



IMPACT OF DOMESTIC DEBT ON ECONOMIC GROWTH IN NIGERIA: ARDL MODEL APPROACH

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Abstract

This research focused on the impact of Nigeria's domestic debt on the country's economic growth. The study aimed to determine if a long-run relationship exists between domestic debt and economic growth and policy options for breaking the growth resistance problem. The study used the ARDL short run and long run estimation techniques on secondary data from the World Bank's World Development Indicators (WDI) and the Central Bank of Nigeria's (CBN) statistical bulletin to estimate its empirical model. The study found that domestic debt and population positively impact economic growth in Nigeria while government expenditure and interest rate do not. The study recommends that domestic debt should be invested in the economy's productive sector and, more specifically, in the real sector, and further productivity gain will be achieved in the improvement of capital project expenditure.

Keywords: Economic Growth, Domestic Debt, and Domestic Savings, ARDL, Nigeria

JEL Classifications: O04, H630, E210, C12

1. Introduction

According to economic theory, a developing country's borrowings at a sustainable level are likely to boost its economic growth (Pereira, 2000). As a result, a developing country that wants to employ capital to assist economic growth and development may have to borrow. Countries in the early stages of development, such as Nigeria, borrow to supplement their capital holdings in order to promote growth. Nigeria is Africa's most populous country and largest economy, yet it also has one of the highest rates of poverty and vulnerability in the world (Action Against Hunger, 2021). This is coupled with having a vast population and material resources that are mostly untapped

compared to other countries. Various regimes have envisioned that the country will find its place among the top 20 economies in the world by the year 2020, with an improved standard of living for its people. Evidently, this vision is yet to be realized.

Internal capital formation is insufficient in developing countries like Nigeria, owing to the vicious circle of low production, poor income, and low savings. Nigeria's internal debt has been rising as a result of the country's tightening budgetary policies. The recent huge variations in revenue are primarily due to financial and global economic turbulence brought on by the impact of economic and political developments in Western countries

(AfDB, 2013). Heavy income cuts, on the other hand, cause consternation among policymakers, particularly when it comes to funding governmental fiscal budgets across federal institutions — the federal, state, and local governments. (Okonjo-Iweala, Soludo, & Muhtar, 2003).

For example, the Nigerian government requested an emergency financial assistance of \$3.4 billion from the international monetary fund (IMF) to meet the urgent financial needs arising from the outbreak of the COVID-19 pandemic. Even before the pandemic, the Nigerian government had been struggling to recover from the 2014 oil price shock, with GDP growth slowing to roughly 2.3 percent in 2019, and the situation is projected to worsen as a result of dropping oil prices (Ekeruche, 2020). As a result, it will have to borrow to meet its balance-of-payments requirements.

Domestic debt has become more pleasing to governments in recent years, and it is evident considering the yearly budgets of government where a chunk of the total budget is financed through borrowing. This may have resulted in domestic debt market activity resurgence, consequently leading Nigeria to a severe debt crisis. Domestic debt increased steadily during the time period under consideration. For example, the federal government's outstanding domestic debt, which was N28.4 billion in 1986, gradually climbed to N477.7 billion in 1995, decreased in 1996, and then began to rise again in 1997. In 2008, the total amount of domestic debt was N2.32 trillion, and it has been steadily expanding since then. It was N7.9 trillion by the end of December 2014, N12.5 trillion in 2017, and N14.2 trillion by the end of December 2019 (CBN, 2019).

Additionally, the 2020 national budget presented to the National Assembly contains a fiscal deficit of N2.18 trillion. As of March 31, 2019, Nigeria's total domestic debt stood at N17 trillion, an equivalent of \$55 billion using CBN's official exchange rate as of March 31, 2019 (DMO 2019). Nigeria's total public debt portfolio stood at N24.9 trillion as of March 31, 2019, out of which domestic debt accounts for 68.49%, while external debt account for only 31.51% of the total public debt (DMO, 2019). Therefore, despite the importance of borrowing in supplementing government finances and a growing debt profile, the research seeks to investigate domestic debt's effects on the Nigerian economy. In light of this, it is crucial to examine the relationship and the possible impact of domestic debt on Nigeria's strive for economic growth.

