PRESS BRIEFING ON THE STATE OF THE NIGERIAN ECONOMY WITH PARTICULAR REFERENCE TO EXCHANGE RATE AND RESERVE MANAGEMENT

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Departmental Directors and Other Executive Staff of the Bank,
Gentlemen of the Press,
Ladies and Gentlemen.

It is my pleasure to welcome you all to this Press Briefing, the third this year, on the Review of the State of the Nigerian Economy. My emphasis, at this time, will be on recent external sector developments and the exchange rate management.

1. Overview of Recent Developments in the Nigerian Economy

2. A review of developments in the economy during the first half of this year reveals a mixed performance. On the positive side, domestic output growth showed some improvement while the macroeconomic environment was relatively stable. On the negative side, the balance of payments was under severe pressure, resulting in the depreciation of the naira and rapid depletion of official external reserves.

3. Real output growth, proxied by agricultural and industrial production for which provisional data are available, showed a modest improvement. More specifically, the index of agricultural production rose by 4.1 per cent, in the first half of 2002, compared with 3.9 per cent a year earlier. Although the index of manufacturing production rose by about 1.0 per cent, capacity utilisation increased significantly to 40.1 per cent, up from 35.5 per cent in the first half of 2001. Constrained by continued structural bottlenecks and the contraction in petroleum and solid mineral production, overall output growth remained promising.

4. On a moving average basis, inflation rate decelerated from 18.9 per cent in December 2001 to 16.8 per cent in May 2002 and was projected to moderate further to 15.8 per cent in July, while on month on month basis, the rate fell from 16.5 per cent in December to 10.2 in May 2002 and is expected to decline further to single digit in July. The improvement in inflation performance was largely attributable to the deceleration in monetary and credit expansion. For example, the growth in narrow money (M1), at 5.5 per cent in the first half of the year, remained within the programmed target of 12.4 per cent for the year. Although the growth rate of broad money (M2), which was 10.6 per cent during the same period exceeded the proportionate growth target of 15.3 per cent for the year, it represented a considerable deceleration from the 21.9 and 29.2 per cent recorded in the corresponding period in 2001 and 2000, respectively. The major moderating factor was the sharp fall in the rate of bank credit expansion to the private sector, from 27.3 per cent in the first half of 2002 to 6.3 per cent in the review period. However, the growth in bank credit to government accelerated, reflecting the substantial

borrowing needs of the Federal Government to finance its budget deficit.

5. Attributable mainly to the sharp fall in oil revenue receipts, the retained revenue of the Federal Government fell below the budgeted level and the actual receipt in the same period a year earlier. Although total expenditure of the Federal Government showed an overall decline, outlays on recurrent expenditure, which represented 81.3 per cent of the total spending, exceeded the budget estimate by almost 14.0 per cent. The deficit was financed largely by the banking system.

6. During the first half of 2002, the interbank funds market was relatively stable with interest rates, particularly at the short-end of the market, moving generally downwards. The development was largely influenced by the modest improvement in macroeconomic environment during the period and the effect of the CBN=s temporary liquidity support for some banks. Moreover, the CBN Minimum Rediscount Rate (MRR) was reviewed downward by 200 basis points to 18.5 per cent in July, from 20.5, mainly to stimulate investment and output growth.

7. The external sector of the economy was under severe pressure during the period under review, resulting in a large overall balance of payments deficit. The external balance swung to a deficit of ₦386 billion in the first half of 2002, from a surplus of ₦ 51.1 billion in the comparable period of 2001. The deterioration in the external sector position was reflected on both the current and capital accounts. Indeed, in contrast to the trend observed in fiscals 2001 and 2000, the current account balance recorded a deficit of ₦80.4 billion. The overall deficit was financed through the draw-down of external reserves, which fell rapidly from US $10.27 billion in December 2001 to US $8.67 billion as at end-June 2002 and further to about US $8.29 billion at the end of July. In addition, payments of external debt service, which was due and unpaid were deferred.

8. We may recall that the level of external reserves increased from a low of US $4.99 billion in May 1999, when the present Administration assumed office, to US $10.72 billion in October, 2001. However, since November 2001 the level of reserves had fallen persistently. Underlying the weak external balance position was the 44.9 per cent fall in petroleum export earnings from US $7.73 billion in the first half of 2001 to US $4.26 billion, in the first half of 2002.

