Non-Oil Exports, Economic Growth and Macroeconomic Stability

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I. Introduction

The topic that I was asked to write about is "Stimulating Non-Oil Exports for Revenue Generation During Economic Downturn". In the process of preparing this paper, it became clear to me first that increased non-oil exports would not necessarily make up for the fall in government revenue arising from the oil price slump and second that increased non-oil exports would be critical for economic growth under all circumstances. Based on this assessment, I have chosen to examine the role of non-oil exports in promoting economic growth and development in the medium to long-term context, and in enhancing macroeconomic stability in the short-term context. In both cases, the Central Bank has important policy responsibilities to carry out. In addition, both cases should be jointly addressed for at least two reasons. First, the policy instruments required for both are either the same or are closely related. Second, the decisions taken for maintaining short-run macroeconomic balance typically have implications for the medium to long-term economic growth and development outcomes as well.

In the rest of this paper, Section 2, discusses the role of non-oil exports in the structural transformation and sectoral diversification processes which are inherently associated with sustainable growth and development. In Section 3, the focus of the analysis shifts to an examination of the role of non-oil exports in the context of short-term macroeconomic management. Effective and productive policy making over the short-, medium- and long-term must take account of the necessity for managing the inevitable policy trade-offs that will be confronted. This constitutes the focus of Section 4. The paper concludes in Section 5.

II. Structural Transformation and Sectoral Diversification

Structural transformation of an economy occurs with the reallocation of resources across different sectors and products. The process of structural transformation is driven by differences in sectoral productivity. In particular, the structural transformation process is growth- and development-enhancing
when it involves resource shifts from lower to higher productivity sectors or sub-
sectors. In comparison, diversification represents the shift to a more varied 
structure manifested by the introduction of new products, higher quality 
products, or the expansion of existing ones. Diversification can occur in the 
forms of output and export. In the former case, it is called domestic sector 
output diversification or the production of a wider range of products. In the 
latter case of exports, diversification can occur either in the form of a wider 
range of products exported or in the form of exports to a larger number of 
export markets or trading partners. In general, countries achieve higher levels 
of export diversification when their export revenues are generated from a 
wide mix of export products and trading partners. In the early stages of a 
country’s economic development, structural transformation and sectoral 
diversification are likely to be closely linked. Thus, the development process of 
the typical low-income country begins from specialisation in a narrow range 
of primary commodity activities, such as agriculture and mining. Structural 
transformation, from this base, through reallocation of resources would 
probably involve diversification into broader production and export structures.

Economic theory asserts and the historical experiences of many countries 
confirm that structural transformation and sectoral diversification are 
necessary for ensuring that economic growth is sustainable and inclusive. In 
particular, structural transformation and sectoral diversification play important 
roles in influencing the macroeconomic performance of developing 
countries. Diversification of domestic production exports facilitate faster 
growth and greater macroeconomic stability.

Many of the success stories of structural transformation and sectoral 
diversification processes that have generated rapid and sustained economic 
growth and development have been based on sectoral diversification in 
favour of manufacturing industry which exhibit many growth enhancing 
features. It is more productive than other sectors; tends to be labour-intensive, 
especially in the early stages of industrialisation and hence, can absorb the 
increasing labour supply shed by the agricultural sector. Manufacturing is 
associated with greater product sophistication which causes higher per 
capital growth in output; and the broader diversification potentials in the 
manufacturing sector that tend to cushion price volatility. As a result of these 
features, the economies of many of the countries that have successfully 
achieved sustainable economic growth and development based on 
structural transformation and sectoral diversification are associated with 
increasing share of the manufacturing sector in GDP as well as rising share of 
manufactured exports goods in total exports.
Nigeria aspired to achieve similar result between the 1960 and mid-1970s by adopting an import substitution industrialisation strategy (ISi) as a means of diversifying the economy away from agriculture. But there were two fatal policy errors. First, the success conditions associated with ISi were not met. These conditions include selection of the beneficiary industries on the basis of their specific features, granting of protection over a limited duration and subject to clear performance standards, and readiness to remove protection when the performance standards are not met. In actual practice, tariff protection was routinely granted to all indefinitely and without any analysis of their growth enhancing features. Second, the use of ISi strategy has an in-built weakness relating to its demand for foreign exchange. While protection from foreign competition which typically applies to the domestic production of final consumer products can save foreign exchange, the foreign exchange requirements for the import of raw materials, semi-processed inputs and capital goods (machinery, etc.) tend to increase with volume of production. This is why ISi must be export-oriented. In actual practice, Nigeria’s manufacturing sector was not designed to be export-oriented. Its generous protection and other incentives focused on meeting domestic demand.

