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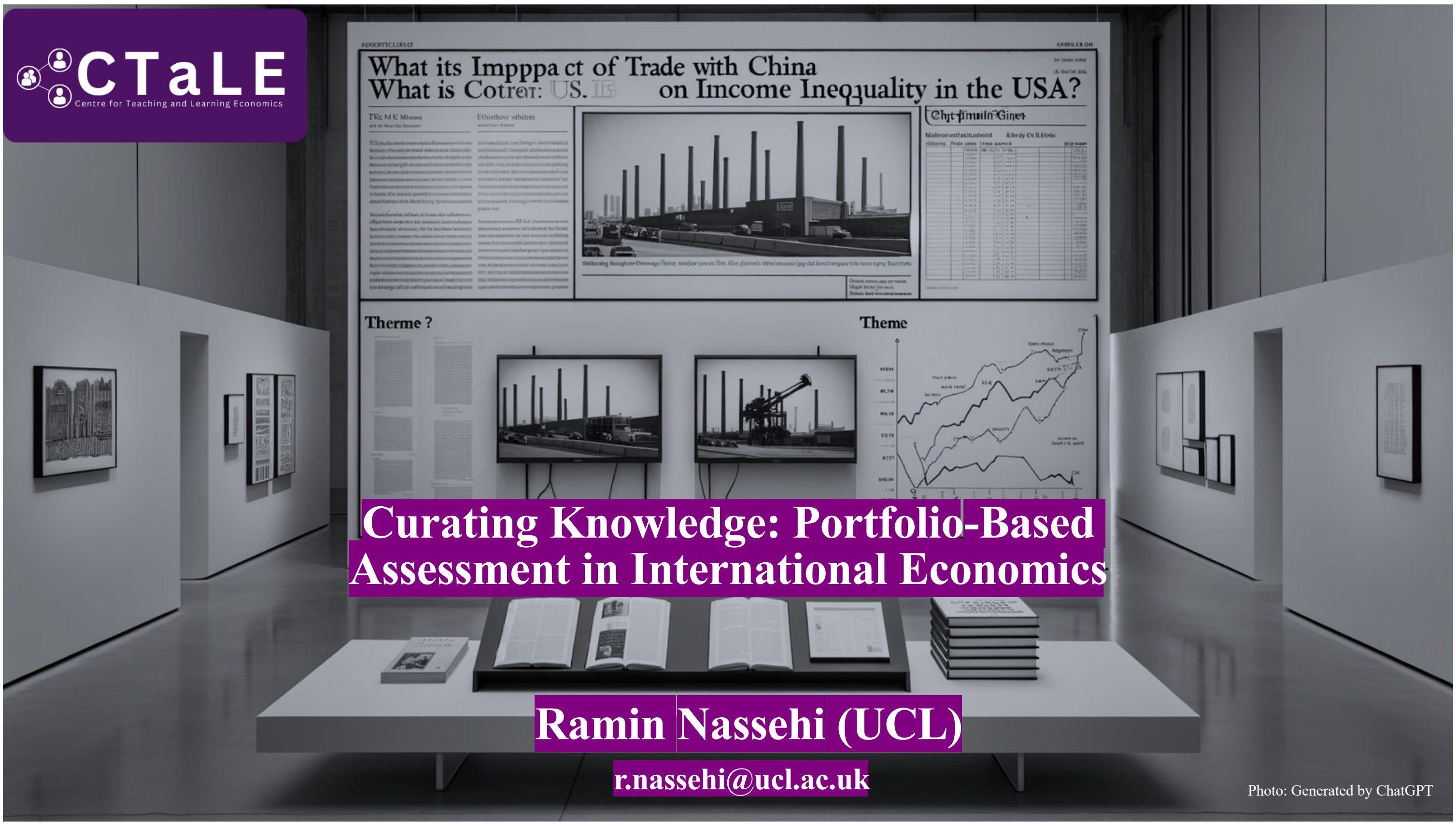

Curating Knowledge: Portfolio-Based Assessment in International Economics

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Part one

Question: Nigerian currency crisis: What was the impact of Naira devaluation on the rate of inflation in Nigerian economy?

