

**FOR  
INFORMATION**

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From: The Secretary

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**Nigeria—Assessment Letter for the African Development Bank**  
**September 30, 2016**

*Macroeconomic conditions have deteriorated further in 2016, raising near-term vulnerabilities and underscoring the urgency of a comprehensive policy response. The authorities recently initiated two important macroeconomic reforms—greater flexibility in the foreign exchange (FX) market and higher regulated prices together with a more liberalized regime for the importation of petroleum products—to reduce structural imbalances. The timely implementation of an appropriate and coherent set of policies, as emphasized in the 2016 Article IV staff report, remains critical for rebuilding confidence and fostering economic recovery.<sup>1</sup>*

**1. Macroeconomic conditions deteriorated in the first half of 2016, increasing near-term vulnerabilities:**

- In Q2 2016, Nigeria fell into recession, having recorded two consecutive quarters of negative **growth** (-0.4 percent and -2.1 percent in the first and the second quarters of 2016, respectively). Sabotage of oil infrastructure intensified, reducing production in May by a third of previous levels, and curtailing power generation. Fuel shortages—resulting from a misaligned fuel price and continuation of FX restrictions—exacerbated the decline in activity, as did the protracted delay in signing the 2016 budget (May 6).
- **Inflation** jumped to 17.6 percent in August (up 8 percentage points since end-2015), from higher utility tariffs, depreciation of the exchange rate, acute fuel shortages that resulted in price hikes above regulated prices, and a passive monetary policy stance that facilitated the pass through of these shocks to the overall price level.
- The **fiscal deficit** widened: in spite of efforts to improve tax compliance, non-oil revenue underperformed, reflecting the slump in growth (the budget was based on growth of 4.2 percent); and low oil production limited oil revenues, despite the recovery in oil prices and depreciation of the naira. The deficit was financed mainly through higher domestic debt (bond issuance and bank loans), but state and local governments also utilized bail-outs from the federal government (FG) and arrears accumulation.
- A sharp decline in imports contributed to a modest recovery in the **external current account balance**, with exports declining by 14 percent, but imports falling more than proportionately by 25 percent in the first half of this year compared to the same period last year. With near-term risks elevated, capital inflows continued to decline (\$1.4 billion during the first half of the year compared with \$4.4 billion in 2015) and reserves dipped from \$28.3 billion at

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<sup>1</sup> This assessment letter complements the latest IMF staff report of April 2016, IMF Country Report No. 16/101 Nigeria: 2016 Article IV Consultation—Press Release; Staff Report; and Statement by the Executive Director for Nigeria.

end-2015 to \$25.3 billion at end-August (about five months of imports, only slightly above the adequate level of reserves suggested by the IMF's reserve adequacy metric).

- While liquidity and capital adequacy ratios for the financial industry as a whole remain above prudential levels, asset quality has deteriorated, with some banks reporting nonperforming loan (NPL) ratios above 20 percent (the NPL for the banking sector is 11.7 percent as of 2016Q2). A prolonged economic slowdown and additional exchange rate depreciation could further increase already high NPLs.

## **2. The outlook for 2016 is for negative growth (-1.7 percent) and a widened fiscal deficit.**

- This outlook envisages a partial execution of the authorities' capital expenditure budget (owing to implementation lags and financing constraints), a slow recovery in oil production, and weak response in non-oil activity. With non-oil revenue projected to remain sluggish, the consolidated fiscal deficit is expected to widen to near 5 percent of GDP. In particular, the 2016 FG deficit is projected to be significantly higher than the 2 percent of GDP in the budget. Interest payments are projected to increase to above 45 percent of FG revenue in 2016 and to above 50 percent by 2018, with declines over the medium term only if sustained revenue mobilization efforts are pursued.
- Renewed disruptions to, or inadequate recovery of, oil production could further increase fiscal financing needs. With external financing likely to fall short of budget, the domestic financing requirements needed if the budget is to be fully implemented are very large, crowding out private sector credit and investment. An additional financing constraint facing the FG is the likely need for further assistance to State governments who are facing deteriorating finances and the re-emergence of domestic payment arrears.

