CHALLENGES FROM NIGERIA'S ECONOMIC RECOVERY[1]

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ABSTRACT

This piece documents the facts of the supply-side recovery in Nigeria in the last few years and identifies the triggers. It then discusses the challenges the new turn of events pose to policy makers, who are only just responding to the previous downturn.

Data that have become available since reforms were announced mid 2004 are presented here to show that the economy had indeed entered a recovery phase since 1999, long before the economic team was assembled. Stagnation has finally given way to strong broad-based economic growth. The large fiscal deficits, the financing of which inflicted inflation, devaluation, and high interest rates, have also now given way to fiscal surpluses. Thus, the economy has changed dramatically, but the policy documents are not yet acknowledging the changes, much less reflect them.

The growing *disconnect* between economic facts and government reforms portend grave risks for the sustainability of the recovery. Unanticipated positive external shocks have stimulated supply-side recovery and provided unexpected funds abroad. Nigeria now has abundant resources that can be used to translate the current windfall to improved living standards and additional capacity for economic growth.

It is hoped that this piece will stimulate the necessary debate to ensure that the boom is not left unmanaged.

Key words: Commodity prices, oil prices, oil sector, non-oil commodity prices, non-oil sector, external reserves, boom, bust, Nigeria

JEL classification codes: N17, O55

[1] Teriba, A. O (2001) 'Nigerian Macroeconomic Evolution in the 1990s', *Nigerian Accountant,* 34 (1), 2001, pages 41-64 reviewed developments in the Nigerian economy from 1990-1999. This piece updates aspects of that study for the first half-decade of the new millennium, 2000-2004.

NIGERIAN ECONOMY IN RECOVERY MODE

BY

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1. TRANSITING FROM BUST TO BOOM

The global economy is on an impressive expansionary cruise, dragging the Nigerian economy along. It is necessary to pinpoint aspects of the Nigerian economy that positive shocks from abroad are affecting the most, and suggest areas in which domestic policies will complement the external growth impulses, rather than counteract them.

- **THE BUST**

The global economy had been largely sluggish since the early 1980s, with commodity price crunch inflicting deep real sector stagnation on the Nigerian economy. Nigeria fared woefully in those years, as domestic policy choices added high inflation to the externally induced real economic contraction. Nigeria witnessed nearly two full decades of output and demand contractions in the face of increased volatility in inflation, devaluation and interest rates. Various efforts were made to stabilize and adjust the economic between 1982 and 1988, before concerns about the economic transition were dwarfed by new concerns for political transition from around 1989, when income from transient improvements in commodity prices became available to fuel political experimentation. The experimentation dragged on until 1999, culminating in the present democratic dispensation.

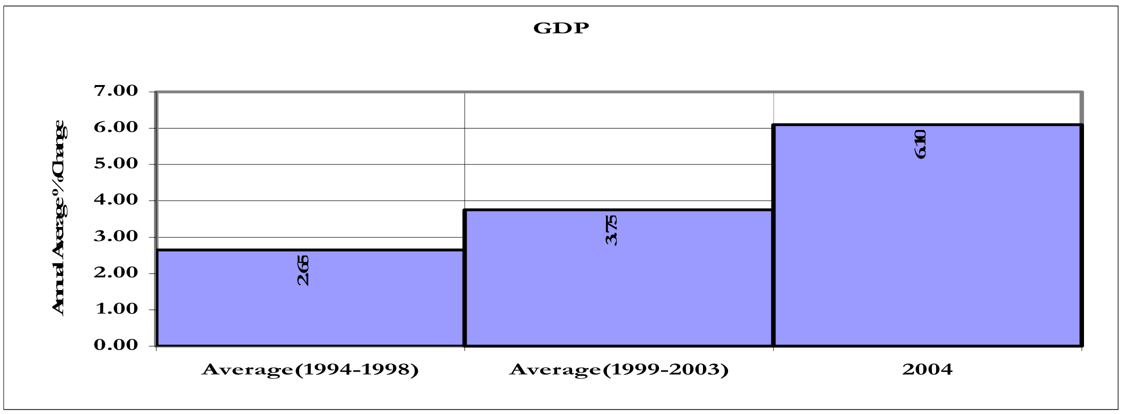
By the time the present regime assumed office mid-1999, the global economy was at its worst situation in two decades: economic collapse were widespread among developing economies in East Asia, Latin America, Eastern Europe, and Sub-Saharan Africa, and the predominant expectation was that the US economy, Euro Area and Japan would join the train, and the global economy would move into a freezing deflationary phase. The exact opposite has happened. Developed countries did not catch any of the recession flu. For various reasons, they managed to continue to grow and even faster, providing the developing countries the needed impulse for recovery. Better still, two large developing economies that have long been stagnant, China and India, have unexpectedly joined the growth train, providing the global economy a new vent for expansion.

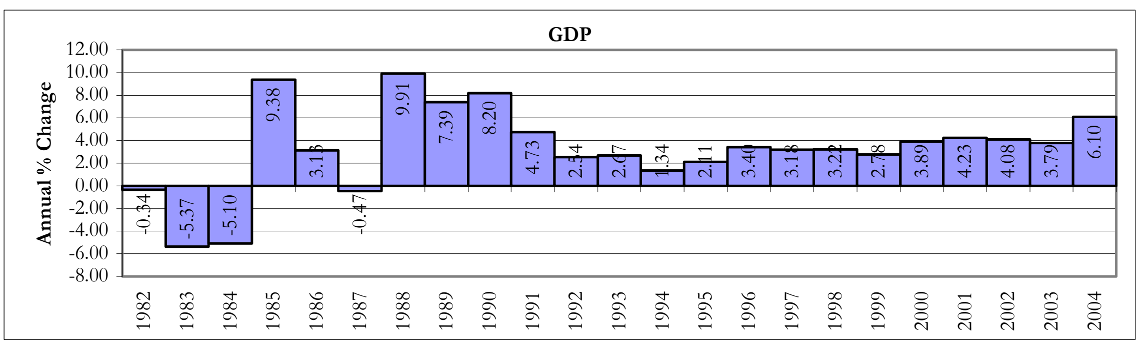
- **THE POLICY RESPONSE**

The response of the present government to the economic crunch it met in 1999 took about five years to fashion out: there was a four year *recognition lag*, as the regime only accepted the need for an economic team by mid-2003; and then another full year *action lag*, as the economic team only began to announce reform measures by mid-2004. *Implementation lag* is still underway, and so is the *impact lag*. Meanwhile, global and national economic conditions have changed. Data that have become available since the reforms were announced suggest the economy had indeed entered a recovery phase since 1999, long before the economic team was assembled. Stagnation has finally given way to strong broad based economic growth. The large fiscal deficits, the financing of which inflicted inflation, devaluation, and high interest rates, have also now given way to fiscal surpluses. Thus, the economy has changed dramatically, but the policy documents are not yet acknowledging the changes, much less reflect them. The growing *disconnect* between economic facts and government reforms portend grave risks for the sustainability of the recovery.

2. THE RECOVERY[2]

GDP GROWTH: GDP growth rate in 2004 was 6.1 percent. This is the highest since 1991, and it defines *a fourteen-year peak*. The annual average growth rate increased from 2.65 percent in the 1994-1998 period to 3.75 in the 1999-2003 period. Thus, the annual average GDP growth rate has exceeded the population growth from 1999 to 2003, but became more than twice as large as the population growth rate in 2004.

