

12-1-1995

Foreign exchange management in Nigeria.

M. R. Rasheed

Follow this and additional works at: <https://dc.cbn.gov.ng/efr>

Recommended Citation

Rasheed, M. R. (1995). Foreign exchange management in Nigeria. *Economic and Financial Review*, 33(4), 352-356.

This Article is brought to you for free and open access by CBN Institutional Repository. It has been accepted for inclusion in *Economic and Financial Review* by an authorized editor of CBN Institutional Repository. For more information, please contact jelongshak@cbn.gov.ng.

Foreign Exchange Management in Nigeria

by

Alhaji M. R. Rasheed

Introduction

The purpose of this paper is to provide a basis for discussion on the topical issue of Foreign Exchange Management among seminar participants. Accordingly, the paper shall explore briefly the evolution and current practices of Foreign Exchange Management, with particular reference to the Central Bank of Nigeria.

Foreign Exchange refers to the revenues earned by a country in convertible currencies from exports of goods and services. Nigeria's principal source of foreign exchange earning is from the export of crude oil. Other sources of foreign exchange flows include non-oil exports, capital importation, foreign investment flows, service incomes, other invisible items, such as external borrowings and foreign aids. The totality of the foreign exchange earned and available at any given time for the settlement of Nigeria's external obligations is referred to as the foreign exchange reserve. The foreign exchange reserve plus Nigeria's holdings of monetary gold, Special Drawing Right (SDRs) and the Reserve Tranche at the IMF constitute the country's External Reserves. The maintenance of an adequate level of reserves is crucial for safe guarding the strength of the economy and the value of the naira against other international currencies.

On the other hand, foreign exchange management in its broadest sense, refers to the efficient holding and optimal deployment of all the country's foreign exchange reserves in order to meet its foreign exchange expenditures and other monetary policy targets. Thus foreign exchange management must aim at accounting for all receivable foreign exchange revenues, investing the foreign exchange reserve in a most efficient manner, determining a sustainable exchange rate for the Naira visa-vis other foreign currencies and above all provide immediate liquidity in meeting Governments' commitments.

Accordingly the CBN's Foreign exchange reserve management function involves the following sub-functions:-

- (1) External Reserve Management. i.e. management of the unspent foreign reserves.
- (2) Assessment of the impact of Exchange rates on External reserve management.
- (3) Monitoring the impact of funding the FEM on reserve management.
- (4) Appraising the impact of funding Government's external payments on reserve management

Foreign Exchange Management in the CBN (External Reserve Management)

The external reserves of a country are the financial assets available to the Government to meet temporary imbalances in the external payments; to intervene in its foreign exchange market in defence of its exchange rate; to settle obligations arising from international trade, financing contracts, diplomatic relations, etc. An adequate level of reserves is, therefore essential to a country's economic and socio-political stability.

The management of Nigeria's external reserves has basically two main objectives. These can be summarised as financing the government's current expenditure and funding the capital account. The current account includes foreign debt service, diplomatic and military expenditures etc. In Nigeria, the reserves are also used to fund the Foreign Exchange Market (FEM) to finance private sector expenditure in respect of goods and services. On the other hand, the capital account consists of investments to hedge government's foreign liabilities, with the aim of providing an income and capital streams from which future interest and capital repayments of loans can be made.

In the light of the stated objectives the reasons for holding external reserves by the Central Bank of Nigeria may be summarised as follows:

- (i) To provide liquidity that is easily spent or exchanged in settlement for transactions with the rest of the world. The higher the domestic propensity to import, as is the case with Nigeria, the higher the level of reserves required to sustain such transactions. When the level of public and private sector imports and invisible commitments are considered, then the country's present level of external reserves can hardly cover five weeks obligations. Indeed, the international standard is for the coverage to be for four months (a rule of thumb) as recommended by the IMF.

