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CONTENTS PAGE

PAGE 1 - OVERVIEW OF EXCHANGE RATE MANAGEMENT IN NIGERIA FROM 1986 TO DATE
MIKE I. OBADAN, Ph. D

PAGE 10 - THE ACHIEVEMENT OF CONVERGENCE IN THE NIGERIA FOREIGN EXCHANGE MARKET
O. O. AKANJI (MRS.)

PAGE 17 - CHALLENGES OF EXCHANGE RATE VOLATILITY IN ECONOMIC MANAGEMENT IN NIGERIA
CHARLES N. O. MORDI

PAGE 26 - THE CHALLENGES OF SUSTAINABILITY OF THE CURRENT EXCHANGE RATE REGIME IN NIGERIA
H. T. SANNI

PAGE 38 - ECONOMICS OF EXCHANGE RATE MANAGEMENT
AYODELE ODUSOLA, Ph. D

PAGE 45 - EFFECTIVE RESERVES MANAGEMENT IN NIGERIA: ISSUES, CHALLENGES AND PROSPECTS
ALHAJI M. NDA

PAGE 52 - EXCHANGE RATE STABILITY AND POVERTY REDUCTION IN NIGERIA
GREG NZEKWU

PAGE 64 - RECENT REFORMS IN THE NIGERIAN BANKING INDUSTRY: ISSUES AND CHALLENGES
U. KAMA

OVERVIEW OF EXCHANGE RATE MANAGEMENT IN NIGERIA FROM 1986 TO DATE

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INTRODUCTION

▪ The exchange rate is a key macroeconomic variable in the context of general economic policy making, and of economic reform programmes, in particular.

▪ It is a very important price which governments take very active interest in.

▪ However, two concepts of exchange rate are commonly distinguished: nominal exchange rate and real exchange rate.

- The nominal exchange rate (NER) is a monetary concept which measures the relative price of two moneys or currencies, e.g., naira in relation to the U. S dollar.

- But the real exchange rate (RER), as the name implies, is a real concept that measures the relative price of two goods-tradable goods (exports and imports) in relation to non-tradable goods (goods and services produced and consumed locally).

▪ Nevertheless, there is a link between the two concepts in that changes in the NER can cause short-run changes in the RER.

- For example, a NER devaluation/depreciation will have the effect of depreciating the RER.

▪ The focus of this paper is on nominal exchange rate management from 1986 when the structural adjustment programme (SAP) was introduced and a new exchange rate policy, markedly different from the previous system of adjustable peg, was introduced.

▪ Accordingly, the paper is organized to cover the following issues.

- Concept of nominal exchange rate
- Significance of exchange rate
- Rates of devaluation /depreciation.
- Exchange rate management in Nigeria before 1986
- Exchange rate management since 1986
  ➢ Exchange rate policy objectives
  ➢ Institutional framework and management strategies
  ➢ Trends and outcomes of exchange rate management Strategies
  ➢ Factors affecting the naira depreciation
- Conclusions.

2. CONCEPT AND SIGNIFICANCE OF THE NOMINAL EXCHANGE RATE

2.1 Concept of NER

♦ The NER, as was noted earlier, is a price. It is the price of one currency in terms of another.

♦ In the light of this, the NER may be defined in two ways:

- as the price of a foreign currency in terms of the units of a local currency, for example, units of naira and per U. S dollar (e.g., N128.00: US$ 1.00); and

- in the inverse or reciprocal manner as the price of the local currency in terms of a foreign currency, e.g., units of U.S dollars per naira such as US$ 0.008: N1.00).

♦ the second definition is simply a mirror-image of the first, and so no conceptual issues are involved.

- Thus, it does not really matter which one is chosen for analysis so long as the measure is well defined and consistent.

♦ However, the first definition, units of naira per dollar, tells us immediately by how much the price level of international goods has risen/fallen relative to domestic prices as a result of changes in the exchange rate.

♦ On the other hand, from the second definition, units of U.S dollars per naira, we can see by what proportion the naira has devalued/depreciated or revalued/appreciated in terms of the foreign currency (dollar). We shall explain these concepts shortly.

♦ Meanwhile, it is important to note that since the second Tier Foreign Exchange Market (SFEM) was introduced under SAP in Nigeria in 1986, the first definition of exchange rate has been used, namely, units of naira per U.S dollar.

2.2 Importance of the NER

- Because of the importance of exchange rates, governments take active interest in their determination.
- Specifically, they are important for the following reasons

\- The exchange rate plays a role in connecting the price systems in different countries, thus enabling traders to compare prices directly.

\- Changes in exchange rates have a powerful effect on imports and exports of the countries concerned through effects on relative prices of goods.

➢ In this direction, exchange rates are important in promoting exports and discouraging imports.

➢ Thus, for example, devaluation/depreciation is a measure to increase foreign exchange receipts by encouraging exports. Devaluation makes the price of exports cheaper in foreign currency and hence attractive to foreign buyers

➢ Devaluation discourages imports by making the price of imports higher in local currency.

➢ Also, devaluation is meant to allocate efficiently foreign exchange receipts among competing import- users by letting the price mechanism rather than government make the allocation.

♦ As a price, the exchange rate performs the role of allocating real resources, particularly between tradable and non-tradable sectors.

\- This can be done in so far as the exchange rate is allowed to affect the decisions of those who produce, consume and invest.

\- Thus, in designing balance of payments programmes efforts are made to ensure that exchange rate changes are adequately reflected in the domestic price structure facing consumers and investors.

\- This enables the exchange rate to perform its function of allocating resources between domestic and external sectors.

2.3 Rates of Devaluation / Depreciation

- Devaluation and depreciation are often used interchangeably in that both refer to a reduction in the foreign exchange value of a national currency.
- The difference between the two arises from the method of arriving at the reductions in the foreign exchange values of the local currency.

\- In devaluation, the government / monetary authority deliberately reduces the foreign exchange value of the national currency whose rate of exchange was fixed.

\- Depreciation applies to currencies that are floating. This means that the market forces of demand and supply cause the reductions in the foreign exchange values of such currencies.

\- Thus, the domestic currency depreciates (appreciates) whenever less (more) units of the foreign currency are required to purchase a unit of the domestic currency (where exchange rate is $ per ₦, for example).

\- Where the exchange rate is defined as ₦ per $, the naira depreciates (appreciates) whenever more (less) units of it are required to buy a unit of foreign exchange.

- Calculation of rates of devaluation / depreciation is often not clearly understood even among some economists.

\- This leads to suggestions of rates of devaluation of more than 100 per cent, e.g. 800 per Cent

\- This cannot be true.

\- If a currency has lost 100 per cent of its value, then it must be worthless. Therefore, 800 per cent devaluation, for example, does not make sense.

- Consider, for example, that the Nigerian official exchange rate (E) changed from N22.0: $1.0 in July, 1994 to N128.0: $1.0 in July, 2006.

- Then, let

$$E_0 = \frac{₦\,22.0}{\$1.0} \text{ or } \frac{\$0.0455}{₦1.0}$$

$$E_1 = \frac{₦128.0}{\$1.0} \text{ or } \frac{\$0.0078}{₦1.0}$$

- The rate of devaluation/depreciation (D) can be calculated in two ways:

(a) Where E is defined in terms of dollars, i.e. $ / ₦:

$$D_1 = \frac{E_1 - E_0}{E_0} = \frac{0.078 - 0.0455}{0.0455} = -82.8\%$$

(b) Where E is defined in terms of naira, i.e., N / $

$$D_1 = \frac{E_1 - E_0}{E_0} = \frac{128.0 - 22.0}{128.0} = 82.8\%$$

- So, the rates of devaluation are the same ($D_1 = D_2$).
- The mistake often made with the second approach is to use E_0 as the denominator such that

$$D_1 = \frac{E_1 - E_0}{E_0} = 481.8\%$$

But this is wrong as a currency cannot lose more than 100 per cent of its value.

3. EXCHANGE RATE MANAGEMENT BEFORE 1986

Exchange rate policy in Nigeria

has undergone substantial transformation since the immediate post-independence era when the country operated a fixed exchange rate system up to the early 1970s and then from 1986 when a market-based exchange rate system was introduced in the context of the structural adjustment programme.

- Before 1973, Nigeria's exchange rate policy was in consonance with the IMF par value or fixed exchange system. The Nigerian currency, not being a traded currency, had its exchange rate largely subjected to administrative management. The exchange rate was largely passive as it was dictated by the fortunes, or otherwise, of the British pound sterling or the U.S dollar

- Naira pegged to British pound sterling up to 1967 when the pound was devalued and thereafter to the dollar.

- Following the breakdown of the IMF par value system in December 1971, the naira was adjusted in relation to the dollar.

- In 1978, the naira was pegged to a basket of 12 currencies comprising Nigeria's major trading partners. This policy was jettisoned in 1985 in favour of quoting the naira against the dollar.

- Main objectives of exchange rate policy during this period were to:

- equilibrate the balance of payments;

- preserve the value of external reserves; and

- maintain a stable exchange rate. This has implications for external and internal macroeconomic adjustment and equilibrium.

- Although a number of ad-hoc measures were adopted to realize the policy objectives, it can be said that economic objectives played a major role in determining the exchange rate.

- Thus, throughout the 1970s, except 1976 and 1977, the nominal exchange rate appreciated every year. This was, perhaps to source imports cheaply to implement development projects and service import-substituting industries.

- The policy encouraged heavy reliance on imports which ultimately led to balance of payments problems and depletion of external reserves.

- But, a policy of gradual depreciation of the naira against the dollar or pound sterling was resorted to from 1981 following the collapse of oil prices in the world market.

- Nevertheless, up to the time of SAP, exchange rate policy encouraged the overvaluation of the naira as reflected in real exchange rate appreciation, particularly in the 1970s (Obadan, 1993b, 1994 and 1995).

- A major factor in the real exchange rate appreciation was the sharp increase in oil prices and foreign exchange inflow. The exchange rate generally mirrored movements in oil prices.

- The real appreciation of the exchange rate encouraged imports and capital flight, discouraged non-oil exports and helped to sustain the manufacturing sectors over dependence on imported inputs. The agricultural sector was seriously undermined.

- The agricultural sector collapsed while initially import-substituting industries boomed due to large-scale imports

- Annual production of major cash crops (cocoa, rubber, cotton, and groundnut) fell by 42, 29, 65, and 64 per cent, respectively, between 1970 and 1985 (Osaka, Masha, Adamgbe, 2003: 329).

- Overall, the overriding objective of exchange rate management was apparently not medium and long-term BOP objective as exchange rate policy was not geared towards the attainment of a long term equilibrium rate that would equilibrate the BOP in the medium-long term and yet facilitate the achievement of certain structural adjustment objectives, e.g., export diversification and less imports dependence.

4. EXCHANGE RATE MANAGEMENT SINCE SAP

- This issue can be examined from the perspectives of exchange rate policy objectives, strategies and frameworks, exchange rate movements and their effects.

4.1 Exchange Rate Policy Objectives

- Under the structural adjustment programme which was implemented from July 1986, the exchange rate strategy was to float the naira and establish an institutional framework for its trading in a market-determined environment.

- Accordingly, a market-determined exchange rate was established and exchange rate policy objectives pursued within the institutional framework of the second-tier foreign exchange market S (FEM).

- S(FEM) was expected to evolve an effective mechanism for exchange rate determination and allocation of foreign exchange in order to guarantee short-term stability and long-term balance of payments equilibrium.

- S(FEM) began as a dual exchange rate system which produced the official first tier exchange rate and the S(FEM) or 'free' market exchange rate.

- The former was administratively

determined and gradually depreciated. It applied to a few official international transactions, such as debt servicing and obligations to international organisation.

- The 'free' market rate which applied to the rest transactions was determined by the market forces of demand and supply within the framework of a foreign exchange market auction system.

- Essence of the dual exchange rate system was to avoid a deliberate uniform and sizable depreciation of the naira but to allow it to depreciate in the SFEM while at the same time the monetary authorities would continue a downward adjustment of the first-tier rate until the two rates converged to produce a realistic exchange rate.

- This convergence was achieved on July 2, 1987 at the rate of N3.74: $1.00. But some analysts described it as forced (Ojameruaye, 1991).

▪ The objectives of exchange rate management under SAP can, to some extent, be said to have reflected the needs of medium / long-term BOP equilibrium.

- Thus, SFEM was expected to achieve a realistic exchange rate of the naira, which would reduce excess demand for foreign exchange to import finished goods and services, as well as stimulate non-oil export earnings.

▪ Essentially, the objectives of SFEM include the following:

- achievement of a realistic exchange rate determined by the market forces of demand and supply;

- more efficient resource allocation through the substantial reduction of fraudulent and wasteful transactions;

- stimulation of non-oil exports;

- encouragement of foreign exchange inflow and discouragement of outflow;

- enhanced revenue for government;

- redressing of the gross imbalances in rural-urban incomes and welfare; and

- elimination of currency trafficking and wiping out of unofficial parallel foreign exchange market.

▪ Thus, the ultimate expectation was that the exchange rate policy and management actions would lead to an improvement in the BOP position and ensure large degree of convertibility of the naira.

4.2 Institutional Framework and Management Strategies

▪ In the bid to achieve the objectives of exchange rate policy, various modifications have been made to the institutional framework such that SFEM later metamorphosed into the foreign exchange market (FEM), autonomous foreign exchange market (AFEM), Dutch auction system and currently the wholesale Dutch auction system.

- FEM. This came into being when the first and second tier markets were merged in July 1987 and a unified exchange rate system emerged. The first tier rate was abolished. FEM had two components: official foreign exchange market auction sessions and autonomous foreign exchange market - the latter was expected to be competitive with the parallel foreign exchange market and thus be attractive to exporters. But the autonomous market later became destabilizing arising from:

➢ tendency towards high arbitrage premium; and

➢ accusations of round tripping by authorized dealers.

- IFEM. Resulted from the merger of the official and autonomous markets in January 1989 to produce IFEM. It was a daily biding system under which the CBN injected official funds into the market as and when funds were available. It ended in December 1990, but reintroduced in 1999.

- Dutch auction system (DAS). First introduced in April, 1987, and reintroduced on December 14, 1990 and again in July 2002 as the retail DAS. Since 2006, the wholesale DAS has been in operation.

- DAS was introduced against the background of widening gaps between the parallel and official exchange rates and high demand for foreign exchange.

- DAS entails the payment by an authorized dealer of the exchange rate that bids for foreign currency unlike where all dealers paid a centrally determined rate by the CBN.

- The system was introduced to enhance professionalism in FEM and prevent outrageously high bid rates which invariably led to the depreciation of the naira.

- This goal was hardly achieved at that time as the naira showed faster depreciation in 1991 compared to 1990 (Obadan, 1992)

- AFEM. This was first introduced in 1987 as part of the FEM for trading in privately sourced foreign exchange. The exchange rate in this market was market-determined, while the CBN interventions were only to ensure stability in the exchange rate.

- Deregulated Exchange Rate System. This was introduced in 1992/93 in a bid to improve the efficiency of the forex market by reducing the parallel market premium. It entailed a discontinuation of the system of

pre-determined quotas for banks and allowed allocations to be determined by the rates which emerged in the market. Thus, the FEM was further deregulated by realigning the official exchange rate with that in the parallel market. The CBN bought and sold forex in the market and was expected to satisfy all requests made by authorized dealers.

- Fixed Exchange Rate System. This was reintroduced in 1994 and the naira exchange rate was pegged at N22.00: $1.00. Also, foreign exchange earnings were domiciled in the CBN. The system was jettisoned in 1995 in favour of guided deregulation of the forex market.

➢ Then, a dual exchange rate emerged with the reintroduction of AFEM in addition to the official exchange rate. AFEM was to operate on the basis of market principles to achieve a stable exchange rate. But the CBN could intervene at its discretion.

♦ Thus, Nigeria's exchange rate management after 1986 could be categorized as “managed float” in which the CBN embarked on a delicate balancing act of controlling volume and price (Nnana, 2002; Osaka, Masha and Adamgbe, 2003).

♦ The Dutch Auction System is essentially an exchange rate determination technique. Besides this, other specific methods were used singly or combined to determine the exchange rates. These include the average and marginal exchange rate determination methods. There have also been operational procedures like daily, weekly and forthnightly foreign exchange bidding systems. All these have been tried with a view to achieving a realistic exchange rate objective.

4.3 Trends and Outcomes of the Exchange Rate Management Strategies

♦ With the introduction of the market-based exchange rate system in 1986, the naira exchange rate has exhibited the features of continuous instability, for most of the period, reflecting unidirectional depreciation in the official, bureau de change and parallel markets for foreign exchange.

♦ Frequent, and often large, devaluation/depreciation of the naira became an issue of serious concern at times.

- for example, in 2001 the parallel foreign exchange market premium widened to 18.3 per cent while sharp depreciations in the exchange rates elicited spontaneous reactions from various stakeholders including President Olusegun who declared that “I will not sit down here and allow Nigeria to hemorrhage to the point of death on the alter of liberalization. There will be no runaway devaluation here”.

♦ And as has also been argued (Osaka, Masha and Adamgbe, 2003: 333), “constant variations in the foreign exchange market framework which was ostensibly aimed at creating better market efficiency, only succeeded in creating instability in the market and, by the 1990s, the exchange rate was becoming more and more divergent from economic realities”.

♦ Table 1, showing the movement of exchange rates, reveals that from its level of N0.89 : US$1.00 in 1985, a year before the introduction of the market- based SFEM, the exchange rate moved to N2.02 : US$1.00 in 1986 and N17.30 : US$1.00 in 1992.

- As at 2002 and 2004, the exchange rate moved to N121.0: US$1.00 and N133.5: US$1.00, respectively.

- The corresponding Bureau de Change rates were N137.8: US$1.00 and N140.8: US$1.00, respectively.

♦ The exchange rate in the parallel market moved from N4.17: US$1.00 in 1986 to N137.42: US$1.00 in 2002. Table 1 shows wide gaps between the official exchange rate and the parallel market rate.

♦ Thus, between 1985 and 2004, the naira had depreciated by 99.3 per cent.

♦ However, for sometime now since 2005, the exchange rate has featured some notable appreciation and stability (for example, an appreciation by 1.8 per cent in 2005). This is probably not unconnected with the huge foreign exchange inflows and external reserves occasioned by the phenomenal oil price increases in the international oil market.

- The average crude oil price increased from $25.0 per barrel in 2002 to 29.2 and 38.5 dollars in 2003 and 2004, respectively. Most of 2005 witnessed prices of over $70.00 per barrel but the price averaged $55.4. Crude oil production also increased from 2.1 mbd in 2002 to 2.5mbd in 2004 and 2005.

- External reserves increased form $16.95 billion in 2004 to $28.28 billion in 2005.

- However, the foreign exchange market reforms entailing the wholesale DAS might have also contributed to the strengthening of the naira in the foreign exchange market.

♦ The instability and incessant depreciation in the foreign exchange value of the naira have several implications which have continued to cause great concern. Among these are (Obadan, 1993, 2004):

- decline in people's standard of living, real value of output and assets;
- increased cost of imported inputs machinery, spare parts, equipment and raw-materials - and hence increased rate of inflation in the economy which moved from 5.4 per cent in December 1986 to 50.5 per cent in 1989 and reduced slightly to 44.6 per cent in 1992; it increased to 72.5 per cent in 1995. It, however, reduced significantly to an average of 8.4 per cent from 1997-99. In the year 2001, inflation at 18.9 per cent resumed a highly uncomfortable upward trend compared to 6.9 per cent in 2000. It stood at 15.0 per cent in 2004;
- Planning and projections have become impossible tasks at the micro levels while efficient industries find it difficult to fix appropriate price for their product;
- Uncertainties for long-term macroeconomic planning and growth; and
- There has been a tendency for the international competitiveness of non-oil exports to be undermined as a result of the inflationary effect of the naira depreciation.

♦ No doubt, the exchange rate policy objectives of SAP, by aiming at structural transformation, were in the right direction. But accomplishments have been less than satisfactory.