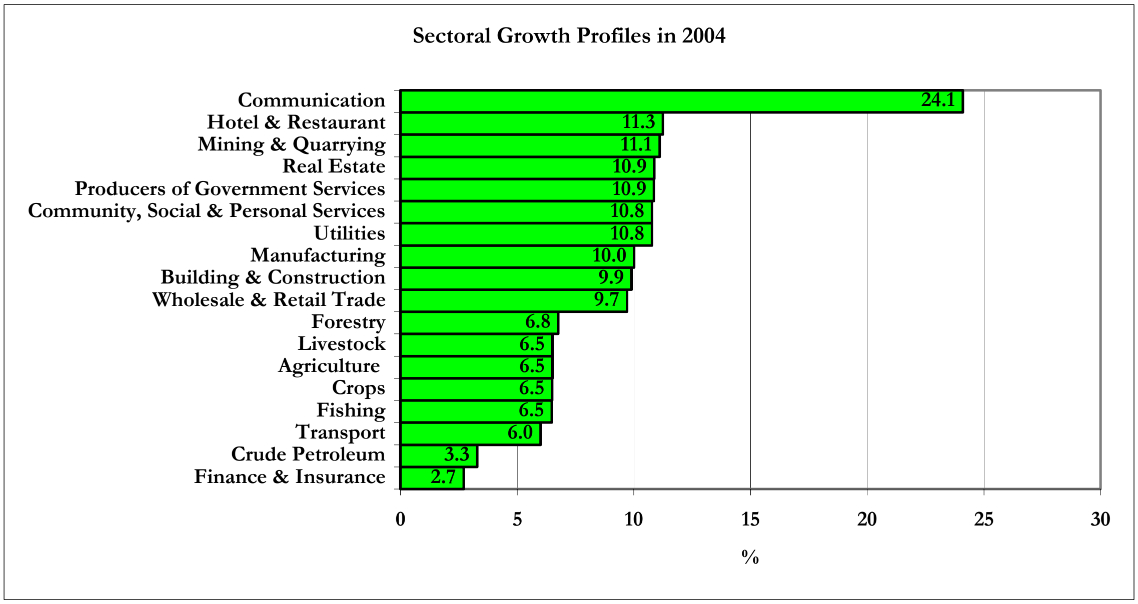




In 2004, while government's target for real economic growth was only 5 percent, Communication grew by 24 percent to lead all the other sectors, as many as nine sectors grew by about 10 to 11 percent each, six sectors grew by between 6 and 7 percent each, only

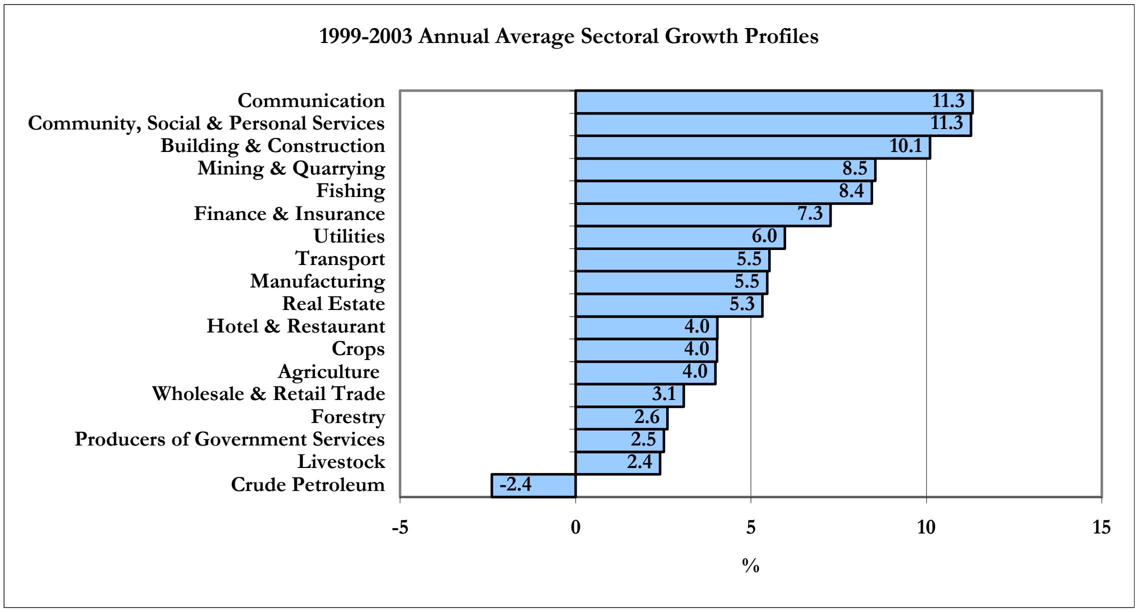
[2] Except otherwise indicated, all data used in his write-up are sourced from three publications of the Central Bank of Nigeria: *Annual Report and Statement of Accounts* (various years), and *Statistical Bulletin* (various issues), and *Monthly Report* (various issues). All production data are the 1984 constant factor cost series that are provided up for 1981-2003. Growth rates reported for 2004 are applied to these series to derive their levels in 2004.

two sectors, crude petroleum[3] and financial services[4], did not achieve the 5 percent target in 2004. It is noteworthy that none of the sectors declined in 2004.

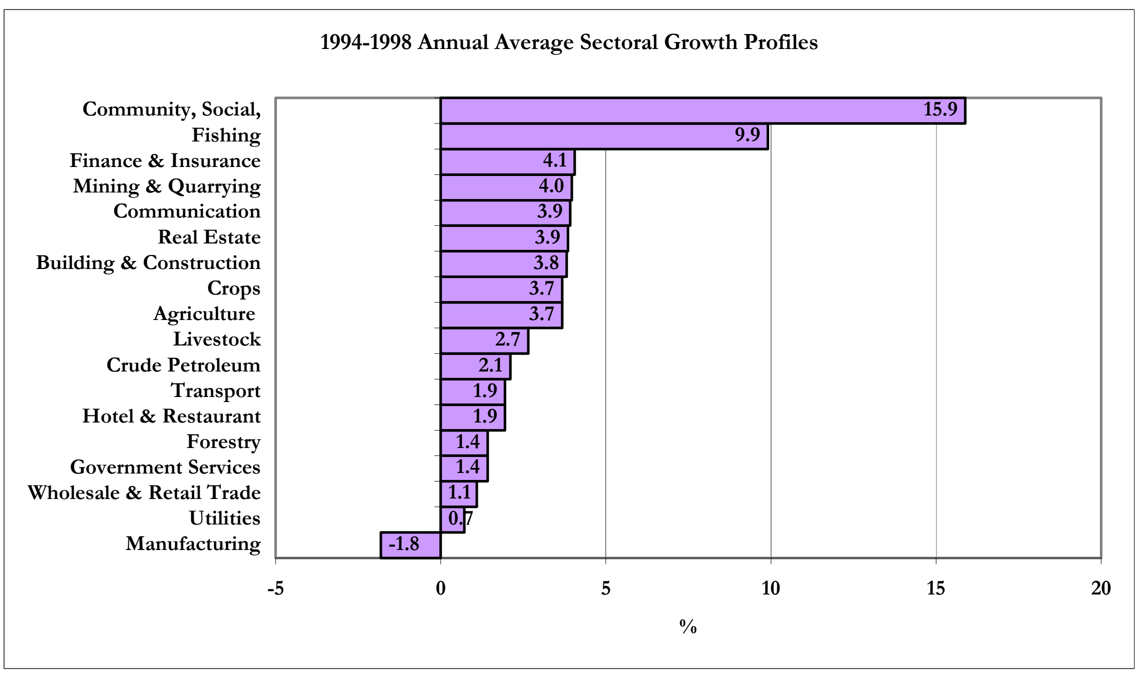


From 1999-2003, the average annual performance of the sectors improved noticeably over the preceding half-decade as three sectors grew by more than 10 percent, seven grew by more than 5 percent, while seven others still grew by less than 5 percent, and one sector, Crude Petroleum, declined.

