<u>THE EFFECT OF CHANGING EXCHANGE RATE REGIME ON THE ECONOMY.</u>

We have a very strong penchant for discussion and debate as a people, and the Nigerian situation is probably one of the most discussed subjects in our time. Whenever those debates turn to economic issues everyone seems to have a view on what the real problems of the country are, though we hardly ever agree on a solution. Regrettably those energy-demanding chats often end up on the note that 'the discussion continues', and we feel satisfied that we have exhausted ourselves for the time being and get ready to do it again at the next opportunity. The discussions on exchange rate have often been very emotive indeed and we frequently reminisce on when the Naira was stronger than the Dollar, when the Naira was one-to-one against the Sterling, when the BTA of N500 fetched us $690, and we went on shopping sprees on the streets of the major capitals of the world. Such exchange rate regime is elevated to matters of national pride. My contribution to the debate may well turn out to be one more in the chain, after all they say that talk is cheap, but I believe that for every symptom of a disease there is a root cause, and we may well be on our way to a solution if we understand the fundamental issues of the matter. Let me say however that my attempt here has been to raise issues in a manner that provokes some thought, and if I succeed in generating more discussion my objective would have been met.

In all the debates about exchange rate regime I have listened to or participated in, there are a few key observations that tend to pass us by. First we know that the Japanese Yen has exchanged at well over 100 to the USD for many decades, and yet the Japanese economy is the second strongest in the world after the United States. Indeed until the economic crisis in that country in the last five years, (which is nothing to do with exchange rate regime) it posed a challenge to the leading economic power. Clearly the figure of exchange rate per se is not the problem.

There must be other more fundamental issues for us to worry about.

The second observation we seem to miss is that we are quite comfortable to live with inflation. We have no difficulty, for example, accepting to pay more for foodstuff from time to time. We complain about it a little and then adjust, and life goes on as usual. It seems strange to me though that we readily accept that our naira will buy less foodstuff, but expect to pay the same or even less for the Dollar, which is also a commodity just like rice and beans. That seems a misnomer to me. Unfortunately some renowned economists have even suggested that all we have to do is to decree what the naira will exchange for, probably with a change in the name of our currency, and because we trust these leading lights of economics, we believe that that is the simple solution we need. We tried this before in the early Abacha years when Chief Ani was Finance Minster, and of course it was a monumental failure. Matters of exchange rate in the world of today cannot be so simplistically treated, except if government were to commit to funding every dollar demand. In a severely import dependent and consumption based economy such as ours that is suicide, and we almost committed suicide in 1994. Thank God that common sense prevailed and we made another U-turn in 1995 to restart our march towards a market driven economy, but this time from a disadvantaged position. The painful lesson of that experience is that in the twenty-first century, it is no longer feasible to adopt the Indian model of the 50s and 60s of closing the economy. It is no wonder that communism has failed.

My third observation is that persons, who are not even remotely connected with the issue, other than by the passion of a national spirit, conduct discussions on exchange rate on the street. The woman selling carrots from her garden blames the increase in the price of her wares on the exchange rate, and the rest of us, the elite, seem to agree with her. Inflation drives exchange rate, not the other way round.

Exchange rate is of course an indication of economic performance, but the exchange rate policy adopted at a point in time has to flow from the broader macro-economic policy of the country. In some cases countries have been known to deliberately allow their currencies to 'float' because it helps them to plug into or engage in the world economic system. For example, where the productive capacity of a country so dictates, devaluation could be undertaken specifically to promote exports. The Japanese economy is largely driven by exports, and I know of no country that is as passionate about exports as Japan. My premise in making these preliminary comments is therefore that exchange rate is not a stand-alone performance measure of an economy. In many respects the exchange rate is the result of policy and action or inaction on the part of the managers of the economy.

