PRESENTATION OF THE GOVERNOR, PROFESSOR CHUKWUMA C. SOLUDO, CFR

AT THE

SENATE OVER EXCHANGE RATE

On

TUESDAY, DECEMBER 16, 2008

GOVERNOR SPEAKS:

The President of the Senate

The Deputy Senate President

Principal Officers

Distinguished Senators

My Colleagues.

Mr. President, it is really a great pleasure for me to be back here, I think, barely two months after the last session to brief you on the state of the economy especially focusing on the Naira depreciation and its implications.

The President of the Senate, Distinguished Senators, during our last presentation here, our last appearance focusing on the global financial crisis and the possible implication on the Nigeria's economy, we did leave you with two key messages. We did point out that the possible channels of effect of the global financial crisis on Nigeria could be through especially two main channels. Through the declining oil prices, capital flows and the capital market meltdown. We did make the point that our banks remain robust enough because of the previous measures taken and because of some other pre-emptive measures taken to withstand the shocks to the global financial crisis. We did point out that the possible pressure points could remain as a consequence of the collapsing or the falling oil price which might have effect through pressure on the fiscal side and the exchange rate. We assured you Mr. President that our Banking System remained buoyant enough or robust enough to withstand the effects of the global financial crisis and that we will not allow anyone of them to fail. And we want to still restate this assurance.

Mr. President of the Senate, Distinguished Senators, the subject of today's discussion is the **'Exchange Rate'**. As we all have observed in the last few weeks, especially in the last three weeks, it has been quite a bit of some dramatic change in the Foreign Exchange Market and I want to submit to the Senate, Mr. President, that this was carefully thought through and deliberately implemented in order to ensure that wemaintain an internal and external balance for the economy.

The economics of exchange rate is such that in a world where you face any pressure on your balance of payment, especially through the external sector, especially since we experienced much of the later part of this year declining oil prices which accounts for more than ninety-five percent of our export revenue and therefore source of foreign exchange; every country that experiences that, you have two options: You either allow the price to adjust by way of the exchange rate, or quantities will adjust and the kind of quantities that will adjust will either need that you cut down on domestic consumption, domestic investment, government spending in order to stem the pressure on the external sector or you allow the price to do the adjustment.

Generally, the exchange rate responds to several factors. Currently we operate a flexible exchange rate regime as most economies of the world and this is actually determined by the demand and supply factors in the market. If you have an increasing supply of foreign exchange, the exchange rate appreciates. If there is a declining supply and the demand is still up there or heightened, you have depreciation. I mean, when the demand for any commodity goes up and the supply is few, the price rises. And there are quite a number of factors that will lead to increase in the demand for foreign exchange including the liquidity conditions in the economy induced by money supply, government spending, the net capital flows, the level of your foreign reserves and the rate at which it grows, domestic productivity and that could actually increase your exports and imports. The global shocks that we have experienced; like we did mention in our last presentation before this House, the major channel of effect on Nigeria would be the declining oil price and therefore what would put pressure on the foreign reserves and the exchange rate and if care is not taken, it could go via the fiscal sector down to the financial sector – that is if that is not properly managed, but we hope that that would not happen. If you look at all around the world today, because of the declining commodity prices, declining trade and therefore declining foreign exchange earning by several countries around the world; whether or not they are experiencing financial crisis, there are many countries in the world that are not having financial crisis including Nigeria. However, these countries as well are experiencing declining commodity prices and therefore declining export earnings; and therefore, their earnings of foreign exchange declining. And in almost all of these countries today with little or no exception, the exchange rate under a flexible exchange rate regime is the variable that is going to adjust. I have with me here a table of countries even here in Africa; a table of African countries, from even countries with the largest level of reserves such as Algeria. Algeria has the largest level of external reserves in Africa, it doesn't have a financial crisis. It doesn't mean, it has huge external reserves in Africa. In fact, as at the end of 2007, it has about a hundred and ten. As at September this year, over hundred and forty billion Dollars but its exchange rate has also depreciated. And you take them all from the emerging markets - most of them whether it's Malaysia, Thailand or Brazil, India, Russia, Indonesia, Philippines, South Africa or other African countries through to Tunisia and so on and so forth with even higher levels of exports or diversified export structure. And most of these countries are not having any financial crisis but it's simply that the global economic regime has altered and therefore the variable that is allowed to adjust is the exchange rate and Nigeria happens to be one of such. Nigeria is not having a financial crisis but the global financial crisis impacts on the Nigerian economy through the declining oil price and therefore the declining pushes to reserve. I have even given the OECD countries that have literarily everyone here such countries whose currencies have gone down in tens of percent, twenty, thirty, forty percent in recent times. As we passed through London to New York the better part of last month, in one day the exchange rate moved almost by more than ten percentage points within twenty-four hours – that's in UK for instance. And as we operate flexible exchange rate regime, like they say, that is the variable that is expected to do the adjustment.

