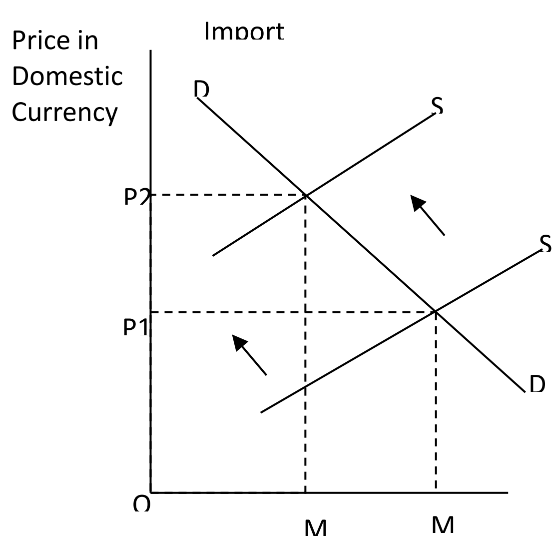
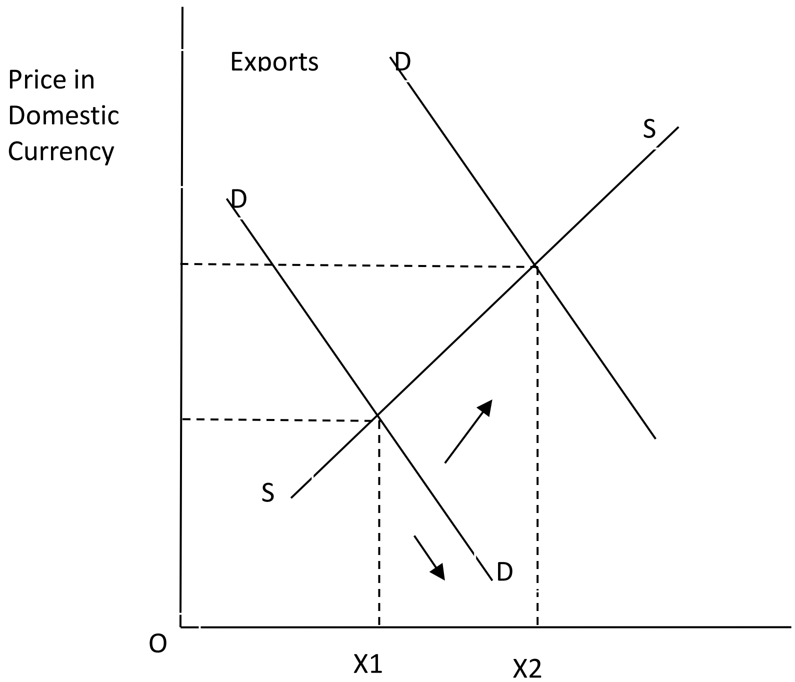
FAILURE OF DEVALUATION AND CURRENCY FLOAT IN NIGERIA

When the economic history of Nigeria will be written, the period from 1980 to 2025 will contain lessons on how to manage balance-of-payments problems. Before the 1980s, orthodox economic wisdom argued that external deficits could be addressed either by financing through reduction of external reserves or by adjustment through devaluation of the domestic currency and adoption of restrictive monetary, fiscal and external trade policies. After the Second Amendment of the Articles of the International Monetary Fund in 1979, major donor agencies of the West and the International Financial Institutions started advising developing countries to devalue their currencies as adjustment policy and as condition for receiving financial assistance. This principle of conditionality split the community of economic advisers into two irreconcilable groups; one siding with the Financial Institutions (i.e. the Nigerian Economic Summit Group) and the other Nigerian experts in International Finance employed by Government as official advisers in this rather technical area of policy advocacy. Nigerian political leaders in this period were military officers, who lacking expert knowledge in these matters, had to rely on competing policy advice before making decisions. The purpose of this paper is to present the role played by expectations in competing policy recommendations and how disregard of expectations of actors in the decision to purchase imports led to errors.

