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PUBLIC DEBT

Agwu S. Okoro

MONETARY POLICY DEPARTMENT
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Anniversary
Commemorative
Edition

Central Bank of Nigeria
33 Tafawa Balewa Way
Central Business Districts
P.M.B. 0187
Garki, Abuja
Phone: +234(0)946236011
Fax: +234(0)946236012
Website: www.cbn.gov.ng
E-mail: info.dmp@cbn.gov.ng

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Aims and Scope

Understanding Monetary Policy Series are designed to improve monetary policy communication as well as economic literacy. The series attempt to bring the technical aspects of monetary policy closer to the critical stakeholders who may not have had formal training in Monetary Management. The contents of the publication are therefore, intended for general information only. While necessary care was taken to ensure the inclusion of information in the publication to aid proper understanding of the monetary policy process and concepts, the Bank would not be liable for the interpretation or application of any piece of information contained herein.

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Enquiries concerning this publication should be forwarded to: Director, Monetary Policy Department, Central Bank of Nigeria, P.M.B. 0187, Garki, Abuja, Nigeria, Email:info.dmp@cbn.gov.ng

Central Bank of Nigeria

Mandate

- Ensure Monetary and Price Stability
- Issue Legal Tender Currency in Nigeria
- Maintain External Reserves to safeguard the international value of the Legal Tender Currency
- Promote a Sound Financial System in Nigeria
- Act as Banker and Provide Economic and Financial Advice to the Federal Government

Vision

"By 2015, be the Model Central Bank delivering Price and Financial System Stability and promoting Sustainable Economic Development"

Mission Statement

"To be proactive in providing a stable framework for the economic development of Nigeria through the effective, efficient and transparent implementation of monetary and exchange rate policy and management of the financial sector"

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To Provide a Dynamic Evidence-based Analytical Framework for the Formulation and Implementation of Monetary Policy for Optimal Economic Growth

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PUBLIC DEBT[1]

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SECTION ONE

Introduction

Governments generally undertake economic and some non-economic policies and activities, which have implications on revenues and expenditures. Governments in pursuit of the above, articulate their intentions in a financial plan known as the budget. The budget contains the details of estimated incomes or receipts, and the proposed expenditure for the given period. When Government revenue is equal to expenditure it shows a balance budget; when revenue is greater than expenditure it shows a surplus budget; and when there is a short fall in government expected receipts (revenues) in the context of expenditure projections it shows a deficit budget.

Government may finance the deficit through tax revenue, money creation, or borrowing from banks and the non-banking public. Government may finance it through the issue of short-term bonds. The act of borrowing creates debt. Debt is the resource in use in an organization, which is not contributed by its owner and does not in any other way belong to them. Debts may be classified into reproductive and dead-weight. Debt is said to be reproductive when a nation, state or organization borrows to purchase some kind of capital projects such as: Electricity, Road construction, Factories, Refineries, among others. On the other hand, debt undertaken to finance wars and expenses on current expenditures are dead-weight debts.

Public debt refers to borrowing by the government. In Nigeria, like many other nations, it is made up of both external and domestic debts.

For debt sustainability purposes a country is expected to be able to continue servicing its debts without an unrealistically large correction to its income and expenditure balance.

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[1]This publication is not a product of vigorous empirical research. It is designed specifically as an educational material for enlightenment on the monetary policy of the Bank. Consequently, the Central Bank of Nigeria (CBN) does not take responsibility for the accuracy of the contents of this publication as it does not represent the official views or position of the Bank on the subject matter.

[2]**Agwu S. Okoro** is a Principal Economist in the Monetary Policy Department, Central Bank of Nigeria

In this paper we attempt to present for easy understanding, an overview of Public Debt. To achieve this objective, rest of the paper following the introduction is structured as follows. Part two contains the concept of public debt and why public debt in Nigeria. Part three contains the classifications and sources of public debt. Part four reviews selected countries experiences. Part five contains a brief overview of debt management in Nigeria, while part six contains the debt sustainability analysis, and part seven is the conclusion and recommendations.

