Bullion

Volume 39 | Number 1 Article 4

9-2015

Implication of closure of RDAS and WDAS segment of the foreign exchange market in Nigeria

Akin Dawodu
City Bank PLC

Follow this and additional works at: https://dc.cbn.gov.ng/bullion

Part of the International Economics Commons

Recommended Citation

Dawodu, A. (2015). Implication of closure of RDAS and WDAS segment of the foreign exchange market in Nigeria. CBN Bullion, 39(1-3), 17-23.

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

IMPLICATION OF CLOSURE OF RDAS AND WDAS SEGMENT OF THE FOREIGN EXCHANGE MARKET IN NIGERIA

MR. AKIN DAWODU
City Bank PLC

EXCHANGE RATE MANAGEMENT

The choice of exchange rate regime is a perennial issue faced by emerging markets. Conventional wisdom, especially after the emerging markets crises of the late 1990s, was the bipolar prescription: countries should choose between either floats (the soft end of the prescription) or hard pegs (monetary union, dollarization, currency board). The thinking was that intermediate regimes (conventional pegs, horizontal bands, crawling arrangements, and managed floats) left countries more susceptible to crises.

While the arguments in favor of free floats are well known, it is less clear why hard pegs - the least flexible regime - should be equally resilient to crisis. One can argue that volatility is so great under floating, that a fixed rate system with periodic large corrections is still preferable, even if the corrections often "overshoot" the necessary adjustment to the real exchange rate.

Proponents of the bipolar view, including Obstfeld and Rogoff (1995) and Eichengreen (1998), predict that countries that have integrated, or are integrating, their domestic capital markets with global capital markets will be unable to sustain intermediate regimes and will be forced to choose one of the two extremes: either a hard fix or a freely floating exchange rate regime. In their opinion, the middle ground - made up of adjustable (soft) pegs - will eventually vanish for countries that are open to international capital flows. Other authors, however, disagree. Williamson (2000), for example, believes that intermediate regimes are, and will continue to be, a viable option for emerging markets. It is argued that intermediate regimes offer developing economies some degree of stability and flexibility. Under the intermediate regimes, emerging markets are able to demonstrate a degree of monetary discipline by using exchange rate as an anchor for price stability.

No.	Group	Cate gory	Type of Exchange rate regime	Rules of the exchange rate regime
1	Fixed peg	Hard Pegs	Exchange arrangement with no separate legal tender	• The currency of another country circulates as the sole legal tender • Adopting such a regime implies the complete surrender of the monetary authorities' control over domestic monetary policy
2	Fixed peg	Hard Pegs	Currency board arrangement	• Regime is based on an explicit legislative commitment to exchange the domestic currency for a specified foreign currency at a fixed rate, combined with restrictions on the issuing authority to ensure the fulfilment of this legal obligation • Domestic currency is issued only against foreign exchange and it remains fully backed by foreign assets, leaving little scope for discretionary monetary policy and eliminating traditional central bank functions • Some flexibility may still be afforded, depending on how strict the rules of the currency board arrangement are
3	Fixed peg; Intermediate regimes	Soft peg	Conventional fixed peg arrangement	• A country pegs its currency within margins of ±1 percent or less vis-a-vis 1) another currency, 2) a cooperative arrangement, such as ERM II, or 3) a basket of currencies that consists of currencies of major trading or financial partners • Exchange rate may fluctuate within narrow margins of less than ±1 percent around a central rate or the maximum and minimum value of the exchange rate may remain within a narrow margin of 2 percent for at least three months • Monetary authorities maintain the fixed parity via direct or indirect interventions (e.g. via the use of interest rate policy, imposition of foreign exchange regulations etc.) • Autonomy of monetary policy, though limited, is greater than in case of exchange arrangements with no separate legal tender and currency boards because traditional central banking functions are still possible
4	Fixed peg; Intermediate regimes	Soft peg	Pegged exchange rate with horizontal bands	• Exchange rate is maintained within certain margins of fluctuation of more than ±1 percent around a fixed central rate or the margin between the maximum and minimum value of the exchange rate exceeds 2 percent • As in the case of conventional fixed pegs, currency can be peg to a single currency, a currency composite, or as a result of a cooperative arrangement • there is a limited degree of monetary policy discretion, depending on the band width

