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THE CHALLENGES OF SUSTAINABILITY OF THE CURRENT EXCHANGE RATE REGIME IN NIGERIA

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Introduction

The motive behind initiating an exchange rate policy, an integral element of monetary policy, is to preserve the value of the domestic currency, maintain favorable external reserves and ensure the realization of price stability in the domestic economy. The pursuance of these goals is to ensure external balance without compromising the need for internal balance and macroeconomic stability. It is important that the monetary authority, in its bid to designing an appropriate and sustainable exchange rate policy framework, addresses issues that are fundamental to the introduction of the policy itself. In designing the exchange rate policy, the monetary authority must consider the objectives of the exchange rate policy which must be in consonance with the desired direction of the country's economic policy. It must also consider issues such as the nature of shocks faced by the domestic economy and the stage of economic development of the country. By extension, the policy framework should de-emphasize high control of foreign exchange market, and ensure the availability of and ease of accessibility to foreign exchange by all end-users. It must also ensure the stability of the nominal exchange rate, the minimization of waste in the utilization of foreign exchange, encourage inflow as well as increase share of autonomous foreign exchange earnings.

In general, exchange rate policy is often used to prescribe the choice of a ruling exchange rate regime. A change in exchange rate policy will facilitate a spontaneous change in the nature of the exchange rate regime. Over the years, most countries of the world have practiced different types of exchange rate regimes. Among these regimes are fixed, floating and hybrid, which are predominantly found in developing economies. In Nigeria, all the aforementioned regimes had been practiced at different periods. Each regime is modified to address the problems confronting the foreign exchange market at any particular time. The adoption of a fixed exchange rate system in Nigeria prior to 1986 took different variants namely a single currency peg, crawling peg system, peg to basket of currencies and adjustable peg system or otherwise referred to as "fixed with bands". Under the floating exchange rate arrangement, the monetary authority adopted multiple and managed/dirty floating exchange rate systems.

Since the adoption of a floating exchange rate regime in Nigeria, the managed or dirty exchange rate instrument has become the major tool used in determining the ruling exchange rate in the foreign exchange market. The choice of a market-determined exchange rate management system since 1986 was to free the foreign exchange market from the control of the government thereby allowing the market forces to prevail. Besides, it would also entail the adoption of appropriate policy that will guarantee stability in the foreign exchange market thereby minimizing arbitrage differential between the official and autonomous rates and consequently making arbitrage activities unprofitable. It is in the quest for corrective measures to minimize; if not ward-off distortions in the foreign exchange market that the monetary authority initiates the current exchange rate reform. The adoption of the current exchange rate policy (Wholesale Dutch Auction System) was intended to consolidate the gains recorded from the use of the retail exchange rate arrangement (Retail Dutch Auction System) with apposite modifications. However, the objective of the paper is to discuss the challenges of sustaining the recently introduced exchange rate regime in Nigeria.

The rest of the paper is organized as follows: Section 2 discusses the exchange rate regimes since inception, while section 3 presents the trend analysis of the foreign exchange market prior to the introduction of the current exchange rate regime. Section 4 contains the basic structure of the current exchange rate regime, while section 5 briefly appraises the progress made so far. Some of the challenges of sustaining the current exchange rate regime are discussed in section 6, while the paper ends with summary and conclusion in section 7.

2.0 Exchange Rate Policy in Nigeria

Exchange rate policy in Nigeria has gone through many changes but spanning between two major regimes. These are fixed and flexible exchange rate systems. The fixed exchange rate system was adopted between 1960 and 1986, while the flexible exchange rate system remains in use from 1986 till date having undergone series of modifications.

2.1 Fixed Exchange Rate Regime

Prior to 1960, there was a global fixed exchange rate arrangement in which currencies were linked to gold. This allowed for unrestricted capital mobility as well as global stability in currencies and trade. However, the system collapsed following the crash in dollar resulting in the disintegration of the Bretton Woods system of fixed exchange rate regimes in the early 1970's. Following the collapse of the fixed exchange rate system, many African countries either take to devaluation of their exchange rate peg (mostly to the Special Drawing Right or basket of currencies) or to a free float. The largest number, however, opted for some form of a peg either to the SDR, US dollar or a basket of currencies. Despite the disintegration, Nigeria still retained its exchange rate policy and operated the fixed exchange rate arrangement in line with the International Monetary Fund's (IMF) par value system.

Due to the fact that the country's currency was not tradable in the international currency market, its exchange rate was largely subjected to administrative management. Thus Nigerian currency was initially pegged at par to the British pound sterling, but due to the devaluation of the pounds in 1967, the domestic currency was allowed to move independently of the sterling but pegged to the dollar in the basket of currencies. Following the change of the Nigeria's pounds to Naira in 1973, the exchange rate of the naira was deliberately appreciated to enable the country source inputs cheaply from abroad purposely to implement development projects. However, the development triggered a number of problems in the Nigeria's external sector. Some of these problems include the rapid erosion of country's external reserves following an unprecedented level of importation and outflow of foreign exchange. It thus became apparent to reverse the trend through policy adjustment. Consequently, a renewed policy was initiated in 1981 to address the deteriorating conditions in the external sector of the economy.

