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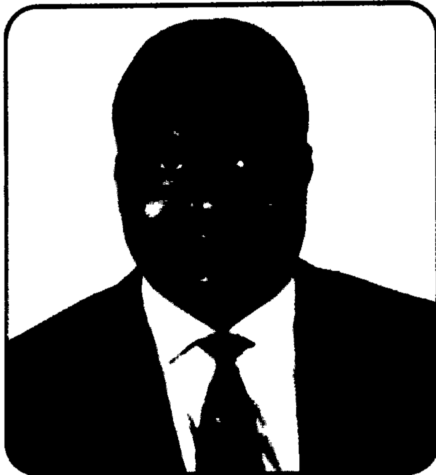
NAIRA CONVERTIBILITY: THE JOURNEY SO FAR

BY

Moses K. Tule[1]



Moses K. Tule

INTRODUCTION

Nigeria has increasingly been playing a leading role in Africa, but not much formal inter-regional trade has been done in naira, although, appreciable level of informal cross border trade does exist, especially, in the ECOWAS sub-region. However, increased oil earnings, democracy, economic growth, the introduction of the euro and the need for the cfa to have a new anchor different from the French Treasury by 2009, the establishment of the 2nd West African Monetary Zone and its fast-track programme of monetary integration, the ECOWAS trade liberalization scheme, etc. have triggered speculations about a convertible naira or a much bigger international role for the naira (the object of these great expectations not withstanding, at the moment, naira balances are not automatically transferable even within ECOWAS).

The conduct of intra-ECOWAS trade has not changed despite Nigeria's clear economic dominance in the region as much of the trade in ECOWAS is in primary products and with non-regional members. Thus, the commercial exchange rate of the naira as well as the exchange rates assigned to the currencies of other ECOWAS countries are merely conversion rates for translating world market prices into country foreign trade currency prices so that the value of the foreign trade naira is determined by this rate, but is not a determinant of this rate, as in the case of real exchange rates. Indeed, the naira exchange rate is irrelevant in foreign trade transaction as it does not serve as a guide in making foreign trade decisions. To be used this way, the exchange rate would have to be a price, which the naira exchange rate is not.

Since the ECOWAS countries began their mutual attempt for a regional currency, to clear trade, there has been renewed hope that a regional currency might become eventually realizable and the envisaged currency might even serve as an international currency, at least, within the sub-region. Since 1999 when this thinking gained momentum (being spearheaded by Nigeria and Ghana), and with at least four deadlines for commencement of the new currency having passed and no noticeable improvement, the conclusion is that no regional currency is feasible in ECOWAS beside the cfa, at least, in the near future. Consequently, most countries in ECOWAS, especially, the WAMZ countries have been making frantic efforts towards positioning their country currencies for better bargaining in the event of a regional monetary union. As for the cfa, it is not automatically transferable within the whole of ECOWAS, the feather weight of the francophone countries' economies, being principally responsible for making the cfa, a very weak currency.

Within ECOWAS, while each member country, especially of the WAMZ has attempted to guide and develop own trade with tools of greater or less sophistication, they have made little individual efforts at improving intra-regional trade aside from the signing of the regional protocols on trade liberalization. The perennial problems remain the primary nature of exports, multi-lateralism and the negative terms of trade, with the latter being a price centric problem. At the moment, all three issues are not seriously on the table in ECOWAS and not likely to be in the near future as the region remains principally, a price taker.

At the moment, ECOWAS countries denominate their exports in the US dollar. However, the absence of real exchange rate in the cfa or naira for instance, implies that revaluation or domestic exchange rate policies alone may not change the fortunes of any of the region's currencies. The lack of real exchange rates in foreign trade is merely one symptom of the necessity to insulate ECOWAS economies from disruptive economic forces.

However, what is needed urgently is an economic mechanism that would directly link the structure of production with foreign trade contract prices within ECOWAS. Presently, the existing currency rates do not form a connecting link between the internal prices of the ECOWAS countries and the foreign trade prices to the extent needed by ECOWAS foreign trade. If such a mechanism was introduced, improvement of exchange rates (which if used to judge trade at present) would give a false impression of the effectiveness of trade in certain goods is seen as one of the conditions for improved trade.