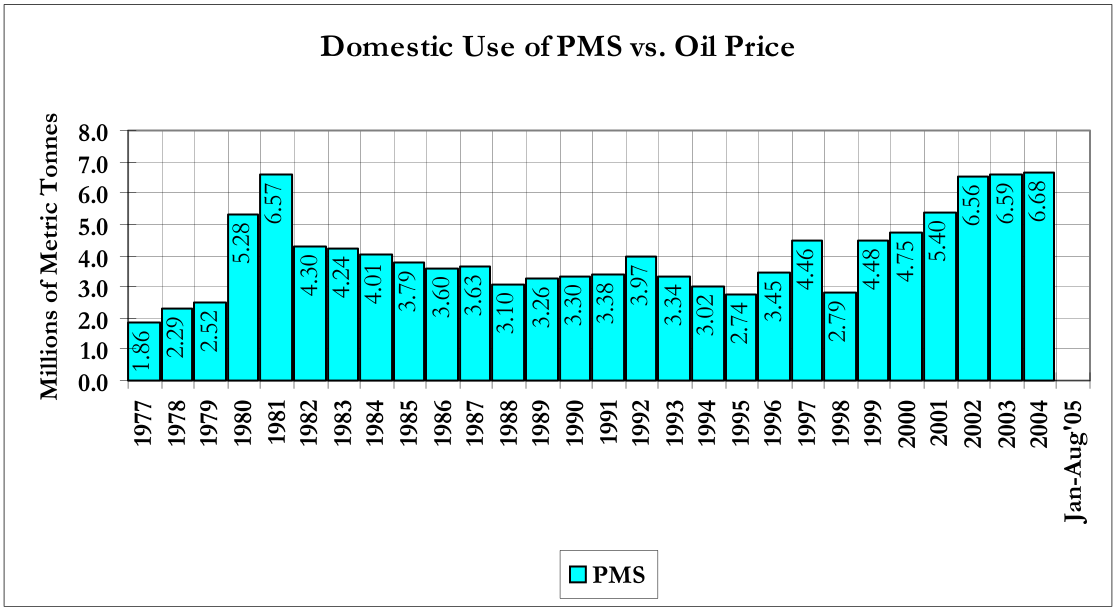
[3] The stagnation in crude petroleum is not unconnected with the endemic local content crisis that now means dwindling domestic value added even as the volume of oil production increases.
[4] The stagnation in financial services last year is not unconnected with the stranglehold of the central bank on the sector in the attempt to coerce players into mergers and larger capital base; prior to the consolidation therapy, the sector had been one of the fastest growing in the economy.



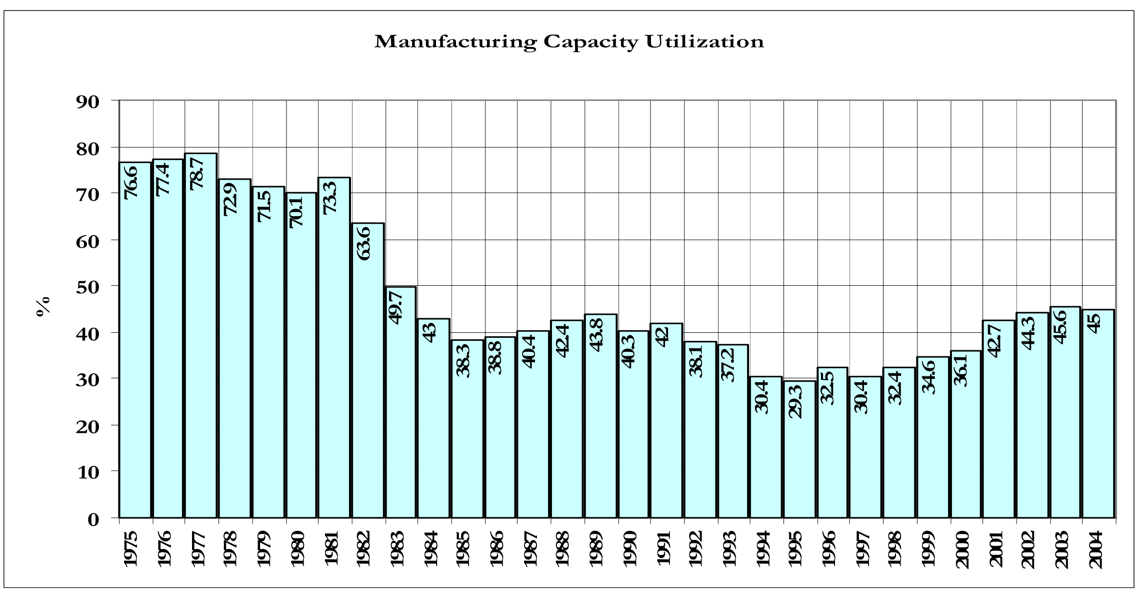
From 1994 to 1998, the average annual performance was such that as many as sixteen of the eighteen sectors grew by less than 5 percent, and manufacturing declined, while Community and Social Services (capturing the increased activities civil rights groups at the time) grew by 16 percent, and fishing grew by 10 percent. This reflects the economic stagnation that prevailed before the democratic transition.



Beyond national income statistics, which might be considered abstract by a few, there are some easily measurable indicators of the fact that productive activity is recovering in Nigeria. Available data on the consumption of premium motor spirit (PMS) and manufacturing capacity utilization in Nigeria both strongly suggest that for the first time in 20 years, the Nigerian economy has entered a recovery phase.



In the 17-year period between 1982 and 1999, *domestic use of premium motor spirit* (PMS) in Nigeria dropped steadily from its peak of 6.57 millions metric tons initially attained in 1981 to 2.74 metric tons by 1995, and was only 2.79 million metric tons by 1998. It has recovered steadily from 1999 to its 1981 level by 2003, and has reached a new peak by 2004. Fuel consumption is a crude indicator of the strength of economic activity, and it is suggestive of a strong and sustained recovery in Nigeria between 1999 and 2004. In spite of the fact that much of the PMS used in Nigeria over that time had actually been imported, its usage has risen to an unprecedented level by 2004.



Capacity Utilization Rate in the manufacturing sector also reached a 20-year high of 45.6 percent by 2003. It had fallen from 73.3 percent in 1981 to 29.3 percent by 1995, and it was still as low as 32.4 percent by 1998. It has however recovered steadily since 1999 to 45.6 percent in 2003, the highest in twenty years. In spite of increases in installed capacity in the sector, as major manufacturing concerns commissioned new plants in 2004, capacity utilization rate still stood at 45 percent by the end of that year.

Although there are no reliable statistics on *employment* yet, the steady increases in PMS usage and capacity utilization must imply recovery in employment level. One thing that makes clear that unemployment level must have dropped is the fact that manufacturing capacity utilization could be rising in the face of evident increases in installed capacity in the sector, as major manufacturing concerns have started building new plants in the last few years. In contrast with the spate of plant closures that characterized the half-decade preceding the present regime, key manufacturing concerns have been building new plants since the return to democracy in 1999. Even with the widespread opening of new plants, capacity utilization has been rising. This indicates a strong recovery in manufacturing, something that has eluded the country for nearly two decades.

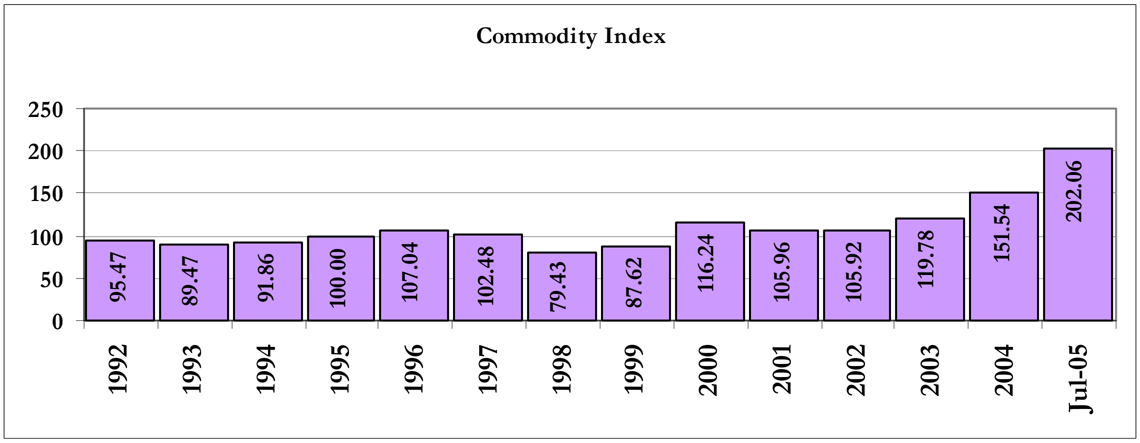
Elsewhere in the economy, the signs of recovery are even more visible. In telecommunications, three new entrants within the last five years have grown rapidly to become giant corporate concerns, with huge impacts on employment, income and spending growth in the country. One indicator of recovery that easily comes to mind is the growth in the *number of telephone subscribers* from only four hundred thousand in 2001 to well over 10 million by 2005. Consistent time series data are however not available on that yet, and many still see the boom in the Nigerian telecommunications sector as an isolated development.