SECTION TWO

The Concept of Public Debt

Public debt occurs when a government borrows to offset its deficits or for the development of its economy. Public debt may be either internal or external. That is, debts may be incurred by the government through borrowing from the domestic or international markets so as to finance a nation's domestic investment.

In Anyanwu (1997), *Public debt is seen as all claims against the government held by the private sector of the economy, or by foreigners, whether interest-bearing or not, less any claims held by the government against the private sector and foreigners*.

Public Debt may include, all the outstanding amount of loans borrowed and the bonds issued directly by the General Government, and the loans guaranteed by it, as well as the loans and bonds borrowed or issued by Parastatals, states and central Government.

2.1 Why Public Debt?

Soludo (2003) opined that: *countries borrow for two broad categories: macroeconomic reasons ((higher investment, higher consumption (education and health)) or to finance transitory balance of payments deficits [to lower nominal interest rates abroad, lack of domestic long-term credit, or to circumvent hard budget constraints]*.

The above suggests that a nation indulges in debt to boost economic growth and reduce poverty. Specifically an economy that is characterized with inadequate internal capital formation arising from the vicious circle of low productivity, low income, and low savings, among others, requires technical, managerial and financial support from other nations, and within, to bridge the resources gap. Therefore, over the years public debt has remained a necessary tool for many countries, including Nigeria, to close the existing gap in the economy.

Public debts therefore, are incurred to finance fiscal deficits created by expansive government expenditures if tax revenues and money creation cannot fill the fiscal gap. But, excessive deficits and public debts can create fiscal imbalances in the economy in a number of ways: Excessive public debts can create burden for future generations; Government debts can crowd out private sector credit; Unsustainable debts can trigger disruptive movements in interest rates and exchange rates as highly indebted countries become vulnerable to global market forces.

SECTION THREE

Public Debt Sources

The sources of public debt include: the Central Bank through ways and means advances; issuance of bonds; and the external or international sources.

One of the money creation processes by the CBN called ways and means can be used by the government to source for fund in order to finance government debt. However, the Central Bank ways and means advances can cause inflation in an economy. That is why the amended Act of the CBN 2007 stipulated that "the government should not be allowed to borrow more than 5.0 per cent of it previous year actual total revenue".

Government can also borrow through the issuance of bonds. At the fundamental level, the government of Nigeria issues bonds to fund budget deficits. In recent years, the government debt policy has focused on shifting from external to domestic debt and also from short-term to long-term profile.

External source, which could be grouped into Official and Private debt sources, is another source of public debt in Nigeria. The official debt consists of the Paris club debt, the multilateral debts and the bilateral debts. The Private debts is made up of uninsured short-term trade arreas contracted through the medium of bills for collection, open account, and commercial bank debts acquired through loans/letters of credit. Credits are in this case referred to London club debts.

Nigeria's external debt in the past few years were majorly owed to creditor countries belonging to the Paris club. It is government-to- government credits or market–based term loans, which are guaranteed by various Export Credit Agencies of the creditors Countries. It can be described as an informal group with no permanent members, which works under the principle of consensus.

The multilateral debts are projects loans owed to multilateral financial institutions such as; the World Bank Group, the Africa Development Bank Group, the European Investment Bank Group, IFAD and ECOWAS Fund by the federal and state governments and their agencies. The bilateral debts are debt owed to Countries which are not members of the Paris club, but whose debts are not insured by the Export Credit agencies.

3.1 Public Debt Classifications

Broadly, public debt may be classified into domestic and external debt. Domestic debt originates from loans sourced within the economy, from the banking system and non-bank public, while external debt originates from multilateral and bilateral sources as explained above.

3.1.1 External Debt

The external debt of a nation describes the financial obligation that ties a debtor country to lender country. It is debt incurred by a nation that is payable in currencies other than that of the debtor country. External debt includes short-term debts, such as trade debts which mature between one and two years, or whose payment would be settled within a fiscal year in which the transaction is conducted.

Gross External Debt, is the outstanding amount of those actual current, and not contingent, liabilities that require payment(s) of principal and/or interest by the debtor-country at some point(s) in the future and that are owed to non-residents by the residents of an economy.

