

THE NIGERIAN CAPITAL MARKET AND 2017 BUDGET: LESSONS FOR 2018

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ABSTRACT

National budgets play an important role of fostering economic growth and development. It was in recognition of this role that the Securities and Exchange Commission (SEC) spearheaded the conduct of annual budget seminars that bring together stakeholders in the capital market and other sectors of the economy with a view to providing useful inputs to policymakers in the formulation and implementation of such budgets. After providing a highlight of the main elements and achievements of 2017 budget, the paper analyzes the 2018 provision, paving the way for an examination of the links between national budget and the capital market. It then presents the set of observations /recommendations that emanated from the 2018 budget seminar and concludes that on the basis of its track record of performance, the Nigerian capital market is set to become the largest in Africa by 2025.

Keywords: Budget, Capital Market, Growth

JEL Classification: H61, H69, G1

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* This paper is based on the 2018 Appropriation Bill

1. INTRODUCTION

National budgets have an important role to play in supporting economic recovery and growth. This is particularly so in developing countries such as Nigeria where infrastructure deficits requiring government intervention are prevalent. Some studies (for example, Barro, 1990; Gwarzo, 2016; Gwarzo, 2017; and Kneller, Bleaney & Gemmell, 1998) have re-freshened our understanding of the link between capital market and the national budget. For example, the capital market provides an avenue for long term funds to be raised at comparatively low costs. It therefore offers government ample opportunities to raise funds from outside the money market, and therefore to finance expenditure with little inflationary repercussions. By the same token, the capital market stands to benefit when government patronizes it to raise funds for its long-term expenditure plans. Borrowing from the capital market allows it to grow faster and become more responsive to meeting the needs of investors. It was in recognition of the need to strengthen the link between capital market and the national budget that the Securities and Exchange Commission organizes an annual budget seminar to coincide with the submission of the draft appropriation bill to the national assembly. At the end of such seminar, a communiqué is published and forwarded to relevant government institutions in the belief that, when properly implemented, it could promote macroeconomic growth and stability, both of which could have significant positive influence on the capital market.

This paper therefore summarizes the discussions that took place at the budget seminar on 10th November, 2017, and it is divided into five sections. Section two gives highlights of the 2017 budget, setting the stage for a discussion of the 2018 appropriation bill in section three. Section four explores the link between national budget and the capital market while the last section offers some concluding remarks.

2. HIGHLIGHTS OF THE 2017 BUDGET AND OUTCOME

The National Assembly passed the 2017 appropriation bill of ₦7.44trillion, with a capital allocation of ₦2.17trillion and recurrent expenditure of ₦2.99 trillion. Debt servicing was allocated ₦1.84 trillion while statutory transfers had a share of ₦0.43 trillion. This was based on the expectation that the oil sector would raise ₦2.12 trillion with the non-oil sector contributing ₦2.96 trillion, making a total of ₦5.08 trillion. A deficit of ₦2.36 trillion would be financed by domestic and foreign sources, with the former expected to contribute ₦1.25 trillion and the latter, ₦1.067 trillion. The budget was based on a benchmark of US\$44.5/barrel. In addition, crude oil output was projected to stand at 2.2million barrels per day. Furthermore, GDP growth of 2.5% was projected while inflation was expected to hover at 12.92%.

By the end of June 2017, some of these expectations were realized but others remained unachievable. On the positive side, crude oil prices had begun to recover, averaging US\$52.14 in the first half of the year, compared with the benchmark of US\$44.5. The

country's currency (the naira) had gained strength, with the dollar falling to ₦366.25 on the parallel market compared with ₦493.29 in January, 2017. The rapid recovery of the naira against the US dollar in particular, and other major currencies in general, can be explained by the relative buoyancy in the foreign reserves, as shown in Figure 1. These are about the couple of areas in which budget projections for 2017 have either been achieved or were likely to be achieved during the rest of the year.

However, there is a catalogue of areas in which the likelihoods of achieving budget expectations are low. In this regard, a number of such indicators come to mind: crude oil output averaged 1.67mbpd in the first half of the year, well below the projected target of 2.2mbpd; budget implementation, measured by the expenditures during the first half of the year, was abysmally low as only about 18.6% of the budget had been released at the time; and with inflation averaging 16.1% during the first half of 2017, the chances of achieving the projected target of 12.92% remained slim. Economic growth of 0.55% recorded during the first half of 2017 was also lower than the projected 2.5% growth provided in the budget. This wide discrepancy between the projected and actual growth figures could be explained by a host of factors such as the economic recession that prevailed during the preceding year and from which the economy had just begun to recover.

