GLOBAL FINANCIAL AND ECONOMIC CRISIS: HOW VULNERABLE IS NIGERIA?

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OUTLINE

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I. Introduction

II. Causes of the Crisis

III. Impact of the Crisis on Global and National Economies

IV. Global and Country Responses

V. Impact on the Nigerian Economy

VI. Response by Nigeria

   I. Exchange Rate Adjustment as Key Shock Absorber

VII. Threats, Opportunities, and the Road Ahead

VIII. Concluding Remarks

1. Introduction

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- Current Global Crisis started as a ‘financial crisis’ but now a ‘Global Economic Crisis’
- The crisis is unprecedented in severity of credit contraction (credit crunch & capital crunch).
- The roots are in banking rather than in securities market or foreign exchange.
- The Crisis started in the U.S (due to certain laxities in the US financial system), spread to Europe, and has become global. Even countries not affected by the financial crisis are now affected by ‘second-round effects’ as the crisis now becomes ‘economic’.

Introduction……

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- The financial crisis started in the U.S in August 2007 with sub-prime mortgage crisis as households faced difficulties in making higher payments on adjustable mortgages.

- By the first quarter of 2008, there was widespread "credit contraction," as financial institutions in the US tightened their credit standards in light of deteriorating balance sheets.

- By the fourth quarter of 2008, increased delinquency rates affected not **only sub-prime** loans but also spilled over into **consumer and other credits.**

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Introduction…..

- Credit Squeeze
  - Reduced lending to the real sector (supply side)
  - Reduced household demand (demand side)
- Wealth Effect
  - Decreasing asset values (e.g., stocks and real estate) led to a loss of consumer confidence and a precipitous decline in consumption; these translated into sharp decline in economic activities
- Job Losses
  - Decreased economic activity resulted in massive job losses in most sectors of the economy

II. Causes

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- Financial innovations:
  - leveraging, swaps, sub-prime lending, etc.
- Loose regulatory regimes and several unregulated financial markets and products
- Uncoordinated and late interventions by Governments and Central Banks
- Easy monetary policy in the aftermath of 9/11 to avoid a recession
  - With high liquidity, investor/lenders seek higher returns through riskier investments

Causes. . .

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- False assumption of an ever increasing housing prices, leading to sub-prime mortgage lending

- Continued fall in house prices and borrowers inability to refinance, thus leading to defaults

- Investment banks exposure through leveraging

- With crash of structured products and mortgage market, consumer loans and mortgage market distress, led to counter- party risk

Causes. . .

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- Rising illiquidity
- Banks stopped lending and recalled some of their loans; potential financial instability
- Stock markets burst
- Pressure on banks to raise capital:
  - Huge write-downs
  - Ratings downgraded

III. Impact of the Crisis on Global and National Economies

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Impact on the Global Economy

- Declining real output growth—slowed economic growth (threat of global recession)
- Weakened financial systems—takeovers and bankruptcy
- Loss of jobs
- Loss of confidence in financial markets- leading to inability to carry out their intermediation role in the economy.
- Stock Market Crashes

Impact of the Crisis on the Global and National Economies (contd.)

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- Liquidity and Credit crunch, leading to confidence crisis, weak consumer demand
- Sub-prime crisis of 2007 and breakdown of confidence in the banking system
- De-leveraging and banks inability to improve capital adequacy
- Possible protracted recession in the US and Europe, with upturn expected perhaps in 2010 and 2011

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Selected World Stock Market Indices, %Change (December 2007-November 14, 2008)			
Argentina (MERV)	(52.8)	Japan (Nikkei)	(44.7)
Australia (ALL Ord)	(42.0)	Malaysia (EMAS)	(40.8)
Belgium (Bel 20)	(50.1)	Mexico (BOLSA) Index	(33.3)
Brazil (BVSP)	(44.0)	Nigeria (NSE)	(35.6)
Britain (FTSE 100)	(34.6)	Poland (WIG)	(52.0)
Canada (S & P TSX)	(33.3)	Russia (RTS)	(72.9)
Chile (IGPA)	(14.4)	Saudi Arabia (Tadawul)	(50.3)
China (SSEA)	(63.3)	Singapore	(49.2)
Egypt (Case 30)	(54.3)	South Africa (JSE AS)	(34.1)
Emerging Market (MSCI)	(57.4)	South Korea (KOSPI)	(42.6)
France (CAC40)	(41.8)	Spain (Madrid SE)	(43.1)
Germany (DAX)	(42.2)	Switzerland (SMI)	(31.5)
Ghana (GSE-All Share)	60.7	Turkey (ISE)	(54.7)
Hong Kong (Hang Seng)	(51.3)	USA (DIJA)	(33.9)
India (BSE)	(53.7)	USA (S&P 500)	(40.5)
Isreal (TA-100)	(48.5)	World Developed Market (MSCI)	(44.6)
		World, all (MSCI)	(46.2)

