

## Trends in Nigeria's Balance of Payments: an Empirical Analysis from 1970-2010

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### Abstract

The paper examines the trends in Nigeria's Balance of Payments position from 1970-2010 using an econometric analysis. It is apparent that the Balance of Payments position in the country has reached an unviable proportion and has become a binding constraint in the realization of government objectives. The Balance of Payments position have been undermined by a relatively poor non oil export, high import bill, stagnated agriculture, high taste for foreign goods and services, continuous fall in the country's foreign exchange, inflationary pressure, inefficient manufacturing sector and mishandling of the oil boom. We carried out a multiple regression analysis using the ordinary least square method for both linear and log linear form. The log-linear form gave a better result and thus was adopted to ascertain the impact of these independent variables (Exchange rate, inflation rate and interest rate) on the dependent variable (Balance of Payments). The result shows that the independent variables appeared with the correct sign and thus, conforms to economic theory, but the relationship between Balance of Payments and inflation rate was not significant. However, the relationship between Balance of Payments, Exchange rate and interest rate was significant. Thus, among other recommendations, the government is advised to increase the non oil exports and diversify the productive base of the Nigerian economy so as to correct the deficits in the current account of the country's balance of payments.

**Keywords:** Balance of Payments, Exchange Rate, Interest Rate, Inflation Rate, Foreign Exchange, Non-oil Exports.

### 1.0 INTRODUCTION

The role Balance of Payments position play in the economy of any nation cannot be over emphasized and Nigeria is no exception. Balance of Payments is a systematic statistical record that summarizes a country international transaction with the rest of the world for a given period of time say one year. At 1964; fifty years after amalgamation of Nigeria in 1914, Nigeria was at the height of her promise: among other promising trends, it was the world's largest producer of groundnuts, palm oil, and petroleum was making its debut in the national accounts.

In the early 1980s, the oil market weakened, substantial external and fiscal imbalances emerged. These were financed by public sector borrowing, depleting international reserves and large accumulation on payment arrears on external trade credits and as such created problems in our Balance of payments. In 1984, austerity measures were introduced to redress the nagging deficits in the country's balance of payments, these included; slashing of budgetary expenditures, administrative control for import licenses, increase and upward review of tariffs. In 1986, the Structural Adjustment Programme (SAP) was introduced, which amongst other things, combined exchange rates and trade policy reforms to promote economic efficiency and long term growth in the stabilization polices designed to restore balance of payments equilibrium and price stability.

The cardinal aim of every government in Nigeria from the regime of Tafawa Balewa up till date is to get the balance of payments position right. This cardinal aim has inspired every major turn of policy; setting of bank rates, changes in taxes, regulation of incomes, the restructuring of industry, introduction of export rebates, control of money supply, level of local government expenditure, etc.

The Current Account Deficit (CAD) in the balance of payments has been a problem for Nigeria because it adds to the already large indebtedness of Nigeria to the rest of the world. International credit is like a drug to us. We accept it indeed grave it even though we know the harm it does to us. If the credit supply that funds our current account deficits and add to our national debts dries up, we would go cold turkey. The balance of payments problem has reached an unviable proportion and has become a binding constraint in the realization of the government objectives. It have been undermined by a relatively poor non-oil export performance, high import bill, stagnated agriculture, high taste for foreign goods and services, continuous fall in the country's foreign exchange, inflationary pressure, inefficient manufacturing sector and mishandling of the oil boom.

The disequilibrium in the country's balance of payments account have generated questions concerning the causes, its impact on social progress and what policies to adopt to achieve favourable balance of payments position. The aim of this paper is to examine and identify the determinants of disequilibrium in the balance of payments and the manner in which these determinants relates and process of correcting it; to examine the polices initiated by the Federal Government of Nigeria aimed at correcting the balance of payment disequilibrium.