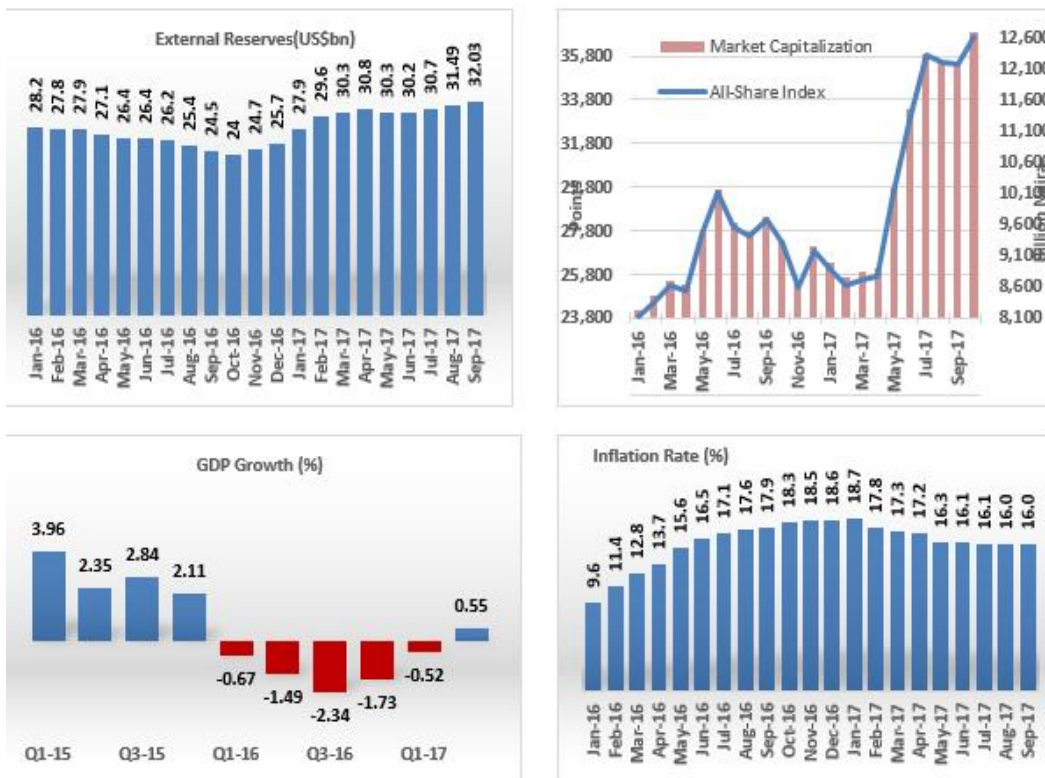


Figure 1: Some macroeconomic and capital market trends

The challenges mentioned above showing the tendency for actual deliverables to fall short of projections seem to pose a number of implications for the capital market and the other sectors of the country's economy. One implication is that inflation remained stubbornly

high, driven in part by high interest rate. High interest rate regimes have the tendency to crowd out private sector investment, with negative repercussions for the capital market.

There were evident signs that the capital market, along with other segments of the country's economy, was weathering the storm. Overall, macroeconomic performance improved, with the country coming out of recession by the second quarter of 2017. The capital market made remarkable improvements, rated the best performing market in Africa and emerging markets. This performance is unsurprising for a number of reasons. One, the government took bold steps to strengthen the market. For example, the Eurobond of \$1.5bn floated in February of 2016 helped the market. The Diaspora bond of \$300 million issued to finance the 2017 budget also helped. On top of these, the N100billion Sovereign Sukuk issued in September 2016 enabled the capital market to support government's efforts to revamp the country's ailing road infrastructure.

3. ANALYSIS OF THE 2018 APPROPRIATION BILL

The foregoing discussion on the 2017 budget was undertaken to provide a convenient context against which the 2018 appropriation bill could be discussed. Total provision in the 2018 appropriation bill stood at ₦8.612 trillion, 15.6% higher than the figure for the previous year. Capital expenditure was allocated 30.8% with the remaining 69.2% going to the recurrent element of the budget. Although the total provision for 2018 has been the highest ever, analysts see no real increase compared to the 2017 figure, especially when inflation is taken into account. With inflation at over 16% and the budget provision growing by less than this, some see the 2018 budget figure as being smaller in real terms than that of the preceding year. This is one reason analysts provide for expecting a much higher figure in the 2018 provision. Another reason they advanced was the government's plan to continue to invest heavily in infrastructure and other money-gulping ventures. A host of them come to mind, such as the Mambilla Hydropower project, the National Housing Programme, the 2nd Niger Bridge, the focus on the Niger Delta and the North-East and the completion of East-West Road.

