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Allocation and Management of Foreign Exchange: The Nigerian Experience

INTRODUCTION

Foreign exchange is a monetary asset used on a daily basis to settle international transactions and to finance deficits in a country's balance of payments. It is therefore, a very important component of a country's stock of external reserves. Other components are holdings of monetary gold, Special Drawing Rights (SDRs) and the reserve tranche at the International Monetary Fund (IMF). The reserves are held to finance any shortfall in foreign exchange earnings and to protect the external value of the domestic currency.

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However, the focus of this paper is on the foreign exchange component of external reserves. As a means of settlement of international transactions, foreign exchange plays a critical role in a country's development process.

A country with adequate supply of foreign exchange is at vantage point to import essential raw materials, spare parts and machinery needed for economic development purposes, while inadequate supply may not only exert pressure on external reserves but may also impose serious constraints on the country's development plan. For this reason, countries make conscious efforts to manage available foreign exchange resources at levels consistent with their overall economic objectives. To a large extent, the degree of a country's exposure to international trade will determine its involvement in foreign exchange management. For our purpose, foreign exchange management is defined as conscious efforts to control and use available foreign exchange resources optimally while ensuring a build-up of external reserves in order to avoid external shocks attributable to dwindling of foreign exchange receipts.

This paper intends to discuss and review the various strategies adopted in the management of Nigeria's foreign exchange resources. For ease of analysis, Part I of the paper reviews the systems adopted before SAP (Structural Adjustment Programme) period as well as those practised from SAP to end of 1993. Part II considers in broad terms the 1994 foreign exchange resource management policies while Part III describes the foreign exchange allocative mechanism adopted in 1994. Part IV provides the summary and conclusion of the paper.

REVIEW OF THE VARIOUS SYSTEMS USED UP TO END - 1993

The period 1962 to September, 1986 was marked by the application of exchange control in varying degrees of severity in an attempt to manage, deploy and conserve Nigeria's foreign exchange resources.

Specifically, the Exchange Control Act of 1962 was promulgated to achieve the following objectives:

i) - To maximise foreign exchange receipts;

ii) - To ensure favourable balance of payment position;

iii) - To stabilise the external value of the Naira;

iv) - To ensure that allocation of foreign exchange resources is in line with the country's objectives and priorities; and

v) - To enhance confidence in the external payments system in Nigeria by honouring international obligations subject to satisfactory documentation.

Essentially, exchange control is an emergency measure intended to be pursued over a relatively short period. Moreover, if the control measures are backed by complementary measures including fiscal discipline, appropriate sanctions and implemented in an efficient manner exchange control could be effective in stemming foreign exchange outflows. However, exchange

Being text of a paper presented by Mr. O.K. Anifowose, Ag. Director, Trade & Exchange Department, Central Bank of Nigeria, Lagos at the 1994 Forex Forum organised by Forbes International Limited and Epsilon Limited, Muson Centre, Onikan - Lagos, October 25, 1994 control adopted over an extended period of time has high social and economic costs including bottlenecks in the production process, evasions, malpractices that engender capital flight and corruption.

As practised in Nigeria, exchange control had the following features:

i) Centralisation of foreign exchange holdings in the Central Bank of Nigeria (CBN). This ensured that all foreign exchange receipts were surrendered to the CBN and applications had to be made to the Bank for use of foreign exchange for any purpose whatsoever.

ii) All foreign exchange transactions were to be channelled through the commercial and merchant banks. For this purpose, the banks became authorised dealers in foreign exchange.

iii) Use of foreign exchange budgeting to determine the quantum of foreign exchange and its disbursement on the needs of the economy.

iv) Sectoral allocation of foreign exchange. To this end, given proportions of available foreign exchange were earmarked for the industry (raw materials, spare parts and machinery for production), agriculture, finished or consumer items and invisibles including travels, educational remittance etc.

v) Import licences which required that importers had to obtain specific licence to enable them execute their import transactions. By implication, foreign exchange would not be allocated for import of goods without the grant of an import licence. In principle, issuance of import licence was to be tied to the availability of foreign exchange.

vi) Imposition of restrictions on use of foreign exchange. The Importation of certain items was either banned or limits were placed on the amount of foreign exchange that could be applied for.