This vacuum and slow pace of the ECOWAS wide programme on monetary integration may have informed the resolve of the non-UEMOA members of ECOWAS to launch a fast track programme on monetary integration in 1999 to achieve a monetary union outside UEMOA for later discussions with the cfa zone. However, four deadlines have passed and progress has been rather slow, howbeit, some institutions

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have been established to midwife the process. Another deadline of December 2009 is fast approaching and the realisation of the integration programme looks quite bleak. Sensing possible failure, individual WAMZ members have been making efforts towards positioning themselves. Thus, two of its most important members (Nigeria and Ghana) have been pursuing policies that seek to strategically position their individual currencies in a position of strength for future negotiations. This may have informed Ghana's redenomination exercise in July 2007 and Nigeria's attempt to denominate and accede to Article IV under the IMF Articles of Agreement, which implies full current account liberalization.

This paper examines the path to Naira Convertibility, the Journey so far. It avers that convertibility is pursued by countries either as an economic management approach or as a tool for achieving higher reckoning on the global economic stage. Consequently, the examples of Argentina, Chile, Peru, Brazil, etc could fall in the first category while the Russian Rubble push could qualify for the second group. Nigeria's efforts at Naira convertibility would fall in the second category, where the country seeks to position itself in realization of its Financial System Strategy 2020 in which the country aims at being one of the twenty largest economies by the year 2020. Following this introduction, the Theory and Evidence for Naira Convertibility is presented in Section II, while Section III examined the Synthesis of the Naira Convertibility Programme. Section IV examines the Issues in Naira Convertibility. Section V summarizes and concludes the paper.

II. THEORY AND EVIDENCE FOR NAIRA CONVERTIBILITY

Naira convertibility involves the dollarization, euroization or substitution of naira assets and liabilities and the internationalization of the naira. This is also referred to as full Capital Account Convertibility. It involves the invoicing of a proportion of world trade in the naira, denomination of international financial instruments (by other countries) such as bonds in naira by other countries, pricing of commodities (such as gold, oil, agricultural produce) in global markets in naira, and maintaining international reserves of other countries (not just ours) in naira.

Thus, when a currency could be converted, exchanged, transferred, purchased, acquired or disposed of for other currencies, in any legal transaction, that currency is said to be convertible. Currency convertibility imply acceptance of the obligations of Article VIII, Sections 2, 3 and 4 of the Articles of Agreement of the International Monetary Fund (IMF). Theoretically, convertible currencies are regarded as reserve or international currencies.

A currency could either be fully or partially convertible, internally or externally convertible. A fully convertible currency involves a situation where a currency is a clean float, exchanged unconditionally at the market exchange rate without undue interference in achieving a particular exchange rate or a particular goal with the currency. It involves removal of controls on current and capital accounts of the balance of payments, absence of exchange control and documentation for foreign exchange procurement as well as the opening up of the currency to speculation.

Partial convertibility on the other hand, involves the existence of a managed float foreign exchange market that allows limited and documented access to the stock of foreign exchange within approved scope of activities permitted by the foreign exchange guidelines. Consequently, it entails limited removal of restrictions on the current account.

External convertibility is a situation where all holdings of a country's currency by non-residents are freely exchangeable into any foreign (non-resident) currency at exchange rates within the official margins. Consequently, all payments that the residents of the country are authorized to make to non-residents may be made in any externally convertible currency that the residents can buy in the foreign exchange market. Internal convertibility on the other hand, entails the absence of restrictions on the ability of residents of a country to use their holdings of domestic currency to acquire any foreign currency to hold or transfer to any non-resident for any purpose. While external convertibility is only partial convertibility, full convertibility entails the sum of both internal and external convertibility.