External debt may be incurred through transactions such as trade, contract or finance, suppliers' credit, private investment and public borrowing. Other sources of external debt include banks, international financial market (euro money and capital markets) international organizations, example, IMF and the World Bank international loans and multilateral private loans. The advanced industrialized countries are usually the lender-countries; Europe, Asia (Japan) and North America, while the borrowing countries are the poor, under-developed countries in Africa, Asia and Latin America. Foreign loans are majorly for development purposes or to facilitate industrial progress, or for improving the quality and quantity of food production. The ultimate objective is to increase the standard of living of the generality of the people (Nwoke, 1990).

3.1.2 Domestic Debt

Three theoretical reasons often advanced for government domestic debts according to Alison *et al*. (2003), are for budget deficit financing; for implementing monetary policy (buying and selling of treasury bills in the open market operation); and to develop financial instruments so as to deepen the financial markets. It is usually expected that as countries expand their output, they also tends to rely more heavily on domestic public debt issuance to finance growth. There is thus a strong cross country relationship between economic growth and the total size of the debt market.

SECTION FOUR

Selected Country Experiences

4.1 Public Debt In USA

Public debt origin in America could be traced to the debt incurred during the Revolutionary War, after its formation in 1789. The debts incurred during the War amounted to $75,463,476.52 by January 1, 1791. The debt grew over the years, and actually shrank to zero by January 1835, under President Andrew Jackson. The American debt was $65 million in 1860, but passed $1 billion in 1863. The debt grew steadily into the Twentieth Century, and was roughly $22 billion as the country paid for involvement in World War I.

World War II financing brought the debt from $51 billion in 1940 to $260 billion. Between 1980 and 1990, the debt more than tripled. The debt shrank briefly after the end of the Cold War, but by the end of Fiscal Year 2008, the gross national debt had reached $10.3 trillion. In recent years there has been a "debt ceiling" in effect. Whereas Congress once approved legislation for every debt issuance, the growth of government fiscal operations in the 20th century made this impractical. The Treasury was granted authority by the Congress to issue such debt as was needed to fund government operations as long as the total debt did not exceed a stated ceiling. The "ceiling" is routinely raised by passage of new laws by the United States Congress. In February 2009, Congress raised the debt limit to $12.104 trillion *(Bureau of the Public, Debt, 2013)*.

4.2 The British Experience

In England, the "Glorious Revolution" of 1688 was followed by the "Financial Revolution" during which Parliament assumed effective control over the national debt. The culmination of that revolution was the creation in 1749, of the "Consolidated Fund" and the issue of undated bonds known as "consols". However, the creditworthiness of the British government in the 8th and 19th centuries enabled it to float huge amounts of irredeemable debt at interest rates as low as 2½ per cent, giving it a significant advantage over its rivals.

Between 1743 and 1815, Britain's national debt increased from £245 million to £745 million. A debt reduction act reduced the ratio of national debt to national income to less than 50 per cent by 1900, but, after two further wars and the prevailing Great Depression, it rose again to over 100 per cent. It was over 150 per cent during the first world war and remained at above that percentage for most of the years between then and the second world war, during which it peaked at 250 percent. After the war, it was reduced steadily to about 50 per cent by 1975, and remained at between 45 and 55 per cent between 1975 and 1990 and between 35 and 55 percent through the 1990s.

4.3 The Nigerian Experience

Nigeria's debt dates back to the pre-independence era. The quantum of the debt was small until 1978. Before 1978, the debts incurred were mainly long-term loans from multilateral and official sources such as the World Bank, and the country's major trading partners. The debts were not much of a burden on the economy because the loans were obtained on soft terms. Moreover, the country had abundant revenue receipts from oil, especially during the oil boom of 1973-1976. Historically, Nigeria's first external loan of US$13.1 million was from the Paris Club of Creditor Nations and was taken from the Italian government in 1964 for the building of the Niger Dam. From that time till the end of the decade, Nigeria's borrowing from foreign lenders was generally insignificant. However, between 1971 and 1981, Nigeria witnessed the era of big borrowing. Loans were acquired by various tiers of government, as Nigeria embarked on major development and reconstruction projects in aftermath of the civil war. The borrowing continued as the Federal Government embarked on guaranteeing many unviable loans taken by private banks, state governments and parastatals.

