Sources of Economic Policy Uncertainty in Nigeria: Implications for Africa

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Abstract

This paper identifies the sources of economic policy uncertainty in Nigeria and draw implications for Africa. The paper finds that economic policy uncertainty in Nigeria has many sources which are interlinked such as: unexpected and sudden central bank intervention; change in government policy after elections; political interference in economic policy making; fall in global oil price, oil price shocks and uncertain government response; recession and unethical public policy and practices.

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Keywords: Economic policy uncertainty, index, bankruptcy, investment, trade, financial institutions, systemic risk, government policy, fiscal policy, monetary policy, political interference, Nigeria.

1. Introduction

In this paper, I identify the sources of economic policy uncertainty in Nigeria and draw implications for Africa.

Economic policy uncertainty (EPU) is defined as the inability of economic agents to predict a change in existing economic policies and the inability to predict future economic policies of the government (Sahinoz et al, 2018). EPU can also be defined as uncertainty about whether existing economic policies of the government will change (Ozili, 2021a; Danisman et al, 2021; Ozili, 2021b).

Many African countries are heavily involved in international trade. They rely on imports from major exporting countries in Europe, Asia and North America. Any shock to the global supply chain will have devastating effect on African countries and will put pressure on economic policy making in African countries which can increase economic policy uncertainty.

The literature has established a link between economic policy uncertainty and economic performance (Caggiano et al, 2020; Xu, 2020). Recently, Baker et al. (2016) construct an index of economic policy uncertainty for the U.S., and find that high economic policy uncertainty has a negative effect on aggregate output and employment in the U.S. Istrefi and Piloiu (2014) show that, in times of rising economic policy uncertainty, the economy contracts, short-term inflation expectations increase and interest rate falls. Other studies use the economic policy uncertainty index to empirically examine the consequence of economic policy uncertainty on the real sector and financial sector, and show that economic policy uncertainty has depressive effects on the financial sector (e.g., Phan et al, 2021; Balcilar et al, 2020; Luo and Zhang, 2020; Nguyen et al, 2020; Danisman et al, 2021), and the real sector (e.g. Jory et al, 2020; Caldara et al, 2020; Choudhry, 2020; Duong et al, 2020).

The motivation for this study is linked to the potential effect of policy uncertainty shocks on import dependent countries such as Nigeria. Understanding the sources of economic policy uncertainty in Nigeria is interesting for three reasons. One, Nigeria is one of the largest economy in Africa and a major importer in international trade. Any unexpected disruption in global supply chains can have serious consequences for Nigeria's economy. An example is the global supply shock that affected Nigeria during the coronavirus COVID-19 pandemic in 2020 (Ozili, 2020; Ozili and Arun, 2020). Secondly, Nigeria has a high degree of openness to trade and financial flows, and most of its economic instability have resulted from external oil price shock and spillovers from other countries. Thirdly, the Baker et al (2016)'s economic policy uncertainty index is only available for major developed economies, and is unavailable for Nigeria.

Although Nigeria has implemented various economic policy reforms, the Nigerian economy is still vulnerable to policy uncertainty shocks. Understanding the sources of economic policy uncertainty in Nigeria can provide important insights into the cause of macroeconomic instability in African countries especially African countries that have similar economic characteristics as Nigeria. In this paper, I identify the sources of economic policy uncertainty in Nigeria. The findings show that unexpected and sudden central bank intervention; change in government policy after elections; political interference in economic policy making; fall in global oil price, oil price shocks and uncertain government response; recession; unethical public policy and practices, are major sources of economic policy uncertainty in Nigeria.

This study contributes to the policy uncertainty literature. It builds on the seminal work of Baker et al (2016). Baker et al (2016) construct an index to measure economic policy uncertainty. In the absence of an economic policy uncertainty index for Nigeria, this study identifies the sources of economic policy uncertainty in Nigeria. Secondly, this study contributes to the literature that examine the consequences of economic policy uncertainty in small open economies (Luk et al, 2020; Wang et al, 2020; Yang et al, 2020; Ozili, 2021b).

