

**WEST AFRICAN MONETARY AGENCY
(WAMA)**



ECOWAS MONETARY COOPERATION PROGRAMME

**MACROECONOMIC CONVERGENCE REPORT
2007 NIGERIA**

FREETOWN, JUNE 2008

The 2007 macroeconomic policy thrust of Nigeria outlined in the National Economic Empowerment and Development Strategy (NEEDS) document aimed at creating a stable environment for accelerated pro-poor growth. In this regard, the government’s fiscal policy sought to enhance revenue collection, strengthen public financial management through effective fiscal allocation, coordination and monitoring. Monetary policy was also designed to consolidate the macroeconomic stability achieved in recent years.

Developments in the global economy in 2007, particularly, the escalating crude oil price continued to impact positively on the economy of Nigeria. At the domestic front, the government continued to grapple with the social unrest in the Niger delta that led to a significant drop in the crude oil production. Notwithstanding these influences, economic activity remained buoyant. The provisional data indicate that output grew by 6.2 percent. The economy remained relatively stable with the average inflation decelerating from 7.5 percent in 2006 to 5.5 percent. The exchange rate appreciated moderately on both the inter-bank and parallel foreign exchange markets, under the influence of massive foreign exchange inflows. The movement in the structure of nominal interest rates was mixed as the rediscount rate, savings and lending rates continued their downward trends whilst the yield on 91 day government treasury bills and 12-month deposit rates firmed up marginally.

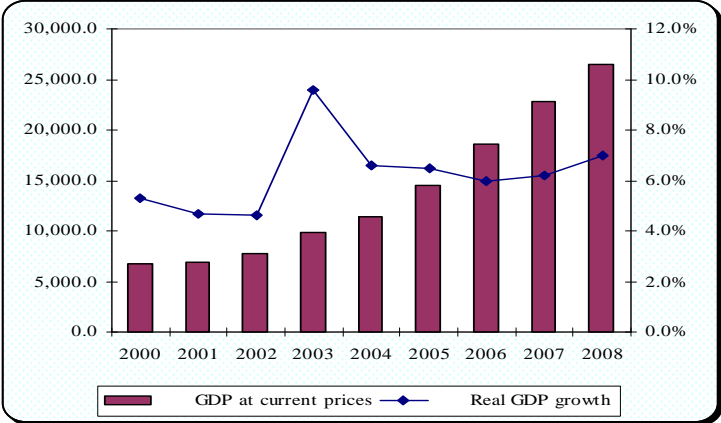
1 Sector Analyses

1.1 Real Sector

The Federal Government of Nigeria outlined a number of strategies aimed at enhancing productivity in the real sector. These included intensification of the President’s Special Initiatives on agricultural products, particularly, cassava, rice, cotton and cocoa. To help maintain prices of agricultural products, which often exhibit seasonal fluctuations, the government established marketing companies to buy excess supply of food commodities.

The provisional data indicate that the economic activity increased marginally as real GDP growth rate of 6.3 percent (compared to 6.0 percent in 2006), although the achievement was below the projected target of 10.0 percent for 2007. The non-oil sector grew robustly by 9.0 percent whilst oil output declined by 5.6 percent, further to the 4.5 percent reduction recorded in 2006, mainly due to the continued social unrest in the Niger delta.

Graph 3.45: Trends in Nominal GDP and Real Economic Growth



The non-oil sector was driven by strong performance in the agricultural, manufacturing, telecommunication, building and construction, wholesale and retail trade sub-sectors. The primary sector grew by 7.7 percent compared to 7.4 percent in the preceding year. The services sector also recorded strong growth, but performance of the secondary sector remained stunted owing to erratic power supply.

1.2 Public Finances

The government continued to manage demand pressures by complying strictly with an oil-based fiscal rule adopted in recent years that requires the transfer of excess oil revenues (value above budgeted oil price and production level) into an excess crude account at the Central Bank of Nigeria. The authorities also initiated certain reforms aimed at improving revenue collection and tax delivery whilst public investment policy emphasized fiscal prudence.

Fiscal policy of the Federal Government of Nigeria was encouraging amidst constraints in revenue collection. The government's fiscal operations resulted in an overall budget surplus equivalent to 14.3 percent of GDP compared to 22.1 percent in the preceding year. However, factoring in the oil-based fiscal regime under which a proportion of total revenue is made available for operational purposes, the federal government recorded a budget deficit of 1.8 percent compared with 2.3 percent in 2006.¹ The fiscal operations resulted in a borrowing requirement of ₦404.0 billion, which was financed entirely from domestic sources, partly from excess crude oil returns and partly by the deposit money banks.