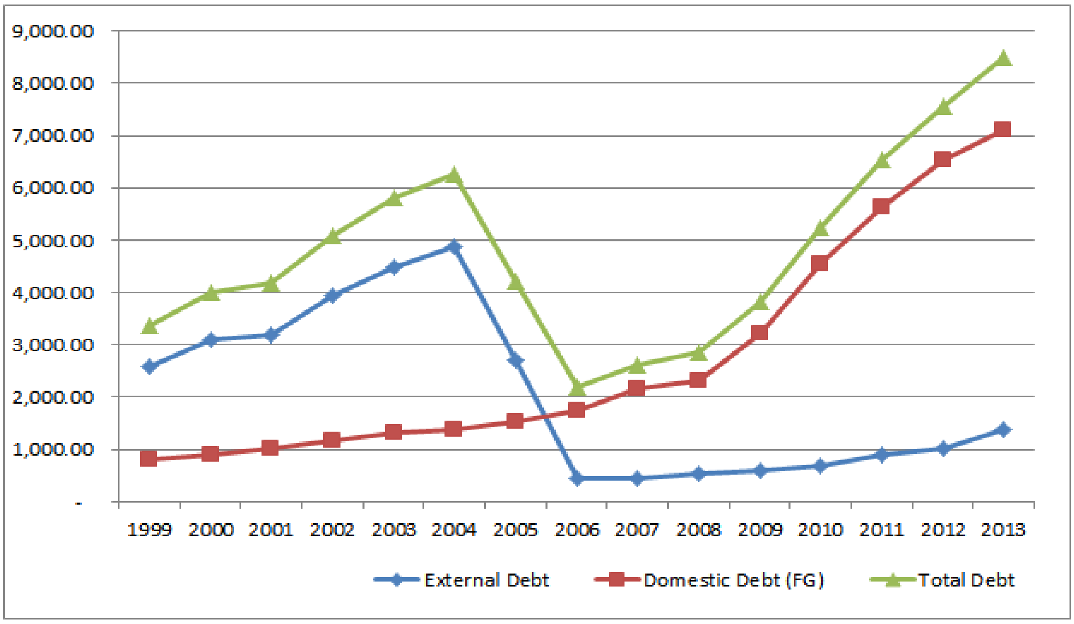
Nigeria's debt stock between 1970 and 1977 was quite negligible, especially the external debt which stood at less than US$600 million. In the early 1970s, Nigeria experienced oil boom, which avails the economy so much resources for the financing of government planned activities. However, between 1980 and 1982 oil prices slumped, resulting in the decline in oil revenues from US$25 billion in 1980 to US$12 billion and US$6 billion in 1982 and 1986, respectively. During the 1980s, Nigeria witnessed wasteful consumption, white elephant projects, uneconomic projects, etc. for instance, 63 projects were undertaken for which US$2.6 billion was borrowed while only one project was viable (Baba, 2012).

The period 1986 to 1992 was characterized with debt rescheduling and strategy for debt reduction. The Nigerian government made several trips to Paris Club in 1986, 1989 and 1991 to reschedule US$7.0 billion, US$6.0 billion and US$3.0 billion debts, respectively. Furthermore, the Nigerian government also made a trip to the London Club to exchange US$5.6 billion commercial bank debt for US$2.1 billion of Par Bonds at a discount of about 60 per cent. By 1992, the debt profile of Nigeria ballooned due to new borrowing from Paris Club, high interest charges, penalties and arrears due for payment. Meanwhile, Nigeria's economic policies could not meet IMF's benchmarks as requirement for debt reduction.

Between 1993 and 1998, Nigeria was faced with a serious debt overhang as payment to Paris Club dropped remarkably below scheduled amount after substantial payment in 1992, although there was no new credit but arrears accumulated, while new disbursements came from the multi-lateral creditors. Consequently, the total debt service burden (of external and domestic debt) of Nigeria by 2004 exceeded the Federal Capital Budget. For instance, US$1.0 billion paid to the Paris Club in 2004, represented 70 per cent of total expenditure of education budget. As at end-December 2005, Nigeria's total debt stock stood at over US$32.0 billion with US$30.8 billion owed to the Paris Club.

