

EXCHANGE RATE MECHANISM: THE CURRENT NIGERIAN EXPERIENCE

President, Nigerian-British Chamber of Commerce,
Distinguished Members of the Council,
Other Members of the Chamber,
Invited Guests,
Ladies and Gentlemen.

Introduction

Let me at the outset express my sincere appreciation to the council and members of the Nigerian-British Chamber of Commerce for inviting me to this luncheon. On an occasion such as this, one would have expected that a guest would be invited to speak on a less rigorous topic than exchange rate issues and opt for one that would give room for enough winning to help digestion. However, recognizing who my hosts are, I should not expect less than I have been called upon to speak on. Indeed, let me quickly acknowledge that the theme of my address, "Exchange Rate Mechanism: The Current Nigerian Experience" is quite appropriate, given the central role of exchange rate in an economy generally, and its importance to international trade and investments in particular. Thus, a gathering of this nature should be commended for providing an opportunity to review the current exchange rate mechanism in Nigeria, appraise its efficiency and where necessary, proffer suggestions for its fine-tuning.

2. Perhaps, I should begin this address by noting that exchange rate arrangements in Nigeria have undergone significant changes over the past four decades. It shifted from a fixed regime in the 1960s to a pegged arrangement between the 1970s and the mid-1980s, and finally, to the various types of the floating regime since 1986, following the adoption of the Structural Adjustment Programme (SAP). A regime of managed

float, without any strong commitment to defending any particular parity, has been the predominant characteristic of the floating regime in Nigeria since 1986. I must quickly add that these changes are not peculiar to the Naira as the US dollar was fixed in gold terms until 1971 when it was de-linked and has since been floated.

3. The fixed exchange rate regime induced an over-valuation of the naira and was supported by exchange control regulations that engendered significant distortions in the economy. That gave vent to massive importation of finished goods with the adverse consequences for domestic production, balance of payments position and the nation's external reserves level. Moreover, the period was bedeviled by sharp practices perpetrated by dealers and end-users of foreign exchange. These and many other problems informed the adoption of a more flexible exchange rate regime in the context of the SAP, adopted in 1986.

4. In theory and practice, a prolonged misalignment of the exchange rate in the foreign exchange market will, in the medium term, tend to impact adversely on economic performance. Consequently, the authorities should always provide a timely intervention to ensure that the exchange rate is in equilibrium. The monetary authorities usually intervene through its monetary policy actions and operations in the money market to influence the exchange rate movement in the desired direction such that it ensures the competitiveness of the domestic economy. In Nigeria, maintaining a realistic exchange rate for the naira is very crucial, given the structure of the economy, and the need to minimize distortions in production and consumption, increase the inflow of non-oil export receipts and attract foreign direct investment. Moreover, the persisting problems of import dependency, capital flight, and lack of motivation for backward linkages in the production process need to be addressed, amongst others.

Brief Overview of Exchange Rate Regimes

5. Numerous exchange rate regimes are practiced globally, ranging from the extreme case of fixed exchange rate system, such as the currency boards and unions to a freely floating regime. In practice, countries tend to adopt an amalgam of regimes such as adjustable peg, crawling peg, target zone/crawling bands, and managed float, whichever suit their peculiar economic conditions.

6. A fixed exchange rate regime entails the pegging of the exchange rate of the domestic currency to either a unit of gold, a reference currency or a basket of currencies or the SDR, with the primary objective of ensuring a low rate of inflation. The advantages and disadvantages of the fixed regime, have been well documented in the literature. They include amongst others, the reduction of transaction cost in trade, increased macroeconomic discipline, possibility of increased credibility due to stability in the exchange rate and increased response to domestic nominal shocks. A major drawback of the fixed/pegged regimes, however, is that it implies the loss of monetary policy discretion (or monetary policy independence).

7. The floating exchange rate regime, on the other hand, implies that the forces of demand and supply will determine the exchange rate. This regime assumes the absence of any visible hand in the foreign exchange market and that the exchange rate adjusts automatically to clear any deficit or surplus in the market. Consequently, changes in the demand and supply of foreign exchange can alter exchange rates but not the country's international reserves. In this arrangement, the exchange rate serves as a "buffer" for external shocks, thus allowing the monetary authorities full discretion in the conduct of monetary policy. The disadvantages of the freely floating regime have been documented. These include persistent exchange rate volatility, high inflation and transaction cost. By

far, the greatest advantage of the floating regime on the other hand, is monetary policy independence, defined in terms of a country's ability to control its monetary aggregates and influence its domestic interest rate and inflation.

8. A variant of the freely floating regime, managed floating regime exists when government intervenes in the foreign exchange market in order to influence the exchange rate, but does not commit itself to maintaining a certain fixed exchange rate or some narrow limits around it. The central bank 'gets its hands dirty' by manipulating the market for foreign exchange. Depending on the central bank's intervention, changes in the demand and supply of foreign exchange might then be associated with changes in the exchange rates and/or changes in international reserves. Under the system, fiscal and monetary policies are used to promote internal and external balance.

