MANAGING EXCHANGE RATE IN AN UNDIVERSIFIED ECONOMY

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ABSTRACT

This paper examined the choice of exchange rate in an undiversified economy. A critical review of the literature on the exchange rate policy and economic diversification determinants was done. The analysis showed that infrastructure and the quality of institutions are important determinants of economic diversification. The country is in a better position to diversify its production base if it has a well-developed physical infrastructure and viable institutions. These findings have wide-ranging policy implications. First, government policies directed at improving government effectiveness and regulatory quality are essential for promoting economic diversification. Second, governments in resource-dependent countries can efficiently promote export diversification by fostering investment and trade freedom. Furthermore, governments in resource-rich countries need to take effective measures to offset the negative impact of large foreign exchange inflows on competitiveness. Effectively managing this is a major challenge for export diversification in resource-dependent countries. More broadly, governments need to grapple with the fact that policies aimed at the economic diversification may negatively affect the odds of export diversification. Finally, the choice of an exchange-rate regime depends on a country's characteristics, including its inflation performance, monetary credibility, its trading patterns, and its vulnerability to external shocks.

Keywords: Undiversified Economy, Exchange Rate Policy, Exchange Rate Regime, Economic diversification

INTRODUCTION

The current down-turn in the Nigerian economy as a result of crash in the crude price, has led to profound anxiety on both the government and the governed. This situation is worsened by the economies near total dependent on a product for bulk of her foreign exchange. This led the unprecedented though justifiable, call for diversification of the economy. Economic diversification entails exploring and utilizing vistas of foreign exchange earning raw materials which is vital to long-term economic growth. Vibrant economies usually generate a large share of their GDP in the manufacturing and service sectors. As important as agriculture and mining sector is to the GDP, when the economy heavily depends on income from them, sustaining long-term economic growth is challenging because of volatility in commodity prices and allocative inefficiencies, hence productivity growth in these sectors is slower than in others. This policy challenge is especially salient in resource-dependent countries. They tend to underperform, in part, because their economies heavily rely on the extractive sector for generating foreign exchange and budget revenues. In other words, the presence of abundant natural resources hurts macroeconomic stability, crowds out the manufacturing sector, increases the likelihood of civil unrest, and undermines democratic institutions (Corden and Neary 1982; Mehlum, Karl, and Ragner 2006; Hausmann and Dani 2007; Tornell and Lane 1999). This was further exacerbated by disarticulation of concrete economic problem solving solutions. To remedy this situation, governments should widen the scope of economic planning beyond the present mono-cultural dominant. It entails opening up vistas of plan option to include other comparative advantageous natural endowment. To achieve this, governments need to develop and implement effective economic diversification strategies needed to develop and implement effective economic diversification strategies.

To stimulate a policy debate on economic diversification, this paper examined the determinants of economic diversification across countries over time. Specifically, the paper analyzed diversification patterns and investigated factors that have influenced economic and export diversification. It argued that an abundance of natural resources creates better conditions for economic diversification while export diversification efforts encounter difficulties in resource-dependent countries. Both economic and export diversification require substantial financial resources, and it is obvious that countries with a wealth of natural resources benefit from them. However, when a country exports natural resources, foreign exchange inflows into the economy grow, making the national currency of this country more expensive compared with foreign currencies. Strong currency reduces competitiveness in the global markets and slows down the export diversification process.

A more fundamental way for countries to buffer themselves against the commodities cycle is to break their dependence on natural resources by diversifying their economies. This is easily achievable through exploring and exploiting variety of economic development opportunities that abound in the manufacturing and service sectors. There is strong empirical evidence that economic diversification leads to higher long-term economic growth. Hausmann and Dani (2007) have shown that a country's economic growth is determined not only by the amount its exports, but also by the composition of exports. The more complex and technologically advanced the exports of a country is, the higher the long-term economic growth is likely to be (Auty 2001). Suffice it to say that Nigeria export is characterized majorly by raw material components with little or no value added. Thus, the technological additive which ordinary would have created windows of opportunities is lacking. Therefore, to benefit from export, there is the need to diversify not only the natural resource sector but the whole economy. Studies (Corden and Peter 1982; Peter 1990; Gylfason *et al.* 1999 and Hildalgo *et al.* 2007) have shown that diversified economies are less susceptible to the price and production shocks of a small number of commodities. They will also be better prepared for the eventual depletion of nonrenewable resources. In addition, diversification widens the window of employment opportunities.

