Nigeria: Moderating Effect of Corruption', *Baze University Journal of Entrepreneurship & Interdisciplinary Studies,* 202

debt as it gives the lending country/institution leverage over them. Nevertheless, specific reasons may necessitate a nation to seek financial assistance from a foreign lender. Some of which are[3]:

- Domestic financial institutions, including commercial banks, do not have adequate funds to sanction a loan.
- Foreign lenders offer loans at a lower interest rate than domestic financial institutions. Moreover, foreign financial institutions may offer better repayment terms.
- A country must use the available domestic funds for specific purposes, such as healthcare and education. Usually, governments take on this debt to fulfill certain objectives like meeting additional expenses and boosting economic recovery after a natural disaster. International financial institutions like the IMF and the World Bank are the most common external debt sources. Besides these, governments may also avail financial assistance from foreign commercial banks to meet their financial objectives. Sometimes, foreign debt may come in the form of a tied loan. This means that the borrower must utilize the loan amount to only make expenditures in the lender's country. For example, a loan might only allow a country to purchase the required resources from the nation that sanctioned the loan. Foreign debt, especially tied loans, might allow a borrower to fulfill certain purposes defined by the two parties. For instance, the borrower might only be able to utilize the funds to recover from a natural disaster by purchasing resources from the lender country[4].

Economic Growth

Economic Growth can be referred to as the increase in a country's output of goods and services over time, typically measure by the growth rate of Gross Domestic Product (GDP)[5]. Economic growth is a key indicator of a nation's economic performance and prosperity. The economic growth of a nation can be affected by several factors, including investment levels, debt levels and fiscal policies.

Debt Overhang Theory

Debt Overhang Theory is a situation where a country's debt level is so high that it discourages new investment because investors fear that the returns will be used to service existing debt rather than be reinvested in the economy[6]. The theory helps explain why external debt can negatively impact economic prospects.

Debt Laffer Curve

This is a concept suggesting that there is an optimal level of debt. Beyond this point, additional debt becomes counterproductive and can be negatively impact economic growth. This Curve illustrates the potential diminishing returns of borrowing, where excessive debt may lead to lower growth rates instead of improving them.

Debt Relief

Debt Relief refers to measures taken to reduce or cancel a portion of a country's debt, often through negotiations with creditors or international financial institutions. This can improve economic conditions by reducing the debt burden, freeing up resources for investment and development.

Debt Burden

Debt is often seen as a burden, requiring the borrower to repay both the principal and interest without default, regardless of the loan amount or interest rate. In some cases, penalties such as loan default fees may further increase the strain. Poor management of multiple loans and reliance on high-interest loans can worsen this burden. As a result, debt burden refers to the substantial debt an entity holds and the cost of servicing it. An increase in this burden signals a worrisome situation, highlighting the need for responsible authorities to implement effective debt management policies to mitigate the risks[7].

3. Types of External Debt

Popular types of external debt include[8]:

Public and Publicly Guaranteed Debt

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[3]Retrieved from www.wallstreetmojo.com on August 18th, 2024.

[4]M.J. Fry (1988). Foreign debt instability: An analysis of national saving and domestic investment response to foreign debt accumulation in 28 developing countries. *Journal of International Money and Finance,* 8, 315-344.

[5] Retrieved from https://www.civilsdaily.com/news/indian-economy-growth-prospects on September 21, 2024.

[6]J. Kagan (2021), 'Debt Overhang: Definition, Effects, Solutions'. Retrieved from https://www.investopedia.com/terms/d/debtoverhang.asp#:~:text=Key%20Takeaways,Debt%20overhang%20refers%20to%20a%20debt%20burden%20so%20large%20that,the%20potential%20for%20defaulting%20higher on September 21, 2024.

[7]F.H. Harrison, A.A. Momodu &M.D. Tamunomieibi (2000), Money Market Dynamics and Debt Management Strategies (Implications for the LDC borrower nations). *The Journal of Investment and Management Studies,* 1(2), 69-99.

[8]A. Gali &R. Perotti (2003). Estimating the Effects of Fiscal Policy in OECD Countries, Government Expenditures on Education, welfare, and defense. *Journal of Economic Development,* 18(1).

Public and publicly guaranteed debt encompasses obligations incurred by public sector entities such as national governments, autonomous public bodies, and other state institutions. This category includes debts where the government or a public entity guarantees the repayment to the lender. In essence, these debts are a commitment from the state to ensure that the borrowed funds are repaid. The guarantee provides a level of security to lenders, often resulting in more favorable borrowing terms.