4				Pegged exchange rate with horizontal bands	• Exchange rate is maintained within certain margins of fluctuation of more than ±1 percent around a fixed central rate or the margin between the maximum and minimum value of the exchange rate exceeds 2 percent • As in the case of conventional fixed pegs, currency can be peg to a single currency, a currency composite, or as a result of a cooperative arrangement • there is a limited degree of monetary policy discretion, depending on the band width
5				Crawling peg	• Exchange rate is adjusted periodically in small amounts at a fixed rate or in response to changes in selective quantitative indicators, such as past inflation differentials vis-a-vis major trading partners or differentials between the inflation target and expected inflation in major trading partners • The rate of crawl can be set according to inflation rate changes or to other indicators (backward looking), or set at a preannounced fixed rate and/or below the projected inflation differentials (forward looking) • Maintaining a crawling peg imposes constraints on monetary policy in a manner similar to a fixed peg system
6				Exchange rate with crawling bands	• Exchange rate is maintained within certain fluctuation margins of at least ±1 percent around a central rate, or the margin between the maximum and minimum value of the exchange rate exceeds 2 percent and the central rate or margins are adjusted periodically at a fixed rate or in response to changes in selective quantitative indicators • Bands are either symmetric around a crawling central parity or widen gradually with an asymmetric choice of the crawl of upper and lower bands (in the latter case, there may be no preannounced central rate) • The commitment to maintain the exchange rate within the band imposes constraints on monetary policy, the degree of policy independence is a function of the band width
7	Floating regimes		Tightly managed floats	Managed floating with no predetermined path for the exchange rate	• Monetary authorities attempt to influence exchange rate without having a specific exchange rate path or target • Indicators to manage the exchange rate are broadly judgmental (e.g., balance of payments position, international reserves etc.), and adjustments may not be automatic • Intervention may be direct or indirect
8			Other floating	Independently floating	• Exchange rate is market determined, without official foreign exchange market intervention • Monetary authorities prevent undue exchange rate fluctuations rather than stabilize exchange rate

EVOLUTION OF FOREIGN EXCHANGE MARKET IN NIGERIA

The Nigeria foreign exchange market has transitioned a great deal since the country's independence. Following independence, Nigeria had a pegged exchange rate regime and strong exchange controls until the Babangida administration introduced the Structural Adjustment Program ("SAP") in 1986. The increasing demand for foreign exchange and the inability of the exchange control system to evolve an appropriate mechanism for foreign exchange allocation in consonance with the goal of internal balance made it to be discarded in September 26, 1986 while a new mechanism was evolved under SAP. The main objectives of exchange rate policy under SAP were to preserve the value of the domestic currency, maintain a favorable external balance and the overall goal of macroeconomic stability and to determine a realistic exchange rate for the Naira.

In an attempt to achieve this, a transitory dual exchange rate system (First and Second -Tier Foreign Exchange Market – SFEM) was adopted in September, 1986, but metamorphosed into the Foreign Exchange Market (FEM) in 1987. Bureau de change was introduced in 1989 with a view to enlarging the scope of FEM. In 1994, there was a policy reversal, occasioned by the non-relenting pressure on the foreign exchange market. Further reforms such as the formal pegging of the Naira exchange rate, the centralization of foreign exchange in the CBN, the restriction of Bureau de change to buy foreign exchange as an agent of CBN etc. were all introduced in the foreign Exchange Market in 1994 as a result of the volatility in exchange rate. There was another policy reversal in 1995 to that of "guided deregulation". This necessitated the institution of the Autonomous Foreign Exchange Market (AFEM) which later metamorphosed into a daily two way quote Inter-Bank Foreign Exchange Market (IFEM) in 1999.