Although there have been various studies on the link between domestic debt and economic development in Nigeria, none has looked at the impact of increased domestic saving as a result of high interest rates combined with federal government domestic borrowing on Nigerian economic growth.

It further appears from the reviewed literature that there has not been a consensus on the relationship between domestic debt and economic growth in the Nigerian experience.

2. Literature Review

The issue of inadequate funds to fuel economic growth and development has to do with promoting a significant leveling off of revenue. The level of debt may be a concern for policymakers, investors, and, by extension, economic growth experts, primarily when the economy relies so much on a particular source of revenue. Woo (2003) analyzes factors

contributing to debt accumulation, including rising long-term interest rates, which invariably impact savings. It may also lead to more distorted taxes, resulting in lower revenue, inflation, and increased uncertainty and vulnerability to crises. However, domestic failings, the fall of the international oil price in 1981, and repeated shocks from the world oil market are cited by Ajayi (1989) as the origins of Nigeria's debt issues. Credit facilities rapidly dried up as a result of the debt situation, causing several projects to stop.

Therefore, several theories have been formulated on the nexus between debt and economic growth. Among which is the debt overhang hypothesis. Debt overhang implies a condition that a business or a government found itself where existing debt becomes so great that it becomes so difficult to accumulate more debts, even when the new borrowing is a good investment that would more than pay for itself. Potential investors may be deterred in this situation because they believe that the more they create, the more they will be taxed by the government. They will be less likely to spend investment costs now to improve future output because the proceeds will be needed to service the public debt (Gordon & Cosimo, 2018). According to Krugman (1988), the debt overhang theory states that if there is a chance that a country's debt will be larger than its repayment ability in the future, expected debt-service costs will discourage further domestic and foreign investment because the expected rate of return from productive investment projects will be very low to support the economy, as the creditor will receive a significant portion of any subsequent economic progress. This will eventually restrict both local and international investment, resulting in a reduction in economic growth (Krugman, 1988,

Sachs, 1989a). Due to the uncertainty and bad incentive effects that debt overhang causes, Spilioti and Vamvoukas (2015) think that debt overhang inhibits private investment plans.

Another theory on debt inurement is the debt crowding-out hypothesis. Whenever a nation engages in debt accumulation, leading to higher debt servicing, the nation's budget deficit increases, thereby decreasing public savings. This might result in a rise in interest rates or a reduction in the amount of credit available for private investment, causing the economy to decline. As a result, private investment may be discouraged or displaced, lowering the amount of production in an economy (Spilioti & Vamvoukas, 2015).

2.1 Empirical Literature

Using annual data from 1982-2017 and the two-stage least square regression technique, Akhanolu et al. (2018) investigated the impact of Nigerian public debt on economic growth. Internal debt, foreign debt, savings, and capital spending were all factors in the study. External debt had a considerable negative impact on growth, but internal debt had a favorable influence, according to the findings.

The domestic borrowing problem, according to Sanusi (1988), is caused by defective domestic policies, such as project financing mismatches and ineffective monetary and fiscal policies. For example, expansionary policies resulted in massive macroeconomic consequences, which favored imports while discouraging export manufacturing. He went on to say that the domestic debt load has negative implications for monetary policy, inflation, and economic development.

Onyeiwu (2012) used the Ordinary Least Squares Method (OLS), Error Correction, and parsimonious models to explore the link between domestic debt and economic development in Nigeria between 1994 and 2008. The analysis discovered that the government's domestic debt holdings are much over the healthy level of 35 percent of bank deposits, implying a crowding-out impact on private investments. The study found that debt has a negative impact on Nigeria's economic growth.

Domestic debt has a detrimental impact on Nigeria's economic development from 1994 to 2008, according to Adofu and Abula (2010). As a result, the authors advocated for tax measures to reduce domestic government borrowing and increase revenue.

