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Understanding the Ongoing Recession in Nigeria

A synthesis of the events and policy options

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Preamble

In the second quarter of 2014, the Nigerian economy witnessed its first recession in twenty years due to the interplay of several external and internal factors. The recession has continued until date and has given rise to relentless unemployment rate and job losses, double digit and soaring inflation, currency depreciation and widening gap between parallel market and official exchange rates, amongst other adverse effect on individuals and firms in the country. Thus, there is a need to take a deeper look into the nature of the present recession as well as the impact of monetary and fiscal policy responses thus far, in order to shed light on the way forward towards tackling the recession and ensuring sustainable economic growth.

This paper analyses the ongoing recession in the Nigerian economy to provide insights into the interplay of events and recommendations for policy. The first section provides a chronological narrative of the chain of events, identifies causative factors, and differentiates external from internal factors that drove the economic crisis. The second section pays particularly attention to the monetary and fiscal policy responses during the crises and its impact on the economy. The third section highlights feasible monetary and fiscal policy options for tackling the present recession, based on theoretical underpinnings and practical implications. The fourth section delves into recommendations for structural reforms to address the underlying structural issues to ensure sustainable growth in the Nigerian economy.

1: ***The build up to the recession***

In the second quarter of 2016 (2016Q2), the Nigerian economy fell into its first recession[1] in 23 years. The trigger in the chain of events that led to the present recession is attributable to the slump in crude oil prices recorded in the third quarter of 2014 (2014Q3). To aid this narration, the chain of events leading up to the recession is broken down into three stages. Stage one gives a detailed account of the key external factors that drove the decline in crude oil price between 2014Q3 and 2015Q4. Stage two presents the internal factors which induced stagflation in 2016Q1. Stage three further discusses the key internal factors that incited the recession in 2016Q2.

Stage One: External factors drive decline in crude oil price, decline in hot money, and attendant stagflation in the domestic economy (2014Q3-2015Q4)

Due to the shale oil revolution[2], the United States (U.S) witnessed an unusual increase in oil production in 2014 –from 1.2 million barrels per day (mbpd) to 8.7 mbpd –representing the largest volume of increase since record-keeping began in 1900[3]. Following the boom in U.S oil production, oil imports into the U.S (a major oil importer) declined to its lowest level since 1995 and its oil exports increased from an average of 7.46 million barrels per day (mbpd) in 2014Q1 to 13.44 mbpd in 2014Q4[4]. The impact of the rise in global oil supply from the U.S was buttressed by the lower demand for oil in Europe and Asia which tapered off on the account of weakening economies and improved energy efficiency measures[5]. Particularly, the slow growth in Germany, and the rebalancing of the Chinese economy (a major oil importer) with the attendant economic slowdown contributed significantly to the decline in crude oil demand. In addition, the Iran nuclear deal reached in July 2015 which limits Iran's ability to produce nuclear weapons in exchange for the removal of the Western sanctions against its oil export increased speculation of an oversupply of oil and contributed to the decline in oil prices. These led to the widening gap between global oil supply (rose from 91.85 mbpd in 2013Q4 to 95.59 mbpd in 2014Q4) and global oil demand (fell from 93.03 mbpd in 2013Q4 to 92.53 mbpd in 2014Q2). Thus, oil prices dropped sharply by the end of the year– from $112.23 in 2014Q2 to $77.74 in 2014Q4[6]. Oil price continued to fall in 2015 as the Organization for Petroleum Exporting Countries (OPEC) were reluctant to respond with a cut in oil production, in hopes that the U.S shale oil production will eventually become unprofitable, reducing its share of global output. Despite OPEC's inaction, the U.S shale oil production continued to boom. In fact, some oil-exporting countries, like Russia, increased crude oil production in a bid to protect the volume of their oil revenues; thus worsening the oil supply glut. By the end of 2015, global oil supply increased to 97.37 mbpd while oil demand fell slightly to 95.53 mbpd in 2015Q4[7]. Thus, despite intermittent recoveries, oil price further fell to an average of $44.08 in 2015Q4.

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[1] Recession is a period of prolonged decline in economic activities in a country indicated by a record of negative GDP growth rates in two successive quarters.
[2] An oil and natural gas production technology that combines horizontal drilling and hydraulic fracturing.
[3] http://www.ibtimes.co.uk/us-oil-production-growth-100-year-high-2014-due-shale-boom-1494342
[4] U.S. Energy Information Administration (EIA), 2016
[5] The World Bank estimates this as the decline in the demand for oil that is independent of global GDP growth. See: https://www.imf.org/external/pubs/ft/weo/2016/01/pdf/text.pdf
[6] U.S. Energy Information Administration (EIA), 2016
[7] U.S. Energy Information Administration (EIA), 2016

At the same time, there was a widespread decline in hot money into the Nigerian economy as foreign investments fell drastically in the last quarter of 2014. As at end-2014, the stock of FPI in Nigeria stood at N5.53 billion, representing a decrease of 53.2 per cent below the 2013 level. By 2015, total capital importation into Nigeria stood at $9.64 billion representing 53.53 percent drop compared to the $20.75 billion received in 2014[8]. The decline in hot money was particularly due to the anticipated rise in the US Federal Reserve Rate (interest rate). In addition, the removal of Nigeria from J.P Morgan's Emerging Market Bond Index (EMBI) also contributed significantly to the decline in FPI. These led to the collapse of the stock market and impacted on the county's forex reserve.

At the domestic level, the plunge in crude oil price alongside decline in foreign investment also had negative impact on Nigeria's foreign exchange (forex) reserves and government revenue. This reflected as negative GDP growth in the oil sector, which stood at -3.60 percent in 2014Q3. With crude oil accounting for about 80 percent of government revenue[9] and over 90 percent of foreign exchange earnings[10], the 61 percent decline in oil price between 2014Q2 and 2015Q4 alongside the drastic decline in FPI had adverse effects on the nation's forex reserve and government revenue. Particularly, forex reserve fell from $38,330 million in 2014Q1 to $29,295 million in 2015Q2*,* while government oil revenue declined from N1,809 billion in 2014Q1 to N831 billion in 2015Q4[11].