The Retail Dutch Auction System (R-DAS) was reintroduced in 2002 as a result of the intensification of the demand pressure in the foreign exchange market and the persistence in the depletion of the country's external reserves. Finally, the Wholesale Dutch Auction System (W-DAS) was introduced in February 20, 2006. The introduction of the WDAS was also to deepen the foreign exchange market in order to evolve a realistic exchange rate of the Naira. This was later changed to the RDAS in October 2013, which enabled the Central Bank to monitor uses of foreign exchange purchases from the apex bank. In February 2015, the CBN discontinued the RDAS with a view to gradually relegating its participation in the FX market to interventions at the interbank market on a need basis.

KEY FACTORS THAT AFFECTS EXCHANGE RATE MANAGEMENT IN NIGERIA

Nigeria remains an import dependent mono-product economy and its dependence on crude oil cannot be underestimated. According to OPEC statistical bulletin (2013/2014) the value of Nigeria's total export revenue in 2013 was US$95,118 million and the revenue of petroleum export from the total export revenue was US$89,314 million which is 93.9% of total export revenue. This means that Nigeria's economy will be vulnerable to the movements of oil prices.

During periods of favorable oil price shocks triggered by conflict in oil-producing areas of the world, the rise in the demand for the commodity by the consuming nations, seasonality factors, trading positions etc., Nigeria experiences favorable terms of trade evidenced by a large current account surplus from 2007-2013. This however began to reverse as in 2014 as oil prices declined; current account is expected to be a deficit of about 3% of GDP in 2015. There is also exchanged rate stability in periods of high oil prices and this has provided opportunities for the government to build its external reserves.

On the converse, when crude oil prices are low, occasioned by factors such as low demand, excess supply due to shale

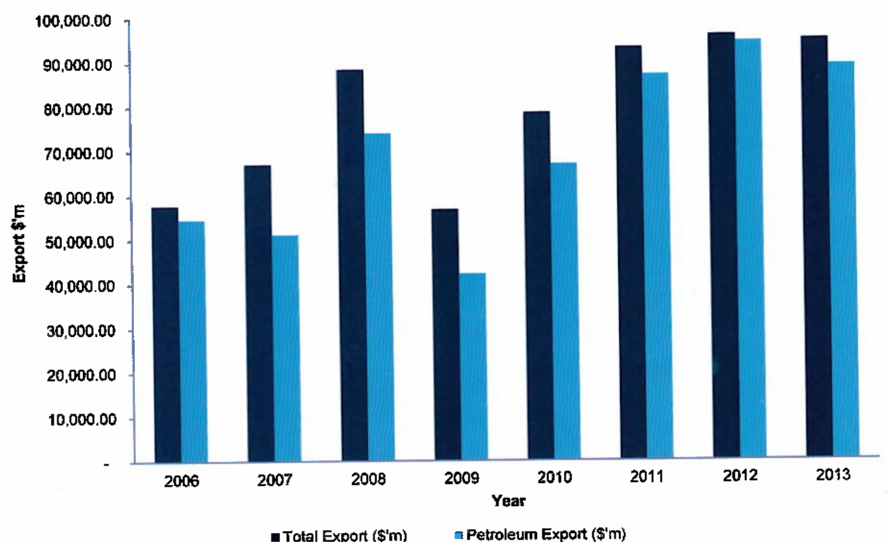


Chart: Chart of Nigeria's Total Export and Petroleum Export (Source: OPEC Statistical Bulletin 2013/2014)

production, increased production by the United States, previously one of the largest importer of Nigeria's crude, the reverse becomes the case with exchange rate under pressure, external reserve depletion, rising budget deficit and slow economic growth (Englama, 2010). An example was a drop in the revenue from oil exports during the global financial crisis in 2009 and the last quarter of 2014. According to, OPEC statistical bulletin (2010/2011), oil export revenue dropped from US$74,033 million in 2008 to US$43,623 million in 2009 and the naira depreciated to N148.902 in 2009 from N118.546 in 2008.

