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EFFECTIVE RESERVES MANAGEMENT IN NIGERIA: ISSUES, CHALLENGES AND PROSPECTS

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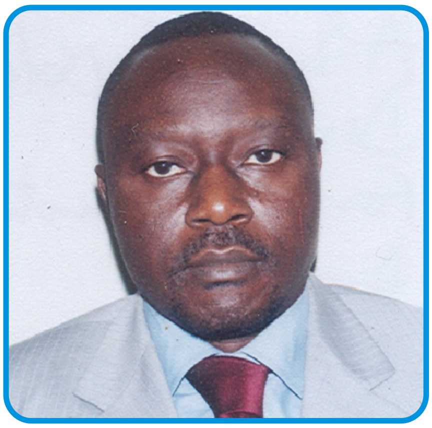

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Introduction

Effective management of foreign exchange reserves is one of the major macroeconomic objectives of countries like Nigeria. This is against the background of rapid rise and accumulated challenges currently facing many emerging economies especially oil producing countries. In Nigeria, the reserves has risen from USD4.99 billion in May 1999 to USD38.07 billion as at July 31, 2006 (see table 1).

The phenomenal rise in the level of Nigeria's external reserves, especially since the beginning of 2004, has generated a lot of interest and debate among both the informed and uninformed members of the public on how the reserves should be managed. While some criticized the monetary authorities and indeed, the government for stock-piling reserves in the midst of poverty and unemployment with a call for the reserves to be injected into the economy to develop infrastructure and create employment, others opined that since the reserves accumulation was through highly volatile and un sustainable sources, the excess revenue should be saved for the future generations.

It is therefore necessary for the CBN to enlighten the public on these issues as well as the strategies it has adopted to ensure efficient and effective management of the external reserves. In this regard, this paper examines the key issues, challenges and prospects of effective management of external reserves in Nigeria and how the CBN has fared in coping with these challenges. The paper is broadly divided into seven sections. Following this introduction, section II examines the concept of International Reserves, the Reasons for holding reserves and the enabling legislation for the management of external reserves in Nigeria; section III examines Reserves Management and Reserves Management objectives; while section IV identifies the key issues in effective reserves management in Nigeria. Section V contains the challenges to effective reserves management; section VI discusses the prospects of reserves management in Nigeria while section VII concludes the paper.

(II) What are External Reserves?

External Reserves are variously called International Reserves, Foreign Reserves or Foreign Exchange Reserves. While there are several definitions of international reserves, the most widely accepted is the one proposed by the IMF in its Balance of Payments Manual, 5th edition. It defined international reserves as "consisting of official public sector foreign assets that are readily available to, and controlled by the monetary authorities, for direct financing of payment imbalances, and directly regulating the magnitude of such imbalances, through intervention in the exchange markets to affect the currency exchange rate and/or for other purposes"

Therefore, foreign exchange holdings of individuals, banks, government agencies and corporate bodies do not form part of a country's international reserves.

The Central Bank of Nigeria Act No. 24 of 1999 (as amended) vests the custody and management of the country's international reserves in the Central Bank of Nigeria. The Act provides that the CBN shall at all times maintain a reserve of external assets consisting of all or any of the following:

- Gold coin or bullion;
- Balance at any bank outside Nigeria where the currency is freely convertible and in such currency, notes, coins, money at call and any bill of exchange bearing at least two valid and authorized signatures and having a maturity not exceeding ninety days exclusive of days of grace;
- Treasury bills having a maturity not exceeding one year issued by the government of any country outside Nigeria whose currency is freely convertible;
- Securities of, or guarantees by, a government of any country outside Nigeria

whose currency is freely convertible and the securities shall mature in a period not exceeding ten years from the date of the acquisition;

- Securities of, or guarantees by international financial institutions of which Nigeria is a member, if such securities are expressed in currency freely convertible and maturity of the securities shall not exceed five years;
- Nigeria's Gold tranche in the International Monetary Fund (IMF);
- Allocation of Special Drawing Rights (SDR) made to Nigeria by the IMF.