The point to take away from here is that the Nigerian economy had been stagnant before 1999, but had moved steadily out of stagnation between 1999 and 2003, and had entered a high growth phase by 2004. *Policies required for getting a stagnant economy to take-off differ in many significant regards from those required for keeping it cruising once it is airborne.*

3. TRIGGERS OF THE RECOVERY

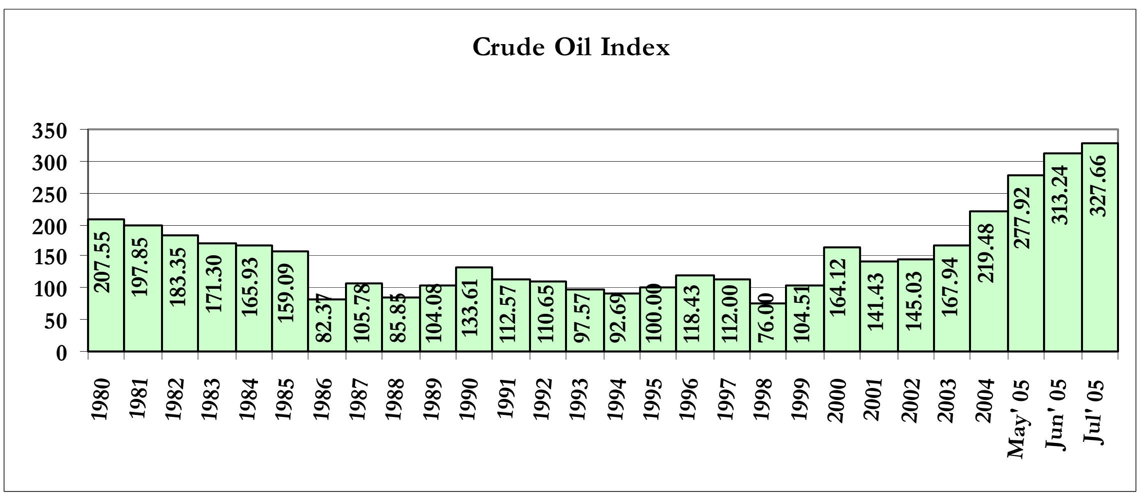
The global recovery impulses are being transmitted to the Nigerian economy through improvements in commodity prices: oil and non-oil[5].

[5] Commodity price indices are from the International Monetary Fund's Online Commodity Database.

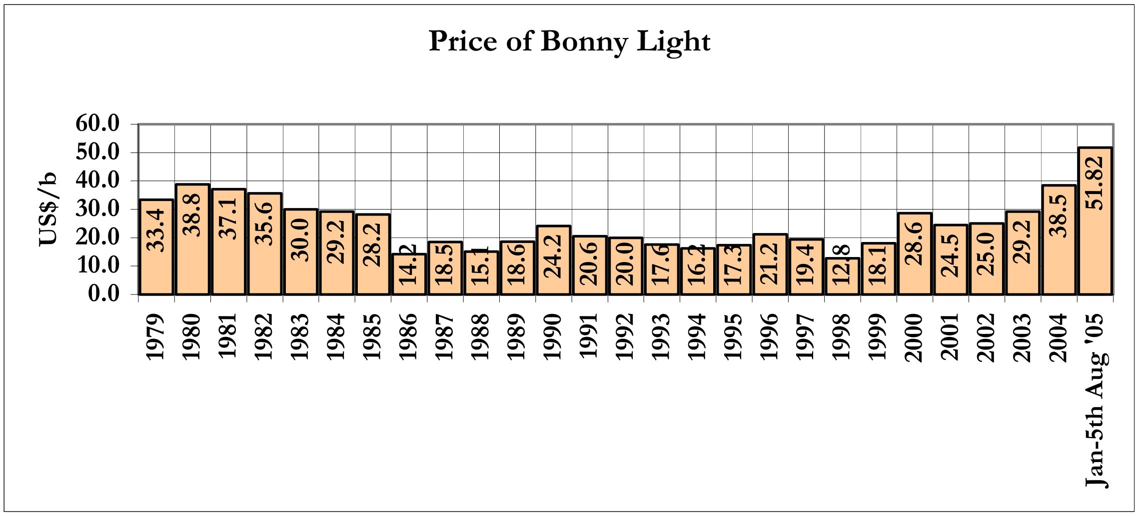


- **THE OIL BOOM**

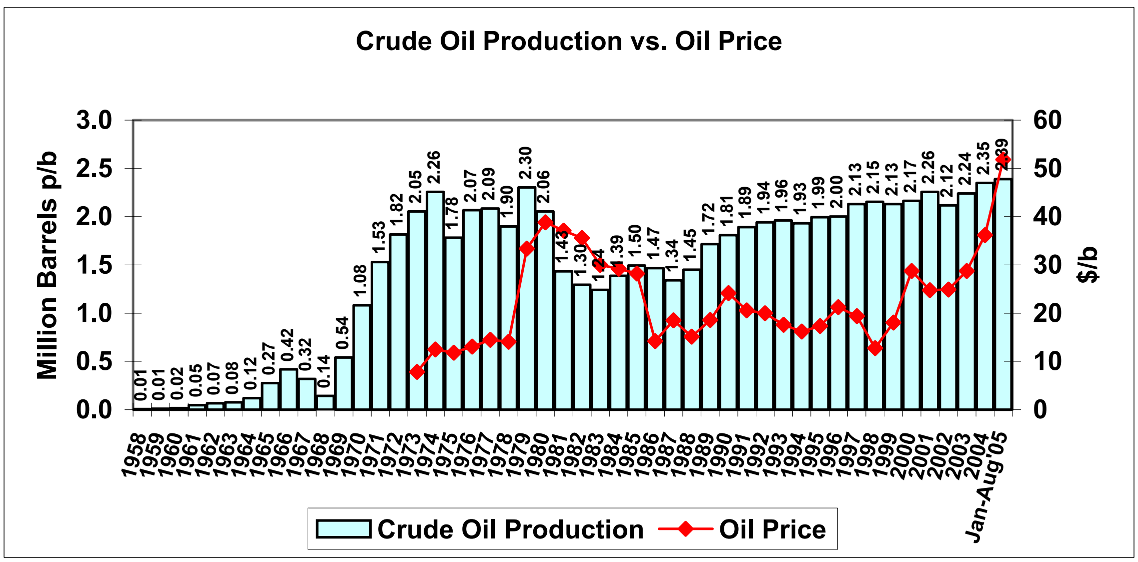
The most visible channel is through the reversal of nearly twenty years downward trend in oil prices. This channel works through sustained increases oil prices leading to the removal of quantitative output restriction by Organization of Petroleum Exporting Countries (OPEC), this paves the way for sustained increases in output, an higher export income, which bloats government revenue, expenditure, and external reserves.



Oil prices, which had trended downwards precipitously for 18 years from 1981 to 1998, surprisingly doubled between 1998 and 2003, and then again between 2003 and mid-2005. Oil prices began to rise in 1999, and are now in the seventh year of the upward climb, and are still gaining strength.