On the monetary policy side, the decline in forex earnings amid rising forex demand, drove the Central Bank of Nigeria (CBN) to implement strict policies. Specifically, the CBN in its monetary policy committee meeting in November 2014 made the decision to move the foreign exchange rate midpoint from N155/$US to N168/$US and widened the forex band around the midpoint by 200 basis point from +/- 3 percent to +/- 5 percent; effectively devaluing the Naira[12]. In February 2015, the CBN closed the Dutch Auction Window and pegged the official exchange rate at N197/$US in February 2015[13]. The dearth of foreign exchange earnings also forced the CBN to impose further forex restrictions and import ban on 41 items in June 2015—a well-trodden protectionist path—denying identified items access to foreign exchange at the official market. This led to the increase in the price of dollar at the parallel markets and thus the widening of the gap between the official and parallel market rates for forex. At the same time, the CBN opted for monetary stimulus in a bid to increase liquidity to support the private sector and stimulate economic growth. The compound effect of the scarcity of forex, devaluation in the value of the Naira, and monetary stimulus led to an increase in import prices for raw materials and finished goods—replacement cost; and thus rising inflation. At large, the scarcity of forex and the attendant forex restriction and currency devaluation had adverse effect on the performance of key sectors of the economy, particularly import dependent sectors such as the manufacturing sector which recorded negative GDP growth of -3.82 in 2015Q2[14].

On the fiscal policy side, the plunge in crude oil price and the attendant decline in government revenue led to a halt in public expenditure, particularly capital expenditure on infrastructures. This adversely affected key sectors of the economy dependent on public finance, particularly, the construction sector

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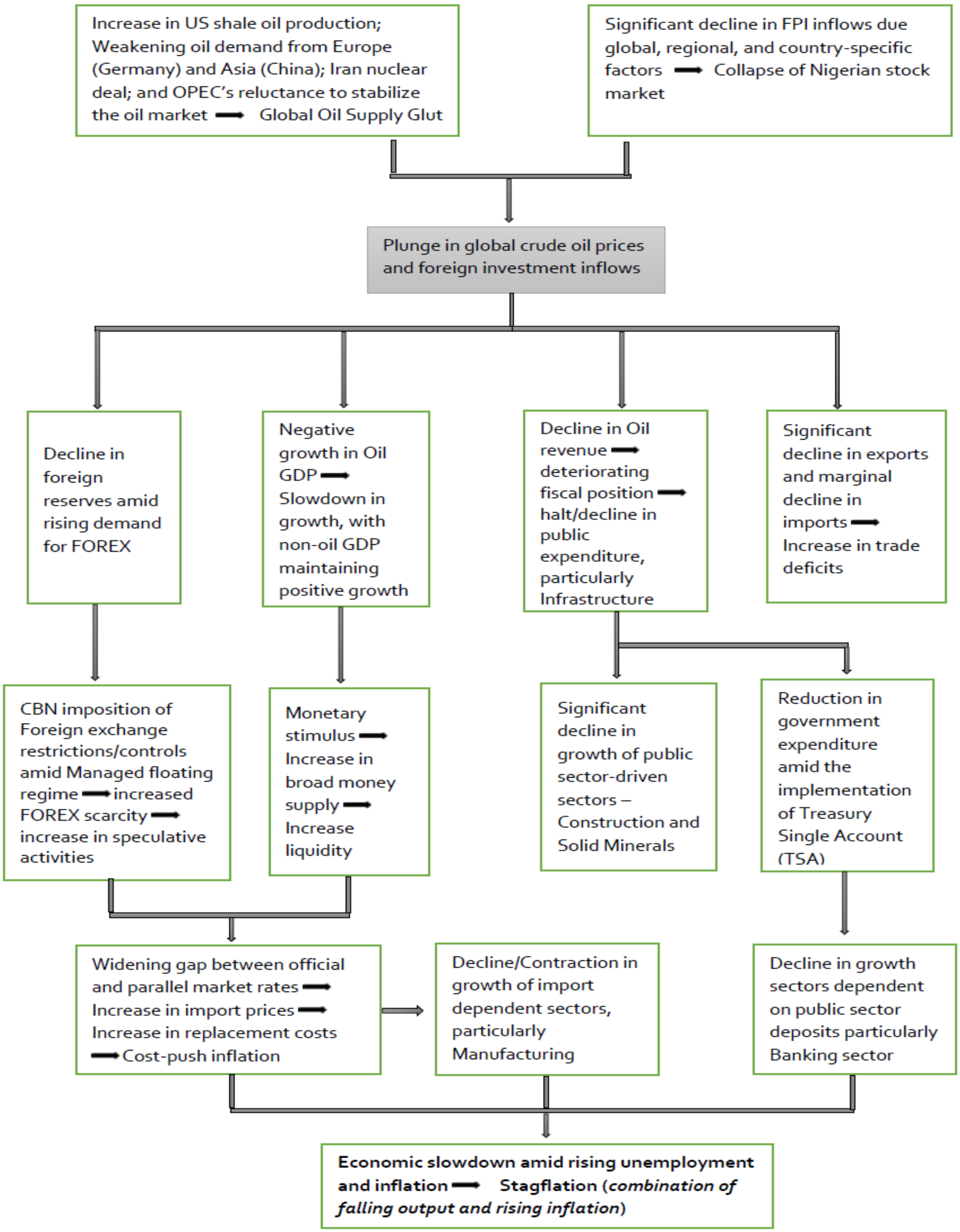
8 http://www.cbn.gov.ng/Out/2016/SD/Nigeria%20Private%20Foreign%20Assets%20and%20Liabilities_2014.pdf
9 "Nigeria's 2015 Budget: Fiscal and Macroeconomic Analyses", Price Waterhouse Cooper (PWC), 2015
10 Central Bank of Nigeria, 2016: https://www.cbn.gov.ng/IntOps/ReserveMgmt.asp
11 Ibid.
12 Centre for the Study of the Economies of Africa (2016), *Nigerian Economic Review: 2015H2*.
13 Ibid.
14 National Bureau of Statistics (2015).

which recorded a negative GDP growth of 0.35 percent in 2015Q3. At the same time, monetary authorities began the implementation of a Treasury Single Account (TSA) in 2015Q3 which constricted extravagant government expenditures and adversely affected other sectors dependent on public sector deposits, particularly the banking sector. Furthermore, the plunge in crude oil price and its attendant impact on fiscal and monetary policies led to the considerable decline in export and marginal decline in imports. This led to a total trade deficit of US$ 7.522 billion for 2015 compare to a total trade surplus of US$ 15,594.68 in 2014[15].