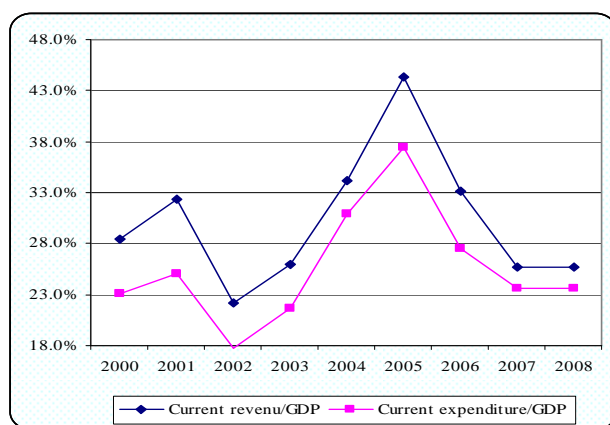
Despite the favourable outcome in revenue mobilization, its efficiency continued to wane under the continued influence of persistent socio-political unrest in some parts of the country. Total revenue declined by 5.7 percent in 2007 to 25.0 percent of GDP compared to 37.7 percent and 33.3 percent in 2005 and 2006 respectively. Shortfalls in tax and non-tax revenue accounted for this sub-optimal performance.²

Total federal government expenditure enhanced by 20.3 percent to 10.7 percent of GDP, albeit, representing a marginal decline from 11.2 percent of GDP in 2006. Recurrent expenditure, which constituted 64.8 percent of total expenditure, also fell from 7.6 percent of GDP to 7.0 percent. On the other hand, capital expenditure increased marginally to 3.8 percent of GDP.

¹ Following the adoption of the oil-based fiscal rule and after certain statutory deductions, the federal government retained 26.7 % and 35.6% of total revenue (or 59.6 % and 84.4 % of tax revenue) in 2006 and 2007 respectively to finance its fiscal operations.

² Tax revenue declined from 14.9% in 2006 to 10.5% whilst non-tax-revenue declined from 18.4% to 14.5%.

Graph 3.46: Trends in Current Revenue and Expenditure



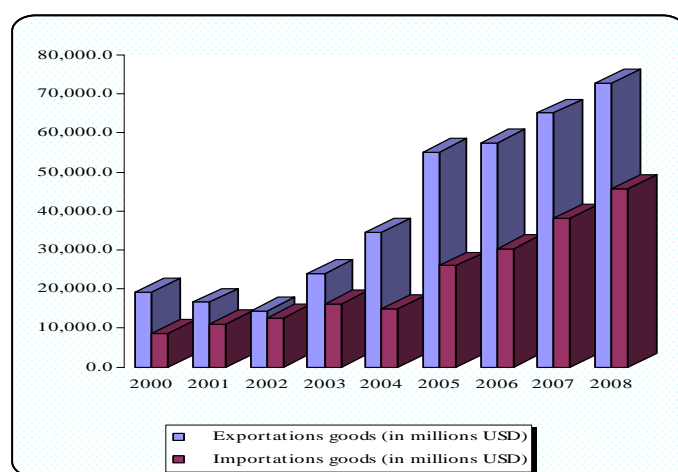
The discretionary component of recurrent expenditure continued to increase during the year under review. The proportion of salaries and allowances relative to recurrent expenditure increased further from 38.0 percent to 47.9 percent. Similarly, expenses on transportation and maintenance also rose from 18.6 percent to 23.2 percent. On the other hand, outlays on goods and other services, including education and health, dwindled by 9.4 percentage points to 8.8 percent. Interest payments also declined significantly owing to debt relief obtained from the country's development partners under the multilateral debt relief initiative.

1.3 External Sector

The government continued the structural reforms introduced in 2006 to improve trade and enhance exchange rate stability. These reforms included liberalization of the import tariff regime and the introduction of a Wholesale Dutch Auction system on the foreign exchange market by the central bank.

The provisional data indicates that the balance of payments remained buoyant, albeit, the overall surplus balance declined from 9.8 percent of GDP in 2006 to 4.9 percent. The surplus balance on the current account declined from 18.9 percent of GDP in 2006 equivalent to 16.3 percent mainly due to unfavourable developments on the merchandise trade and services accounts.