In 2023 the Nigerian Central bank introduced major changes to its foreign exchange operations. The country has been struggling with internal challenges and has recently been in a currency crisis. These new currency reforms are aimed at revitalising the Nigerian economy through the adjustment of exchange rates. However, these adjustments are costly to the Nigerian economy and the current rate of inflation of 33.2% has been largely caused by the recent devaluation of the Naira. The importance of this question lies within its potential to understand the appropriate policy responses to this ongoing crisis and future crises with the same characteristics.

This question links to the topic of "International Finance", which deals with the different types of exchange rate systems, their benefits, and flaws. Specifically, it is related to the fixed exchange rates and the costs of overvaluing a country's currency. This portfolio will complement the discussion of the consequences of devaluation covered in week 8 lecture and will focus specifically on inflation.

Part two

Source 1: Video

Why Is Nigeria's Naira such a mess? Bloomberg Television January 30, 2024

This source serves as the introduction to the current currency crisis in Nigeria and the current government policies used to address it. The video starts off mentioning Nigeria having multiple exchange rates which started because of the drop in the oil prices in 2014. Instead of devaluing the currency, the Nigerian government implemented an exchange rate pegged to the US dollar for government transactions and a weaker market-determined rate for investors and exporters. This new system failed to deliver foreign exchange inflows and the increasing demand for US dollars led to the emergence of the black market that had a weaker rate than the official. This gave a rise to speculation on the Nigerian currency.

In June 2023, the Central Bank announced that the Naira will trade freely until it found a new market-related level, this was followed by another devaluation of 31% against the US dollar, converging the official and the black-market rate.

Source 2 : News article

Currency crisis pushes consumer groups from Nigeria April 14, 2024, Financial Times

This rigorous case study discusses how a currency crisis in Nigeria has impacted the multinational companies and consumer groups in the country. As a result of the sharp devaluation of the Naira, multinational companies such as Unilever, GSK, and P&G have scaled back their operations or exited the market completely. This was a direct result of the soaring costs, as many multinational companies have fixed costs in USD. Local companies such as Nigerian Breweries had to increase prices rapidly to stay in business further fuelling inflation. The soaring inflation is mentioned at 31.7%, which has put significant pressure on both domestic and multinational businesses.

Source 3: Research paper

Borensztein, Eduardo, and José De Gregorio. "Devaluation and inflation after currency crises." International Monetary Fund (1999): 1-34.

This source introduces the theoretical background for the discussion on significant and abrupt devaluations on domestic prices. Examining a sample of 41 episodes of currency crises. The findings suggest that 30% of the initial devaluation effect on prices is offset by higher inflation after 3 months and the offset climbs to 60% over the two years.

The magnitude of inflationary pass-through relies on the underlying factors, including the initial overvaluation. Furthermore, the paper outlines that the inflation rate is directly related to the underlying equilibrium of relative prices. The potential for inflation to be a short-run phenomenon is mentioned, but it is also acknowledged that there is the potential for inflation to persist due to sluggish adjustments and sticky price levels.

In determining the extent of initial overvaluation, the paper considers the long-term purchasing power parity (PPP) equilibrium. The overall conclusion drawn from empirical data analysis is the enduring nature of inflation following a currency devaluation. It is estimated that the impact of a 10% devaluation is approximately 3%, 4%, 5% and 5.5% after 3 months, 6 months, 1 year and 2 years, respectively. However, the source acknowledges that the economies that start with a large overvaluation tend to have lower inflationary pass-through than predicted by the model.

Part 3: **Answer, reflection, and link to the lecture**

The first two sources highlight how the impact of the recent currency crisis and subsequent devaluation of the Naira have been felt throughout the Nigerian economy in terms of economic instability and rampant inflation. The difficulty in maintaining profitability has pushed the domestic corporations as well as multinational corporations into raising prices. According to the estimates of the third source, a 31% devaluation should have resulted in additional 15.5% of inflationary pressure, as we approach 1 year since devaluation. Suggesting that other factors are also influencing the inflation rate in Nigeria.

The question of persistence of this phenomenon relies on the underlying factors, as discussed in the research paper. Most dominant out of these factors is the long run PPP equilibrium in terms of relative prices of goods and services in Nigeria relative to the US. The sharp devaluation has been successful in bringing the official rate closer to the black-market rate, but the real extent to which the Naira was overvalued is yet to be determined.