This paper is organized as follows. The recent literature is reviewed in Section 2. Section 3 describes the sources of economic policy uncertainty in Nigeria. Section 4 provides some avenues for future research on economic policy uncertainty in Nigeria. Section 5 discuss the implications for Africa. Section 6 concludes.

2. Literature Review

2.1. Theory

Economic theory suggest that uncertainty and uncertainty shocks have real consequences on the level of economic activities. Bloom (2009) argue that uncertainty increases after major economic and political shocks such as the Cuban Missile crisis, the assassination of JFK, the OPEC / oil-price shock and the 9/11 terrorist attacks; and such uncertainty shocks affects the dynamics of investment and hiring behavior in firms. Also, there is a consensus among economists that uncertainty rises in financial markets and the real economy during recessions (e.g., Handley and Limao, 2015; Nguyen et al, 2020; Ozili and Arun, 2020; Ozili, 2021a; Phan et al, 2019; Phan et al, 2021; Steinberg, 2019).

For instance, Alessandri and Mumtaz (2019) argue that a rise in uncertainty is inflationary and has little impact on economic activity in normal times while a rise in uncertainty is deflationary and its impact on output is six times larger during a financial crisis. Bekaert et al (2013) show that expansionary monetary policy reduces both risk aversion and uncertainty with the former effect being stronger, leading to greater production and investment levels in firms. Alessandri and Mumtaz (2019) show that uncertainty shocks caused a 1 per cent drop in industrial production in the US during the Great Recession.

2.2. Empirical evidence

Recent studies in the literature have focused on the consequence of economic policy uncertainty in many countries and regions but there are no studies that investigate the effect of economic policy uncertainty in Nigeria. For instance, in the literature we know that economic policy uncertainty shocks may have spillover effects into other countries. Caggiano et al (2020) quantify the impact of economic policy uncertainty shocks originating in the US on the Canadian unemployment rate in times of booms and recessions. They find that the unemployment rate in Canada reacts to economic policy uncertainty shocks in recessions only.

In the real sector, Xu (2020) examine the impact of government economic policy uncertainty on corporate innovation through the cost-of-capital transmission channel, and find that government economic policy uncertainty increases firms' cost of capital which translates into lower innovation. Xu also observe that firms with more exposure to economic policy uncertainty face a higher weighted average cost of capital and innovate less as economic policy uncertainty rises. Chen et al (2020) investigate the impact of oil price shocks on economic policy uncertainty. They find that oil price shocks lead to a positive change in economic policy uncertainty in the short- and long-term. Jory et al (2020) find that economic policy uncertainty has a negative effect on the length of trade credits. Caldara et al (2020) examine the effect of unexpected changes in trade policy uncertainty on the U.S. economy using three measures of trade policy uncertainty namely, newspaper coverage, firms' earnings call and tariff rates. They find that high trade policy uncertainty reduces business investment. Choudhry (2020) investigates the effect of the economic policy uncertainty on house prices in some regions of England and Wales, and observed that economic policy uncertainty has a long- and short-term negative effect on house prices in England and Wales. Duong et al (2020) find that U.S. corporations increase their cash holdings in response to higher economic policy uncertainty because holding more cash help U.S. firms mitigate the negative effect of policy uncertainty on investment and innovations.

In the financial sector, Phan et al (2021) investigate the effect of economic policy uncertainty on financial stability in a cross-country context, and find that economic policy uncertainty has a significant negative impact on financial stability and the effect depends on financial system characteristics. Balcilar et al (2020) examine the effect of economic policy uncertainty on the cost of insurance. They find that economic policy uncertainty leads to an increase in insurance premiums both in the short and long run, and the long-run impact is greater than the short-run impact. They also observe that economic policy uncertainty exerts a bigger influence on non-life insurance premium than on life insurance premium. Luo and Zhang (2020) examine the impact of economic policy uncertainty on firm-specific crash risk for listed firms in China from 2000 to 2017. They find that listed firms are more likely to experience stock price crashes when economic policy uncertainty increases, and the impact of economic policy uncertainty on stock price crash risk is stronger for firms whose returns are more sensitive to economic policy uncertainty. In the banking sector, Nguyen et al (2020) show that higher levels of economic policy uncertainty have a negative impact on bank credit growth, while a positive change in economic policy uncertainty has favorable effects on bank credit growth. Danisman et al (2020) investigate the effect of economic policy uncertainty on US banks' loan loss provisions, and find that US banks increase their loan loss provisions in times of higher economic policy uncertainty. Ozili (2021c) show that high economic policy uncertainty will transmit fewer new information to firms which can motivate managers to influence accounting numbers in the direction of the desired financial reporting outcome.