In discussing the effect of exchange rate fluctuation on the economy, let me start by attempting to answer the question; why does the exchange rate fluctuate? Exchange rates move at all in response to demand and supply position, relative to a basket of international currencies. The reference currency for exchange rate purposes is the US Dollar. Nations trade with themselves on the basis of agreed norms, and having a reference currency is like creating a common base for measurement of weight. The international market place has been increasingly integrated over the years and that integration has been driven by the phenomenon of globalisation, which is in turn powered by the three forces of liberalisation, deregulation and technology. The consequent democratisation of finance, technology and communication has elevated the concept of globalisation into a new world system. This new world system has replaced the Cold War that governed the world polity for decades as the world saw a shift from military strength as the measure of power, to economic might. The democratisation of finance and technology also means that no one person is in charge of this world system, unlike the cold war system that depended entirely on the leaders of US, or USSR as it was then. I suspect that President Bush will be first to tell you that if he wants to know exactly what is going on, he turns to Alan Greenspan, and Alan will point to the market. Who is the market then? The market comprises owners of capital who take their investment decisions, as they feel empowered to do by the phenomenon of globalisation. The democratisation of finance and technology means that super-empowered individuals can move funds at the click of a button, in a manner that impacts currencies of other countries. For example, a person that holds substantial investments denominated in Naira can decide that the face-off between the Executive and the Legislature in Nigeria would suggest that enough attention is not being paid to priority issues, and the inconsistent economic policies do not inspire confidence. Or he may consider the serious allegations of bribery and corruption against the leadership of the Legislature intolerable. So he calls up his Fund Manager to sell his Naira positions and buy something else. That single action can generate a whole chain reaction in the market, because market operators typically behave like a herd of sheep. The resultant stampede creates a run on the Naira, and of course it is devalued. I suspect that many of the people in this room today have taken such a decision at one time or the other in the last ten years. So who is in charge?

It is important to perceive globalisation as a world system, because it helps us to relate to it as appropriate. Some people have suggested that we are not ripe to join the globalisation system, and should therefore not liberalise our economy. Unfortunately, globalisation is not a club you choose to join or not join. It is a game that goes on whether we play or not – and even more unfortunately, we are on the field whether we know it or not. It may be unfair to force a person to play a game he is not interested in, but fairness is not the big strength of the world we live in. We must work to plug our economy into the high-voltage global system and take advantage of the benefits, but with internal processes that guarantee that we do not suffer a backlash or shock. It's like plugging our homes into the national electricity grid. You need the appropriate gear to do so otherwise it can be fatal. You do not stay unconnected only because it can be dangerous.

There are four key issues that impact the exchange rate and cause fluctuations. These four are not exhaustive and I later identify a few others, which I will not discuss in detail.

1. <u>The structure of the economy</u>. The cardinal root cause of our exchange rate "palaver" lies in the fact that the Nigerian economy is based almost entirely on exploiting natural resources with very little value added, and we only sell one commodity seriously. This means that:

a) We have little or no control on our revenue stream since the revenues earned from trading in primary commodities are determined entirely by the international market. The international prices of these commodities sometimes fluctuate so widely it is hard to predict. This makes the producer economies extremely vulnerable and the extent of our vulnerability shows clearly in our budgeting process. We have to first take a view on how much a barrel of oil will sell for in the succeeding year. I will return to this later

b) Because the value added is low, we are dependent on imports, which means we need a lot of Dollars, and therefore our currency is weak in the parity markets.

c) We have no control on our costs, since we must pay the price dictated by the exporter of the goods we consume.

With our margins and our costs beyond our control, it is no surprise that we have difficulty meeting the demand for foreign exchange and therefore the price of the Dollar is high.

This fundamental weakness in the structure of the Nigerian economy has to be redressed if the economy will return to rapid growth.

2. <u>Very low ratio of Savings to GNP.</u> The savings ratio at 11% is an indication of a short-term economy, and is insufficient to drive investments on the desired scale. Emerging economies tend to achieve a savings ratio of 25 – 30%. Only at this level is there enough long-term funding available to power major investments. Low savings gets us into the liquidity problems very frequently, and impacts inflation and interest rates.

3<u>. A large and unquantifiable informal economy</u>. It has been suggested that our informal economy may be as large as the formal, or even bigger. This creates a thriving extra-legal sector, a notion of increase in economic activity, and considerable currency speculation fuelled by corruption. There is a clear imperative to create a counter force in the formal sector.

4<u>. Government deficits</u>. The deficits created by Government's failure to keep expenditure within budget could be a major factor driving inflation, and we do have first hand experience of this. As I will show later, Government is sometimes forced to over-spend because our revenue base is simply too low to support our aspirations. A lot of the deficit arises from un-coordinated monetary and fiscal policies.

There are other factors that contribute to a fluctuating exchange rate, including

- Volume of money supply
- Activities of Banks (round tripping)
- Trade imbalance
- Capital movements
- Debt management issues, and
- The widening parallel market premium

These other factors arise from the four key issues identified above.

At this point I would like to digress a little and address the notion that even with oil revenues alone we are a rich country. It is a myth and it's time to break it. I agree that we are potentially rich, and we have all the ingredients of wealth, but the arithmetic of the income from oil shows that if we assume that we sell 2 million barrels of oil per day at $25 each, the net revenue per capita after deducting the cost of production is less that $100 per year. Our wealth will only materialize if we add value to the natural resource, and diversify our economy.