Another measure of reserve adequacy is the debt service ratios i.e. total debt service falling due as a proportion of a country's export earnings in goods and non-factor services. A ratio of below 20% is considered healthy; anything in excess of 20% is too high and will have implications not only on external reserves but also on external debt management.

- (ii) To fund the Foreign Exchange Market with a view to having a stable exchange rate provided other economic fundamentals, especially those relating to fiscal policies are sound. In many other countries, central banks just intervene from time to time to stabilise exchange rates. The exchange rate policy can be used as a tool for management of a country's external reserves. For instance, a devalued Naira exchange rate discourages demand for foreign exchange (and enhances external reserve). The reserve so saved would be available to:
 - (a) meet external payments;
 - (b) intervene in the FEM; and
 - (c) Settle external trade and diplomatic obligations.

On the other hand, an over valued exchange rate encourages excessive demand with the following consequences:

- Capital Flight
- Increase in Importation of goods and services

- Speculators (including manufacturers) resort to trading in foreign exchange as against its use for productive purposes. The summation of these effects results in excessive demand pressure on the external reserve as was the case in 1994.
- (iii) To enhance our international credit-worthiness. External reserves represent the ultimate line of defence if credit-worthiness of a country is in doubt and it cannot have access to new borrowing. More importantly, a respectable level of reserves serves a notice to the international community that a country's economic prospects are good. This tends to enhance international investor confidence and attracts foreign investment into a country.
- (iv) To use the available stock as a buffer against external shocks. A high level of external reserves provides a cushion for the country against external shocks, such as sudden fall in the price of oil, thereby giving the country some time to adjust its expenditure patterns to this external shock without causing any destabilisation in the economy.

Against the above background, the important factors guiding the CBN's reserves management strategy are the amount of reserves available and the form (types of securities) in which to hold them. In view of the inherent distortions in Nigeria economy, and the fact that the country has a mono-export-product economy, the country's balance of payments is highly vulnerable to external shocks. This therefore, necessitates the maintenance of adequate external reserves – sufficient to cover at least four months imports. However, since 1985 several factors, including increasing government commitments, a high debt service burden and the funding of the Foreign Exchange Market have made it impossible to achieve this objective.

Nevertheless, our reserve management strategy has involved the following:

- (a) Investment of reserves in secure, short-dated liquid assets in order to ensure prompt availability of funds when required;
- (b) Rescheduling of our external debt in order to reduce the debt service burden, and thereby enhance our reserves;
- (c) Selection of only a few correspondent banks to operate our documentary credits on an unconfirmed basis in order to enable us pay only when shipments are made. In this way (although there will be some contingent liabilities against the CBN) the unremitted funds count as part of the Country's reserves until the liability crystallises; and
- (d) Limiting the foreign exchange expenditure of the public sector through budgetary controls.

The reserve management strategy of the Central Bank of Nigeria is anchored on liquidity management and capital preservation as the level of foreign exchange receipts is grossly inadequate to accommodate the country's payment obligations. Given this constraint and the unpredictable nature of our payments, the Central Bank endeavours to place reserves in assets that are sufficiently liquid to ensure prompt and timely settlement of our obligations, and yet profitable enough to ensure adequate capital appreciation.

Foreign exchange receipts by the Bank come from proceeds of Nigerian National Petroleum Corporation (NNPC) direct crude oil sales, Petroleum Profit Tax (PPT), Royalties, Gas flaring

charges etc. on the one hand, and non-oil export proceeds such as the sale of foreign exchange by parastatals and organisations such as the Commission of the European Communities (CEC) and the World Bank, on the other.

The Central Bank of Nigeria's foreign investment portfolio has, over the years, been diversified to comprise foreign government bonds, treasury bills, time deposits and other miscellaneous securities. The level of investment of course, depends on availability of surplus funds. By 1973, only pound sterling foreign investments were held. With increasing prosperity resulting from the oil boom, our investments were diversified into U.S. dollars, Deutsche Marks, Swiss Francs, French Francs, Japanese Yen, etc. Currently, the country's reserves is largely held in US Dollars because the bulk of our international trade and loan obligations is in US Dollars, and the New York money and bond markets are by far the biggest and most liquid investment centres.