Ultimately, these events contributed to the economic slowdown noted in the third and fourth quarters of 2015, and worsening macroeconomic indicators in the period. Effectively, Nigeria's GDP growth rate declined to 2.84 percent and 2.11 percent in 2015Q3 and 2015Q4 respectively, relative to an average GDP growth rate of 6 percent recorded in 2014[16]. Unemployment rose to 9.9 percent and 10.4 percent in 2015Q3 and 2015Q4 respectively, relative to an average unemployment rate of 7.8 percent in the preceding year[17]. Inflation also rose to an average of 9.4 percent in 2015Q4 relative to 8.1 percent inflation rate recorded over the a similar period in the preceding year[18]. Hence, the incidence of stagflation—characterized by slow output growth alongside rising unemployment and inflation.

[15] Centre for the Study of the Economies of Africa (2016), *Nigerian Economic Review: 2015H2*.
[16] Ibid.
[17] Ibid.
[18] Ibid.

Stage 1: External factors drive decline in crude oil price (2014Q3-2015Q4)



Source: Author's analysis

Stage Two: Internal factors worsen stagflation (2016Q1)

While the incidence of low oil prices which triggered the economic downturn in 2015H2 were externally-driven, the fall in crude oil production was occasioned by domestic security tensions emanating from the Niger Delta region at the start of the year 2016, renewed attacks on oil and gas infrastructures in the Niger Delta region began. This led to the decline in crude oil production and a sharp fall in crude oil exports—crude oil production fell from 2.16 mbpd in 2015Q4 to 2.11 mbpd in 2016Q1. At the same time, crude oil price remained depressed—falling to a record low of US$ 34.39 in 2016Q1[19]. Consequently, Gross Federally Collected revenue further declined from N830.81 billion in 2015Q4 to N666.13 billion in 2016Q1[20]. The shortage of government revenue was worsened by reoccurring Boko Haram insurgency in the North East that led to the use of the country's scarce resources to dampen the adverse effect of Boko Haram –notably food supply deficit and internal displacement of a significant portion of the North-Eastern population (which would have otherwise been spent on economic activities). The dearth of government revenue amid delay in the passage of the 2016 budget led to unfavourable changes in fiscal policy. Particularly, given the decline in government revenue on account of falling crude oil price and lower crude oil output, there was neither funding nor appropriation to cover a subsidy regime in the 2016 Budget. This contributed to the partial deregulation of the market for importation of crude oil which led to further increase in fuel scarcity and an unprecedented rise in the price of fuel.

Furthermore, the shortage of government revenue and attendant inability to support the electricity industry contributed to the introduction of a new electricity tariff entailing an increase in the cost of electricity across the country. These further raised business costs and contributed to the continued rise in inflation, which rose to double digits in 2016Q1. In addition, the decline crude oil production and export further affected foreign exchange earnings and exerted pressure on forex reserves. This led to a further rise in business costs for forex dependent sectors and considerably accounted for the contraction in non-oil GDP (by -0.81) in the 2016Q1. Moreover, the worsening forex scarcity amid the federal government's vehement stance against further currency devaluation by the CBN despite widespread call for devaluation in the period, sent negative signals to foreign investors. This resulted to another sharp decline (by 71.54 percent) in foreign portfolio investment (FPI) recorded in the period to a historic low record of $271.04 million in the 2016Q1[21].

As a result of these events, stagflation in the Nigerian economy worsened. Nigeria recorded its first negative GDP growth rate since the second quarter of 2004, at -0.36 in 2016Q1. Furthermore, unemployment continued to rise—reaching 12.1 percent in 2016Q1, and inflation rose to an average of 13.3 percent in the same period[22].

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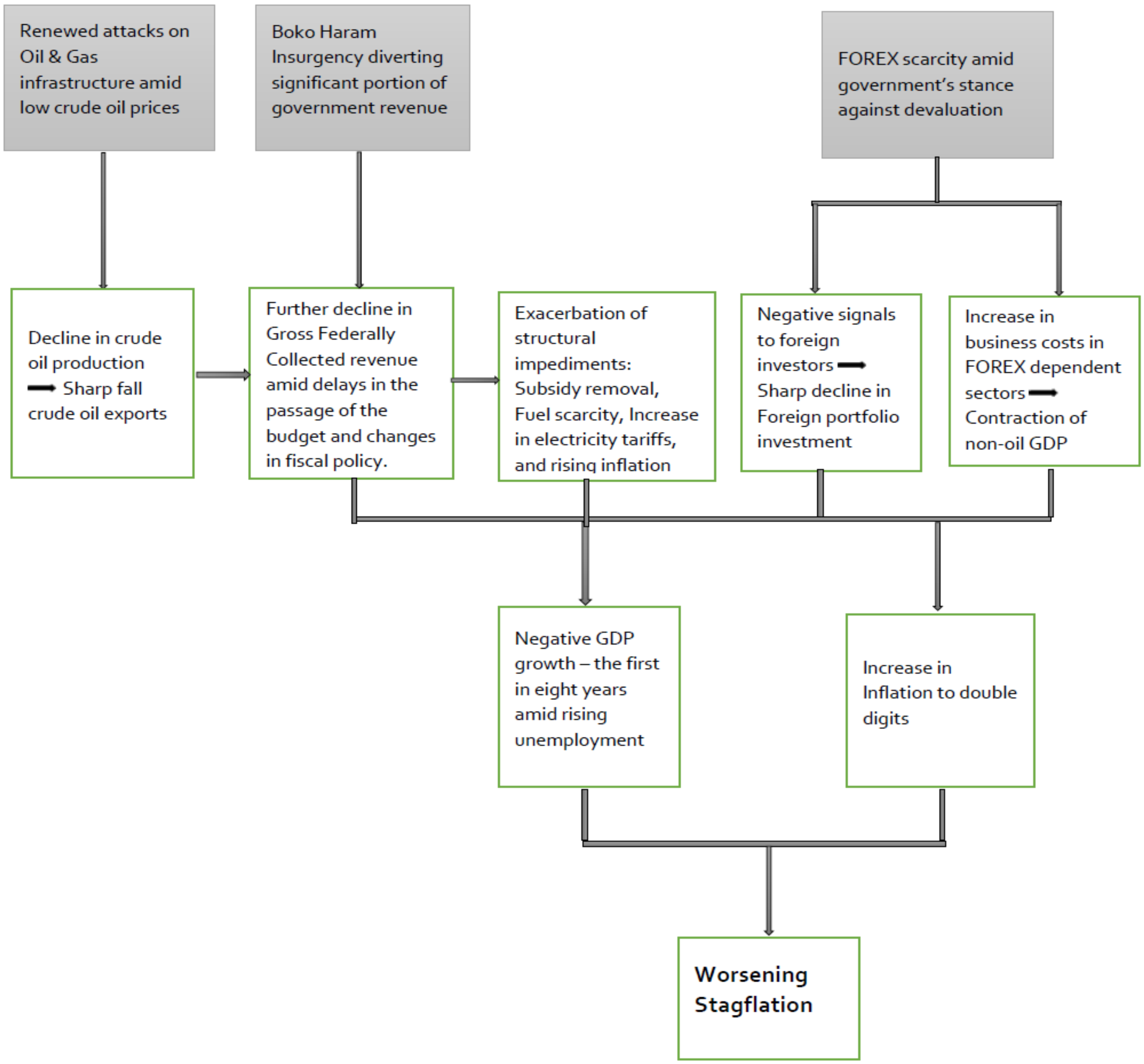
[19] Central Bank of Nigeria (2016).
[20] Ibid.
[21] Centre for the Study of the Economies of Africa (2016), *Nigerian Economic Review: 2016Q1*.
[22] Ibid.