Almost all countries hold foreign exchange reserves, although the reasons for doing so differ from country to country. In Nigeria, reserves are held for the following reasons:

- Support and maintain confidence in the monetary policy and exchange rate management, including capacity to intervene in the foreign exchange market (WDAS) in support of the Naira. Hence the higher the level of the nation's reserves, the higher the potential for Naira to appreciate vis-à-vis other currencies. This is evident in the relative stability in the foreign exchange market since 2004 and the historic merger between WDAS and Bureau de Change rates;
- Servicing of foreign currency liabilities and debt obligations - The country was able to obtain debt relief of US$18 billion by using the reserves to pay off the Paris Club debt of US$12.4 billion. In addition, the Federal Government is negotiating the London Club debts. These efforts have contributed significantly to the enhancement of the country's credit worthiness to BB rating by Fitch and Standard & Poors, which in turn is already attracting huge foreign investments;
- To finance government expenditure abroad e.g. for import of goods and services, for government programs;
- Defense against emergencies or disaster; and
- Provide a source of income, as the reserves can be invested in income generating instruments such as treasury bills, bonds, time deposits, etc.

(III) What is Reserve Management?

Reserves management can be defined as a process that ensures that adequate official public sector foreign assets are readily available to, and controlled by the authorities for the purpose of meeting specific objectives of a country.

The main objectives of reserves management in Nigeria are:

a) Safety (capital preservation);

b) Liquidity; and

c) Return

Like all other central banks, capital preservation is the most important objective of CBN's reserves management. This explains why the Central Bank of Nigeria invests reserves mainly in government securities such as treasury bills and bonds, and in foreign banks with highest credit quality. The Bank also maintains adequate liquid assets for the purpose of intervention in the foreign exchange market, payment of external obligations, financing day-to-day official transactions and meeting unforeseen needs. The return objective helps the Bank to earn income in order to meet its operating costs. This objective is becoming more important as the traditional sources of the Bank's income such as Ways and Means and purchase of government (domestic) bonds are on the decline.

(IV) Key Issues in External Reserve Management in Nigeria

Some of the issues that have occupied public discussion of external reserves include the

Following:

<u>Accumulation Vs Spending</u>

As mentioned earlier, accumulation of reserves is a global phenomenon and not peculiar to Nigeria. Global official reserves have increased from about USD2 trillion at the end of 2002 to over USD4 trillion as at January 2006, with emerging and developing countries accumulating bulk of the world's foreign exchange reserves (please see table 2). The rise in the oil prices has now shifted reserve accumulation from the rest of Asia (ex China and India) to oil exporting countries. Many of these countries are accumulating reserves out of lessons learnt during the various financial market crises of the 1990's. Consequently, they continue to build reserves in order to shield themselves from volatile capital movements. Nigeria, like other oil producing countries, has been accumulating reserves since 2004 following the upsurge in oil prices occasioned by the general tension in the Middle-East , regional conflicts and increasing global demand for oil, especially from China. In spite of the Paris Club debt payment however, the country's external reserves have reached an unprecedented level of USD38.07 billion as at July 31, 2006. This consisted of the following three components:

Federation - USD 8.18 billion

Federal Government - USD 2.71 billion

CBN - USD 27.18 billion

Total: - USD38.07 billion

The Federation component consisted of sterilized funds (unmonetized) held in the excess crude and PPT/Royalty accounts at the CBN belonging to the three tiers of government. This portion has not yet been monetized for sharing by the federating units. It is sometimes ignorantly referred to as the reserves of the country. The Federal Government component consists of funds belonging to some government agencies such as the NNPC, for financing its Joint Venture expenses, PHCN and Ministry of Defense, for Letters of Credit opened on their behalf, etc. The CBN portion consists of funds that have been monetized and shared. This arises as the Bank receives foreign exchange inflow from crude oil sales and other oil revenues on behalf of the government. Such proceeds are purchased by the Bank and the Naira equivalent credited to the Federation account and shared, each month, in accordance with the constitution and the existing revenue sharing formula. The monetized foreign exchange thus belongs to the CBN. It is from this portion of the reserves that the Bank conducts its monetary policy and defends the value of the Naira.

