Macroeconomic impact series

# Shock-proofing in 2017

## Proactive reserve management in Nigeria and beyond

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## Key messages

- Rebuilding reserves will be an important means to increase resilience to shocks in 2017, especially for resource producers vulnerable to oil and commodity price swings.
- Economies in recession – such as Nigeria's – are vulnerable to further shocks and should pursue fully floating the exchange rate and policies that build up domestic financial breadth.
- Indonesia's experience of three-pronged policy proves instructive for developing economies: reserve accumulation, financial sector reform and diversification of the real economy.

### Higher interest rates in 2017

Global interest rates look set to rise in 2017, with the US Federal Reserve likely to continue to raise interest rates beyond its 13-14 December meeting, given that it has flagged a long-term normalisation in its policy rate. Though the European Central Bank (ECB) has recently extended the length of its quantitative easing programme, the ECB plans to reduce the monthly amount of net asset purchases from April 2017.[1] This is the first sign that it is starting to taper its unconventional easing, triggering a rise too in some long-term European interest rates.

As we have argued in this series, in this context of rising global interest rates, a number of emerging and developing economies, could see their access to finance negatively impacted through higher cost of finance – or worse. Moreover, a continued 'lift off' effect from the expectation of higher US rates could also impede capital inflows into emerging economies. All of this will take place in and be exacerbated by an environment of more moderate global economic growth.

What does 2017 hold for developing economies? As their balance sheets become more exposed to global financial markets, emerging and developing country central banks should be more proactive in their reserve and exchange rate policies. A number of policies can be used to address crises in these countries. The most important measures relate to the real economy, including diversification for resource producing economies. However, in the shorter-term, financial stabilisation policies matter too.

### Resource producers should continue to rebuild reserves

The oil price outlook is subdued, despite recent OPEC output cuts.[2] Reserve management remains important for resource-dependent economies vulnerable to price swings. The comparative experiences of Indonesia and Nigeria prove useful: they are the largest economies in the South-East Asian and sub-Saharan African regions, and both are oil producers that have countered successive crises. The December *ODI Shockwatch Bulletin*[3] argues that Indonesia's reserve accumulation was critical in supporting the broader economy, and can offer some lessons in tackling Nigeria's current recession.

Having weathered a number of economic crises, including the oil price shocks of the 1970s and the South-East Asian (SEA) financial crisis, Indonesia has emerged with a more resilient economy. As an oil-exporter, a major change was that it diverted its resources to the non-oil sector early on, away from single-commodity dependence. It also deepened central bank usage of money market instruments to stabilise its economy. Diversification, first into manufacturing, then into services, was a long term policy. Today, crude petroleum accounts for only around 6% of Indonesia' total exports. These reforms, along with a more flexible rupiah policy, enabled it to rapidly recover from successive shocks, including the SEA crisis, where its economy was one of the worst hit in the region.[4]

Nigeria's oil dependence has persisted: petroleum export revenues account for over 90% of total export revenues. This has resulted in continued weakness in its oil sector underlining the current recession and drastically reducing Nigeria's foreign exchange reserves. Down from a peak of $62 billion in September 2008, at around $25 billion, Nigeria's reserves continue to fall short of estimates of even a minimum adequate reserve level of $32 billion, to absorb further shocks to the economy.[5]

## Building resilience to shocks – Nigeria and beyond

With a lack of reform action, Nigeria's current economic recession will deepen further, particularly in a new global environment of rising interest rates and a subdued oil price outlook. On the financial side, the December *ODI Shockwatch Bulletin* argues for policy options that Nigeria could pursue to enhance macroeconomic stability. Diversifying the economy is key over the longer term. Until that is achieved, the Central Bank of Nigeria (CBN) should move to fully freely floating the naira, target currency volatility and strengthen its reserve management. One important institutional change should be for the Nigerian sovereign investment authority to begin fully managing its Stabilisation Fund instead of outsourcing it to external investment banks. This will enhance Nigeria's internal capacity to respond to shocks in closer coordination with macroeconomic policies.

Globally, a number of policies could help to build resilience against shocks for emerging and developing economies; some countries have increased precautionary reserves, in part, to 'self-insure' given inadequate global resources. First, development finance institutions could help provide further finance and facilitate domestic financial capacity to mitigate some of the risks that countries face. Second, the International Forum of Sovereign Wealth Funds could strengthen its recommendations relating to transparency of funding and withdrawal rules, in order to bolster reserve management. Finally, global foreign exchange volatility could be mitigated through further analysis of high-frequency trading and its transmission to developing country currencies, potentially by the Bank for International Settlements. There are policies that can be taken from historical lessons, but ultimately individual country success will depend on proactive policy-making in 2017.

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1 ECB Introductory statement to the press conference, 8 December 2016. Available: http://www.ecb.europa.eu/press/pressconf/2016/html/is161208.en.html.

2 Motavelli, G., Razzouk, N., and Rascouet, A. (2016) 'OPEC Confounds Skeptics, Agreeing to First Oil Cuts in 8 Years'. Bloomberg. Available: http://www.bloombergquint.com/markets/2016/11/30/opec-said-to-agree-oil-production-cuts-as-saudis-soften-on-iran.

3 Papadavid, P. (2016) 'Assessing reserve management during economic crises: lessons from Indonesia and Nigeria'. ODI Shockwatch Bulletin, 9 December. Available: https://www.odi.org/publications/10656-assessing-reserve-management-during-economic-crises-lessons-indonesia-and-nigeria.

4 Radelet, S. (1999) 'Indonesia: Long Road to Recovery'. Harvard Institute for International Development. Available: http://www.cid.harvard.edu/archive/hiid/papers/indonesia.pdf.

5 Tule, M.K., Ebunga, E.N., Sagbamah, J.E.L. (2015) 'Determination of optimal foreign exchange reserves in Nigeria'. CBN Working Paper Series. Available: https://www.cbn.gov.ng/out/2015/ccd/determination%20of%20optimal%20foreign%20exchange%20reserves%20in%20nigeria.pdf.

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