♦ Initially, following the introduction of the market-based exchange rate system, there were a few desired macroeconomic outcomes. For example:

- non-oil GDP which had recorded an average growth rate of - 5.4 per cent in the four years prior to 1986 grew at an average of 6.0 per cent in the 1986 - 90 period;
- However, non-oil exports, in dollars, have fallen far short of expectations, declining from $612.7 million in 1988 to $405.5 million in 1990 and $244.4 million in 1992. It initially increased from $363.3 million in 1985 to $394.4 million in 1986 and $530.0 million in 1987. Non-oil exports have, however, increased from $244.2 million in 2000 to $735.1 million in 2003.
- But the impact of the exchange rate on the naira revenue of the government has been phenomenal at both the federal, state and local government levels, thus easing the budgetary constraint. See Table 2 for the phenomenal growth in government revenue.
- And initially, capacity utilisation in industry also responded positively to the massive devaluation of the naira as a result of switching from imported to local inputs for manufacturing. Moser (1995) has showed that in those industries that substituted their imported inputs for domestically source inputs, average capacity utilisation had risen to 60 per cent, post 1986, compared to 44 per cent in sectors that relied more on imported inputs.

♦ But most of the positive macroeconomic outcomes were not sustained, except perhaps government revenue which continues to benefit from naira depreciation. Non-oil production and real income fell during most of the 1990s.

5. FACTORS THAT LED TO THE DEPRECIATION OF THE NAIRA

A number of factors have contributed to the dwindling fortunes of the naira in all the foreign exchange markets. Some of them are fundamental while others are secondary (Obadan, 2001). The fundamental factors emanate from structural imbalances relating to:

- Weak production base and undiversified nature of the economy;
- Import-dependent production structure;
- Fragile export base and weak non-oil export earnings;
- Fiscal imbalances and accommodating monetary policy or expansionary fiscal and monetary policies.

The other factors include:

- Sluggish foreign capital inflow;
- Phenomenon of excess demand for foreign exchange in relation to supply;
- Instability of earnings from crude oil, upon which the economy depends very heavily;
- Unguided trade liberalisation policy;
- Speculative activities and sharp practices of authorized foreign exchange dealers, for example, round tripping in the foreign exchange market;
- Over-reliance on an imperfect market system in Nigeria to determine a crucial price as the exchange rate;
- Heavy debt service burden;
- Weak balance of payments (BOP) position. The capital account of the BOP has in the past experienced significant pressures with deficits rising from 8.6 per cent of GDP in 2000 to 11.6 per cent in 2002. The overall balance declined from a positive balance of 6.9 per cent of GDP to a negative balance of 10.5 per cent in the same period. Huge BOP deficits engender pressures on the naira exchange rate; and
- Capital flight. This not only engenders a loss of productive resources to the country, but also has destabilizing effects on domestic macroeconomic variables including the exchange rate.

Specifically, the huge depreciations in most of the years of the first half of the 2000s were attributed to additional factors such

as:

- Excess liquidity in the system induced by the transfer of government accounts from the Central Bank of Nigeria to commercial banks and the huge extra budgetary spending of 1999 on unproductive activities; excess liquidity in the economy has also not been helped by the need for the CBN to accommodate the fiscal operations of the government;
- The release in the first quarter of year 2001 of N198 billion excess crude oil revenue to various tiers of government, besides their various huge development budgets; and
- Speculative demand for foreign exchange emanating from uncertainties created by social and political unrests, expectations of future depreciation of the naira as the currency weakens, as well as the deterioration of the external sector position.

6. CONCLUSION

- The exchange rate management strategy introduced under SAP, and sustained with some modifications of procedures thereafter, was aimed at the achievement of certain structural transformation objectives, such as export diversification, less import dependence and medium/long-term BOP equilibrium.
- But accomplishments have been less than satisfactory.

- Until the exchange rate began to appreciate in the last few months, the exchange rate could not be described as realistic. As was noted before, constant changes in the exchange rate framework, rather than foster a better market efficiency, only succeeded in creating instability in the markets and, by the 1990s, the exchange rate was becoming more and more divergent from economic realities.

- And apparently inappropriate exchange rate management in Nigeria has impacted negatively on overall macroeconomic management in several ways (Osaka, Masha and Adamgbe, 2003: 333).

- Non-oil exports have not been stimulated in any meaningful way. The country has still not been able to achieve the $1.0 billion target for non-oil exports under SAP to be achieved by 1990.

- Foreign capital inflow has been below expectations except perhaps, the inflows recorded following the telecommunication sector (GSM) deregulation in the last few years. On the other hand, capital flight has heightened.

- And the parallel foreign exchange market has not been eliminated.

- The rather poor exchange rate performance may not be unconnected with unfulfilled expectations concerning the role of the market mechanism in determining exchange rate in our type of environment, coupled with the absence of complementary policies, e.g. monetary, fiscal, wage and investment policies

- It is thus important for the monetary authorities to learn important lessons from the exchange rate management experience of the past in order to ensure continued exchange rate stability.

- The desirability of exchange rate stability is not in doubt in view of the implications of instability for micro and macroeconomic planning and projections, costs of production and inflation, foreign investment flows and standard of living.

- So, the present strategies which have ensured appreciation and stability of the exchange rate in the recent past need to be sustained.

- The CBN should continue to intervene in the foreign exchange market to maintain stability.

- Finally, the exchange rate is important as a major price that affects all sectors of the economy and all economic agents. And the nominal exchange rate affects the real exchange rate. It is thus desirable to monitor the movements in the rates so as to foster competitiveness and improve the supply of exportable.

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Table 1

Naira Exchange Rate Movements in the Official and Parallel Foreign Exchange Markets

	Official FEM		Parallel FEM	Parallel FEM	
Year	Rate(N:$)	Depreciation/ Appreciation (%)	Rate(N:$)	Depreciation/ Appreciation (%)	Premium (%)
1973	0.66	-	n.a	-	n.a
1974	0.55	-20.0	n.a	-	n.a
1980	0.55	0.0	0.90	-	63.6
1982	0.67	17.9	1.14	21.1	70.1
1984	0.76	11.8	3.25	64.9	327.6
1985	0.89	14.6	3.79	14.20	325.8
1986	2.02	55.9	4.17	9.1	106.4
1987	4.02	49.8	5.55	24.9	38.1
1988	4.54	11.5	6.05	8.30	33.3
1989	7.39	38.6	10.55	42.7	42.8
1990	8.04	9.3	9.61	-9.8	19.5
1991	9.91	18.9	13.04	26.3	31.6
1992	17.30	42.7	20.03	34.9	15.8
1993	22.05	21.5	36.23	44.7	64.3
1994	21.89	-0.7	59.79	39.4	173.1
1995	81.20	73.0	59.79	39.4	3.1
1996	81.20	0.0	83.09	-0.7	2.3
1997	82.00	1.0	85.00	2.2	3.7
1998	84.00	2.4	87.90	3.3	4.6
1999	93.95	10.6	99.20	11.4	5.6
2000	102.10	8.0	112.00	11.4	9.7
2001	111.93	8.8	132.36	15.4	18.3
2002	121.0	7.5	137.42	3.9	19.1
2003	129.3	6.4	n.a	n.a	n.a
2004	133.5	3.1	n.a	n.a	n.a
2005	131.1	-1.8	n.a	n.a	n.a

Notes: In columns 2 and 4, (-) indicates appreciation of the naira while the positive figures represent depreciation.

Source: Central Bank of Nigeria

Table 2: Some Macroeconomic Indicators

Year	GDP Growth Rate (%)	Manufacturing Capacity Utilisation (%)	Non-oil Export Earnings (US$ Mn)	Federal Govt. Revenue (₦ Mn)	Net Foreign Private Capital inflow (₦ Mn)
1985	9.3	38.3	363.3	10,001.4	329.7
1986	3.7	38.8	394.4	7,969.4	2,499.6
1987	0.5	40.4	530.0	16,129.0	680.0
1988	9.2	42.4	612.7	15,588.6	1,345.6
1989	7.3	43.8	401.1	25,893.6	-439.4
1990	8.3	40.3	405.5	38,152.1	-464.3
1991	4.6	42.0	472.0	30,829.2	1,808
1992	3.0	38.1	244.4	53,264.9	8,269.2
1993	2.7	37.2	227.8	126,071.2	32,994.4
1994	1.3	30.4	244.4	90,622.6	3,907.2
1995	2.2	29.3	285.7	249,768.1	48,677.0
1996	3.4	32.5	287.2	325,144.0	2,731.0
1997	3.2	30.4	357.2	351,262.3	5,731.0
1998	2.4	32.4	406.5	124,573.0	24,078.9
1999	2.8	34.6	211.1	218,874.5	1,779.1
2000	3.9	36.1	244.2	502,294.4	3,347.0
2001	4.6	42.7	250.3	530,657.6	3,377.0
2002	3.5	44.3	785.7	859,014.9	8,206.8
2003	10.2	45.6	735.1	917,100.0	13,056.1
2004	6.6	45.0	852.0	1,147,900.0	19,908.7

Note: GDP growth rates for 2000 2005 are based on 1990 base year while those earlier have 1984 as base year.

Source: Central Bank of Nigeria. Statistical Bulletin, December 2002 and 2004; Annual Report

THE ACHIEVEMENT OF CONVERGENCE IN THE NIGERIA FOREIGN EXCHANGE MARKET

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Introduction

The last 10 years have seen two important developments that have implications for monetary and exchange rate policy frameworks in Nigeria. First, as capital controls became less effective, the exchange rate experienced turbulent with high level of depreciation of Naira. This led to the market determination of exchange rate using the Dutch Auction System (DAS) since 1999 - which means operating floating exchange rate regime. Floating foreign exchange rate have gained increased support as a preferred system for reducing the vulnerability of emerging markets to external shocks.

The fact that Naira is floating is not a panacea for effective monetary policy management learning from the Argentina experience. Also with volatile capital flows, there are associated over- and undershooting of exchange rates that the economy would encounter. More importantly, the volatility associated with floating exchange rates, however, exposes economic agents to risk of changes in the assets and liabilities in their balance sheet, as well as in their stream, of current and expected cash flows. Consequently, in the absence of developed derivative markets, in the year 2005, the foreign exchange management was structured to support the monetary policy by introducing the band of ±3% to anchor the rate for effective planning and to prevent volatility in the financial market.

Second, inflation which has been on the increase since 1999 was at a single digit in 2004 and maintained at about single digit by end of the second quarter of 2006. The decline was re-establishing the fact that monetary control was achieved after a period of unstable double digit inflation. These two developments have shown that the exchange rate do have a very strong role in monetary policy framework either using monetary targeting or inflation targeting, the role of foreign exchange management should not be ignored.

The outcome of the exchange rate management is also dependent on the degree of openness of an economy. Therefore, since the liberalization of exchange rate management started in 1986, the degree of openness had been single digit which is indicative of some level of restriction. A double

1.0 CHARACTERISING THE EXCHANGE RATES SINCE 1999

Table 1

DEGREE OF OPENNESS OF ECONOMY: NIGERIA, 1999 - 2005

Year	International Trade (N million)	GDP at constant price (N million)	Ratio of Openness
1999	2051.49	312.18	6.6
2000	2908.69	329.17	8.8
2001	3358.93	344.28	9.8
2002	3463.20	356.30	9.7
2003	4431.56	392.76	11.3
2004	4782.15	416.72	11.5
2005*	5160.42	445.89	11.6

*2005 figures are estimates: Source: CBN Statistical Bulletin and 2004 Annual Report

digit level of openness indicates the liberalization of the external sector management.

Table 1 shows the movements of the degree of openness of the economy since 1999. The achievement of convergence is predicated on the degree of openness and the technique of intervention of CBN in the foreign exchange market.

It has been established that central banks in developing economies at earlier stages of development often intervene to support a pegged exchanged rate and more likely functioning as "market makers" while developed countries central banks intervene to dampen exchange rate volatility. Central Banks also enter foreign exchange market to regulate the amount of foreign exchange reserve (to build reserves for intervention or to reduce reserves to lower carrying cost).

Consequently, the foreign exchange management is first and foremost management of a monetary indicator. It is often a signal of the stance of monetary policy and if the Central Bank of Nigeria (CBN) is to manage price stability then efficient management of the exchange rate has a link with the price level changes and interest rate management.

This paper will discuss the achievement of convergence in the Nigerian foreign exchange market in the Nigeria foreign exchange market in five sections with Section 1 being the introduction. Section 2 discusses the exchange rate management and monetary policy. Section 3 dwells on the liberalization of the foreign exchange market, while section 4 explains the process of foreign exchange convergence. Section 5 provides concluding remarks.

Section 2

Exchange Rate Management and Monetary Policy

In this section, we briefly describe the characteristics of the Nigerian Foreign exchange rate management and the implication for monetary policy.

Exchange rate management in Nigeria is characterized by official intervention in the foreign exchange market because of the level of development. Even though the exchange rate management regime is a floating regime, but it could be described as a "dirty" float. The fear of "clean" float has recently come to be seen as one of the central de facto characteristics of exchange rate regimes in emerging markets. The interpretation of this phenomenon is still open to question. Does the optimal monetary regime for emerging markets with open capital markets entail limited exchange rate flexibility? Is the flexible exchange rate, liquid financial market and credible inflation targeting regime dilemma for emerging markets a choice between open capital markets or monetary freedom with no separate choice of exchange rate policy? Does the pervasive fear of floating indicate instead that many emerging markets inadvisably choose to limit exchange rate flexibility when a genuine floating regime would be preferable? These are issues and with the Chilean experience, we are supportive of flexible exchange rate in a liquid and deep market and with credible inflation targeting environment.

Although the literature on the relationship between exchange rate management and monetary policy are versed, we discussed in this section that exchange rate intervention using floating regime is optimal for monetary policy management, taking into account the particular economic environment and shocks faced by emerging markets, where anticipation of exchange rate policy can drive inefficient private sector decisions. The main factors that are claimed to support fear of floating ex post are the pass-through of (excessive) exchange rate volatility into domestic inflation, the costs to inflation credibility this might entail, and the contractionary effects of devaluation on an economy with a high level of dollarized liabilities.

Under more rigid exchange rate arrangements, including various forms of pegs, central banks have little discretion over intervention policies. Operational aspects of intervention, including the timing, frequency, amounts and modalities of intervention are among the most important decisions taken by monetary authorities. Intervention is defined as official purchases and sales of foreign exchange to achieve one or more of the following four objectives:

- Moderating exchange rate fluctuations and correcting misalignment
- Addressing disorderly market conditions characterized by sharp fluctuations in the exchange rate, high exchange rate volatility, and wide bid-offer spreads relative to calm periods, and sudden change in foreign exchange turn over.
- Accumulating foreign exchange reserves and;

- Supplying foreign exchange to the market.

These objectives capture what are known to be widely adopted policy objectives of foreign exchange operations in many developing countries. However, central banks globally face the same set of questions on the mechanics of intervention and these include:

- Amount and timing when and in what amount should a central bank intervene in the foreign exchange market?
- Should the official intervention be rules based or discretionary?
- What market factors (liquidity, or flows, etc) should be used to help determine the timing and amount of intervention?
- Degree of transparency should the central bank interventions be announced or kept secret?
- Market and counterparties in which currency pair, instruments (spot or forward contracts) should intervention take place?
- With whom (any authorized dealer or primary dealers) should the central bank trade and how should it approach them (directly or through brokers) to achieve its intervention objectives?

In order to measure flexibility of the exchange, we compare movements in exchange rates with movements in monetary policy instruments that affect the exchange rate. Examining the exchange rate in isolation is not informative about exchange rate policy; as it does not take into account the shocks that monetary policy faces. If exchange rate is stable, we do not know whether it was due to policy choices despite shocks or to a lack of shocks. To deal with this problem, we define a flexible exchange rate as an exchange rate that is volatile relative to the instruments that could stabilize it. The implicit idea is that the policy maker faces a choice about how to accommodate a given external shock: it can be allowed to affect the exchange rate if policy is inactive, or the exchange rate can be insulated if policy is active.

All these points showed that exchange rate operates as intermediate target of monetary policy and therefore it then implies that the domestic interest rates have implications for the path of exchange rate. In an import dependent economy such as Nigeria, the pass-through from exchange rate changes to inflation is transmitted through to the economy faster than through the changes in the interest rates.

Section 3
Liberalization of Foreign Exchange Market

Up till August 1986 from independence, the foreign exchange market operated under exchange control. In September 1986, the Nigeria's exchange rate framework changed with the implementation of the Structural Adjustment Programme (SAP); which was to promote price stability as a sound basis for sustainable economic growth.

Since September 1986, different exchange rate regime had been experimented. The exchange rate framework incorporated the basket, band and crawl (BBC) regimes (Williamson, 1998.1999). First, Naira was managed against a basket of currencies of its major trading partners and competitors. Second, the CBN operated Inter-bank Foreign Exchange Market (IFEM) as a managed float-market based relying on inter-bank exchange market as the core. This resulted in serious Naira depreciation which was not reflective of economic fundamentals.

Third, is the implementation of retail Dutch Auction System (RDAS) adopted in 2002 where the exchange rate was determined by auctioning with clearing rate declared as the ruling rate. The Authorized dealers bought foreign exchange for their customers account. Fourth, is the policy adopted in 2005 whereby the exchange rate was allowed to fluctuate within a policy band of ±3%.

The liberalization of the foreign exchange market since 1995 during the implementation of IFEM achieved some level of success particularly with the increasing level of reserves. The RDAS adopted in 2002 achieved among others the following:

- Naira exchange rate was determined by the interplay of market forces of demand and supply
- Conserve external reserves
- Reduced to the barest minimum the premium between official rate and that of the parallel market and/or bureau de change.
- Ensure stability of Naira exchange rate

However, the RDAS which expired in February 19, 2006 operated for 43 months 19 days and had some inadequacies in spite of its achievements. These included cumbersomeness of its process etc. RDAS was operated in an inherent capital account restriction policy environment. It encouraged capital flight through the banks buying foreign exchange for the customers account. It was largely manual and highly prone to speculation and supported rent-seeking behaviour

of the authorised dealers. RDAS did not give opportunity to price discovery which is what drives the floating exchange rate market.

With the robust external reserve position, bank consolidation and fiscal discipline achieved by end 2005, on the 20th February, 2006, CBN moved to Wholesale Dutch Auction System (WDAS).

In addition to the objectives that guided the introduction of RDAS, the WDAS is aimed at:

- Further liberalization and development of the foreign exchange market to facilitate the convertibility of the Naira
- The unification of exchange rates between the official and inter-bank markets and to resolve the multiple currency problems
- Facilitating greater market determination of exchange rates for the Naira vis-à-vis other currencies.
- Promote the efficient and smooth functioning of the foreign exchange market as well as achieve a stable and realistic exchange rate.

Section 4

The Process of Foreign Exchange Convergence

This section documents the process of foreign exchange market convergence achieved at inter-bank and official market in May, 2006 and the three markets convergence (inter-bank, official and bureau de change) in July, 2006.

The WDAS implementation took off with the expected depth and sophistication using electronic and computer based processing, having tested intervention which appreciated Naira in August and December, 2005. The intervention of 2005 before the implementation of WDAS was to test the effect of foreign inflows in the economy on foreign exchange market and to prove that the laws of economics of supply and demand do work in the Nigerian economy.

The capital flow into the Nigeria economy since the start of bank consolidation exercise has been substantial and had persisted even after consolidation. When we examined the type and structure of the capital flows, we observed that the flows are directed toward equity with some attracted to the money market. There are three properties that account for crisis/volatility of capital flows in an emerging economy:

- The domestic macroeconomic stability which is important to external or supply factors of the flows.
- The differential between the international interest rates and domestic interest rates.
- The financial development and quality of institutions.

