

THE EFFECTS OF GLOBAL FINANCIAL CRISIS ON NIGERIAN ECONOMY

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Abstract

The world economy is facing the most severe financial crisis since the Great Depression of the last century. The risk of global recession has heightened significantly and volatility of commodity prices, which is the mainstay of most developing countries like Nigeria, has increased further. If this situation continues to deteriorate, developing countries could be in great jeopardy. This study examined the influence of the Global Financial Crisis on Nigerian economy. It was discovered that the financial crisis will cause fall in commodity prices, decline in export, lower portfolio and FDI inflow, fall in equity market, decline in remittance from abroad etc. It was recommended that the federal government should come up with intervention policies that will minimise these effects and jumpstart the economy and that business operator should learn to do things using resources at their disposal to develop and expand at manageable level to stem the tide of the crisis.

Introduction

The global financial crisis began in the United States of America and the United Kingdom when the global credit market came to a standstill in July 2007 (Avgouleas, 2008). The crisis, brewing for a while, really started to show its effects in the middle of 2008. Around the world stock markets have fallen, large financial institutions have collapsed or been bought out, and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems.

The original root of the current financial mess is in the US- the world's largest Industrial-Military complex. With an estimated GDP of \$14 trillion, the US contributes about 25% of world output. If, as is being forecast, the US economy contracts by just 1%, this will imply a direct output loss of approximately \$140 billion- equivalent to the GDP of Pakistan, the 47th largest economy in the world! And the crises are not restricted to the US. Financial markets have tumbled and slumped the world over: from London to Tokyo, Seoul to Sydney, Sao Paulo to Moscow, Bombay to Frankfurt etc. No economy-whether developed, emerging or developing is, so far, insulated from what Greenspan refers to as '*once-in-a-century credit tsunami*'.

The initial response of the policy makers in Nigeria was meek. Either they did not understand the crises or underestimated its magnitude. In general, they thought of the crisis as only a 'storm in a tea cup', an aberration, a 'hiccup'. They insisted that the 'fundamentals of the financial system look impressively strong' even when the capital market has been bleeding uncontrollably. The Minister of Planning stated, rather insensitively, 'there is no problem in the Nation's capital market. What we have presently is just corrections and adjustments....shareholders are getting dividends and bonuses and they are happy...' this was at a time when market capitalization had dropped from N12 trillion to less than N9 trillion.

When they finally accepted there was a crisis, they promised to take some unspecified 'drastic and unusual action' to stem the global financial crises from causing havoc in the Nigerian financial system. (DT October 6, quoting the Minister of State, Finance).

That initial response was, to put it mildly, naïve. The country's dependence on the export sector is very significant: 99% of FX and 85% of local revenues are directly derived from activities related to export of a single commodity, which is at the center of the current financial crises, oil. It is estimated that 58.4% of Nigeria's exports are US bound and up to 25% to the Euro zone. 67% of our non-oil exports go to Western Europe, 20% to Asia while ECOWAS accounted for only 11% in 2007. The stock of our FX reserves is kept in European capitals where financial markets have tumbled and banks distressed. *How can any one think we are insulated?* International financial crises which affect trade and investment flows are bound to impact on the domestic economy.

Because the world economies are integrated financially, it is the aim of this paper to discuss the global financial crisis as it affects the Nigerian economy. The paper is structured as follows; part two and three discusses the concept of financial crisis and the causes of the crisis respectively, Africa and the financial crisis are looked at in part three. Part four looked at the Nigerian perspectives as well as possible policy responses, part five conclude the paper.

The concept of financial crisis

The term **financial crisis** is applied broadly to a variety of situations in which some financial institutions or assets suddenly lose a large part of their value. In the 19th and early 20th centuries, many financial crises were associated with banking panics, and many recessions coincided with these panics. Other situations that are often called financial crises include stock market crashes and the bursting of other financial bubbles, currency crises, and sovereign defaults (Kindleberger and Aliber, 2005, Laeven and Valencia, 2008).