9. Several factors influence the choice of one regime over the other. A major consideration is the internal economic conditions or fundamentals, the external economic environment and the effect of various random shocks on the domestic economy. Thus, countries like Nigeria which are vulnerable to unstable internal financial conditions and external shocks, (including terms of trade shocks, and excessive debt burden), which require real exchange rate depreciation, tend to adopt a regime which ensures greater flexibility. Overall, there is a general consensus that a fixed exchange rate regime is preferred if the source of macroeconomic instability is predominantly endogenous. Conversely, a flexible regime is preferred if disturbances are predominantly exogenous in nature. It is, nevertheless, becoming increasingly recognized that whatever exchange rate regime a country may adopt, the long-term success depends on its commitment to the maintenance of strong economic fundamentals and a sound banking system.

The Nigerian Case

10. Since the establishment of the CBN, Nigeria's exchange rate policy, has been aimed at preserving the external value of the domestic currency and maintaining a healthy balance of payments position, which, indeed, is a major provision of the enabling law. With the failure of the Autonomous Foreign Exchange Market (AFEM), introduced in 1995, an Inter-Bank Foreign Exchange Market (IFEM) was introduced on October 25, 1999. It would be recalled that the IFEM was designed as a two-way quote system, and intended to diversify the supply of foreign exchange in the economy by encouraging the funding of the inter-bank operations from privately-earned foreign exchange. The IFEM also aimed at assisting the naira to achieve a realistic exchange rate. The operation of the IFEM, however, experienced similar problems and setbacks as the AFEM, owing to supply-side rigidities, the persistent expansionary fiscal operations of government and the attendant problem of persistent excess liquidity in the system.

11. The peculiarity of the Nigerian foreign exchange market needs to be highlighted. The country's foreign exchange earnings are more than 90 per cent dependent on crude oil export receipts. The result is that the volatility of the world oil market prices has a direct impact on the supply of foreign exchange. Moreover, the oil sector contributes more than 80 per cent of government revenue. Thus, when the world oil price is high, the revenue shared by the three tiers of government rise correspondingly and, as has been observed since the early 1970s, elicited comparable expenditure increases, which had been difficult to bring down when oil prices collapse and revenues fall concomitantly. Indeed, such unsustainable expenditure level had been at the root of high government deficit spending. It is therefore important that reserves be built up when the price is high to cushion the effect of revenue shortfall on government spending when oil price falls in the international oil market.

12. Specifically, the sustained demand pressure and the consequent depreciation of the naira exchange rate under the IFEM were traced to the following causes.

- Limited sources of foreign exchange supply. In particular, the anticipated supplies from autonomous sources, such as oil companies, banks and non-bank financial institutions were significantly below what was required to broaden and deepen the market;
- The excess liquidity in the system induced by the transfer of government accounts from the CBN to banks and the huge extra-budgetary spending in 1999 on unproductive ventures;
- The heavy debt service burden; and
- Speculative demand, driven by uncertainties created by social and political unrest, expectations of future depreciation of the naira, as well as the deterioration of the external sector position.

13. It became a matter of serious concern that despite the huge amount of foreign exchange, which the CBN supplied to the foreign exchange market, the impact was not reflected in the performance of the real sector of the economy. Arising from Nigeria's high import propensity of finished consumer goods, the foreign exchange earnings from oil continued to generate output and employment growth in other countries from which Nigeria's imports originated. This development necessitated a change in policy on 22nd July 2002, when the demand pressure in the foreign exchange market intensified and the depletion in external reserves level persisted. The CBN thus, re-introduced the Dutch Auction System (DAS) to replace the IFEM.

14. The DAS was designed to achieve a realistic exchange rate of the naira that will stem the excessive demand for foreign exchange, conserve the dwindling external reserves and achieve a realistic exchange rate for the naira. The DAS was conceived as a two-way auction system in which both the CBN and authorised dealers would participate in the foreign exchange market to buy and sell foreign exchange. The CBN is expected to determine the amount of foreign exchange it is willing to sell at the price buyers are willing to buy. The marginal rate, which by definition is the rate that clears the market, represents the "ruling" rate at the auction.

15. Since its introduction in July 2002, the DAS has been largely successful in achieving the objectives of the monetary authorities. Generally, it has assisted in narrowing the arbitrage premium from double digit to a single digit, until the emergence of irrational market exuberance in the fourth quarter of 2003. Secondly, the DAS has enhanced the relative stability of the naira, vis-à-vis the US dollar-the intervention currency. Specifically, the naira has fluctuated within a single digit band, since the DAS was introduced in July 2002. Thirdly, it has also assisted in stemming the spate of capital flight and curbing rent-seeking amongst market operators.