Different levels of convertibility are identifiable in the literature. Thus, we make the distinction between regional and global convertibility. Whereas the former conveys the right to convert the domestic currency into currencies of specific countries in the region, the latter allows the holder of the domestic currency to convert it into any currency of choice. In addition, we differentiate on the basis of transactions demand for foreign exchange i.e. the purpose for which foreign exchange is sought. Thus, we distinguish between current and capital account convertibility.

The current account includes the value of trade in merchandise, services, investment, income and unilateral transfers. Current account convertibility conveys the right to convert domestic currency into foreign exchange for the purpose of making offshore payments for goods and services. There are three approaches to current account convertibility: pre-announcement, by-product, and front-loading approaches. Each approach is distinguished by the importance it attaches to convertibility relative to other economic objectives.

The capital account involves transactions in financial assets. Capital account convertibility entails the limited conversion of domestic currency into foreign exchange for payments in respect of capital transfers and transactions. This also implies the freedom to convert local financial assets into foreign assets in any form and vice versa at market-determined rates of interest. Capital controls restrict or prohibit offshore movement of capital. Such controls include: need for prior approval, authorization and notification, multiple currency practices, discriminatory taxes, and reserve

requirement or interest penalties imposed by the authorities.

Naira convertibility, therefore, involves a Naira-based commodity trading system where Nigeria's principal exports: crude oil, palm oil, gold, cocoa, cassava, soya beans, grains, etc, would be traded in Naira, creating in the process, a euro, dollar, yen, sterling, etc demand for the Naira in Nigeria. The Malaysian palm-oil ringit, crude oil-ringit, Russian grain ruble, crude oil-ruble and gold-ruble are classic examples of domestic currency convertibility. This arrangement enables the attainment of inward-looking full convertibility for the domestic currency. A workable convertibility programme involves a gradual reduction in the stock of public domestic debt to achieve an interest free domestic currency capable of stimulating growth and commanding international acceptability.

A convertible currency encourages currency substitution in favor of that currency. However, de facto euroization, dollarization or nairaization results from individuals voluntarily choosing to use foreign currency as either a transaction substitute or as a store of value substitute (asset substitution) for the monetary services of the domestic currency. This calls for increased output by the country seeking to make its currency convertible and ensuring stability of prices to make the domestic currency a stable asset substitute. The premise is that a successful convertible currency is one which is reliable and expected to retain its value sufficiently over time as a substitute asset (or store of value).

Currency substitution means the use of a foreign currency in the domestic economy instead of the local currency. There has been widespread currency substitution in Nigeria with some vendors who offer services in the domestic economy preferring to be paid in foreign currency instead of the naira. Currency substitution takes place when the public perceive that the local currency has failed to perform its role as a store of value, a unit of account and as a medium of exchange. Currency substitution has implications for tax revenue as well as monetary and foreign exchange policies of the country.

III. SYNTHESIS OF THE NAIRA CONVERTIBILITY PROGRAMME

The idea of a convertible Naira has been long in the making following the attainment of political independence in 1960. However, the import substituting industrialization strategy at independence, which was meant to position the country on the path to self reliance was not export oriented and so, the external sector relied mainly on the export of primary agricultural commodities, whose values fluctuated widely. The emerging new economy was confronted with economic and political problems of enormous dimension leading to a 30 month civil war in which most of the country's infrastructure in the eastern axis of the country, the amphitheatre of the war, was destroyed.

The post war reconciliation efforts opened avenues for huge inflow of foreign investment. However, the accompanying oil boom and reverse policy of indigenization of foreign owned enterprises in 1977 (the enabling Decree, the Nigerian 'Enterprises Promotion Decree (1977) barred foreigners from participating in certain sectors of the economy and limited their participation in others to between 40-60 per cent, depending on the sector), was counter productive to the flow of direct foreign investment. The Decree which aimed at promoting domestic enterprises, proved an anti-climax as it encouraged huge disinvestment from the country as substantial controls were introduced to curb foreign exchange transactions. The Austerity Measures of 1981, designed as a macroeconomic stimulating package increased controls, further weakening the prospects for naira convertibility.