In the African literature, Aizenman and Marion (1993) examine the correlation between policy uncertainty and growth, and find evidence of correlated relationship in Africa and Asia. Specifically, they find a strong negative relationship between government expenditure surprises and growth in Africa and Asia. On the other hand, there is a positive relation between government revenue surprises and growth, and between unexpected public investment expenditures and growth in Africa and Asia. Kotze (2017) examines the effect of fiscal volatility shocks on the macro economy in South Africa, and find that fiscal volatility shocks produce prolonged contractions in economic output, consumption and investment, which implies that fiscal volatility shocks have adverse effects on economic activity in South Africa. Hlatshwayo and Saxegaard (2016) examine the role of policy uncertainty in reducing the responsiveness of exports to price changes. They find that increased policy uncertainty reduces the responsiveness of exports to the real effective exchange rate. They also observe that policy uncertainty has short and long-run level effects on export performance. Serven (1997) shows that instability and policy uncertainty are important factors responsible for Africa's poor investment record over the last two decades.

3. Sources of economic policy uncertainty in Nigeria

3.1. Central bank intervention in financial markets

Intervention in financial markets by the central bank is common in Nigeria. One example is the frequent intervention of the central bank to burst bubbles in financial markets caused by sustained increase in the price of financial assets. For example, the Central bank of Nigeria often does this by lowering the yield on 365-day treasury bills rate to a single digit rate, say below 5%, to discourage speculative investment in the short-term money market. Although this is a type of monetary policy control mechanism, such action makes it difficult for market participants, including investors, to buy and hold stocks for a longer time due to expectations of uncertain yields.

Another example relates to the central bank intervention during the 2007/2008 global financial crisis. In 2009, the sudden intervention of the Central bank just after the 2008 global financial crisis came as a shock to the Nigerian financial sector. The Nigerian economy was hit by the aftershock of the global financial crisis as the Nigerian stock market collapsed by 70 per cent in 2008-2009. Many Nigerian banks sustained huge losses due to their exposure to the capital market and the downstream oil and gas sector (Sanusi, 2011). Prior to the crisis, there were unethical practices in the Nigerian banking sector mainly: large and sudden capital inflows, major corporate governance failure in banks, lack of investor and consumer sophistication, inadequate disclosure and transparency about the true financial position of banks, deficient regulatory framework and regulations, uneven supervision and enforcement, unstructured governance and management processes at the Central bank, and weaknesses in the business environment (Sanusi, 2011). These problems made the banking system fragile and vulnerable to the aftershock of the global financial crisis, and led to the near-collapse of the entire banking system in Nigeria. The CBN intervened and rescued 8 banks through capital and liquidity injections. The CBN also removed the top executives of the affected banks in order to restore confidence in the banking system (Sanusi, 2011). Although the sudden intervention of the central bank brought confidence to the banking sector, banks subsequently became cautious and uncertain about what the regulator might do in the near future.

The uncertainty created by unexpected regulatory intervention in the banking sector often make banks delay investment in emerging sectors when they think the regulator might issue a policy statement that discourage banks' participation in the emerging sector. A notable example of this relates to cryptocurrency. Some banks were reluctant to engage in cryptocurrency trading and investment because they were unsure whether the Central bank will issue policy statements that support or oppose cryptocurrency in the Nigerian financial market. More generally, the uncertainty created by unexpected regulatory interventions can encourage financial institutions to reduce lending and excessive risk taking.