Peter, Denis, and Chukwuedo (2013) looked into the link between Nigerian domestic government debt and economic development. Domestic debt and credit have a large and direct association with GDP, but debt servicing has an inverse relationship with GDP, according to their research. Furthermore, government spending has a direct but minor association with GDP.

Obiwuru et al. (2013) used a time-series design and empirical technique to look at how domestic debt influenced Nigerian economic development from 1990 to 2010. They found that domestic debt and credit to the economy had substantial beneficial effects based on particular economic growth and domestic debt indices, as well as moderating variables such as interest rate and credit.

Ordinary least squares (OLS) regression analytic techniques were used by Umaru, Hamidu, and Musa (2013) to investigate the

influence of public debt on economic development in Nigeria from 1970 to 2010. They discovered that external debt stifled the economy's development potential, but internal debt boosted it.

Madow et al. (2020) used a Bayesian Model of Averaging (BMA) to examine the causes of public debt in Africa, using data from 51 African nations. Foreign aid, fiscal deficits, trade openness, military spending, interest and exchange rates, debt service, domestic credit, government stability index, political regime type, and socio-economic crises are revealed to be the main and robust drivers of public debt accumulation in African countries, according to the findings.

The factors of dynamic macroeconomic views, such as fiscal deficit and India's economic development, were studied by Rahman and Islam (2020). For growth empirical, the linear autoregressive distributed lag technique and vector error-correction model were used. The findings reveal that monetized actual budget deficits reduce real economic growth in the short and long run.

Over the period 1995–2015, Thao (2018) looked at the impact of government debt on economic development in six ASEAN countries: Indonesia, Malaysia, Philippines, Singapore, Thailand, and Vietnam. The influence of government debt indicators on economic development was estimated using the General Method of Moments (GMM) estimation approach. The data found that public debt, FDI, GFCF, and the real effective exchange rate all have a large and positive impact on economic growth, but population increase has a considerable negative impact on these nations' growth rates.

3. Methodology

3.1 Data Sources and Method of Analysis

This analysis used secondary data from the Statistical Bulletin of the Central Bank of Nigeria, the National Bureau of Statistics, and the World Bank Economic Outlook. The time-series data spanned the years 1986-2019. Real GDP, GDP growth rate, domestic savings, domestic debt stock, government expenditure, interest rate, gross capital creation, and population growth are the economic factors reflected in these many publications. The research is based on yearly time series data that spans 33 years.

When conducting research involving time series analysis, the first point of call is to test for the nature of the trend possessed by the variables at hand. Due to the nature of the data employed in this study, it is expedient to apply Augmented Dickey Fuller (ADF) test statistics to evaluate the stationary properties of the time series. Due to the stationarity level of the variables at first difference and at levels, the autoregressive distributive lag (ARDL) was conducted to carry out the coefficient diagnostic Bound test. The autoregressive first difference error correction method long run short run was used for the regression analysis to study the impact of the domestic debt on economic growth in the short and long run.

$$\ln RGDP_t = \beta_0 + \beta_1 POPG_t + \beta_2 GCF_t + \ln \beta_3 DS_t + \ln \beta_4 DDS_t + \ln \beta_5 GE_t + \beta_6 INTR_t + \mu_t \dots\dots\dots 2$$

where;

β_0 = intercept of the regression

$\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6$ = parameters of the regression equation to be estimated

3.2 Model Specification

This work adapts (Ozurumba & Kanu, 2014) empirical work to meet the needs of the current investigation. This was done by replacing the individual component of domestic debt such as treasury bonds, treasury certificate, and development stock with the total domestic debt as the objective of this work was to examine the impact of domestic debt on economic growth rather than the contributions of domestic debt component to economic growth. Also, to fill some of the research gaps highlighted from the studies reviewed, Domestic saving was added to capture the effect of increased domestic saving that may result from high-interest rate accompanied by federal government domestic borrowing on the economic growth of Nigeria. This work also involves the inclusion of Interest rate, government expenditure, population growth rate, and gross capital formation to form part of the independent variables.