A closer look at the sectoral allocations in Table 1 shows the sectors given the highest allocations, which include Works, Power & Housing allocated over half a trillion naira. Others are Transport, Defence, Agriculture, Water Resources, Industry, Interior, Education and Health. The table shows that five of the ministries (Works, Power and Housing, Transport, Agriculture, Health and Education) have received additional growth in allocations, rising by 8.8%, 14.6%, 8.8% and 27.9% respectively.

Table 1: Top Capital Spenders (N'bn)

Ministry	2017	2018	Growth(%)
Works,Power & Housing	553.7	555.9	0.4
Transport	241.7	263.1	8.8
Defence	139.3	145	4.1

Agriculture	103.8	119	14.6
Water Resources	104.2	95.1	-8.8
Industry, Trade and Inv.	81.7	82.9	1.5
Interior	63.8	63.3	-0.8
Education	56.7	61.7	8.8
Health	55.6	71.1	27.9

As shown in Figure 1, the country's macroeconomic environment has improved and it is therefore expected that the capital market will have a greater role to play given the theoretical expectation of a positive link between the capital market and national budget. Government plans to raise funds from the capital market to fund infrastructural development. This underscores the emphasis it lays on the need to reduce the infrastructure deficits. The 2018 appropriation bill seems to recognize the fact that raising funds from the capital market helps government to cover budget deficits in a more cost effective way. If the government were to raise such funds entirely from the money market, the interest rates will shoot up, with adverse effects on inflation.

Another notable area of concern is whether the plan in the Appropriation Bill to raise over 60% of the budget from the non-oil sector can be achieved. This question is even more germane considering the historically high level of dependence on oil as a source of government revenue.

4. STRENGTHENING THE LINK BETWEEN THE CAPITALMARKET AND NATIONAL BUDGET

Aside from the trends mentioned in section 2, it is helpful to establish the theoretical links between national budget and the capital market. As shown in Figure 2, national budgets can have direct as well as indirect effects on the capital market. A contract given to one or more listed firms to construct a new or rehabilitate an existing road could have a direct impact on the financial performance of the contracting firms. If such opportunities help the firms to register better financial performance, this would be an example of a positive effect. National budgets could propose higher or lower corporate taxes, depending on the fiscal stance of government. High corporate taxes could negatively affect the performance of firms, and therefore of the capital market; lower corporate taxes could exert a positive effect.

One could also assess the indirect effect of national budgets on the market through its influence on certain macroeconomic aggregates such as GDP growth, exchange rate and inflation. A properly conceived and implemented budget could have positive effects on GDP growth. In addition, wide fiscal deficits and how they are financed could determine in large measure the nature of their effects on the capital market. A wide fiscal deficit financed chiefly from the money market, could drive interest rates up, helping to crowd out

private investment. By the same token, wide fiscal deficits could exacerbate uncertainty which if not well managed could have a deleterious effect on exchange rate.

It should be mentioned that there is paucity of empirical evidence on the theoretical links between national budget and the capital market as depicted in Figure 2 and exemplified in the preceding paragraph. For example, little is known about the degree to which the capital market will rise or fall when aspects of national budget such as deficits rise or fall. Despite the paucity of empirical evidence on the magnitude of those links, at least a number of observations can be made. First, fiscal authorities through the instrument of national budget, could provide opportunities for the capital market to support the process of budget implementation. Second, the capital market itself must continue to attract and retain investor confidence so that all categories of investors (individuals, firms and governments) could take advantage of the opportunities for investment that it offers.