Normal Foreign Trade Conditions





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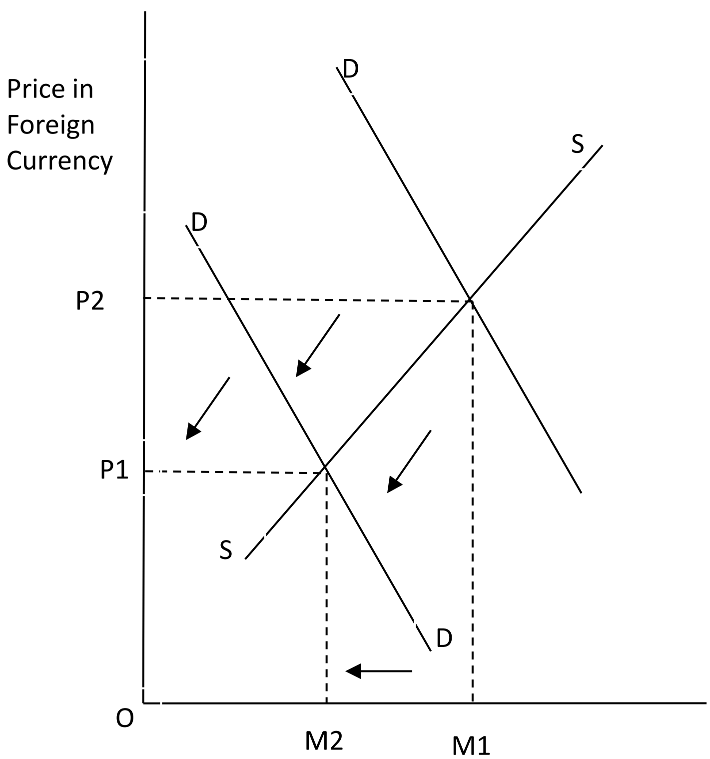

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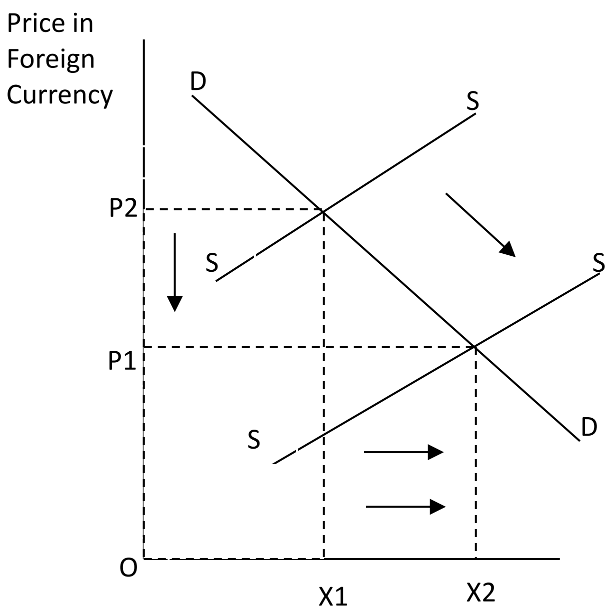

Diagram 1: Shows changes in prices of imports, exports before and after devaluation.

The upper diagrams depict the situation before and after devaluation. Assuming that the demand for exports is price elasticity, the quantity of exports and the price of export increase and total value of exports increases in domestic currency. However, the price of imports increases, quantity imported declines and when elasticity of demand for import is sufficiently large, value of imports declines. Thus, as a result of devaluation, import value declines, export value increase and the trade balance improves after devaluation. 1 In the lower diagrams, after devaluation, the demand curve declines, price of imports declines, and total value of imports in foreign exchange declines. However, the supply curve shifts out and to the right, and when the demand curve for exports is elastic, total value of exports increases. Hence, assuming the demand curve for exports and imports are elastic, devaluation always improves the trade balance. The International Finance Institutions assume that this is the case for developed and developing countries. Hence their one recommendation of devaluation for all countries experiencing trade deficits. Abnormal Conditions with Inelastic Demand for Exports and Imports The result of devaluation when demand curves for exports are inelastic (i.e. the situation in developing countries) is the exact opposite of that for developed countries. Due to rigidities in tastes and production structures, devaluation invariably leads to higher imports values and lower export values. In this case, devaluation worsens rather than improves the balance of trade. The appropriate policy in this case is not devaluation but revaluation (increase the value of the domestic currency). Adopting such may appear “crazy” and is not usually recommended, as economic advisers unfamiliar with the economic structure of the country recommend alternative adjustment policies. Foreign Exchange Markets under Stable and Unstable Conditions It is when analyzing the effects of devaluation that we realize that devaluation does not always lead to improved trade balance. Stable foreign exchange markets produce stable equilibrium as demonstrated below, but unstable exchange markets always escalates initial imbalance.