Reflecting on this portfolio, it is evident that the sharp devaluation is only a result of the underlying factors and hence subsequent inflation is rooted deeply in the economic conditions of Nigeria. As mentioned, a painful adjustment for the economy is the consequence of overvaluing its own's currency. The Nigerian currency crisis is the most recent example of a sharp devaluation to happen. The lack of automatic adjustment due to a fixed exchange rate within the economy provides a need for decisive action from the government to manage the currency to ensure macroeconomic stability. Yet it is evident that the Nigerian government has failed in that objective. Whether inflation persists as suggested by the research paper or slows down from now on, only depends on the actions taken by the government in adjusting the relative prices to the long-run PPP equilibrium. The complexity of the underlying situation is the key factor behind the uncertainty of the long-term impact of devaluation. To estimate the impact of devaluation on Nigeria's inflation in the long term, an empirical study could be conducted utilizing the findings of the research paper and incorporating new variables, such as the currency black market and current instability within the country, providing great opportunity for further research

This portfolio complements the lecture material on the fixed exchange rates and expands upon the consequences of a devaluation on an economy. The findings presented showcase the abstract models and theories contained in one recent and rigorous case study. Specifically, the long-run PPP equilibrium comes out as an exceptionally relevant piece of theory to the current situation in Nigeria. Furthermore, the chosen sources highlight the importance of government policy when following a fixed exchange rate, as the currency crisis is the direct result of consistent failures of the Nigerian government. Lastly, the shortcomings of the long-run PPP equilibrium theory are evident, as it is difficult to accurately estimate the appropriate rate.

Appendix 1: Video

Why Is Nigeria's Naira such a mess? Bloomberg Television January 30, 2024

[Why Is Nigeria's Naira such a mess? - YouTube]

Appendix 2

Currency crisis pushes consumer groups from Nigeria Financial Times April 14, 2024

Nigeria + Add to myFT

Currency crisis pushes consumer groups from Nigeria

Economic problems have overshadowed promise of Africa's most populous country for big brands

Unilever has stopped producing homecare and skin-cleansing products, a key plank of its Nigeria sales, because of the economic crisis © Afolabi Sotunde/Reuters

Aanu Adeoye in Lagos and **Madeleine Speed** in London APRIL 14 2024

Many consumer groups on the front line of the global cost of living crisis have assured shoppers that the relentless price increases of the past few years will taper as global inflation cools. But for consumers in Nigeria there is little relief in sight.

Nigerian Breweries, which is part-owned by Heineken, has increased prices three times so far this year. So dire is the economic distress in Africa's most populous nation that the brewer's chief executive, Hans Essaadi, complained on an investor call that customers can no longer afford Goldberg, a cheap and well-loved lager.

Some customers, like Ayo Ajanaku, have started cutting down their consumption in response. "My consumption is now well thought out — it's no longer based on spontaneous decisions," the communications consultant said.

The surging prices are a symptom of an economic malaise in the country that appears to have no end.

A long-running shortage of foreign exchange and a sharp devaluation of the naira pose a double blow for multinationals. Many of them have fixed costs, such as those for raw materials, invoiced in dollars that they must now purchase using a slumping currency — and then they find it almost impossible to repatriate any earnings. The central bank said in late March that it had cleared all "valid" foreign exchange obligations.

Consumer groups that invested heavily in the country have been left particularly exposed with the forex crunch hitting groups including Unilever, GSK and PZ Cussons as well as domestic champions such as Nigerian Breweries.

It has cast a shadow over Nigeria, whose large population — of about 200mn, according to the World Bank — meant it was once hailed as a beacon of emerging markets growth.

In response to the economic challenges, some of the world's biggest consumer groups have headed for the exit, essentially giving up on a market where headline inflation, which stood at 31.7 per cent in February, has eroded consumer spending power.

Unilever stopped producing homecare and skin-cleansing products, a key plank of its Nigeria sales, a year ago. Chief executive Hein Schumacher cited the impact of the foreign exchange crisis and said the group was "not being able to fight at competitive prices".