## **2.0 AN OVERVIEW OF THE NIGERIAN ECONOMY**

The Nigerian economy is fundamentally rich, self-sufficient in energy, a semi-literate population and adequate level of wealth among less developed countries (LDCs), Anya (1995). But the country have suffered from considerable mismanagement leading to erratic economic growth, slow GDP growth rate, high inflation, high unemployment rate, balance of payments crisis and reduced economic activity. Other vulnerabilities are reliance on a single export commodity, a weak political structure, regional and religious tension.

Until the time of this study, the economy is a typical low-income developing country with an abundance of unskilled and underemployed labour and inadequate industrial capital stock. The economy was stagnant and its structure has a strong agrarian base, savings and investments are at low level and the growth rate of the economy is at an abysmal rate lower than the population growth rate. This macro-economic policy structure is as confusing and inimical as that of many African countries and non-oil exports was still negligible. The result is that development dynamics are conspicuously missing. In terms of per capita income, Nigeria is at the button of poverty league.

The monetary policy in the country is targeted, at least theoretically, at a set of macroeconomic objectives aimed at influencing the aggregate level performance of the economy. The broad first rank objectives included price stability, full employment, balance of payments equilibrium and growth in the real sector. A new economic scheme, the Structural Adjustment Programme (SAP) was introduced by the militancy government in July, 1986. The monetary and financial policy structure was reoriented with an objective to support high diversification of production base of the economy, commercialization and revitalization of state-owned enterprises. Arising from the deregulation of various economic variables, for example, interest rates, there was an increase in financing assets, that is time and savings deposit.

Contractionary monetary policies were followed whenever inflationary forces seemed to get out of hand, Afolabi (1999). Fiscal policies and budget deficits have a significant bearing on the aggregate demand, inflation level, composition of economic activity and the external economic balance, Agiobenebo and Onuchuku (2000). The lack of a credible fiscal policy can trigger capital flight, leading external balance to plunge into the red. The entire major external policy instrument like tariffs subsidies and flexible exchange rates have important fiscal policy implications. Gbosi (1993) posits that budget deficits have been a recurrent fiscal feature of the economy arising directly or through off-budget activities. According to Akpakpan (1999), he asserted that the financial sector comprises of monetary institutions, specialized financial institutions and non-bank financial intermediaries. The Central bank of Nigeria, which is the apex regulator of the financial sector, was established in 1961, and has virtually not been independent. Financial repressions, direct controls and monetary policies have been sources of distortion to the banking system, Anyanwu (1993). The interest rate policies swept away the intermediation functions of rate of interest. They did not reflect the market-clearing rate. Monetary policies neglected the profitability of banks by minimizing the spread between lending and deposit rates. Commercial loans were not based on feasibility and credit worthiness of the project.

The government is preparing Nigeria's Vision 2020 which focuses on diversification of the economy away from oil. Vision 2020 will articulate the government's goal of placing Nigeria among the top 20 economies in the world. At present the country's economic structure reflects an undiversified economy that is highly dependent on a capital - intensive oil sector, with a traditional agricultural sector accounting for the bulk of employment. Agriculture was the leading contributor to GDP in 2009, helped by a good harvest.

## **2.1 CONCEPTUAL FRAMEWORK ON BALANCE OF PAYMENTS**

The balance of payments is defined as a systematic record of economic and financial transactions for a given period of time, say one year, between residents of an economy and non residents - rest of the world. These transactions involves the provision and receipts of real resources – goods, services and income – and changes in claims on and liabilities to the rest of the world. Specifically, the balance of payments records transaction in goods, services and income, changes in ownership and other changes in an economy's holdings of monetary gold, Special Drawing Rights (SDRs) and claims on and liabilities to the rest of the world. It also records unrequited or unilateral transfers – the provision or receipts of an economic value without the acceptance or relinquishing of something of equal value.

Generally, transactions involving payments to a country by non-resident are classified as credit entries. Those involving payments by country to non-residents are debt entries.