Following the crash in crude oil prices in the international oil market in 1981, the monetary authority adopted a policy of gradual depreciation of the nominal exchange rate of the naira with a view to reversing the observed overvaluation of the naira. However, the administrative depreciation of the naira was not strong enough to wipe out the perceived overvaluation of the currency. Thus, the situation was further exacerbated with the accumulation of payment arrears and the erosion of the nation's credit worthiness. By 1985, a single currency intervention system was introduced which necessitated the quoting of the naira against the US dollar. Evidently, the fixed exchange rate policy which was sustained till 1986 failed to correct the imbalances in both internal and external positions.

The development, however prompted the government to introduce a Structural Adjustment Programme (SAP) in 1986, designed not only to bring about the evolvement of a realistic exchange rate for the naira, but to restructure the production pattern along the country's consumption tendencies. Within the framework of SAP and with the support of the World Bank and the IMF, many developing countries including Nigeria began to re-examine their exchange rate arrangements. It is in this context that many countries progressively moved within this continuum of exchange rate arrangement towards more flexible exchange rate regimes.

2.2 The Floating Exchange Rate Regime

A major policy reversal was effected in September, 1986 when the fixed exchange was discarded and replaced with a flexible exchange rate mechanism. The system was propelled by market forces as the naira was allowed to find its level according to the strengths of demand and supply of foreign exchange. However, the monetary authority retained the discretion to intervene in the market to influence the course of exchange rate movement towards maintaining stability and achieving policy objectives.

Within the institutional framework of market-determined arrangement, various methods were applied in the quest for a realistic exchange rate of the naira and its stability. On September 26, 1986, the naira was first floated in the Second-tier Foreign Exchange Market (SFEM), and a dual exchange rate mechanism, a combination of the first and second-tiers exchange rate system, was introduced. While the first-tier exchange rate was administratively determined and used for official transactions including debt service payments, expenditures on Nigerian missions and public sector transactions, the floating exchange rate was used for determining the value of other transactions using major pricing methods such as average successful bids, marginal rate and the Dutch Auction System (DAS). The dual exchange rate system resulted in multiplicity of rates which encouraged subsidy element with attendant fluctuations. The system was later jettisoned and the two rates were merged into a single enlarged Foreign Exchange Market (FEM) on July 2, 1987

The autonomous foreign exchange market which was created in 1988 was highly destabilizing due to its inherent speculative tendencies and was subsequently merged with the Foreign Exchange Market (FEM) in January 1989 when the Inter-bank Foreign Exchange Market (IFEM) was created. Under the IFEM, the exchange rate was determined through one or more of the following: marginal rate pricing, average rate pricing, highest and lowest bid, weighted average pricing, average of successful bids. In the same year, the Bureau de Change (BDC) was instituted to accord increased access to small users of foreign exchange in a less formal manner and encourage the integration of the informal market to the officially recognized market. In spite of these modifications, the exchange rate still failed to attain a stable level, thus the procedures of the IFEM were modified by re-introducing the DAS in December 1990 with daily bidding sessions and payments based on actual bid rate by the authorized dealers, yet the depreciation of the naira continued unabated. The development was not unconnected with the prevailing demand pressure in the foreign exchange market.

The monetary authority later discontinued the use of DAS and replaced it with complete deregulation of the FEM on March 5, 1992. The policy depreciated the IFEM rate by equating it with the parallel market, all in a bid to reducing, if not eliminating, the premium and enhancing efficient allocation of the IFEM through adequate participation in the market. Under the system, the Central Bank of Nigeria (CBN) undertook to meet all demand for foreign exchange that was fully backed by naira cover. This was however suspended following the depletion in reserves on December 15, 1992. However, the policy still failed to achieve the desired results. The de facto pegging of the official exchange rate was formalized when the naira was officially pegged at N21.9960/$1 in the 1994 Budget and the parallel market was declared illegal with plans to promulgate relevant laws that would outlaw it. The re-regulation of the FEM in 1994 worsened the situation in the FEM as the naira depreciated sharply, parallel market premium widened while stability in exchange rate and in the FEM proved elusive. The balance of payments was put under severe pressure and demand for foreign exchange rose significantly.

The dismal performance of the domestic economy arising from the control measure informed the policy reversal in 1995 from regulation to guided deregulation of the FEM. Thus the dual exchange rate was reintroduced, a combination of fixed and autonomous foreign exchange market. This was intended to boost external reserves, improve the country's credit worthiness, strengthen the naira and gradually move the currency towards convertibility. The policy was made to run up till September 1999 and by October 25, 1999, the IFEM was re-introduced to further deepen the foreign exchange market and allow the CBN to be an active player in the market. Contrary to expectations, the CBN became a major supplier of foreign exchange in the market thus frustrated the evolvement of a realistic exchange rate.