The model is thus in its general form specified as;

$RGDP = f(\text{Domestic Savings, Domestic Debt, Government Expenditure, Interest Rate, Population Growth, Gross Capital Formation}).1$

Stating the relationship in an economic model, it becomes;

RGDP is a real gross domestic product, POPG is population growth, GCF is gross capital formation, DS is domestic savings, DDS is domestic debt stock, GE is government expenditure and INTR is interest rate.

4. Data Presentation and Analysis

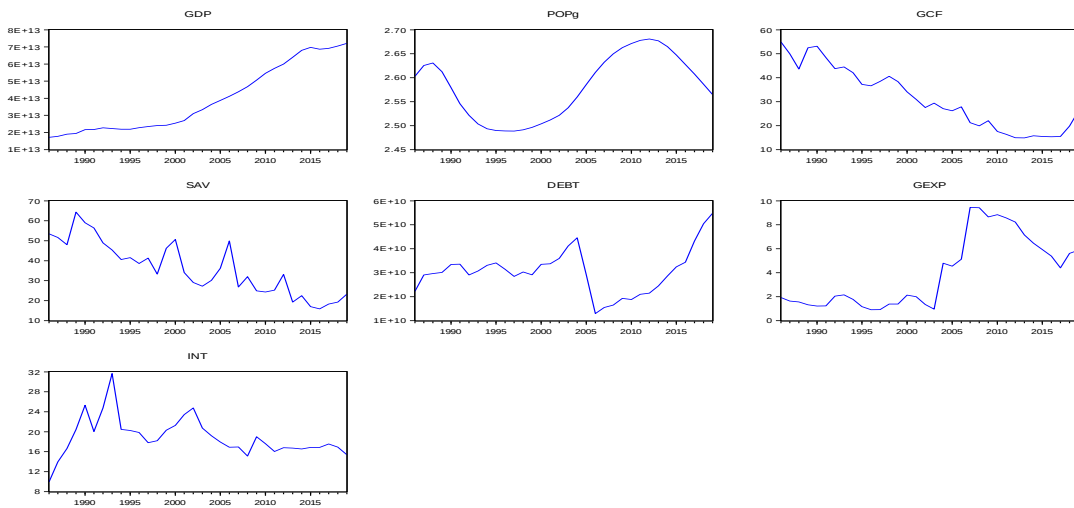


Figure I: Trend Analysis of Variables

Source: Author's Computation, 2022

The figure shows that real GDP exhibits an upward trend throughout the period under investigation. This can be seen by its upward movement, which has consistently increased over time. Population growth is seen to exhibit both upward and downward trends. Gross capital formation is seen to be falling over the period. Its fall was steady and consistent from the beginning to the end of the period. Savings is also seen to exhibit a consistent fall throughout the period, even though there were some cases of spikes of increases. Debt steadily rose during the early years of the period under investigation but fell sharply in 2006. However,

it rose immediately afterward and increased consistently till date. Government expenditure started at a low level and continued at this low level until the middle of the period. However, it rose drastically afterward, reaching its peak in the late 2000s and continuing to fall consistently afterward. Interest is seen in the figure to exhibit some spikes of increase at the beginning of the period but later fell and remained around 20 percent till the end of the period.

4.1 Pre-Estimation Tests

4.1.1 Unit Root Test

Table 1: Unit Root Test Results

Variables	LN(RGDP)	POPG	GCF	DS	LN(DDS)	GE	INTR
ADF	0.333	0.001*	0.328	0.328	0.311	0.704	0.024*
Δ ADF	0.009**	-	0.000**	0.000**	0.002**	0.000**	-

*, ** - denotes the stationarity of the variables at levels i.e., $I(0)$ and at first difference i.e., $I(1)$ respectively.

Source: Eviews 10

The Augmented Dickey-Fuller (ADF) approach was used for the unit root test. Some of the

variables show trends (either downward or higher) over time, as seen in the graph above.

As a result, while running unit root tests for such variables, the trend and intercept choices were picked. Other variables that do not trend with time are given an intercept. Except for population growth and interest rate, all variables were stationary at levels and at a 5% significance level, according to the ADF results. Each of the other variables' p-values is larger than 0.05, and each of their ADF test statistics is less than the 5% critical value, but population growth and interest rate have p-values of less than 0.05, and each of their ADF test statistics is greater than the 5% critical value.