Graph 3.47 : Trends in Imports and Exports



Merchandise trade, which represented about 90.4 percent of the balance on the current account, fell by 28.4 percent on account of a significant increase in non-oil imports, which rose by 53.5 percent in 2007 against 27.4 percent in the preceding year. The expansion in non-oil imports was driven by a higher

demand for vehicles, intermediate and final goods. On the other hand, net oil exports grew by 13.6 percent compared to 1.9 percent in 2006. Services received in respect of transportation, travels and others as well as payments made abroad on account of investment income also contributed to the developing rigidity in the current account. The capital and financial account recorded a significant improvement in 2007 as the deficit balance enhanced from 12.0 percent of GDP to 8.0 percent by end-2007. This improvement was attributed to a reduction in other investment liabilities. Transactions in the balance of payments resulted in a build-up in the stock of gross external reserves from US\$ 42,298.0 million to US\$ 51,333.2 million, representing 16.1 months of imports cover.

As in recent years, the massive foreign exchange inflows continued to have an upward pressure on the domestic currency, although it remained relatively stable. Further to the 2.8 percent and 0.7 percent upward movements recorded in the consecutive years of 2005 and 2006, the naira appreciated by 7.7 percent against the U. S. dollar in 2007.

After redemption of its debts with the Paris and London clubs, the country's external debt position as at end-2007 stood at US\$ 3,348.2 million, representing 4.0 percent of GDP. The level of external debts relative to exports (of goods and non-factor services) also decreased from 8.0 percent at end-2006 to 4.7 percent. These statistics indicate that the external debt position is sustainable³.

NIGERIA: EXTERNAL DEBT SUSTAINABILITY

	2001	2002	2003	2004	2005	2006	2007
External debt/GDP	46.0	48.1	42.2	41.9	30.8	2.5	4.0
External debt/export of goods and non-factor services	169.5	214.8	135.8	104.5	62.4	8.0	4.7
External debt service/export of goods and non-factor services	18.0	8.1	7.6	5.1	18.7	15.3	0.2
External debt service/GDP	4.9	1.8	2.4	2.0	9.2	4.8	0.1

1.4 Monetary Sector

Consistent with the 2007 macroeconomic policy thrust, the Central Bank of Nigeria pursued a restrictive monetary policy stance aimed at attaining single-digit inflation. In this regard, the bank issued tenured repos and other financial instruments aimed at enhancing liquidity management and introduced other measures to reduce the large spread between the savings and lending rates.

Contrary to the policy expectation, money supply rather expanded in 2007. Reserve money, the intermediate target of the Central Bank of Nigeria increased significantly by 56.7 percent against a growth rate of 27.8 percent recorded in 2006. Consequently, broad money supply grew by 30.9 percent, basically reaching the same growth level recorded in the preceding year. The expansion in broad money supply reflected significant increases in all the monetary aggregates, especially in demand deposits.

NIGERIA: GROWTH IN KEY MONETARY AGGREGATES

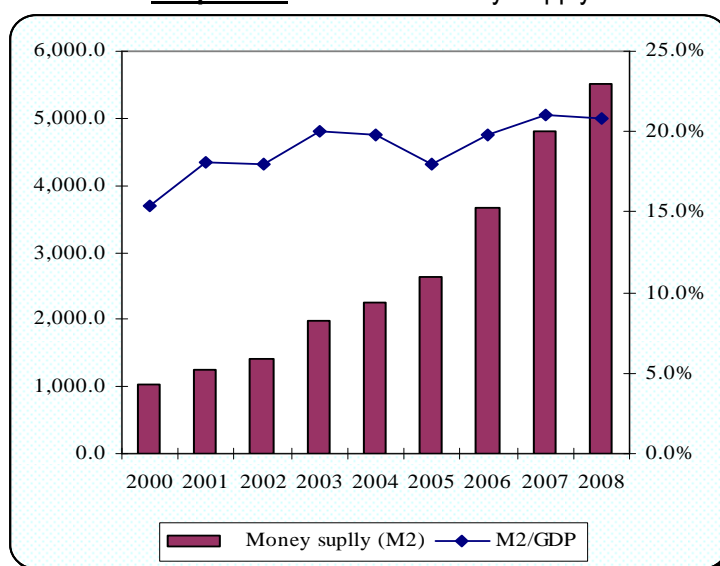
MONETARY AGGREGATES	2001	2002	2003	2004	2005	2006	2007
Reserve Money	-	30.7	16.4	6.3	4.2	27.8	56.7
Broad Money (M2+)	20.7	12.1	41.6	14.0	24.4	30.5	30.9
Narrow Money (M1)	15.7	2.7	58.7	8.6	29.7	12.1	32.4

³ A country's external debt position is generally considered sustainable if the scheduled debt service payments are below 25.0 percent of exports of goods and services and the ratio of the debt to exports is below 250.0 percent.