The emergence and immediate dominance of oil from the mid-1970s ultimately struck the final blow. Since it provided an immediate source of foreign exchange, it appeared to solve the problem of the manufacturing sector’s increasing demand for foreign exchange to meet its raw materials and other input requirements. But due to the volatility of global oil prices, this problem continued to surface and to periodically cripple the manufacturing sector by drastically reducing its capacity utilisation. This has done serious damage to the dynamic growth of Nigeria’s manufacturing sector. But it, in fact, represents a minor irritation compared to the second problem.

This second problem emanates from what the literature calls the “Dutch Disease”. When an economy has a dominant and booming tradable sector (such as oil) which brings into the economy huge amounts of capital inflows, the economy’s equilibrium real exchange rate tends to appreciate! This means that the external value (in terms of foreign currencies) of the domestic currency rises. This, in turn, means that the prices of tradable imports are lower in the domestic market, while the domestic exports are higher in price in foreign markets. As a result, the domestically produced goods find it more difficult to compete with imported products in the domestic market and virtually impossible to compete in export markets abroad. To some extent, increased tariff protection and import prohibition may enable domestic
producers to survive in the domestic market, but only at the expense of domestic consumers whose welfare is reduced in the process.

As indicated earlier, the developing countries of the 1950s and 1960s which were successful in achieving sustainable economic growth and development through structural transformation and sectoral diversification are characterised by two important features: large and increasing share of manufacturing sector in GDP, and high and rising share of manufactured exports goods in total exports. By comparison, Nigeria’s output and trade structures are deficient on both counts. More specifically, Nigeria’s economy features both a small and falling manufacturing sector output share of GDP and a minimal and diminishing contribution of manufactured exports in total exports. In effect, while Nigeria experienced fairly rapid economic growth between 1995 and 2013, this performance was essentially driven by the oil boom associated with the commodity super cycle of that period. The growth episode was apparently not associated with structural transformation and sectoral diversification.

More specifically and as the rebased GDP series shows, the contribution of manufacturing sector to GDP remained in single digits at 6.6, 7.8, 7.8 and 9.3 per cent, in 2010, 2011, 2012 and 2013, respectively. In terms of structure, Nigeria’s manufacturing sector’s output is dominated by low-level technology. Over the period of 2010-2012, the food, beverages and tobacco (FBT) sub-sector accounted for an average of 66.8 per cent of total manufacturing sector’s output.

This was followed by textiles, apparel and footwear (TAF) sub-sector’s average share of 14.3 per cent; and that of other manufacturing (OM) sub-sector’s average contribution of 6.9 per cent over the same period. Thus, these three sub-sectors accounted for an average of 88.0 per cent of total output of Nigeria’s manufacturing sector. Furthermore, sugar’s share of FBT’s total output was 42.9 per cent over the period, while that of bread was 23.4 per cent. Thus, sugar and bread accounted for 66.3 per cent of the total output of FBT which, in turn, accounted for 66.8 per cent of the total output of Nigeria’s manufacturing over the 2010-2012 period.

In the case of exports, the share of non-oil goods averaged 29.6 per cent over the same period. The poor performance of non-oil exports has its roots in the corresponding adverse production incentives that are generated by the effect of the capital inflows associated with the oil-boom which appreciated the equilibrium real exchange rate. Due to the repressive effect of this on non-
oil tradables, Nigeria’s manufacturing sector has generally been unable to take advantage of generous trade that Epstein (2006), associated with the European Union in the context of the series of Lome Convention and Cotonou Partnership Agreement since 1775, as well as that offered by the United States through its African Growth and Opportunity Act (AGOA). In the specific case of the AGOA whose preferential margins in the case of garments and apparels were generous and fully utilised by other African countries, Nigeria’s own policies constituted the major constraint. By imposing very high import tariffs or prohibition of textiles, the incentive structure produced the result that textiles accounted for an average of 91.7 per cent of the TAF total output; with garments and apparel accounting for only an average of 1.6 per cent during the 2010-2012 period. The high tariff protection on textiles which induced this output performance also had a price in the form of the corresponding high cost of garments and apparel products that use textiles as inputs. The African countries which took advantage of the generous preference margins for garments and apparel succeeded because they also took advantage of AGOA’s permission for them to use the cheapest textile inputs they could find. Nigeria’s tariff policy closed this route to Nigeria’s garment producers. Hence, while Nigeria was eligible to benefit from this trade preference, its own self-inflicted wound made it impossible to do so.