It is clear that the monetized reserves constitute the largest portion (71.4%). Hence the much talked about accumulated reserves is dominated by the foreign exchange equivalent of the amounts that have been shared monthly, among the three tiers of government for their annual budgets. Public attention should therefore equally be on how the monthly allocations of the federation reserves have been utilized as on the foreign exchange counterpart with CBN. As the saying goes, you can not eat your cake and have it. The criticism that the CBN is accumulating foreign reserves in the midst of poverty and unemployment is therefore misplaced. To illustrate how the CBN portion of the reserves accumulated, table 3 shows crude oil proceeds that have been monetized, on monthly basis, from January 2004 to July 2006.

Currency Composition of Nigeria's External Reserves

Another topical issue in the discussion of reserves management is the sliding value of the US Dollar. Many sections of the society have expressed concern about the possible adverse impact of the depreciation of the dollar on the nation's external reserves predominantly denominated in that currency. Fortunately for Nigeria, over 90% of its foreign exchange inflows and outflows are denominated in the US Dollar, mainly due to the fact that its crude oil receipts and other non-oil exports are invoiced in US Dollar while most of its obligations such as external debt service (especially after the payment of Paris Club debt), foreign exchange intervention, as well as other service obligations are also denominated in US Dollar. This insulates the reserves from the loss in value that could have arisen even if the Dollar continues to fall against other major currencies. This explains why the dwindling fortune of the Dollar is not a major and immediate concern to the CBN. However, the Bank always ensures sufficient holding of non-dollar convertible currencies such as the Euro and Pound Sterling in proportion to the country's transaction needs in those currencies. Any holding of non-dollar currencies beyond this requirement will amount to speculation which a central bank should avoid.

Besides the natural hedge, the US Dollar today remains by far the most important reserve currency for central banks. Furthermore, in spite of several rumors that countries with huge foreign exchange reserves such as China and Japan will diversify out of US Dollar, little change is forecast because any heavy movement out of the Dollar by such countries will depreciate the currency further with adverse consequences on those countries. Given this uncertainty, the CBN position is that the current dwindling fortune of the US Dollar is part of cyclical movement and not a fundamental change. Therefore the Bank will not normally alter significantly its currency composition in the short-run.

(V) Challenges to Effective Reserve Management in Nigeria

Volatility of Foreign Exchange Inflow

Nigeria's over dependence on oil for over 90% of its foreign exchange earnings makes its capital account vulnerable to the fluctuations in crude oil prices. This, in addition to its high import bills contributed to the fluctuations in the level of reserves over the years and consequently the way the reserves are being managed. During the oil boom of the mid-seventies which has resulted in the build up of reserves, the external reserves were diversified into an array of financial instruments including foreign government bonds and treasury bills, foreign government guaranteed securities, special drawing rights (SDRs), fixed term deposits, call accounts and current accounts. This provided significant investment income as well as liquidity. However, during the glut in the global oil market which led to collapse in the crude oil prices and consequently a drawdown in the reserves, the reserves were held mainly in current accounts and treasury bills. This underscored the need to diversify the sources of foreign exchange inflow of the country.

Legal and Institutional Environment

Sections 162(1) and 162 (3) of the Constitution of the Federal Republic of Nigeria made it mandatory for all revenues accruing to the nation to be paid into the Federation account and to be distributed among the Federating units in accordance with the existing revenue allocation formula. The implication of this constitutional provision is that each tier of government has the right to spend its own share of the revenue and when this happens, in view of the limited instruments for sterilization, the Bank has to sell more dollars in order to mop up the excess liquidity.

Furthermore, the CBN Act has been very restrictive as to the diversity of instruments the CBN could invest the nation's reserves. Specifically, the Bank is not allowed to invest in equities, corporate bonds and agency instruments that are not explicitly guaranteed by Sovereign Governments. This posture impedes the ability of the Bank to maximize returns.