These three factors will give fillip to the foreign exchange management. These factors are observed to exist now in the Nigerian economy and to that extent it confirmed the fact that even if the reserve accretion reduces, WDAS would not suffer from unstable and low volume of foreign exchange inflows; and with consolidation exercise completed, the fringe banks who were engaged in infractions would have been eliminated. It is also believed that the consolidated banks with the Authorised dealership are now operating with trust and are given more information by the CBN to ensure efficient and effective conduct of the foreign exchange market.

The success of the bank consolidation exercise has provided muscle for WDAS as the threat of insolvency problems with domestic money banks is a thing of the past, coupled with the fact that payment and communication system has become more efficient. WDAS market starts and ends in 2 hour (8.30 a.m. to 10.30 a.m.) and payment is T+1 moved from T+2 before the take-off of WDAS.

The debate on capital account convertibility and capital account management has been strongly influenced by specific country experiences and so when the WDAS was planned to take-off, it was a signal that some level of capital account convertibility must also be implemented by removing some controls on some capital account transactions. Consequently, the take-off of WDAS signaled the move towards final removal of exchange control relics and move towards capital account convertibility. In particular, Chile's experience with controls on capital inflows in the 1990s formed the lessons that guided the moves in the WDAS.

The control of capital mobility has costs and benefits so also are the removal of controls on capital mobility. Most of the potential costs of control are related to possible increases in corruption and to microeconomic inefficiencies. The benefits on the other hand are potentially related to reducing the country's vulnerability to external crises and helping the monetary authorities achieve specific macroeconomic objectives, including monetary policy (liquidity management) and exchange rate objectives.

Consequently, the moves towards WDAS was part of the sequencing of the financial sector reforms and the timing of further liberalization of the foreign exchange market, and removal of constraints on some of

the capital account of the balance of payment. CBN developed the code of conduct for dealing in the WDAS market, agreed on the Information and Communication Technology (ICT) platform and that was done on the background of the strengthened payment and clearing arrangements.

WDAS which started on the 20th of February, 2006 has addressed the multiple exchange markets and the exchange rates converged at the official and inter-bank market at the end of May, 2006. This achievement signaled effective foreign exchange management and the efficiency that the foreign exchange market has started to witness (see figure 1)

.The WDAS is an eNOODLES process (electronic Naira /Dollars Exchange System). The rating of Nigeria by Fitch rating group and Standard and Poor rating group placed Nigeria's foreign exchange management at the level of the markets in Turkey, Chile, and Mexico. Consequently, it behooves on the eNOODLES WDAS to operate in the international standard as a matter of urgency. As an emerging market, Nigerian must prove to the international market that Nigeria's foreign exchange market "can do" and will do using any instrument to stabilize price.

The achieved convergence between WDAS and inter-bank occurred within a space of 12 - 13 weeks of WDAS take-off. The following factors were supportive of the convergence result:

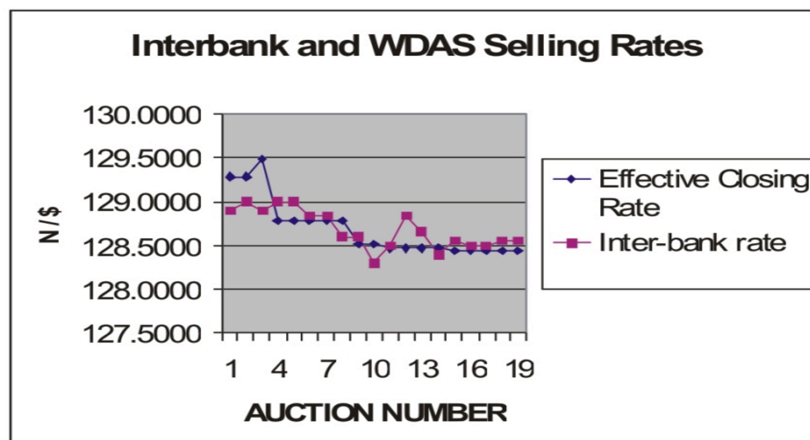
- The strict monitoring of the authorized dealers open position limits.
- Effective coordination between the money market and foreign exchange market operations.
- The daily monitoring of the market by the foreign exchange dealers to address any market surprises.
- The success of the consolidation exercise.
- The mopping up exercise for liquidity management

However, the politico - economic dynamics shifted in the middle of the second quarter of 2006. The shift created pressure on the BDC/parallel market demand for foreign exchange resulting in heavy depreciation of the Naira exchange rate in this market. It would have been theoretically acceptable that these markets are fringe market and so should have no impact on the inter-bank foreign exchange market. However, the development in the BDC/parallel market became alarming when the conical shaped behaviour of pricing were emerging such that at the inter-bank market, Naira was appreciating while it was depreciating at the BDC/parallel market with a premium of over N20/USD. Consequently, the CBN had to strategize by doing the following:

- Study the factors responsible for the depreciation of Naira at the BDC/parallel market
- Have open discussions with the operators of the BDC/Parallel market and the Authorized dealer and Travelex to understand the dynamics of the market.

It was observed that there were supply shortage and so the supply side of resource allocation was deployed. It was also observed that the harmony between the money market and foreign exchange market must be strengthened. The exchange rate is exogenous to money market operators while the interest rate is exogenous to foreign exchange market and both require having consistency in resource allocation. The CBN then took the decision in March, 2006 to allow the BDCs to the official market as brokers. The brokerage was to have the BDC operators come to buy cash at the official windows twice a week and thus increased the supply of dollar. The CBN sells a sum of US$40,000 (forty thousand Dollars) per week to the brokers. The increased supply of dollars, the continuous liquidity

FIGURE 1



management in response to monetary policy target ensured that Naira was not overheated and the further liberalization of documentation at the demand end resulted in the convergence of the official, inter-bank and BDC/Parallel markets observed in July 2006 (see Figure 2).

In addition to macro-policy issue, is the operational issues of ensuring that banks quote two-way and that there is discipline in the spread. In this dispensation, the market is one market and there is no more CBN effective rate as the CBN dealers are always in the market calling for quotes (bid/offer), buying and selling apart from the spot market that operates twice a week. Consequently, the CBN Chief Dealer must deal profitably within the established targets he must operate within the market. The Director of the market has also been given target and must deal within target. The dealers and the director of market are continuously trending to gauge the market and to ensure effective conductive of the market. (see figure 3).

Section 5

Summary and Concluding Remarks

The goal of this paper is to provide insight into the achievement of the exchange rate convergence in the three markets, thus eliminating the multiple foreign exchange markets in the economy. There are supportive factors which had been discussed in the paper. In the last 20 years, foreign exchange management suffered tremendous depreciation even when economic

FIGURE 2

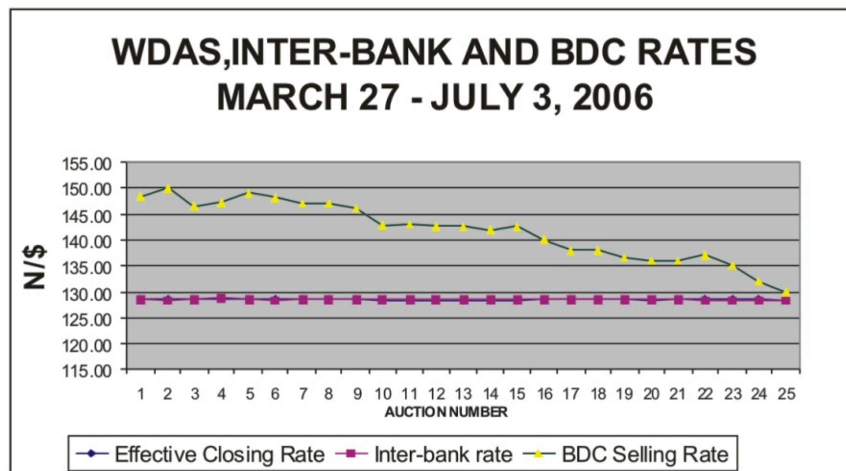
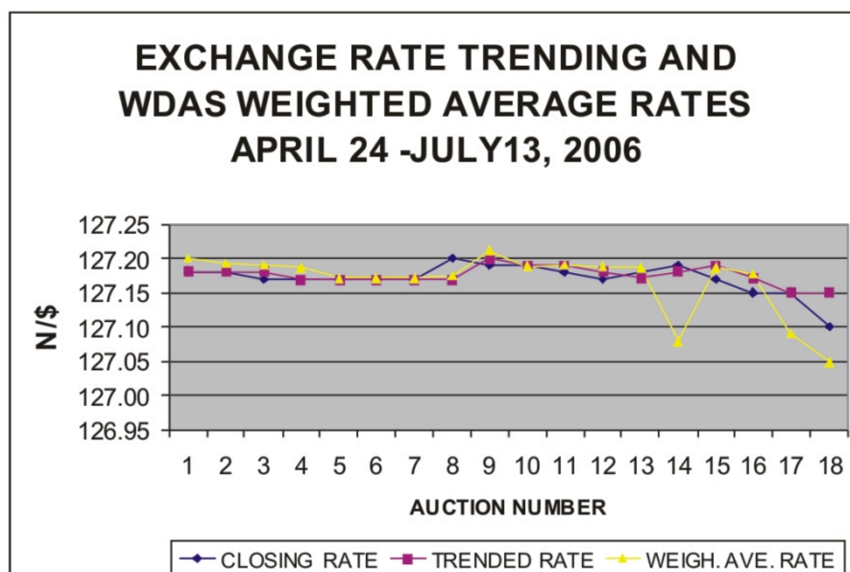


FIGURE 3



CHALLENGES OF EXCHANGE RATE VOLATILITY IN ECONOMIC MANAGEMENT IN NIGERIA

BY
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1. Introduction

The debate on exchange rate management has preoccupied economists and public sector managers for a very long time. This transcended the collapse of the gold standard in the 1930s to the emergence of the Bretton Wood System of adjustable peg from the 1940s, through the adoption of a flexible exchange rate regime by developing economies in the 1970s and those undergoing structural reforms in the 1980s, as well as in the aftermath of the currency crises in emerging economies in the 1990s. Besides factors such as market opportunity, political risks and the legal environment, business entities take exchange rate into consideration in making investment decisions. The focus has always been on the volatility of exchange rates in the foreign exchange market and its impact on business outcomes.

It has been established in literature that "getting the exchange rate right" or maintaining relative stability is critical for both internal and external balance and, hence growth in an economy. Failure to properly manage the exchange rate induces distortions in consumption and production patterns. Excessive volatility in exchange rate creates uncertainty and risks for economic agents with destabilizing effects on the macro economy. Private sector operators are concerned about exchange rate fluctuations because it impacts on their portfolios, and may result in capital gains or losses. Policymakers also focus on the pervasive effects of exchange rate movements on the economy and macroeconomic policy objectives of price stability, economic growth, employment and external viability.

Exchange rate is a key price variable in an economy and performs dual role of maintaining international competitiveness, and serving as nominal anchor for domestic prices. It is therefore, defined as the price of one currency vis-à-vis another and is the number of units of a currency required to buy another currency. Since the collapse of the generalized fixed exchange rate regime and the adoption of a generalized floating system by the industrialized countries in 1973, most countries including Nigeria, have experimented with various types of exchange rate arrangements ranging from the peg system to weighted currency basket to managed floating and more recently to the monetary zone arrangement. In practice there is nothing like a "clean" or "pure" float whereby the exchange rate is left entirely to the vagaries of market forces. The predominant system is the "dirty" or "managed" float whereby the monetary authorities intervene periodically in the foreign exchange market to achieve certain strategic objectives.

Economic management is concerned with the design and implementation of appropriate policies to enhance the performance of an economy in a desired, usually positive direction. The ultimate goals of economic management are increased prosperity as well as equity and sustainability. Economic management is taken at various levels with a view to keeping some key economic aggregates at improved level in cognisance with set macroeconomic targets and within a given period. The instruments of economic management are either macroeconomic (fiscal, monetary, exchange rate and external debt policy instruments) or microeconomic (sectoral policy instruments) comprising agricultural, industrial and social sector development policies (Ojo, 1995).

In Nigeria, the management of the exchange rate is vested in the Central Bank of Nigeria (CBN) and since the introduction of the Structural Adjustment Programme (SAP) in 1986, exchange rate management has been a core macroeconomic policy function. The overriding objective has been to achieve a realistic and stable exchange rate consistent with internal and external balance. Although many initiatives have been taken in pursuit of this objective, it had remained elusive until the most current dispensation in which some milestone success was achieved but the question is whether it is sustainable. Indeed, since 2005, the exchange rate has appreciated and has been relatively stable. The rest of this paper is organized into five parts. In section 2, we define some concepts that are germane to the topic at hand. Section 3 reviews

fundamental had been quite promising.

We have observed that the CBN has in a very technical way planned to position the Nigerian economy in a competitive manner using the market approach and electronically driven process of dealing in the foreign exchange market. There is less human intervention and there is recorded time efficiency.

The impact of the openness of the economy, the positive external shocks in terms of oil revenue; the unprecedented capital inflows arising from bank consolidation exercise - as well as their effects on the economic growth and robust external reserve levels have supported the convergence of the rates. This development has helped in not halting the incipient growth process that has just began for Nigeria

We agreed that the appreciation of Naira exchange rate is complementary to lower inflation rate considering the import dependent of the economy. Naira exchange rate has played an anchor role for the monetary policy management where effective liquidity management had made a success of the convergence of the rates in July, 2006.

In twenty years, the CBN has achieved the fit that had eluded the country by achieving convergence of the inter-bank rate and the BDC/Parallel rates. The key message here is that there is greater role exchange rate plays in the monetary policy management in an emerging market than the interest rate particularly in the Nigerian monetary transmission mechanism which is an import dependent economy. If this development is supported with more openness of the financial sector, it will increase growth effect of trade related shocks while attenuating the impact of regional capital inflows. More importantly, economic theories work in a market environment where human intervention is limited.

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the exchange rate policy regime and discusses exchange rate volatility in Nigeria. Section 4 takes a look at the determinants of exchange rate while the challenges of exchange rate volatility are examined in Section 5. The paper ends with some concluding remarks in Section 6.

2. Some Conceptual Issues

2.1.1 Rate of Exchange

Exchange rate has been defined as the price of one currency in terms of another. It can be expressed in one of two ways: as units of domestic currency per unit of foreign currency; or units of foreign currency per unit of domestic currency. For example, on December X, 200x, the Nigerian currency the Naira traded for N126.40 to a US dollar in the foreign exchange market giving an exchange rate of N126.40 per US$1.00 or US$0.0079 per N1.00. However, since transactions are often carried out in national currencies, the former is generally applied for exchange. In addition, distinction is often made in the foreign exchange market between buying, selling and central rate.

2.1.2 Depreciation/Appreciation

Using the domestic currency per unit of foreign currency, when exchange rate increases (that is, the amount of domestic currency required to buy a foreign currency increases), the domestic currency is said to have depreciated while the foreign currency appreciates. Similarly, a decrease in the rate of exchange of the domestic currency for foreign currency implies an appreciation of the domestic currency and a depreciation of the foreign currency.

2.1.3 Foreign Exchange Market

The foreign exchange market is the market for buying and selling different currencies. It is the medium through which the interaction of demand and supply results in the determination of the rate of exchange of a local currency against other foreign currencies. In Nigeria, the foreign exchange market consists of the official window (DAS), the open inter-bank (OIB) market and the bureau de change(BDC) which are legal markets; as well as the parallel market, which is not officially recognized but operates as the "underground" window.

2.1.4 Exchange Rate Policy

Exchange rate policy encompasses the design and deployment of strategies to ensure the achievement of a stable and realistic exchange rate for the country's domestic currency, consistent with overall macroeconomic policy objectives.

2.2 Exchange Rate Volatility

Exchange rate volatility refers to the swings or fluctuations in the exchange rates over a period of time or the deviations from a benchmark or equilibrium exchange rate. The latter which also reflects the misalignment of the exchange rate could occur where there is multiplicity of markets parallel with the official market. The monitoring of these markets is essential because they tend to provide a signal (though not normally acknowledged in official circles) on exchange rate misalignment, particularly when official exchange rate deviates widely from what obtains in the free market. Empirically, volatility is measured in terms of the 'coefficient of variation' which is the standard deviation divided by the mean for a series. Fluctuations and price volatility may be measured on any time-scale, from year-by-year to day-by-day. Volatility over any time interval tends to be higher when supply, demand or both are liable to large random shocks and when the elasticity of both supply and demand is low. Price volatility tends to be higher for commodities, shares and exchange rates than for industrial products.

Once an exchange rate is not fixed it is subject to variations, thus floating exchange rates tend to be more volatile. The degree of volatility and the extent of stability maintained are affected by economic fundamentals. Strong economic fundamentals are meant to produce favourable economic conditions and outcomes which in turn would appreciate the currency and maintain relative stability in the market. Supporting this line of argument Friedman in his 1953 thesis noted that "… instability of exchange rate is a symptom of instability in the underlying economic structure …" For instance, the theoretical argument that exchange rate volatility may hinder trade is based on the fact that volatility represents uncertainty and will impose costs on risk averse traders. Exchange rate stability, which is essential for growth is influenced greatly by the appropriate policy mix by governments in their quest to attain macroeconomic targets.

In theory, a distinction is made between the short-run and long-run equilibrium exchange rates. The short-run rate refers to that established in a liberalized environment by the interplay of market forces demand and supply. The long-run equilibrium rate is the rate that would equilibrate the external balance in the medium and long-term as well as facilitate the achievement of macroeconomic stability. The purchasing power parity (PPP) clearly approximates the long-run equilibrium exchange rate. The concept of equilibrium exchange rate is useful for policy makers as it helps in determining the degree of over-valuation or under-valuation of a particular national currency.

2.3 Importance of Exchange Rate in the Economy

It is a vital price in an economy which influences most other prices and, indeed, the general level of prices. Consequently, exchange rate levels and movements have far-reaching implications for inflation, price incentives, fiscal viability, and competitiveness of exports, efficiency in resource allocation, international confidence and balance of payments equilibrium. Because of their widespread impact, exchange rate developments are a matter of interest and often concern, to government, the business community and the general public.

3. Exchange Rate Volatility in Nigeria

3.1 Nominal Exchange Rate

The exchange rate of the naira depreciated against the major intervention currency, the United States dollar from 1986 with the adoption of the flexible exchange rate regime. This development occurs in spite of the frequent changes in the technique of the determination of the exchange rate of the naira. From 1970-1985, the exchange rate averaged N0.67=US$1.00, but it depreciated to an average of N2.02, N8.04 and US$9.91 =US$1.00 in 1986, 1990 and 1991, respectively. It further depreciated to N17.30 and N22.05 = US$1.00 in 1992 and 1993, respectively. Owing to the persistent depreciation of the exchange rate, the exchange rate policy was completely reversed in 1994 with the re-introduction of a fixed exchange rate regime. Thus, the exchange rate of the naira was fixed at N21.8861 = US$1.00. The dismal performance of the economy at the end of that year compelled the authorities to re-introduce the market-based approach under the Autonomous Foreign Exchange Market (AFEM) from January 1995 till October 1999.

The exchange rate, which depreciated from the fixed rate of N21.8861 per dollar in 1994 to a high of N82.33 = US$1.00 in 1995, depreciated further to N84.38 = US$1.00 and N92.65 = US$1.00 in 1998 and 1999, respectively. The average exchange rate at N111.90 = US$1.00 for 2001 depreciated to N128.75 during the period 2002 - 2005. The trend analysis showed that the exchange rate in Nigeria has remained unstable over the years. However, some relative stability was achieved from 2003, with the rate actually appreciating in 2005 and 2006. Similarly, declining trend (depreciation) was observed in the other segments of the foreign exchange market as shown in figure 1 using annualized data for the period 1985 through 2006.

3.2 Exchange Rate Volatility

Using the generalized autoregressive conditional heteroskedasticity model (GARCH) and a high frequency monthly data for the period 1992 -2005 confirmed the high volatility of the Naira exchange rate as shown in Figures 2 and 3. Figure 2 introduces the period of regulation from 1994 to 1998, in which the exchange rate for official transactions was fixed at N21.6681 = US$1.00. Figure 3 however, presents a variant of figure 2 but with AFEM rates that are market determined under the guided-deregulation introduced in 1995.