The Structural Adjustment Programme (SAP) of 1986, however, represented the first major step in easing capital controls, post independence. Following the adoption of the International Monetary Fund (IMF) sponsored SAP, fundamental steps were taken towards liberalization of the financial system in 1987 with the removal of most controls, including the introduction of a more liberal foreign exchange market as well as the introduction of bureaux-de-change for across the counter transactions in foreign exchange for limited amounts. In addition to these, policies encouraging the flow of foreign direct investment into Nigeria as opposed to the more volatile portfolio flows were introduced.

Over the years following the mis-guided indigenization programme, government established several institutions, designed to promote foreign investment and the inflow of foreign capital, generally. Thus, the Industrial Development Coordinating Committee (1988), Nigeria Investment promotion Commission (1995), Foreign Exchange Monitoring Decree (1995), establishment of Nigeria Export Import Bank, Calabar Export Processing Zone, Export Development Fund, Export Expansion Grant Scheme, formed part of the enabling environment created for promoting capital flows. In addition to these, a plethora of tax incentives and concessions were given to foreign investors in the Annual Monetary and Foreign Exchange Guidelines of the CBN.

The emerging trend of globalization following the end of the cold war, created high appetite for the movement of global finance across frontiers to locations where conditions were most favourable. The emerging economies of Eastern Europe provided a more fertile environment for the attraction of western capital than most regions. Elsewhere, most countries tried to play the beautiful bride by reducing or eliminating erstwhile barriers to free trade through trade and capital account liberalization and reforming the foreign exchange markets, as signals of commitment to sound macroeconomic policies. The fear, however, was that improper sequencing of the liberalization of the current account and intervening circumstances increased the possibility of sudden capital reversals as in Mexico, Argentina, Chile, Brazil, etc. and a resort to a regime of fixed exchange rates. These fears were premised on the grounds that economies with weak banking systems and no previous experience with trade liberalization are acutely exposed to the vagaries of attack on the international financial system in the event of crises.

Within this period, in Nigeria, a number of foreign exchange management regimes were experimented, each allowing limited convertibility. However, following the reforms of the foreign exchange market in March 2006, a Wholesale Dutch Auction System (wDAS) replaced the retail Dutch Auction System of foreign exchange trading. As part of the reforms, the foreign exchange market was substantially liberalized while foreign investors were encouraged to invest in all segments of the economy, including Nigerian Treasury Bills, Federal Government of Nigeria Bonds, as well as in the equities sectors, with the proviso that such investment was to remain domiciled in the country for at least one year before repatriations of any kind could be made. The provisions were intended to check the inflow of hot capital which was not intended to benefit the economy.

A more dramatic attempt towards Naira convertibility was made on August 14, 2007, when the Governor of the Central bank, Prof. Chukwuma Soludo reeled out a programme tagged "Strategic Agenda for the Naira" in Phase Two of the reform agenda, Phase One having being launched three years earlier.

The Strategic Agenda for Naira was anchored on the Central Bank of Nigeria Act, 2007 (Section 2) which outlines the key objectives of the Bank to include inter alia: (a) ensure monetary and price stability; (b) issue legal tender currency in Nigeria; (c) maintain external reserves to safeguard the international value of the legal tender currency; (d) promote a sound financial system in Nigeria; and (e) act as banker and provide economic and financial advice to the Federal Government.

As indicated by the CBN Governor, by focusing on the Naira in the Phase Two of the reform agenda, the Bank desired to give greater emphasis to the most important function of central banks everywhere in the world namely, to issue legal tender currency and to defend its value. Thus, Phase Two was to "make the Naira the currency of reference in Africa, and thus a strategic catalyst for achieving the goal of an international financial centre as well as promoting Nigeria's rapid economic development".