vii) Extensive documentation. Users of foreign exchange were required to satisfy various documentary requirements to enable them secure allocation of foreign exchange. For example, with the introduction of Comprehensive Import Supervision Scheme (CISS) in 1979, the use of Form 'M' for any import transaction, whatever the value, became compulsory. For invisible transactions, Form 'A' was instituted etc. The use of Form 'M' and/or Form 'A' ensured that if approved, foreign exchange would be allocated in respect of each and every application. An approved Form 'M' for instance served and still serves as an authority for opening of a letter of credit as well as a supplementary instrument for import control. To this extent, exchange control was restrictive and depending on the prevailing economic condition, it was applied as a comprehensive and generalised measure or in a selective manner. It was either stringent or applied liberally.

Transactions of high priority were favoured for purposes of foreign exchange allocation and disbursement while those with low priority were either discouraged or denied foreign exchange facilities.

Generally, the exchange control measures were made very stringent during periods of severe foreign exchange shortage and relaxed when the foreign exchange position was more comfortable.

Although central in the scheme, exchange control was not used in isolation as a foreign exchange management strategy during the period under review. Fiscal and monetary measures which shall not be elaborated upon were also applied as supportive measures. However, it is necessary to discuss the use of exchange rate in some details as an efficient foreign exchange management also entails setting an appropriate clearing price in the foreign exchange market to ensure adequate supply of foreign exchange in relation to the demand.

Exchange rate measures the price or the cost of purchasing each unit of a foreign currency. Exchange rate and changes therein have far reaching implications for resource allocation, balance of payment position, inflation rate etc. Thus, failure to pursue an optimal exchange rate policy could cause serious damage to economic development and impair socio-political stability.

During the pre-SFEM period, the main instrument for managing the naira exchange rate was exchange control. The rate was managed or administratively fixed largely because the Naira was not traded on the exchange markets. A survey of exchange rate management during the period indicated that three broad approaches were used at different times.

These were:

i) Parity with the British Pound Sterling until November, 1967 and fixed parity with the United State Dollar up to March, 1974.

ii) Following the monetisation of gold and the emergence of floating rates, Nigeria embarked on an independent exchange rate policy between April, 1974 and 1978. The Naira exchange rate during the period was fixed in terms of the US Dollar and the Pound Sterling independently, based on the relative strength of these two reserve currencies.

iii) From February, 1978 to introduction of SFEM in 1986 the Naira exchange rate was based on import weighted basket of currencies. Although the use of trade-weighted basket of currencies and such factors as balance of payments, level of reserves, relative rates of inflation, across rate consideration etc influenced exchange rate determination during the period, the actual rate arrived at was based essentially on judgement, depending on the levels of foreign exchange receipts and reserves. For example, a policy of exchange rate appreciation, was adopted when the level of reserves increased, but as the exchange rate was not promptly depreciated when the reserves level declined and over-valuation of the Naira emerged. The policy of progressive depreciation of the nominal rate was applied only from 1984 but the changes did not fully correct the over-valuation. For instance, between the end of 1984 and the end of 1985 the nominal Naira/ Dollar exchange rate had a cummulative downward adjustment of some 20.00 per cent at a time the Naira was estimated to be overvalued by about 60 per cent.

By 1985, it became increasingly evident that an administered exchange rate propped up by a regime of controls had failed to bring about real improvement in Nigeria's balance of payments. Although, the measures, assisted in reducing the rate of foreign exchange outflow to some extent, this was achieved at great cost to the economy.

It was against this background that the 1986 budget was formulated. Remarkably, government decided not to impose further restrictions during the fiscal year. Instead, it introduced measures aimed at expanding the resource base and generate more foreign exchange. Moreover, some aspects of the existing regulation and administrative practices which tended to be counter-productive were avoided and controls were made more responsive to the needs of the country. In particular, efforts were geared towards ensuring that the prime movers of the economy were not unnecessarily penalised under generalised restrictive management.

In a way, the 1986 budget was the forerunner of the structural adjustment programme (SAP) introduced in September of the same year. The second-tier Foreign Exchange (SFEM) was the main instrument put in place to achieve foreign exchange management policy objectives under the SAP. It was believed that with appropriate pricing of the exchange rate through market forces rather than by administrative fiat, resources would be more efficiently allocated. Thus an auction system was adopted for the allocation of foreign exchange and setting the rate at which business would be done.