3.2 Review of Exchange Rate Policy

The objectives of an exchange rate policy include determining an appropriate exchange rate and ensuring its stability. Over the years, efforts have been made to achieve these objectives through the applications of various techniques and options to attain efficiency in the foreign exchange market. Exchange rate arrangements in Nigeria have transited from a fixed regime in the 1960s to a pegged regime between the 1970s and the mid-1980s and finally, to the various variants of the floating regime from 1986 with the deregulation and adoption of the Structural Adjustment Programme (SAP). A managed floating exchange rate regime, without any strong commitment to defending any particular parity, has been the most predominant of the floating system in Nigeria since the SAP. Following the failures of the variants of the flexible exchange rate mechanism (the AFEM introduced in 1995 and the IFEM in 1999) to ensure exchange rate stability, the Dutch Auction System (DAS) was re-introduced on July 22, 2002. The DAS was to serve the triple purposes of reducing the parallel market premium, conserve the dwindling external reserves and achieve a realistic exchange rate for the naira. The DAS has helped to stabilize the naira exchange rate, reduce the widening premium, conserve external reserves and minimize speculative tendencies of authorized dealers. The foreign exchange market has been relatively stabilise since 2003.

The conditions that facilitated the re-introduction of DAS in 2002 included, the external reserve position which could guarantee adequate funding of the market by the CBN; reduced inflationary pressures; instrument autonomy of the CBN and its prompt deployment of monetary control instruments in support of the DAS as well as the bi-weekly auctions as against the previous fortnightly auctions, thus assuring a steady supply of foreign exchange.

In order to further liberalize the market, narrow the arbitrage premium between the official, inter-bank and bureau de change segments of the markets and achieve convergence, the CBN introduced the Wholesale Dutch Auction System (W-DAS) on February 20, 2006. The introduction of the W-DAS was also to consolidate the gains of the retail Dutch Auction System (R-DAS) as well as deepen the foreign exchange market in order to evolve

a realistic exchange rate of the naira. Under this arrangement, the authorized dealers were permitted to deal in foreign exchange on their own accounts for onward sale to their customers. The system has since been expanded to include not only the authorized dealers in foreign exchange, but also bureaux de change operators. In addition, banks have been directed to own and open bureau de change windows at their branches to enable them access the official foreign exchange window.

4. Determinants of Exchange Rate

4.1 Drivers of Foreign Exchange

Friedman (1953) had argued that exchange rate instability is a manifestation of economic volatility. The determinants of exchange rate include among others: economic fundamentals, such as the GDP growth rates, inflation, balance of payments position, external reserves, interest rate movements, external debt position, productivity; market psychology and expectations; socio-political factors; macroeconomic shocks and speculative contagion.

These drivers influence exchange rate dynamics through the demand for and supply of foreign exchange which can exert or ease the pressure on the market and cause the exchange rate to depreciate or appreciate. For instance, a draw-down of external reserves increase in external debt servicing, low productivity, macroeconomic shocks that precipitate capital reversals will, all things being equal, cause the exchange rate to depreciate. Political tension, social unrest, pipeline vandalisation and hostage taking usually send warning signals of a nation under siege and, therefore, not in a position to play host to foreign investment which could put more pressure on the foreign exchange market and cause distortions. This could also induce capital flight. Similar impact is expected for poor growth prospects and renewed inflationary pressures and expectations. Uneasiness in market psychology, as manifested in the phenomenal increase in foreign exchange demand for both hedging and speculative purposes, can trigger exchange rate movements. Exchange rates are strongly influenced by market expectations of future exchange rates, and these expectations are in turn influenced by beliefs concerning the future course of monetary and fiscal policies as well as socio-political developments.

Lack of depth at both the inter-bank autonomous and parallel market segments could induce speculative attack as a result of scarcity of foreign exchange in the market in the wake of increased demand pressure. Thus, relatively small changes in demand or supply are reflected in even larger and exaggerated movements in the exchange rate. Structural rigidities, the undue dependence of the economy on oil and imports, the poor performance of non-oil exports and low level of productivity in the country, also precipitates depreciation of the exchange rate.

4.2 Exchange Rate Movement and Macroeconomic Aggregates

Analysis of Nigeria's exchange rate movement from 1970-2005 showed that there exists a causal relationship between the exchange rate movements and macroeconomic aggregates namely inflation, fiscal deficits and economic growth. Consequently, the persistent depreciation of the exchange rate trended with major economic variables such as inflation, GDP growth, and fiscal deficit/GDP ratio. In this context, the exchange rate movements in the 1990's trended with the inflation rate. During periods of high inflation rate, volatility in the exchange rate is high, which is reversed in a period of relative stability. For instance, while the inflation rate moved from 7.5 per cent in 1990 to 57.2 and 72.8 per cent, respectively in 1993 and 1995, the exchange rate also moved from N 8.04 to $1 in 1990 to N22.05 and N81.65 to a dollar in the same period. When the inflation rate dropped from 72.8 per cent in 1995 to 29.3 and 8.5 per cent, in 1996 and 1997, respectively and rose thereafter to 10.0 per cent in 1998 and averaged 12.5 per cent in 1999-2005, the exchange rate trended in the same direction. A similar trend was observed for fiscal deficit/GDP and GDP growth rate as shown in figure 4.

5. Challenges of Exchange Rate Volatility

The naira exchange rate has been fluctuating since the introduction of the Structural Adjustment Programme (SAP) in 1986. The Nigerian situation since SAP has mostly been characterized by increasing demand which outstripped supply, contributing generally to the continuous depreciation of the naira. Several factors have accounted for the instability of the naira exchange rate among which are the expansionary fiscal and monetary policies, structural deficiencies in the economy, inadequate funding, as well as the role of the authorised dealers and other operational constraints. Therefore, the challenges facing economic management are curtailing the liquidity surfeit in the economy, maintaining and sustaining macroeconomic stability, reducing the high arbitrage in the foreign exchange market occasioned by rent seeking, reducing the high import dependency, curtaining the huge debt service payments, encouraging capital inflows and sustaining the current high level of external reserves.

5.1 Liquidity Surfeit

The exacerbation of the

Liquidity overhang in the banking system through excessive monetary growth occasioned by the rapid monetisation of petrodollars presents a major challenge to exchange rate stability and economic management. Huge budgetary releases used in financing imports amidst low output growth impact adversely on exchange rate and aggravate inflationary pressure. Uncertainty about future inflationary tendencies has diverted assets' holdings to highly volatile financial instruments with short-term maturities. Although excess liquidity is linked with the monetisation of foreign exchange receipts by government and rapid growth in aggregate credit, the real problem is with running deficits in the face of higher benchmark oil price and the financing of such deficits by the banking system as well as additional spending from excess crude oil receipts.

Government expenditure has been on the increase since the introduction of the SAP for various reasons. Government fiscal operations resulted in substantial deficits, rising from N5.9 billion in 1987 to N12.2 billion, N15.3 billion and N22.2 billion in 1988, 1989 and 1990 respectively. It further increased from N35.7 billion in 1991 to N171.9 billion and N293.3 billion at the end of 2001 and 2002, respectively before dropping in 2003-2005. Government budget deficits have serious implications for liquidity in the economy and the movement of naira exchange rate at the foreign exchange market, particularly if such deficits are financed by borrowing from the banking system. Concomitantly, the growth in broad money supply (M2) has been on the increase averaging 20.5 per cent in 2001-2005. Records also showed that the rapid expansion in money supply was attributed largely to the growth in credit to the government sector which poses a major challenge for exchange rate stability realizing its impact on demand for foreign exchange. Apart from 1989, 1995-1997 and 2004, when actual credit to government declined relative to the target, credit to government in other years was rather excessive.

5.2 Macroeconomic Stability

The problems of excess liquidity, excessive monetary growth, high and rising inflation and exchange rate in stability have been traced directly to government's fiscal operations. Distortions in these macroeconomic aggregates result in both internal and external disequilibrium. The excessive growth in monetary aggregate and continued banking system financing of governments' fiscal outcome has the tendency to increase the demand for foreign exchange and to exert more pressure on the exchange rate. Conversely, restraint on the growth of money and prudent fiscal operation would reduce the demand for foreign exchange and reduce stability in the exchange rate. Consequently, the challenge is for monetary and fiscal policies to be harmonized, to ensure exchange rate stability and macroeconomic balance.

5.3 High Import Dependency

The economy is highly dependent on import for both consumption and production. Virtually all the major industrial raw materials are sourced from abroad while the country depends wholly on foreign supply for intermediate and capital goods. Production for exports is highly inelastic because the major non-oil export products are basically primary produce whose prices have been on the downward trend and are exogenously determined. Besides, these exports are slow in responding to exchange rate adjustments. Most importantly, output of manufacturers is relatively low with most of the output consumed locally leaving very little for export. The implication is that the economy is highly prone to external shocks and in the event of a crash in oil price, the economy may face decline in foreign exchange earning which may destabilize the exchange rate. Also, the high level of importation to meet domestic needs puts severe pressure on the foreign exchange market and may result in the depletion of the external reserve. In this context, measures aimed at diversifying the production and export base, through incentives to promote exports of semi-manufactured and manufactured goods will help increase the foreign exchange earnings by the private sector. This will help reduce the demand pressure and ensure exchange rate stability.

5.4 Huge Debt Service payments

In the 1980s, the economy witnessed continued resort to external borrowing for the financing of domestic production in the wake of declining foreign exchange earnings occasioned by the glut in the international oil market. Payments arrears arising from the inability of the authorities to provide foreign exchange for imports accumulated. Consequently, the stock of debt increased to US$35.94 billion at end-December 2004 before the Paris Club deal in 2005 which reduced the stock to US$20.48 billion as at end-December 2005. The debt servicing was maintained at US$1.5 billion annually at about 50 per cent of the scheduled debt service resulting in huge deferred debt service payments (arrears) and penalty charges. The ratio of debt service payments to exports of goods and services officially put at 30 per cent from 1986 is considered high. In fact for the period 1986 through 2003, the actual debt service payments (due) to exports

of goods and non-factor services was above 60.0 per cent on the average. These payments put pressure on the foreign exchange market and the exchange rate. Currently the emphasis is on the London Club debt and promissory notes following the complete exit from the Paris Club of creditors. To ensure that we do not go back into debt crises and, thus, compromise the current stability in the foreign exchange market and exchange rate, external borrowing should be project-tied and such projects should be capable of paying back such borrowings when completed and operational.

5.5 High Arbitrage Premium

The existence of the parallel market has continued to foster speculative activities in the foreign exchange market. Throughout the 1990s, annual investigations by the regulatory authorities have revealed significant exchange rate premium between the official rate and the parallel market rate for the arbitrage gains. This served as a major incentive for operators to perpetrate their rent-seeking activities. For example, the parallel market premium was as high as 79.2 per cent in February 1992, compared with 35.5 per cent in 1991 and the internationally acceptable standard of 5.0 per cent. The high parallel market premium that emerged overtime resulted from the inadequate supply of official foreign exchange, before the introduction of the auctioning system, led to various abuses. These developments resulted in capital flights and enormous diversion of official foreign exchange to the parallel market, a practice known as "round tripping".

Efforts made by the CBN to unify the rates in 1992 and 1995 did not yield the desired result. However, with the introduction of the wholesale Dutch Auction System (WDAS) in February 2006 and the further liberalization of the foreign exchange market by allowing the bureaux de change access to official funds, the arbitrage premium has reduced to below the 5.0 per cent benchmark. In fact, exchange rates convergence was achieved for the first time in more than a decade. The major challenge is the ability to sustain the current level of arbitrage premium over time.

5. Concluding Remarks

Nigeria's exchange rate management has produced mixed results. While the initial overvaluation of the naira has been substantially eliminated, the resurgence of huge fiscal deficits has undermined the tight monetary policy stance of the CBN and engendered a state of persistent demand pressure on foreign exchange resources and thus, the exchange rate. The excess liquidity in the system has further compounded the problem. The problems of demand pressures and supply shortages which have caused persistent instability in the foreign exchange market are rightly being addressed by the further liberalization of the market through the wholesale DAS and the high level of external reserves which has restored confidence in the market and supported the CBN interventions.

Despite the successes achieved currently in exchange rate management and the relative stability sustained in the last two years, there is need for fiscal restraint and discipline at all levels of government and greater coordination and harmonisation of fiscal and monetary policy actions to ensure that injections of liquidity into the system are consistent with macroeconomic stability. In addition, there is need to create a truly autonomous inter-bank foreign exchange market whereby the CBN ceases to be the dominant player supplying foreign exchange to banks and other authorized dealers on a predictable, routine basis. Government financing should be through non- inflationary sources mainly through the non-bank sources.

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Figure 1:

Annualized Exchange Rate Movement (1985-2006) in various Market Segments

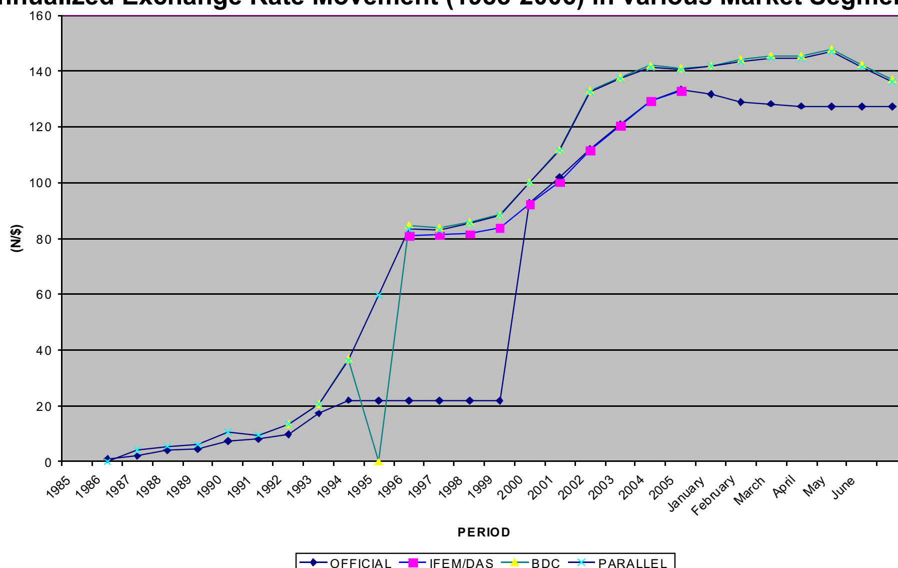

Figure 2:

Exchange Rate Volatility (1992-2005) Showing the fixed regime of 1994-1998

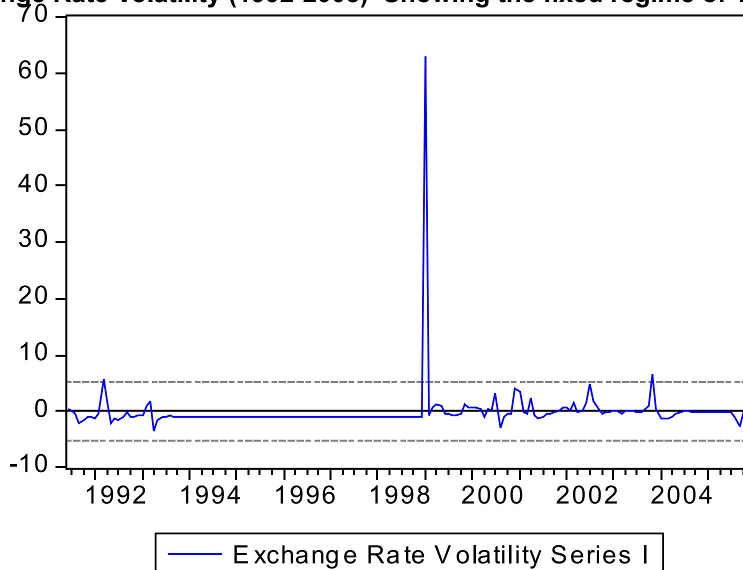

Figure 3: Exchange Rate Volatility (1992-2005) Under a Deregulated Regime

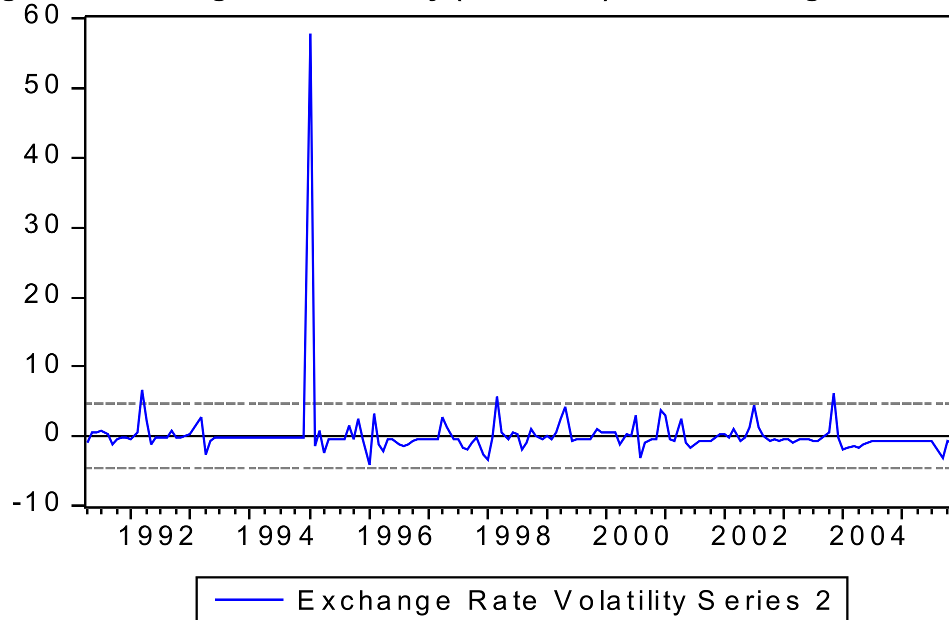

Figure 4: Movement in Exchange Rate and Macroeconomic Aggregates

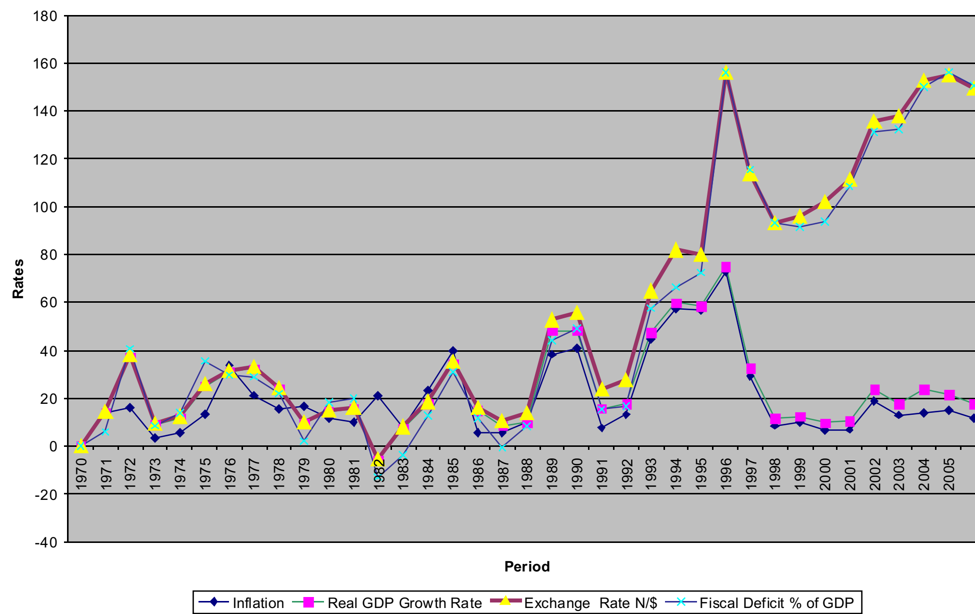

Table 1:
Schema of Events in Exchange Rate Management in Nigeria

	YEAR	EVENT	REMARK
1.	1959-1967	Fixed parity solely with the British pound sterling	Suspended in 1972
2.	1968-1972	Included the US dollar in the parity exchange	Aftermath of the 1967 devaluation of the pound and the emergence of a strong US dollar.
3.	1973	Revert to fixed parity with the British pounds	Devaluation of the US dollar
4.	1974	Parity to both pounds and US dollar	To minimize the effect of devaluation of the individual currency
5.	1978	Trade(import)-weighted basket of currency approach	Tied to 7 currencies – British pounds, US dollar, German mark, French franc, Japanese yen, Dutch guilder, Swiss franc
6.	1985	Referenced on the US dollar	To prevent arbitrage prevalent in the basket of currencies.
7.	1986	Adoption of the Second-tier Foreign Exchange Market (SFEM)	Deregulation of the economy
8.	1987	Merger of the first and second –tier markets	Merger of rates
9.	1988	Introduction of the inter-bank foreign exchange market (IFEM)	Merger between the autonomous and the FEM rates
10.	1994	Fixed exchange rate	Regulate the economy
11.	1995	Introduction of the Autonomous foreign exchange market (AFEM)	Guided- deregulation
12.	1999	Re -introduction of the inter-bank foreign exchange market (IFEM)	Merger of the dual exchange rate, following the abolition of the official exchange rate from January 1, 1999
13.	2002	Re-introduction of the Dutch Auction System (DAS)	Retail DAS was implemented at first instant with CBN selling to end-users through the authorized users (banks)
14.	2006	Introduction of Wholesale DAS	Further liberalized the market

* These avalanches of measures clearly reveal the instability of exchange rate management in Nigeria

THE CHALLENGES OF SUSTAINABILITY OF THE CURRENT EXCHANGE RATE REGIME IN NIGERIA

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Introduction

The motive behind initiating an exchange rate policy, an integral element of monetary policy, is to preserve the value of the domestic currency, maintain favorable external reserves and ensure the realization of price stability in the domestic economy. The pursuance of these goals is to ensure external balance without compromising the need for internal balance and macroeconomic stability. It is important that the monetary authority, in its bid to designing an appropriate and sustainable exchange rate policy framework, addresses issues that are fundamental to the introduction of the policy itself. In designing the exchange rate policy, the monetary authority must consider the objectives of the exchange rate policy which must be in consonance with the desired direction of the country's economic policy. It must also consider issues such as the nature of shocks faced by the domestic economy and the stage of economic development of the country. By extension, the policy framework should de-emphasize high control of foreign exchange market, and ensure the availability of and ease of accessibility to foreign exchange by all end-users. It must also ensure the stability of the nominal exchange rate, the minimization of waste in the utilization of foreign exchange, encourage inflow as well as increase share of autonomous foreign exchange earnings.