9. Overall, while inflows of foreign exchange through the CBN was only US $3,796.5 million outflows totaled US $5,373.1 million, indicating a net outflow of US $1,576.6 million in the period under review. Thus, despite the dwindling inflows, high demand pressure for foreign exchange was sustained during the first half of 2002. During the period, about 80.0 percent of total foreign exchange disbursements through the IFEM was spent on imports of goods, of which 30.0 per cent was absorbed by finished goods, including food and other items that could easily be produced in Nigeria. The effect was

the further depreciation of the naira exchange rate from ₦113.45 to US $1.00 at the end of December, 2001 to N125.67 to US $1.00 on July 19, 2002, before the Dutch Auction System (DAS) was re-introduced on July 22, 2002. Against this background, the need for effective measures to redress the situation cannot be over-emphasised.

II **Management of Nigeria=s Exchange Rate and External Reserve**

10. It is important to emphasise that exchange rate of a currency and the level of the nation=s external reserves are vital external sector indicators that have implications for the overall macroeconomic performance. Similarly, the distortion, which a misaligned exchange rate system could cause in macroeconomic management is well settled. For example, an overvalued exchange rate will induce or reinforce import dependency that could quickly deplete the level of external reserves and thus, render the country uncreditworthy and vulnerable to shocks. As you are all aware, the management of the exchange rate of the naira has transited from a re-regulated regime between 1995 and 1999, under the Autonomous Foreign Exchange Market (AFEM). The regime of managed floating started from October 1999 with the introduction of the Inter-bank Foreign Exchange Market (IFEM). Lately the re-introduction of the Dutch Auction System (DAS) on July 22, 2002 ushered in the regime of market based system in the determination of the naira exchange rate.

11. Under the IFEM, the exchange rate moved from an average of ₦96.12 to US $1.00 in 1999, the US dollar exchanged for ₦101.85 and ₦111.96 in 2000 and 2001, respectively, representing depreciations of about 5.6 and 9.0 per cent in the past two years. The magnitude of depreciation experienced during this period depicted the degree of demand pressure in the foreign exchange market. However, the widening arbitrage premium between the IFEM and the parallel market rate was indicative of the fact that the exchange rate in the IFEM was misaligned, while the demand for foreign exchange was for all practical purposes, unsustainable.

12. The IFEM was conceived as a two-way quote system, to be funded by the authorised dealers, with the CBN intervening only when necessary. This objective was not achieved as the CBN remained the dominant supplier of foreign exchange in the market. IFEM ceased to be a dynamic process for exchange rate determination as the two-way quote received from banks converged while the CBN met all demands from banks. Moreover, the IFEM was characterised by sharp practices, unbriddled demand for foreign exchange and misalignment of the naira exchange rate, as evidenced by the wide arbitrage premium between the official and parallel market rates. With the connivance of some authorised dealers, the parallel market and AFree Funds@ market whose main source of funding was traced to the IFEM, also emerged. Against this background, the need to sanitize Nigeria=s foreign exchange market and introduce a system that will considerably reduce the parallel market premium became obvious.

13. Consequently, the Central Bank of Nigeria made a major policy change on 22nd July, 2002 with the reintroduction of the Dutch Auction System (DAS), to replace the Inter-bank Foreign Exchange Market (IFEM). The objective of the DAS is to enhance transparency in foreign exchange transactions, conserve Nigeria=s foreign exchange resources through the achievement of a realistic naira exchange rate, which will minimise incidences of round tripping and capital flight as well as make goods produced in the domestic economy competitive with their imported counterparts. I make bold to say that Nigerians will be better served by an exchange rate regime that encourages domestic production, creates job at home, and eliminates unemployment and poverty. It is also hoped that the DAS will eliminate subsidy in the pricing of foreign exchange, and thereby assist in eliminating multiple exchange rates in the system.