Currency In Circulation	-0.1	6.0	8.4	8.7	17.7	21.3	23.3
Demand Deposits	33.9	0.9	45.4	7.2	33.3	7.1	47.2
Quasi Money	29.2	26.2	16.3	22.8	16.8	59.7	29.3
Foreign Currency Deposits	-	75.8	47.7	40.7	9.3	111.4	17.7

The growth in broad money was driven by sustained increases in both net foreign assets and net domestic assets of the banking system. Further to the increases of about 51.0 percent in the consecutive years of 2005 and 2006, net foreign assets increased by 18.5 percent in 2007, driven by significant foreign exchange inflows. Total credits extended by the banking system to the private sector nearly doubled to ₦5,049.5 million, thus, explaining the relative enhancement in demand deposits. However, the government repaid a significant proportion of its outstanding indebtedness to the banking system.

Graph 3.48 : Trends in Money Supply



Against the backdrop of the relative increase in broad money supply within the last couple of years, the government achieved its programmed low inflation objective. The end-period inflation abated moderately from 8.5 percent to 6.6 percent by December 2007. A number of factors accounted for this development, including, the slow down in demand under the strict implementation of the oil-price-based fiscal rule, the appreciation of the domestic currency (naira) and easing food prices due to favourable output.

The movement in interest rates generally remained mixed during the year under review. Whilst the yield on government treasury bills and other short-to-medium term financial assets increased marginally, the average savings and lending rates continued to trend downwards. The 91-day treasury bills rate increased marginally from 7.5 percent to 7.9 percent and the 12-month deposits rate also increased by 47.0 basis points to 7.9 percent. The minimum rediscount rate of the central bank also stood at 9.5 percent at end-2007, having declined by 50.0 basis points during the year. Whereas the inter-bank rate was maintained at 9.0 percent, the average savings and lending rates declined marginally by 6.0 and 13.0 basis points to 3.2 percent and 16.5 percent respectively.

2 Performance under Macroeconomic Convergence

Nigeria, one of the leading countries under the convergence programme, sustained its performance by meeting the same five targets realized since 2005, comprising the three primary benchmarks of budget deficit, central bank budget deficit financing and gross external reserves) and two secondary criteria in respect of salary mass and public investments.

NIGERIA: STATUS OF MACROECONOMIC CONVERGENCE

	target	2001	2002	2003	2004	2005	2006	2007	2008
Primary Criteria:									
i) Budget Deficit/GDP	≤4%	3.2	3.9	-13.3	-21.2	-24.8	-22.1	-14.3	-13.1
ii) Inflation Rate	≤5	16.5	12.1	23.8	10.0	11.6	8.5	6.6	7.3
iii) Budget Deficit Financing	≤10%	29.3	0.0	12.0	0.0	0.0	0.0	0.0	0.0
iv) Gross External Reserves	≥6m	11.3	7.3	5.6	13.6	11.8	15.1	16.1	19.8
Secondary Criteria:									
i) Domestic Arrears	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
ii) Tax Revenue/GDP	≥20%	14.7	10.0	11.1	14.6	16.8	14.9	10.5	9.9
iii) Salary Mass/Tax Revenue	≤35%	28.0	47.2	26.9	21.7	17.7	19.5	31.6	31.0
iv) P. Invest/Tax Receipts	≥20%	71.1	83.1	21.4	23.0	23.9	23.9	35.7	31.3
v) Real Interest Rate	≥0	-13.1	-8.4	-20.6	-5.6	-8.3	-5.2	-3.4	-4.1
vi) Real Exchange Rate**	±10%	11.1	-0.5	-5.4	2.7	15.0	7.4	-12.2	2.7
Total No. Of Criteria Met		4	5	3	6	5	5	5	6

Source: CBN, WAMI

*projected end-2007 data

2.1 Primary Criteria

Performance under the primary criteria was encouraging. Government operations resulted in a significant budget surplus of 14.3 percent of GDP. Even after the application of the oil-based fiscal regime, the budget deficits of 2.3 percent and 1.8 percent recorded in 2006 and 2007 respectively were favourably below the required target of 4.0 percent. However, the government needs to address the social agitations in the Niger delta and erratic power supply in order to sustain the efficiency of the revenue mobilization apparatus.

In spite of the increase in broad money supply, inflationary pressures continued to abate, although the required target was missed by 1.6 percentage points. Favourable output helped to dampen the inflation pressures.