If you recall Mr. President of the Senate, Distinguished Senators, that this is not the first time that Nigeria has experienced declining or a decline in the oil price. The most significant shock occurred late 1981 through early 82; and the differences between then and now in terms of the economy are about three/four key areas. The first is that then, we had high external debt relative to either the GDP, relative to government expenditure. Then we had a fragile financial banking system. Indeed, most of the banks were owned by Government, lacked depth, just too fragile to take up a shock. Today, we have a stronger banking sector that grants credit; and the total credit granted as at the end of September to the private sector was indeed larger than the Federal Government expenditure and the banking sector credit that is expected to take much of this shock even in the years ahead if Government spending declines. Then we had a command and control economy: Government controlled a whole lot, fixed a whole lot and we had a fixed exchange rate regime. With import licensing regime, we restricted access to foreign exchange and tried to persecute or prosecute anyone found in possession of foreign exchange. That led to all manner of distortions out there and we know, and we know that when we face a similar kind of declining oil price, the way that the government of the day at that time responded was by enacting the Economic Austerity Measures then and key planks of that were import ban, restriction to foreign assets, restriction to granting access to foreign exchange and so on, and we know the consequences then. Today, we run a more liberalized and deregulated economy and you allow the price level to do much of the adjustment.

Why and how we acted, as I mentioned in the background is that oil prices declined from about $147 to as low as $39 before it began to recover back again to 40 today. Investors, because of the shocks that they faced in their home countries, especially those who have invested in our capital market and some other portfolio investors divested and were making remittances back home. Decline in private capital flows induced by credit crunch in their home countries; requirement that confirmation of letters of credit to be cashed back as it were on the part of banks, thereby putting greater demand for foreign exchange. There is also an interesting part which is as a result of the recession in OECD countries – asset prices have come down significantly, housing prices have come down. I learnt that in one of the major countries today, they say you buy a car either you get one free or you get one half price. Because of the declining asset prices, stock prices abroad, there is also high in demand by some nationals – they want to take money to go to buy those assets abroad. We have falling commodity prices, freight charges are down and the cost of imported goods were also falling greatly abroad thereby making imported goods very very cheap. Infact at the rate that it is going, it would be cheaper to import literarily everything into the economy than to produce anything. If the exchange rate does not adjust, what you are going to have is that you have to import literally everything and that will wipe off some of your nascent industries. We've seen this through before – we've gone through this before and unless we take some proactive measures, we will experience it again. There was also the speculative part of it because the economic agents; the investors and those who make money could see what is going on around the world. They could notice that as your earnings were dropping, your export earnings were dropping, your foreign exchange earnings were dropping, that you have little option – sooner or later, you are bound to allow the exchange rate to adjust. And so some speculators began to take position. If you take a look at the foreign exchange sales that we've had; a time was when the WDAS on our Wholesale Dutch Auction System, people who came to our window were actually very, very few. The amount of demand at that window was very very minimal. But as these other private sources dried up or significantly reduced and these other pressures to access foreign exchange increased dramatically, we began to see billions of Dollars getting out – that there is only one way; unless the price adjusts, unless you allow the price to adjust in a gradual systematic way, you will be forced to adjust it with vengeance at the later stage because if you don't adjust now, and you keep running down your reserves at three, four, five, six, ten billions a month or thereabout; you will run out of your reserves. And when the economic agents see that you are running out of your reserve, that's when depreciation will come with vengeance. We've seen countries whose exchange rates went from one to one into thousands within a year or two. Once you run out of reserves, it's by having delayed response, delayed response that you get this kind of thing. It's very 'populist' to say ah! We will defend it at whatever the case, we then fix, don't allow it to adjust. It's emotionally satisfying but in economic sense, it doesn't make any sense whatsoever – you just ruin the economy because you will either adjust in a gradual manner or you will be forced to adjust with vengeance.

