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Bismark J. Rewane
CEO, Financial Derivative Company, Lagos

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BISMARK J. REWANE,
CEO, Financial Derivative Company, Lagos

INTRODUCTION

The topic of the exchange rate is one that has taken centre-stage in national discourse in recent times. Nigeria's import dependency makes the issue a particularly sensitive one. The timing of this event could hardly be better. It is coming at a time where the plunge in oil prices has had a dramatic effect around the world as winners and losers have emerged. Weaker global oil consumption and increasing global oil supply have conspired to send oil prices to lows not witnessed since 2009. Consumer nations have been smiling all the way to the gas pump while many producer nations are still reeling from the shock.

Nigeria has clearly been one of the losers. The oil shock has ignited a chain reaction of events which threaten macro-economic stability. Oil revenues are down, foreign exchange receipts are on the decline, external reserves have dwindled and the exchange rate is facing unprecedented pressure. The Central Bank has had to make monetary adjustments – some of which have been bordered on industrial policy – to maintain naira stability even as the options available have become fewer.

This speech highlights key developments and presents an analysis of the current issues facing the Nigerian currency.

A brief History of Exchange Rates

Firstly, in order to fully grasp the challenges facing the naira, an understanding of the very framework of the exchange rate system is imperative.

Indeed the world has seen an evolution of exchange rates regime. From the times of the classical gold standard when currencies were backed up by gold, to the Bretton Woods era when exchange rates were characterized by fixed trading rates, the structure of the exchange rate system has conformed to the needs of an international and globalized world. Today, there are essentially two types of exchange rate systems: the fixed and the floating. While countries around the world select a system that suits their peculiar economic conditions, the usual choice is a fusion of these two exchange rate systems resulting in a hybrid regime such as the managed float, adjustable peg or crawling peg.

A fixed exchange rate regime is one where the currency is tied "pegged" directly to the value of another currency. Examples are the Botswanian Pula and the Venezuelan Bolivar that are pegged to the United States dollar, and the West African CFA pegged to the Euro. A floating exchange rate regime is a system that allows its currency value to change freely. The market dictates movements in the exchange rate and it is often called managed float due to intervention by the central banks to avoid excessive appreciation or depreciation.

Each regime has its advantages and disadvantages. For the fixed regime, increased macroeconomic discipline and reduction in transaction costs of trade are some benefits while the loss of monetary policy independence is the major drawback. The major cons of the floating system are the persistent exchange rate volatility, high inflation and transaction cost. The pro is monetary policy independence.

Determinants

The type of system is one thing, what about the value? Does the exchange rate regime influence the actual value of the currency?

The major determinants of the value of a currency are a country's terms of trade, exports of goods & services, current account deficit, tax haven status. Differentials in the inflation and interest rates also play major roles in determining the value of a currency. The mechanism behind the inflation differential is guided by the Purchasing Power Parity. This theory states that currencies would adjust to a value equivalent to their purchasing power so that an identical good would have the same price when expressed in different currencies. So a country with a higher inflation would depreciate against a country with lower exchange rate. The interest rate differential means that capital outflows from one country (country A) in search of higher returns in another country (country B) over time would lead to a depreciation in currency A and a an appreciation in currency B. These movements compensate for differentials, prevent the build-up of unsustainable global imbalances and keep the international trade system balanced.

The Global Foreign Exchange Market

Because it greatly influences what happens in the international trade system - the widest traded market- the exchange rate system or Foreign Exchange (Forex) market needs to be kept relatively stable.

All international trade is settled in the FX market as the spread of technology and the internet has made trading easier. Bureau de Change (BDC) emerged in 1989 for privately sourced foreign exchange as a result of scarcity and bureaucratic procedures contributed to the growth of the parallel market.

The Forex market now operates a 24hours, 5day a week market. Today it is the largest and most liquid market in the world. The low barriers to entry and exit and high liquidity prove very attractive to traders. According to the Bank of International Settlements, $5.3 trillion was traded per day in 2013 – up from $3.4trn in 2010 - and the US dollar makes up 75% of all spot transactions. The market is forecasted to increase to $7.8 trillion by 2019.

History of Exchange Rate Management in Nigeria

Now that we have established the basis of understanding, let's have a look at the history of the Naira exchange rate system.

Nigeria shifted from a fixed regime to a pegged arrangement in the 1960s. The naira was pegged to GBP until 1967 when the pound was devalued. Thereafter, the naira was pegged to the dollar. During these times the naira was largely passive and dictated by the fortunes of the GBP or USD. Nevertheless, the exchange rate appreciated every year throughout the 70s. The pegged system induced an overvaluation of the naira and exchange controls engendered further distortions in the economy. The massive importation of finished goods that resulted from a naira appreciation proved adverse for domestic production, the balance of payments position and the nation's external reserves level. The real appreciation also undermined the agricultural sector. Annual production of major cash crops fell significantly.

Additionally, it was during this same 70s that Nigeria began to fully capitalize and exploit its black gold ('oil') and the exchange rate began to also mirror the movements in oil prices. Thus, following the 1973's collapse of oil prices from $35 to $10 (approx $100 to $29 today), Nigeria's exchange rate went into crisis. This crisis coupled with the $17.3 billion indebtedness flung Nigeria into major economic emergency.

It was this emergency crisis that informed the Structural Adjustment Program (SAP), which adopted a regime of managed float with no strong commitment to defending any particular parity.

The first devaluation occurred in 1986 as a result of the oil shock. The Nigerian Forex market eventually liberalised and a managed floating exchange rate was adopted and has been maintained up to date. The naira is not a traded currency or a convertible one so it moves according to supply and demand levels.

The Naira in the Last 10 Years

In the last decade the naira has depreciated by 34.67%, from N130/$ to N199/$. Meanwhile, oil prices have fallen by 44% from $115pb in June 2014 to $63.5pb in June 2015. The oil price shock has led to a depletion in the external reserves and increased pressure on the currency. External reserves oscillated variably over the last 10 years. Rising from the starting low point of about $20bn in 2005 (where naira traded $1=N132), the naira peaked at $62bn in 2008 ($1=N116), and then settled at its current level of $xbn ($1=N198). Such negative outcomes have been prolonged by the poor timing of currency adjustments. Not to mention, the subsidies (exchange rate and fuel) that are major sources of leakages. Fuel subsidies constitute 30% of Nigeria's import bill. Removal of these subsidies would relieve aberrational pressure and reduce import bill of bogus demand by 15-20%.

Alternative Methods of Currency Valuation

Furthermore, the price and the value of the naira are at tangents. Using the formula of the Purchasing Power Parity (PPP) I spoke about earlier, our data shows that the naira is actually undervalued.

For example, if we take the price of a 50cl bottle of coke in Nigeria and in the US in June 2015, it was N100 and $2 respectively, showing a PPP of N50/$. Compared US and Nigerian prices of a basket of consumables and non-consumables would show a relative PPP of N186/$ compared to the average exchange rate of N230/$ in June. The difference between the two rates is the fear factor; it is this speculative pressure that keeps the naira undervalued. Also, the naira will not appreciate to N186/$ due to the inflation and interest rate differential.

Outlook

Contrary to the sentiments of the CBN, various leading investment banking and research firms have all made projections of a further depreciation in the naira within the next 12 months: The Economist Intelligence Unit (EIU) forecasts an exchange rate of N225/$ by the end of 2015 and N233/$ by 2016. RenCap projects a value of N235 by mid-2016, while, Bank of America projects a 10% devaluation of the naira to about N220 by end of 2015.