Some economic theories that explained financial crises includes **the World systems theory** which explained the dangers and perils, which leading industrial nations will be facing (and are now facing) at the end of the long economic cycle, which began after the oil crisis of 1973. While **Coordination games**, a mathematical approach to modelling financial crises have emphasized that there is often positive feedback between market participants' decisions (Krugman, 2008). Positive feedback implies that there may be dramatic changes in asset values in response to small changes in economic fundamentals, **Minsky's theorised** that financial fragility is a typical feature of any capitalist economy and financial fragility levels move together with the business cycle, but the **Herding and Learning models** explained that asset purchases by a few agents encourage others to buy too, not because the true value of the asset increases when many buy (which is called "strategic complementarity"), but because investors come to believe the true asset value is high when they observe others buying (Avery and Zemsky, 1998, Chari and Kehoe, 2004, Cipriani and Guarino, 2008).

Causes of the Crisis

The reasons for this crisis are varied and complex, but largely it can be attributed to a number of factors in both the housing and credit markets, which developed over an extended period of time. Some of these include: the inability of homeowner to make their mortgage payments, poor judgement by the borrower and/or lender, speculation and overbuilding during the boom period, risky mortgage products, high personal and corporate debt levels, financial innovation that distributed and concealed default risks, central bank policies, and regulation (Stiglitz, 2008).

Avgouleas (2008) enumerated the causes of the crisis as: breakdown in underwriting standards for subprime mortgages; flaws in credit rating agencies' assessments of subprime Residential Mortgage Backed Securities (RMBS) and other complex structured credit

products especially Collateralized Debt Obligations (CDOs) and other Asset-Backed Securities (ABS); risk management weaknesses at some large at US and European financial institutions; and regulatory policies, including capital and disclosure requirements that failed to mitigate risk management weaknesses.

Taking the views of the various commentators into consideration, the current financial crisis is caused by the followings;

Firstly, *Liberalisation of Global Financial Regulations* is one reason for the crisis. The regulatory model adopted by banks in the US emerged as a result of liberalisation of banking business in the early 1990s and international consensus reached within the Basle Committee of Banking Supervision as regards the acceptable model of prudential supervision of banking institution (Scott, 2008 in Abubakar, 2008). This liberalisation facilitates the global abolition of restrictions on capital flow in the 1990s and caused the operation of international investment funds to be largely unregulated.

Another cause is the *Boom and Bust in the housing market*. A combination of low interest rates and large inflows of foreign funds help create easy credit conditions for many years leading up to the crisis. Due to low interest rates and large inflow of foreign fund, subprime lending/borrowing for investment became very attractive in both US and the UK. Since the demand for housing was rapidly rising in the US, most investors and homeowners took mortgaged loans and invested in housings. The overall US home ownership rate increased from 64% in 1994 (about where it was since 1980) to peak in 2004 with an all-time high of 69.2%.

Furthermore, *Speculations* is also one of the causes of the crisis. Traditionally, homes were not treated as investment like stocks, but this behaviour changed during the housing boom as

it attracted speculative buyers. This makes speculation in real estate a contributing factor. During 2006, 22% of homes purchased (1.65 million units) were for investment purposes – it means that nearly 40% of home purchases were not primary residences (wikipedia, 2008). This speculative buying makes housing prices to fall drastically.

New Financial Architecture (NFA) – according to Crotty (2008) NFA is “a globally integrated system of giant bank conglomerates and the so-called ‘shadow banking system’ of investment banks, hedge funds and bank-created Special Investment Vehicles.” This makes excessive risk to build up in giant banks during the boom; and the NFA generated high leverage and high systemic risk, with channels of contagion that transmitted problems in the US subprime mortgage market around the world.

Poor credit rating - due to securitization practices, credit rating agencies have the tendency to assign investment-grade rating to Mortgage-Backed Securities (MBS), and this makes loans with high default rate to originate, packaged and transferred to others. Quoting Black’s Law Dictionary (7th ed.) in Wikipedia (2008), “securitization is a structured finance process in which assets, receivables or financial instruments are acquired, classified into pools, and offered as collateral for third-party investment.”