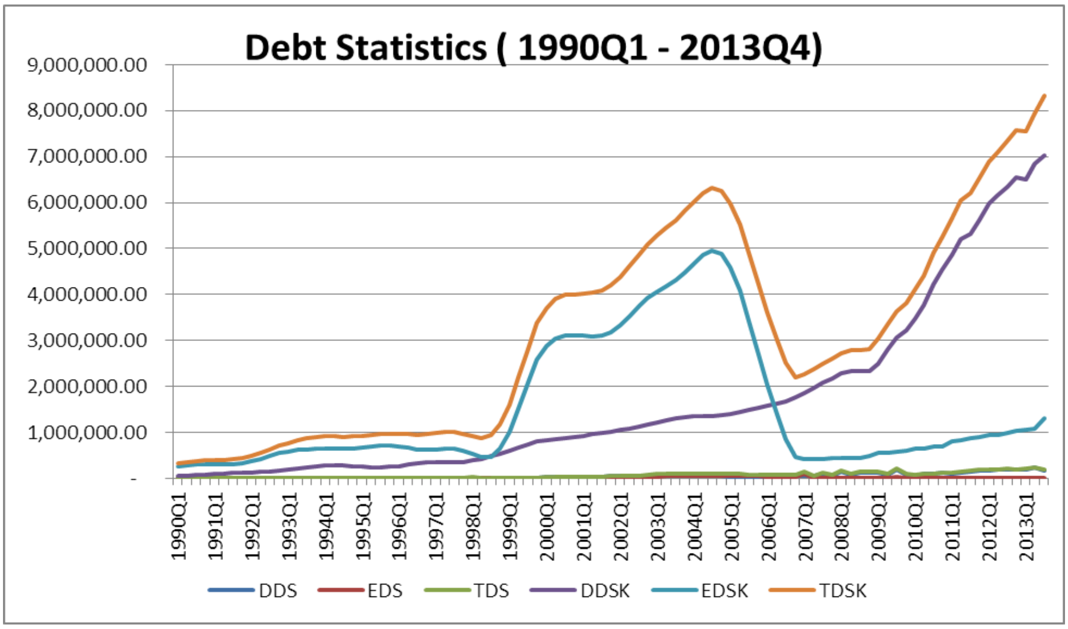
Nigeria embarked on a relentless campaign for debt relief at the return to civilian rule in 1999. Before 2005, Nigeria's public debt was about US$46.2 billion. External debt stood at $35.9 billion while the stock of the domestic debt amounted to $10.3 billion. Following the debt write off, external debt fell to $3.5 billion, while domestic debt rose to $13.8 billion in 2005, giving a total public debt of $17.3 billion and a debt-to-GDP ratio of 11.8%. Nigeria's public debt stood at $58, 643.18 million as at September 2013 (DMO, 2014). From 2005, Nigeria government deficits are majorly funded through domestic borrowing in the bond market**.** The graph below shows the profile of Nigeria's debt from 1999 to 2013, it indicates that external debt was higher than the domestic debt from 1999 to 2004, while domestic debt increased from 2005 to 2013.

Graph showing Nigeria Debt Profile (1999-2013)



Source: CBN Data

In Nigeria, the changing domestic debt profile from the 1960s to date, could be linked to major factors such as high budget deficits; low output growth; large expenditure growth; high inflation rate; and narrow revenue base witnessed since the 1980s. Output growth declined as it recorded annual average values of 5.9% in 1980-1984, 4% in 1990–1994 and 2.8% in 1998–1999, respectively. Public expenditure as a percentage of GDP increased from 13% in the 1980 – 1989 to 29.7% in the 1990–1994 periods. This increased public expenditures to GDP ratio resulted from fiscal policy expansion embarked upon during the oil boom era of the 1970s. However, as the oil boom declined in the 1980s, priorities of government expenditure did not change. As at September 2014, the total domestic debt outstanding was N9,358.67 billion, this was N2,239.67 billion or 31.46 per cent higher than its level of N7,119.00 billion as at end-December, 2013. New domestic debt borrowing in 2015 is estimated at N570.00 billion, decreasing by 12.81 per cent from N653.72 billion recorded in fiscal 2014.