IV. Global and Country Responses

- Types—direct (Treasury) or indirect (Central Banks) or both. Measures taken by countries have varied, but the actions can be summarized under several categories as follows:
  - interest rate cuts and liquidity injections by Central Banks
  - capital injections into banks/companies by Governments (e.g. U.K. & U.S.A.)
  - lending guarantees by Governments to restore liquidity, and
  - reviving the ailing banking system through recapitalization and strengthening of supervision
  - bank deposit guarantees,
  - Minimizing market disruptions – crackdown on short selling
  - Fiscal Stimulus packages to shore the economy out of recession--- stimulating aggregate demand
  - Subsidies to ailing sectors

V. Impact on the Nigerian Economy

- Commodity prices collapse (especially oil price)
- Revenue contraction (possible burst syndrome)
- Declining capital inflows in the economy
- De-accumulation of foreign reserves and pressure on exchange rate
- Limited foreign trade finances for banks—credit lines may dry-up for some banks.
- Capital market downturn, divestment by foreign investors with attendant tightness and possible second round effects on the balance sheet of banks by increasing provisioning for bad debt and decrease in profitability
- Counter party risks vis-à-vis external reserves but CBN has taken measures to safeguard the reserves
- Nigerian banks remain robust to withstand the shocks

VI. Response by Nigeria

- Presidential Steering Committee on Global Economic Crisis --- January 16, 2009
- Presidential Advisory Team on capital market set up (Aug. 2008) to deliberate on measures to reverse the declining fortunes of the Nigerian capital market.
- SEC, NSE and all capital market operators reduced fees by 50%.
- NSE reviewed trading rules and regulations.
- 1.0 per cent maximum downward limit on daily price movement and 5.0 per cent on upward movement. This has been harmonized to 5 % either way from end-October 2008.

Response by Nigeria (contd.)

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- SEC released guidelines/rules on market makers.
- Strict enforcement of NSE's listing requirement with zero tolerance for infractions.
- NSE de-listed 19 moribund companies.
- Rules on share buy-back have been released, with a limit of 15.0%.

Response by Nigeria (contd.)

- Central Bank has reacted by the following measures:
  - Reduction of the MPR from 10.25 per cent to 9.75 per cent
  - Reduction in Cash Reserve Requirement (CRR) from 4.0per cent to 2.0 per cent
  - Reduction of Liquidity Ratio from 40 .0 per cent to 30.0 per cent
  - Directive to banks that they have the option to restructure margin loans up to 2009
  - Expanded lending facilities to banks up to 360 days
  - Introduced expanded discount window facility
  - Stopped Liquidity Mopping-up since September 2008

VII: OUTCOMES SO FAR AND PROSPECTS

- GDP growth rate increased from 6.2% in 2007 to estimated 6.8% in 2008 (NBS) despite the global crisis (with non-oil growth at 9.5%, while oil sector declined by 4.5%)
- End period HEADLINE inflation in Dec. 2008 was 14.6%, while CORE (non-food) inflation was 9.2%
- Credit to private sector grew by over 50% by end Dec 2008
- GROSS liquidity injections by CBN through expanded discount window and repayment of maturing OMO bills from September '08 to Jan.7, 2009 stood at about N2.2 trillion. This has moderated interest rates in the money market, and currently interbank rates below the MPR.
  - Expanded Discount Window facility to banks now stands at N275 billion (down from N1 trillion as banks repay the temporary loans)
  - Repayment of Maturing OMO bills since Sept 2008 is N1.2 trillion
- Stock of External Reserves stood at US$52.9 billion as at end Dec. 2008, with 'Excess Crude' balances at about $20 billion (relative sharp decline in the inflow of forex relative to the demand pressure).

OUTCOMES AND PROSPECTS….

- Exchange Rate allowed to adjust to reflect the demand pressures relative to supply: Exchange rate depreciated from N117 to N135 per US dollar as at end of Dec 2008
- Currently, exch rate depreciation approx. 20%, effectively translating to about N2.5 bn extra revenue per day to the Federation Account
- Stock Market remained depressed as at end Dec 2008.
- Outlook for oil price in 2009 is about $51 (optimistic range) and below $51 on the pessimistic range)
- Growth rate of GDP betw 7- 9% still possible--- despite the economic crisis (Nigeria won't experience economic recession)

VIII: Threats, Opportunities and The Road Ahead

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- <u>Threats</u>
- Oil price shock: Fiscal and BoP pressures (Recall similar crisis in 1982): The Obama Government to invest heavily on Alternative Energy Sources– with a permanent threat to oil as mainstay of economy
- Fiscal burden and threat of Abandoned projects syndrome
- Pressure on Exchange Rate and Foreign Reserves
- High level of excess liquidity in the economy plus rising fiscal expansion will pose great challenge to the Central Bank
- Inflationary Threat as CBN relaxes monetary policy
- Possible Fiscal Deficits at all levels and crowding-out of private sector credit and risk of banks' credit concentration
  - Government deficits mean that interest rates will continue to be 'high'
- Possibility of Reduced confidence in business environment
- Possibility of Renewed Debt accumulation by various tiers of govt
- Continued depression of capital market could lead to higher loss provisioning by banks thereby reducing profitability and lending

Threats . . . .