GSK's Nigeria affiliate also scaled back its business last year, putting an end to its own medicines distribution and switching to third-party Nigerian companies. Germany's Bayer and French giant Sanofi, which makes polio vaccines, have followed suit.

An asthma inhaler manufactured by GSK. The company has scaled back its business in Nigeria © Temilade Adelaja/Reuters

The deepest cut has come from American group Procter & Gamble, which in December announced that it would cease in-country production and switch to importing into the west African nation.

It will undergo a restructuring as a result of the macroeconomic conditions in markets including Nigeria, the cost of which will be up to $1bn to $1.5bn, "including foreign currency translation losses to be recognised upon the substantial liquidation of operations in the affected markets", the company said.

DEVALUATION AND INFLATION AFTER CURRENCY CRISES*

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International Monetary Fund

José De Gregorio
Universidad de Chile

This version: February 1999

Abstract

This paper studies the effect of large devaluations on inflation. It analyzes a sample of 41 episodes of currency crisis. The data show that about 30% of the devaluation is offset by higher inflation after three months, and the offset climbs to about 60% after two years, with a significant real depreciation present for longer periods. The main determinants of the extent of inflationary pass-through of the devaluations and inflation are the position of output relative to trend, the extent of initial overvaluation, and mainly the initial rate of inflation. Our results explain well the evolution of inflation after currency crisis, except for the EMS crisis of 1992 that has a very low pass-through. We also analyze the inflationary impact of devaluations in the Asian crisis.

* Part of this paper was prepared while De Gregorio was visiting the Research Department of the IMF. We thank comments by Rodrigo Valdes, and participants at seminars in the Central Bank of Chile, Universidad de Chile, Universidad di Tella, and LACEA meetings. We are also very grateful for the superb research assistanship of Manzoor Gill and Cristobal Huneeus.

I. INTRODUCTION

The most challenging question when exiting an exchange rate peg is whether the devaluation will be an effective means of changing relative prices (the real exchange rate) in the economy (see, for example, Edwards, 1989). A similar question also applies in the context of more flexible exchange rate regimes prevailing in the post-Bretton Woods era. In particular, in the aftermath of most currency crises there is the concern that the inflationary impact of the large devaluation may greatly complicate the management of the crisis.

In this paper we investigate the inflationary effects of large, sudden devaluations.[1] Do changes in the exchange rate of this nature have a large immediate impact on domestic prices? How does the inflationary impact evolve over time? How does the effect depend on the initial conditions of the economy? We investigate these questions by analyzing a large sample of currency crises since 1970. These include some of the most conspicuous cases of large devaluations in recent experience, including the Mexican crisis of 1994, the last European currency realignments, the CFA franc devaluation, and other episodes in Asia and Latin America.

[1] In this paper we use the term devaluation to signify either a change in the parity in a pegged exchange rate regime (a devaluation) or a depreciation of the exchange rate in the context of a floating exchange rate regime, perhaps after the abandonment of a peg (a depreciation). In any event, it is often difficult to distinguish exchange rate regimes with precision. In many currency crisis episodes, for example, countries were following a formally floating system but the authorities were *de facto* pegging the exchange rate.

These questions have important policy implications. Large and sudden devaluations usually occur when an exchange rate peg is abandoned, often in the context of strong market pressure or a balance of payments crisis. While in these situations there are always clear signs of overvaluation of the domestic currency, determining the magnitude of the necessary depreciation (or of a desired range for the exchange rate to align policies in a floating exchange rate regime) poses difficult questions. It could be argued that the depreciation should just offset the estimated overvaluation, bringing the exchange rate back in line. However, some degree of pass-through to domestic prices is unavoidable, and thus it is necessary to overshoot the required devaluation initially. The consequences of this decision are often weighty. On the one hand, a large overshooting in the initial nominal depreciation may affect large segments of the population by increasing the prices of basic imported (or tradeable) commodities, create short-run financial strains for banks and corporations with foreign indebtedness, and generally undermine investor confidence. On the other hand, if the devaluation achieves a durable exchange rate adjustment, the current account will show a substantial improvement, confidence may be regained, and the crisis may be shorter. The speed with which domestic prices rise after a sudden devaluation (and the degree to which they do) thus becomes the critical factor.