Training and Retention of Staff

Reserve Management task is becoming more complex as central banks are moving into new asset classes with higher risk/return profile in search of higher risk adjusted returns. In the case of CBN, we are moving from the hitherto investment in money market instruments such as time-deposits; treasury bills etc into longer dated instruments like treasury and agency bonds (having explicit guarantee of a sovereign government). Although these are default-free instruments, they however have market risk. This development has necessitated the need for highly skilled personnel who could measure and control the associated risks. Although the Bank is making efforts to develop capacity in reserves management, the challenge is how to retain these staff in view of the high demand for their skills in the private sector.

(VI) Prospects of Effective Reserve Management in Nigeria

Fiscal Support

In line with its reform agenda under the National Economic Empowerment and Development Strategy (NEEDS), the Federal Government has continued to pursue prudent fiscal operations that support the reserves management initiatives of the Bank. To this end, the Government is at the final stage of enacting a Fiscal Responsibility Act. The Act is to provide for prudent management of the nation's resources, ensure long-term macroeconomic stability of the economy, and secure greater accountability and transparency in fiscal operations within a medium term fiscal policy framework. The Fiscal Responsibility Act will promote harmony among key agencies in the economy and ensure coordination of monetary and fiscal policies.

Use of External Managers

The use of external fund managers in reserves management is becoming popular among central banks. A recent survey by UBS Investment Bank shows that some 70% of central banks around the world now use external managers. The following are some of the benefits of external manager program:

1. External managers could be used as yard stick for measuring the performance of internal managers.

2. External managers could be used to train internal staff through organizing seminars, conferences, attachment programs, etc.

3. External managers could also provide internal staff with access to their research materials as well as provide them with market information.

4. Since External managers are highly specialized and have deeper understanding of global markets, they could enhance returns on the reserve portfolio.

5. External managers could serve as fall back option in the event that some experienced internal staff leave the central bank.

In view of the benefits highlighted above, the CBN has resolved to outsource the management of a portion of its component part of the reserves to external funds managers. This portion will be invested in bonds which will yield higher return than fixed deposits. To that effect, the necessary due process has been set in motion including evaluation of Requests for Proposal (RFP) and due diligence visits.

The Bank has also appointed a Global Custodian (JP Morgan Chase) which will among other services, take custody of all the securities purchased by the External managers.

Policy on Partnership Agreement between Local and Foreign Banks in the Management of External Reserves

As part of the external manager program mentioned above, the CBN is leveraging on the program to encourage the transformation of the local banks into significant players in the global financial markets. This is intended to be achieved through collaborative arrangements between foreign and local banks in managing a portion of the external reserves. To realize this objective, prospective foreign asset managers are required to partner with at least one local bank to develop the skills of the latter to render custody, asset management and other financial services. This arrangement will be backed by concrete agreements between the foreign and local banks in accordance with the Guidelines for Partnership agreement issued by the Bank.

Increase in the Number of Counterparties

In order to reduce concentration of risk and enhance competition and return, the Bank has substantially increased the number of counterparties with which it places funds. These counterparties meet the minimum credit rating of the Bank.

Increased Transparency in Reserves Management:

The Central Bank of Nigeria has intensified the process of transparency in policy formulation and operational activities through the adoption of some of the IMF Guidelines for Foreign Exchange Reserves Management approved by the Executive Board of the IMF in 2001. The Bank also disseminates information to the general public through its website as well as its quarterly/half yearly and annual publications. Information is also divulged through Governor's conferences and press releases.

High Level of Oil Price

The phenomenal increase in the oil price is expected to remain unchanged at least in the next one year. This will invariably translate to more accretion to the reserves.