Basically, the balance of payments is divided into the current and capital account. The capital account is made up of portfolio and direct investment, either long or short term capital and capital transfers. While the current account records all current transactions, which are transactions that include either the export or import of goods and services. They include merchandise and services. The capital account also refers to charges in financial assets and liabilities, portfolio investment, external loan drawings and amortization and charges in short-term capital movements. However, it should be noted that development in the other sectors – real, monetary and public – has implications for the balance of payments. As a result, current account deficit may not necessarily be an inappropriate policy to pursue especially in a country that is for example, importing to increase domestic investment. However, in a short-term, import bills may remain unpaid or external reserves could be drawn down. A long-term and more viable solution lies in ensuring balance of payments viability. A viable balance of payments position may be defined as a current account position, which can be financed on a sustainable basis by net capital movements on terms that are compatible with reasonable development, growth prospects and debt servicing capacity as well as macro-economic stability. It can be seen that the balance of payments is linked with the other accounts in a general equilibrium framework. This implies that disequilibrium in one sector; say external sector is transmitted to the other sectors and vice versa. Thus, there is need to achieve both internal and external balance.

According to Marsha (1994), two types of policy measures are used in dealing with balance of payments problems. These are expenditure switching measures and expenditure reducing policies. Expenditure reducing policies refer to fiscal policy (conducted by changing government expenditure and /or taxes) and monetary policy which refers to changes in money supply, which in turn affect interest rate. Expenditure switching policies refers to devaluation (depreciation) and revaluation (appreciation) of the country's currency. The aim of expenditure reducing policies is to reduce domestic expenditure on consumption and increase expenditure on investment, thus, releasing goods and services for exports while leaving aggregate output unchanged. The aim of expenditure switching policies is to switch domestic demand from imported goods to home made goods. However, the extent to which expenditure switching policies is achieved depends on elasticity of supply and demand for tradable goods. If the depreciation of the nominal exchange rate is matched by increase in wages, absorption and inflation, the real exchange rate would not depreciate and so the balance of payments would not improve. However, expenditure reducing policies have costs in terms of loss of output, investment and employment. The loss will be minimized if resources can be easily moved to the tradable goods sector. Alternatively bridging external loans may be contributed to sustain investment and output.

## **2.2 BALANCE OF PAYMENTS THEORIES**

There are two basic theories that have been propounded to addressing balance of payments imbalance, these include: Inflationary theory: Inflation is a state of persistent rise in the general price level and hence falling value of money, Dullo (1974). It is a malign condition that eats accumulated wealth and diverts the energies of the economy. Countries report by the IMF, shows that the cause of Nigeria's inflation are; increase in money supply despite decrease in foreign exchange reserves (a decrease in foreign exchange reserve has the effect of decreasing money supply). Budget deficit is also stated to be a contributory factor. Faced with increasing population and the need to improve the standard of living, the Nigerian government has embarked on various programmes to accelerate the rate of economic growth and provide government services, thereby increasing expenditure within a limited scope of public borrowing leading to fiscal deficits.

Structural Theory: This theory argues that balance of payments disequilibrium abates due to an inherently inefficient or imbalanced economy Gbosi (2001). Two specifications of structural problems that affect the Nigerian economy are:

Weakness in fiscal system: This leads to budget deficit, expenditure increases due to population increase and the need for development, while the revenue system and tax rate of the Nigerian economy are inadequate to obtain the needed growth in revenue. What is needed is restructuring and improvement of the country's revenue system and increase in taxes. The revenue system of the economy should be elastic relative to economic growth, that is, revenue should grow proportionally with higher GNP.

High External Debt Burden: Debt sustainability analysis of Nigeria by the IMF indicates that the country's debt has been increasing since 1960. Over a period of 30 years, the external debt has risen by 2,899 percent. Determining

whether or not the level of debt is sustainable in the country is one of the most fundamental issues. There is no conclusive level of measure amongst economists to determine when an external debt is sustainable or not. However, for debt to be sustainable over the long term, a country's rate of economic growth should be higher than the rate of interest on foreign loans.

Structural inadequacies of Nigeria arose mainly from the flowing sources: Dependence on one primary commodity (especially petroleum) as a major source of foreign exchange earner. This commodity is open to world price fluctuations which affects the current account of the balance of payments; Excessive debt service payment due to high non-concessional interest rates; and Weak industrial base by the manufacturing sector of the country.