The months October and November particularly because of this demand was quite high, and so we've done so much, Mr. President, the Distinguished Senators, If we leave the rate as it was, like I said it is emotionally satisfying and meet all the demands for forex; both those who are making all these frivolous demands for foreign exchange including those who are now going to invest abroad; you will simply be subsidizing them. That's technically what you are doing. You fritter away the foreign exchange at no net benefit to the economy, period. You would continue to run down reserves with greatly cheaper imports, cheaper to import everything than to produce locally; it would greatly affect the industrial sector and unemployment will come and of course somebody would say 'why don't they ban them?' Well, you need to roll out the entire army and Police Force to go to police the boarders, and then you come back again and say 'They were not effective in stopping them' and so on and so forth. The problems with resorting to that, we all know. You make Nigeria a very expensive place as well. If the Naira gets on too strong, Nigeria will become too expensive for foreign capital to flow into the country because for every one they are bringing, they take lower quantity of Naira and that this discourages people from bringing in their resources in the first instance. Both remittances, portfolio inflows will continue to dry up; because the inflows are fewer then the exchange rate will have to adjust when you run out of reserves. And of course, this has also fiscal consequences; because we have a peculiar fiscal structure where the revenue accruing to government has quite a lot of bearing on the exchange rate that you have. The amount of Naira at that moment per Dollar that you earn is also very sensitive to the exchange rate. So while the oil prices were falling, your recurrent expenditure, your wage bill is not falling. Much of the other expenditures remain fixed. And the way the economy responded in the 1980s, early 80s was that we had a fixed exchange rate regime. When the oil prices were falling, revenue fell drastically – we all remember clearly, then many States even Federal Government could not pay salaries. Some were owing nine/eleven months of salaries then and the kind of adjustment that came much later was that it led to massive fiscal retrenchment. About 1984 or thereabout, the Federal Government here had to drastically lay-off thousands of workers and so on – that's on the fiscal side. And therefore, if you let your reserves run down like I said, it will invariably come much later.

The second option we had Mr. President, Distinguished Senators, was to allow the exchange rate to respond to the forces of demand and supply in the market. This is what we've allowed to do as what makes sense now and makes sense in the future for the benefit of the economy. And this will help to stem some of the frivolous demand for foreign exchange especially the speculators and those embarking on capital flight to invest in cheaper assets abroad. We don't benefit by subsidizing these people. It will discourage us from frivolous imports which have now become much cheaper to import than to produce at home. It will lower the pressure on the foreign reserves and will lessen the pressure on the domestic industries. We ensured that those who remit forex into the economy have incentive to do so and hence greater foreign exchange inflow because you have to encourage inflows; and those who also export (whatever thing they export) can also have the incentive, that they could earn higher margin. The primary reason for this action, I must say this Mr. President, the primary reason for this was not motivated by revenue consideration – No. I've seen that speculated in the Newspapers that the reason why the Naira has been so is to generate revenue to fund the budget; this was not the primary reason for that, but it happens to be one of the fall-outs of that. That one of the benefits that will ensue is that you are going to have greater accruals to the budget; the Federation Account. And actually if you look at the rate in which that has changed, I am pretty sure, there was Newspaper headline that put it to about five hundred and something billion. In our own casual computations, if the rates remain where they were even like last week or thereabout, you probably have extra over half a trillion to the Federation Account, that is if the other fundamentals remain constant.