In the period between the oil price peak of 2008 and the trough of 2009, the nation's external reserve declined by US$20.33 billion from US$62.08 billion in September 2008 to US$41.75 billion in August 2009 as the central bank attempted to stabilize the currency. A similar trend can be observed in the recent oil price decline that has resulted in the first major adjustment in naira exchange rate since 2009. This shows that defending the currency is a costly and ultimately futile exercise as the currency eventually adjusts according to fundamentals and market forces. The question should be whether we want the adjustment quick and fast or whether we want a gradual process? Either path has it implications with regards to market volatility as well as depletion of the foreign reserves.

In the last decade, Nigeria's financial market has become more open to the global market and thus impacted by global events other than the oil price. The inclusion of Nigeria's government bonds in the JP Morgan emerging market index resulted in significant inflow into the country by both Index trackers and investors searching for higher returns. As a consequence, Nigeria underwent a period of appreciating and stable naira as well as external reserve growth. Between August 2012 and March 2013, the interbank rate hovered between 156.10 and 158.90, in-line with the CBN effective RDAS rate of 157.36 in the same period. The convergence in interbank and RDAS rate meant that corporate clients accessed the interbank market for a significant amount of their transactions instead of the CBN RDAS market. However, global shift in risk and constant changes in risk appetite in emerging market securities means Nigeria is likely to witness more exchange rate volatility in the future.