Stage 2: Internal factors induce Stagflation (2016Q1)



Source: Authors' analysis

Stage Three: Worsening internal factors drive the Nigerian economy into a recession (2016Q2)

Episodes of vandalism of oil and gas facilities continued into the second quarter of 2016, which led to a further fall in crude oil production- to 1.69 mbpd in 2016Q2. Hence, oil sector GDP contracted deeply by -17.48 percent in 2016Q2. Furthermore, the persistent fall in crude oil production and export, further depressed foreign exchange earnings and forex reserves which continued to raise the exchange rate. By June 2016, the Naira to dollar exchange rate rose to N352/US$ at the parallel markets and N233/US$ at the interbank forex market. This continued to raise production input prices and fueled inflation. Notably, the fall in crude oil production as well as public and opportunity costs of Boko Haram insurgency continued to depress Federal Government revenue –which fell to a record low of N537.19 billion in 2016Q2. Ultimately, these events led to the worsening of domestic business environment, with the attendant downsizing and even shutdown of several firms especially in trade, construction and ICT sectors. Hence, Nigeria recorded its first recession in 23 years – with consecutive negative GDP growth rates of -0.36 in 2016Q1 and -2.06 in 2016Q2.

Figure 1: Stage 3: Worsening internal factors drive Recession (2016Q2)

Source: Author's analysis

2: Monetary and Fiscal Responses to the Recession and their Impact

Monetary authority and government agents on the fiscal side initiated series of policy responses aimed at containing ongoing economic challenges which comprise: rising inflation, declining output, and falling international value of the Naira. These are explored in the discussion that follows.

2.1 The monetary authority pursues restrictive policy stance to address inflation and exchange rate pressure while allowing fiscal measures activate growth.

The occurrence of rising inflation and declining output in the economy presents policy challenges to the policymakers, especially the monetary authority. This is because of the associated trade off in maintaining stable inflation and achieving greater economic growth via the monetary channel. Policy instruments that can contain surging inflation might be growth-inhibiting and vice versa. Given the conflicting goals of promoting price stability and economic growth through monetary policy tools, the CBN in its July 2016 communique, responded in line with its primary mandate of maintaining price and exchange rate stability; and therefore, embarked on a monetary policy tightening. Accordingly, the apex bank raised Monetary Policy Rate (MPR) by 200 basis points from 12% to 14% - to address the soaring inflation and foster liquidity in the foreign exchange market through "hot" capital inflow into the economy.

Prior to the upward revision of the MPR, specifically in June 2016, the apex bank had announced the discontinuation of the much-disastrous exchange rate controls[23] embarked upon since 2015Q1 in favour of a free floating exchange rate policy. It was believed that the increase in MPR together with the new exchange rate policy will restore investors' confidence and enhance foreign investment inflows in the economy.

Notwithstanding the above policy reactions, inflation continued to soar, rising from 16% to 18% in June and December 2016 respectively. Also, the margin between exchange rate at the official channel and the parallel market has widened tremendously. As at January 2017, exchange rate (N/US$) in the parallel market hovered around N497/$ as against N348/$ recorded in June 2016 - compared to N282/$ and N305/$ recorded in the official market in June 2016 and January 2017 respectively. Thus the aforementioned economic indicators worsened as a result of the multi-faceted challenges confronting the economy. On one hand, the drivers of the recent inflation surge are more of structural factors than a monetary phenomenon. Recent reforms that led to increasing electricity and petroleum prices, seasonality of agricultural produce[24], and a shortage of foreign exchange constitute major drivers of the ongoing inflation experience. On the other hand, the new exchange rate policy is bereft of credibility given increasing speculation in the parallel market with its attendant worsening value of the Naira.

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[23] The policy succeeded in worsening the speculation in the parallel market with damaging and destabilising effects on the Naira value.

[24] See Central Bank of Nigeria Communiqué No. 106 of the Monetary Policy Committee Meeting of Monday and Tuesday, March 21 and 22, 2016

2.2 On the fiscal side, an expansionary policy was instituted to activate the economy. However, the waning revenue from oil largely drags implementation.

The 2016 budget of N6.08 trillion, which is about 35% higher than what was appropriated in 2015, was aimed at addressing the infrastructure deficit and improving socio-economic development in the country. Essentially, the budget made provision for expansive capital investments in road construction and power generation, as well as housing. Also, it sought to improve human capital development and welfare of the poor through various job creation schemes and social transfer to the bottom poorest. While some of the programmes in the 2016 budget were laudable, the late passage of the budget in addition to falling oil revenue dragged the implementation of most items in the budget in the 2016 fiscal year. The budget passed through Senate final screening on March 23, 2016, and was assented into law by the President on May 6, 2016 – the middle of the second quarter. Due to revenue gaps from oil, there was a significant implementation delay of the budget. Despite a rebound in oil price above the 2016 budget benchmark, there were, however, production disruptions due to incessant attacks on oil facilities in major oil producing states in Niger Delta[25]. The activities downgraded crude oil output to about 1.6 million barrels per day in September 2016 – far below what was projected in the 2016 budget[26]. This also negatively affected revenue collection by the Federal Inland Revenue Service and the Nigerian Customs Service. As at September 30, 2016, aggregate revenue inflow was N2.17 trillion or 25 percent less than prorated projections. The revenue performance led to slightly above 59% budget implementation as at December 2016[27].

Aside from low revenue from oil which constrained large spending that could have activated the economy in the 2016 fiscal year, the drag in articulating a strong blueprint to pull the economy out of recession is contributing to the heightening uncertainty in the economy with a waning effect on investors' confidence, and consequently, worsens the recession experience.

2.3. The federal government seeks to boost patronage of locally made products and key into diversification that promotes local contents.