14. The DAS recognises that foreign exchange is a scarce commodity hence, it discourages implicit or explicit subsidy on the commodity. The CBN under the new system determines the amount of foreign exchange it will sell, at a price which consumers are willing to pay at the auction. The ruling market rate, however, is the marginal rate that clears the market. Under the system, the CBN intervenes twice weekly, leaving the other three days of the week for the inter-bank market to function. The modus operandi of the DAS contrasts sharply with the IFEM, in which the Bank intervened daily and met virtually all demands from banks. The Dutch Auction System of foreign exchange management has been practised by many oil exporting nations with positive results. These countries have achieved exchange rate stability and have eliminated the incidence of multiple exchange rates in their respective economies. In addition, they have reduced their dependence on imports for production and consumption. We are optimistic that Nigeria=s experience under the DAS should not be different - provided, we pursue prudent monetary and fiscal policies. It would be recalled that DAS was first introduced in 1987, jettisoned, and reintroduced in 1990-1991 but could not be sustained because of the prevailing adverse macroeconomic conditions and the low level of external reserve during the period.

15. The outcome so far, has been generally positive. While the general apprehension that the DAS would trigger a continuos depreciation of the naira and heighten inflationary pressure has proved largely unfounded, the CBN has succeeded in calming the market through proactive intervention, thereby stabilising the exchange rate. Moreover, the parallel market premium has been significantly reduced. We recognise that the parallel/black market for dollars will, however, persist if the activities of tax-dodgers and impostors who avoid tariffs through non or inappropriate documentation are not curtailed. This therefore creates a challenge to which the Custom Services must respond forcefully through an effective 100% inspection. While tariff increases or/and total ban on certain imports, both of which can be evaded by tax dodgers, have been advocated by some people, I believe that a more effective market-based instrument which is potent and

unevadable is an appropriate exchange rate. The DAS also promotes openness and unrestrained transparency in the determination of the exchange rate. More importantly, the CBN has firmer control over the amount of foreign exchange it offers to the market and is thereby placed in a stronger position to protect and manage the nation=s external reserves.

16. Distinguished Ladies and Gentlemen, I wish to solicit the co-operation of all stakeholders, particularly the bankers and end-users to give the new system a chance by adhering strictly to the rules of the game. I must emphasise, however, that in exchange rate management, there are no miracle solutions. Whatever regime is adopted is bound to be defective over time, as the passage of time will reveal its strengths and weaknesses, particularly, if not supported by disciplined policies. The critical factor is that the productivity of the economy must be enhanced. Exchange rate is a dynamic policy instrument and must be reviewed from time to time.

17. It has often been stressed that the current state of our mono product economy - oil dominance in foreign exchange earnings and in government revenue, has remained for too long. The economy must be diversified and domestic productivity must be increased. These cannot be achieved with a subsidised and overvalued exchange rate. Nigerians have been too sensitive for too long on the value of the naira, forgeting that the value can only be the product of the efficiency and productivity of the economy. Our sensitivity to naira exchange rate derives from our import dependency which is facilitated by earnings from oil. It is not sustainable for Nigeria to use its earnings from oil to create jobs in other countries.

18. Let me recall that the CBN=s management of the exchange rate in late 1999 and 2000 was highly criticised because the naira was not allowed to appreciate at the time when the earning from oil was buoyant. We in the CBN recognised the volatility of the oil price and the fact that an appreciation of the naira that would make import cheap and increase the volume was unsustainable since it was not backed by strong economic fundamentals. In other words, although there were increased earnings from oil, the productivity of the domestic economy was low. The exchange rate policy adopted then and the careful management of the oil receipts resulted in our ability to build up external reserves, which today serves as a cushion for the naira, preventing it from the massive depreciation that would have been the automatic consequence of the current low foreign exchange earnings.

19. You would also recall my press briefing on 20th February, 2001 in which I highlighted the need for the three tiers of government to save some of their revenue, not only to avoid the over-heating of the economy, but also to keep for the rainy day. Our advice, if taken, could have obviated the resultant inflation spiral and prevented the current crisis whereby Local/State Governments and even Federal Government are today

having problems in paying salaries and meeting other recurrent expenses on timely basis, and, indeed, creating a situation that leaves little or nothing for current capital development. We must, therefore, learn from our past errors in order to evolve policies that would improve the welfare of our people.

20. Gentlemen of the Press, it is my believe that the current stability observed in the market the past few weeks should be sustained. This can only happen if there is fiscal discipline by all tiers of governments and other official agencies efficiently discharge their responsibilities.

21. I thank you all for your attention.

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