In general, exchange rate policy is often used to prescribe the choice of a ruling exchange rate regime. A change in exchange rate policy will facilitate a spontaneous change in the nature of the exchange rate regime. Over the years, most countries of the world have practiced different types of exchange rate regimes. Among these regimes are fixed, floating and hybrid, which are predominantly found in developing economies. In Nigeria, all the aforementioned regimes had been practiced at different periods. Each regime is modified to address the problems confronting the foreign exchange market at any particular time. The adoption of a fixed exchange rate system in Nigeria prior to 1986 took different variants namely a single currency peg, crawling peg system, peg to basket of currencies and adjustable peg system or otherwise referred to as “fixed with bands”. Under the floating exchange rate arrangement, the monetary authority adopted multiple and managed/dirty floating exchange rate systems.

Since the adoption of a floating exchange rate regime in Nigeria, the managed or dirty exchange rate instrument has become the major tool used in determining the ruling exchange rate in the foreign exchange market. The choice of a market-determined exchange rate management system since 1986 was to free the foreign exchange market from the control of the government thereby allowing the market forces to prevail. Besides, it would also entail the adoption of appropriate policy that will guarantee stability in the foreign exchange market thereby minimizing arbitrage differential between the official and autonomous rates and consequently making arbitrage activities unprofitable. It is in the quest for corrective measures to minimize; if not ward-off distortions in the foreign exchange market that the monetary authority initiates the current exchange rate reform. The adoption of the current exchange rate policy (Wholesale Dutch Auction System) was intended to consolidate the gains recorded from the use of the retail exchange rate arrangement (Retail Dutch Auction System) with apposite modifications. However, the objective of the paper is to discuss the challenges of sustaining the recently introduced exchange rate regime in Nigeria.

The rest of the paper is organized as follows: Section 2 discusses the exchange rate regimes since inception, while section 3 presents the trend analysis of the foreign exchange market prior to the introduction of the current exchange rate regime. Section 4 contains the basic structure of the current exchange rate regime, while section 5 briefly appraises the

progress made so far. Some of the challenges of sustaining the current exchange rate regime are discussed in section 6, while the paper ends with summary and conclusion in section 7.

2.0 Exchange Rate Policy in Nigeria

Exchange rate policy in Nigeria has gone through many changes but spanning between two major regimes. These are fixed and flexible exchange rate systems. The fixed exchange rate system was adopted between 1960 and 1986, while the flexible exchange rate system remains in use from 1986 till date having undergone series of modifications.

2.1 Fixed Exchange Rate Regime

Prior to 1960, there was a global fixed exchange rate arrangement in which currencies were linked to gold. This allowed for unrestricted capital mobility as well as global stability in currencies and trade. However, the system collapsed following the crash in dollar resulting in the disintegration of the Bretton Woods system of fixed exchange rate regimes in the early 1970's. Following the collapse of the fixed exchange rate system, many African countries either take to devaluation of their exchange rate peg (mostly to the Special Drawing Right or basket of currencies) or to a free float. The largest number, however, opted for some form of a peg either to the SDR, US dollar or a basket of currencies. Despite the disintegration, Nigeria still retained its exchange rate policy and operated the fixed exchange rate arrangement in line with the International Monetary Fund's (IMF) par value system.

Due to the fact that the country's currency was not tradable in the international currency market, its exchange rate was largely subjected to administrative management. Thus Nigerian currency was initially pegged at par to the British pound sterling, but due to the devaluation of the pounds in 1967, the domestic currency was allowed to move independently of the sterling but pegged to the dollar in the basket of currencies. Following the change of the Nigeria's pounds to Naira in 1973, the exchange rate of the naira was deliberately appreciated to enable the country source inputs cheaply from abroad purposely to implement development projects. However, the development triggered a number of problems in the Nigeria's external sector. Some of these problems include the rapid erosion of country's external reserves following an unprecedented level of importation and outflow of foreign exchange. It thus became apparent to reverse the trend through policy adjustment. Consequently, a renewed policy was initiated in 1981 to address the deteriorating conditions in the external sector of the economy.

Following the crash in crude oil prices in the international oil market in 1981, the monetary authority adopted a policy of gradual depreciation of the nominal exchange rate of the naira with a view to reversing the observed overvaluation of the naira. However, the administrative depreciation of the naira was not strong enough to wipe out the perceived overvaluation of the currency. Thus, the situation was further exacerbated with the accumulation of payment arrears and the erosion of the nation's credit worthiness. By 1985, a single currency intervention system was introduced which necessitated the quoting of the naira against the US dollar. Evidently, the fixed exchange rate policy which was sustained till 1986 failed to correct the imbalances in both internal and external positions.

The development, however prompted the government to introduce a Structural Adjustment Programme (SAP) in 1986, designed not only to bring about the evolvement of a realistic exchange rate for the naira, but to restructure the production pattern along the country's consumption tendencies. Within the framework of SAP and with the support of the World Bank and the IMF, many developing countries including Nigeria began to re-examine their exchange rate arrangements. It is in this context that many countries progressively moved within this continuum of exchange rate arrangement towards more flexible exchange rate regimes.

2.2 The Floating Exchange Rate Regime

A major policy reversal was effected in September, 1986 when the fixed exchange was discarded and replaced with a flexible exchange rate mechanism. The system was propelled by market forces as the naira was allowed to find its level according to the strengths of demand and supply of foreign exchange. However, the monetary authority retained the discretion to intervene in the market to influence the course of exchange rate movement towards maintaining stability and achieving policy objectives.

Within the institutional framework of market-determined arrangement, various methods were applied in the quest for a realistic exchange rate of the naira

and its stability. On September 26, 1986, the naira was first floated in the Second-tier Foreign Exchange Market (SFEM), and a dual exchange rate mechanism, a combination of the first and second-tiers exchange rate system, was introduced. While the first-tier exchange rate was administratively determined and used for official transactions including debt service payments, expenditures on Nigerian missions and public sector transactions, the floating exchange rate was used for determining the value of other transactions using major pricing methods such as average successful bids, marginal rate and the Dutch Auction System (DAS). The dual exchange rate system resulted in multiplicity of rates which encouraged subsidy element with attendant fluctuations. The system was later jettisoned and the two rates were merged into a single enlarged Foreign Exchange Market (FEM) on July 2, 1987

The autonomous foreign exchange market which was created in 1988 was highly destabilizing due to its inherent speculative tendencies and was subsequently merged with the Foreign Exchange Market (FEM) in January 1989 when the Inter-bank Foreign Exchange Market (IFEM) was created. Under the IFEM, the exchange rate was determined through one or more of the following: marginal rate pricing, average rate pricing, highest and lowest bid, weighted average pricing, average of successful bids. In the same year, the Bureau de Change (BDC) was instituted to accord increased access to small users of foreign exchange in a less formal manner and encourage the integration of the informal market to the officially recognized market. In spite of these modifications, the exchange rate still failed to attain a stable level, thus the procedures of the IFEM were modified by re-introducing the DAS in December 1990 with daily bidding sessions and payments based on actual bid rate by the authorized dealers, yet the depreciation of the naira continued unabated. The development was not unconnected with the prevailing demand pressure in the foreign exchange market.

The monetary authority later discontinued the use of DAS and replaced it with complete deregulation of the FEM on March 5, 1992. The policy depreciated the IFEM rate by equating it with the parallel market, all in a bid to reducing, if not eliminating, the premium and enhancing efficient allocation of the IFEM through adequate participation in the market. Under the system, the Central Bank of Nigeria (CBN) undertook to meet all demand for foreign exchange that was fully backed by naira cover. This was however suspended following the depletion in reserves on December 15, 1992. However, the policy still failed to achieve the desired results. The de facto pegging of the official exchange rate was formalized when the naira was officially pegged at N21.9960/$1 in the 1994 Budget and the parallel market was declared illegal with plans to promulgate relevant laws that would outlaw it. The re-regulation of the FEM in 1994 worsened the situation in the FEM as the naira depreciated sharply, parallel market premium widened while stability in exchange rate and in the FEM proved elusive. The balance of payments was put under severe pressure and demand for foreign exchange rose significantly.

The dismal performance of the domestic economy arising from the control measure informed the policy reversal in 1995 from regulation to guided deregulation of the FEM. Thus the dual exchange rate was reintroduced, a combination of fixed and autonomous foreign exchange market. This was intended to boost external reserves, improve the country's credit worthiness, strengthen the naira and gradually move the currency towards convertibility. The policy was made to run up till September 1999 and by October 25, 1999, the IFEM was re-introduced to further deepen the foreign exchange market and allow the CBN to be an active player in the market. Contrary to expectations, the CBN became a major supplier of foreign exchange in the market thus frustrated the evolvement of a realistic exchange rate.

Against this background, the government re-introduced the DAS on July 22, 2002 purposely to narrow the gap between the official and parallel market rates, evolve a realistic exchange rate of the naira and conserve the foreign exchange reserves. While the system was still running, the IMF stressed the need for countries to constantly modify their exchange rate policies to reflect the prevailing developments in their foreign exchange markets. In line with this suggestion, the monetary authority deemed it appropriate to modify its existing exchange rate policy and thus, announced the commencement of the Wholesale DAS on February 20, 2006.

3.0. A Synopsis of the Foreign Exchange Market

Prior to the introduction of the WDAS, a number of systems had been practiced ranging from the administrative approach to retail Dutch Auction System. The major shortcoming of the exchange control system was the failure of the system to achieve internal and external balance in the short term and guarantee external equilibrium in the long run. The overvaluation of

the currency under this system posed a major obstacle to the achievement of internal balance. Consequently, the exchange control was discarded and replaced with a market determined system. In spite of the adoption of the market-based exchange rate system in 1986 coupled with the several modifications introduced, the exchange rate movements still exhibit unsavory developments.

To a greater extent, the foreign exchange market has been largely characterized by growing instability for most part of the period, reflecting a problem of information asymmetry resulting in inefficiency in the foreign exchange market operations. A number of problems such as excess demand for foreign exchange caused by the penchant for imported products, siphoning of corrupt funds abroad, and frequent changes in foreign exchange policy caused by changes in government, prevented these policies from having their full circle. Others were unethical and sharp practices by the authorized dealers and other operators in the foreign exchange market especially the prevalent issue of round tripping of foreign exchange, sought at the official and diverted to the parallel market, the fiscal dominance which reduced the efficacy of the monetary policy and the failure of the government to accede to the harmonization of monetary and fiscal policies hindered the policy from achieving its set goals.

Beginning from 1986 to 1994, there was observed demand pressure which culminated in a wide premium. The exchange rate at the official market was N2.02 per dollar compared with N4.17 a dollar in the parallel market in 1986, representing a premium of 106.4 per cent. The introduction of the DAS in 1987 helped in no small measure to curtail the high premium to 38.1 per cent and later to 33.4 per cent following increased supply of foreign exchange by the CBN. However, the year 1989 witnessed the phenomenon of excessive demand pressure in the foreign exchange market as US$17.3 billion was demanded against a supply of US$2.4 billion. This was in spite of the policy initiatives to liberalize the market and the initiative of the government to institutionalize the Bureau de Change along with the encouragement of inter-bank foreign exchange transactions.

The rising demand trend continued in 1990 from US$20.2 billion as against a marginal rise in supply level to US$2.5 billion. This represented a wide demand gap of US$17.7 billion or 87.6 per cent. Consequently, the CBN immediately modified the procedure in the IFEM and re-introduced the DAS in 1990 which in effect helped to prune down demand to US$9.5 billion in 1991 and later to US$6.5 billion in 1992, while supply of foreign exchange trended between US$2.9 and US$4.05 billion during the review period. In a continued pursuance of a liberalized foreign exchange market, the government fully deregulated the market on March 5, 1992 and was sustained till December 1993. Unfortunately, the demand peaked at US$40.6 billion, reflecting the growth rate of money supply at 49.8 per cent, the highest level of demand during the period under review. It later moderated to US$35.7 billion in 1994. Throughout the period, the CBN continued to reduce supply having observed the incidence of speculative demand by authorized dealers. Thus, supply of foreign exchange declined significantly from US$4.05 billion in 1992 to US$1.96 billion in 1994.

Against this background, demand suddenly trended downward from US$35.69 billion in 1994 to US$1.72 billion in 1995. During the period, the CBN endeavored to supply all that was demanded by the authorized dealers, and consequently moderated the excess demand pressure in the foreign exchange market. However, the premium trended upward from 64.3 per cent in 1994 to 302.9 per cent in 1998, owing to high incidence of speculative trading by foreign exchange operators in the market and the lack of confidence in the ability of the CBN to meet the foreign exchange requirements of the operators. This impetus contributed to the flourishing activities of the parallel market.

From October 25, 1999, the IFEM was re-introduced to further deepen the foreign exchange market. Although it was intended to assuage the overdependence of the dealers on the CBN for foreign exchange and beef-up the autonomous sources, but could not be realized due to existing distortions in the domestic economy. Thus, the CBN continued to play the role of a major supplier of foreign exchange to the market. By July 22, 2002, the DAS was re-introduced with the aim of narrowing the gap between official and parallel market rates and evolving a realistic exchange rate of the naira. Consequently, the premium narrowed downward to a single digit of 7.6 per cent in December 2005.

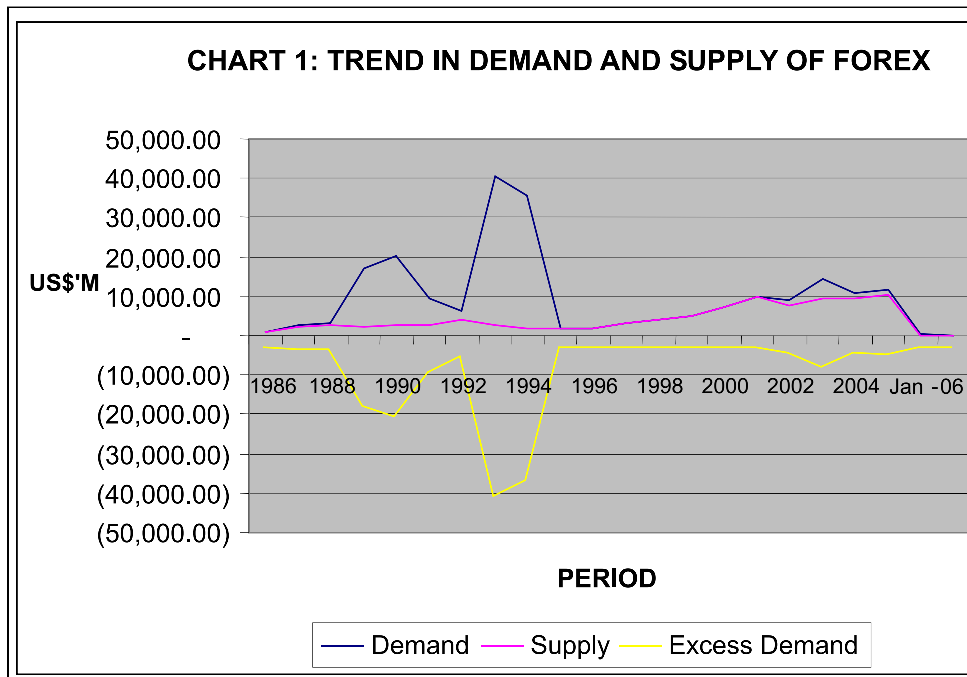
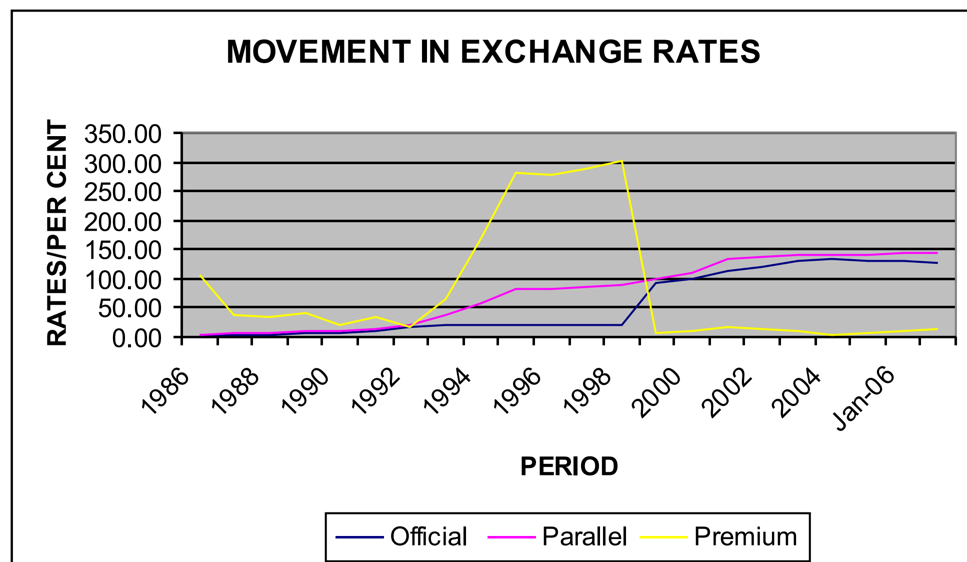


Chart 2



4.0 The Structure of the Wholesale Dutch Auction System (WDAS)

The modification of the procedures of the DAS metamorphosed into the WDAS, a window designed to provide foreign exchange to the authorized dealers wishing to replenish their stocks. The overall objectives of introducing the WDAS included among others: the need to consolidate the gains accruing from the RDAS, in particular, the achievement of market transparency, the reduction in capital flight as well as the appreciation of the exchange rate of the naira. To reduce the dependence of authorized dealers on the CBN as a major supplier of foreign exchange, to further liberalize the foreign exchange market and achieve convergence in exchange rate. The system operates twice in a week, every Monday and Wednesday, respectively. The major participants are the authorized dealers, but now include the registered Bureau de Change (BDC) operators. The BDC including Messrs Travelex and Amex are now allowed to source funds from the official window on their account for onward sale to their customers. The approval was granted on March 28, 2006 in the

circular 55, aimed at increasing access of foreign exchange to small end-users and developing the local BDC. Under the new arrangement, the CBN is expected to be an active player in the foreign exchange market, not only as a supplier but also allowed to purchase funds from other authorized dealers or inter-bank outlets at competitive rates. Where it happens that the CBN engages in both sales and purchases to and from other authorized dealers, the net trading position is eventually created. On the part of the authorized dealers, they are expected to maintain an Open Position Limit (OPL) such that the maximum amount of foreign exchange that is maintained in the banks' books of account at the close of business each day shall not be less than 10.0 per cent of shareholders' funds.