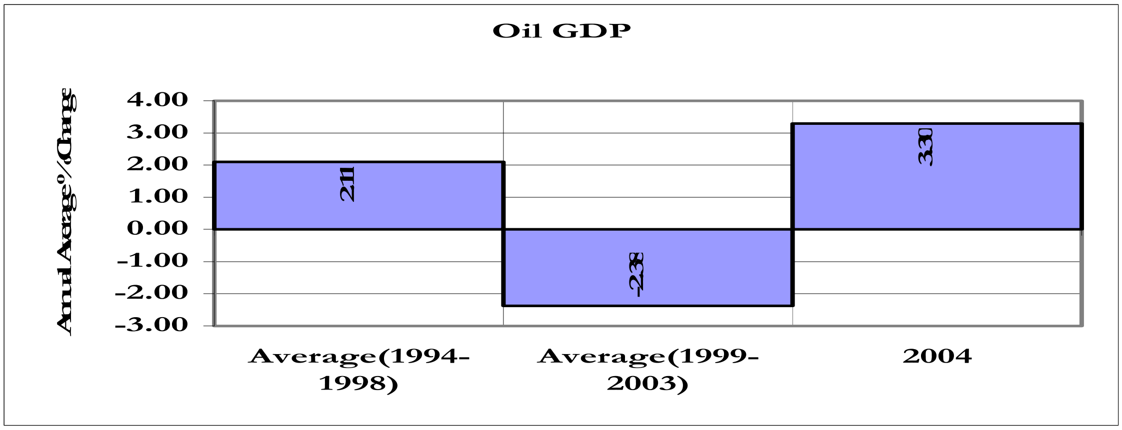
The price of Nigeria's bonny light, which had collapsed from about US$40 in 1980 to US$13 in 1998, has now climbed above US$50 in 2005. Nigeria has not enjoyed this type of push from the global economy in about two decades.

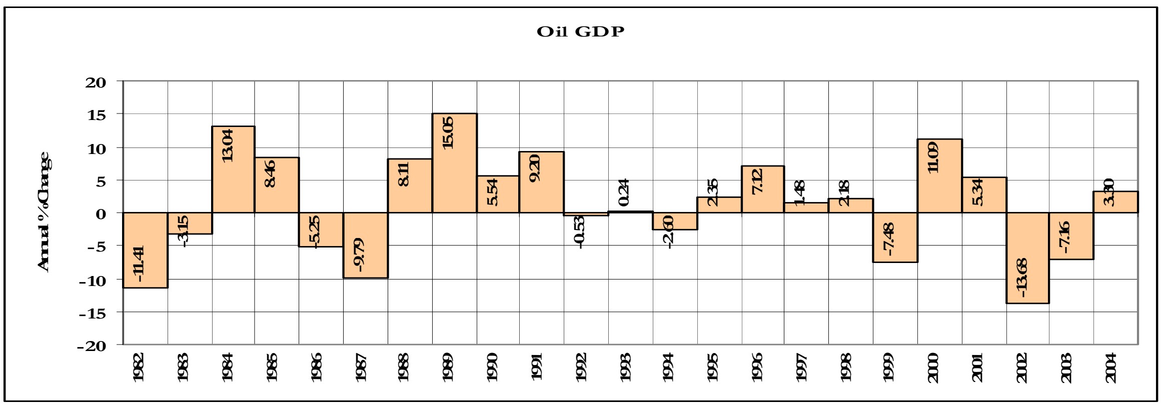


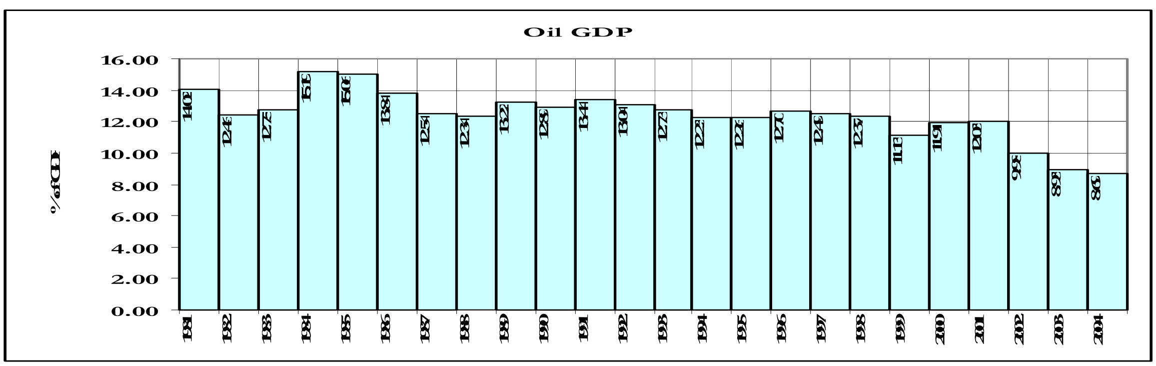
Nigeria is once again in a situation where it can sell as much crude oil as it can produce at high prices. From a peak of 2.302mbd in 1979, oil production started to decline in 1980, and had hit a bottom of 1.241mbd by 1983[6]. Average production level between 1981 and 1988 was 1.4mbd. Output began to rise in 1989, from 1.7mbd that year to 2.0mbd in 1996; Nigeria attained the 2.0mbd oil production level for the first time in 1973. Production level continued to rise after 1996, but the 1979 level was not re-attained until 2004, when it was indeed surpassed at 2.35mbd. The production level has averaged 2.39mbd in 2005. Ironically, the domestic value-added in the oil sector is however declining in spite of the higher levels of production, exports, export prices and export value. Contributions of the oil

[6] Well below OPEC production ceiling of 1.3mbd for April 1982 to December 1986.

sector to GDP dropped from a peak of 15 percent in 1984 to 8 percent in 2004, in spite of an increase in daily oil production from 1.388 million barrels per day to 2.5 million barrels per day over the same period.

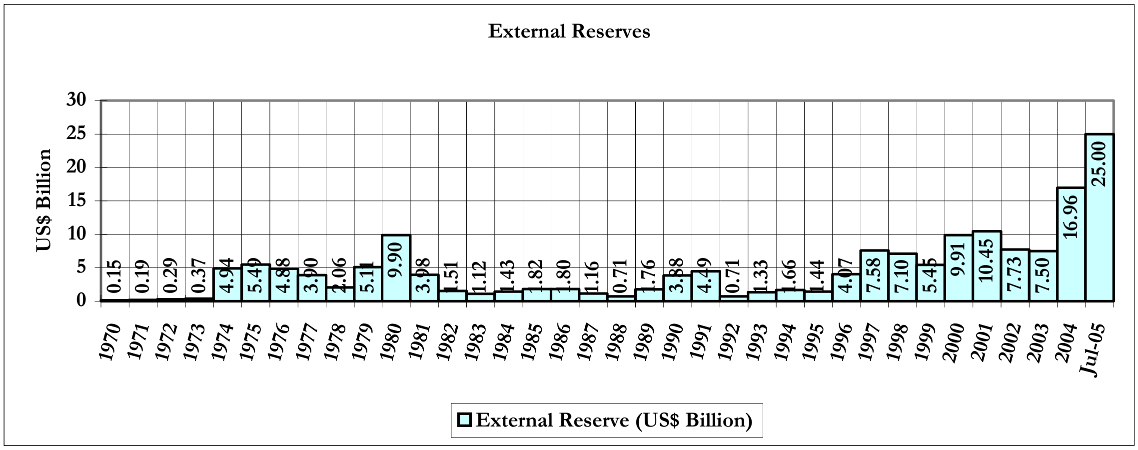




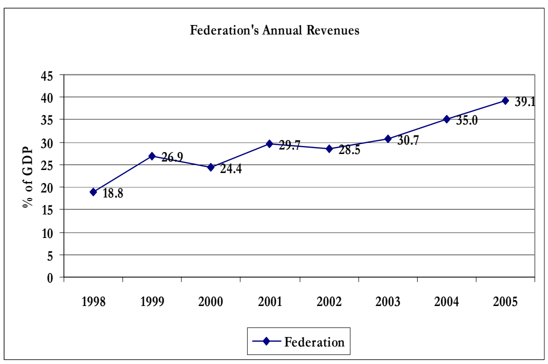


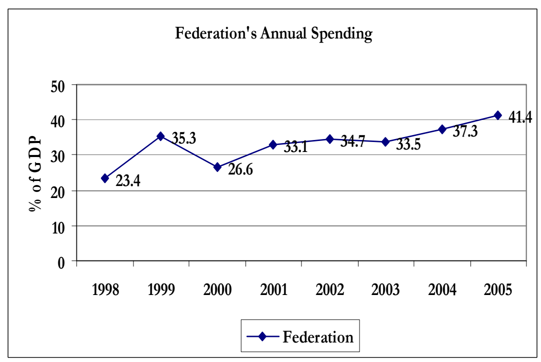
The production crisis in the Nigerian oil sector is often captured by the oft-expressed need to increase 'local content' in the sector. Only 14 percent of the total contracts awarded in the sector in 2003 went to domestic firms, the figure increased to 17 percent in 2004.