To date, few resource-rich states have diversified their economies out of the extractive sector into non-resource sectors. In this regard, the experiences of Chile, Indonesia and Malaysia stand out. From 1970 to 2008, the share of mining products in total Chilean exports declined from 85.5 percent to 58.7 percent, while the share of manufactured goods in total exports increased from 11.6 percent to 35.3 percent. In Malaysia, the share of agriculture in GDP fell from 26.7 percent in 1970 to 7 percent in 2005, whereas manufacturing's share increased from 12.2 percent to 35.8 percent (Sachs and Andrew, 2011)

Moreover, in the wake of the recent global economic downturn, the experience of resource dependent countries provides compelling evidence that without economic and export diversification these economies remain highly vulnerable to various external shocks. Neither the creation of special resource funds nor rigid fiscal rules can fully shelter them from the negative impact of excessive fluctuations in commodity prices. These countries lack clear policy guidelines on how to effectively diversify their economies and export portfolios. In addition, policy makers and development experts do not seem to fully understand the forces driving the diversification process; nor do they seem to know what public policies lead to

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new products and effectively promote the process of innovation, imitation, adaptation and technological change.

METHODOLOGY

Largely due to the nature of data considered for this study and the empirical evidences on the exchange rate dynamics within the economy, secondary sources of information was extensively employed. This entails content analysis of government foreign exchange policies, economic analysts' opinion, Bureau Du Change (BDC) operators and indeed other relevant literature. The thorough review of the views from the aforementioned and aligning same with empirical evidence helped to explain the dynamics in managing exchange rate in Nigeria.

THE REVIEW

Patterns of Diversification

Economic diversification is generally defined as the process in which the economy becomes more diverse in terms of goods and services it produces. It falls into two major types: economic (product) diversification and export diversification

Export diversification refers to deliberate policies intended to change the shares of commodities in the existing export mix, introduce new products in the export portfolio, and/or break into new geographical markets. Both types are believed to propel economic growth, create an environment conducive to productive investment, and reduce short-term macroeconomic volatility (Esanov and Patrick 2010).

At the national level, economic diversification takes place by reducing a country's overdependence on a narrow economic base. In resource-dependent countries the process entails moving the production base away from the extractive sector by supporting manufacturing and other non resource sectors (Hasse 2008). This process can be broadly defined as industrialization.

Export diversification is positively associated with economic growth (Hesse 2008). There are at least three channels through which export diversification can improve economic performance. First, if the export diversification process involves discovering new products or adding value to existing goods, then it leads to higher productivity through knowledge spillovers. Second, export diversification into new industries enhances growth by promoting output growth in other industries through backward and forward links. Third, export diversification reduces the volatility of export earnings, which in turn reduces macroeconomic uncertainty. Less volatility of export earnings and macroeconomic uncertainty supports the growth process of any economy (Jean and Romain 2003).

The current policy debate about economic diversification centers around two competing strategies of industrialization: import substitution industrialization and export-led industrialization. The objective of import substitution industrialization is to promote domestic industries to replace foreign-made goods for domestic goods; export-led industrialization intends to speed up the industrialization process by opening domestic markets for foreign competition and by supporting export sectors. In this debate, the economic performance of the newly industrialized Asian economies is often contrasted with development experience of Latin American and African countries in the 1970s. While larger Latin American countries such as Argentina, Brazil and Mexico had some success with the import substitution strategy, smaller and poorer countries failed to industrialize their economies strictly following inward-oriented policies (UNIDO 2009). In stark contrast, the successful industrialization experience of some Asian nations, including Malaysia and South Korea, is largely attributable to their export-promoting policies, rather than import substitution strategies (Sonobe and Keijiro 2006). In terms of policy options, countries that adopted import-substitution strategy as opined by UN (2011) relied on more direct government interventions in the economy, while export-led industrialization is mostly associated with creating incentives that indirectly influence the behavior of economic agents.