According to the procedure, operators in the market are required to submit their bid rates which are treated with confidentiality, while the CBN determines the ruling rate using the marginal pricing method. However, the marginal rate lies between the band that is the lowest and highest bid rates. In this context, bidders compete for the available foreign exchange resource, while the CBN, at its discretion, determines the acceptability or otherwise of the bids submitted for approval. In practice, bids that are accepted are further processed to a logical conclusion and the wining bids are determined on the basis of the rules and regulation of the auctions. These bidders are duly notified accordingly. Bids that are not accepted are automatically disqualified from the allocation process. The rejection of any bid often arises from the non-conformity of the bidder's application with the trading rules. One of the striking conditions is that authorized dealers are required to quote two ways that is the bid and offer rates, which must be displayed in a conspicuous manner in their banking halls.

The outcome of every auction is announced on the same day. Thus, the transaction cycle has now been reduced from t_1 to t_0 since it is electronically processed using spreadsheets and well updated database. In line with the consistent policy of the Bank towards promoting an efficient and effective banking system, the monetary authority has acquired a page in the Reuters for displaying rates for each trading session at the foreign exchange market. Plans are also underway towards making the foreign exchange transactions on a real time basis. This will further make the entire process far more efficient and transparent. Within the existing foreign exchange policy framework, banks and other authorized dealers are to bid on their own account as against the previous arrangement of bidding for their customers. Every transaction must be backed by naira cover otherwise the request will be turned down. The banks in turn are expected to re-distribute the foreign exchange to their end-users on the basis of the latter's requests, though it could be sold at the inter-bank market to other authorized dealers. Banks shall be required to forward details of its foreign exchange transactions to the CBN in order to ensure that funds are deployed to the productive sectors of the economy, and are judiciously utilized by the various agents in the domestic economy.

5.0 Appraisal of the Current Exchange Rate Regime: WDAS

Of all the methods adopted in reversing the negative trend in exchange rate, the Dutch Auction System appears to have achieved dependable results. It would be recalled that the system was first introduced in 1987 when the exchange rate movement was fast depreciating but was able to stem the persistent downward slide in the naira exchange rate for a while and reduce the premium significantly. It was also re-introduced in December 1990 in an attempt to stabilize the market and evolve a realistic exchange rate of the naira. During that period, desirable results were recorded. This was in terms of enhanced professionalism in the foreign exchange dealings, thereby helping in controlling the rising demand trend, and consequently narrowing the premium. Again, the re-introduction of the DAS in 2002 was informed by the success story in Latin America where it was used successfully in correcting misalignment in their foreign exchange market.

It has been a remarkable success for the Dutch System as it has helped in conserving the country's foreign reserves, which declined slightly from $7.99 billion in 2002 to $7.78 billion in 2003 and thereafter increased to $28.28 billion in 2005. As at end-October, 2006, reserves stood at $41.39 and could possibly finance the current foreign exchange disbursements by 22.4 months. The demand pressure that hitherto characterized the foreign exchange market has been greatly subdued following the adoption of some control measures on foreign exchange disbursement and the sudden improvement in foreign exchange earnings of the government. Thus, the premium between the official and parallel market rates narrowed from 13.5 per cent to 5.2 per cent in 2004 but later increased to 7.6 per cent in 2005. It has also reduced significantly to 2.6 per cent as at end-October, 2006. Undoubtedly, the various efforts of the government at improving the

exchange rate have yielded desirable results under the continued use of the Dutch Auction system. It is a remarkable achievement since the deregulation of the foreign exchange market. However, the positive development has been partly attributed to the adoption of an appropriate policy mix and in part to the strict adherence to the CBN's monetary policy guidelines by public and private sectors as well as a stable macroeconomic environment.

Since the introduction of the WDAS, the foreign exchange market has further experienced significant changes when compared with other exchange rate system of the past. One of the critical achievements of the new system of determining exchange rate in the market is the convergence in rates between the official and inter-bank markets albeit with minor distortions from the imposition of charges by banks. For instance, exchange rate at the official market was N127.01 per dollar in October 2006 compared with N128.42/$1, N130.30/$1 and N129.89/$1 in the Inter-bank, BDC and parallel segments of the market, respectively. It is evident that the foreign exchange market is becoming more competitive and relatively more efficient than before. A truly professional market is gradually emerging now that the CBN only announces a marginal rate post auction, leaving the authorized dealers to take on added risk. Besides, the CBN now plays a crucial role of not only a market maker but also a price maker or taker as the case may be. There is enhanced competition in the market through the display of professionalism by the authorized dealers. The modification has facilitated greater market determination of the exchange rate of the naira, promoted efficient and smooth functioning of the foreign exchange market and achieved a sustainable exchange rate regime that would usher in a robust economic planning for the country in the long run.

Other noticeable achievements included the introduction of electronic platform for dealings in the foreign exchange market and all the dealers are now expected to migrate to the new software application provided by the Bank. The CBN has hitherto acquired a page in the Reuters column for publication of rates and information needed by dealers. Complementing the giant stride achieved is the newly developed “electronic-Financial Analysis Surveillance System” (e-FASS) by the Bank to integrate with the rest of the dealers in the foreign exchange market. In this context, a truly liberalized foreign exchange market is being practiced as it has now become easy for end-users to access the foreign exchange market through their banks, bureau de change outlets and other designated dealers.

It is equally important to mention at this juncture that since the system came into force, the incidence of market distortions in the form of arbitrage trading, arbitrary demand, round-tripping, and speculations have been curtailed to a significant level. Consequently, the rate of inflation reduced from 11.6 per in 2005 to 6.1 per cent on year on year basis as at end-October 2006. From this perception, the economy is expected to record a higher growth in output as monetary policy continues to operate more efficiently than the preceding period. It should also be mentioned that since the improvement in exchange rate, the naira has been gaining confidence in the domestic economy, thereby increasingly serving as a store of value with drastic reduction in the degree of currency substitution in favor of foreign currency. Other macroeconomic indicators have also showed significant improvements. For instance, the balance of payments position remains in surplus following the spate in the seizure of non-essential goods imported into the country. The development has made Nigerians to be more inward-looking thereby encouraging domestic production for immediate exports. The prevailing steps have helped the exchange rate to further appreciate in the foreign exchange market. The timely intervention by the CBN has also assisted in moderating the fluctuations in exchange rate movements along the desired path as the authority ensures effective application of both demand and supply management approach towards stabilizing the exchange rate.

Overall, the system has contributed immensely to the reduction in premium from 12.8 per cent at the inception to 2.6 per cent in October 2006, a level below the 5.0 per cent IMF acceptable benchmark. This was made possible owing to the improvement in the activities of the autonomous foreign exchange market, coupled with fiscal restraints. The extent to which the official rate tracks the autonomous rate has been largely dependent on the size of the autonomous market for foreign exchange. In affirmative, the less the bureaucratic constraints at the official market, the more likely the autonomous rate remain responsive to movements in the official rate. The general observation therefore is that the success of the current monetary policy in the pursuance of the set target hinges on sound fiscal position of the government and the efforts of the CBN at maintaining a healthy financial system.

6.0 The Challenges of Sustainability of the WDAS in Nigeria

The various exchange rate policies adopted in the management of Nigeria's foreign exchange market were confronted with a number of problems over the years. These problems seriously constrained the ability of the CBN to operate a more dynamic foreign exchange management strategy. However, the current exchange rate regime has been one of the core agenda of the recent financial sector reforms designed to offer numerous advantages to the economy. Despite the potential benefits of the current exchange rate policy, the challenges are abound in the coming years. In this section, the paper attempts to outline some of these challenges.

6.1 Stable Macroeconomic Environment

The poor macroeconomic environment of the past largely contributed to the problem in the external sector of the economy. Some of the problems include among others the excessive liquidity position arising from expansionary fiscal operations coupled with the growth in monetary aggregates; increased penchant for import products, debt burden, unfavorable political environment and high arbitrage premium prevailing in the foreign exchange market. The recent adoption of economic and political reforms by the current administration has significantly improved macroeconomic environment. As at end-October 2006, available statistics showed that inflation trended downward from 11.6 per cent in 2005 to 6.1 per cent, average interest rate stood at 17.1 per cent, external debt position also declined to $5.0 billion, while external reserves has risen to about $41.39 billion. Overall, the real GDP growth rate is, however, estimated at 6.5 per cent in 2006 given the improved capacity utilization. The current macroeconomic indicators have been quite remarkable. It is important to re-emphasize that the monetary policy of the CBN does not operate in vacuum as what happens in the fiscal area does matter a lot. Therefore, a fiscal stance not supportive of monetary policy is likely to trigger inflationary pressures hence the need for appropriate policy mix. An optimum policy-mix in which a monetary and fiscal policy stance are complementary and mutually supportive remains a major challenge to the sustainability of the current exchange rate policy. A stable macroeconomic environment will no doubt help to guarantee a sustainable exchange rate policy in the country.

6.2 Financial Deepening

The poor performance in growth and employment in the past was due to the shallow financial depth brought about by inappropriate policies. Thus, the low level of financial deepening constrained the country from generating employment for enhanced productivity and sustainable economic growth. However, the role of the banking sector in ensuring financial deepening through promoting efficient mobilization of funds from surplus units to deficit units will depend on well developed inter-bank market instruments such as Treasury Bills, Certificate of Deposits, National Savings Certificate, Commercial Paper, Repurchase Agreement etc,. The ultimate goal of realizing high financial deepening in the country is a major challenge to the monetary authority and the entire stakeholders in the domestic economy. It is being established in the literature that countries with high financial deepening often recorded significant economic growth. Besides, it would provide a level playing field for both money and foreign exchange markets, enhance competition and the spread of risk, and consequently improve the efficiency of the foreign exchange market and thereby ease the discovery of the ruling rate under the new exchange rate policy.

6.3 Compliance with the Prudential Standard

It would be recalled that the acceptance of the Basle committees' recommendation on the need to adopt a global accounting standard and internationalize prudential banking standard culminated in the introduction of the prudential guidelines in 1990. It was initiated to promote greater competition, innovative environment and sanitize the banking industry. The laid down standards include among others, a publication of accurate accounting information and operating results of banks. It also emphasize the need to embark on effective surveillance of the books of accounts of the banks and ensure high level of compliance with the overnight limit set by the CBN, particularly the maximum amount of foreign exchange that must be maintained in the books of accounts of the banks at the close of business. Also, the CBN must ensure that the banks comply with their internal procedures which must be seen to be adequate to prevent flagrant violation of the prudential standards. Adopting stringent prudential regulations, strengthening banking supervision and improving accounting standards in accordance with

internationally accepted standards are crucial for sustaining the WDAS. The CBN should not hesitate to deal with erring banks as such actions would serve as deterrent to others from contravening the regulations of the monetary authority. Other measures that would strengthen the WDAS include the strict adherence to the code of professional ethics, improved corporate governance and adoption of zero tolerance policy on data transparency.

6.4 Enhance Risk Management Process

There are all manners of risks present in the banking environment as advancing technological and social developments bring forth new or hitherto risks associated with such phenomena. One of the commonest risks in the foreign exchange market is the exchange rate fluctuations which often occur when there is market instability. The monetary authority has an obligation to be fully aware of the state of the art in risk management, and prevent losses which may erode the gains in the foreign exchange market. The Department saddled with the responsibility of assessing these risks should strive to determine the most economical way to reduce the level of risks to the barest minimum. The challenge to every bank including the CBN is to understand the risk and have a strong ability to control the potential risks capable of undermining the efficacy of the newly introduced exchange rate policy. In this context, the sustainability of the current exchange rate policy is contingent upon effective and cohesive management of these risks through sound risk policy framework to address any foreseeable risks in the foreign exchange market.

6.5 Intensify Surveillance in the Financial System

The financial system remains the linchpin of the economic system; however the link between economic activity and money is mainly through the clearing and settlement process. This process has a crucial role to play in the execution of monetary policy. Therefore the major concern of the monetary authority in ensuring stability in the financial system, as a necessary condition for supporting the operations of a foreign exchange market, is to monitor the pace of liberalization and guarantee the integrity of the payment system. Since the cross-border settlement arrangements would continue to have pervasive implications for macroeconomic indicators, especially the exchange rate, the monetary authority would have to embark on routine and unscheduled monitoring of the banks' trading activities in the foreign exchange market so as to instill fear of running foul of the regulatory authorities' policy. In order to sustain the existing exchange rate policy, an effective regulatory and supervisory framework that would ensure a stable financial system must be put in place so as to strengthen the confidence of the banking public. Successful operation of the WDAS will help to strengthen the confidence reposed on the financial system and in particular the external payments positions, if and only if the operation of the foreign exchange market is made more efficient and dynamic.

6.6 Strengthen the Technical Capacity of Desk Officers of the CBN

The effectiveness of the current exchange rate management depends largely on the accuracy and timeliness of information available to the CBN as well as deep understanding of the workings of the foreign exchange market by desk officers of the Bank. The inadequate experience in data analysis and in-depth technical knowledge of the market could make it extremely difficult for these personnel to appreciate the importance of data. The need to upgrade the skill of the stakeholders including customers and finance correspondents becomes imperative. The desk officers must be adequately exposed to foreign exchange dealings and made to identify with the changing banking and commercial world.

In this context, the challenge confronting the authority is in terms of the quality of the desk officers monitoring the operations of the WDAS in the Trade and Exchange as well as Research and Statistics Departments of the Bank, which needs to be strengthened to keep pace with the growing changes in the banking sector. It is high time for the monetary authority to be ahead of the institutions it is supervising, and also be adequately equipped to detect any possible infractions in the foreign exchange market. Data on foreign exchange market activities as well as projection on demand and supply of foreign exchange and its effects on the exchange rate must be generated on periodic basis and thoroughly analyzed to ward-off collusion during the process of determining banks' bidding rate. This must be complemented with transparency of information disclosure by foreign exchange dealers. The transparent reporting of the foreign exchange schedule by banks will help to foster the ethics of good corporate governance and enhance the prospects for effective liberalization of the foreign exchange market.

6.7 The Role of Finance Correspondents

The role of finance correspondents in the sustenance of the new exchange rate system remains crucial. They are expected to generate a credible reporting system that would expose Nigerians and non-Nigerians who are after derailing the process of achieving economic development in the country. The finance correspondents are now confronted with the responsibility of producing accurate information on activities in the foreign exchange market and avoid sensational reporting which could distort the workings of the current exchange rate policy. The recently approved bill on freedom of information is a welcome development which finance correspondents should take advantage of and prepared to face challenges ahead of them. At this point, it is advisable that the CBN work with them as partners in progress and continue to hold regular dialogue. It is only through this approach that the current policy on exchange rate can be well sustained for the realization of the set goals of the government.

6.8 Ensuring Availability of Robust Reserves

One of the necessary and sufficient conditions for effective workings of the floating exchange rate regime is the availability of very large reserves. Robust reserves are crucial ingredient in economic development of any country as it indicates strong national assets on which the country depends. In Nigeria, the rising trend in reserves which is currently being experienced has positive implications for both domestic and international economy. It has contributed significantly to the recent appreciation in the exchange rate. The challenge posed by these very large reserves is for managers (banks) to direct their efforts at ensuring that the management of the available asset reserves to the pursuance of high return is not at the expense of security and liquidity. Reserves managers should endeavor to strike a balance between these conflicting aims given the systemic risks of the international financial market. The involvement of local banks in the management of the country's reserves is an indication of the strong confidence reposed on the domestic financial system. The strive to achieving sustainability of the current exchange rate policy will also depend on the efforts of the government at diversifying its economic base, particularly through promotion of non-oil sector for boosting reserves level. Another subsisting challenge is for the government to strengthen its efforts at attracting foreign investment and increasing capital inflows through guaranteeing conducive political environment and ensuring high social security.

7.0. Summary and Conclusion

The choice of an exchange rate by a given country depends on the policymaker's economic objectives, the source of shocks to the economy and the structural characteristics of that economy. However, the overall consideration for choosing a floating exchange rate is the need to safeguard against destabilizing speculations and the establishment of monopoly positions by some operators in the market. This is because the exchange rate policy is a veritable tool used for directing the trend in domestic prices along a sustainable path. It is also a valuable instrument when used in a proactive manner.

The pursuance of a stable exchange rate is usually an arduous task but requires an optimal policy-mix. It thus poses challenge to the CBN on the need to pursue a stable exchange rate objective as an essential element of its monetary policy even under a flexible exchange rate regime which now dominates the global environment. In addition, the increasing openness of the economy under the impetus of globalization also challenges the CBN to adopt a more skilful approach to the management of floating exchange rate of the naira; otherwise it may cause the depletion in country's external reserves. It is however, expected that an effective management of the current exchange rate policy will help to further strengthen the value of the domestic currency and enhance the confidence on the exchange rate system. Although, the sustainability of the WDAS is an ambitious one, it is however abound with attendant challenges for which the CBN must prepare for thoroughly. The impressive performance of the current exchange rate policy gives the confidence to state that the CBN and other stakeholders are quite prepared to confront these challenges with determination and sincerity.

To recap the main argument in this presentation, let me reiterate that the major challenge noted in this paper for the sustainability of WDAS is to ensure sound macroeconomic environment, fiscal sustainability, improved corporate governance, and effective risk management process. In particular, a sound financial system that will ensure an efficient and stable exchange rate mechanism and contribute to the development of the financial markets need to be guaranteed. In

addition, the concern of many policymakers in adopting a floating exchange rate regime has been the availability of robust reserves. In complement, the exchange rate policy should be backed by implementation of appropriate policies of demand restraint and structural change and by increased resource inflows, especially the type that can be readily fed into the foreign exchange market.

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Table 1

MOVEMENT IN EXCHANGE RATE

2006	WDAS	IFEM	BDC	Parallel
20-Feb	128.07	128.82	145.58	144.75
March	127.43	128.68	145.47	144.63
April	127.19	128.58	147.85	147.03
May	127.18	128.57	142.33	141.52
June	127.18	128.50	136.82	136.02
July	127.11	128.43	130.12	129.55
August	127.06	128.43	130.46	129.96
September	127.02	128.39	130.21	129.71
			130.30	
October	127.01	128.42		129.89

Source: Trade and Exchange Department, CBN, Abuja

Table 2:
MACROECONOMIC INDICATORS

	2002	2003	2004	2005	2006 *
Inflation (%)	12.9	14.0	15.0	11.6	6.1
BOP ($' M)	-4,673.5	-1,258.8	8,452.3	10,366.4	3,804.8
Average Interest Rate (%)	20.6	19.6	18.9	17.8	17.1
Ext. Debt ($'B)	31.0	32.9	35.9	20.5	5.0
External Reserves ($' B)	7.7	7.5	17.0	28.3	41.4
Real GDP Growth (%)	3.5	10.2	6.1	6.2	6.3

***October 2006**

Source: CBN, Abuja

ECONOMICS OF EXCHANGE RATE MANAGEMENT

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I. INTRODUCTION

Exchange rate policy plays an important role in national economic development management. If well managed, it could facilitate the achievement of macroeconomic objectives of rapid economic growth, low rate of inflation, high employment generation, buoyant balance of payment condition, and progressive income distribution. Of all economic policies, it is the most suitable policy for ensuring internal and external balances.