Against this background, the government re-introduced the DAS on July 22, 2002 purposely to narrow the gap between the official and parallel market rates, evolve a realistic exchange rate of the naira and conserve the foreign exchange reserves. While the system was still running, the IMF stressed the need for countries to constantly modify their exchange rate policies to reflect the prevailing developments in their foreign exchange markets. In line with this suggestion, the monetary authority deemed it appropriate to modify its existing exchange rate policy and thus, announced the commencement of the Wholesale DAS on February 20, 2006.

3.0. A Synopsis of the Foreign Exchange Market

Prior to the introduction of the WDAS, a number of systems had been practiced ranging from the administrative approach to retail Dutch Auction System. The major shortcoming of the exchange control system was the failure of the system to achieve internal and external balance in the short term and guarantee external equilibrium in the long run. The overvaluation of the currency under this system posed a major obstacle to the achievement of internal balance. Consequently, the exchange control was discarded and replaced with a market determined system. In spite of the adoption of the market-based exchange rate system in 1986 coupled with the several modifications introduced, the exchange rate movements still exhibit unsavory developments.

To a greater extent, the foreign exchange market has been largely characterized by growing instability for most part of the period, reflecting a problem of information asymmetry resulting in inefficiency in the foreign exchange market operations. A number of problems such as excess demand for foreign exchange caused by the penchant for imported products, siphoning of corrupt funds abroad, and frequent changes in foreign exchange policy caused by changes in government, prevented these policies from having their full circle. Others were unethical and sharp practices by the authorized dealers and other operators in the foreign exchange market especially the prevalent issue of round tripping of foreign exchange, sought at the official and diverted to the parallel market, the fiscal dominance which reduced the efficacy of the monetary policy and the failure of the government to accede to the harmonization of monetary and fiscal policies hindered the policy from achieving its set goals.

Beginning from 1986 to 1994, there was observed demand pressure which culminated in a wide premium. The exchange rate at the official market was N2.02 per dollar compared with N4.17 a dollar in the parallel market in 1986, representing a premium of 106.4 per cent. The introduction of the DAS in 1987 helped in no small measure to curtail the high premium to 38.1 per cent and later to 33.4 per cent following increased supply of foreign exchange by the CBN. However, the year 1989 witnessed the phenomenon of excessive demand pressure in the foreign exchange market as US$17.3 billion was demanded against a supply of US$2.4 billion. This was in spite of the policy initiatives to liberalize the market and the initiative of the government to institutionalize the Bureau de Change along with the encouragement of inter-bank foreign exchange transactions.

The rising demand trend continued in 1990 from US$20.2 billion as against a marginal rise in supply level to US$2.5 billion. This represented a wide demand gap of US$17.7 billion or 87.6 per cent. Consequently, the CBN immediately modified the procedure in the IFEM and re-introduced the DAS in 1990 which in effect helped to prune down demand to US$9.5 billion in 1991 and later to US$6.5 billion in 1992, while supply of foreign exchange trended between US$2.9 and US$4.05 billion during the review period. In a continued pursuance of a liberalized foreign exchange market, the government fully deregulated the market on March 5, 1992 and was sustained till December 1993. Unfortunately, the demand peaked at US$40.6 billion, reflecting the growth rate of money supply at 49.8 per cent, the highest level of demand during the period under review. It later moderated to US$35.7 billion in 1994. Throughout the period, the CBN continued to reduce supply having observed the incidence of speculative demand by authorized dealers. Thus, supply of foreign exchange declined significantly from US$4.05 billion in 1992 to US$1.96 billion in 1994.

Against this background, demand suddenly trended downward from US$35.69 billion in 1994 to US$1.72 billion in 1995. During the period, the CBN endeavored to supply all that was demanded by the authorized dealers, and consequently moderated the excess demand pressure in the foreign exchange market. However, the premium trended upward from 64.3 per cent in 1994 to 302.9 per cent in 1998, owing to high incidence of speculative trading by foreign exchange operators in the market and the lack of confidence in the ability of the CBN to meet the foreign exchange requirements of the operators. This impetus contributed to the flourishing activities of the parallel market.

From October 25, 1999, the IFEM was re-introduced to further deepen the foreign exchange market. Although it was intended to assuage the overdependence of the dealers on the CBN for foreign exchange and beef-up the autonomous sources, but could not be realized due to existing distortions in the domestic economy. Thus, the CBN continued to play the role of a major supplier of foreign exchange to the market. By July 22, 2002, the DAS was re-introduced with the aim of narrowing the gap between official and parallel market rates and evolving a realistic exchange rate of the naira. Consequently, the premium narrowed downward to a single digit of 7.6 per cent in December 2005.