At the industry level, the diversification debate boils down to the selection of particular industries that have the potential to expand and ultimately develop sufficient capacity to compete with advanced economies in the global market. Although governments possess powerful policy instruments in their policy toolbox to stimulate structural change and the diversification process, choosing the right instruments determines success in the long run. Another challenge is to identify and take into consideration policy constraints on diversification. Reflecting these concerns, the debate at this level deals with identifying and deploying appropriate policies and policy tools. Even though the importance of industrial policies in encouraging diversification is widely recognized, there are divergent views on whether vertical industrial policies, which involve "picking winners," can successfully be adopted in resource-dependent countries characterized by weak institutions (Sachs and Andrew 2011). In Eastern Europe, for example, governments have refrained from picking winners and placed more emphasis on improving the general business environment.

As industrialization takes place, the structure of the economy changes and countries' income grows, leading to improvements in standards of living. High-income countries are more industrialized, and the manufacturing sector's share in GDP is higher in these countries compared with less developed ones. As countries develop, the manufacturing and service sectors tend to grow faster, compared with the primary sectors. It appears that the manufacturing sector in resource-rich countries has not been expanding along the path observed during the earlier stages of development in high-income countries. If this pattern is not reversed, the structure of the economy in resource-dependent countries will continue to be dominated by the non-tradable and mining sectors, thus hurting future growth prospects. Finding of this exercise is that an abundance of resources hurts export diversification. In contrast, the same variable plays no significant role in the economic diversification process.

In sum, an undiversified economy is the one characterized with the growth or extraction of a single commodity which tend to dominate the economy. This lack of diversification makes the economy vulnerable to unpredictable factors such as variations in harvests, and price slumps on the world export market (Hildalgo et al. 2007). It aggravates short term instability and intensifies the problem of long term growth. The commodities produced may have weak world market prospects, lack a domestic market which would permit actual or potential import substitution, fail to provide additional rural employment and fail to lend themselves to processing by domestic industry. Nearly 50% of the developing countries earn more than 50% of their export receipts from a single commodity.

Drawing lessons from how the United States and Canada industrialized their economies, Balami, Ahmed and Balami (2016) suggested that policymakers can leverage three types of extractive sector linkages to promote diversification. First, there are ***fiscal linkages*:** the use of revenues from the resource sector to promote other sectors. Second, there are ***production linkages*:** including backward linkages through investments in services and goods used to produce the commodities, and forward linkages through investments in services and goods used to process the commodities. Finally, there are ***consumption linkages*:** the demand resulting from the incomes earned in the commodities sector.

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Exchange Rate Policy

Although the paper is mainly concerned with undiversified economy we provided in the interest of completeness, a brief analysis of exchange-rate policy; more so as it is very vital to import and export of products.

Flexible and Fixed Exchange Rates

Flexible Exchange Rates: Countries with flexible exchange rates allow their currency to rise or fall in value against other currencies, depending on the demand for and supply of the currency relative to other currencies. For example, if the U.S. government supplies many more dollars than the French government supplies Euros to the world economy—for example, through more expansionary monetary policy—then there will be an increase in the relative world supply of dollars and a decrease in the relative supply of Euros (Sach and Andrew 1997a). Consequently, barring other changes in demand, the price (value) of the dollar relative to the euro will fall (or depreciate), and the price of the euro relative to the dollar will rise (appreciate).

An increase in relative demand also can also cause the currency to fluctuate. Assuming other variables do not change, an increase in demand for U.S. dollars relative to the euro (for example, because of an increase in demand for American goods or financial assets) will increase the price (value) of the American dollar and decrease the price of the euro. The advantage of fluctuating exchange rates is that the rates are more likely to reflect the true underlying value of the currency, thereby minimizing economic distortions.