High-risk loans - There appears to be widespread agreement that periods of rapid credit growth tend to be accompanied by loosening lending standards (Dell’Arriccia, Igan and Laeven, 2008). For instance, in a speech delivered before the Independent Community Bankers of America on 7 March 2001, the then Federal Reserve chairman, Alan Greenspan, pointed to ‘an unfortunate tendency’ among bankers to lend aggressively at the peak of a cycle and argued that most bad loans were made through this aggressive type of lending (IMF, 2008). Without considering high risk borrowers, lenders give ‘Ninja loans’ - high-risk

loans to those with No income, No job, and no Assets. They also give home loans to immigrants that are undocumented (Wikipedia, 2008).

Government policies - some critics believed that the crisis was fuelled by US government mortgage policies which encouraged trends towards issuing risky loans. For instance, Fannie Mae Corporation eases credit requirements on loans and this encourages banks to extend home mortgages to people that do not have good enough credit rating.

Africa and the Global Financial Crisis

The direct impact of the financial crisis on the African economies has thus far been limited as most commercial banks in the region refrained from investing in the troubled assets from the US and other part of the world. This is why most commentators argue that Africa is so far insulated from the direct effects of the financial crisis. The current financial crisis affects Africa and other developing countries in two possible ways;

First, there could be financial contagion and spillovers for stock markets in Africa. Stock markets in the region showed some volatility, driven by a sell-off by foreign investors. The Nigerian stock market for instance has been experiencing a continuous downward trend in prices of stocks for over two months now. The India stock market dropped by 8% in one day at the same time as stock markets in the USA and Brazil plunged. Stock markets across the world – developed and developing – have all dropped substantially since May 2008. Share prices have tumble between 12 and 19% in the USA, UK and Japan in just one week, while the MSCI emerging market index fell 23%. This includes stock markets in Brazil, South Africa, India and China (ODI, 2008). We need to better understand the nature of the financial linkages, how they occur (as they do appear to occur) and whether anything can be done to minimise contagion.

Second, the economic downturn in developed countries may also have significant impact on developing countries particularly Africa. The channels of impact include; the indirect effect of volatile and falling commodity prices, particularly crude oil, on export revenue and the inflow of capital into the region, low remittance from abroad, decline in foreign aids, low foreign direct investment and portfolio investment.

The financial crisis came as African economies were turning the corner. However, the effect is to the economies of African countries, in general. African Banks are not suffering from credit crisis as such since they are less exposed to the global credit system. Effect of global financial crisis is already being felt; e.g. Tanzania downgraded growth forecast to 7.5% down from 7.8%. AFDB forecast average growth of 5% down from 6.5%. (Mtango, 2008).

The Nigerian Perspectives

Like other African countries, the Central Bank of Nigeria, the Finance Ministry as well as other government commentators have been arguing that Nigeria economy is partially insulated from the direct effects of the financial crisis. But, as our economy is integrated with that of the US and the UK to some extents, we are feeling some indirect impacts of the crisis. The effects on Nigerian economy are specifically discussed as follows:

- i. Foreign direct investment (FDI) and equity investment; these will come under pressure. While 2007 was a record year for FDI to Nigeria and other developing countries, equity finance is under pressure and corporate and project finance is already weakening. The fall of inward investments will affect important sectors such as agriculture, infrastructure development, health and education (Mtango, 2008). Withdrawals of portfolio investment as a result of contagion effects have been causing a reduction in stock prices for over two months.