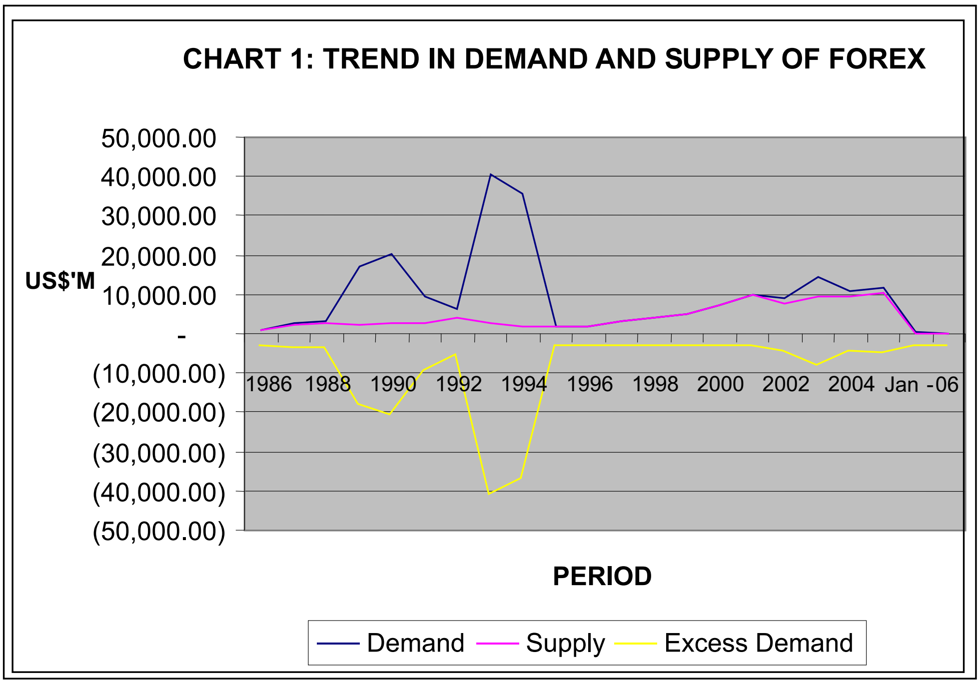
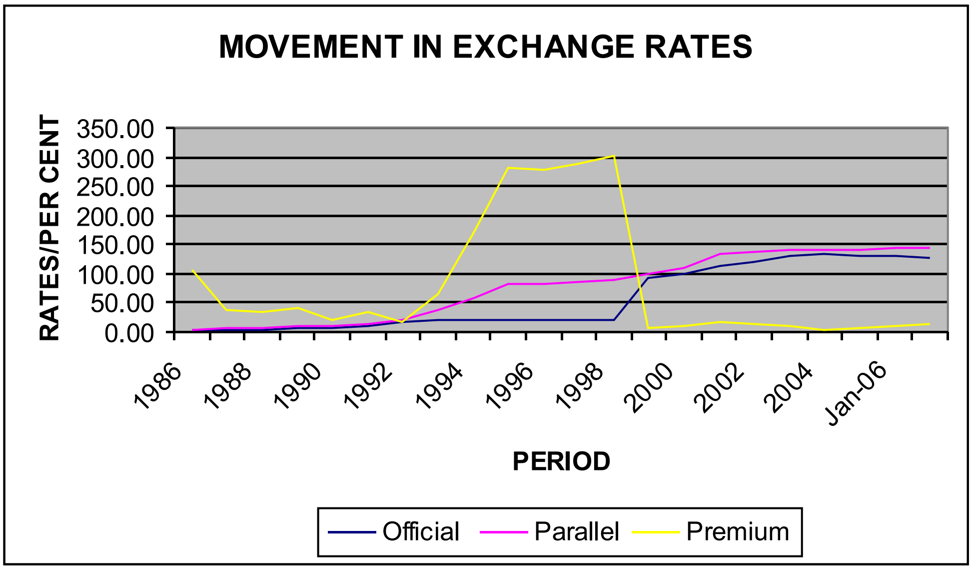


Chart 2



4.0 The Structure of the Wholesale Dutch Auction System (WDAS)

The modification of the procedures of the DAS metamorphosed into the WDAS, a window designed to provide foreign exchange to the authorized dealers wishing to replenish their stocks. The overall objectives of introducing the WDAS included among others: the need to consolidate the gains accruing from the RDAS, in particular, the achievement of market transparency, the reduction in capital flight as well as the appreciation of the exchange rate of the naira. To reduce the dependence of authorized dealers on the CBN as a major supplier of foreign exchange, to further liberalize the foreign exchange market and achieve convergence in exchange rate. The system operates twice in a week, every Monday and Wednesday, respectively. The major participants are the authorized dealers, but now include the registered Bureau de Change (BDC) operators. The BDC including Messrs Travelex and Amex are now allowed to source funds from the official window on their account for onward sale to their customers. The approval was granted on March 28, 2006 in the circular 55, aimed at increasing access of foreign exchange to small end-users and developing the local BDC. Under the new arrangement, the CBN is expected to be an active player in the foreign exchange market, not only as a supplier but also allowed to purchase funds from other authorized dealers or inter-bank outlets at competitive rates. Where it happens that the CBN engages in both sales and purchases to and from other authorized dealers, the net trading position is eventually created. On the part of the authorized dealers, they are expected to maintain an Open Position Limit (OPL) such that the maximum amount of foreign exchange that is maintained in the banks' books of account at the close of business each day shall not be less than 10.0 per cent of shareholders' funds.