Source: compiled from CBN Data various years.

DDS	Domestic Debt Service in Million Naira
EDS	External Debt Service in Million Naira
TDS	Total Debt Service in Million Naira
DDSK	Domestic Debt Stock in Million Naira
EDSK	External Debt Stock in Million Naira
TDSK	Total Debt Stock in Million Naira

SECTION FIVE

Public Debt Management in Nigeria

Public debt management in Nigeria embraces the management of both external and domestic debts. External debt management refers to the establishment of the conditions of issue and redemption of foreign loans. It involves the process of administering the external public debt. That is providing for the payment of interest, and arranging the refinancing of maturing bonds/debt. It involves a conscious and carefully planned schedule of the acquisition, deployment and retirement of loans contracted either for developmental purpose or to support the balance of payments. The specific measures used by Nigeria to reduce the burden of her debt in the past include the following:

a) Limit on debt service payments: This requires setting aside portion of export earnings to meet debt service obligations to allow for internal development.

b) Embargo on new Loans and issuance of directives to State Government to restrict external borrowing to the barest minimum. The embargo was to check the escalation of total debt stock and minimize additional debt burden. This policy was applied in 1984 to state Governments' borrowing from external sources. However, these have not been particularly effective, as the indiscriminate quest for external loans has not abated. Although rescheduling has conferred short term relief on debt service obligations, the debt over-hang, however, hardly abated as the debt stock continued to increase significantly in the past.

c) Debt Restructuring: This involves the reduction in the burden of an existing debt through refinancing, rescheduling, buy back, issuance of collateralized bonds and the provision of new money. Debt Rescheduling involves the postponement, extension and re-orderings of the repayment of the existing debt. An agreement between creditors (government authorities and the commercial banks acting as a group) and the debtor, to roll over payment due to the former from the later, over a certain period and under new terms and conditions falls under either debt rescheduling or refinancing. This involves the provision of new money to replace maturing debt. The four elements of loan restructuring are:

    I) Rescheduling of the principal or a part of an existing loan, by postponing repayment i.e. rearranging maturities and grace periods involves the rescheduling of the interest payments.

II) Refinancing of an existing loan, by raising fresh or complementary fund to meet existing obligation, that is, making provision for new credits with proceeds to be used to repay outstanding loans;

III) Restoring of trade –related bank credit lines; and

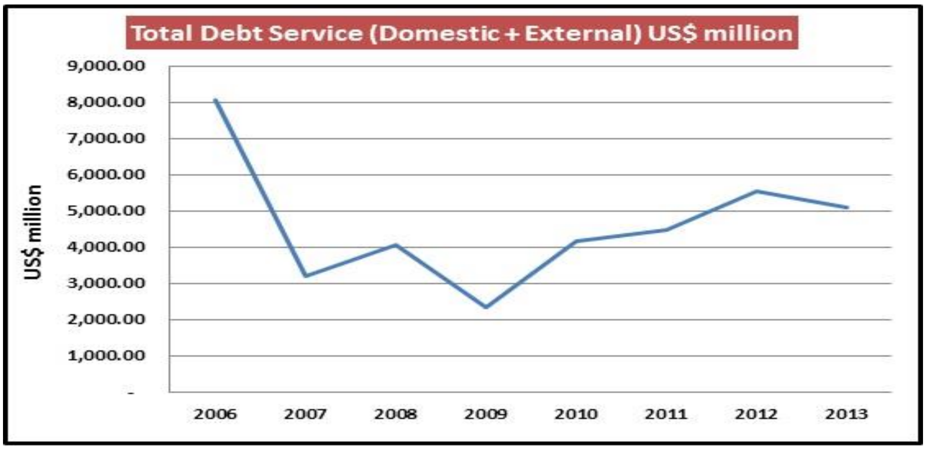
IV) Persuading the financial community to restore inter-banks lines of credit to a certain minimum level.