Local Currency Price of Foreign Exchange.

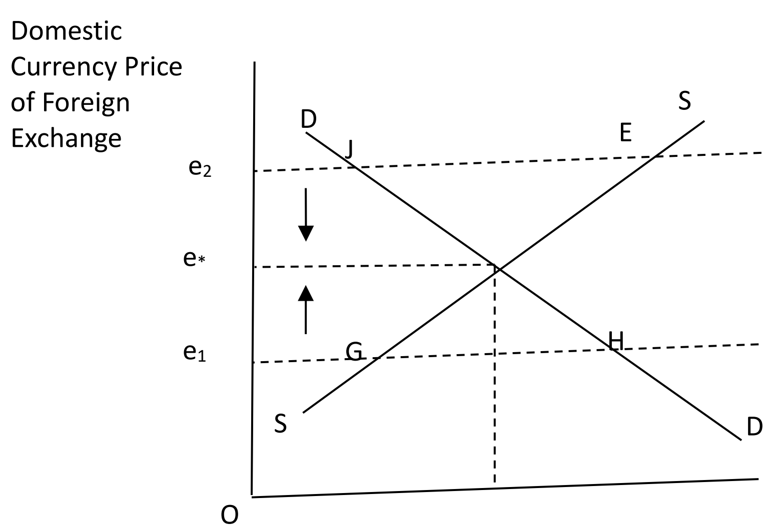

Diagram 2: Foreign Exchange Market

Point E is a stable equilibrium to which it returns whenever the exchange rate differs from the equilibrium rate. However, when a particular foreign currency is designated as foreign currency and citizens think that it is preferable to hold it instead of their local currency, they act differently from their decision under stable market conditions. Suppose a country records a trade deficit and people expect that the local currency will be devalued, they demand more foreign exchange in the expectation that the local 2 currency will continue to lose value in the future. Hence, in this case, the demand curve is upward-sloping. Similarly, those earning foreign currency reduce their quantity of foreign exchange to the market. In this case, an initial trade deficit adjusted by devaluation increases rather than reduces the initial deficit. It is this important point that exchange rate policy makers in Nigeria, and arguably in other African countries, miss that devaluation has almost always been followed by amplified deficits.

Domestic Currency Cost of Foreign Exchange

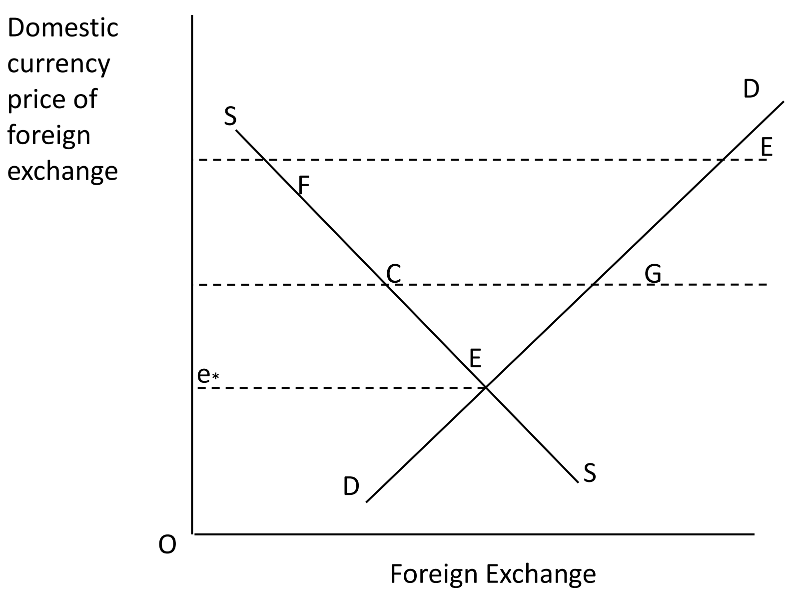

Diagram 3: Foreign exchange market

In the diagram, E is the point of unstable equilibrium. When the domestic is currency devalued, e moves to e2 at which rate the deficit increases. This has been the experience of Nigeria since 1986; yet the country continues to make the same mistake.