Both government and the capital market need to recognize the need to strengthen the links between the capital market and national budget. The Securities and Exchange Commission is implementing a number of measures to develop the capital market and therefore enhance its ability to contribute to national development. It is working with stakeholders in the capital market, other regulatory bodies in the country, and foreign partners to develop the country's capital market. The SEC is pursuing this objective in fulfillment of our dream enshrined in the country's Capital Market Master Plan that seeks to make Nigeria's capital market the largest and most developed in Africa by 2025. In the pursuit of this dream, measures are being implemented that include those targeted at attracting foreign portfolio investment in the country. They include promotion of sound corporate governance, improving risk based management systems and ensuring better disclosure of accounting information in line with international standards. These measures, along with others, have begun to yield fruit, with market capitalization nearing the pre-financial crisis peak. The Commission also sees foreign portfolio investment returning. In the first half of 2017, total investment in the capital market stood at N220.27 billion with foreign portfolio investment (FPI) accounting for nearly half of this. Our measures aimed at promoting FPI are in tandem with country-level governance measures pursued by the government. The fight against corruption is gathering pace; ease of doing business is improving; and macroeconomic policies (on exchange rate for example) are more market-friendly. As efforts are geared towards strengthening the regulations for developing the capital market as a complement to government's efforts at transparency, the outlook for foreign investment attraction will continue to be bright in Nigeria. The Commission believes these will have the additional advantage of developing the expected positive links between national budget and the capital market.

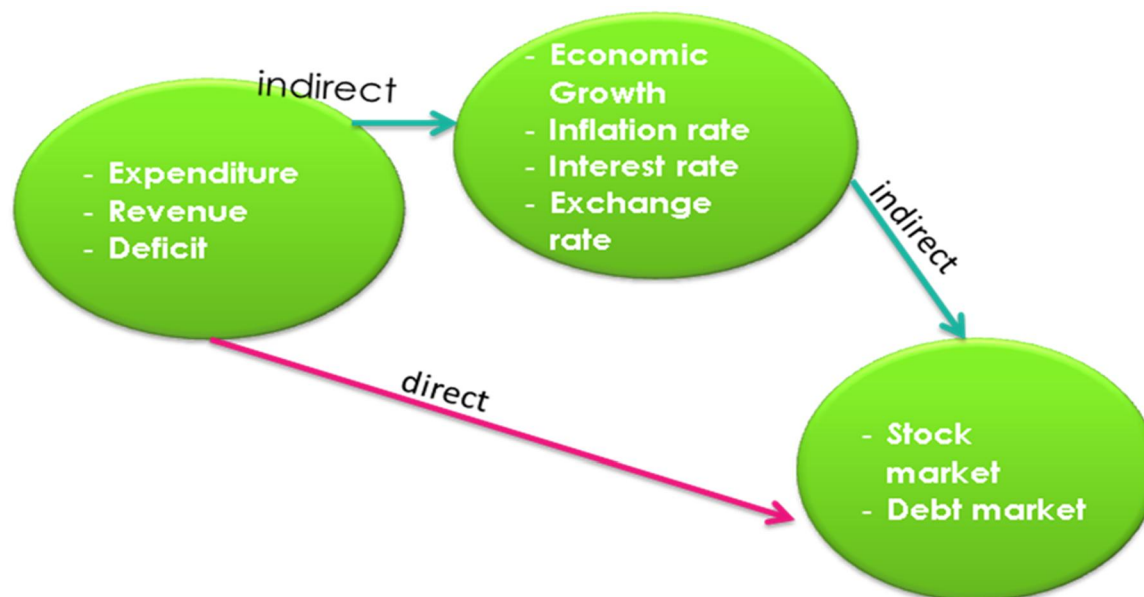


Figure 2: Direct and Indirect Effects of Budget on the Capital Market

Data from the capital market shows overwhelming dominance of the equity market. As at the end of June 2017, total market capitalization was ₦19.03 trillion, with equities contributing ₦11.46 trillion and bonds ₦7.55trillion. In terms of trading activity, however, the bond market contributed less than 1% in the capital market. Clearly, in terms of value of trading, there is an overwhelming dominance of equities which in the first half of 2017 accounted for nearly 99%. As the statistics have demonstrated, there is urgent need to improve the level of activity in the debt capital market, although overall activity should also be boosted in all spheres.

In addition to sound corporate and country-level governance, the need is dire for us to continue to implement the initiatives of the master plan in order to increase trading churn in the country's equity and debt markets. Among the set of other measures are improving capital market literacy, implementing measures to reduce cost and time to market, demutualizing the exchange, promoting direct cash settlement (which allows investors to receive proceeds from sale of shares directly into their bank accounts), and strengthening the e-dividend policy that removes the need for dividend warrants and the associated tendency for market infractions.

The SEC is also promoting trading in non-interest products. Some state governments have issued or are exploring the idea of sukuk, an Islamic non-interest product. The Central Bank of Nigeria has granted liquidity status to sukuk, and the federal government issued a sovereign sukuk for N100 billion in 2017. The Commission is also working to promote the issuance of green bonds as an alternative asset class to further deepen the market.