In this study, the $I(0)$ and $I(1)$ variables were combined to produce this result. If there is no long-run cointegration, this finding means that

Table 2: ARDL Bounds Cointegration Test Results

Test Statistic	Value	K
F-statistic	4.005075	6
Critical Value Bounds		
Significance	$I(0)$ Bound	$I(1)$ Bound
10%	2.12	3.23
5%	2.45	3.61
2.5%	2.75	3.99
1%	3.15	4.43

Source: Author's Computation, 2021.

The null hypothesis of the cointegration test is that there is no long-run cointegration (or relationship). By comparing the F-statistic value to the critical boundaries, this may be validated. The null hypothesis is rejected if the value exceeds the $I(1)$ bound, and the conclusion is that there is a long-term link. The null hypothesis is not rejected if the F-statistic value is smaller than the $I(0)$ critical bound, and the conclusion is that there is no long-run link. At a 5% significance level, the F-statistic value of 4.005075 is bigger than the $I(1)$ critical value constraint of 3.61. As a result, the null hypothesis of the test is rejected. As a result, a

using the Ordinary Least Squares (OLS) approach to estimate the parameters will result in erroneous regression results. This needs the cointegration test to see if the stationary and non-stationary variables in the model have a long-run connection. Because of the varying order of integration among the variables, this is done using the ARDL bounds test process for cointegration. Because the dependent variable $LN(RGDP)$ was stationary at first difference, the ARDL limits test was also used. (For more information, see Motenegro, 2019)

4.1.2 ARDL Bounds Cointegration Test

long-term partnership exists. The conclusion may subsequently be drawn that the stationary and non-stationary series in the model have long-run connections. As a result, the ARDL short-run error correction model and long-run coefficients may be used to obtain both short and long-run estimates for the model's parameters.

4.2 Regression Analysis

The regression analysis used to investigate the influence of domestic debt on Nigerian economic development is presented in this

section. In a natural logarithm transformation, real GDP is the dependent variable, while domestic debt is the independent variable. As control variables, the model incorporated variables including population growth, gross

capital creation, savings, government expenditure, and interest rate. The model's parameters were estimated using the ARDL short- and long-run methods.

Table 3: ARDL Short- and Long-Run Regression Result

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Short Run Coefficients				
D(POPG)	0.431399	0.150657	2.863443	0.0103
D(GCF)	-0.003409	0.001767	-1.928952	0.0697
D(DS)	0.000052	0.001071	0.048276	0.9620
D(LNDDS)	0.026467	0.033176	0.797778	0.4354
D(GE)	0.007956	0.004906	1.621709	0.1223
D(INTR)	0.002069	0.002009	1.029729	0.3168
ECT(-1)	-0.272921	0.048645	-5.610519	0.0000
Long Run Coefficients				
POPG	1.580672	0.539345	2.930725	0.0089
GCF	-0.042238	0.007884	-5.357612	0.0000
DS	0.014177	0.007311	1.939149	0.0683
LN(DDS)	0.434525	0.105527	4.117671	0.0006
GE	0.029151	0.016259	1.792869	0.0898
INTR	-0.000550	0.008694	-0.063306	0.9502
C	17.486330	2.906720	6.015830	0.0000
R-Squared	0.998342			
F-statistic	833.4787			
P-value of F-statistic	0.0000			

Source: Author's Computation, 2022.

The table above shows the results of an OLS regression used to look at the influence of domestic debt on Nigerian economic development. The model's stated R-squared indicates that it explains around 99.8% of fluctuations in GDP in Nigeria. The F-statistic recorded is 833.4787, with a p-value of 0.0000, indicating that it is statistically significant. This means that the model as a whole is statistically significant and well-fitting. The negative coefficient of the first period lag of the error correction term [i.e., ECT(-1)] and its significance due to its p-value being less than 0.05 indicate that the model has returned to long-run equilibrium following a short-run

disequilibrium. Its coefficient of -0.272921 shows that each period corrects roughly 27.3 percent of short-term mistakes, and the economy will reach complete convergence (i.e., 100%) in about four periods.