Under the new regime, the banks were required to bid for foreign exchange during the bidding sessions. The bids, gave an indication of the quantum of foreign exchange required to meet their customers' demand. Various methods, including the simple average, marginal rate and the Dutch auction, were adopted in the determination of the exchange rate and the allocative mechanism.

It is noteworthy that under the new system, the manufacturing sector received the greater proportion of foreign exchange even without a predetermined formula for sectoral allocation of foreign exchange. However, the new system also had its problems; major of which was the inadequacy of foreign exchange to fund the market, a situation that created an ever increasing supply gap.

For example, the supply gap widened from $11.1 million per week in 1987 to $287.3 million per week in 1989. The inability to satisfy the demand for foreign exchange encouraged activities of the parallel market and the widening of the premium between the official and parallel market rates. By end of February, 1992 the premium had widened to about 80 per cent, a situation that was considered intolerable.

In order to arrest the situation and create a conducive atmosphere for the FEM to thrive, a comprehensive reform package was unfolded in the first week of March, 1992. Under the reform package, Central Bank discontinued with the practice of allocating foreign exchange to banks on predetermined quotas, while the banks were required to procure foreign exchange from other sources to complement what they had acquired from the FEM. In support of the reform, a number of measures were also put in place, including curbing of excessive demand for foreign exchange by the banks and increasing the funding of the FEM. Towards this end, the CBN undertook to meet the total foreign exchange demand of the banks in the FEM. In order to close the gap between the official and parallel market rates, the Naira was depreciated by almost 80% from N10.3091 to the dollar to N18.6000 to the dollar.

The relative stability of the exchange rate after the March, 1992 reform was short lived even with CBN supplying the foreign exchange requirements of the banks. This was because the fiscal discipline needed to support the reform package was lacking. Thus, although stock of the external reserves was reduced drastically from $4,485.0 million at the end of 1991 to $2,388.1 million at the end of 1992 as a result of the interventions of the CBN in the FEM, the gap between official and parallel market rates was wider at about 18% by December, 1992 compared with about 5% at the end of March, 1992.

The experience was not different

during 1993. Indeed, as the official rate was virtually pegged at about N22.00 to the dollar as from April 1993, the premium widened considerably to 53.8% at the end of 1993.

FOREIGN EXCHANGE MEASURES FOR 1994

The foreign exchange measures introduced in 1994 attempted to address the perceived low value of the Naira in relation to other foreign currencies. It was expected that with exchange rate stability, the Naira would be strengthened. This in turn would encourage inflow of foreign investments thus increasing aggregate supply of foreign exchange to meet the needs of the economy. In particular, it was recognised that all the foreign exchange resources of the country should be harnessed and put in a central pool in the CBN to ensure efficient utilisation.

Apart from the existing measures which would continue to be in force, new ones were put in place. Central among the measures was the fixing of the naira exchange rate at N21.996 to the dollar. Others included:

i) Centralisation of foreign exchange earnings in the CBN. Thus, all government parastatals, departments, agencies etc at all levels and all corporate bodies in the private sector as well as individuals that earned foreign exchange were required to surrender such earnings to the Bank. By implication, the concession granted to private exporters to retain their foreign exchange earnings was abolished.

ii) Foreign exchange would be allocated directly to end users while the banks would only serve as channels for the remittance.

iii) All imports into Nigeria must be on the basis of letters of credit. Bills for Collection/Open Account as a mode of payment was abolished except otherwise granted special approval and only for manufacturing and agricultural sectors.

iv) All imports of foreign exchange must be through the Central Bank or designated banks and all those who lodged such funds were assured of unimpeded access to foreign exchange in case of need.

v) The parallel market was outlawed and operators in the market if caught would be severely penalised.

III FOREIGN EXCHANGE ALLOCATIVE MECHANISM IN 1994

As indicated in the preceding section, the CBN was required to allocate foreign exchange directly to end users during the 1994 fiscal year. To this end, an Allocation Committee was constituted comprising: The Presidency, Federal Ministries of Finance, Agriculture, Industry, Commerce and Tourism, MAN, NACCIMA, NLC, CIBN representatives of the banks and Nigerian Associations for Small Scale Industries (NASSI) with CBN as the chairman. Later, the National Economic Intelligence Committee (NEIC) was coopted into the committee.