3.2. Change in government policy after election increases policy uncertainty

Government policies can promote business growth and survival in the business environment (Congregado et al, 2012; Smallbone and Welter, 2010; O'Connor, 2013). In Nigeria, businesses rely on the government to issue market-enabling policies, and the effectiveness of such policies depend on the quality and effectiveness of the institutions responsible for implementing and monitoring compliance with the policies. There are problems of policy inconsistency, discontinuity and instability. For instance, after elections, a new government in Nigeria may discontinue the policies of the previous government and introduce its own policies. Emodi and Yusuf (2015) show that when a new administration comes in, old policies are abandoned and new policies initiated. Aliyu et al (2015) and Musa et al (2016) show that the frequent change in military government brought political instability and policy discontinuity which led to the failure of several poverty alleviation programs. Dauda (2011) show that policy uncertainty and instability are obstacles to public social spending in developing and transition economies. Ihugba et al (2013) show that inconsistent government policies are a major challenge to entrepreneurship in Nigeria when government policies are unfavourable for entrepreneurial activities, and the entrepreneur has no choice but to swiftly adjust your business to align with the changing and inconsistent policies. Although the entry of a new government creates an opportunity for the new government to reevaluate existing policies to determine whether they are still relevant for the current economic realities in the country, it is important that policymakers issue policies that are consistent, expected and stable over time, and give businesses enough time to prepare to implement new policies in Nigeria.

3.3. Political interference in economic policy making

Political interference in economic policy making generally increases economic policy uncertainty by making firms in the private sector hesitant about whether to make new investment or divest from existing projects. Such delay can affect the performance of firms. Shen and Lin (2012) show that political interference depress the performance of government banks. Mukherjee et al (2001) investigate the experience and perception of politicians about corruption. Using a case study of a single firm in Bangladesh, they show that the perception of corruption in organizations decreases by 31 percent when politicians stop interfering in day-to-day decisions of the firm. Gokcekus et al (2001) find that 42 percent of the officials interviewed stated that politicians' interference is frequently a "significant problem" in Guyana.

In Nigeria, policy makers often face pressure to discontinue existing policies that hurt the business interest of politicians in the private sector, and the literature document evidence to support this assertion. For instance, Nnanna (2001) show that political federalism which Nigeria practices is a serious constraint on the Central Bank's ability to control the level of money supply in the economy, which implies that the efficiency of monetary policy in Nigeria is undermined by fiscal dominance and political interference. Also, the political and legal environment in which a central bank operates is crucial to the success of its policy making particularly monetary policy. Sanusi (2002) states that the central bank needs an appropriate legal framework, institutional structure and conducive political environment to allow the Central Bank operate with operational autonomy in decision-making. Political interference also exists even in the local governments. Usang and Salim (2016) argue that local governments in Nigeria experience varying levels of interference from politicians and state governments which is responsible for the poor performance of local governments. They analyse the relationship between political interference and local government performance, and find a negative and significant relationship between political interference and local government performance in Nigeria.

3.4. Fall in global oil price, oil price shocks and uncertain government response

A fall in global oil prices is a major external shock that affects the Nigerian economy in a significant way. A sustained fall in oil price, combined with uncertainty about how the government will respond to it, often transmit policy uncertainty to the private sector, and firms in the private sector will respond to such policy uncertainty by reducing the level of investment, reducing cost overheads, increasing cash holdings and reducing liabilities, among others.

Oil price shocks are also a major consideration when it comes to examining the impact of oil prices on the Nigerian economy. Oil price shocks can be divided into two categories: the demand-side oil price shocks and supply-side oil price shocks. The 'demand-side oil price shocks' arises from abnormal changes in aggregate demand for oil and the uncertainty about the future availability of oil. 'Supply-side oil price shocks' arises from abnormal changes in oil production. In Nigeria, oil price shocks will increase economic policy uncertainty through its spillover effects on economy activity. This is because the negative effect of oil price shocks on economic activity will put additional pressure on economic policy decision making which will lead to increased economic policy uncertainty. Also, the way the government or policy makers respond to oil price shocks can have a direct effect on the production and investment decisions of firms which can affect the demand for oil and thus oil price. Uncertainty about how the Nigerian government will respond to oil price shocks is often caused by disagreement about the right mix of monetary and fiscal policy, fiscal dominance, balance of payment deficit, debt sustainability problems and political interference.