The elements of the programme involved a restructuring of the domestic currency through redenomination by dropping two zeros with a view to restoring the value of the Naira (in the short term) to its 1985 value, anchoring inflationary expectations, strengthening public confidence in the Naira, ease of conversion to other currencies, reversing the tendency for currency substitution, eliminating higher denomination notes, reduction in currency production costs, promoting a coins usage culture thereby achieving more efficient pricing and payments system; and laying the foundation for Naira convertibility and thus positioning it as the reference currency. The need to thus position the Naira as an African Reference currency was given greater push by the African Union's concession of the Headquarters of the African Central Bank to Nigeria, making it incumbent on the country to provide responsible leadership in terms of properly aligning its currency structure with international best practice and sound monetary policy.

Complementary measures outlined in the Strategic Agenda for the Naira included the adoption of inflation targeting framework of monetary management by the Central Bank of Nigeria, sharing of Federation Accounts in US dollars, a move designed to deepen the foreign exchange market as well as improve liquidity management, and liberalization of the current account i.e. current account convertibility implying accession to Article VIII of the IMF. Full current account liberalization/convertibility means that Nigeria would eliminate all restrictions on current account transactions while accession to Article VIII implies that the policy is not easily reversible.

The Naira convertibility programme embellished in the Strategic Agenda for the Naira poised to create a sound currency with the attributes of the naira being a satisfactory store of value, medium of exchange, and a unit of account addressed headlong some critical issues to effective monetary management, including arresting the penchant for fiscal dominance and excessive borrowing by government from the CBN (to be addressed through inflation targeting) and the possibility of the Naira emerging as a dominant currency by December 2009 (in line with the ECOWAS Programme of Monetary Integration).

The goal of these policies was to push further, the drive towards a single currency in West Africa with greater vigor. With a control of 70 per cent of ECOWAS economy and control of 80 per cent of its reserves, a properly aligned naira is intended to serve as a reference currency; the realization of the dream of a regional monetary union would become more credible and realistic.

The implementation of the strategic agenda for the naira became a subject of much media bliss and subsequently, suspended by government. Although a number of countries have acceded to Article VIII of IMF Articles of Agreement, not all IMF members have approved capital account liberalization. For instance, China, India and Russia have had several debates on the matter domestically but none of them has taken a definite step yet. Consequently, as the wind of globalization intensify, the trend towards convertibility is becoming more prominent and would continue to attract the attention of several countries.

The attempt to influence foreign trade efficiency and promote the use of a dominant regional currency, however, has not served to transmit the internal prices of ECOWAS countries outward, and hence, have not had any appreciable impact on regional trade pricing. At the moment, although very desirable, intra-ECOWAS trade is not quoted in any of the regional currencies but in US dollar or euro. A programme of naira convertibility would begin by the dominant economic power in the region, Nigeria, demanding that regional members settle trade with her in naira. Thus, Nigeria would have to put up efforts at ensuring that the regional naira trade connects the value formation of the national economy with that of the ECOWAS trading partners and that the transferable naira comes into existence by passing from the internal

money circulation into the sphere of interstate clearing arrangements. At the moment, even Nigeria and the other ECOWAS members when it comes to trade, think in dollar terms, but the dollar price is just another price quoted at the naira conversion rate.

IV. ISSUES IN NAIRA CONVERTIBILITY

It is important to note that it is the joint product of trade restrictions and exchange controls on current account transactions that determine how fully a country's goods markets are integrated into the world economy. However, the substance of current account sustainability would be denied if relaxing exchange controls was abandoned through an intensification of trade restrictions. Currency convertibility, however, seem to be a necessary condition for a country to be integrated efficiently into the world trading system, because it creates avenue for international relative prices to prevail in the domestic economy, with provisions for trade restrictions, transport costs and arbitrage. It is important that the exchange rate is appropriately valued as an overvaluation of the domestic currency would cause domestic firms to prefer imports to exports, resulting in an unsustainable current account deficit.