- ii. Downward trend in oil price; The deteriorating global economic outlook is likely to put further downward pressure on crude oil prices, which are expected to remain highly volatile. The indirect effect of volatile and falling commodity prices, particularly crude oil, on export revenue and the inflow of capital into Nigeria cannot be over emphasised. This is because the country depends on revenue from oil to finance its budget and the countries that are mostly hit by the crisis are the primary market for our oil. For instance, about 45% of our oil is exported to the US; therefore, this crisis is leading to fall in oil prices. To stabilize and pushes the price of oil up, OPEC have recently met and cut output by 2.2 million barrel per day (BBC.co.uk). In a precautionary move, the Federal Government of Nigeria reduced the 2009 budget revenue estimate to \$45 per barrel from over \$60 per barrel.
- iii. Remittances; Remittances to Nigeria and other developing countries will decline. There will be fewer economic migrants coming to developed countries when they are in a recession, so fewer remittances and also probably lower volumes of remittances per migrant. This will affect the calls by government on Nigeria in Diaspora to invest in the country.
- iv. Aid; Aid budgets are under pressure because of debt problems and weak fiscal positions, e.g. in the UK and other European countries and in the USA. While the promises of increased aid at the Gleneagles summit in 2005 were already off track just three years later, aid budgets are now likely to be under increased pressure (ODI, 2008). This will affect the Millennium Development Goals (MDG) of most developing countries as well as Nigeria.
- v. Commercial lending; Banks under pressure in developed countries may not be able to lend as much as they have done in the past. This would limit investment in the country as investors will find it difficult to borrow from these banks.

- vi. Countries with liberalized capital accounts (Nigeria, South Africa and Kenya) will be the first to suffer due to the tendency for investors to withdraw to safer markets.
- vii. Losses in other financial assets by banks and other financial institutions in Nigeria (e.g. those deposited with foreign correspondent banks). Banks with high foreign currency exposure will also be affected.
- viii. Other official flows; Capital adequacy ratios of development finance institutions will be under pressure (ODI, 2008). However these have been relatively high recently, so there is scope for taking on more risks.
- ix. Capital repatriation by private banks which are usually foreign-owned. For instance, Standard Chartered Bank, Citigroup (Nigeria International Bank).
- x. Countries' foreign reserves usually invested abroad will most likely be affected. This is because most big banks in Europe and the US are affected in one way or the other.
- xi. Slow down of economic growth, foreign currency income slump, unemployment increase, reduced Overseas Development Aid (ODA), depreciation of local currency, etc. will result in a setback in achieving the MDGs.

While the effects will vary from country to country, the economic impacts could include: Weaker export revenues; further pressures on current accounts and balance of payment; Lower investment and growth rates; and lost employment.

There could also be social effects: Lower growth translating into higher poverty; more crime, weaker health systems and even more difficulties meeting the Millennium Development Goals.

Possible Policy responses

The current macro-economic and social challenges posed by the global financial crisis require a much better understanding of appropriate policy responses. Some recommended policy responses which can be applied to the situation in Nigeria are enumerated as follows:

- There needs to be a better understanding of what can provide financial stability, how cross-border cooperation can help to provide the public good of international financial rules and systems, and what the most appropriate rules are with respect to development;
- There needs to be an understanding of whether and how Nigeria and other developing countries can minimise financial contagion;
- Nigeria and other developing countries will also need to manage the implications of the current economic slowdown – after a period of strong and continued growth in developing countries, which has promoted interest in structural factors of growth, international macro economic management will now move up the policy agenda.
- Nigeria and other developing countries need to understand the social outcomes and provide appropriate social protection schemes.
- Central Banks should regulate issue of foreign exchange to companies during this time of crisis to avoid creating a deep in foreign reserves.
- Non-bank financial sector such as Pension Funds should also be regulated. This is to protect pension funds from being invested in some of this complex instruments to enable them meet their liquidity obligation as at when due.
- African countries should strengthen domestic and regional markets and boost intra-African trade and it is also important to promote domestic tourism.
- There is a need for new stability of the global financial system in which the voice of every nation, every continent is heard and their concerns taken into account.

Conclusion

The global financial crisis is already causing a considerable slowdown in most developed countries. Governments around the world are trying to contain the crisis, but many suggest the worst is not yet over. Stock markets are down more than 40% from their recent highs. Investment banks have collapsed, rescue packages are drawn up involving more than a trillion US dollars, and interest rates have been cut around the world with US and Japan cutting theirs to all time low of 0.25% and 0.1% respectively (bbc.co.uk), in what looks like a coordinated response. With a recession already in place in most developed countries, Nigeria and other developing countries should try and come up with policies that will minimise the spread of this crisis to their economy.

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