According to the procedure, operators in the market are required to submit their bid rates which are treated with confidentiality, while the CBN determines the ruling rate using the marginal pricing method. However, the marginal rate lies between the band that is the lowest and highest bid rates. In this context, bidders compete for the available foreign exchange resource, while the CBN, at its discretion, determines the acceptability or otherwise of the bids submitted for approval. In practice, bids that are accepted are further processed to a logical conclusion and the wining bids are determined on the basis of the rules and regulation of the auctions. These bidders are duly notified accordingly. Bids that are not accepted are automatically disqualified from the allocation process. The rejection of any bid often arises from the non-conformity of the bidder's application with the trading rules. One of the striking conditions is that authorized dealers are required to quote two ways that is the bid and offer rates, which must be displayed in a conspicuous manner in their banking halls.

The outcome of every auction is announced on the same day. Thus, the transaction cycle has now been reduced from t_1 to t_0 since it is electronically processed using spreadsheets and well updated database. In line with the consistent policy of the Bank towards promoting an efficient and effective banking system, the monetary authority has acquired a page in the Reuters for displaying rates for each trading session at the foreign exchange market. Plans are also underway towards making the foreign exchange transactions on a real time basis. This will further make the entire process far more efficient and transparent. Within the existing foreign exchange policy framework, banks and other authorized dealers are to bid on their own account as against the previous arrangement of bidding for their customers. Every transaction must be backed by naira cover otherwise the request will be turned down. The banks in turn are expected to re-distribute the foreign exchange to their end-users on the basis of the latter's requests, though it could be sold at the inter-bank market to other authorized dealers. Banks shall be required to forward details of its foreign exchange transactions to the CBN in order to ensure that funds are deployed to the productive sectors of the economy, and are judiciously utilized by the various agents in the domestic economy.

5.0 Appraisal of the Current Exchange Rate Regime: WDAS

Of all the methods adopted in reversing the negative trend in exchange rate, the Dutch Auction System appears to have achieved dependable results. It would be recalled that the system was first introduced in 1987 when the exchange rate movement was fast depreciating but was able to stem the persistent downward slide in the naira exchange rate for a while and reduce the premium significantly. It was also re-introduced in December 1990 in an attempt to stabilize the market and evolve a realistic exchange rate of the naira. During that period, desirable results were recorded. This was in terms of enhanced professionalism in the foreign exchange dealings, thereby helping in controlling the rising demand trend, and consequently narrowing the premium. Again, the re-introduction of the DAS in 2002 was informed by the success story in Latin America where it was used successfully in correcting misalignment in their foreign exchange market.

It has been a remarkable success for the Dutch System as it has helped in conserving the country's foreign reserves, which declined slightly from $7.99 billion in 2002 to $7.78 billion in 2003 and thereafter increased to $28.28 billion in 2005. As at end-October, 2006, reserves stood at $41.39 and could possibly finance the current foreign exchange disbursements by 22.4 months. The demand pressure that hitherto characterized the foreign exchange market has been greatly subdued following the adoption of some control measures on foreign exchange disbursement and the sudden improvement in foreign exchange earnings of the government. Thus, the premium between the official and parallel market rates narrowed from 13.5 per cent to 5.2 per cent in 2004 but later increased to 7.6 per cent in 2005. It has also reduced significantly to 2.6 per cent as at end-October, 2006. Undoubtedly, the various efforts of the government at improving the exchange rate have yielded desirable results under the continued use of the Dutch Auction system. It is a remarkable achievement since the deregulation of the foreign exchange market. However, the positive development has been partly attributed to the adoption of an appropriate policy mix and in part to the strict adherence to the CBN's monetary policy guidelines by public and private sectors as well as a stable macroeconomic environment.

Since the introduction of the WDAS, the foreign exchange market has further experienced significant changes when compared with other exchange rate system of the past. One of the critical achievements of the new system of determining exchange rate in the market is the convergence in rates between the official and inter-bank markets albeit with minor distortions from the imposition of charges by banks. For instance, exchange rate at the official market was N127.01 per dollar in October 2006 compared with N128.42/$1, N130.30/$1 and N129.89/$1 in the Inter-bank, BDC and parallel segments of the market, respectively. It is evident that the foreign exchange market is becoming more competitive and relatively more efficient than before. A truly professional market is gradually emerging now that the CBN only announces a marginal rate post auction, leaving the authorized dealers to take on added risk. Besides, the CBN now plays a crucial role of not only a market maker but also a price maker or taker as the case may be. There is enhanced competition in the market through the display of professionalism by the authorized dealers. The modification has facilitated greater market determination of the exchange rate of the naira, promoted efficient and smooth functioning of the foreign exchange market and achieved a sustainable exchange rate regime that would usher in a robust economic planning for the country in the long run.