This issue has become quite relevant with the sequence of emerging market crises in the past few years. In the Asian crises of 1997-98, for example, huge swings in exchange rates were observed after countries were forced to let their exchange rates float. When exchange rates doubled or even quadrupled (in terms of the price of the U.S. dollar) the possibility of triggering an inflation spiral rose strong concerns. Although in some cases, notably Korea and Thailand, the exchange rates rebounded and settled at much more reasonable levels, the apparently small extent and slow speed of the inflation passthrough was a critical factor to permit the return of stability to the foreign exchange markets. The same kind of concerns applies to Brazil in 1999.

It may be argued that devaluations of the sort studied in this paper should not have a significant inflationary effect when they are basically correcting a misaligned exchange rate rather than reflecting a sustained monetary imbalance. Simply restoring equilibrium to relative prices while maintaining a broadly appropriate monetary policy stance should not result in generalized inflationary pressures. An opposite argument would be that, with reasonably flexible prices, a policy-induced change in a nominal variable should not have lasting effects on relative prices, and thus devaluations would only produce an increase in the price level in the fairly short run, for example as predicted by purchasing power parity. From this perspective, the view that nominal devaluations have significantly lasting effects on the real exchange rate relies on the existence of sticky prices and slow adjustment.

A quick look at the evidence suggests that economies go through prolonged periods of changes of the real exchange rate after changes in the nominal exchange rate, implying that frictions are relevant and that devaluations have real effects. However, it is also true that, in many instances, the inflationary effect of devaluations is quite significant. While changes in the nominal exchange rate help to restore equilibrium in relative prices faster, they also have an impact on inflation, and nominal devaluations have different degrees of effectiveness from country to country and episode to episode.

One strand of the empirical literature has focussed on the pass-through from exchange rates to prices in connection with the sharp swings of the U.S. dollar during the 1980s.[2] The purpose of those studies was to understand why not all of the appreciation or depreciation of the U.S. dollar was passed on to prices. The explanations were mainly based on imperfectly competitive market structures. Different pass-through coefficients were explained mainly on the basis of market structure in the United States and trading partners.

In contrast, this paper focuses on the behavior of the price level, rather than particular markets or sectors. Our work is thus closer to Edwards (1989) who analyzes 39 devaluation experiences between 1970 and 1982, and studies the extent to which whether they were finally undone by inflation. An extension of that work, including more experiences and examining the policy responses, is in Edwards and Santaella (1993). Similarly, Goldfajn and Valdés (1998) examine a similar issue by looking at experiences of "large appreciations" and then uncovering whether the appreciations were corrected by falls in the rate of inflation or by devaluations. Work by Kamin (1988) and Kiguel and

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[2] See, for example, Dornbusch (1987) and the references in Obstfeld and Rogoff (1996) pp. 711-712.

Marking criterion for the portfolio assignment

Research question (20 points):

Is the question clear and specific enough?

Is the question original?

How is the question linked to the topics we discussed in the module?

Source 1: Video/podcast (20 points)

Does the source relate to the question? Does it make the topic intuitive at the household or firm level?

Source 2: News article (20 points)

Does the source relate to the question? Do the highlight parts relate to the concepts that we discussed in the module?

Source 3: Policy paper or journal article (20 points)

Does the paper relate to the question? Is it from a reputable source? Do the highlight parts relate to the concepts that we discussed in the module?

Synthesis (10 points):

Do the presented source relate to each other? Altogether, do they provide an answer to the question?

Metacognition (10 points)

How does this portfolio of selected sources complement the lecture material? How gathering this portfolio helped the student better learn the topic?

To help students plan their portfolio

Template for Portfolio outline

**How to name your submission file? If your name is Ramin and you are in tutorial B, please name your submission file as "TB-Ramin".

Your Proposal must be written in font size 11 and must not exceed one page. If you go over one page only the first page will be reviewed.

Research Question	*Write your research question here + **one single sentence** explaining the importance/relevance of this question.*
Video/Podcast	*Post the link here + a **one single sentence** explaining why you chose this source*
Newspaper article	*Post the link here + a **one single sentence** explaining why you chose this source*
Academic article	*Post the link here + a **one single sentence** explaining why you chose this source*
How do they complement the lecture material?	*Explain how your plan relates to the material learned in this module.*