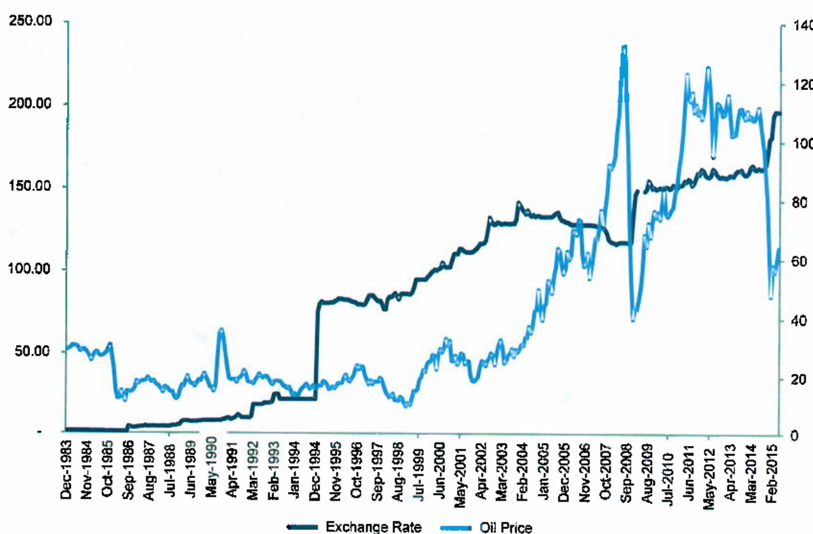


Chart: Graph Showing Correlation between Oil Prices and the Naira Exchange Rate

CLOSURE OF THE RDAS/WDAS MARKET IN NIGERIA: TOWARD FLOATING OR BACK TO THE PEG

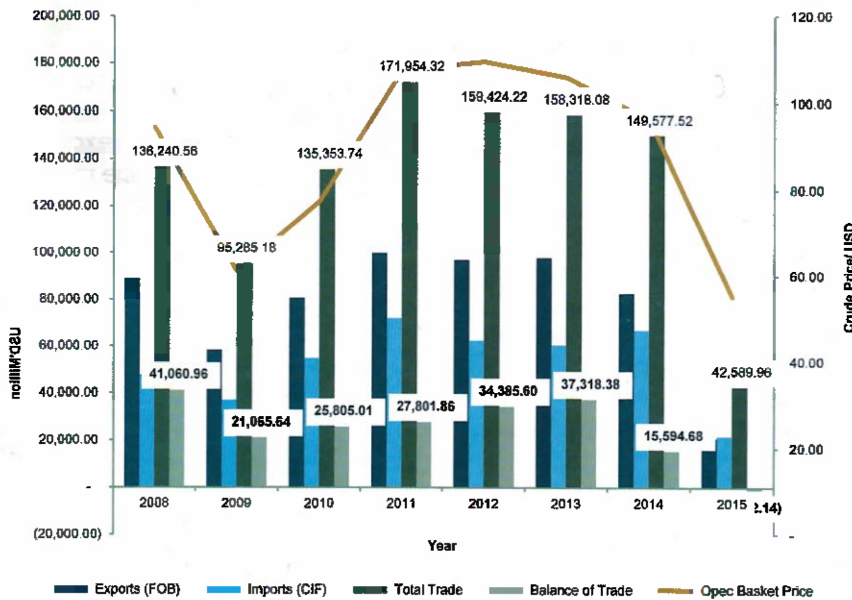
The origin of the RDAS/WDAS was the foreign exchange market liberalization that occurred in 1995. Following the liberalization, the Autonomous Foreign Exchange Market (AFEM), where the CBN sells foreign exchange to end-users through selected authorized dealers at market determined rate, was established. The RDAS/WDAS are offshoots of the AFEM system. The WDAS is an auction system whereby the CBN receives bids from authorized dealers for purchase of forex. The authorized dealers on behalf of end users of foreign exchange (like corporates, importers etc.) submit bids to the CBN for purchase of foreign exchange during an auction. Once their bids are successful they then sell the dollars to the end users.

The RDAS, which was first introduced in 2002, is a direct sale of foreign exchange by the CBN through the banks to end users. Unlike the WDAS, the RDAS is based solely on actual demand of foreign exchange by the end users. As such, the authorized dealers will only bic for foreign exchange based on the number of actual request received from end users. The key difference between the RDAS and WDAS is that RDAS enables CBN at the point of sale to determine who the end user is.

The WDAS was first introduced on February 20, 2006. It is important to note however, that under the WDAS the bids submitted by the authorized dealers need not match the total request by its end users. WDAS is transferrable when the CBN allows banks to sell the funds in the interbank market. The ability to resell the WDAS fund at the interbank market or to other end users means exchange rate price discovery is easier. WDAS is the halfway house between a free float and a managed soft peg.

In February 2015, the Central bank of Nigeria officially discontinued its weekly RDAS/WDAS auction. Historically, doubts have been raised concerning the sustainability of the auction system. Data shows that an average of USD26.56 billion is sold at both the spot and forward auction annually. The increasing use of the foreign reserve during periods of declining oil prices increased the debate on the RDAS/WDAS in 2014. As an import dependent nation, Nigeria's use of foreign exchange has grown significantly over the years. In addition, the changing appetite of Nigerians for luxury goods has further bloated the nation's use of foreign exchange and import bill, which has had adverse effect on the exchange rate.

Despite being an oil exporting country, Nigeria remains plagued by its importation of refined petroleum products. Data shows that the oil sector, which is mainly the downstream sector of the oil and gas industry, is the single largest buyer of foreign exchange from the central bank. The oil sector utilization of foreign exchange is for financing imports of refined petroleum products (diesel, PMS and kerosene). The sectors' dollar demand should therefore fluctuate depending on the price of crude oil. In a period of high crude prices, the sector's demand and utilization of foreign exchange effectively increases thus limiting the ability of the central bank to grow the reserve. In addition to this, Nigeria's import dependence extends to agriculture products (food) and manufactured products. The country is crippled with importing food items such as rice and palm oil as well as manufactured products ranging from cotton and toothpicks to cars and private jets.