Other noticeable achievements included the introduction of electronic platform for dealings in the foreign exchange market and all the dealers are now expected to migrate to the new software application provided by the Bank. The CBN has hitherto acquired a page in the Reuters column for publication of rates and information needed by dealers. Complementing the giant stride achieved is the newly developed "electronic-Financial Analysis Surveillance System" (e-FASS) by the Bank to integrate with the rest of the dealers in the foreign exchange market. In this context, a truly liberalized foreign exchange market is being practiced as it has now become easy for end-users to access the foreign exchange market through their banks, bureau de change outlets and other designated dealers.

It is equally important to mention at this juncture that since the system came into force, the incidence of market distortions in the form of arbitrage trading, arbitrary demand, round-tripping, and speculations have been curtailed to a significant level. Consequently, the rate of inflation reduced from 11.6 per in 2005 to 6.1 per cent on year on year basis as at end-October 2006. From this perception, the economy is expected to record a higher growth in output as monetary policy continues to operate more efficiently than the preceding period. It should also be mentioned that since the improvement in exchange rate, the naira has been gaining confidence in the domestic economy, thereby increasingly serving as a store of value with drastic reduction in the degree of currency substitution in favor of foreign currency. Other macroeconomic indicators have also showed significant improvements. For instance, the balance of payments position remains in surplus following the spate in the seizure of non-essential goods imported into the country. The development has made Nigerians to be more inward-looking thereby encouraging domestic production for immediate exports. The prevailing steps have helped the exchange rate to further appreciate in the foreign exchange market. The timely intervention by the CBN has also assisted in moderating the fluctuations in exchange rate movements along the desired path as the authority ensures effective application of both demand and supply management approach towards stabilizing the exchange rate.

Overall, the system has contributed immensely to the reduction in premium from 12.8 per cent at the inception to 2.6 per cent in October 2006, a level below the 5.0 per cent IMF acceptable benchmark. This was made possible owing to the improvement in the activities of the autonomous foreign exchange market, coupled with fiscal restraints. The extent to which the official rate tracks the autonomous rate has been largely dependent on the size of the autonomous market for foreign exchange. In affirmative, the less the bureaucratic constraints at the official market, the more likely the autonomous rate remain responsive to movements in the official rate. The general observation therefore is that the success of the current monetary policy in the pursuance of the set target hinges on sound fiscal position of the government and the efforts of the CBN at maintaining a healthy financial system.

6.0 The Challenges of Sustainability of the WDAS in Nigeria

The various exchange rate policies adopted in the management of Nigeria's foreign exchange market were confronted with a number of problems over the years. These problems seriously constrained the ability of the CBN to operate a more dynamic foreign exchange management strategy. However, the current exchange rate regime has been one of the core agenda of the recent financial sector reforms designed to offer numerous advantages to the economy. Despite the potential benefits of the current exchange rate policy, the challenges are abound in the coming years. In this section, the paper attempts to outline some of these challenges.

6.1 Stable Macroeconomic Environment

The poor macroeconomic environment of the past largely contributed to the problem in the external sector of the economy. Some of the problems include among others the excessive liquidity position arising from expansionary fiscal operations coupled with the growth in monetary aggregates; increased penchant for import products, debt burden, unfavorable political environment and high arbitrage premium prevailing in the foreign exchange market. The recent adoption of economic and political reforms by the current administration has significantly improved macroeconomic environment. As at end-October 2006, available statistics showed that inflation trended downward from 11.6 per cent in 2005 to 6.1 per cent, average interest rate stood at 17.1 per cent, external debt position also declined to $5.0 billion, while external reserves has risen to about $41.39 billion. Overall, the real GDP growth rate is, however, estimated at 6.5 per cent in 2006 given the improved capacity utilization. The current macroeconomic indicators have been quite remarkable. It is important to re-emphasize that the monetary policy of the CBN does not operate in vacuum as what happens in the fiscal area does matter a lot. Therefore, a fiscal stance not supportive of monetary policy is likely to trigger inflationary pressures hence the need for appropriate policy mix. An optimum policy-mix in which a monetary and fiscal policy stance are complementary and mutually supportive remains a major challenge to the sustainability of the current exchange rate policy. A stable macroeconomic environment will no doubt help to guarantee a sustainable exchange rate policy in the country.