The Commission believes that these measures, and many in the pipeline, are important to sustain the steady development of the country's capital market. The capital market has

received a shot in the arm with the currency float, thanks to new measures adopted by the monetary authorities. Under the previous system, foreign exchange transactions were subject to allocation and controls. The current policy allows faster access to foreign exchange, helping to ease business. Investors will come when they know they can exit with minimal costs.

The SEC is also determined to increase listings on the country's securities markets. A host of initiatives have been introduced, including working with stakeholders in the capital market to improve capital market literacy amongst firms as well as the general public. We are also forging ties with the tax authorities and the national assembly to review tax laws required to foster company listing. It is our belief that these initiatives and others will improve the prospects for listings.

On the international scene, the Commission is hopeful that the development of Nigeria's capital market would go in tandem with helping the development of regional capital markets, especially in West Africa. In an increasingly globalised world, competition for capital is keener amongst countries. A domestic investor would include foreign assets in their portfolio if there are benefits from doing so. A key factor motivating cross-border movement of capital is observance of rule of law and adoption of measures to protect shareholder rights. Sound corporate governance and transparency are important determinants of market integration. Assets will yield return if managers are ready to guarantee investor protection. As the first country in Africa to adopt a corporate governance score card, we have no doubt that our market is ready for faster integration into the global system. Market integration produces desirable outcomes through portfolio diversification, but has its own risks – in the face of negative shocks, foreign investors tend to exhibit herding behavior, leading to large outflows, and the challenge for us is to ensure that our market is resilient to cope with those shocks.

Regional integration is presently feeble owing to differing legal systems arising from differences in colonial experiences of West African countries. However, as members of IOSCO and WASRA, there is scope to overcome these challenges in the medium to longer term.

5. CONCLUDING REMARKS

Economic theory argues for a positive link between the capital market and national budget. Both fiscal and the capital market authorities need to work together to consolidate those links in order for the capital market to make more meaningful contributions to national economic growth and development. The SEC will continue to engage with all stakeholders in the capital market and other sectors of the economy to achieve the Commission's mission and objectives. In that way, the link between the capital market and national budget will be properly harnessed and maintained. Detailed observations and recommendations that emerged from the seminar are presented in the communique shown in the appendix.

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APPENDIX: SEMINAR COMMUNIQUE

At the end of the seminar, the following communiqué was issued:

Observations

1. Macroeconomic environment has improved, with the country emerging out of recession, companies posting improved earnings, inflation moderating, external reserves growing and exchange rates stabilizing;
2. There is an intimate connection between the capital market and the national budget, each affecting the other in a mutually beneficial way;
3. The emphasis of government on removing obstacles to private sector growth (such as infrastructure development and the rejuvenation of the power sector) is a welcome development as it has the capacity to boost the private sector and improve growth;
4. In order for the capital market to remain on its current growth trajectory, steady growth and macroeconomic stability are critical;
5. Relative to total budgetary allocations, the capital projects have received increasing emphasis, rising from below 20% in the past, to hover above 30% in 2017 and 2018;

Recommendations

1. as actual provision for 2018 when adjusted for inflation will actually translate into zero growth compared to the provision in the previous year, the need for additional budgetary provision is urgent, particularly when account is taken of the fact that the current provision is just about 8% of GDP, a much smaller proportion when compared with what obtains in other jurisdictions;
2. Government needs to make its position about fuel subsidies clearer, especially in view of the fact that the NNPC is the main supplier of petroleum products in the country;
3. the appropriation bill needs to explain more clearly how the non-oil sector will be able to raise the required contribution of 63.04%, which the participants considered overly optimistic;
4. there is the need to agree on the framework for measuring budget performance that can track budget implementation using more meaningful indices, not just budget spending;
5. there is need for a strong budget office comprising of experienced technocrats to be set up in the National Assembly;
6. urgent action is necessary to promote the understanding of development plans such as Economic Recovery and Growth Plan (ERGP) especially in the executive and legislative arms of government;
7. the appropriation bill should be more explicit about government's plan to deal with issues of minimum wage and how to settle the debt it owes private sector contractors;
8. making provisions based on official exchange rate of ₦305 to the dollar may not be realistic because most transactions are executed based on the parallel rate of ₦363;
9. the budget cycle needs to be adjusted to begin in January and end in December and this could be achieved through early and regular engagement between the executive and legislative arms of government on matters relating to appropriation bills.
10. the bond market should benefit from the 2018 budget if externally issued instruments are listed and traded locally; and
11. given the increasing role of technology firms in other climes, there is the need to explore emerging products and opportunities arising from the global and local environment.