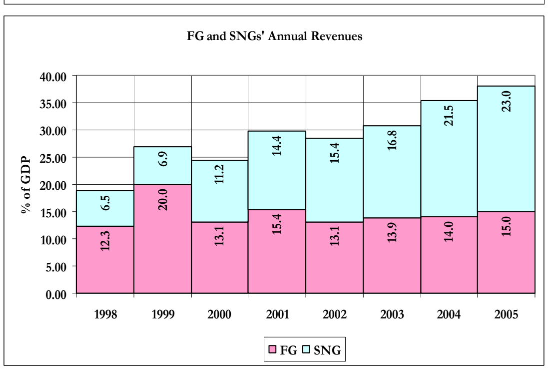
Nigeria's external reserves have however recovered strongly from the 1999 level of US$5.45 billions to an unprecedented level of about US$25 billion by mid-2005. The highest level before the current boom has been 9.9 billion dollars in 1980, the peak of the first oil boom. Reserves collapsed to an average of US$2billion a year between 1982 and 1995, and were less than US$1 billion in 1988 and 1992.

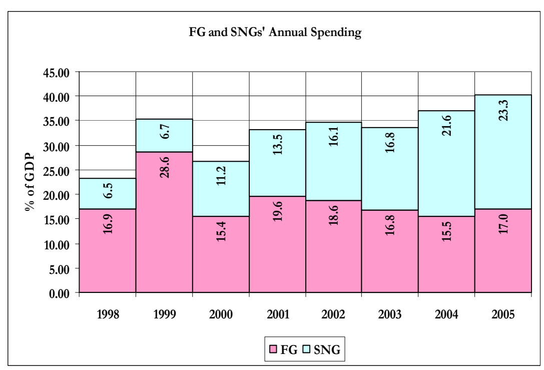


Oil wealth in Nigeria ends up in government coffers, but the coincidence of the onset of the current oil boom with the transition to democratic government has ensured that more resources now go to the sub-national governments than the Federal Government. Indeed, the states and local governments seem to have captured the bulk of the increased resource revenue flows into government from the present boom as their collective budget has increased from a mere 6.5 percent of GDP in 1998 to 23 percent of GDP in 2005; the Federal Government's budget has remained the 17 percent of GDP that it was in 1998.





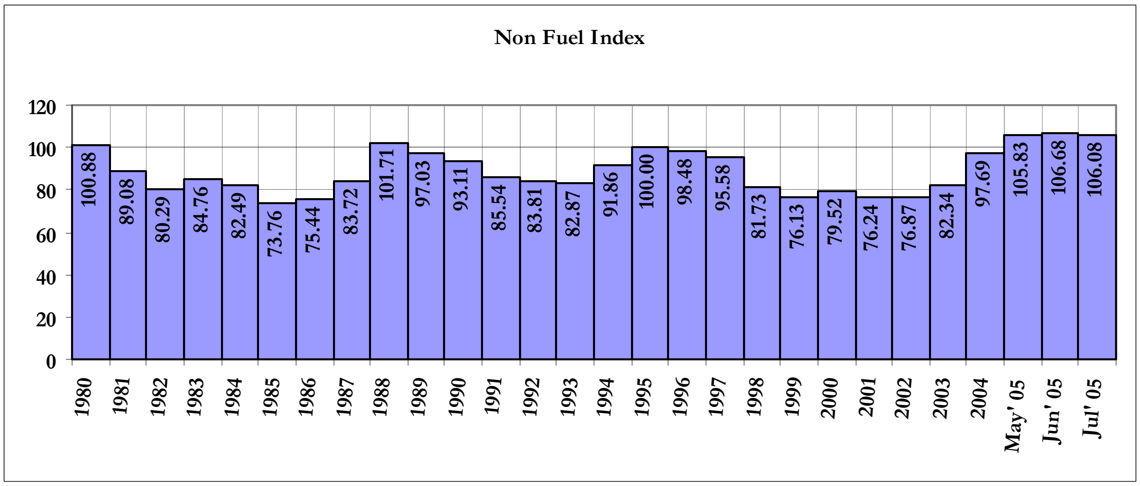




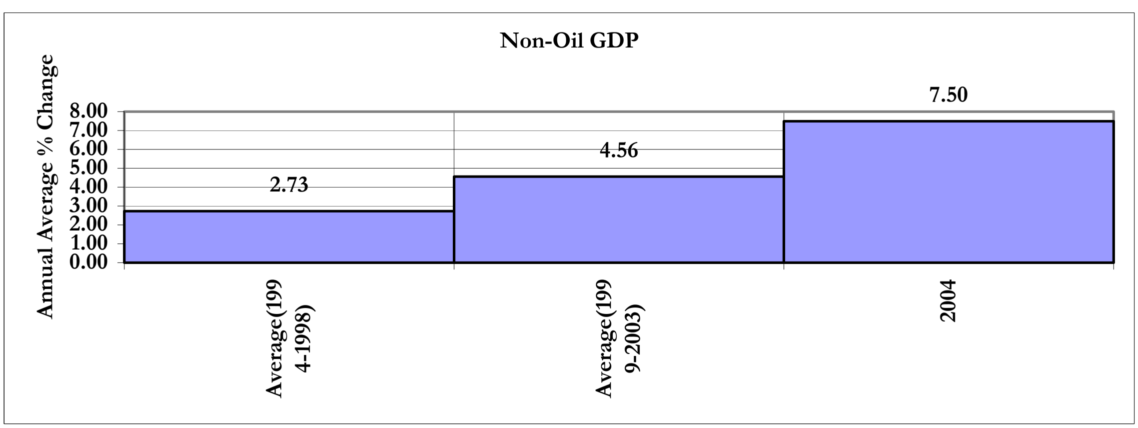
Thus, the present boom has been catalyzed by the dispersion of resources across the federation. With such resources at the disposal of the sub-national governments, Nigeria now has 37 potential centers of business and economic transformation, rather than a single one that the military rule gravitated towards. Also, with more that half of the non-oil sub-sectors of the economy growing at more than 5 percent a year, Nigeria's growth outlook has never been more diversified, and the fact that the oil money is being funneled through the 37 outlets (Federal and 36 Sub-national Governments) guarantees that the money is going to trickle down to the real sectors through their budgetary activities, just as it also ensures that the largesse will trickle down to the generality of Nigerians.