6.2 Financial Deepening

The poor performance in growth and employment in the past was due to the shallow financial depth brought about by inappropriate policies. Thus, the low level of financial deepening constrained the country from generating employment for enhanced productivity and sustainable economic growth. However, the role of the banking sector in ensuring financial deepening through promoting efficient mobilization of funds from surplus units to deficit units will depend on well developed inter-bank market instruments such as Treasury Bills, Certificate of Deposits, National Savings Certificate, Commercial Paper, Repurchase Agreement etc,. The ultimate goal of realizing high financial deepening in the country is a major challenge to the monetary authority and the entire stakeholders in the domestic economy. It is being established in the literature that countries with high financial deepening often recorded significant economic growth. Besides, it would provide a level playing field for both money and foreign exchange markets, enhance competition and the spread of risk, and consequently improve the efficiency of the foreign exchange market and thereby ease the discovery of the ruling rate under the new exchange rate policy.

6.3 Compliance with the Prudential Standard

It would be recalled that the acceptance of the Basle committees' recommendation on the need to adopt a global accounting standard and internationalize prudential banking standard culminated in the introduction of the prudential guidelines in 1990. It was initiated to promote greater competition, innovative environment and sanitize the banking industry. The laid down standards include among others, a publication of accurate accounting information and operating results of banks. It also emphasize the need to embark on effective surveillance of the books of accounts of the banks and ensure high level of compliance with the overnight limit set by the CBN, particularly the maximum amount of foreign exchange that must be maintained in the books of accounts of the banks at the close of business. Also, the CBN must ensure that the banks comply with their internal procedures which must be seen to be adequate to prevent flagrant violation of the prudential standards. Adopting stringent prudential regulations, strengthening banking supervision and improving accounting standards in accordance with internationally accepted standards are crucial for sustaining the WDAS. The CBN should not hesitate to deal with erring banks as such actions would serve as deterrent to others from contravening the regulations of the monetary authority. Other measures that would strengthen the WDAS include the strict adherence to the code of professional ethics, improved corporate governance and adoption of zero tolerance policy on data transparency.

6.4 Enhance Risk Management Process

There are all manners of risks present in the banking environment as advancing technological and social developments bring forth new or hitherto risks associated with such phenomena. One of the commonest risks in the foreign exchange market is the exchange rate fluctuations which often occur when there is market instability. The monetary authority has an obligation to be fully aware of the state of the art in risk management, and prevent losses which may erode the gains in the foreign exchange market. The Department saddled with the responsibility of assessing these risks should strive to determine the most economical way to reduce the level of risks to the barest minimum. The challenge to every bank including the CBN is to understand the risk and have a strong ability to control the potential risks capable of undermining the efficacy of the newly introduced exchange rate policy. In this context, the sustainability of the current exchange rate policy is contingent upon effective and cohesive management of these risks through sound risk policy framework to address any foreseeable risks in the foreign exchange market.

6.5 Intensify Surveillance in the Financial System

The financial system remains the linchpin of the economic system; however the link between economic activity and money is mainly through the clearing and settlement process. This process has a crucial role to play in the execution of monetary policy. Therefore the major concern of the monetary authority in ensuring stability in the financial system, as a necessary condition for supporting the operations of a foreign exchange market, is to monitor the pace of liberalization and guarantee the integrity of the payment system. Since the cross-border settlement arrangements would continue to have pervasive implications for macroeconomic indicators, especially the exchange rate, the monetary authority would have to embark on routine and unscheduled monitoring of the banks' trading activities in the foreign exchange market so as to instill fear of running foul of the regulatory authorities' policy. In order to sustain the existing exchange rate policy, an effective regulatory and supervisory framework that would ensure a stable financial system must be put in place so as to strengthen the confidence of the banking public. Successful operation of the WDAS will help to strengthen the confidence reposed on the financial system and in particular the external payments positions, if and only if the operation of the foreign exchange market is made more efficient and dynamic.

6.6 Strengthen the Technical Capacity of Desk Officers of the CBN

The effectiveness of the current exchange rate management depends largely on the accuracy and timeliness of information available to the CBN as well as deep understanding of the workings of the foreign exchange market by desk officers of the Bank. The inadequate experience in data analysis and in-depth technical knowledge of the market could make it extremely difficult for these personnel to appreciate the importance of data. The need to upgrade the skill of the stakeholders including customers and finance correspondents becomes imperative. The desk officers must be adequately exposed to foreign exchange dealings and made to identify with the changing banking and commercial world.

In this context, the challenge confronting the authority is in terms of the quality of the desk officers monitoring the operations of the WDAS in the Trade and Exchange as well as Research and Statistics Departments of the Bank, which needs to be strengthened to keep pace with the growing changes in the banking sector. It is high time for the monetary authority to be ahead of the institutions it is supervising, and also be adequately equipped to detect any possible infractions in the foreign exchange market. Data on foreign exchange market activities as well as projection on demand and supply of foreign exchange and its effects on the exchange rate must be generated on periodic basis and thoroughly analyzed to ward-off collusion during the process of determining banks' bidding rate. This must be complemented with transparency of information disclosure by foreign exchange dealers. The transparent reporting of the foreign exchange schedule by banks will help to foster the ethics of good corporate governance and enhance the prospects for effective liberalization of the foreign exchange market.