In specific terms, most countries focus attention on exchange rate policy for many reasons. Whatever exchange rate regime adopted has some implications on the prices of goods and services in any economy. This is particularly so for imported commodities and those produced within the economy whose intermediate inputs and raw materials depend heavily on importation. As a tool of correcting internal and external imbalances as well as an instrument of improving the efficiency of resource allocation, governments in many developing countries use exchange rate as the linchpin of any stabilization policy. From all intent and purposes, exchange rate plays an important role in the management of any economy not only in terms of facilitating the achievement of macroeconomic objectives at the domestic end but also in terms of its importance on international trade and investments. The primary objective of foreign exchange policy (FOREX) has therefore become the main motivation for the choice of any exchange rate regime.

The starting point of examining the economics of exchange rate management is therefore to have a better understanding of the specific objectives of exchange rate. This can be grouped into two broad categories: traditional and non-traditional objectives. Traditionally, foreign exchange management in Nigeria is aimed at the following three mutually exclusive objectives:

- Conservation of available foreign exchange resources so as to check expenditure and undue depletion of external reserves;
- Ensuring adequacy of reserves consistent with current and future international commitment; and
- Preserving the value of external reserves through appropriate portfolio diversification and optimal deployment into strong currencies.

The non-traditional objectives include:

- Reduction of excessive demand for foreign exchange;
- Removal of distortions in the economy;
- Stimulation of non-oil exports; and
- Promotion of efficient allocation of foreign exchange resources through: reduction of dependence on imports and oil exports, elimination of unfavourable capital flight and stimulation of inflows of capital, and reduction and possibly elimination of exchange rate misalignment and exchange rate premium. In recent times, achieving exchange rate convergence has therefore become one of the intermediate objectives of central banks in many countries.

The main objective of this paper therefore is to examine the economics of exchange rate management. To address the main focus of this paper therefore, it is structured into five main parts. Following the introduction is section two which examines the conceptual issues in exchange rate management. In the third section, types of exchange rate regimes are examined while section four contains the significance of exchange rate management. Exchange rate management questions are reviewed in section five. Section six draws relevant lessons and concludes the paper.

II. CONCEPTUAL ISSUES

This section addresses key concepts that facilitate the appreciation of the economics of exchange rate management. It serves as the frameworks for contextualizing the focus of the paper.

What is a Foreign Exchange?

#Generically, foreign exchange can be defined as foreign currency or any other financial instruments acceptable as a means of payment or exchange for international transactions. Foreign exchange is made up of convertible currencies that are accepted for the settlement of international transactions - trade and other external obligations.

Specifically, the International Monetary Fund (as cited in Odusola 2002) defines it as the monetary authorities' claims on foreigners in the form of bank deposits, treasury bills, short-term and long term government securities and other claims usable in the events of balance of payments deficits, including non-marketable claims arising from inter central banks and inter-government arrangements, without regard to whether the claim is denominated in the currency of the debtor or creditor.

The Central Bank of Nigeria also defines it as any currency other than the Nigerian currency and includes coins or notes which are, or have at any time been legal tender in any territory outside Nigeria: poster orders, money orders, bills of exchange, promissory notes, drafts, letters of credit and travellers' cheques payable or expressed in a non-Nigerian currency.

What are Foreign Exchange Rates?

Exchange rates are the prices at which currencies trade for each other: spot and forward rates. It is simply the value of a foreign currency expressed in terms of domestic or other currencies. This can further be classified into nominal and real exchange rates. They are often expressed in terms of two currencies: domestic and foreign. Exchange rate can be expressed either in nominal or real terms.

Nominal exchange rate, for instance, can be viewed from two angles: domestic-currency terms and foreign-currency terms. Nominal exchange rate from the domestic-currency term (E_d) is defined as units of domestic currency per unit of foreign currency. From foreign-currency term (E_f), it is the units of foreign exchange per unit of domestic currency. The domestic-currency measure is the reciprocal of the foreign currency term.

Real Exchange Rate (RER): While nominal exchange rate measures the relative price of two moneys, the real exchange rate measures the relative price of two goods.

Real Exchange rate can be defined from both external and internal perspectives:

- External RER is the nominal exchange rate adjusted for price level differences between countries. It is the ratio of the aggregate foreign price level or cost level to the home country's aggregate price level or cost measured in a common currency.
- Internal RER: Measures the relative prices of two broad categories of goods tradable and non-tradable goods: ratio of the domestic price of tradable to non-tradable goods within a single country. The main objective is to capture the internal relative price incentive in a particular economy for producing or consuming tradable as opposed to non-tradable goods.

(i) Bilateral RER (BRER): It comprises the price of a representative consumption or production basket in the home country with similar representative price in a foreign country measured in the same currency. The choice of this simple index RER is usually informed by the existence of a major trading partner, or an association to such currency blocks as the dollar, the franc, the yen, the DM or the euro zones.

(Ii) Effective Real Exchange Rate ($ERER_d$): The use of the term “effective” in describing exchange rate in the literature portends two different meanings. First, it connotes “weighted average”. It is synonymous to multilateral RER (MRER). Second, it connotes incorporation of all forms of taxes charged on imports and exports.

(iii) Multilateral RER (MRER): This is a weighted average of the external real exchange rate index with respect to using multiple trading partners. On the other hand, NMER is nominal multilateral exchange rate in domestic currency term and $NEER_d$ stands for nominal effective exchange rate in domestic currency term between the home country and the major trading partners.

Fundamental Equilibrium Exchange Rate (FEER): As defined by Williamson (1997), it is the real effective exchange rate compatible with simultaneous achievement of internal and external balances in the medium term. By internal balance we mean the highest level of economic activity that is consistent with a desirably controlled level of inflation, based on the existing factor endowments including technology. The concept of external balance refers to determining the level of current account deficit that is consistent with development objectives ensuring sustainable medium term target for the current account. This also connotes improvement of balance of payments position and maintenance of a level of reserve consistent with macroeconomic stability.

What is an efficient foreign exchange market?

This refers to a situation where the prevailing exchange rates fully reflect available information. That is the actual profit in any given period from any arbitrage or speculation activity equals, on the average, the equilibrium expected profits for the time period the actual exchange rate equals the equilibrium exchange rate. Because the current exchange rate adjusts fully to all the information available in the previous period and also adjusts instantaneously to any new information, any positive or negative profit opportunities are easily eliminated.

III. TYPES OF EXCHANGE RATE REGIMES

The literature is replete with many

forms of exchange rate regimes. They are often grouped into the following: fixed, flexible and multiple exchange rate regimes. The salient features of each of these regimes are examined below.

Fixed Regimes: Pegged Exchange Rates

For this regime to achieve the overall objectives of exchange rate management, it must fulfill the following conditions:

- The monetary authorities have the discipline, honesty, and capacity to allocate resources efficiently in line with economic growth objective.
- The economy's capacity to earn foreign exchange can easily support the fixed rate without putting undue pressure on the balance of payment condition.
- The economy has reasonably open capital account to provide necessary incentives for accommodating repatriation of income without causing serious stress to the BOP.
- The relevant authorities have the capacity to effectively check smuggling and control the activities of parallel exchange market operators.

Fixed exchange regimes can take several forms. Some of these are highlighted below:

(i) Domestic currency fixed to a single foreign currency.
(ii) Domestic currency fixed to a basket of currencies, for instance, main trading partners or standardized currency composites such as the European Currency Union (ECU) or the Special Drawing Right (SDR).
(iii) Domestic currency fixed to within pre-established margins.
(iv) Fixed but adjustable peg.

Most countries moved out of pegged exchange rate regime because they were no longer able to meet their convertibility commitment, i.e., when they have run out of reserves. As a matter of fact, countries tend to adopt fixed exchange rate regime when they are relatively buoyant. However, its main drawback is its inability to provide for adequate and systematic reserve growth thereby precipitating balance of payment deficit.

***Flexible Regimes*:** This otherwise called adjustable Exchange Rates regime and can be grouped into three, namely,

(i) Making domestic currency adjustable to selected indicators that are mostly economic fundamentals.
(ii) Adopting managed floating system, which allows exchange rate movements to reflect developments in variables such as reserves and the payments positions.
(Iii) Independently floating system, which reflects the dynamics of market forces.

The adoption of flexible exchange rate tends to coincides with severe economic turmoil. A variant of flexible exchange rate is the ***crawling pegged regime***. This occurs when government allows the value of exchange rate to be determined by market forces, but the adjustment to the appropriate rate is slow and smooth as opposed to quick, abrupt and disruptive. This is particularly a good recipe to countries experiencing hyperinflation. The difference between the foreign and domestic inflation is used to calculate the annual rate of crawl.

Adjustable peg system: Governments having realised that fixed exchange rate is very rigid to manage while floating regime is equally disadvantageous have charted a middle course of action between the two regimes. This regime allows a currency to be fixed, but because the domestic country and its trading partners have different inflation rates, periodic official parities are allowed in order to bring exchange rate to its appropriate level (Dernburg, 1989).

Multiple Exchange Rate Regimes (MERS)

A multiple exchange rate regime is any exchange rate regime that applies two or more exchange rates to the same currency:

❖ a system involving one or more fixed exchange rates for current account transactions; and
❖ one or more floating or market driven for capital transactions.

- Primary motivations for adopting MERS are to:
- Insulate domestic prices and economic activities from exchange rate fluctuations deriving from transitory shocks in the financial market.
- Protect international reserves and avoid substantial devaluation in the face of severe balance of payment difficulties.

This regime is, however, saddled with some problems:

- Because parallel exchange rate is often more depreciated than the official one, there is the temptation of not adjusting the official exchange rate when it needs to be adjusted, allowing it to become increasingly overvalued and the economy decreases in competitiveness.
- It is difficult to prevent leakages from one market into the other round tripping effects. This is often the source of multiple system breakdowns.
- It creates incentives for cheating and can blur the line between legal and illegal activities.

Over the past four decades, Nigeria has experimented with different forms of exchange rate regimes. In the 1960s, fixed regime was experimented before shifting to pegged arrangement in the 1970s up till June 1986 when the structural adjustment programme (SAP) was introduced. Since this time, however, different forms of floating approaches (freely, dirty and stinking) have been experimented with. During this period there was no commitment to defending the parity of naira to any currency.

Generally, the primary objectives of adopting fixed or pegged regimes are to ensure a low rate of inflation in the economy, reduce transaction costs of international trade, promote exchange rate stability and reduce domestic economy's exposure to external shocks. . To achieve this, exchange rate regulation was

promoted and enforced. The experience had however shown that exchange rate control engendered substantial distortions in the economy. Apart from promoting rent seeking activities that culminated into sharp prices in the foreign exchange market, it changed the consumption pattern of Nigerians with predilection for foreign goods. Consequently, this led to massive importation of finished goods with its impact on current account deficits, de-industrialization of the economy through closure of local industries as a result of weak demand for locally produced goods. In addition to this, naira became unduly overvalued particularly during the oil boom era and there was massive exchange rate misalignment. In the process of defending the exchange rate parity, the monetary authorities lose its monetary policy discretion and to large extent the foreign reserves were depleted.

The need to avoid the foregoing limitations coupled with the need to promote foreign direct investment in the country, reduce heavy dependence on imported goods, and diversify the economy, a floating exchange regime was adopted at the outset of SAP in 1986. During this regime, monetary policy discretion in maintaining effective exchange rate system was achieved, achievement of appreciable monetary policy independence, building up of external reserves, among others. The major shortcomings of the adoption of this regime in Nigeria include persistent exchange rate volatility, high inflation and high transaction costs on international trade.

It is important to note that in spite of the experimentation with the various exchange rate regimes, the productivity of the domestic economy is yet to be achieved. The real sector of the economy remains un-rejuvenated, the diversification of the economy away from the oil sector remains highly elusive and achieving international competitiveness remains daunting challenge. The main challenge however is that exchange rate volatility and instability is not congenial to promoting domestic investment, foreign inflows of capital and transformation of the real sector of the economy.

IV. ECONOMIC SIGNIFICANCE OF EXCHANGE RATE AND MANAGEMENT

The economic significance of exchange rate and its management is anchored on the goals of exchange rate policy in any economy. In specific terms, the critical ones are as highlighted below.

- ***Special price for resource allocation:*** As a relative price, it plays an important role by performing resource allocation function within an economy. It also serves as a major direct link with other sectors of the economy, as well as link the general price level within the economy with prices in the rest of the world.
- ***Lower commercial and currency transaction costs***: Effective management of exchange rate particularly among countries of strong trade links offers opportunities for seamless trade through lower commercial and currency transaction costs. If a particular currency regime leads to an economic upswing in countries where the currency is predominantly used, it could boost that region's output and demand for imports. In turn, this could benefit the economies of countries' trading partners.
- ***Facilitate access to investors and financial market***: Predictable and credible exchange rate management also offers distinct advantages of "more commercial outlets”. This creates one of the conditions to attract more investors and access to financial market of the hard currency origins. In fact, there is a close linkage between the implementation of 'sound and convergent economic and financial policies' and access to foreign investors and financial markets. This is however contingent on institutional investors' (such as pension fund and insurance companies) eagerness to diversify their portfolios by moving some of their funds to the affected country. Traditionally, borrowers from countries maintaining good exchange rate management would find that they could raise funds more easily and at cheaper rates in the deeper, more competitive financial markets where their currency is tied. Experience has however shown that this is dependent on pursuit of sound macroeconomic policies and the ability to strengthen the domestic financial systems.

- ***It is a tool of macroeconomic management***: As a major tool of economic stabilization, exchange rate policy and its management affect an economy through three main channels:

  - Expenditure-reducing effects: As a way of reducing deficit from current account balance, exchange rate is used to discourage imports especially those goods that can be sourced locally.

  - Expenditure-switching effects: Exchange rate is often used to discourage spending on goods and services that serve as drains on the balance of payment position while at the same time encourage those that add to foreign exchange earnings. Specifically, it facilitates switch in domestic demand from tradable to non-tradable, i.e., goods that are produced and consumed at home. In Many countries, it is used as a tool of industrialization by encouraging value added exports.

  - Domestic currency price of imported intermediate inputs: As a major source of imported inflation, exchange rate management brings stability into domestic prices which are mostly import dependent due to heavy reliance on imported raw materials and intermediate inputs. In this regard, it reduces the fluctuations associated to variability of exchange rates.

- ***Other specific importance***

of exchange rate include:

It is very useful for determining the status of any currency; whether it is overvalued or undervalued. Besides, it also serves as an economic management signal where continuous appreciation suggests devaluation of the nominal exchange rate while depreciation provides signals for potential competitiveness.

It is a veritable tool of effecting external adjustment by ensuring competitiveness and avoiding real exchange rate misalignments. The strength of a country's competitive position in international trade is determined by its real exchange rate. This occur when the domestic currency depreciates or foreign inflation rises or domestic inflation falls or a combination of two or more of the above scenarios. As earlier mentioned, it is equally a tool of resource allocation. Through this, it influences the pattern of domestic production and expenditure. It switches domestic consumption from imported goods to those produced at home and encourages local producers to produce goods for exports that are relatively cheaper than what it used to be prior to deregulated exchange rate regimes.

V THE EXCHANGE RATE MANAGEMENT QUESTIONS

In examining the economics of exchange rate management in any country, some key issues need to be understood: the choice of the exchange rate regime and its level. Since the adoption of the Structural Adjustment Programme (SAP) in Nigeria in 1986, the choice of exchange rate regimes has been questioned by many analysts without any recourse to the economics of it. As a starting point, therefore, it is important to ask why the government chooses some exchange rate regimes over others? Second, what is the motivation behind the targeting of certain exchange rate levels? To complement the foregoing questions, the third question becomes imperative: why in spite of serious unfavourable and undesirable effects, governments refused to abandon the prevailing exchange rate regime? These constitute the exchange rate issues or questions. Answers to these questions, to a large extent, provide explanation to the economics of exchange rate management in any economy.

Choice of Exchange Rate: The choice of the exchange rate regime is often polarized between the obvious extreme alternatives of *fixed* and *pure floating*. There are several intermediate categories between these two extremes like fixed with discrete realignments, crawling pegs, bands, and dirty floating. By choosing one exchange rate regime, simultaneously other underlying objectives are also being selected. In practice, the most common trade off is between *volatility* and *flexibility*. In countries with moderate inflation, a fixed exchange rate is assumed to reduce volatility in the real exchange rate (RER) to the extent that prices are one order of magnitude less volatile. This however, limits government's ability to counteract non-anticipated real shocks.

A flexible exchange rate, on the other hand, allows countries to implement discretionary policy to react to real shocks but it is usually associated with a higher degree of RER volatility. However, in countries that have experienced high and chronic inflation, the relationship between real and nominal exchange rate volatility apparently breaks up: an increase in the volatility in the nominal exchange rate does not necessarily imply an increase in volatility of the real exchange rate.

Hence, the volatility-flexibility trade off is no longer valid to explain the selection of a particular exchange rate regime and other factors needs to be taken into account to explain such choice. Furthermore, to the extent that inflation does not converge to international levels, the choice is not primarily between volatility and discretion, but between *competitiveness* and *inflation*. A fixed exchange rate provides a nominal anchor that can help to build the credibility necessary to fight inflation. But at the same time a pegged rate results in real appreciation that can jeopardize the viability of external accounts.

Motivation for targeting a particular exchange rate level: There are different motivations for targeting a particular level of exchange rate. Countries often target a more depreciated exchange rate in order to increase competitiveness or to solve a balance of payments crisis. It is often used as a tool of economic stabilization via *demand contraction* and *expenditure switching* frameworks. Exchange rate depreciation, to a large extent is primarily based on the need to address deviations from productivity adjusted purchasing power parity (PPP). It is usually aimed at enhancing domestic productivity towards value added exports, i.e., to increase the scope of tradable in the economy.

Exchange rate policy has been at the service of multiple and often-contradictory purposes, namely:

- ❖ sometimes as a nominal anchor to fight inflation
- ❖ sometimes as an instrument to promote international competitiveness
- ❖ as an important relative price within a set of policies aimed to industrialize an economy
- ❖ an instrument for creating an outward -oriented economy.

Experiences from many countries have however shown that exchange rate targeting is often done at the expense of higher inflation.

VI ISSUES, LESSONS AND CONCLUSION

One of the critical issues in the management of foreign exchange is to know the main determinants of exchange rate management in the country. Many factors come to mind on this issue. In addition to

pressure from international financial institutions that often exert pressure on developing countries to adopt sound macroeconomic policies, external shocks also impose some serious constraints on monetary authorities. Critical among these external shocks are *deteriorating terms of trade* and change in *international interest rates*.

Another factor is to maintain a *good orientation with the overall policy framework*. This is about ensuring an internal consistency on development policy management. Other factors include non-policy induced openness, measure of productivity, and long term capital flows. An obvious issue in the emerging literature is that targeting a more depreciated exchange rate to increase competitiveness or to solve a balance of payments crisis is usually done at the expense of higher inflation. Consequently, most countries often immersed in inflation-devaluation/depreciation spiral.