As has been the case in recent years, the central bank did not accommodate government operations during the year under review. The Federal Government settled a significant proportion of its indebtedness to the banking system, given the high revenue returns.

The country's gross external reserves remained high at 16.1 months of imports cover, well above the minimum requirement of 6.0 months. The windfall returns on crude oil exports and other foreign exchange inflows continued to impact positively on the external reserves of Nigeria, which however contributed to a further appreciation of the domestic currency.

2.2 Secondary Criteria

Performance under the secondary criteria was rather not very encouraging. The criterion on domestic arrears could not be assessed due to inadequate data. Considering its significance to the convergence programme, it is necessary for Nigeria to provide the required data for analysis.

The level of tax revenue relative to GDP continued to dwindle from 14.9 percent of GDP to 10.5 percent. The country's over-reliance on crude oil exports, the relative slowdown in economic activity and the recent adoption of the ECOWAS common external tariff regime contributed to this declining trend.

The wage burden relative to tax revenue was however within the required maximum limit, albeit, the level increased significantly from 19.5 percent to 31.5 percent. This relative increase in the wage burden may be attributed to the decrease in tax revenue and an enhancement in the size of the public sector.

The level of public investment financed from domestic resources increased significantly from 23.9 percent to 35.7 percent. This improvement was attributed to massive investments undertaken in the agricultural sector under the presidential special initiatives and other infrastructural developments.

The prevalence of negative real interest rates, measured as the difference between the minimum savings rate and inflation, persisted in 2007. The downward movement in the average savings and lending rates suggests excess liquidity within the banking system. Coupled with the large spread between the savings and lending rates, the negative real interest rates may thwart efforts in financial intermediation and investment.

In spite of the relative stability of the domestic currency, real exchange rate stability was not achieved, possibly, due to the appreciating nominal exchange rate.

3 Prospects for 2008

The outlook for 2008 appears favourable considering the impact of the rising crude oil price, efforts in private sector development and massive investment in agriculture, communication, banking and other services. The macroeconomic programme of Nigeria indicates that the economy would grow by 9.0 percent in 2008. The downside risks to this expectation are the limited power supply, persistent social unrest in the Niger Delta and bottlenecks in transportation and business infrastructure.

The economy is likely to remain stable, given the favourable supply conditions. However, the massive foreign exchange inflows and ongoing agitations from the state and local governments for sharing of excess crude oil revenue may derail the relative stability attained in 2007, if this problem is not addressed. The appreciating currency may further accentuate budding constraints in balance of payments if immediate measures are not taken to maintain the country's external competitiveness with its trading partners. The government would need to sustain further liberalization of the financial market to encourage the prevalence of positive real interest rates and reduce the large spread between the savings and lending rates in order to maintain the investment momentum.

The projections further indicate that the performance of Nigeria under macroeconomic convergence would not improve slightly in 2008. The country may meet six targets by sustaining its performance in 2006 and meet the target on real exchange rate stability. However, the projections show that even though inflation would be contained within the single digit range, it may be difficult to realize the required target of 5.0 percent, *ceteris paribus*. The authorities would also grapple with tax revenue and negative real interest rates.

4 Conclusion and Recommendation

The economy has generally been resilient in achieving programmed objectives in all sectors of activity. However, the unrelenting social unrest in the Niger delta and erratic power supply adversely affect the performance of the real sector.

Despite the relative improvement in fiscal policy, the country still has a problem meeting its tax revenue target. It may be necessary to strengthen the tax mobilization apparatus and coverage. In the monetary sector, the central bank has been effective in controlling inflation to a large extent. However a lot still need to be done to reduce the pressures further. Monetary policy also needs to be strengthened to enhance liquidity management and sterilise the massive foreign exchange inflows to stem the continual

appreciation of the domestic currency which may adversely affect the country's competitiveness in the long-run.

The sluggish performance of the oil sector and the country's increasing demand for imports provide substantial constraints on the balance of payments. The external sector would require reforms to enhance non-oil exports and address the country's over-reliance on crude oil.

Against the backdrop of the above limitations and downside expectations, the following recommendations may be relevant for Nigeria:

1. strengthen the institutional tax collection structures and expand the tax base;
2. strengthen monetary policy to address the lingering excess liquidity problem by issuing high yielding medium to long-term financial instruments and intensifying open market operations;
3. adopt a realistic interest rate policy to encourage private sector investment;
4. sterilize the additional income arising from the escalating crude oil prices in order to control aggregate demand and inflation;
5. establish relevant infrastructure and pro-poor economic ventures to provide employment in the Niger delta in order to address the social unrest in this area.