Official debt restructuring under Paris club: This involves the rescheduling of both official medium-term and long-term debt falling due in a given period, including those in arrears. The rescheduling terms under Paris Club are generally non-concessionary. Moreover, Paris Club is extremely reluctant to reschedule payments on short-term debt with an initial maturity of one year or less.

In Nigeria, efforts on debt rescheduling included holding a first round of talks with the Paris club on rescheduling of her debt in October, 2000. The second talk held in December 2000 resulted in an agreement to reschedule Nigeria's debt under the Houston Terms. This led to re -scheduling of Nigeria's Paris club debt totaling US$20.5 Billion in 2000 over an 18-20 year period. Credits were to be rescheduled over 20 years at concessional interest rates, and enjoy 10 year's grace periods. Commercial credits were to be rescheduled over 18 years at market-based interest rates, including a three-year moratorium interest of about US $1.063 Billion, which was capitalized. It was agreed that the debt service payment in 2001 should be kept at $1 billion. Nigeria made bilateral negotiations with about fourteen-creditor countries on the specific details of each agreement. Nigeria confirmed her stand with the Paris club in the Agreement minute in December, 2000 for a further negotiation after July 31, 2001.

The agreement was however, subject to a good track of record in implementing the IMF – supported stand; implementation of follow-up medium term programme supported by the IMF, and lastly satisfactory implementation of the 2002, Paris club agreed minutes, including timely debt servicing.

The graph below shows the total public debt service 2006 to 2013, it shows that debt service in Nigeria was low in 2007 and 2009, from all-time high in 2004 and 2005. It also indicates that from 2010 to 2013 public debt service was on the increase.



Source: DMO 2014

5.1 Strategies of Public Debt Management in Nigeria

An external debt stock GDP ratio of 20% was recommended by The Debt Management Office (DMO). The DMO also set up guidelines for borrowing, which includes:

1) Any government or its agencies and parastatals desirous of borrowing shall specify the purpose for which the borrowing is intended, and demonstrate how this purpose is linked with developmental objectives.

2) Any arm of government in the federation or its agencies and parastatals can only obtain external loans through the federal government.

3) New loans must have a grand element of at least 35% when calculated with an appropriate discount rate.

The DMO had between 2007 and 2012, implemented a debt management strategy at the subnational level of government, leading to the establishment of the debt management department in each state of the country, the departments were saddled with the responsibility of reconstructing the domestic debt data of the respective states, facilitating of the enactment of public finance management laws and development of debt management capacity. This resulted in the publication of a comprehensive domestic debt data base for the 36 states and the Federal Capital Territory (F.C.T).

SECTION SIX

Debt Sustainability Concept

One of the major goals of a public debt policy is to create debt continuously and maintain it over time. This can be described as debt sustainability. A sustainable debt is the product of several market development actions, debt policy and debt management factors.

The International Monetary Fund (IMF) in 2002, posited that debt is sustainable, if it satisfies the solvency condition without a major correction in the primary balances (fiscal and current account) given the cost of financing.

The World Bank in 2005, expressed that a country can be said to achieve debt sustainability, if it can meet its current and future debt service obligations in full without recourse to debt rescheduling and compromising growth. In other words, a country's debt is sustainable when it is expected to be able to continue servicing its debts without an unrealistically large correction to its income and expenditure balance. Thus, Debt Sustainability reflects a country's solvency, liquidity and adjustment capacity.

A country is said to be solvent, if the present value (PV) of its current and future primary expenditure (net of interest), is not greater than the PV of its current and future stream of income receipts; and an economy is said to be liquid, if it is able to rollover its maturing debt obligations in an orderly manner.

6.1 The Debt Sustainability Analysis (DSA) Framework.

The DSA framework comprise of two complementary assessments of the sustainability of gross public sector debt and gross external (public and private) debt. DSA provides countries with valuable inputs for macroeconomic policy design, but cannot, in isolation, determine an optimal borrowing path. Assessment of debt sustainability is made for three main reasons:

(i) Assess the current debt situation – outstanding debt stock, maturity structure, fixed or variable interest rate composition, currency composition, and debt holder.