Loans Offered By IMF

The role of the International Monetary Fund in the global financial system cannot be over emphasized or ignored as it provides financial assistance to member countries facing balance of payments problems. The two main types of IMF of loans include: *Non-Concessional Loans*: These are loans extended at market-based interest rates and are typically provided to high and middle-income countries. Non-concessional loans are intended to address temporary balance of payments issues and are often tied to specific economic policy conditions aimed at stabilizing the borrowing country's economy. *Concessional Loans*: These loans are offered at lower-than-market interest rates and are aimed at low-income countries. Concessional loans are designed to support long-term development goals and reduce poverty by providing more affordable financing. They come with conditions that promote economic reforms and sustainable development practices in the borrowing nations.

Non-Guaranteed Private Sector External Debt

Non-guaranteed private sector external debt refers to long-term external obligations incurred by private sector entities without any guarantee from public bodies. This type of debt includes loans and bonds issued by private companies or financial institutions, where the repayment is solely the responsibility of the private borrower. The absence of a public guarantee means that lenders assume higher risks, which can lead to higher interest rates. This debt is important for private sector growth, as it provides the necessary capital for expansion, innovation, and investment in various industries. However, it also poses risks if the private borrowers face financial difficulties, potentially leading to default and impacting the broader economy.

4. Impact of Debt Burden on Economic Growth of Nigeria

In the long run, Nigeria's debt burden has negatively impacted economic growth in the country. It has slowed GDP growth, reduced investment returns and capital formation, and led to higher taxes to generate funds for debt servicing. This burden has stifled growth and worsened living standards by directing resources away from crucial areas like healthcare, education, and infrastructure. As a result, the economy has become more vulnerable to economic shocks and financial distress, as seen today. A significant portion of cash flow is directed toward debt servicing, limiting improvements in business operations such as production, marketing, and employment by reducing national spending power. Additionally, increased leverage, reduced investment, and a negative equity position expose the country to a high risk of insolvency[9]. The theoretical framework for understanding the effects of external debt on economic growth is grounded in several key economic theories and models. These theories help explain how external borrowing can influence a country's economic performance, both positively and negatively. Below are the main theories that underpin this analysis.

Debt Overhang Hypothesis

The Debt Overhang Hypothesis, initially articulated by economists Krugman[10] and Sachs[11], posits that when a country's debt level exceeds its capacity to repay, the resulting debt burden discourages investment and economic growth. Investors anticipate that a large portion of the returns on their investments will be used to service the existing debt, reducing the incentives to invest in the country's economy. Reinhart and Rogoff's seminal work, "Growth in a Time of Debt,[12]" finds that high levels of public debt (90% of GDP or above) are associated with lower growth rates. This relationship highlights the debt overhang effect, where high debt burdens deter investment and slow economic growth.

Dual Gap Theory

The Dual Gap Theory, developed by Chenery and Strout[13], suggests that economic growth in developing countries is constrained by both a savings gap and a foreign exchange gap. External borrowing can help bridge these gaps by providing the necessary funds for investment and by alleviating foreign exchange constraints, thus promoting economic growth.

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[9]S. Johansen & K. Juselius (1991) Maximum Likelihood Estimation and Inference on Co integration with Applications to the Demand for Money, *Oxford Bulletin of Economics and Statistics*, 52 (1990).

[10]P. Krugman (1988) 'Financing vs. Forgiving a Debt Overhang.' *Journal of Development Economics*, 29(3), 253-268 (https://www.sciencedirect.com/science/article/abs/pii/0304387888900442)

[11]J.D. Sachs (1989) 'The Debt Overhang of Developing Countries.'

[12]C.M. Reinhart & K.S. Rogoff (2010) 'Growth in a Time of Debt.' *American Economic Rev*iew, 100(2), 573-578

[13]H.B. Chenery & A.M. Strout (1966) 'Foreign Assistance and Economic Development.' *American Economic Review*, 56(4), 679-733

Harrod-Domar Growth Model

The Harrod-Domar[14] Growth Model showcased the essence of investment in promoting economic growth in an economy. According to the model, external debt can be beneficial if it is used to finance productive investments that enhance a country's capital stock and output.[15]

Endogenous Growth Theory[16]

Endogenous Growth Theory, advanced by economists such as Romer and Lucas, suggests that investment in human capital, innovation, and knowledge can drive long-term economic growth. External debt can facilitate these investments by providing the necessary funds for education, research, and development.[17] By utilizing these theoretical frameworks, there is a better chance of understanding the complex dynamics between external debt and economic growth in an economy. These insights will inform the subsequent sections of this article as to the policy implications for managing external debt to foster sustainable economic growth.