APPROPRIATE EXCHANGE RATE POLICY

An appropriate foreign exchange policy should be aware of the following: First, the foreign exchange market is unstable because of the people's assumption that foreign exchange is superior to the local currency and tends to appreciate in the future because of this speculative belief. Second, the major causes of external deficits are over invoicing of imports and under-invoicing of exports, theft of valuable minerals by foreign non-state actors, uncontrolled import of such luxury like private jets, limousines, food and drink that can be easily produced in the country, and wide-spread export of raw commodities without processing and refining, and money laundering in its various forms. To be successful in appreciating the value of the domestic currency, all loopholes of foreign exchange leakage must be plugged and the foreign exchange market managed in such a way as to generate foreign trade surpluses over a sustained period suggesting a trend to which holders and suppliers of foreign exchange adjust. Financing part of the surplus by sale of foreign exchange appreciates the local currency. Continued appreciation over an extended period moves the exchange rate to the neighbourhood of unstable equilibrium. The Central Bank Authorities then fix the exchange rate there, fixing upper and lower limits beyond which the exchange rate cannot fluctuate. The management of the exchange rate should be left to economic and financial market experts and regular simulation exercises should be organized to find out macro 3 economic effects on output, prices, income, wages, employment and other sectors. It is important to ensure that as the local currency appreciates, efforts should be made to ensure that costs and prices adjust downwards so that citizens benefit. This is the reason why an independent price and income board should be established to ensure appropriate adjustments in prices, costs and incomes. The example of Ghana during the first year in office of President Mahama is instructive. After taking appropriate steps to bring production and processing of gold, cocoa and oil under government control, the Government was able to apply part of the increment in foreign exchange to appreciate the value of the cedi from 19 to 1 US dollar to about 11 to 1 US dollar. The appreciation was successful, but the objective of reducing costs and prices was to a large extent frustrated because of reluctance or unwillingness of companies to reduce costs and prices in cedi. This problem could have been avoided or at least minimized if an effective price, costs and incomes board was operational.

Local Currency Price

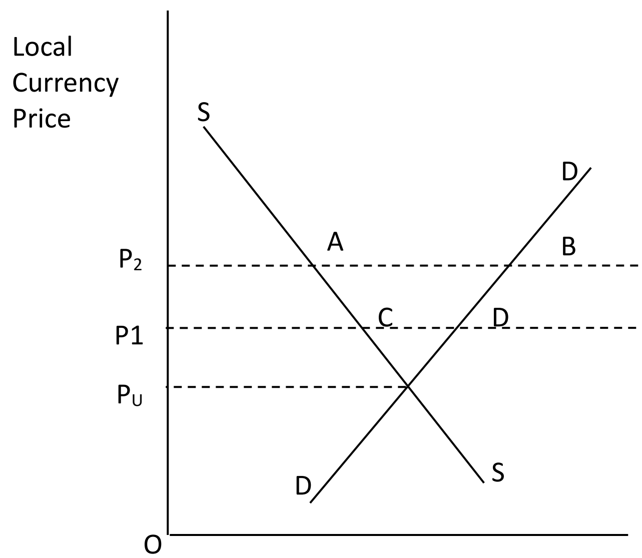

Diagram 4: Re-establishing foreign exchange rate in unstable foreign exchange market.

At exchange rate P2, trade deficit is AB. But as Government closes loopholes to improve trade balance which is expected to be sustained in the future, quantity supplied of foreign exchange increases and quantity demanded falls as transactions strive to avoid capital loss. When the exchange rate is in the neighbourhood of unstable rate Pu, the Government fixes it and establishes upper and lower bands beyond it cannot fluctuate.

