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››› Nigeria – a poor example of macro-economic adjustment?

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One Pager

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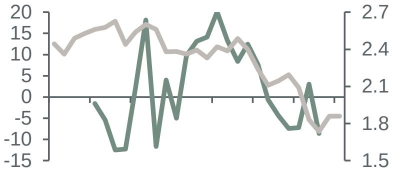
The sharp, fast decline of the oil price from mid-2014 was a serious macro-economic shock for Africa's largest economy (in terms of GDP). Nigeria is strongly characterised by oil production. Today the oil sector accounts for just under 10 % of GDP, but the high share of oil and natural gas in exports (some 90 %) and government revenues (some 75 % before the oil price decline) illustrates the country's dependence on this sector.

No adequate economic-policy response

Unlike other oil-exporting states, Nigeria was not able to offset part of the oil price decline by expanding production. Unprofitable extraction and, in particular, acts of sabotage in the Niger Delta forced the closure of some oil production facilities. Between mid-2014 and mid-2016, oil production dropped by approx one third and investment activity declined sharply (Figure 1).

Figure 1: Oil prices and investment

Real gross fixed capital formation: Per cent variation on previous year (left); oil production: million barrels per day (right)



Source: Bloomberg

Adjusting to shocks of such magnitude is a challenge for a developing country with weak institutions such as Nigeria. Effective economic-policy measures are difficult to implement in a politically difficult environment characterised by structural weaknesses. Besides, the measures taken were not adequate to the shock:

- Nigeria has structural problems that were 'masked' by oil revenues which had been flowing reliably for a long time and that are now becoming all the more apparent. Problems include an ineffective banking sector, high levels of corruption, excessively high energy subsidies, high unemployment, inadequate government revenues (some 5 % of GDP compared with an average of around 17 % for Sub-Saharan Africa) and a fragile security situation. In short, Nigeria's economy was not fit to offset at least part of the negative impacts of the oil price development with additional growth.

- The economic policy response to the oil price shock was inadequate. The naira, which is pegged to the US dollar, was not devalued quickly and strongly enough (Figure 2) to stabilise the value of exports in domestic currency. That exchange-rate policy allowed currency reserves to melt away, which should have been controlled through restrictions on capital movements. Still, the country was unable to avert real economic adjustment as parallel rates and import restrictions sent the inflation rate soaring (currently 16.1 %) despite the US dollar peg.

- The low tax quota makes adequate fiscal stimulus almost impossible. In addition, the insufficient currency devaluation removed less pressure from the national budget than would have been possible under a flexible exchange rate regime. That restricted the country's fiscal scope even more.

As a result, the oil price development and, with it, the Nigerian oil sector put great pressure on Nigeria's economy despite its relatively low weight. Investor confidence plummeted and real GDP contracted by 1.5 % in 2016.

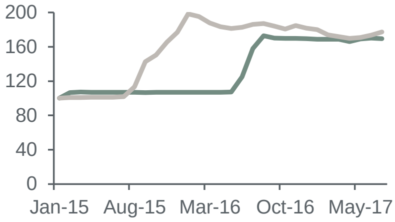
What could be done better?

The above observations suggest that a country heavily dependent on the oil sector should keep its currency as flexible as possible in the present situation. It would support exports and ease pressure on currency reserves as well as on the budget – since oil trade is accounted for in US dollars. The inevitable real adjustment will take place more quickly and with less noise.

An example of more effective macro-management of an oil price shock is Kazakhstan. It floated its currency in 2015 (late, but nevertheless) (Figure 2). Kazakhstan's GDP growth fell to 1.2 % and 1.1 % in 2015 and 2016, but a recession was averted. Inflation rose as expected (to nearly 18 % in mid-2016) but has eased to now 7.1 %.

Figure 2: Exchange rates

Nominal, Nigeria's naira and Kazakhstan's tenge per 1 USD, 1 Jan. 2015=100



Source: Bloomberg, own calculations

Conclusion

Although it is Africa's largest economy, Nigeria cannot be held up as a paragon of economic policy response to the oil price shock. It must pursue its structural reforms more vigorously. While that imperative applies to many developing countries, it applies all the more to a heavily populated class leader. ■