As part of efforts to address the country's economic challenges and enhance diversification of the economy, the President attended the 44th Annual General Meeting (AGM) of the Manufacturers Association of Nigeria (MAN) on 29th September 2016 to roll out government plans and strategies towards supporting the association. At the event, the federal government reiterated its commitment to partner with the association in the actualization of the industrialization road map as contained in the Nigeria Industrial Revolution Plan (NIRP) and the National Enterprises Development Programme (NEDEP). It was also unveiled at the event, the need to promote locally made goods, bridge the gap between skills required by industry and those provided by the educational institutions, and create finance access to Small and Medium Enterprises in the country[28].

However, most of the aforementioned support pledges from the federal government are long term ingredients required for sound industrial take-off and therefore, cannot address the current challenges

[25] http://sunnewsonline.com/niger-delta-avengers-blow-up-more-facilities-in-delta-bayelsa/
[26] http://www.financialwatchngr.com/2016/09/13/nigeria-records-biggest-drop-oil-output/
[27] http://www.premiumtimesng.com/news/headlines/217958-59-per-cent-nigerias-2016-budget-implemented-buhari.html
[28] http://www.premiumtimesng.com/news/more-news/211631-buhari-told-nigerias-manufacturers.html

confronting MAN. Some of the critical challenges to domestic productions are high production costs arising from an increase in electricity tariff without an expansion of energy supply, high gasoline prices, and a shortage of forex to import required inputs. The combined effect of these culminates in decelerating capacity utilization and operation scale-downs of firms with a depressing effect on output.

3. Policy Options

3.1 Monetary Policy Options

This section identifies key potential monetary policy options to the recent stagflation challenge with a view to having a fair understanding of their effectiveness and policy implications. Current challenges confronting the economy comprise rising inflation, declining output, and falling international value of the Naira. Given that the primary mandate of the CBN is to promote price and exchange rate stability, the Apex Bank typically aligns policy instrument towards that direction while allowing fiscal measures to activate growth[29]. Instruments within the purview of the Apex Bank are the Monetary Policy Rate (MPR), Cash Reserve Requirement (CRR), and Liquidity Ratio (LR). These are adjusted in the desired direction to achieve both short and long-term monetary targets.

In reacting to the present challenge, several options are open to the monetary authority. It can intervene by pursuing expansionary monetary policy, contractionary policy, or remain neutral. Each option with policy implications is discussed in a policy environment of rising inflation, negative real interest rate, and continuous depreciation of the Naira in the foreign exchange market.

3.1.1 CBN and Quantitative Easing

In a bid to complement fiscal policy in growth stimulation, the monetary authority can embark on an accommodative policy by expanding the money supply. This can be done via a reduction in the MPR, lowering of cash reserve ratio in the banking system or a combination of both measures. It can achieve targeted low-interest rates by buying debt instruments (such as treasury bills) through Open Market Operations (OMO). This depresses or lowers returns (i.e. interest rates) on debt instruments. The process can also lead to an increase in the monetary base which raises money supply through the effect of the money multiplier.

How effective is quantitative easing in addressing the current challenges? On one hand, driving down interest rate through expansionary monetary policy would make an investment in interest-earning assets less attractive. Therefore, the policy might further dampen domestic and foreign portfolio investment. Considering recent negative real interest rate (MPR) experience[30], pursuing such policy will create a disincentive to foreign investors as they would consider directing their investment where it could yield positive returns. The needed foreign inflows that can ease the pressure of free fall of the Naira in the foreign exchange market are no longer forthcoming. On the other hand, it is not certain if the policy can stimulate output. In the mainstream economics, especially from the classical

[29] This assumption is close to reality given the passage of 2016 budget

[30] As at December 2016, MPR is retained at 14% while inflation rate rises to about 18.6% - indicating a negative real interest rate.

viewpoint, it is argued that demand and supply for funds in the loanable fund market determine interest rates. And output is determined by the level of interest rate that clears the loanable fund market. Therefore, any shock to output is self-corrected through the interplay of demand and supply of funds in the loanable funds market. Lower interest rates would create excess demand for loanable funds (for investment) which eventually leads to higher output and vice-versa. Even Keynes liquidity preference theory also aligns with this view in the sense that lower interest rates cause expenditure-switching effect that raises consumption and reduces savings. However, the possibility that the policy would stimulate output is ambiguous if firms decide to invest in non-reproduce assets rather than value-added services. In this case, higher consumption would not correspond to an increased production- the effects might be transmitted on the price level. An outlook of such can occur in environment with high level of uncertainty and low investment climate like Nigeria.

Wide adoption of lower interest rates by most central banks[31] in the developed countries in periods of economic stagnation was largely hinged on the belief that output can be stimulated through cheap credit. However, most of the economies experience very low and stable inflation. Cases of lower interest rate policy in a time of stagflation are rather uncommon. Given the high inflation pressure confronting the Nigerian economy at present, pursuing expansionary monetary policy would exacerbate the problem and may not guarantee output growth. In fact, previous expansionary policy of the CBN since the global oil crisis in 2014 was counter-productive[32].

3.1.2 Contractionary Monetary Policy

Another option is to align policy instruments toward containing inflation upsurge and tackling exchange rate depreciation. This can be achieved through monetary tightening that raises policy rate (MPR) and cash reserve requirement in the banking system. It can conduct OMO by selling debt instruments and withdraw money from circulation. Interest rates increase through this process and given the Classical and Keynesian orthodoxies, it is expected that savings would rise (due to higher returns on interest-earning assets) and investment decline (as a result of high borrowing costs to finance investment activities). Dampening effects of higher interest rates on investment will lead to a reduction in aggregate demand and consequently cause lower output and aggregate price level at least in the short run. Higher interest rates also attract foreign portfolio investment which is a source of foreign capital inflow. Higher foreign inflow would lead to an appreciation of Naira in the foreign exchange market.