This above analysis has several implications. First, the current industrial development strategy has clearly failed. Its application over half a century has produced a manufacturing sector which contributes little to GDP and exports. The economy has achieved neither structural transformation nor sectoral diversification without which sustainable growth and development cannot be achieved. Second, it is important to identify and understand the reasons why the current strategy is judged to have failed. It is easy to pinpoint at least two reasons. One relates to its bastardisation in the process of application through the sustained violations of virtually all of its success conditions. The other is that the strategy’s principal tool, i.e., import control (through tariff or non-tariff measures) does not address the fundamental source of the problem, i.e., the “Dutch Disease”- induced real exchange rate appreciation which persistently undermines the competitiveness of domestic production.

To the extent that this diagnosis is correct, a tempting recommendation would be to scrap the current industrial development strategy completely and immediately. But this will be “a bridge too far”, and will amount to “throwing the baby out with the birth water”. The more logical way to go is probably a carefully re-designed and phased programme of ban, removal and tariff rate reductions over a suitable period of time that is established on the basis of more detailed analysis.
The more positive recommendation is to transfer the industrial protection mechanism from tariffs to the exchange rate. The exchange rate is a macro price whose use in this context does not require the kind of product specific selection that is associated with tariffs. This reduces its been captured by powerful individuals or groups of producers. By comparison, the use of the exchange rate tool requires that the exchange rate be market-determined in the context of a managed float arrangement; while the Central Bank reserves the right to intervene asymmetrically. That is, only when there is pressure (due to rising capital inflows) to appreciate the exchange rate. The system would assist in sustaining and enhancing the competitiveness of Nigerian non-oil exports. In this arrangement, the lower the external value of the naira, the more expensive will be Nigeria's imports, the cheaper will Nigeria's exports be abroad, and the higher will be the per unit revenue of exports to domestic producers. Yes, of course, the naira price of imported raw materials and other inputs required by domestic manufactures will be higher as well as the naira price of their output. But since these inputs constitute only a proportion of the total cost of final output, the per unit profitability needs not be reduced.

The use of the exchange rate tool in this system is not without cost, of course. It will, for example, require the Central Bank to accumulate and sterilise foreign exchange reserves; a process that forfeits the return that could otherwise have been earned if not sterilised.

III. Short-Term Macroeconomic Management

In the context of the basic analytical framework, the primary objectives of short-term macroeconomic management are to establish and continually maintain both sets of the internal and external balances of an economy. A significant oil price decline could pose serious challenges of short-term macroeconomic management for oil-exporting developing countries especially those that are heavily dependent on oil exports and whose economies are, to that extent, undiversified. One of these challenges emanates from the likelihood that, as a result of the oil price slump, oil-exporting countries will earn less oil export revenue and their budgets will be under pressure. Based on previous experience of large and unpredictable oil price declines, these events typically have major impact on fiscal balances of the affected countries. Even a small fall in oil price may generate a large increase in their financing needs, since their exports are not diversified and oil revenue accounts for a large proportion of total revenue. Thus, a mechanical effect of an oil price decline is likely to be a fiscal deficit for most oil-exporting developing countries.
The fiscal deficit may, in turn, necessitate abrupt macroeconomic adjustments in the short-term. But, in order to avoid the disruptive pains of such abrupt adjustments, the affected countries may try to smooth out the adjustment by not curtailing government expenditures immediately and to the extent required for re-establishing internal balance. But for countries that lack accumulated funds to finance the deficit, a larger real exchange rate depreciation would be required. This could become problematic because a strong monetary framework would be required to avoid the situation in which the depreciation leads to persistently higher inflation and further depreciation.

There exists a second challenge that is posed for macroeconomic management of oil-exporting developing economies by an oil price slump. This derives from the fact that the oil price slump which reduces government revenue also reduces export revenue which, in turn, may place external balances under pressure. In the event that this happens, financial stability risks would increase and significant pressure could be placed on the domestic currency. This is the mechanism through which falling oil prices typically lead to the depreciation of oil-exporters' currencies. If this depreciation is carefully and effectively controlled, it should assist the affected oil-exporting developing country to adjust smoothly and successfully. But things could go wrong for at least two reasons. First, financial problems could be exacerbated for the government and individual firms whose debts are denominated in foreign currencies such as dollars. Second, if inflation expectations are not well anchored, depreciations may become uncontrollable and thus lead quickly to very high inflation. The fact that the adjustment processes required for restoring both internal and external balances involve depreciation implies considerable interactions across both. It also reveals the critical importance of the exchange rate for the process of short-term macroeconomic management.