OTHER PROBLEMATIC ADJUSTMENT AND FINANCIAL POLICIES

There are a number of policy areas where Government decisions have produced results exactly different from desired goals. We consider three of them below; First, Nigerian Governments assume that inflation in Nigeria is demand-pull inflation adopt inflation-targeting policy of raising interest rates to combat it. While this policy works in developed countries, it fails in Nigeria because inflation in Nigeria is the cost push type requiring policies that attack cost-increasing factors such as supply chain disruptions, labour-market disruptions, foreign trade restriction and devaluation of the 4 local currency. In the Nigerian context, inflation-targeting policy of raising short-term interest rates largely reduces investment with little or no impact on consumption. Also, higher interest rates induce private investors to move cash balance from commercial banks to investment in the money market. This creates inadequate capitalization in banks which in turn constrains their lending and requirement to recapitalize. The result of adoption of inflation-targeting monetary policy does not control inflation rate, but reduce investment, output and capitalization of commercial banks. It is when we come to consider fiscal policy that we see the link between budget deficits and budget deficit financing by foreign borrowing and Central Bank lending to the Federal Government. Under normal conditions, that is before market-determined devaluation, budget-deficits are modest and relatively managed by the Ministry of Finance and the Central Bank whose key officials take steps to ensure that their financing is not inflationary. But when devaluation occurs, the domestic currency value of all stock of foreign debt increases by the percentage of devaluation. Since domestic revenue is collected in local currency, a major problem arises. Revenue cannot cover recurrent, capitals and debt-serving expenditure. In some periods, debt servicing exceeds capital expenditure and whatever remains cannot cover all recurrent expenditure. This explains why government services in the areas of education, health, pensions, infrastructure and security are lacking. This is mainly due to increased costs of government expenditure that Government is forced to borrow funds denominated in foreign currency and revert to ways and means of borrowing from the Central Bank; the first intensifies a foreign debt trap and the other intensifies the rate of inflation. In this situation, the Government, misled by the simplistic thinking of “common sense economics” decides to raise tax rates and widen the coverage of taxation in an already depressed economy. Such policies fail to address the source of budget deficits and through the economy into recession and aggravate impoverisation in the economy.

THE WAY OUT

An effective solution to national economic problems requires that Government take note of the following considerations as necessary for success. First, economic problems have their origin in the real economy where goods and services are produced and consumed. Any attempt to adjust monetary aggregates to attain economic goals is bound to fail in the final analysis. Second, successful economic policy formulation requires the leading participation of competent economists in correct diagnosis and policy formulation. Economic policy 5 formulation goes beyond recording of data which closely related professionals as accountants, bankers and statisticians do efficiently as well. Such analyses are ex post in nature. But when it comes to economic policy formulation and implementation, the appropriate professional required are economists with expertise in econometrics in predicting the quantitative impact of policy variables on targeted macroeconomic variables in the future. This is ex ante analysis and involves the specification and estimation of equations and impact of specific policy variables on target such as output/ income, prices, exchange rates, interest rates and external balance. Leaving economic policy formulation and implementation in the hands of non-economists exposes an economy to poor diagnosis of economic problems and the adoption of wrong policies which aggravate rather than address economic problems. Third, economic structures and the role of peculiar expectations require that policy makers are aware of these peculiarities in policy formulation. These features invariably require that economic policy makers reject policies which may be appropriate for developed countries but ineffective for developing countries. This is the reason why policy advice provided by foreign donor agencies and International Financial Institutions need to be rejected. Fourth, policies may not be effective because certain theoretical preconditions are not met. In that case, what is required are institutional and geopolitical changes which ensure that required preconditions are met. Specifically, such changes as removal of trade barriers leading to enlarged markets, improvement in payments systems, introduction of common currencies and enlarged markets at high levels of economic integration enlarge markets and create conducive conditions for application of orthodox economic policies. The role of Nigeria in the realization of stable conditions in West Africa is important.

Each of these countries is the creation of European colonial rule, and as a result, may not be optimal economic and political areas. The urgent political assignment before Nigeria and other West African countries is to restructure domestically to protect local autonomy and integrate sub-regionally. It is expected that such restructuring in the future will lead to the emergence of a West African Confederation that will be a major player in the global economy. It would not be aligned with the free market in the West or more controlled Asian economic grants, or the Islamic-oriented Middle East. Rather, it would be an integratist political force highlighting cooperation and collaboration between professions and ethnicities and based on clearly outlined Afrocentric ideas.

6. CONCLUSION

This paper has discussed reasons why orthodox economic policies often fail in Nigeria. The main culprits are wrong diagnosis of problems using wrong professionals and sidelining homegrown economists. The result has been poor economic performance and increasing mass impoverization. A major aspect of revival will have far-reaching economic and political restructuring anchored on integratist and Afrocentric principles. This will not only facilitate economic development in Africa but also usher in the birth of a vibrant and prosperous West African Confederation, which is destined to become a global economic giant starting from the second half of the 21st century.

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