(ii) Identify vulnerability in the debt structure or policy framework, to give room for policy corrections before payment difficulties arise.

(iii) Examine the impact of alternative debt-stabilizing policy paths in cases where difficulties emerged, or about to emerge.

The debt repayment capacity of a country can be measured in terms of gross domestic product (GDP), export proceeds, or fiscal revenue. Consequently, GDP ratios allows the indicators to be adjusted by the size of the country; export ratios indicate whether the country can be expected to generate sufficient foreign exchange to meet its external debt obligations in the future; and revenue ratios measure the ability of the government to mobilize domestic resources to reimburse debt. Some measures of ascertaining debt sustainability condition include the following:

1) From the External Debt point, we can ascertain;

Liquidity Burden

a. Total external debt service /export of goods and services, or debt service ratio – it measures the proportion of export earnings to debt servicing.

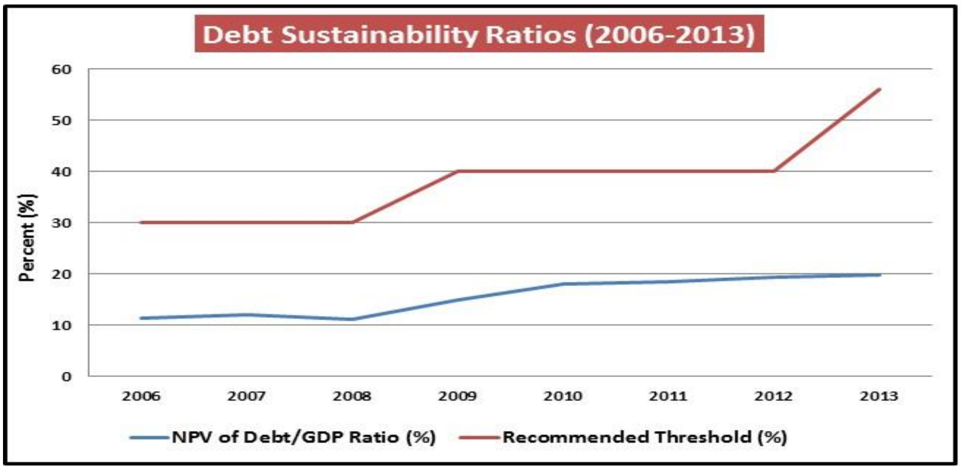
b. Total external debt service/domestically generated budget revenue, or budget service ratio – it measures government's ability to finance debt service from domestic sources.

Solvency

c. Present value of external debt/export of goods and services – it measures the present cost of external debt service burden in terms of the repayment ability from exports

d. Present value of external debt/domestically generated budget revenue – it measures the present cost of debt service relative to government ability to repay from domestic sources.

e. Present value of external debt/GDP – it measures the present cost of debt service compared to the national income level.



Source: DMO

The graph above shows the debt/GDP ratio compared with the recommended threshold for Nigeria between 2006 and 2013. The graph shows that the recommended threshold remained higher than the debt/GDP ratio over the years. This suggests that Nigeria's debt over the above chosen years was sustainable.

2) From Total Debt point, we can ascertain;

Liquidity Burden:

a. Total debt service/domestically generated budget revenue – it measures government ability to finance both external and domestic debt service from domestic sources.

Solvency:

b. Present value of total debt/domestically generated budget revenue – it measures the present cost of total external and domestic debt service compared to government ability to repay from domestic sources.

SECTION SEVEN

Conclusion

This paper attempts to present an overview of public debt of a nation's economy (Nigeria inclusive). When there is a budget deficit, government finds ways of financing the deficit through tax revenue, money creation, or borrowing from banks and the non-banking public within and outside the nation. The act of borrowing creates debt. Borrowing is a very potent tool in the hands of government for increasing effective demand. Sources of public debt include, international financial markets (euro money and capital markets), banks (including Central Bank through ways and means or sale of bonds), international organizations e.g. IMF and the World Bank, international loans and multilateral private loans. A country (a borrower) is expected to be able to continue servicing its debts without an unrealistically large correction to its income and expenditure balance. Thus, Debt Sustainability reflects a country's solvency, liquidity and adjustment capacity.

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