International Trade Summary (USD Million) Source: CBN

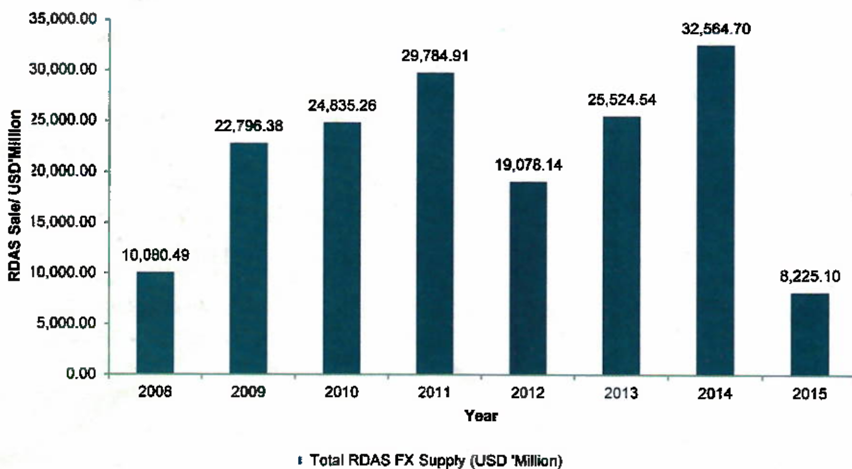


Chart showing yearly RDAS sale by the CBN

As stated above, for as long as the CBN continues to be a major supplier of FX to market, the change in the supply strategy would be more administrative than transformative. With stable exchange rate remaining a policy thrust of the CBN, unless we see a significant change in the demand and supply dynamics the CBN will remain a big part of the FX market. Currently, the Central bank intervenes in the interbank market, effectively taking out the demand which would have been otherwise filled at the RDAS. What this means is that despite the removal of RDAS, the central bank dominates the interbank foreign exchange market and act as the primary foreign exchange intermediary. What has changed has largely been the removal of the "subsidy" on FX sales at the auctions. With the CBN intervening at the interbank market, we have taken a step further towards a free floating currency driven mainly by market forces.

FEAR OF FLOATING

The reasons for this fear of floating can be linked to three factors, according to Calvo and Reinhart (2002). The first factor is a deep-seated distrust of markets, which

many emerging-market economies believe move in perverse and unpredictable ways. In Nigeria's case, this distrust of market has led to introduction of restrictions at the interbank market on different occasions and revision to less market friendly exchange rate regimes. The second factor is that depreciations in emerging-markets tend to be associated with economic contractions rather than expansions. Instead of stabilizing growth and employment in response to an external shock, therefore, the resulting exchange rate movements tend to exacerbate the pressures, leading to more severe economic dislocation. This is due in part to the absence of a credible mechanism, such as an inflation target, with which to anchor expectations. In addition, a significant portion of government and private sector debt in many of these economies is often denominated in a foreign currency, causing debt-servicing costs to rise every time the domestic currency depreciates. In Nigeria, there is a general slowdown in economic activities following currency depreciations. Furthermore, naira depreciation often occurs during periods of falling oil prices which results in declining government revenue, leading to both a decline in government spending and consumption. The third factor concerns the demonstrated inability of many emerging economies to conduct effective, countercyclical monetary policies. In many cases, the monetary policy independence that a floating exchange rate confers has simply led to chronic inflation. Monetary conditions tend to tighten, therefore, in reaction to any economic weakness or exchange rate depreciation, rather than easing to help offset the shock.

In a world of capital mobility a more flexible exchange rate system seems the best bet. A floating exchange rate allows automatic adjustments in the balance of payments. The currency depreciates when a country is running a balance of payments deficit. This is particularly the case for Nigeria. The effect of this should make exports cheaper and imports more expensive. Following the fall in oil prices in the fourth quarter, the country ran a balance of payment deficit in November 2014, its first balance of payment deficit since September 2011. The currency adjusted at both the CBN RDAS and the interbank market. This shows that with a floating exchange rate, balance of payments disequilibrium should be rectified by a change in the external price of the currency. However, with a fixed rate, curing a deficit could involve a general deflationary policy resulting in unpleasant consequences for the whole economy such as unemployment. Peculiar problems with the structure of the economy in not just Nigeria but in most of sub Saharan Africa as a whole means that we have a strong fixation of the exchange rate, sometimes to the detriment of other economic indices. Ideally, the floating rate allows governments freedom to pursue their own internal policy objectives such as growth and full employment without external constraints.