Another point needs to be made here. We often speak of the resource endowment of Nigeria, and it is true. It is true that Nigeria holds a significant proportion of the world's mineral deposits. But resources by themselves are not enough to ensure the country's development. Leaders and managers who possess the requisite skills and a keen sense of sustainable development must mobilize them. Our inability to add value to those resources results from the dearth of management skills, and is the root cause of poverty. This suggests that the secondary problem in the economic development issue is that of the capacity of our human capital. We have not invested in our human capital as a nation and it shows at every turn. I think this is because we have looked at development only in terms of physical infrastructure, and not in terms of human capital development. We have concentrated on building things instead of building people, and we need to redress this as well. When we build people, they in turn will build things.

The four key issues discussed above can be distilled into two:

1. **Scarcity**. Foreign exchange is short and imports are increasing faster than export, which in turn creates the need for high external reserves. Also investment grade naira is short, and there is not enough to power growth.
2. **Low production and low productivity**. With hardly any investments, whether in physical asset or human capital development, it is hard to raise productivity.

But how do we come out of the vicious cycle of low investments, low productivity, low growth and a vulnerable economy, and step into the virtuous circle where we are in better control of our revenue stream and begin to grow again? My proposal will be along three tracks:

Track 1. Ventilate the economy. There are two action points in this track.

a) Increase forex supply. This can be done by

   i) Selecting a small portfolio of arrowhead forex drivers, especially where we have competitive advantage, such as agriculture and solid minerals. Cocoa, Rubber, Palm Oil, Cotton are major opportunity areas.

   ii) Identify and select winners who will drive production strictly for export.

   iii) Restructure the subsidy for agriculture such that we use State funds to generate seedlings of these strategic crops to be sold to farmers at cost. When the crops are matured, the cost of the seedlings can be refunded in full, plus interest. This deferred gratification ensures that the job is done first, and prevents the ubiquitous middleman from diverting the resources away from the target.

   iv) Provide active support for exporters. We have fairly adequate export incentives, but the bureaucracy still constitutes to be a stumbling block to aggressive exports. We need to learn a lesson or two from countries like India, Japan, and South Korea

b) Increase supply of **investment grade** Naira.

The bulk of naira in circulation is 'hot' money, and has to be kept moving. More stable investment grade naira can be generated through Pension reform for both the public and private sectors. Such scheme should be compulsory and contributory and funded by joint contributions from employers and employees. Private Pension Fund Administrators, who must operate to stringent guidelines, should manage the Fund. Apart from creating a pool of long-term funds for investments, a Pension Reform as suggested will achieve two other objectives of lowering interest rates and promoting a savings culture. Check out the math. Personnel cost at Federal level for half year 2002 was N166b. If there had been a contributory scheme of say 10% from employees and 15% from employers, this would have created a saving of N41b. By contrast, the pension liability Government had to fund in the same period was N35b.

The Track 1 action discussed above will provide stability to carry through Tracks 2 and 3.

Track 2. Monetary and Fiscal Policy Coordination.
Low inflation is the driver for reasonable interest rates and stable Naira. The management of interest rate and inflation should be supported by realistic exchange rate, not the other way round. Increasing competition, and improving the risk environment can improve interest rate management. Also taxation should be used as a tool, and one area of improvement is to advance to real Value Added Tax, which is consumption tax, and not Sales Tax. A target-lending rate of less than 15% is achievable.

The States and Local Governments, who seem to spend as if it was going out of fashion and on things that do not create value, generate a significant part of the money supply problem. In the absence of true Fiscal Federalism, it will help if the three tiers of Government will subscribe to a Fiscal Responsibility Pact, which constrains them to concentrate their spending on value-adding and non-inflationary projects. The average growth of 27% in money supply compared to an average growth of 3% in real output leads to high inflation, high nominal interest rates and a depreciation of the naira.

This is where I return to the earlier point about our revenue base being too low. The Federal Government 2002 half-year fiscal operations show a recurrent surplus of only N11b that is available for transfer to Capital Budget.

Expenditure heading	N'b	N'b
Total Revenues		357.52
* Personnel cost	166.26	
*Pension	35.08	
*Overheads	41.40	
*Domestic debt	88.13	
Total Recurrent Expenditure		330.87
Recurrent surplus (Deficit)		26.65
Deduct: *External debt service		7.40
*NDDC		6.30
*National Judicial Council		1.84
Leftover transferred to Capital		**11.11**

The N11b is barely able to finance one half of the Owerri-Onitsha road that requires about N30b not to mention other roads, electricity, water, education, health, INEC, etc. The N11b is N229b short of the appropriated half-year capital budget of N240b. The result is that either most of the projects will be abandoned, or the FG will be forced to print inflationary money to cover the resource gap. FG response has been to borrow N49b from CBN to fund a capital programme of N60b for the half-year. It has also embarked on a rapid depreciation of the naira as a means of raising cash.