5. Interpretation of the Effect of External Borrowing in the Context of the Theories

Debt Overhang Theory

The negative relationship observed between external debt levels and economic growth in Nigeria supports the debt overhang theory. High debt burdens can deter investment and consumption due to the anticipated need to allocate a significant portion of national income to debt servicing. The findings suggest that high debt levels may have constrained its economic growth, aligning with the theory's prediction that excessive debt impedes future growth prospects.[18]

Debt Laffer Curve

The regression results indicating a nonlinear relationship between debt and growth are the propositions with the Debt Laffer curve theory. This theory suggests that beyond a certain point, the benefits of additional borrowing diminish and become detrimental. Where moderate debt levels correlated positively with growth, but high levels correlated negatively, reflects this curve. The debt relief period, showing improved growth, illustrates how reducing debt can enhance economic performance.[19]

Debt and Development Nexus

The case studies of debt relief and infrastructure investments support the idea that debt can be a double-edged sword. While debt relief led to improved economic conditions, the effectiveness of debt-funded projects like infrastructure investments depends on how well the funds are managed and used. The findings show that external debt can be beneficial if used for productive investments that stimulate growth, but mismanagement can lead to poor outcomes.[20]

6. Effects of External Debt on Economic Growth

When governments lack the financial resources for capital expenditures and investments to boost income levels, they often take on foreign debt/loan. A huge debt increases the default risk, and failure to repay the debt impacts heavily on the borrower's credit ratings. Servicing of external debt leaves the borrower with almost no funds to invest in economic development. Besides this, the borrowing country's exposure to interest rate risk increases when it takes on foreign debt.[21]

7. Advantages and Disadvantages Associated with Foreign debt

It gives government's access financial resources that can help them meet various expenses and boost economic growth. It aids improved governance and macroeconomic policy in the borrowing country. It gives government's access to financial resources when domestic financial institutions cannot offer loans. However, it most times results in a vicious cycle of debt for nations. High level of foreign debt can hinder a nation's ability to invest in different sectors, thus hindering long-term economic growth.

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[15]E.D. Domar (1946) 'Capital Expansion, Rate of Growth, and Employment.' *Econometrica*, 14(2), 137-147

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8. Policy Implications and its Effect on Foreign Debt

Debt Relief and Restructuring: The positive effects of debt relief on economic growth highlight the importance of strategic debt relief initiatives. Policymakers should explore opportunities for debt restructuring or relief, especially if debt levels become unsustainable. Negotiating with creditors to achieve more favorable terms can free up resources for investment in growth-promoting activities[22].

Efficient Use of Borrowed Funds: The analysis of infrastructure projects funded by debt emphasizes the need for effective management of borrowed funds. Policymakers should prioritize projects that offer high returns on investment and contribute directly to economic growth. Transparency and accountability in the use of debt proceeds are crucial for maximizing their impact.[23]

Diversification of Debt Sources: Relying on a single source of external debt can be risky. Diversifying debt sources, including exploring concessional loans and grants from international organizations, can reduce dependency on high-interest loans and mitigate risks associated with external debt.[24]

Strengthening Economic Institutions: Improving economic institutions and governance can enhance the ability to manage external debt and its impact on growth. Strong institutions can ensure better planning and execution of debt-funded projects, as well as more effective debt management policies.[25]

9. Conclusion and Recommendations

The study provides an invaluable insight into the complex relationship between external debt and economic growth with Nigeria as a case study. By summarizing key findings, offering actionable recommendations, and suggesting areas for future research, this article aims to contribute to more effective debt management practices and sustainable economic development. The following measures are appropriate:

Debt Relief and Restructuring: For the Country to continue exploring opportunities for debt relief and restructuring, especially when debt levels become unsustainable and engage with creditors to negotiate better terms and conditions that can alleviate debt burdens.

Efficient Use of Debt Funds: Prioritization and careful management of debt-funded projects to ensure that borrowed funds are used for investments that offer high economic returns. Implementation of rigorous oversight and accountability measures to maximize the impact of debt resources.

Diversification of Debt Sources: Diversification of the sources of external debt to reduce reliance on high-interest loans. Seek concessional loans and grants from international financial institutions to mitigate debt servicing pressures.

Strengthening institutions: Investment in strengthening economic institutions and governance frameworks to enhance debt management capabilities. Effective institutions can ensure better planning, execution, and monitoring of debt-funded projects.

Debt management and Policies: Development and implementation of comprehensive debt management policies that balance borrowing with sustainable economic growth. Monitor and evaluate debt impacts regularly to adjust policies as needed.

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