The highlight from economic theory above points a possibility of reversing and easing rising inflation trends and foreign exchange pressure through monetary tightening measures. However, this is conditional on the existence of certain mechanisms. There must be a functional free market that guarantees free capital mobility. Adequate rule of law with reasonable degree of consistency in the policy environment (to minimize uncertainty) needs be ensured. Sadly, Nigeria is clearly deficient in both cases. Thus these shortcomings usually fault the applicability of the mainstream economic theories in the Nigerian context. Motivations that guarantee practicability and workability of most

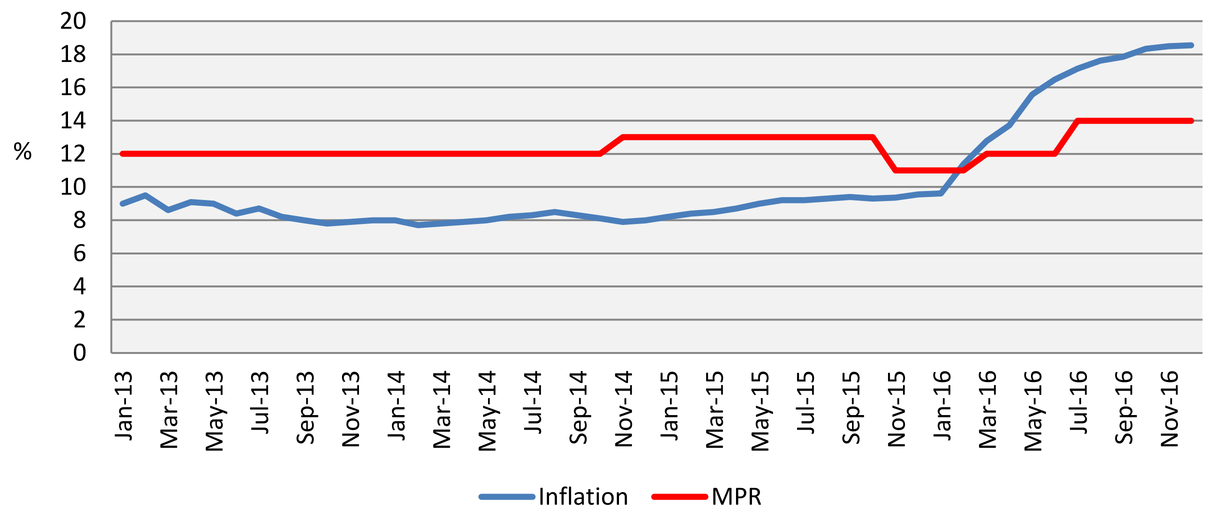
[31] In fact, some central banks have adopted non-positive (i.e. zero and negative) interest rates policy as an adjustment mechanism to the series of global economic crisis. Notable among them are the Bank of Japan, the European Central Bank, the Swiss National Bank, the Swedish Riksbank, and the Danish Central Bank. See Thomas I. Parley, 2016

[32] See CBN communiqué, February 2016

economic theories are inadequate at best. Therefore, local knowledge of what drives different markets is required for sound economic judgement.

Going forward, pursuing contractionary policy seems to be a better policy option for the monetary authority. On a lighter ground, it allows the apex bank to deliver its traditional mandate of maintaining price and exchange rate stability albeit at the expense of output growth. In the 2016 July communiqué of the Monetary Policy Committee (MPC) meeting, the bank raised the MPR by 200 basis points from 12% to 14% - to address the soaring inflation and foster liquidity in the foreign exchange market. However, the real interest rate is still negative as inflation has overtaken MPR since February 2016 till present (See Figure 1 below). Contractionary measures being pursued by the CBN since March 2016 has not been effective in containing recent inflation upsurge. This is true in view of the fact that drivers of the inflation are more of structural factors than a monetary phenomenon. Recent reforms that led to increasing electricity and petroleum prices, seasonality of agricultural produce[33], and shortage of foreign exchange constitute major drivers of the ongoing inflation experience.

Figure 1: Inflation and Monetary Policy Rate in Nigeria: Jan 2013-Dec 2016



Source: CBN Database

3.2 Fiscal Policy Options

This section examines fiscal policy options, based on Keynesian orthodoxy, as part of short-term measures to the recent recession experience.

Following Keynesian proposition, output fluctuations is a demand management problem that can be corrected solely through demand management measures. Specifically, a recession is seen as a period associated with deficient or weak aggregate demand. In a recession, consumption and investment spending are weak largely due to uncertainty and expectation. The fact that unemployment tends to

[33] See Central Bank of Nigeria Communiqué No. 106 of the Monetary Policy Committee Meeting of Monday and Tuesday, March 21 and 22, 2016

be on the increase lowers probability of better future economic opportunities and this would bring about increased tendency to consume less and save more. Also, an expectation of lower future profit driven by low demand depresses investment in new stock and inventories. Keynes observed that if the government does not intervene, an economy might go through a protracted period of slump associated with low output and income, high unemployment, and waning profits etc.

An evidence-based analysis indicates that the current recession experienced in Nigeria is largely driven by a shrinkage in government expenditure on the demand side[34] and decline in crop production, crude oil production, oil refinery, and manufacturing activities on the supply side[35]. However, unlike typical recession narrative in the literature, there was significant increase in consumption and investment spending prior to the growth dip. This shows that the ongoing recession is driven more by supply factors than a demand phenomenon. In a sense, the focus should be on tackling challenges to domestic production. And part of the roles of the government is to invest massively in critical infrastructure so as to reduce the cost of doing business, promote property rights as well as embark on reform that is catalytic to industrial take-off and business expansion. Focusing on the incentives that could lead to positive shift in aggregate supply constitutes key to economic recovery in the medium term.

Given the present reality, active stabilization in form of higher spending is required to pull the economy out of recession and stimulate recovery. This calls for huge fiscal spending that requires large deficit financing. Two options are open in this regard. The government can result to (internal or external) borrowing or monetize the deficit. The first approach leads to increase in debt stock with higher debt-service burden in the future, while the second option can worsen the inflationary tendency in the economy. In the present scenario, borrowing to finance government deficit is far a better policy option than debt monetization. However, for a new debt to be beneficial to the economy, it should be efficiently secured (in terms of low-interest payment and longer gestation period) and judiciously utilized in such a way that the benefits derived from the utilization of the debts would outweigh the cost of the debts.

As a way towards improving revenue potential, government can benefit from domestic resource mobilization reforms that seek to tap from the informal sector of the economy. This is highly critical at the moment considering the high level of informal activities in the economy. A lot of businesses still operate underground with no identity and away from financial services. An initiative that identifies with, organize and regulate the activities in the shadow economy would not only boost the revenue structure of the government in terms of a wider tax net but also foster high employment potentials in the economy.

While revenue mobilization remains critical to fiscal solvency, public expenditure framework that seeks prudential and efficient spending, and minimizes waste to the barest can foster large economic gains. The implementation of the Treasury Single Accounts (TSA) by the federal government is a step in the right direction. This, to an extent, allows the government an unhindered visibility of its resources and enhances the efficiency of fiscal management. However, the initiative is yet to enjoy full-scale adoption especially at the sub-national tiers of governance. Effective and efficient Public Expenditure Management (PEM) in the current period entails spending on infrastructural development based on

[34] http://www.nigerianstat.gov.ng/report/399

[35] http://www.nigerianstat.gov.ng/report/371

sound project evaluation and assessment. At the heart of PEM are policy prescriptions that consider a reduction in the cost of governance and enhances efficiency in public service delivery. Government agencies with duplicated or overlapping functions should be merged to promote effectiveness.