### 3.0 METHOD OF STUDY

The study examines the trends in Nigeria's balance of payments from 1970-2010 using an econometric analysis. The econometric analysis is used to evaluate estimate and analyze the influence of the explanatory variables (exchange rate, inflation rate and Interest rate) on the dependent variable (Balance of Payments). The outcome from this approach is used to predict and conclude this study.

#### 3.1 SOURCES OF DATA

Data will be sourced from secondary sources. Secondary will be from Central Bank of Nigeria (CBN) Statistical Bulletin, Federal Bureau of Statistics (FBS) and other Federal Government of Nigeria publications.

#### 3.2 MODEL SPECIFICATION

The econometric model of multiple regression analysis will be used to test the relationship between the dependent and independent variables. This functional relationship is represented as thus:

$$\text{BOP} = f(\text{EXR}, \text{INF}, \text{IR}) \dots\dots\dots (1)$$

Mathematically, this functional relationship can be specified in linear form as thus:

$$\text{BOP} = a_0 + a_1 \text{EXR} + a_2 \text{INF} + a_3 \text{IR} + U \dots\dots\dots (2)$$

However, the Log Linear specification is specified as thus:

$$\text{Log BOP} = \log a_0 + a_1 \log \text{EXR} + a_2 \log \text{INF} + a_3 \log \text{IR} + U \dots\dots\dots (3)$$

Where:

BOP = Balance of Payments

EXR = Exchange Rate

INF = Inflation Rate

IR = Interest Rate

$a_0$  = Constant

$a_1, a_2, a_3$ , = co-efficient of the respective independent variable

U = Error term

Log = logarithm

### 4.0 DATA PRESENTATION AND ANALYSIS OF DATA

The relationship between balance of payments, exchange rate, inflation rate and interest rate in Nigeria during the period under review (1970-2010) is presented in table 1.

From the table 1, we can see that during the 70s in the Nigerian economy, the country was experiencing a favourable condition in her balance of payments position; this is as a result of the increase exports especially in agricultural products, a stable interest and inflation rates. This increase in exports provided adequate foreign exchange for the country and improved her balance of payments. But during the 80s, we noticed that deficits started appearing in the country's balance of payments position. The deficits experienced in the country's balance of payments, was as a result of the crash in the international market for crude oil, which was the major source of exports for the Nigerian economy. Also, during this period, the country started importing virtually everything ranging from machineries and consumable goods that could be manufactured in the country if properly managed. Since the 80s till date, the country's balance of payments position have been unfavourable due to some factors such as high taste for foreign goods and services, high inflation rate, dependence on a single commodity for export, neglect of the agricultural sector, etc.

#### 4.1 INTERPRETATION AND DISCUSSION OF RESULT

$$\text{Log BOP} = 14.97740 + 2.314221\text{LogEXR} - 0.168662\text{LogINF} - 6.556385\text{logIR}$$

$$t - \text{statistic} = (1.915477) \quad (4.958889) \quad (-0.248166) \quad (-3.035897)$$

$$R^2 = 0.834407, \text{ Adjusted } R^2 = 0.865404, F - \text{statistic} = 23.51494$$

$$\text{Durbin Watson} = 1.025187$$

**Source: E-view 7.1**

From the result obtained, the log-linear specification was adopted for our analysis because it gives a better goodness of fit since it has a higher explanatory power of the model ( $R^2$ ), higher adjusted  $R^2$  and higher F – statistic.

From the log-linear regression result above, the coefficients of Exchange Rate, Inflation Rate and Interest Rate appeared with their correct signs and as such conform to apriori or economic expectation.