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- Nigeria to possibly miss 2 out of 4 ECOWAS Convergence Criteria for common currency (inflation and deficit to GDP ratio)
- Probably lower GDP growth rate if adequate measures are not taken
- Oil production and the Niger Delta Challenge
- Possible political pressures to spend the ‘excess crude’.
- Falling commodity prices abroad and freight costs may cheapen imports and threaten domestic industrial and productive base
- US dollar as global reserve currency and possible inflationary spiral and Dollar crash, with implications for the value of Nigeria’s foreign reserve (could trigger global currency crisis)

Opportunities……

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- How is the crisis different from 1982 crisis?
- Nigeria Not insulated from crisis, but prepared better for it than in 1982 (Better 'Shock-Absorbers' Now than in the past to withstand the shock)
  - Debt Relief (effectively saving about $4bn in annual debt service payments)
  - Banking Sector consolidation and competitiveness: well capitalized banks with capital adequacy ratio of 22%--- one of the highest in the world: Banking sector to provide significant funding for various tiers of govt in 2009.
  - Robust External Reserves (about $52 billion) with 'Savings for the Rainy Day" ($20 bn) as possible cushion
  - Liberalized economy--- forex market, and private sector-led economic framework
  - More active capital market for raising capital
  - Better Fiscal and Monetary Policy Regimes

Opportunities…..

- Huge “Growth Reserves” to be exploited---60% of arable land for agriculture remains fallow; solid minerals; gas; infrastructure, etc
- Nigeria may continue to attract FDIs, particularly in the oil and gas sector and portfolio inflows due to high returns to investment
- Lower world prices will benefit Nigeria because of her large imports: This is time to target strategic capital investment in sectors where input prices are depressed globally
- Lower freight costs

Opportunities…. Role of Nigerian banks?

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- Accounts for over 90% of financial system asset
- Dominate the Stock market
- Banks are Nigeria's multinational companies
- Increasing dominant source of financing for the economy (more credit to the private sector than Federal Govt. expenditure) and also state governments
- Banks constitute the Engine of the economy for the near term which must be guarded!

Opportunities…. Are the Banks under Threat?

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- Not significantly!
  - Capital base as at end Sept. 2008 was N2.7 trillion
  - Exposure to capital market below N900 bn
    - Even if you wipe-off all of them, capital adequacy ratio still about 15% higher than most countries
  - Rate of profitability may reduce but large scale losses may not occur
  - Policy on Foreign banks has helped to minimize exposures
  - Interbank market active
  - Banks' lending activities still high
  - Aggregate credit to private sector growing "too high"--- according to World Bank/IMF
  - Credit to private sector about N7.4 trillion by end of 2008, up from about N4.6 trn in 2007 or about 60% growth.

Opportunities… Why Nigeria is not very vulnerable!

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- Merrill Lynch – one of the world's leading financial management and advisory companies ranked Nigeria among ten least vulnerable economies in the world.

- Risk ranking based on 7 indicators:

  Current Account financing gap;

  FX Reserves/Short term External Debt Ratio;

  Export/GDP Ratio; Private Credit/GDP Ratio; Private Credit Growth; Loan/Deposits Ratio; and Banks Capital / Asset Ratio.

  - Europe, Middle East and Africa (EMEA) most vulnerable
  - BRIC the safest

Opportunities…. Features of Vulnerable economies

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- Worsening Balance of Payments Position
- Over Stretched External Debt Service Ratio
- Overleveraged Financial Systems

Exchange Rate Adjustment as an Opportunity/Shock- Absorber

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- Key benefit of flexible exch rate regime is to adjust in face of external shocks
- Major currencies around the world have adjusted in the face of dwindling resource flows (UK pound sterling; South African Rand; South Korea; Ghanaian Cedi; India; and many more)
- Supply of foreign exchange to Nigeria declined due to:
  - Falling oil price (from peak of $147 to about $34
  - Falling portfolio, FDI, and remittance inflows
  - Decline in trade/credit lines to banks from foreign banks

Exchange Rate Adjustment as an opportunity….