In terms of fiscal sustainability over the medium term, there is need to develop counter-cyclical buffers that allow for higher spending (fewer savings) during economic bursts and lower spending (more savings) in booms. Essentially, making fiscal spending counter-cyclical is critical to the oil revenue volatility management. This approach has been effective in managing oil revenue especially in Norway. In addition, diversification of revenue source away from oil is also essential to minimize shocks from oil price volatility. Greater attention need be given to the development of non-oil sector in order to boost revenue potential of the government. Towards this, government should consider developing solid mineral sector so as to attract foreign direct investment and enhance the nation's foreign exchange earnings.

4. Recommendations

4.1 Short-term recommendations

(i) The ongoing stagflation experience presents limited policy options to the monetary authority. Most factors contributing to the recession and inflation are largely structural in nature and therefore effective remedies may not be through monetary measures. However, given the current challenges of rising inflation and falling Naira, the economy could benefit from restrictive monetary policy, which should accompany expansionary fiscal policy. In pursuing such policy, there is need to revise the real MPR upward to a positive range. The current negative real MPR is a disincentive to investors as there is an option to direct their investments to where it could yield positive returns. In order to ensure effectiveness of the policy, there is need for the monetary authority to ensure **credibility in its free floating exchange rate policy**. Commitment to free capital mobility would improve investors' confidence and foster foreign investment inflow in the near term.

(ii) The ongoing recession requires active stabilization measures that can stimulate growth recovery. This, among others, entails large spending in activities that enhance business operations in the economy. In essence, expansionary fiscal policy that seeks to boost investment in infrastructure in the areas of power, transportation, and housing would go a long way in enhancing investment climate and reduce the cost of business in the country.

(iii) It is essential that the monetary and fiscal policies be directed specifically to address critical bottlenecks to domestic production some of which include: rising electricity tariffs, high gasoline prices, and a shortage of forex to import required inputs – the effects of those contribute to the rising general price level and high production costs in the economy.

(iv) To achieve a robust macroeconomic framework, both monetary authority and government agents on the fiscal side need to work collaboratively. There should be policy coordination and harmonization between the two agents for effective macroeconomic policy-making. Monetary and fiscal policy goals need be mainstreamed to forestall any form of conflicts and inadequacy.

4.2 Medium-term recommendation

(i) In the medium term, fiscal policy reforms that promote effectiveness, efficiency, transparency, and accountability are critical to public financial and expenditure management. Given the daunting challenge in raising revenue to finance large spending, ensuring productivity in government expenditure can foster large gains. Current low revenue earnings from oil necessitate credible fiscal adjustment and effective expenditure controls. In this sense, spending should be tied towards productive ventures based on sound project evaluation assessments.

(ii) Given the severe fiscal crisis associated with oil revenue volatility, the study advocates counter-cyclical fiscal policy as an effective measure towards ensuring fiscal sustainability in the medium term. Also, restructuring of government revenue away from oil is essential towards managing revenue shocks. In this regard, non-oil sector should be developed and make viable as credible alternative revenue source.

4.3 Long-term Recommendations

Besides the aforementioned monetary and fiscal policy recommendations for short term and medium-term economic recovery, it is imperative to address some of the structural issues in Nigerian economy to allow for long-term sustainable economic growth. Some recommendations for tackling key structural issues in the domestic economy are as follows:

i. ***Diversifying revenue base to minimize volatilities:*** In the 1960s, non-oil (agriculture) exports accounted for 78 percent of total exports, but this fell to 9 percent in the 1970s and further down to 3 percent in the 2000s. Remarkably, the Nigerian economy was most diversified in the 1970s when building and construction, wholesale and retail, as well as the services sectors expanded relative to the 1960s and recorded their highest shares of GDP[36]. However, the oil boom of 1970s led the way to a mono-product economy. Over the years, crude oil took its place as Nigeria's major commodity accounting for over 85 percent of export since 1977. This has severely narrowed the revenue base of the Nigerian government as well as the inflows of foreign exchange to the CBN, with resultant implications.

    Thus, more than ever, there is the need to guide the Nigerian economy to a path of multiple revenue stream in order to make the country less volatile to changes in global crude oil prices and the aggravations of Niger Delta militants. While the oil and gas sector would remain paramount to the Nigerian economy, other sectors of the economy ought to be developed further. This can be achieved by creating a support scheme and protection mechanism that allows firms in other key economic sectors to thrive successfully. For instance, initiating short-term tax relief for local manufacturers or access to credit at lower interest rates for businesses in the construction sector could be useful. However, there should be appropriate monitoring and evaluation mechanism to ensure that these incentives are not abused.

[36] Structural transformation of the Nigerian Economy: A Policy Paper. September 2014. Retrieved from: http://www.relooney.com/NS4030/Structural_Transformation_of_the_Nigerian_Economy_A_Policy_Paper.pdf

Furthermore, reforms to enhance government revenue collection could be explored to allow for stable non-oil revenue flow. Particularly, broadening the tax base by improving the ease of doing business in the country is paramount. This will entail, first, improving the efficiency of tax administration by adopting the high standard technology to facilitate the preparation, filling and payment of taxes. Second, undertaking legal and judicial reforms with the aim of shortening delays in the enforcement of contracts and improving legal backing for businesses is also critical. Third, improving availability of key information and credit access to start-up businesses with the aim of formalizing the informal sector would also be vital. Fourth, necessary actions towards incremental improvement in renewable and non-renewable power generation and distribution is called for; as constant electricity supply is indispensable to business operations. Embarking on such reforms targeted at key non-oil businesses can substantially boost industrial growth and improve overall economic performance while creating stable non-oil revenue inflows to the government

ii. ***Prudent public financial management by cutting the cost of governance:*** Beyond revenue generation, it is critical for the government to embark on cost-cutting reforms with respect to reducing wasteful recurrent expenditure. In Nigeria just as in many African countries, the cost of governance is very huge despite with the absence of efficiency in governance. The cost of Federal Government administration in 1981 was 0.91 billion, but this has reached 1,228.99 billion in 2015[37]. This rising rate of government consumption of final goods and services is not consistent with efforts to maintain a culture of prudent public financial management. Fiscal discipline and strict management of revenue is essential for sustainable macroeconomic stability, especially at this time. With the present dearth of government revenue, prudent financial management is important so as to minimize fiscal deficit and the accumulation of national debt. Cost-driver analyses could be employed in evaluating and eliminating some of the multiple government agencies and administrative costs that do not significantly contribute to economic growth and the wellbeing of citizen.