Most of the benefits of full convertibility can be reaped through partial convertibility such as equity and direct foreign investment. This is because while free trade has been shown to generate net positive benefits, evidence of similar gains from free capital mobility has simply not been provided (Bhagwati, 1998). While full convertibility may be desirable, countries are not in a hurry to embrace it because it brings with it the twin problems, one in the currency market and the other in the banking sector. For instance, China despite its strong global economic performance, does not have current or capital account sustainability, but remains an investor's haven, attracting high rate of return on investment. Given the current global financial crises, the cost of convertibility would indeed have been very high for China.

However, it may be argued that crises could be avoided by adopting a flexible exchange rate. The argument here is that with higher capital inflows, the local currency would appreciate, while returns on future inflows decline, thus arresting further capital inflows before a crises point. The policy implication of this argument is that capital account convertibility is more compatible with flexible exchange rate regimes because a fixed exchange rate system like Bretton Woods would easily breakdown under increased capital mobility. However, flexible exchange rate regimes do not insulate the financial system from the risk of currency and banking crises as an appreciating real exchange rate harms the country's external competitiveness, thus affecting growth. Stock prices are about the most volatile of prices and these volatilities occur in adjudged safe flexible markets.

Flexible exchange rates do not rule out banking crises which result from capital mobility. This is especially so where the banking sector is vulnerable. The Japanese experience provides a classic example in this regard as the banking crises in that country was thought to have been triggered by capital mobility. Japan had in the late 1970s and early 1980s provided inefficient guarantees to weak banking institutions and firms through 'cash flow insurance' under an arrangement of complex regulations that allowed the banks to function as a cartel. The guarantees sought to enable the benefiting institutions to stay afloat, but placed the burden for such guarantees on the more profitable firms. With liberalization in the 1980s, the erstwhile big profitable banks defected in a big way to the euro-dollar market, leaving the domestic banks with less profitable firms as their only borrowers. The big banks later turned to real estate and the rest of Asia for more profitable investments, thus creating enormous crises for the banking system. The implication is that a sound banking system is instrumental to full convertibility to avert a currency and banking crises. The experiences of countries such as Malaysia (1994), Spain (1992), Brazil (1994), Chile (1991), indicate that convertibility is a one way street, there is no reverse gear.

A number of factors may influence the level of currency convertibility. Thus, political, social, environmental as well as economic factors may play relevant roles in determining the degree, direction and ease of currency convertibility. A country considered to be politically unstable may not provide attraction for other countries to deal in its currency or its exchange rate in the market would yield an undesirable exchange rate. However, when there is a change in government considered to be favored by other countries, trading in the currency of that country is considerably enhanced.

From the social viewpoint, trade with the country may be considered undesirable, and serves as basis for making it more difficult to convert the currency involved. Environmental factors or natural disasters may decrease the desirability to trade the currency issued by that country. This may result in an undesirable exchange rate or a clear refusal to trade the currency issued by that country for other currencies.

V. SUMMARY AND CONCLUSION

The paper traced the evolution of naira convertibility in Nigeria from independence to present day, situating in the process, efforts of monetary unification in the ECOWAS sub-region. It showed that divergent interests being pursued by both blocks in ECOWAS (i.e. the UEMOA and the WAMZ), have frustrated efforts at pursuing a realistic programme of monetary unification in the zone.

The failure of the region-wide efforts resulted in the emergence of the WAMZ splinter group within ECOWAS spearheaded by Nigeria and Ghana which galvanized the non-francophone ECOWAS members to pursue a fast-track approach to monetary unification. Several deadlines have passed and results have been rather slow.

The slow pace of the fast-track approach and its missed deadlines led to individual countries developing their own approaches at strategically positioning themselves for better bargaining power in a future monetary union. Having successfully redenominated amidst a highly

devalued cedi, Ghana was soon followed by Nigeria which not only announced a redenomination but also accompanied it with a timetable towards naira convertibility. The Nigerian programme was however stopped by government fiat.

The paper suggested that Nigeria should initiate a more realistic naira convertibility programme through trade guarantees where it insists that imports from Nigeria from member ECOWAS members would have to be paid for in naira rather than any other currency. This approach, it is thought, would engender the growth of naira consciousness in the sub-region and make the naira a dominant currency in the region.

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