In recent years the nation's foreign exchange obligations have exceeded the receipts resulting in persistent balance of payment deficits. In the light of this major constraint, the Central Bank of Nigeria has had to significantly realise most of its foreign investments and to shorten the maturity profile of what remains in the portfolio in favour of more liquid assets. As a result of this measure, there has been a complete elimination of bond investments from the portfolio, and a consequent loss in yield.

The present investment strategy of the Bank is to hold the larger proportion of our reserves in secure, liquid although low yield assets especially foreign government treasury bills and time deposits with reputable institutions such as the Bank for International Settlement, Basle and AAA-rated banks such as Morgan Guaranty Trust Company, New York. The other component of this strategy is to hold the reserves in various trading currencies - their relative proportions dictated by our use of each currency in international trade settlements and external debt service and the liquidity of its domestic market.

The effect of this strategy is that we have been able at all times to meet our international payment obligations in a timely and cost effective way, while at the same time earning the best yields available in our selected securities and maturities. At present, our investments are in:

1. Time Deposits
2. Treasury Bill - US and Japanese
3. The Federal Funds Market
4. The Repo Market
5. Other miscellaneous Securities'

Our maturities rarely exceed one month except where yield curve or relative value considerations attract us to go in for a longer tenor.

Thus far our reserve Management strategy has been quite cautious. As we move in to the future, and hoping that our economy improves, there is a need to redefine this strategy to take advantage of opportunities in the international foreign exchange and bond markets. Future strategies must, subject to prevailing constraints, aim at creating a more balanced portfolio (in terms of duration, convexity, etc) which must be properly immunised against interest rate risk and reinvestment risk. This, no doubt, entails greater investment in office automation and staff development, will significantly improve returns, the CBN's expertise and its ability to take advantage of opportunities presented by the financial markets of the 21st century.

Summary and Conclusion

This paper has reviewed Foreign Exchange Management in Nigeria; identified the various reasons for holding external reserve and in addition, discussed some of our recent experiences in reserve management. Among the key factors that have influenced the management strategy of the CBN are:

- the mono-export-product base of the country's foreign exchange earnings structure;
- a high debt service burden; and
- managing the domestic propensity to import.

Against this background, the reserve management strategy of the Bank has been cautious with understandable emphasis on liquidity management and capital preservation. Equally important in this review is the impact of the regime of exchange rate management policies adopted during the years of economic prosperity. The distortions created by such administratively fixed rates have persisted into years of austerity and have placed avoidable burden on the Bank's reserve management efforts.

Thus far, and inspite of the obvious constraints, we have been able to meet our international payment obligations in a relatively, timely and cost effect way, while at the same time earning the best yield for our reserve. It is also gratifying to note that the Autonomous Foreign Exchange Market (AFEM) which is market determined, is at the centre of the 1995 exchange rate policy. In spite of its failure to reverse the depreciation of the Naira exchange rate and the attendant inflationary consequence, the AFEM has addressed some of the distortions in the economy, traceable to the failures of the exchange rate policies of our recent past. Some of the successes recorded in favour of the AFEM include:

- (i) Achievement of exchange rate stability within the rage of N80 to N82 to the Dollar in the first six months of 1995;
- (ii) Meeting fully, the demand of end users in each of the three interventions by the CBN;
- (iii) Cutting out a large extent, speculators' demand for foreign exchange and by extension reduced the aggregate demand;
- (iv) Reducing significantly the premium that existed between the official and parallel market rates; and
- (v) Engendering in end-users, the prudence culture in foreign exchange utilization, since users are now more conscious of the cost of funds.

In view of these achievements, our focus for the future would aim at consolidating our effectiveness in reserve management with a view to maximizing the benefits derivable from our scarce foreign exchange reserve.