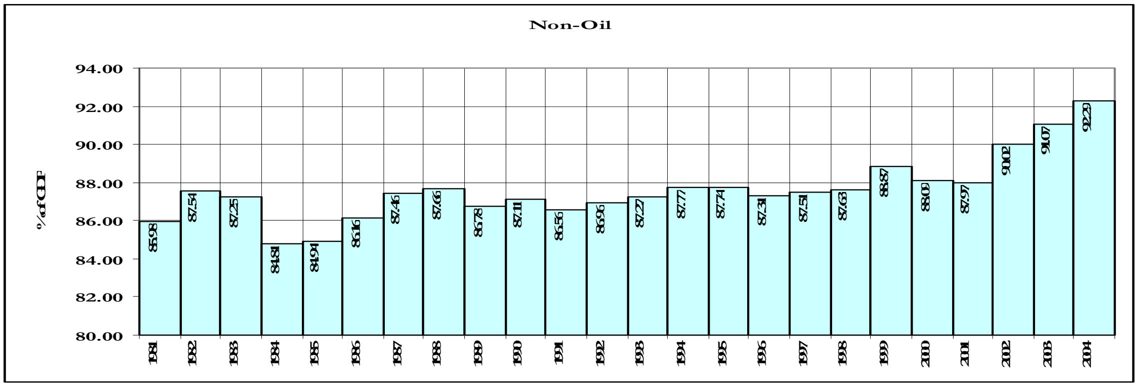
- **THE NON-OIL BOOM**

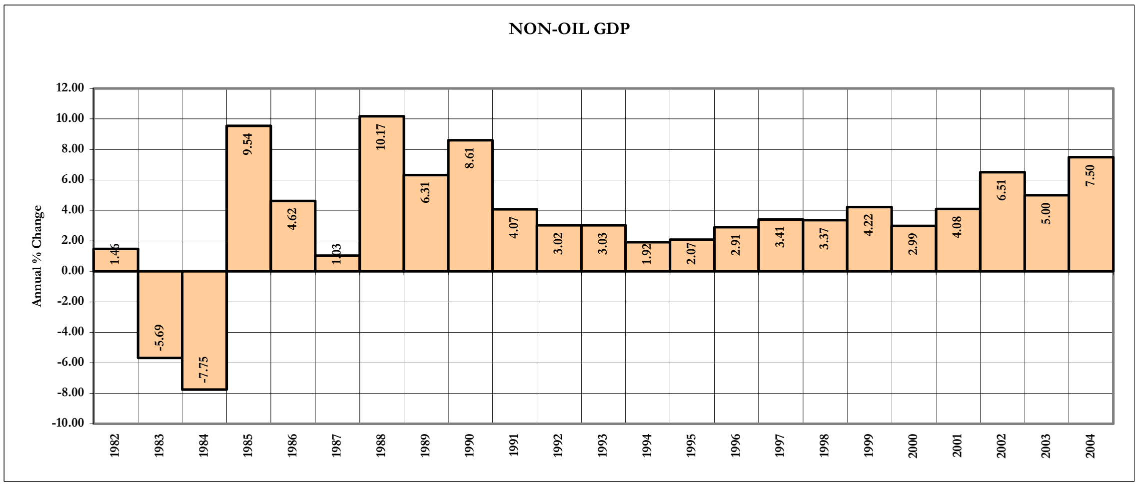
Oil prices however only part of the current global recovery and are therefore not the only channel through which the Nigerian economy is benefiting from the current global expansion. Non-oil commodity prices have also been on a steady upward climb since 2002, and have now risen to a 25-year peak by 2005.



This is perhaps the bigger story for Nigeria, given that oil is a much smaller component of Nigeria's output than agricultural commodities, and incomes from agricultural production accrue to private agents who are widely dispersed across the country, unlike oil income that accrues primarily to the government. The Nigerian economy grew by 6.1 percent in 2004, and the bulk of that growth came from the non-oil sector. Indeed the non-oil sector grew by an impressive 7.5 percent in 2004, but the lackluster 3 percent growth in the oil sector resulted in the slightly lower growth reported for the whole economy. The non-oil sector now accounts for over 92 percent of production activity. When the oil boom ended, the nation needed to reduce its dependence on the oil sector.



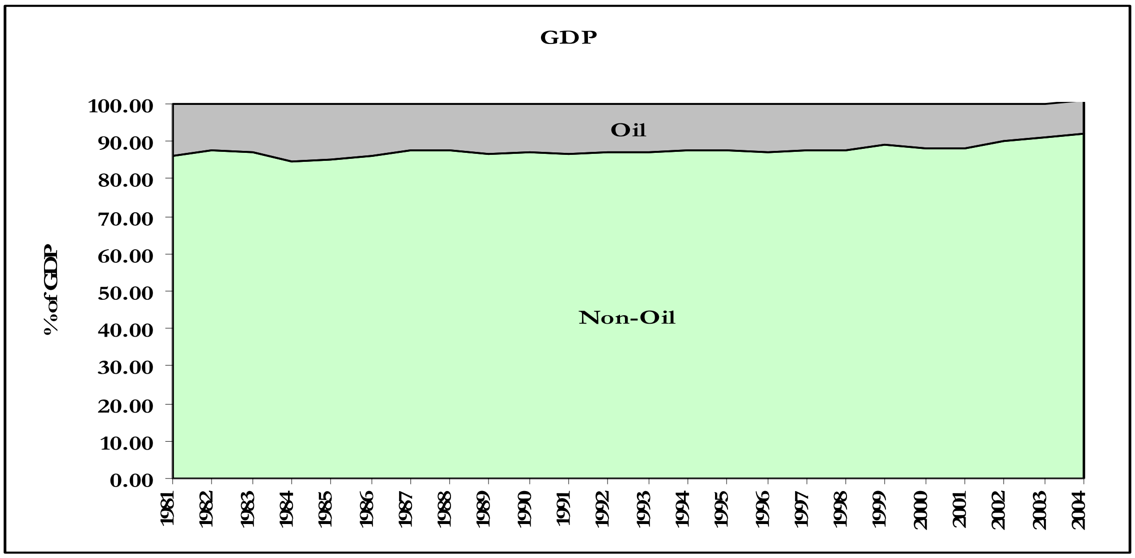




There have been spirited attempts to boost non-oil sector since the early 1980s. But the sector contributed just as much (87.63 percent) by 1998 as it had in 1982 (87.54 percent). However, between 1999 and 2004, there has been a remarkable lift in this sector. The non-oil sector now contributes more than 92 percent of GDP and it is in the longest expansionary phase since 1982. The fact that it is the non-oil sectors that are behind the growth must strike a very sensitive chord in the minds of those who are familiar with our recent economic history. Nigeria has been in search of a *non-oil sector driven economy* since the early eighties, with numerous socially painful reform packages deployed towards that end, but the feat had remained elusive, until now.

The fact that the non-oil sector grew more than twice as fast as the oil sector last year suggests that feat might have been attained; an examination of the data for the past decade indeed confirms that the non-oil sector recovery had been underway, strong and sustained for more than five years. Indeed, different pieces of measurable evidence are now available to lend credence to that notion. It is puzzling why the non-oil recovery has remained unacknowledged for so long. It could be an oversight arising from our tendency to look at the overall level of economic growth, rather than separately examine the performance of oil and non-oil sectors. It could also be because the recovery is induced by the unanticipated recovery in the global economy. Finally, it could be because the recovery has occurred more on the supply side of the economy, which is closely linked to the global economy, and less on the demand side, which is shaped by government's demand management policies.

Once one overcomes the euphoria associated with high export earnings, external reserves, and rising government revenues from oil, the focal point in the current economic recovery in Nigeria is that the non-oil sectors of the Nigerian economy have once again become the engine of *production growth*. On the contrary, in spite of historically high oil prices and the numerous gains they bring to the nation, the Nigerian oil sector is ironically the sorry focus of a new drive to raise 'local content', which is known to have fallen well below 20 percent, as more and more of the production activities in the sector are undertaken abroad, and therefore not captured in domestic production.



The non-oil sector's sustained growth is good news because of the implied *employment effect*. This sector grew by 7.5 percent in 2004! This must have involved a surge in employment because the key non-oil sectors– agriculture, mining and quarrying, manufacturing, and services- have huge employment effects. Unfortunately, there are no reliable and consistent data on employment. Six consecutive years of growth in non-oil sector must doubtless have meant six years of growth in employment.

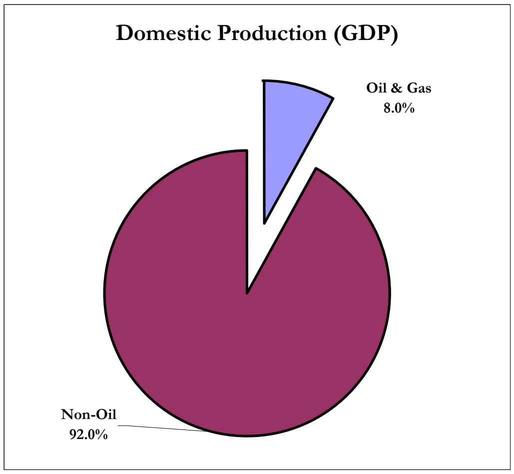
Agriculture, manufacturing, and services also have strong *linkages* with all other sectors of the economy such that the growth in any of the non-oil sectors would almost invariably trigger growth in other sectors. Nonetheless, oil exports contribute the bulk of the official foreign exchange supply, and also funds the bulk of *government revenue*. In spite of the dominance of the non-oil sector in domestic production and consumption, it still earns less than 4 percent of the nation's export income.