A number of initial conditions and certain features of the policy framework have been found to be helpful in ensuring an effective macroeconomic management of the consequences of an oil price decline. As discussed above, a major consequence of an oil price decline is an unanticipated cash-flow shock. The ability of a country to absorb such a shock depends on the strength and robustness of the government's financial position. If the position is strong, the government would have the room to manoeuvre and accommodate the cash-flow fluctuations through an appropriate mix of adjustment and financing. This would enable the country to implement short-run fiscal strategies which can be suitably focused at avoiding fiscal instability while insulating the domestic economy from oil revenue volatility. Many oil-exporting developing countries typically acquire this capacity by establishing
policy cushions such as oil saving funds and fiscal rules which enable them to save during periods of high oil prices with a view to using such saving to sustain spending when lower oil prices occur. When successful, this strategy ensures the decoupling of current spending from current earnings.

Both theory and evidence also suggest that the exchange rate regime matters for the management of the adjustment associated with an oil price decline in oil-exporting developing countries. More specifically, countries with flexible exchange rate regimes can adjust through currency depreciations. This process yields a smaller and smoother output response due to large and immediate real exchange rate depreciation. In addition, there is less need for contractionary fiscal policy because the real depreciation tends to exert an adequate dampening role. In the case of fixed exchange rate regimes, however, monetary policy is typically constrained and the major burden of macroeconomic stabilisation falls upon fiscal policy. In effect, adjustment typically requires substantial fiscal spending reductions which may turn out to be particularly damaging for recovery and subsequent growth.

The patterns of oil price decline, impact on internal and external balances, policy responses and their consequences are largely mirrored by Nigeria's experience over the previous five oil price decline episodes. Several issues stand out, however. One of these is the continued inability of the country to tame its generally pro-cyclical fiscal policy posture. Going forward, therefore, the key policy imperatives should include the following elements:

- pursuit of fiscal policy strategy aimed at breaking the pro-cyclical response of expenditure to volatile oil prices
- elimination of expansionary fiscal policy bias during oil booms
- targeting prudent non-oil fiscal balances
- reduction of the non-oil fiscal deficit gradually and systematically over time.

These fiscal policy imperatives listed above are not new. In fact, they have always been recognised and they constitute the justification for the establishment of arrangements, laws and institutions such as the Excess Crude Account, the Fiscal Responsibility Act, and Nigeria Sovereign Investment Authority. If these had been allowed to work effectively, the era of pro-cyclical fiscal policy could have ended and Nigeria would have been in a strong financial and fiscal position to adjust to the current oil price slump more efficiently and with much less pain.
The second issue relates to the role of export diversification. As argued in section 2, structural transformation and sectoral diversification constitute key elements of a dynamic process for generating sustainable and inclusive economic growth. This process neither happens automatically nor does it necessarily produce the desirable kind and extent of structural transformation and sectoral diversification. Low-income countries of the 1950s and 1960s that have successfully created vibrant and export-oriented manufacturing sectors and, have achieved much higher levels of per capita income and economic development have done so largely by effectively deploying the exchange rate policy tool.

In the context of oil price and revenue volatilities which create difficult macroeconomic management problems for oil-dependent developing-country economies, a more diversified export structure obviously has a role in ameliorating these problems. While this amelioration would not necessarily apply to a full extent in the case of government revenue, it should do so in the case of strengthening the country's external balance position. Thus, an exchange rate policy which focuses effectively on sustaining the competitiveness of the domestic economy and, thus, promotes non-oil exports can be expected to reduce the volatility of total exports as well as the extent and cost of adjustment through contractionary fiscal policy.

IV. Managing Policy Trade-Offs

In Sections 2 and 3 above the real exchange rate is recognised as the most important factor which shapes the economy's incentive structure through the movements of relative tradable and non-tradable product prices. In the context of an oil dominated economy such as Nigeria, the resource reallocation effect of changes in the exchange rate can be particularly strong. For example, it is well established in the literature on the "Dutch Disease" that the exchange rate appreciates in response to surge in capital flows and that this reduces the competitiveness of the capital-receiving country's exports. The implication of this is that if Nigeria wishes to create and sustain a dynamic and export-oriented non-oil sector, an appropriate policy intervention strategy must be designed and implemented to effectively counteract this "natural" tendency of exchange rate appreciation. The design and implementation of such a policy intervention strategy must begin with the recognition that tradeoffs often exist between policies and that these trade-offs need to be understood so that they can be effectively managed. A very useful and simple analytical scheme for this purpose is the Impossible Trinity or Trilemma, a paradigm of open economy macroeconomics. In its simple form, this paradigm asserts that it is impossible for a country to have all three of the following at the same time:
• a stable foreign exchange rate
• free capital movement (or absence of capital controls)
• an independent monetary policy