6.7 The Role of Finance Correspondents

The role of finance correspondents in the sustenance of the new exchange rate system remains crucial. They are expected to generate a credible reporting system that would expose Nigerians and non-Nigerians who are after derailing the process of achieving economic development in the country. The finance correspondents are now confronted with the responsibility of producing accurate information on activities in the foreign exchange market and avoid sensational reporting which could distort the workings of the current exchange rate policy. The recently approved bill on freedom of information is a welcome development which finance correspondents should take advantage of and prepared to face challenges ahead of them. At this point, it is advisable that the CBN work with them as partners in progress and continue to hold regular dialogue. It is only through this approach that the current policy on exchange rate can be well sustained for the realization of the set goals of the government.

6.8 Ensuring Availability of Robust Reserves

One of the necessary and sufficient conditions for effective workings of the floating exchange rate regime is the availability of very large reserves. Robust reserves are crucial ingredient in economic development of any country as it indicates strong national assets on which the country depends. In Nigeria, the rising trend in reserves which is currently being experienced has positive implications for both domestic and international economy. It has contributed significantly to the recent appreciation in the exchange rate. The challenge posed by these very large reserves is for managers (banks) to direct their efforts at ensuring that the management of the available asset reserves to the pursuance of high return is not at the expense of security and liquidity. Reserves managers should endeavor to strike a balance between these conflicting aims given the systemic risks of the international financial market. The involvement of local banks in the management of the country's reserves is an indication of the strong confidence reposed on the domestic financial system. The strive to achieving sustainability of the current exchange rate policy will also depend on the efforts of the government at diversifying its economic base, particularly through promotion of non-oil sector for boosting reserves level. Another subsisting challenge is for the government to strengthen its efforts at attracting foreign investment and increasing capital inflows through guaranteeing conducive political environment and ensuring high social security.

7.0. Summary and Conclusion

The choice of an exchange rate by a given country depends on the policymaker's economic objectives, the source of shocks to the economy and the structural characteristics of that economy. However, the overall consideration for choosing a floating exchange rate is the need to safeguard against destabilizing speculations and the establishment of monopoly positions by some operators in the market. This is because the exchange rate policy is a veritable tool used for directing the trend in domestic prices along a sustainable path. It is also a valuable instrument when used in a proactive manner.

The pursuance of a stable exchange rate is usually an arduous task but requires an optimal policy-mix. It thus poses challenge to the CBN on the need to pursue a stable exchange rate objective as an essential element of its monetary policy even under a flexible exchange rate regime which now dominates the global environment. In addition, the increasing openness of the economy under the impetus of globalization also challenges the CBN to adopt a more skilful approach to the management of floating exchange rate of the naira; otherwise it may cause the depletion in country's external reserves. It is however, expected that an effective management of the current exchange rate policy will help to further strengthen the value of the domestic currency and enhance the confidence on the exchange rate system. Although, the sustainability of the WDAS is an ambitious one, it is however abound with attendant challenges for which the CBN must prepare for thoroughly. The impressive performance of the current exchange rate policy gives the confidence to state that the CBN and other stakeholders are quite prepared to confront these challenges with determination and sincerity.

To recap the main argument in this presentation, let me reiterate that the major challenge noted in this paper for the sustainability of WDAS is to ensure sound macroeconomic environment, fiscal sustainability, improved corporate governance, and effective risk management process. In particular, a sound financial system that will ensure an efficient and stable exchange rate mechanism and contribute to the development of the financial markets need to be guaranteed. In addition, the concern of many policymakers in adopting a floating exchange rate regime has been the availability of robust reserves. In complement, the exchange rate policy should be backed by implementation of appropriate policies of demand restraint and structural change and by increased resource inflows, especially the type that can be readily fed into the foreign exchange market.

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Table 1

MOVEMENT IN EXCHANGE RATE

2006	WDAS	IFEM	BDC	Parallel
20-Feb	128.07	128.82	145.58	144.75
March	127.43	128.68	145.47	144.63
April	127.19	128.58	147.85	147.03
May	127.18	128.57	142.33	141.52
June	127.18	128.50	136.82	136.02
July	127.11	128.43	130.12	129.55
August	127.06	128.43	130.46	129.96
September	127.02	128.39	130.21	129.71
October	127.01	128.42	130.30	129.89

Source: Trade and Exchange Department, CBN, Abuja

Table 2:
MACROECONOMIC INDICATORS

	2002	2003	2004	2005	2006 *
Inflation (%)	12.9	14.0	15.0	11.6	6.1
BOP ($' M)	-4,673.5	-1,258.8	8,452.3	10,366.4	3,804.8
Average Interest Rate (%)	20.6	19.6	18.9	17.8	17.1
Ext. Debt ($'B)	31.0	32.9	35.9	20.5	5.0
External Reserves ($' B)	7.7	7.5	17.0	28.3	41.4
Real GDP Growth (%)	3.5	10.2	6.1	6.2	6.3

***October 2006**

Source: CBN, Abuja