Fixed Exchange Rates

Some countries prefer to keep the value of their currency fixed (or pegged) relative to other currencies, regardless of prevailing demand and supply. Advantages of this system include more predictability for businesses engaged in international trade. Fixed exchange rates also can perform a useful role in anchoring inflation expectations in a country that is determined to break from high inflation. The disadvantage is that countries often find it difficult to exit from a pegged exchange rate, even once the exchange rate has become clearly overvalued (Sachs and Andrew 1997b). In such a situation, central banks often intervene to defend the currency by selling foreign reserves. When central banks' reserves become depleted, however, countries are often forced to devalue their currency. This can lead to higher inflation and import prices—hurting the poor— and can damage the balance sheets of the government (by raising the burden of servicing foreign debt), of banks (if they have more foreign liabilities than assets), and of corporations (again, if they have foreign liabilities unmatched by foreign income streams).

More and more developing countries have adopted floating or flexible exchange-rate arrangements during the past 15 years. Maintaining fixed exchange rates can cause a gradual erosion of competitiveness if domestic inflation is higher than that of trading partners (which is often the case for developing countries). China is a singular example where, while maintaining a fixed exchange rate, its exports have been very competitive, as its currency has been grossly undervalued. For the most part, however, for developing countries that are heavily dependent on exports of a few commodities, flexible exchange rates often play a useful buffer role (Porter 1990; Klinger and Daniel 2004 and Esanov and Patrick 2010).

Other Exchange-Rate Options

Full Dollarization: Under this option, followed by Panama and Ecuador, among others, the local currency is abolished and a foreign currency (in this case the U.S. dollar) is adopted as the sole legal tender. Although this has the advantage of providing stability, certainty, and low inflation (essentially U.S. inflation), it also has several disadvantages. If a country's trade is not heavily weighted in favor of the adopted currency—for example, if most of its trade were with the euro area—full dollarization might not be a satisfactory option. More generally, unless the country has very close ties with the parent country, adopting the parent's monetary regime may not make much sense. Another disadvantage is that by abolishing its domestic currency, countries give up ― seignorage‖ — the profits derived from issuing currency at very little cost.

Currency Board: Under currency board arrangements, a country retains its own currency but promises to exchange the domestic currency for a foreign currency at a fixed given rate. To back up this promise, the central bank holds reserves at least equal to the domestic base money supply (so that the exchange promise can be fulfilled) and allows the money supply to be determined solely by inflows and outflows of foreign exchange. Domestic credit expansion is prohibited under such a system, even for lenders of last resort. By providing a stronger exchange-rate commitment than regular exchange-rate regimes, a well-run currency board, such as those of Hong Kong and Lithuania, can provide credibility and anchor expectations—substantial advantages. At the same time, the exit problem is intensified and can result in terrible economic consequences as in Argentina's forced exit from the currency board in 2001.

Most countries adopt none of the solutions identified above. Few countries float freely (that is, free of intervention), and fixed rates rarely last long without some form of exit. Many countries practice ―dirty or managed floating exchange-rate regimes, normally refraining from intervention but resorting on occasion to foreign-exchange transactions when the market is thought to have strayed too far from equilibrium.

Un-diversification and Management of Foreign Exchange in Nigeria

The current free for all fall in global oil price has exposed the weakness in depending on mono-cultural and import driven economy. The various risk factors inherent in so doing include but not limited to the following:

i. Lower crude oil prices
ii. Pressure on the Naira
iii. Constraint to credit growth.
iv. Fiscal challenge.
v. Increasing level of non –performing loans.
vi. Rising level of trade imbalance.
vii. Low external reserve.
viii. Capital reserve reversal.
ix. Creation of liquidity.
x. Interest rate is destroying jobs.
xi. Dilemma of holding prices and quantity in foreign exchange market
xii. The problem of fuel subsidy

The implication for global development for the Nigerian Economy is that capital reversals and low international oil prices do exert pressure on the exchange rate with some pain through volatility in the international oil market and the raising demand for exchange rate. Government has adopted the following measures to stabilize the foreign exchange. Demand management policies have been put in place among others which include:

i. Tightening monetary policies

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ii. Closure of official foreign exchange windows (i.e the wholesale Dutch Action system and Retail Dutch Action System.
iii. Review of operators net open positions.
iv. Placement of 72-hour limit on foreign exchange utilization by customers.
v. Introduction of BVN.
vi. Banning access of foreign exchange to 41 commodities (investors.)
vii. Federal Government of Nigeria stiffens measures on foreign exchange street trading.
viii. Commercial banks refusing to accept dollar deposits in to domiciliary accounts.