Establishment of National Investment Fund for the Federation

It is a known fact that the recent build up in the nation's external reserves was attributed mainly to the upsurge in oil prices which is not sustainable. Indeed, high oil prices are already driving research into the exploitation and utilization of alternative energy sources. Consequently, there has recently been a call for the nation to establish a National Investment Fund in which to invest excess earnings from oil in order to shield the nation from the uncertainty and volatility of oil prices. Many countries have successfully established such a fund including Botswana, Venezuela, Norway, and Sao Tome and Principe, to mention a few. In fact, most of these countries sterilize the proceeds from oil and other minerals and finance their budgets through other sources. The establishment of such a fund in Nigeria can serve the twin objectives of stabilizing the volatility of fiscal revenues and creating pool of capital that can provide an alternative source of foreign exchange earnings.

In order to address the concern of the stakeholders regarding the issue of transparency on the utilization of the fund, a certificate bearing the nominal value for each stakeholder should be issued, based on the revenue sharing formula.

The New Reserve Management Thrust

The Investment Committee

In line with the general re-structuring of the Central Bank of Nigeria's processes with a view to making the Bank more efficient and effective in the conduct of its core functions (i.e. Project EAGLES), series of initiatives have been taken to improve the efficiency of the reserves management operation. To this effect, a new Investment Committee was inaugurated to oversee the reserves management function in line with international best practice.

The World Bank Program (RAMP)

In 2003, the Bank joined the World Bank's Reserves Advisory and Management Program (RAMP). The RAMP is both technical advisory program designed to build capacity in reserves management, as well as an asset management engagement allowing the World Bank to manage, for a fee, a portion of the external reserves of member central banks. The RAMP program has been very rewarding especially in terms of capacity building for internal portfolio managers and policy formulation on the revenue sharing formula.

Strategic Asset Allocation

In view of the growth of the reserves in excess of the liquidity needs of the CBN, the Bank has undertaken a

Strategic Asset Allocation (SAA) of the external reserves. The aim of the exercise is to optimize the long-term return on the reserves portfolio taking into account the risk tolerance of the Bank. The SAA tranched the reserves into liquidity, investment and stable trenches reflecting the capital preservation, liquidity and return objectives of the CBN's reserves management.

The liquidity tranche is for the day-to-day liquidity needs of the Bank. The Investment tranche is a buffer to the liquidity tranche while the Investment tranche is for return maximization.

Provision of Modern Functional Dealing Room

In order to enhance the efficiency of the reserve management operations, arrangements have been concluded to equip the reserves management dealing room with IT and communication equipments, and a portfolio management system which will be used in measuring the performance of the portfolio against a benchmark as well as generating holdings and risk reports. These are aimed at ensuring effective management of the reserves.

Capacity Building in Reserves Management

The Bank has been making frantic efforts to develop internal capacity in reserves management to meet the challenges of the changing nature of reserves management operation. Apart from training under the World Bank's RAMP, the Bank has also been sending staff on training to some specialized training institutions, seminars and workshops organized by our correspondent banks on reserves management. Furthermore, the Bank has sponsored some staff for the Chartered Financial Analyst Exam, a well recognized certification program for investment professionals. One staff has recently passed the final level (level III) while others are at levels 1 and 11 stages of the program.

(VII) Conclusion

In conclusion, the recent accumulation of foreign reserves is not peculiar to Nigeria as oil producing countries with similar history and level of exports as Nigeria are accumulating even more reserves. The rising level of reserves has assisted the country in financing its budgetary programs, maintaining exchange rate and price stability and settling its external obligations, in particular the Paris Club debt, thereby enhancing its credit worthiness.

The reserves consist substantially of the portion that has been monetized and shared monthly in accordance with the constitution and sharing formula. Consequently, just as there is the need to ensure efficient and effective management of the reserves, it is also important to focus attention on the utilization of the Naira counterpart that has been distributed to the 3(three) tiers of government.

Furthermore, there should be deliberate and systematic effort in saving part of the reserves for the future generation as oil, which is the main source of the reserves accumulation, is a wasting asset. This can be given a solid impetus through an appropriate constitutional provision. The rising level of reserves is also a challenge for the Central Bank of Nigeria as it is important that the reserves are managed effectively and efficiently in accordance with the statutory objectives of safety, liquidity and return. The Bank is bracing up to this challenge by various reforms initiatives and provision of necessary infrastructure.

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