When confronted with this Trilemma, policy makers have to select a combination of any two because all the three goals can be mutually inconsistent. For example, if a country chooses to maintain a fixed exchange regime and decides to raise the interest rate in order to control inflation, this will increase the difference between its own rate and the world interest rate. Given the emerging arbitrage opportunity in open capital markets and the underlying interest rate parity condition, such a move would attract capital inflows into the domestic economy, and results in an appreciating pressure on the fixed exchange. In order to eliminate this pressure and restore the fixed exchange, the country would have to intervene in the foreign exchange market to buy international reserves by selling domestic currency. This will end up defeating the original objective of controlling domestic inflation.

A review of country experiences shows that some developed countries and regions have tended to select the corner solution that the Trilemma implies. Thus, the United States allows its exchange rate to vary in the context of open capital markets while retaining an independent monetary policy as its control instrument. By comparison, the countries in the Euro-Zone component of the European Union have chosen to give up monetary policy independence in exchange for exchange rate stability and open capital markets.

Many other countries, including those of emerging markets, appear to have chosen to move away from the corner solutions and towards the middle ground. This seems to reflect the understanding that open capital markets are associated with significant costs and benefits. On the side of benefits, open capital markets permit capital flows which help to bridge the gap between domestic saving and investment as well as productivity-enhancing technology and skilled managerial capacity. On the cost side, unbridled capital inflows can fuel inflationary pressures, fan asset price bubbles and appreciate the exchange rate, thus reducing domestic competitiveness. In addition, sudden reversals in capital flows can lead to instability, including crises in financial and currency markets.

Thus, middle ground solutions tend to embrace gradual opening up of non-debt capital flows (principally foreign direct investment), while maintaining some control over debt and portfolio capital flows. An example of such
middle-ground policy making is presented by the experience of the Reserve Bank of India (RBI). More specifically, the RBI intervenes in the foreign exchange market in an asymmetric way; it generally intervenes only when the exchange rate is appreciating, and adopts a “hands off” approach during times of depreciation. This approach is capable of achieving three different objectives. First, the depreciating currency assists in enhancing or restoring the competitiveness of exports. Second, the depreciating currency helps to ameliorate trends towards growing current account deficits. Third, it minimises the risk of losing foreign exchange reserves.

Like India, several other emerging market economies operate in an intermediate range of limited financial integration and managed floating exchange rate regimes. In this context, their central banks actively intervene in foreign exchange markets both to promote structural transformation and sectoral diversification in the medium to long-term, and using reserve management policies in the short-run to balance the trade-offs presented by the Trilemma. In this context, reserve accumulation gives the policy makers more flexibility in dealing with the short-run trade-offs between monetary policy independence and exchange rate stability for a given level of capital account openness. There is, of course, “no free lunch”. This approach involves an inherent disadvantage in terms of rising fiscal cost of reserve sterilisation. In view of the multiple objectives of macroeconomic management such as maintaining a robust and sustainable economic growth rate, manageable current account deficit, competitive exchange rate, access to adequate external capital for domestic investment, moderate inflation, and adequate foreign exchange reserves, the process of macroeconomic management in the context of significant policy trade-offs remains inherently complex; there is unlikely to be a cost-less solution.

V. Concluding Comments
The current oil price slump and its immediate effects of reduced government revenue and export revenue will, no doubt, impose a costly and painful adjustment process on the Nigerian economy. The appropriate approach for an effective management of this process in order to minimise the cost and the pain will also continue to generate heated debate for quite a while, as current projections suggest that oil prices may not return to the level before the slump for roughly five years.

The volatility of oil prices is not new, and the current oil price fall will not be the last. In addition, based on the experience of the previous five episodes, a lot is known about the consequences of such oil price and revenue slumps. Based on this knowledge, appropriate countervailing institutions have been created
and relevant policy packages designed. The real tragedy for Nigeria may be the inability to learn from experience and past mistakes so that adequate preparation can be made for the future. That future is now.

There are studies which suggest that difficult periods such as this actually provide both the challenge and opportunity to initiate and fast-track the processes of structural transformation, sectoral diversification as well as the enhanced capacity for a rational and effective management of the economy. Perhaps this opportunity can be seized upon now. If this succeeds, the mistakes of the previous five episodes could be forgotten and forgiven.
References