Exchange Rate appeared with the right sign, which is a positive sign and thus conforms to economic theory. Thus, indicating that there is a positive relationship between Exchange Rate and Balance of Payments. Our result showed that the coefficient of Exchange Rate is 2.314221 meaning that a unit increase in Exchange Rate would lead to a 2.314221 unit increase in the Balance of payments. This means that if the Exchange Rate of Nigeria Currency (Naira) is increasing in relation to other currencies of the world, the balance of payments position for the Nigerian economy will also be increasing and as such will lead to a favourable position in Nigeria's Balance of Payments. This is possible because as the Exchange Rate of the Nigerian Naira is increasing in relation to other currencies of the world, it would make exports cheaper and imports more expensive. Though Exchange Rate is high, Nigeria still experiences unfavourable Balance of Payments position because of some of the following reasons: exportation of a mono product (crude oil), high taste for foreign goods and services, inability to produce consumer goods etc.

The estimated coefficient of inflation rate appeared with the right sign which is negative and thus, conforms to economic theory, which states that there is an inverse or negative relationship between the balance of payments and inflation rate. Our result showed that the coefficient of inflation is -0.168662, meaning that a unit increase in inflation rate would lead to 0.168662 decreases in balance of payment. Thus, a rise in the general prices of goods and services in the country makes Nigeria's exports expensive compared to that from other countries of the world and this will discourage foreigners from other countries to purchase these goods and services produced in Nigeria. Inevitably, this will affect the balance of payments position of the country by creating deficits in the country's balance of payments.

Similarly, the regression coefficient of interest rate came out with the correct sign, which is negative, thus conforming to apriori or economic theory. This means that there is an inverse relationship between the balance of payments and interest rate in Nigeria for the period under review. The coefficient of interest rate is -6.556355, meaning that an increase in interest rate, would lead to a 6.556355 fall in balance of payments. If there is an increase in the interest rate in the Nigerian economy, this will discourage borrowing and as such would lead to a fall in investment/production of goods and services. This fall in investment/production of goods and services will lead to a rise in the prices of available goods and services in the economy. As a result of rise in the prices of available goods and services in the economy, it will now make exports of these goods and services more expensive and as such lead to a fall in the aggregate demand for them. This reduction in aggregate demand for our exports will now lead to a fall or deficits in the country's balance of payments position.

Our result also pointed out that the coefficient of multiple regression determination ( $R^2$ ) is 0.834407; meaning that 83% of the dependent variable (balance of payments) is explained by the independent variables (Exchange Rate, Inflation Rate and Interest Rate), while the other 17% is explained by factors not captured in the model during the period under review (1970-2010). This indicates that the goodness of fit is very strong, showing that the relationship between the regressors (Exchange Rate, Inflation Rate and Interest Rate) and the regressand (Balance of payments) is strong. This implies that 83% variation in the Balance of Payments is explained by variation in Exchange Rate (EXR), Inflation Rate (INF) and interest Rate (IR).

The t-test shows that Exchange Rate and Interest Rate are statistically significant at 5% level of significance because the calculated t-value in absolute terms (t cal) is greater than the theoretical value (t-tab). For instance calculated t-value in absolute terms (t-cal) of Exchange Rate (4.958885) is greater than the theoretical value of t (t tab) (2.042). Thus, Exchange Rate is statistically significant and it means there is a significant relationship between the Balance of Payments and Exchange Rate. Also the calculated t-value (t cal) in absolute terms for Interest Rate (3.035897) is greater than the theoretical value of a (t cal) (2.042). Thus, Interest Rate is statistically significant, implying a significant relationship between Balance of Payments and Interest Rate. For inflation Rate, it is not statistically significant, because the calculated value of t (t cal) in absolute term of interest Rate (0.2248166) is less than the theoretical value of t (t cal) (2.042). Thus, there is no significant relationship between the Balance of Payments and Interest Rate for the period under review.

The joint test of significance of all parameters was conducted using the F-statistic. Our result showed the observed F-cal ratio is 23.51494 and this is greater than its theoretical value of 2.69. This further confirms the result of the  $R^2$

test, which suggests that the entire regression model is significant in explaining the relationship between the dependent variable (BOP) and the explanatory variables (Exchange Rate, Inflation Rate and Interest Rate).