3.5. Recession

Recessions are often characterized by heightened economic policy uncertainty. Firms in Nigeria often respond to a recession by cutting down production and investment which leads to a fall in economic output. Banks will reduce credit supply during a recession which will increase the cost of capital. During a recession, wholesalers and retailers will hoard goods and commodities in order to benefit from a rise in the prices of retail products. Entrepreneurs will increase the prices of goods and services sold during a recession, while the consumers suffer the fallout of a recession. Whenever there is a recession in Nigeria, a lot of policy experiments are carried out by policy makers. Policy makers implement a variety of policies to steer Nigeria out of the recession. Some policies succeed while others fail.

3.6. Unethical public policy and practices

Unethical public policy and practices also increase economic policy uncertainty such as lack of continuity of government policy programs, cultural factors, lack of planning, lack of political will, corruption, etc (Arowolo, 2012).

4. Economic policy uncertainty in Nigeria: Areas for future research

4.1. Impact of unexpected changes to trade negotiations and trade policy

Trade negotiation and re-negotiation have become an important source of policy uncertainty in many countries (Caldara et al, 2020; Handley and Limao, 2015), but there are no studies on the impact of uncertainty regarding trade policy in Nigeria. The impact of trade policy uncertainty in the Nigerian economy is still unknown. It will be interesting to know whether an increase in trade policy uncertainty will hurt the Nigerian economy through its effect on the level of investment, or capital accumulation, and more generally, the level of economic activity. Since the level of foreign investment in Nigeria is dependent on the foreign exchange rate, which oftentimes depreciates in response to falling global oil prices, policy makers in Nigeria will need to consider favourable re-negotiation of major trade arrangements in Asia, Europe and North America that can help to reduce uncertainty in trade policy and to stabilize the exchange rate in order to promote investment in Nigeria.

4.2. Policy uncertainty spillovers to and from other countries

Policy uncertainty shocks in one country can be transmitted to other countries due to globalization. In the real-world, small-open economies and developing countries are largely affected by policy uncertainty shocks coming from neighbouring countries and the rest of the World (Caggiano et al, 2020). For instance, Nigeria's economy is interconnected to the economy of its neighbouring West African countries such as Togo, Benin and Niger. These West African countries depend heavily on Nigeria for trade supplies such as electricity supply. A sharp increase in electricity tariffs in Nigeria can transmit shocks to these countries, thereby creating spillovers through unexpected changes in trade tariffs for electricity. Similarly, Nigeria depends on major exporting countries in Asia and North America for essential imported consumer goods. A major increase in the price of imports by China, India and Germany can have real effects on the Nigerian economy. To date, much is not known about economic policy uncertainty spillovers into Nigeria as well as how policy uncertainty shocks in Nigeria might spill-over into neighbouring West African countries. In the literature, there are no studies that investigate economic policy uncertainty spillovers in Nigeria. More research is needed to determine the spillover effects of rising policy uncertainty in Nigeria to neighbouring West African countries.

4.3. Impact of rising EPU on financial institutions

The effect of economic policy uncertainty on financial markets and institutions is also unknown for Nigeria. While this topic has been studied in other regional context, it will be interesting to investigate the impact of rising economic policy uncertainty on financial institutions in African countries such as Nigeria. In the literature, we know that financial institutions respond to high economic policy uncertainty by increasing their stock of cash holdings, hoarding liquidity, reducing lending, repricing existing loans, increasing interest rates, and by increasing loan loss provisions in the case of banks (see, Phan et al, 2019; Ng et al, 2020; Berger et al, 2020; Bordo et al, 2016). Nonetheless, the reaction of financial institutions in Nigeria to rising economic policy uncertainty may deviate from this general picture due to Nigeria's unique financial market structure, regulatory and business environments. Future research can examine the impact of economic policy uncertainty on financial institutions in Nigeria, and how these financial institutions react to rising policy uncertainty.