- Demand for forex increased due to:
  - Demand for forex by foreign investors in the stock market who were exiting
  - Import level of the economy already high, and likely to increase due to declining prices of goods abroad because of the recession as well as drop in freight costs
  - Demand for forex by Nigerians wanting to invest in cheaper assets abroad (stocks, houses, etc)
  - Demand for forex to meet maturing debt obligations
  - Foreign institutions recalling existing loan facilities
  - Demand by speculators who believe that exch rate may depreciate in the future since Govt would unlikely defend the Naira indefinitely if External Reserves continue to fall

Exchange Rate Adjustment as an opportunity . . .

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- Timely adjustment needed to avoid the disastrous consequences of delayed response or the 1982 Experience
  - Preserve the External Reserves (Russia lost about one quarter of its reserves in 6wks due to delayed adjustment; South Korea lost hundreds of billions, etc
  - If the Reserves are allowed to be run down completely, the exchange rate would then adjust in a most drastic form which other countries have experienced (recall Ghana; and many others)
  - With cheaper import prices, it would be cheaper to import everything than produce them in Nigeria, and imports would wipe out domestic industries, thereby increasing unemployment. Exchange rate adjustment is a defence for local jobs

Exchange Rate Adjustment as an opportunity. . .

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- Exchange rate adjustment ensures that Govt budget continues to function:
  - Recall the 1982 oil price shock and with FIXED exchange rate, with consequences including:
    - Abandoned projects all over Nigeria
    - Salary arrears
    - Massive retrenchment of civil servants, and unemployment
    - Austerity measures, including queuing up for the "Essential Commodities"
    - Massive import bans
    - Resort to import licensing, and even making it illegal to be found with foreign currency (recall the Fela trial)
  - Recall that 2009 budget is a deficit budget even with zero capital spending at $45 per barrel; imagine the scenario at $34 or less without exchange rate adjustment

Exchange Rate Adjustment as an opportunity. . .

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- Will Depreciation be Highly Inflationary?
  - NOT Necessarily:
    - Prices of imported goods abroad have fallen by more than 20% on the average; some even more than 50%. Thus, a 20% depreciation could at most leave prices unchanged. Any such price adjustment will be temporary and cannot be sustained once exch rate stability returns.
    - It depends on what happens to agricultural output, and other domestic production
- Strategy of Adjustment?
  - Shock Therapy--- quick adjustment to avoid the consequences of painful, long adjustment
  - Long drawn out depreciation would have wiped-off the Reserves before you get to the 'appropriate' level

Exchange Rate Adjustment as an opportunity. . .

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- Outcome and Outlook?
  - Fear and Speculation invaded the market
  - We warned that speculators would be punished
  - Rates quickly went up (official rate went up to N150; interbank went up to N162; while BDC rate went up to N170 per US dollar)
  - CBN implemented sweeping changes including return to Retail Dutch Auction System; reduction in banks' open position limit from 20% to 5%; and BDCs can only buy and sell forex within 2% around the CBN rate
  - Rates have crashed down within the range of N144 – N149 in all markets within 7 days
  - Speculators who bought dollars at over N150 per dollar may have lost a lot of money

Exchange Rate Adjustment as an opportunity . . .

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- Outlook?
  - CBN committed to stable exchange rate regime
  - Will keep the rate stable, and monitor the developments in the forex market. It is possible the Naira could strengthen further
  - So far the official and bureau de change (BDC) rates remain within a margin of plus or minus 2 - 5%---- signaling a convergence of the rates!
  - The Exchange Rate regime will continue to be a key shock absorber for the economy--- to keep internal and external balance.

The Road Ahead….

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- Renewed vigor in implementation of Vision 2020, 7- Point Agenda, and FSS2020
  - Agriculture; Infrastructure; Financial sector; Gas, Housing/mortgage; as key growth sectors to target
- Fiscal adjustment
  - Fiscal Responsibility; Procurement reforms; Sensitivity to Fiscal sustainability and value-for-money spending
- Tax, Tariff, and Ports Reforms urgent to stimulate the economy
- Deepening market institutions--- competition and anti-trust policy; regulatory regimes
- Deepening regulation and supervision of financial services sector
  - Against pro-cyclical regulatory policy
- Aggressive Legislative reforms (key laws to unleash the economy)
- Cooperative Federalism required as a response (State govts and Fed. Govt must coordinate intensely)

The Road Ahead . . .

- CBN to ensure market determined but Stable Exchange Rate regime (but avoid FIXITY).
- CBN to continue to focus on banking/financial system stability
  - Intensify surveillance and watch out for early warning signals of possible systemic distress and either act proactively to prevent such or advise Govt on possible responses
- Financial sector reforms under FSS2020 to deepen consumer credit, and mortgage
- CBN to work with relevant MDAs and private sector to mobilize and disburse special credit (N200—N500 billion) for agriculture; housing; and possibly infrastructure.

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Thank You For Listening