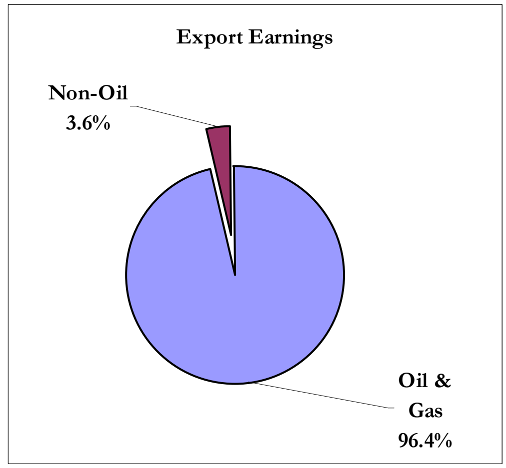
RELATIVE CONTRIBUTIONS OF THE OIL AND NON-OIL SECTORS

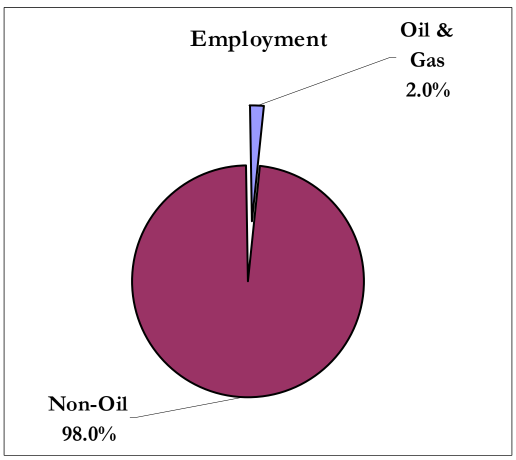
PERCENT CONTRIBUTIONS TO:	OIL AND GAS	NON OIL SECTOR
Export Earnings	***96.4 percent***	3.6 percent
Government Revenue	***86 percent***	14 percent
Domestic Production (GDP)	About 8 percent	**About 92 percent**
Employment	About 2 percent	**About 98 percent**

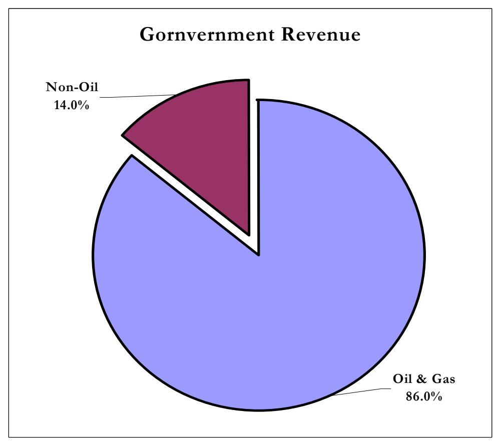
Dominant sectors are written in **boldfaced** text. Contributions to employment are Economic Associates' estimates.

The non-oil sector still accounts for less than 15 percent of the revenue in the federation account in spite of its 92 percent share in GDP. The oil-sector contributes over 85 percent of government revenue, while it accounts for 8 percent of national output.









- **The Tale of Twin Booms**

The story of the impact of the present global boom on the Nigerian economy is such that higher oil prices have boosted income from exports, government revenue and external reserves, while higher non-oil commodity items have boosted private income, non-oil sector growth, employment and spending. It is a tale of twin booms for Nigeria: the oil boom, which provides foreign exchange and government revenue; and the non-oil boom, which provides strong output, private income and employment recovery. Even using the 2005 budget target oil price of US$30per barrel, revenue in the federation account is now twice as large as its 1998 level. The actual price has averaged over US$50 in 2005; the proceeds of the more than US$20 'excess price' per barrel are sterilized in an excess crude account, creating the surge in external reserves. Nigeria has suddenly found itself in a situation where idle funds are unexpectedly growing in government accounts at home and abroad. The non-oil commodity boom on its own part is stimulating supply side expansion of the non-oil sectors of the Nigerian economy. *Unanticipated positive external shocks* have stimulated supply-side recovery and provided unexpected funds.

4. Current Policy Challenges

Although the good news of the supply side recovery has been buried in the data put out by the government since 1999, it is not clear whether the government is still unaware of the fact, or is only yet to openly acknowledge the fact and stimulate necessary debates about how to sustain the recovery. A lot of the funds accruing to the nation from the terms of trade improvements are visible to all, but the government is yet to open any debate on the new opportunities and challenges that these funds bring with them.

- **Improving Living Standards**

The first key challenge is that supply side economic recovery does not automatically translate to increased welfare for the generality of Nigerians. Understandably, tangible evidence of improved living standards of Nigeria's poor must emerge for claims of economic recovery to make sense. Unfortunately, things have not got that much better on the demand side of the Nigerian economy. The recovery is confined to the supply side that is directly linked to the global economy. Things might have indeed got worse on the demand side of the Nigerian economy that is more closely linked to the domestic fiscal and monetary policies of the government.

- **Focusing on Disposable Income**

Aggregate supply and aggregate demand can be and have been widely divergent in Nigeria since 1999. What drives a wedge between the two is what government takes out or puts into the economy: the elementary notion of national output being different from disposable income as a result of the net taxes and subsidies withdrawn or injected by the government is very helpful in understanding this point. It is not the growth of national output that matters for people's living standards, but rather the growth of the disposable income. Disposable income will rise if government injects a subsidy or grants a tax cut, but fall if government withdraws a subsidy or imposes an additional tax.

- **Managing Aggregate Demand**

It does not matter whether the reasons for withdrawing subsidies or imposing the additional taxes are good or bad; the fact is that they will result in contraction of disposable income, aggregate demand, and overall living standards in the economy. 'Appropriate pricing' of petroleum product prices had involved the withdrawal of huge amounts of subsidies from Nigerians since 2000. This is one sector reform measure that has inflicted unintended contractions on the living standards of Nigerians. Indications are that except the government consciously pursues policies that will ensure expansion in aggregate demand in the economy, demand is more likely to crash further, and life will get worse or the average Nigerian, even in the face of strong supply side recovery.

- **Central Banking**

The 2004 Annual Report of the Central Bank of Nigeria reveals that government's idle deposits with the central bank stood at ₦2 trillion (about 20 percent of GDP) by December 2004. That was already larger than the deposit-base of the nation's banking system of ₦1.66 trillion. The Nigerian central bank is now probably the only central bank in the world that holds more deposits than its national commercial banking system. This undermines the collective quest of Nigerians to have a deeper banking system. It is most unlikely that the central bank has the capability (or even the willingness) to intermediate such deposits to sectors that need them, yet the apex bank is known to have been withdrawing additional public sector deposits from the banking system in 2005.

- **EXTERNAL RESERVES MANAGEMENT**

Outside the country, the nation had US$17 billion in external reserves by the end of 2004; this has risen to US$25 billion by July 2005. It is the first time the Central Bank of Nigeria has to manage foreign currency assets of such magnitude since it was established. It is however not the easiest of times, given that the dynamics of the current global economic recovery are so complex that the threat of reserve losses to exchange rate realignments among the major currencies is high and rising. The Central Bank of Nigeria is already having difficulty coping; it reported a loss of ₦8.79 billion on foreign currency in 2004 in its Annual Report.

5. CONCLUSION

To conclude, the current economic recovery in Nigeria is unexpected and largely unacknowledged. Care has to be taken to make sure that it does not remain unmanaged.

If care is not taken to complement the supply side improvements in Nigeria with policies that will enhance disposable income and strengthen private demand as well, falling purchasing power may eventually halt the supply side expansion. Concerns about improved living standards of Nigerians apart, sluggish aggregate demand may eventually slow aggregate supply down.

There is a need to accord a higher level of priority to growth-inducing fiscal policies. There are non-inflationary ways of boosting real purchasing power and aggregate demand; the tax cuts in the US will exceed US$2 trillion, but the sum is being injected over a period of ten years. Nigeria needs to think up some way of making its numerous poor feel the fact that the lot of the country is better today than in the 1990s.

Nigeria now has abundant resources that can be used to translate the current windfall to improved living standards and additional capacity for economic growth. But the resources are currently kept in idle deposits in foreign banks and at central bank of Nigeria. Nigerians therefore wonder what boom we are talking about. It will be a shame if the funds end up in foreign Treasury Bills, rather than in physical and human capacity expansion in Nigeria.