From the regression we can deduce that the degree of correlation between the dependent variable (BOP) and the explanatory variables (Exchange Rate, Inflation Rate and Interest Rate) is high which again suggest a strong positive relationship between the dependent variable and the explanatory variables.

Lastly, our test for auto correlation using the Durbin Watson (DW) shows that DW is 1.025187 and since  $0 < d < 2$ , we conclude that there is a high degree of positive auto correlation.

## 5.0 CONCLUSION AND RECOMMENDATIONS

Balance of payments position of any country is one of the indicators of economic growth and as such countries try to make sure that they realize favourable balance for payments position. In this paper, the relationship between balance of payments, exchange rate, inflation rate and interest rate were analyzed in Nigeria for the period under review (1970-2010). The log linear multiple regression (OLS) was adopted for our analysis because it gives a better result than the linear multiple regression (OLS). From the findings, it was observed that the explanatory variables appeared with the right signs and thus conforming to economic theory. However, it was discovered that out of the explanatory variables, only Inflation rate was not statistically significant at 5% level of significance. Due to the findings, we recommended that the government should embark on efficient and effective expenditure switching policy or devaluation of Nigeria Currency (Naira), as devaluation of the country's currency will make exports cheaper and imports more expensive, thus, leading to a favourable balance of payments position in the country; the government should stimulate exports and substitute imports effectively, the government should make better use of direct controls; the government should make effective capital movement adjustment and the government should control and manage inflationary pressure efficiently.

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**Table 1: Data on Balance of Payments, Exchange Rate, Inflation Rate and Interest Rate from 1970-2010**

YEARS	BALANCE OF PAYMENTS (N Million)	EXCHANGE RATE (N/\$)	INFLATION RATE (%)	INTEREST RATE
1970	46.6	0.7143	1.7	8.0
1971	117.4	0.6579	1.6	10.0
1972	57.2	0.6579	9.4	10.0
1973	197.5	0.6579	4.6	10.0
1974	3102.2	0.6162	13.5	10.0
1975	157.5	0.6267	33.9	9.0
1976	339.0	0.6308	21.1	10.0
1977	527.2	0.6514	21.5	6.0
1978	1293.6	0.6475	13.3	11.0
1979	1868.9	0.5605	11.6	11.0
1980	2402.2	0.5445	10.0	9.50
1981	-3020.8	0.6369	21.4	10.00
1982	-1398.3	0.6702	7.2	11.75
1983	-301.3	0.7486	23.2	11.50
1984	354.9	0.8083	40.7	13.00
1985	349.1	0.9996	4.7	11.75
1986	-784.3	3.3166	5.4	12.00
1987	159.2	4.1916	10.2	19.20
1988	-2294.1	5.3530	56.0	17.60
1989	8727.8	7.6500	50.5	24.60
1990	18498.2	9.0001	7.5	27.70
1991	5959.6	9.7545	12.7	20.80
1992	-65271.8	19.1609	44.8	31.20
1993	13615.9	22.6309	57.2	36.09
1994	-42623.3	21.8861	57.0	21.00
1995	-195216.3	21.8861	72.8	20.79
1996	-53152.0	21.8861	29.3	20.86
1997	1076.2	21.8861	10.7	23.32
1998	-220671.3	21.8860	7.9	21.34
1999	-326634.3	92.5284	6.6	27.19
2000	314139.2	109.5500	6.9	21.55
2001	24729.9	112.4864	18.9	21.34
2002	-563483.9	126.4000	12.9	30.19
2003	-162298.4	135.4067	14.0	22.88

2004	1124157.2	132.6700	15.0	20.82
2005	74450.11	130.4000	17.8	19.49
2006	68348.84	128.2700	8.2	18.70
2007	62187.02	117.9860	5.4	18.36
2008	63648.72	130.7500	11.6	18.70
2009	80826.64	147.6000	12.4	22.90
2010	68887.46	139.1750	12.0	19.99

**Source: Central Banks Statistical Bulletin (2010)**

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