Let us look at this in another way. In 1980, Nigeria produced 2.2 mbpd of oil at an average price of $30/barrel. In 2002, the country produces 1.7mbpd at an average price of $22/barrel. This means our daily revenue has dropped from $66m to $37m, and remember that in that time our population has increased by 25 million, the number of Universities has almost doubled, and workers' wages has more than tripled in naira terms. Also the number of State Governments has increased from 19 to 36, and

Local Governments have gone up to 774. We now have 50 Ministers who each has a retinue of 10 cars, and we have increased the numbers in the bureaucracy several fold. I leave you to do the rest of the math.

Look at it even in another way. Every forecast now suggests that the price of oil will decline steadily, and if we assume $18 in 2007 and a slightly lower production rate, we could have a resource gap of $16b - $20b over the next four-year period. By 2012, oil price may be around $15/barrel, due to projected over-capacity and the increasing demand for cleaner energy source, which will shift the focus away from oil. This could mean that our revenue continues to decline unless we generate revenue from other sources. **THIS IS THE TIME TO ACT, AND TO ACT FAST.**

<u>Track 3. Redress the imbalance and drive growth</u>. I propose five action points here:

a) Grow the real sector
   i) Agriculture
   ii) Competitive Industrialisation. The cost of doing business needs to be reduced systematically.
   iii) SMEs need to be nurtured and consciously built through joint ventures and franchising. Access to venture capital will be critical to the success of SMEs.

b) Drive exports aggressively.

In the past we adopted an import-substitution strategy, which was the right thing to do at the time. For a country as well endowed as Nigeria, we should adopt a targeted export-led industrialisation strategy for economic growth. This approach increases foreign exchange earnings to pay for essential imports and relieves the pressure on exchange rate. Our export drive must be targeted and focused. This is not an area that federal character or geographical spread takes precedence.

It has to be said that we currently do have adequate incentives for export, if only the bureaucrats will facilitate the processing of the incentives smoothly for those businesses that need to take advantage of them. I think the problem here could be that our public servants have been brought up in the school of control rather than facilitate, and it is still difficult to make the transition. Every civil servant says the private sector is the engine of growth and then does everything to stop the private sector from performing.

c) Create entrepreneurs. We need to change our mindset from one of sharing national resources to that of creating wealth. The twenty-first century game is entrepreneurship as opposed to stewardship.
d) Sustain the active sectors. The Oil & Gas sector does require an increase in local content, while in the Banking & Finance sector there is a need to create incentives for the private sector to create venture capital.
e) Pursue the deregulation path with sale of unproductive government assets to cover the resource gap. The privatisation proceeds should then deployed to improve the social infrastructure (education, health, social security) and a structured linkage to production.

You will notice by now that I have concentrated on the causes of exchange rate fluctuation and presented thoughts on how we might stabilise it, rather than discuss the superficial symptoms. The causes provide an insight into what the solution might be. We know that a changing exchange rate regime creates a notion of instability, especially if there is no clear strategy behind such change and it is not obvious from the overall economic agenda that it will be short-lived. Such a state holds back the much-needed investments, makes doing business more difficult due to the unpredictable nature of the environment, and discourages production.

The new Government in 2003 will inherit a number of key issues, including

- An exchange rate of N140/$
- Domestic debt of about N1.3 trillion
- Foreign debt of $30b
- Non-existent non-oil export sector
- High budget deficit, and
- A hungry and angry citizenry.

We will need a leadership courageous enough to take the hard decisions, wise enough to access appropriate capacity, and humble enough to ask when they do not know. We need the leaders who genuinely will put the Nigerian people first at all times and ahead of all other considerations. The government policy must feature an export bias in its conception, with milestones and revenue targets, a carefully articulated privatisation programme to make assets more productive without any demand on State funds. Our leaders in future must understand economic diplomacy, so that we can have a more collaborative relationship with the international community. Investors need to be targeted more sharply, instead of the current generic approach, and we need to deploy sovereign authority to open the doors for business. For example, it is not inconceivable to negotiate a deal that ties the sale of our oil in African countries to non-oil export opportunities for Nigerian business. Above all we need a God-fearing leadership, who care about showing example in moderation and who do not catch the Abuja syndrome

I have a passionate belief in Nigeria and its great future. The solutions are not as large as the problems, and we only need to identify the few critical issues that need to be addressed. But let me say that humanly speaking there are no quick fixes; rapid solutions will come as we focus on the vital few areas that will tip the apple cart. Attaining that tipping point will however not come from business as usual.

If this makes me an incurable optimist, I am only living out my genetic code as a Nigerian.

I thank you for your patient attention.
Bunmi Oni
Lagos, November 20, 2002