Challenges

16. Distinguished Ladies and Gentlemen, Nigeria has come a long way in evolving an enduring exchange rate management policy, and we have, no doubt, made appreciable progress in this regard. Indeed, the need to ensure that a realistic exchange rate of the naira is achieved has been a major objective of the Central Bank of Nigeria. This is because a realistic exchange rate would result in the simultaneous achievement of internal and external balances and facilitate the achievement of sustainable economic growth and development. The most critical factor and challenge, however, remains how to increase the productivity of the domestic

economy. The higher the productivity, the less the pressure on the naira exchange rate and its volatility. All structural rigidities facing the economy have to be reduced to the barest minimum if they cannot be completely eliminated.

17. The evil effect of having an over-valued exchange rate is legion. The most critical is the creation of a high propensity to import because an over-valued currency makes import cheaper and promotes balance of payments deficits. We experienced an unsustainable demand for foreign exchange in the early 1980s when the government resorted to exchange control mechanism to support the over-valued naira. We will recall the days of foreign exchange rationing through import licensing and the suffocating distortion and corruption, which it created in the Nigerian economy. In addition to these, because the economic agents have resources in Naira that command more foreign exchange at the official rate than could be made available, foreign obligations contracted which could not be settled immediately subsequently crystallised into Paris and London Clubs foreign debts. These debts, with the accrued interest and penalties, constitute more than 80 per cent of Nigerian total external debt. Indeed, most of these were not debts incurred by the government but by Nigerian private sector induced by over-valued naira. We sometimes, remember the day the rate was \$1.8 to the Naira with nostalgia, forgetting to recognize that it did incalculable damage to our economy. Worst of all, it destroyed our agricultural base as food import became so cheap that farmers abandoned their farms and became traders. The manufacturing sector was not spared. A new culture of import dependency was created, which is proving slow and difficult to change and at a painful cost that causes the current aggravations and discomfort in the land.

18. A realistic exchange rate would also ensure that the naira is not overvalued in real terms, and that our external sector remains competitive. In our quest for a realistic naira

exchange rate, the CBN employs the Purchasing Power Parity (PPP) model as a guide to gauge movements in the nominal exchange rate and to determine deviations from the equilibrium exchange rate. Although the PPP as a relative price does not provide clear criteria for choosing a base period, and is generally criticized for its insensitivity to short-term policy actions, it nonetheless, provides a reasonable framework for a comparative analysis of trading partners' performances.

19. You will agree with me, Ladies and Gentlemen, that the exchange rate under the DAS represents an improvement over the previous mechanisms for determining the exchange rate of the naira, and its operation is in line with current global trends. Indeed, viewed against other currencies in the world, the naira has been reasonably stable. For example, between July, 2002 and February 20, 2004, the naira depreciated by 11.5 per cent against the dollar, the intervention currency, compared with the 15 per cent band allowed under the protocol of the West African Monetary Zone on exchange rate, to which Nigeria is a signatory.

20. Mr. President, exchange rate management policy is an evolving process and the challenge before all of us as stakeholders in the foreign exchange market is to work together as a team to improve its efficiency. To this end, the CBN is ready to consider suggestions on strategies for enhancing the efficiency of foreign exchange management in Nigeria, particularly in meeting the urgent need to strengthen and diversify the non-oil export base of the economy. Every stakeholder is invited to work assiduously towards addressing the lingering problems facing the foreign exchange market, if we are to achieve the much-desired stability of the naira exchange rate. We must therefore not undermine the system by engaging in speculative and rent-seeking behaviors. On our part, the CBN will continue to pursue sound monetary policy to complement prudent fiscal regime that will ensure and sustain macroeconomic stability in Nigeria.

21. Finally, it is critical to mention that the greatest challenge before all of us as stakeholders is to ensure that exchange rate is used as an appropriate instrument to enhance the productivity of our economy. A strong naira not supported by the economic fundamentals will only destroy the productive base of our economy. An appropriate exchange rate will make local production, all things being equal, competitive. The extreme sentiments which currently trail exchange rate adjustments must be changed.

22. In conclusion, let me reiterate that a strong naira will make imports cheaper but we must appreciate that the consequence of such a policy is the failure of our domestic economy to create wealth and generate employment for our youths. We need to change our import dependency syndrome and export more. Do we want a strong naira? If the answer is yes, our motto from today should be

- (a) To produce more;
- (b) Import less;
- (c) Export more; and
- (d) Buy more Nigerian goods.

23. The right exchange rate, therefore, is the one that facilitates the optimal performance of the Nigerian economy as a part of the new integrated global village and make the above objectives (a-d) possible.

24. I thank you for your kind attention.

Chief (Dr.) J. O. Sanusi
Governor
Central Bank of Nigeria
Abuja.

February 24, 2004