## **3. The authorities have introduced some key measures, but much stronger measures are needed to be done to address the severe imbalances.**

- On May 15, regulated fuel prices were raised by 68 percent, bringing them in line with the cost of importation. While the 2016 budget assumed no subsidies, it is estimated that the continuation of the previous regime would have cost 0.3 percent of GDP. However, the regulated price system remains in place, posing a risk that further increases in the landing cost of fuel or additional depreciation of the exchange rate could result in renewed shortages if the price is not adjusted.
- On June 20, the Central Bank of Nigeria (CBN) introduced a primary dealer system for the interbank FX market, to allow the exchange rate to be more market-determined. The move resulted in an immediate 40 percent depreciation of the interbank rate, significantly narrowing the wedge between the interbank and parallel market rates. The CBN also cleared the backlog of pending requests for FX, largely through forward trades. However, the FX market continues to

be tightly regulated: restrictions on access to FX for 41 categories of items are still in place and a new directive was introduced requiring banks to allocate 60 percent of FX sales to manufacturing inputs and raw materials. As a result, the volume of transactions in the interbank FX market has remained modest, price discovery has been weak, and a large spread (about 33 percent) to the parallel market has re-emerged.

- On July 25, the monetary policy committee (MPC) raised the monetary policy rate by 200 basis points, to support objectives of a sustainable external position and price stability. However, the CBN continues to extend subsidized credit through quasi-fiscal operations.

**4. There is an urgent need to implement an appropriate and coherent set of policies to rebuild confidence in the near term and foster economic recovery over the medium term.**

This includes articulating a plan to place fiscal policy on a sustainable footing, ensuring the monetary policy stance is kept sufficiently tight, and pressing ahead with structural reforms to improve competitiveness and facilitate economic diversification. Specifically, it will be important to:

- **Pursue strong macroeconomic policies to provide the fiscal space to enable priority capital expenditure to be executed.** For the remainder of 2016, implement high-impact and priority capital expenditure, subject to available financing. Significant under-execution of the capital budget will limit the anticipated impact on growth.
- **Implement measures to support fiscal and debt sustainability.** This would include: (i) containing the fiscal deficit across all tiers of government; (ii) boosting the ratio of non-oil revenue to non-oil GDP, through a combination of improvements in revenue administration, broadening the tax base (including through curtailing of waivers and exemptions), and adjusting tax rates; (iii) rationalizing recurrent expenditure, and implementing an independent price-setting mechanism to minimize/eliminate petroleum subsidies; (iv) adopting safety nets for the most vulnerable; and (v) fostering transparency and enhanced accountability and an orderly adjustment of sub-national budgets, by encouraging reform of budget preparation and execution and strengthening public financial management.
- **Improve the monetary and FX policy frameworks.** A more forward-looking monetary policy strategy, with the overriding objective of price stability, would help better anchor expectations and policy credibility. As emphasized in the 2016 Article IV staff report, staff does not support the policies that have given rise to exchange restrictions and multiple currency practices, as they distort the allocation of FX and inhibit the adjustment of the exchange rate to underlying fundamentals.
- **Enhance vigilance of the financial sector.** The authorities are taking measures to strengthen financial intermediation, but with declining asset quality in a low growth environment, intensifying monitoring of banks and further enhancing contingency planning and resolution frameworks become even more important.

- **Reduce impediments to growth**, including by investing in infrastructure and improving the business environment, thereby facilitating higher private investment and national savings. Strong macro policies that underpin macro stability could provide the fiscal space or conditions to allow borrowing for implementing priority capital expenditure.

**5. Nigeria remains on the standard 12-month Article IV Consultation cycle.** Staff continue to actively engage with the authorities, including through the provision of technical assistance.