Our strategy, therefore, Distinguished Senators, was to ask whether to allow for a very gradual prolonged process of adjustment or whether to allow for a quick and sharp adjustment and then maintain stability. To allow for an extended period of that would leave the Naira open to continuing speculation in the market and therefore we opted to have a quick and sharp response adjustment and then maintain stability in the market thereafter. We have already sunk quite a lot of hundreds of billions of Naira for speculation as a consequence. Because of the heightened demand, infact last week or thereabout, I think sometime last week, there was some demand of about $1.4 billion and people were willing to pay as high as 136.5; and who are we to say, I mean, people are willing to buy and pay that much that they needed it, they wanted to have it. Why would you go to sell it to them at much cheaper rate? Who benefits? You are simply subsidizing them. But now that we've stopped much of that aspect, we are already beginning to see from billions, as at last week, even early part of last week, ending of November, the daily demand, the demand of the forex is actually coming to over one billion till yesterday. The demand yesterday was about 257 million and the demand for today was about seventy-two million. You can see; as of today, the rate has actually come down. Infact the rate has just appreciated because again there is a declining demand. We have sucked out much of the Naira and I think much of those speculative demands in the market is now much lower and the rate is beginning now to come down.

As I said, Mr. President, in a statement that we had issued two weeks ago, and had pointed out that those who want to speculate on the Naira would be made to incur huge losses, and those who were making all those huge bills, whatever, they want to pay whatever, we will give it to them at that price but when the Naira is all sucked out, the rate will now stabilize at the rate where it should settle and we have already begun to see that – a downward trend from what it was a few days ago now today, I think it must have appreciated by about one Naira fifty Kobo or thereabout. And so, the market will work and we are going to have a stable exchange rate.

There is a question often raised – Will imported inflation heighten? And Mr. President, Distinguished Senators; the answer is 'Not necessarily'. It would not necessarily heighten inflation. Yes, some of the prices could go up but given the fact that major commodity prices around the world have come down significantly, some even freight charges, some of them have come down by more than forty percent. It is still a challenge that the adjustment in exchange rate has not more than completely offset the decline in those commodity prices but at least there is some adjustment and therefore the feedback into the general price level is not likely to be very very huge.

Is it a conflict with liquidity injection? Yes, to some extent because as we are making sure that our banking system remains highly liquid. We've opened the, made sure, a pre-emptive measure that we don't allow them to get to the stage where the rest of the world was in terms of allowing their banks to face liquidity crunch before easing off. And basically what we have done to stem that is to limit or lower the banks' Open Position Lending from twenty percent to ten percent with effect from yesterday actually.

In conclusion, well there is a question often asked on what is about the appropriate rate. It will continue to be decided on the basis of the forces in the market. But so far at least as at Friday, we would soon get the level of our foreign reserves as of today; as at yesterday (we get it one day after). But as of Friday, we are still at about fifty-seven or thereabout billion. We've not frittered this away and it could be a tragedy to fritter it away. And the appropriate place; some have done some analysis, all manner of analysis flying around. And just as part of it, if you look at the rates where the exchange rates were at corresponding period when we had benchmarked oil prices at some levels, we might begin to get a sense. It would greatly be a function of the level of liquidity in the system. But now that we have sucked out most of the liquidity from the system, Mr. President, Distinguished Senators, I think the rate will obviously stabilize.

In conclusion, I want to reiterate to the President of the Senate, Distinguished Senators that the Central Bank remains committed to a stable exchange rate regime but not a fixed exchange rate regime. You cannot have, I mean, we've done away with fixed exchange rate. It has to be stable and the stability is different from fixity. And we would continue to have a rate that is market-determined. We have opted not to play populism with the health of the national economy. This may not be very popular, I mean, in terms of populism but like medical doctors, you act like a Medical Doctor. The medicine required to remain healthy may not necessarily be the sweetest one but I think over time, these are measures required to keep the economy on an even keel today and tomorrow.

Thank you Mr. President, Distinguished Senators.