iii. ***Improving Budget Implementation, Monitoring and Evaluation:*** According to a comprehensive study by the International Budget Partnership (IBP) in 2015, Nigeria scores 24 out of a 100 in the Open Budget Index; implying that Nigeria is one of the few countries in the world that provides little or no information about budget implementation to foster government accountability. Weaknesses in the monitoring and evaluation of budget implementation in the past have greatly hampered the quality of capital projects. The high level of corruption and opaqueness in the public sector has led to miniature outcomes (in terms of capital projects) despite huge government expenditures. Thus, there is a need to strengthen monitoring and evaluation in the implementation of national budgets, so as to increase efficiency in government capital expenditures and improve service delivery to the Nigerian public. The Medium Term Expenditure Framework, 2016-2018, have stressed the need to enforce a more transparent fiscal management to promote inclusive growth. Actionable reforms to enforce this transparency, particularly with regards to budget implementation, should follow suit especially at this time.

[37] CBN Statistical Bulletin (2015).

iv. ***Increasing physical capital-labor ratio to check unemployment:*** The Nigerian economy have witnessed decline in capital-labor ratio since the 1980s on the account of infrastructure deficit acting as a principal disincentive to investment in physical capital. At the same time unemployment rate have maintained an upward trend since 2011; further rising consecutively since the fourth quarter of 2014 until date. The poor state of infrastructure constantly feature as the main cause of high operation cost that impedes private sector investment in physical capital. With the steady rise in the nation's population dominated by youths and children, the incommensurate rise in capital investment by the private sector is a recipe for low wages and high unemployment rate. Even as the present economic recession continues, companies are further discouraged from expanding their ventures while many are contracting activities. Thus, there is the long-standing need for the Nigerian government to boost capital expenditure especially for basic infrastructures such as electricity and good road/rail networks needed to encourage the start-up and expansion of private businesses. Sadly, capital expenditure only accounts for about 12 percent of government aggregate expenditure (as at 2015); the figure has been much lower in the past. This age-long structure of government expenditure needs to be addressed so as to boost capital-labor ratio and check the trend of rising unemployment in the country.

v. ***Labour market reforms to minimize long-term unemployment, shortfalls in productivity, and job losses:*** Given the steady rise in the nation's labour force participation amid sustained economic downturn, there is the need for concerted efforts to prevent long-term unemployment, ease shortfalls in productivity, and help individuals remain attached to the labour force. Specifically, governments could consider the following labor market priorities: First, employment policies such as work-sharing schemes could be pushed forward at this time to help workers keep their jobs. This would not only help check unemployment but also help businesses cut costs; as job sharing could lead to a net reduction in per-employee income. Second, the government could give wage subsidies to encourage employers in key sectors of the economy to expand their businesses and take on new staff. However, to minimize deadweight costs, these measures should target individuals who are vulnerable of becoming long-term unemployed or losing attachment to the labour force, such as the youths and the low-skilled. Third, strengthening re-employment policy to improve the employability of the unemployed, thus reducing the risk of long-term unemployment and facilitating potential structural changes in the labour market. Fourth, renewed focus on human capital development is particularly crucial to resolving the large skill-gap and skills-mismatch in the country. This will entail improving educational infrastructure, especially libraries, in public schools to world-class standards; improving governance of public universities as well as research and extension institutions; and also creating policies that ensures collaborations between businesses and educational institutions towards improving technical and vocational trainings such as compulsory internship for third- year students in both private and public schools. Also, efforts should be made streamline the postings of national youth service corpers in line with their study programme or career path to foster learning in preparation for future employment.

vi. ***Pursuing Rural Development***: Among other strategies, Indonesia pursued a development strategy focused on rural development between 1969 and 1974; by allocating 30% of capital budget to agriculture[38]. As a result, agricultural productivity and value chains spurred labor intensive manufacturing in the 1970s. The lesson from the Indonesian experience is that a clear focus on rural development with emphasis on agricultural productivity, value chains and the supportive rural infrastructure could unlock the potentials of the sector to spur industrialization. Thus, the Nigerian government should inculcate in its agenda strategy to carry the rural areas along. This can be achieved by creating incentives for the financial services sector to provide capital to entrepreneurs in agriculture. While the present administration has shown commitment to develop the agricultural sector, improving access to credit and trainings for rural farmers would go a long way. More so, urban infrastructure projects could focus on creating new cities to avert explosion of urban slums in Lagos, Abuja, and Port Harcourt.

5. Conclusion

Due to the present economic recession triggered by the fall in global crude oil prices, widespread regional decline in foreign investments, and domestic attacks on oil facilities, the Nigerian economy is presently confronted with multiple challenges including: rising inflation, declining output, and declining international value of the Naira. After assessing the options open to the monetary authority, the study is of the opinion that the economy could benefit from restrictive monetary policy stance that makes return on investment attractive to investors coupled with exchange rate policy that promotes unhindered capital mobility. In essence, the current negative real interest rate (MPR) should be revised to a positive band; and there is need to ensure credibility in the free floating exchange rate policy of the CBN. However, expansionary fiscal policy that boosts infrastructure (e.g. power, transportation, and housing) is required to activate the economy and stimulate growth recovery. Also, fiscal policy reforms that promote effectiveness, efficiency, transparency, and accountability are critical to public financial and expenditure management.

In addition to these, several structural issues ought to be addressed to ensure long-term economic growth. Particularly, diversifying Nigeria's revenue stream to minimize volatilities by supporting business activities in other economic sectors beyond the oil and gas sector. Furthermore, ensuring prudent financial management by cutting the cost of governance as well as improving the monitoring and evaluation of budget implementation is also deemed paramount. More so, increasing capital expenditure that supports business operations (particularly basic infrastructures), as well as reforming the labour market is vital in checking the ever-rising unemployment, in the medium and long terms. Finally, the Nigerian government should also include in its agenda a rural development strategy particularly by creating incentives for the financial services sector to provide capital to entrepreneurs in agriculture.

[38] Structural transformation of the Nigerian Economy: A Policy Paper. September 2014. Retrieved from: http://www.relooney.com/NS4030/Structural_Transformation_of_the_Nigerian_Economy_A_Policy_Paper.pdf