WAY FORWARD

Markets while not being perfect are still considered the best way of allocating scarce resources. When one looks at the list of countries with either the lightly managed float or free floating exchange rate regimes it is quite evident that it's the direction to take. However questions need to be asked with regards to the readiness of the Nigerian economy. A competitive local economy will reduce the fixation we have with the exchange rate. It will allow for the flexibility that comes with the system.

There are arguments that Nigeria's economy is currently not positioned for a free floated currency. However, the economic reforms being taken by the Federal government would bring the economy closer to the point where the currency can be freely floated. A drastic economic transformation is required to reduce Nigeria's import bill. Agricultural self-sufficiency and a shift toward an industrialized economy which is being targeted by the government is a step in the right direction. Nigeria is at a cross-road in terms of fiscal and monetary policy. Further monetary policy tightening will be counterproductive as it could reduce credit to the private sector and stifle growth. The limit of monetary policy seems to have been reached and the baton in restructuring the economy and driving growth must now be driven by fiscal policy. The recent government transition has created an opportunity for a rethink in fiscal policy. Economic reforms which started under the previous administration must be intensified. More importantly, fiscal disciplines will be required to truly transit the economy and the exchange rate. We can draw parallel with Brazil here. In 1999, following a financial crisis and an unsuccessful defense of the currency which led to the external reserve declining from more than US$70 billion at the beginning of 1998 to half that amount by year end. Brazil was forced to devalue and float its currency, Real. While Nigeria is not under pressure to float, implementing similar fiscal changes as Brazil could help steer the Nigeria toward free floating the currency.

The successful transition by Brazil in early 1999 to a floating exchange rate regime was due mainly to a rigorous fiscal adjustment program conceived to ensure long term stability of fiscal accounts. The program included such measures as the Fiscal Responsibility Law, which was

approved by Congress in 1999. This comprehensive piece of legislation consolidates Brazilian fiscal management directives and establishes limits for personnel expenditures at the federal, state and municipal level. Brazil also changed its trade policy and intensified production in its area of strength. Brazil's export of goods and services increased in a magnitude not seen before. Export of goods and services increased to 9.5% of GDP in 1999 from 7% of GDP in 1998; and has stabilized between 11.5% and 12%. Furthermore, the larger role of net direct investment in the latest surge in capital flows is encouraging from a debt accumulation perspective and has also aided in the float process. It is explicit from this that for the Nigeria foreign exchange market to be fully liberalized, economic transformation and fiscal discipline must come first. It is also important to look at the past experience in Brazil if Nigeria is to eventually float the naira.

The empirical evidence on the effectiveness of intervention in influencing the exchange rate is mixed, and the impact of intervention on the exchange rate level appears to be short-lived. In Nigeria, empirical studies have also found that intervention tends to increase, rather than decrease, exchange rate volatility. Thus, short-term exchange rate volatility may not warrant intervention, especially when it occurs in a liquid, or orderly, market. Volatility may reflect the market process of price discovery and provide useful signals to the central bank and other market participants.

In general, central banks should be selective in their interventions and frugal in their use of foreign reserves as empirical evidence shows that the use of the reserve to defend the currency especially when fundamental misalignment is visible only results in further pressure on the exchange rate. The difficulty of detecting exchange rate misalignments and disorderly markets means that decisions on the timing and amount of intervention are subjective and may be off the mark. Moreover, by entering the market infrequently, central banks can convince the markets of their commitment to exchange rate flexibility and improve the potential effectiveness of the occasional intervention.

In conclusion, the closure of RDAS is the first step toward a complete liberalization of the foreign exchange market. However, this cannot be achieved without the change in the structure of the Nigeria economy. It is hoped that the ongoing economic reforms will help set up the stage for this to happen.