Under the new dispensation, the prorata system of allocation of foreign exchange was adopted as it ensured transparency, fairness and equity. The banks were required to submit bids incorporating their customers' demand for foreign exchange under four different sectors namely: manufacturing, agriculture, finished goods and invisible transactions.

In respect of the first three sectors, foreign exchange was allocated directly to end users through their banks while the bulk allocation for invisible transactions was given to the banks to be allocated among their customers.

Each bank's customer was expected to fully back up demand for foreign exchange with equivalent naira cover in order to reduce frivolous and fraudulent demand. In a further attempt to curb excessive foreign exchange demand, importers were not allowed to submit multiple applications. In other words, the same importer was not expected to bid for the same item in more than one bank. An importer requiring different items could, of course, bid for them through two or more banks.

An allocation formula which highly favours the productive sectors was also put in place. Initially, 50% of foreign exchange offered for sale but later increased to 60% was allocated to the manufacturing sector while agriculture got 10%. Finished goods initially got 30% but was later reduced to 20% and 10% went to the invisibles sector.

The prorata system ensures that all importers whose applications are neither queried nor disqualified get a little slice of the foreign exchange offered for sale.

In submitting their applications, importers are required to provide adequate information on their operations to guide members of the Allocation Committee. Such information includes: nature of business; if a manufacturer, location and factory address, membership of MAN, NACCIMA or alternatively, NPF and ITF numbers. In order to ensure that any irregularity discovered in the applications was promptly and adequately addressed for transparency of the new system, a Technical Sub-Committee was appointed to review the allocation schedules.

Although, the prorata system to a large extent ensures fairness in the allocation of foreign exchange, it also has its draw backs. In particular, it tends to spread foreign allocation too thinly as a result of which importers have had to bid several times in order to accumulate sizeable amount of foreign exchange for their import transactions. There is also the problem of sterilisation of funds in the CBN, making it difficult for the banks to grant credit facilities for other purposes.

As a result of these short-comings, the system had to be fine-tuned. First, importers were allowed to utilise funds partially allocated to them. Secondly, they were also allowed to pool together funds allocated on various Forms 'M' provided the funds had been allocated for goods within the same sector or sub-sector and through the same bank. Funds so consolidated could be utilised on any of the Forms 'M' used in applying for foreign exchange allocation under the sector or sub-sector.

Furthermore, the Allocation Committee was reconstituted to include two Ministers and a Minister of State with one of the Ministers as the new chairman.

As a further way of fine-tuning the system, 15% of the foreign exchange available for sale was reserved for spe cial allocation to augment the production and/or importation of goods perceived by Government to be in short supply, while the balance of 85% would continue to be allocated on prorata basis. The 15% for special allocation would be spread over four or five priority items. This was to ensure that the special allocation was not thinly spread among too many products in order to make the impact of the exercise felt.

Sectoral classification of priority goods was then carried out as a guide for foreign exchange allocation. For this purpose, priority items were grouped into nine broad groups and coded. Although the three Ministers have disengaged from the Allocation Committee, the main guide lines are still in force.

Since the special allocation was introduced, a number of products have benefitted from the special dispensation. The list included: milk, sugar, salt, baby food, frozen fish, drugs and pharmaceuticals, textiles and wearing apparels, chemicals, animal feeds and wheat flour.

In order to ensure that the funds allocated were properly utilised a subcommittee was set up to monitor the beneficiaries in this regards.

IV SUMMARY AND CONCLUSION

The foregoing review has identified the various methods of foreign exchange allocation adopted in Nigeria. Being an import dependent country with limited foreign exchange resources, each method of allocation has its problems.

For example, exchange control coupled with import licence was highly discriminatory, producing what turned out to be arm-chair importers. The introduction of the SFEM and the auction system resulted in the depreciation of the naira exchange rate with the attendant inflationary pressure on the economy. The current method of allocating foreign exchange on prorata basis has resulted in piece-meal allocations that have not fully met the demand of the end-users. As none of the methods has so far satisfied the needs of the economy, the search for a more efficient system of allocation would continue. Such a system will have to embrace both market forces and elements of discretion based on clearly spelt out criteria.

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