In the long run, population growth (POPg), domestic savings (DS), domestic debt (DDS), government expenditure (GE) have positive coefficients in the result, which are 1.580672, 0.014177, 0.434525, 0.029151, respectively. On the other hand, gross capital formation (GCF) and interest rate (INTR) have negative coefficients in the result, which are -0.042238 and -0.000550. Looking at the significance of these

coefficients through the p-value, population growth, gross capital formation, and domestic debt have p-values of 0.0089, 0.0000, and 0.0006, which are lower than 0.05 (i.e., 5% significance level), while domestic savings, government expenditure, and interest rate have p-values of 0.0683, 0.0898 and 0.9502 which are greater than 0.05. The lower p-values of the coefficients of population growth, gross capital formation, and domestic debt indicate that they are statistically significant in affecting economic growth at 5% significance levels, while the higher p-values of domestic savings, government expenditure, and interest rate indicate that they are not statistically significant in affecting economic growth.

Population increase has a substantial positive coefficient, indicating that it has a strong long-run beneficial influence on Nigeria's economic growth. In Nigeria, a percentage point increase in the population growth rate would result in a 1.58 percent gain in real GDP in the long run, and vice versa. Domestic debt, too, has a substantial positive coefficient, indicating that it has a considerable long-run beneficial influence on Nigerian economic growth. In Nigeria, a percentage point increase in domestic debt as a proportion of GDP would result in a 0.434 percent increase in real GDP in the long run, and vice versa. The considerable negative coefficient of gross capital creation, on the other hand, implies that capital formation has a significant negative long-run influence on Nigeria's economic growth. In Nigeria, a percentage point increase in gross capital creation as a proportion of GDP would result in a 0.042 percent drop in real GDP in the long run, and vice versa.

5. Conclusion and Recommendations

The goal of this study was to determine the influence and magnitude of domestic debt on Nigerian economic development from 1986-2019 in order to give suggestions on how to manage the risks of domestic debt in Nigeria. Domestic debts thus, have a major impact on Nigerian economic growth, according to the conclusions of this study.

Domestic debt and population expansion have strong positive effects on economic growth, whereas domestic savings and government spending have little beneficial effects. The interest rate, on the other hand, has a negligible negative influence on economic growth, whereas gross capital creation has a considerable negative impact on economic growth at the 5% level of significance. It is proposed that the negative influence of gross capital creation on economic development, contrary to our expectations, might be explained by the fact that gross capital formation was mostly dropping during the research period.

Domestic savings have a negligible beneficial influence on economic development, according to the study. As a result, domestic savings have yet to be completely harnessed to the desired level of contribution to economic development. It might also mean that the government sector pushes out private-sector savings.

Government spending has a direct but insignificant link with Real GDP, which is consistent with our presumption. However, because capital spending is one of the pillars of sustainable growth, the fact that it is not considerable suggests that the government should increase its efforts.

Findings from the research work have substantial policy implications for how the Nigerian government might handle domestic debt more responsibly. Based on such findings, the following are hereby recommended:

- i. To minimize overhang in terms of compounding both interest and principal, debt repayment should be done without prompting for the private sector to have access to long-term lending to drive the economy.
- ii. Population growth and domestic debt, as found in the study, has a significant positive impact on economic growth; hence, the accumulation of domestic debt must be encouraged for productive capital project, and the quality of the population must be enhanced as much as the quantity so as to drive economic growth in the country further, as this is expedient in attaining economic growth in Nigeria.
- iii. To generate jobs and eliminate poverty in the country, domestic debt should be invested in productive sectors of the economy, particularly in the real sector. Also, the borrowed funds must be entrusted to capable hands and used for the purpose it was incurred. If public debt is taken on, it should be done so that capital projects can be undertaken to increase productivity.
- iv. Government capital expenditures, such as infrastructure, should be improved more because they are the key to growth and lower production and investment costs. Government capital expenditure does not account for a significant portion of GDP, implying that the government should invest more in capital project development.

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