4.4. Effect on systemic risk through corporate bankruptcies

The effect of economic policy uncertainty on systemic risk in Nigeria is also unknown. Shifting our attention to corporate bankruptcy, one can argue that rising policy uncertainty in Nigeria can increase systemic risk by pushing many firms to bankruptcy. The decline in corporate lending by banks and liquidity hoarding by liquidity providers during periods of high EPU can cause significant financial friction to firms which can lead to corporate bankruptcies in Nigeria particularly for firms that rely heavily on bank financing. Future research can examine the effect of rising EPU on systemic risk in Nigeria, and examine whether rising EPU in Nigeria is associated with increased likelihood of corporate bankruptcy.

4.5. Developing an EPU index for Nigeria

To determine the economic consequence of policy uncertainty in the Nigerian economy, we need to first construct a set of indices to measure economic policy uncertainty for Nigeria. In the literature, Baker, Bloom, and Davis (2016) use the content in newspaper articles to construct an economic policy uncertainty index for major developed countries. But such index does not exist for developing countries like Nigeria, and this creates a fruitful opportunity for future research. Future studies can construct new indices to measure economic policy uncertainty in Nigeria. For example, such studies can rely on articles discussing economic policy uncertainty in leading Nigerian newspapers, by searching for relevant keywords in the electronic archives of major Nigerian newspapers.

5. General implications for Africa

The sources of economic policy uncertainty in Nigeria has some implications for African countries. Firstly, increased economic policy uncertainty can negatively affect investors' confidence to invest in African countries. It can discourage investors from investing in African economies, and can lead to a fall in private foreign investment in the African continent.

Secondly, in an era of increasing international trade among African countries, economic policy uncertainty has become a key element affecting the macro economy of several African countries.

Unstable and uncertain trade policies in a major exporting African country can transmit shocks to import-dependent African countries and can negatively affect them in significant ways. For instance, unexpected changes in import tariffs and exchange rate policy can transmit price shocks which can hurt import-dependent African economies by significantly increasing the price of imported goods. Stable trade policies are needed to ensure that price shocks are reduced to minimum levels to promote trade among African countries.

Thirdly, Nigeria is one of the largest economies in Africa and a major exporter to several African countries. It is expected that high economic policy uncertainty in Nigeria will negatively affect Nigeria's economy and have spillover effects to African countries that depend on Nigeria for imports. Policy makers in affected African countries should consider reaching a trade pact on a wide range of trade tariffs in order to insulate their economies from trade policy uncertainty shocks.

6. Conclusion

This paper identified the sources of economic policy uncertainty in Nigeria. The findings revealed that economic policy uncertainty in Nigeria has many sources which are interlinked. The identified sources of economic policy uncertainty in Africa are: central bank intervention in financial markets; change in government policy after elections; political interference in economic policy making; fall in global oil price, oil price shocks and uncertain government response; recession and unethical public policy and practices.

The implication of the study is that rising economic policy uncertainty in Nigeria has a significant effect on the Nigerian economy and for African countries. Firms in Nigeria and Africa will need to make difficult business decisions in the face of rising economic policy uncertainty, and such corporate decisions will have ripple effects on the level of unemployment, economic output, inflation and the economy at large. Policy makers in Nigeria should consider how unexpected changes in fiscal, monetary and regulatory policies affect firms in the private sector. Policy makers should put in considerable effort to reduce, if not eliminate, uncertainty regarding fiscal, monetary and regulatory policies in the country.

As discussed in the paper, future research studies can explore important issues such as the impact of unexpected changes in trade negotiations and trade policy; the likely effect of policy uncertainty spillovers from Nigeria to other African countries and from Nigeria to countries; the impact of rising economic policy uncertainty on the performance of financial institutions; the effect of economic policy uncertainty on systemic risk through corporate bankruptcies; and the need to develop an economic policy uncertainty index for Nigeria.

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