Potential solutions in fixing the Nigerian economy include among others:

i. Nigeria needs to plan systematically 1 to 4 years.
ii. Adoption of 1SI.
iii. Government to build buffers as part of inflation strategy.
iv. Reserve preservation mode.
v. Many more companies are owing banks therefore should be encouraged to pay
vi. Resuscitation of moribund plantation and/or encourage private participation in large scale plantation scheme eg palm sugar-cane, cocoa, rubber etc

Solution to Diversification of Nigerian Economy

Fiscal authorities should harmonize –import substitution and agricultural value chain taking into account the backward integration (for example in the cement industry). This is with a view to ascertaining how backward integration impacted on the foreign exchange market. Investors should be encouraged to invest in the economy by providing enabling environment while discouraging importation.

CONCLUSION

In this paper we discussed the exchange rate regimes as it relates to economic diversification. An undiversified economy is known as the one relying much on one commodity for its foreign exchange earnings. After defining the concepts of economic diversification and exchange rate we examined the main determinants of economic diversification worldwide and particularly to resource- abundant nations such as Nigeria. The study found that the composition of exports in resource-rich countries is not only poorly diversified but also is technologically less sophisticated than other countries in the sample. Over time, both the level of diversification and product sophistication in resource-rich countries have experienced little change and remained at the lower levels. In these countries, manufacturing value added accounts for about 11 percent of GDP, and the trend has been downward throughout the past couple of decades.

The analysis showed that infrastructure and the quality of institutions are important determinants of economic diversification. The country is in a better position to diversify its production base if it has a well-developed physical infrastructure and viable institutions. In contrast, infrastructure and the quality of institutions seem to be of little significance for export diversification. Instead, investment and trade freedom and the measure of resource dependence determine the level of export diversification. While these freedoms boost the level of export diversification, resource dependence slows down the process. Another important finding from this study is that FDI flows facilitate economic diversification, but have negligible effects on export diversification.

The empirical review of literature restricted to resource-rich countries produced similar results. The quality of institutions and infrastructure are critical to the economic diversification process, while trade and investment freedom are important for export diversification. The paper also examined that resource dependence adversely affects export diversification and helps economic diversification. These findings have wide-ranging policy implications.

POLICY RECOMMENDATIONS

First, government polices directed at improving government effectiveness and regulatory quality are essential for promoting economic diversification. Second, governments in resource-dependent countries can efficiently promote export diversification by fostering investment and trade freedom. Furthermore, governments in resource-rich countries need to take effective measures to offset the negative impact of large foreign exchange inflows on competitiveness. Effectively managing this is a major challenge for export diversification in resource-dependent countries. More broadly, governments need to grapple with the fact that policies aimed at the economic diversification may negatively affect the odds of export diversification. The choice of an exchange-rate regime depends on a country's characteristics, including its inflation performance, monetary credibility, its trading patterns, and its vulnerability to external shocks.

For resource-rich countries to break the commodities cycle, prudent macroeconomic management is a prerequisite. This entails controlling revenue volatility from export earnings and keeping a close eye on inflation and exchange rates to prevent the economy from overheating and other tradable sectors from suffering. Well-governed natural resource funds can help by smoothing government expenditure, sterilizing the economy from resource revenues and helping to earmark resource revenues for investment projects that increase productivity.

Diversifying out of the commodities sector is a difficult undertaking, and not many countries have succeeded. Most have not been able to secure macroeconomic stability in the first place, is partly because the temptation to spend available revenues is strong. However, it is pertinent that there is no single diversification path, as the optimal strategies largely depend on a country's comparative advantages and bargaining position. Botswana, for example, was only able to drive a hard bargain to move downstream because it is the second-biggest diamond producer in the world, and De Beers could not afford to lose access to such an important source. Nigeria can borrow from Botswana in order to reap the benefits of diversification.

What is certain is that breaking the commodity cycle requires fiscal discipline, a medium- to long-term development plan, integrated governmental policies to capture available linkages and targeted sectoral support; bearing in mind that commodities boom inevitably turn to busts, as the recent price downturn has once again illustrated. When they do, the importance of breaking resource dependency becomes clear.

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