The main objectives of foreign exchange management can only be achieved if exchange rate is stable; devoid of undue volatility and oscillations. The term stability does not connote static condition but a situation that permits variability in response to changes in the market fundamentals, e.g., changes in relative prices, international terms of trade and other factors that impinge on the price competitiveness of the domestic market agents and products. It also connotes variability within a range that does not distort the planning process of market agents. Exchange rate volatility can lead to de-capitalisation of the economy and possibly de-industrialisation.

The sustainability of the current exchange rate stability and the convergence of the official and parallel markets need to be taken very seriously. What seems to be a stable issue now may turn out to be something else when the oil boom era is over. As such there is need for the main goal of exchange rate policy to be synchronised with other macroeconomic objectives of government. For the current exchange rate policy to be sustainable there is need for proactive programme of economic diversification. The economy should be moved away from depending solely on oil oriented-foreign earnings to non-oil. The current diversification index with an annual average of about 1.3 is abysmally low when compared with countries such as Algeria (5.5), Egypt (about 20 in recent times), Morocco (36) and Tunisia (28).

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EFFECTIVE RESERVES MANAGEMENT IN NIGERIA: ISSUES, CHALLENGES AND PROSPECTS

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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:

Accumulation Vs Spending

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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EXCHANGE RATE STABILITY AND POVERTY REDUCTION IN NIGERIA[1]

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Introduction

Nigeria's economy is growing at an impressive rate compared to the historical. This reflects in part increased investor confidence due to the improvements in macroeconomic management and positive dividends of the new found economic direction and general political stability. However, the renewed optimism is unlikely to be sustained if appreciable progress is not made to advance growth, general macroeconomic stability and poverty reduction.

The increased awareness of the need to tackle poverty has focused attention on the role of macroeconomic policy in achieving social as well as macroeconomic objectives. However, the preservation of macroeconomic stability is important, not as an end to itself, but as a necessary precondition for sustained economic growth, which is the single most important factor influencing poverty reduction. Without a disciplined macroeconomic stance, the achievement of sustained economic growth and social objectives becomes much difficult. With responsible growth which embraces both environmental sustainability and social development, human welfare is increased through improved consumption, human capital, social equity, all of which target poverty reduction.

In order to formulate sustainable macroeconomic and social policies, there is a need to understand the diversities in the country, the social context and how they are linked to poverty and livelihoods. Macroeconomic policies are those policies that have direct or indirect impact on key variables such as the inflation rate, the exchange rate, the external current account balance, the fiscal deficit or the level of international reserves. These policies are primarily fiscal, monetary, or relate to the exchange rate. They are usually formulated with a view to their impact on the economy as a whole, rather than on individuals, groups or sectors. However, a given policy change may have differential impacts on different groups. Structural policies on the other hand, aim at improving the efficiency of resource allocation; strengthening economic incentives; removing impediments to the smooth function of markets and to private sector development; and expanding the overall productive capacity of the economy.

Exchange Rate Basics

Money serves as a medium of exchange that simplifies transactions between millions of people interacting in a market place. Transactions between people who live in different countries use different mediums of exchange. Cross-border transactions therefore typically require a corresponding exchange of one currency for another. An exchange rate describes the price of one currency in terms of another.

The ***nominal exchange rate*** between two countries is the one country's currency in terms of the other country's currency. It is the domestic currency units per unit of foreign currency. So the Nigerian naira/U.S. Dollar exchange rate is given as 129 Naira per U.S. Dollar instead of 0077519 Dollars per Naira. Nonetheless, we can multiply the price of a good denominated in foreign currency by the nominal exchange rate to convert it to domestic currency terms; we can divide the price of goods denominated in domestic currency by the nominal exchange rate to convert them to foreign currency terms. An increase in the nominal exchange rate is called depreciation of the domestic currency, i.e. the Nigerian Naira has decreased in value (more naira are needed to buy one unit of foreign currency). A decrease in the nominal exchange rate is an appreciation of the domestic currency, i.e. the naira has increased in value (fewer naira are needed to buy one unit of foreign currency.)

Changes in the exchange rate change the relative price of goods in two countries. However, the nominal exchange rate is not the only variable that affects the relative price of goods in two countries, the price levels in each country matter as well. Hence the use of real exchange rate to

[1] *The content of this paper does not in any way represent the views of the World Bank but are solely the responsibility of the author.*

compare prices in two countries. I will use the symbol **R** to denote the real exchange rate, which can be defined as

$$R = \frac{eP^*}{P}$$

R is the relative price of foreign goods and can be further elaborated as

$$R = \frac{\$/\text{foreign currency* foreign currency price of goods}}{\$\text{ price of domestic goods}} = \frac{\$\text{ price of foreign goods}}{\$\text{ price of domestic goods}}$$

An increase in **R** is known as a depreciation of the real exchange rate (foreign goods become more expensive) and a decrease in R is an appreciation of the real exchange rate (foreign goods become cheaper). However, nominal exchange rate appreciation can cause real exchange rate appreciation, all else equal, i.e. if relative prices in the two economies do not change. Also, changes in prices can cause the real exchange rate to fluctuate without an underlying change in the nominal exchange rate. An increase in domestic prices, all else equal, will cause the real exchange rate to appreciate; a decrease in foreign prices, all else equal, will cause a real exchange rate appreciation. A decrease in domestic prices, all else equal, will cause the real exchange rate to depreciate, but an increase in foreign prices, will also cause a real exchange rate depreciation.

Exchange Rate Policy

Allowing for an overvalued currency to depreciate can enhance export competitiveness and raise the local currency income of exporters. However, the cost of imported inputs and consumables (and, possibly, of services such as urban transport) will also rise, leading to an erosion of the real purchasing power of household incomes. Changes in exchange rates will thus have both income-raising and price-raising effects, giving rise to net benefits or detriments that differ across socioeconomic groups. Key factors that determine the net impact are the composition of the consumption basket and who purchases what within the household. For example, women may not benefit as much as men from a depreciation/devaluation[2]. Real earnings in the informal sector (where more women than men are employed) and nontraded sector may fall, affect overall consumption and welfare. The urban poor may be more adversely affected as consumers, but may also benefit if their output is exportable or is an import substitute.

There is also some social impact arising from various exchange rate policies. For instance, in the area of health care, increased costs of imported medicines may lead poor people to use more traditional local medicines or go untreated. These differential impacts mean that attenuating measures may be necessary to protect some vulnerable groups, even though the net benefit for the society as a whole remains positive.

Classifying Regimes

Beyond the traditional fixed-floating dichotomy lies a spectrum of exchange rate regimes. The de facto behavior of an exchange rate, moreover, may diverge from its de jure classification.

While it is customary to speak of fixed, stable and floating exchange rates, regimes actually span a continuum, ranging from pegs to target zones, to floats with heavy, light, or no intervention. The traditional dichotomy can mask important differences among regimes. Accordingly, this analysis uses a three-way classification: pegged, intermediate (i.e., floating rates, but within a predetermined range), and floating.

Regimes can be classified according to either the publicly stated commitment of the central bank (a *de jure* classification) or the observed behavior of the exchange rate (a *de facto* classification). Neither method is entirely satisfactory. A country that claims to have a pegged exchange rate might in fact instigate frequent changes in parity. On the other hand, a country might experience very small exchange rate movements, even though the central bank has no obligation to maintain parity.

Inflation

Pegging the exchange rate can lower inflation by inducing greater policy discipline and instilling greater confidence in the currency. Empirically, both effects are important.

Policymakers have long

[2] *Women are often involved in the food crop sector and will have to face higher costs of transportation, fertilizers, and other imported inputs. These higher costs may also raise food prices, again affecting women, who are responsible for feeding the family within the household. A currency depreciation may make export crops, usually under the control of men, more profitable, but may not benefit the household as a whole since income may not be pooled. Meanwhile, women are responsible for buying food and medicines with their own resources, which may not have increased in value.*

maintained that a pegged exchange rate can be an anti-inflationary tool. Two reasons are typically cited. A pegged exchange rate provides a highly visible commitment and thus raises the political costs of loose monetary and fiscal policies. To the extent that the peg is credible, there is a stronger readiness to hold domestic currency, which reduces the inflationary consequences of a *given* expansion in the money supply.

Inflation Performance

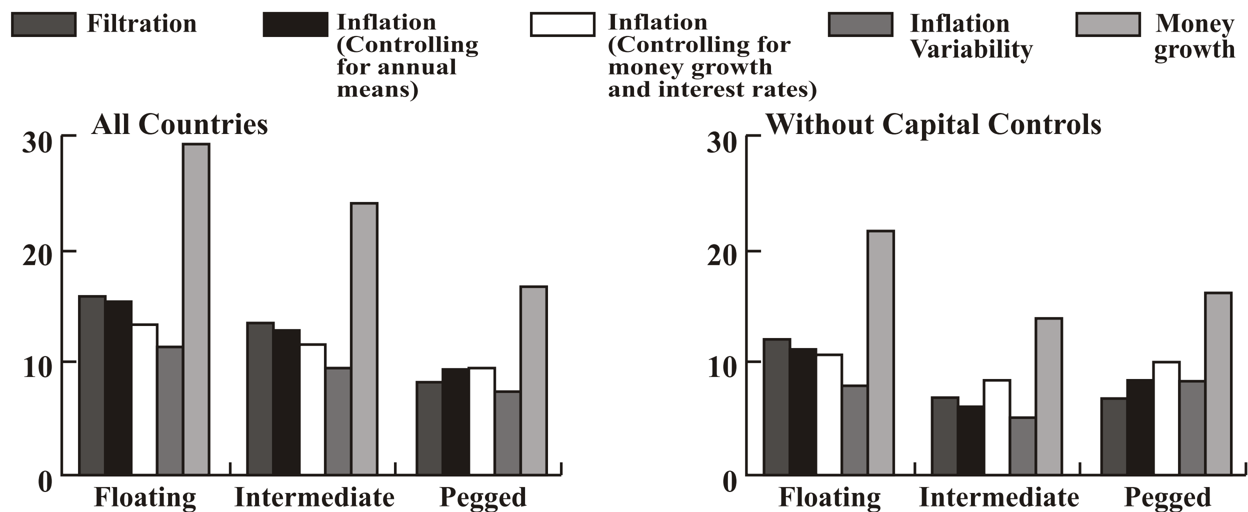
Inflation over our sample averaged 10 percent a year, with pronounced differences in various exchange rate regimes (Chart 1). Countries with pegged or stable exchange rates had an average annual inflation rate of 8 percent, compared with 14 percent for intermediate regimes, and 16 percent for floating regimes.

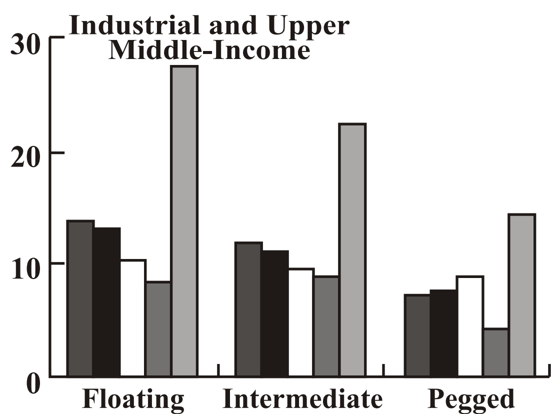
The differences among regimes are starker for the lower-income countries, where the differential between pegged and floating rates was almost 10 percentage points. As might be expected, countries without capital controls tended to have lower inflation in general. Even for these countries, however, inflation was lower under pegged regimes compared with either intermediate or floating exchange rates.

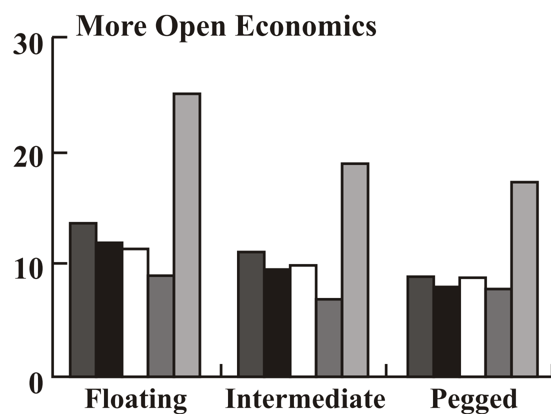
Although inflation performance is generally better under pegged exchange rates, the last panel in Chart 1 illustrates an important caveat: mere declaration of a pegged exchange rate is insufficient to reap the full anti-inflationary benefits. Countries that changed their parity frequently--though notionally maintaining a pegged exchange rate--on average experienced 13 percent inflation. While this is still better than the performance under nonpegged exchange rates (17 percent), it is significantly worse than countries that maintained a stable parity (7 percent).

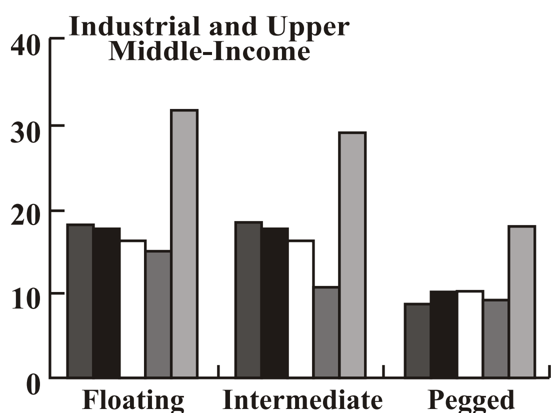
Since there was a preponderance of pegged exchange rate regimes in the 1960s--when inflation rates were low--the association between low inflation and pegged rates might be more an artifact of the general macroeconomic climate than a property of the regime itself. One way to purge the data of such effects is to measure inflation rates for each regime relative to the average inflation rate (across all regimes) in that year. Doing so, however, leaves the story largely unchanged: as

Chart 1. Inflation Performance
(In percent per year)









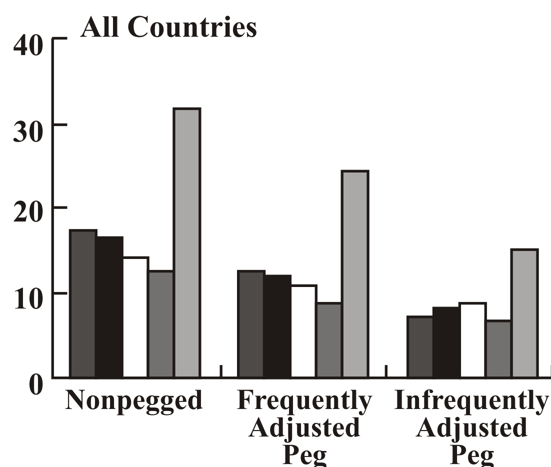


Chart 1 shows, under pegged rates, inflation was 3 percentage points lower than under intermediate and 6 percentage points less than under floating regimes. Again, countries with only occasional changes in parity fared significantly better than those with frequent changes.

Explaining the Differences

What accounts for these results? They derive, in fact, from two separate effects. The first is discipline. Countries with pegged exchange rates have lower rates of growth in money supply, presumably because of the political costs of abandoning a peg. The growth of broad money (currency and deposits) averaged 17 percent a year under pegged exchange rates compared with almost 30 percent under floating regimes. This difference holds regardless of the income level of the country.

In addition, for a *given* growth rate of the money supply, higher money demand (the desire to hold money rather than spend it) will imply lower inflation. Pegged exchange rates, by enhancing confidence, can engender a greater demand for the domestic currency. This will be reflected in a lower velocity of circulation and a faster decline of domestic interest rates. In the extreme case of perfect credibility, domestic interest rates--even in countries with a history of high inflation--should fall immediately to the world level. Over the sample period, nominal interest rates have tended to rise, but the rate of increase for countries with floating rates was almost 6 percent, as against 2 percent for countries with pegged rates. It was actually highest for countries with intermediate regimes, where the growth rate of interest rates was almost 9 percent. A change in nominal interest rates is of importance because a fall in these rates will lead to a stronger demand for money. But the level of real interest rates (i.e., the nominal rates adjusted for inflation) also gives a direct measure of confidence. On average, the real interest rates were 0.2 percent a year under pegged regimes, 1.8 percent under intermediate regimes, and 2.3 percent under floating regimes.

For a variety of reasons--including interest rates that are set by the authorities rather than being determined by the market--the greater confidence that pegged exchanges can bring may not be fully reflected in the observed domestic interest rate. Nonetheless, it is possible to identify the "confidence effect" of various regimes by considering the residual inflation once the effects of money expansion, real growth, and domestic interest rates have been removed. A higher residual inflation implies lower confidence.

Do pegged rates lead to greater confidence? They do. Chart 1 shows the residual inflation rates. Countries with pegged exchange rates had inflation 2 percentage points lower than those with intermediate regimes, and 4 percentage points lower than those with floating regimes. This differential in favor of pegged rates is as large as 6 percentage points in the lower-income countries, but only 3 percentage points for countries without capital controls--perhaps because abjuring capital controls itself inspires confidence in the domestic currency.

Not only do countries with pegged exchange rates have lower inflation on average, they are also associated with lower inflation variability.

Growth

The exchange rate regime can influence economic growth through investment or increased productivity. Pegged regimes have higher investment; floating regimes have faster productivity growth. On net, per capita GDP growth was slightly faster under floating regimes.

Economic theory has relatively little to say about the effects of the nominal exchange rate regime on the growth of output. Typically, arguments focus on the impact on investment and international trade. Advocates argue that pegged exchange rates foster investment by reducing policy uncertainties and lowering real interest rates. But equally, by eliminating an important adjustment mechanism, fixed exchange rates can increase protectionist pressure, distort price signals in the economy, and prevent the efficient allocation of resources across sectors.

Growth Performance

Annual GDP growth per capita averaged 1.6 percent over our sample. Although differences exist across exchange rate regimes, these are generally less marked than the differences in inflation rates (Chart 2). Different samples, moreover, lead to varied conclusions about growth under fixed and floating exchange rates. Growth was actually fastest under the intermediate regimes, averaging more than 2 percent a year. It was 1.4 percent a year under pegged exchange rates and 1.7 percent under floating rates. This pattern emerges mainly because of the lower middle-income and low-income countries; growth was somewhat higher under pegged rates for the industrial and upper middle-income countries.

Just as inflation was generally lower in the 1960s, growth rates tended to be higher. Controlling for this widens the differential in favor of floating exchange rates to 0.8 percent over all countries, and as much as 1.5 percent for the lower-income countries.

Explaining the Differences

By definition, economic growth can be explained by the use of more capital and labor (the factors of production) or by residual productivity growth. This productivity growth reflects both technological progress and--perhaps more important--changes in the economic efficiency with which capital and labor are used.

Investment rates were highest under pegged exchange rates--by as much as 2 percentage points of GDP--with the largest difference for the industrial and upper middle-income countries and almost none for the lower-income countries. With higher investment rates and lower output growth, productivity increases must have been smaller under fixed exchange rates.

Part of the higher productivity growth under floating rates is reflected in faster growth of external trade. Trade growth (measured as the sum of export growth and import growth) is almost 3 percentage points higher under floating rates. The lower-income countries--where real exchange rate misalignments under fixed rates have been more common--show an even larger difference in trade growth between pegged and floating exchange rates.

While not overwhelming, the evidence suggests that fixing the nominal exchange rate can prevent relative prices (including, perhaps, real wages) from adjusting. This lowers economic efficiency. Part, though not all, of this lower productivity growth is offset by higher investment under pegged exchange rates. A comparison of countries that switched regimes shows that a move to floating exchange rates results in an increase of GDP growth of 0.3 percentage points one year after the switch and of more than 1 percentage point three years after the switch. One manifestation of the rigidities that pegged exchange

rates can engender is the higher volatility of GDP growth and of employment. As the last rows of Charts 7-12 indicate, GDP growth was more volatile under pegged exchange rates, as was employment.

Poverty in Nigeria

Poverty has been defined in various ways. These include the inability to attain a minimum standard of living (World Bank, 1990) and in "relative" (e.g., unable to buy a pre-specified consumption basket) and "absolute" terms (i.e. below US $ 1 per day per person), among others. There are different types of poverty, that is, income poverty and basic needs (food, education, health care etc.) poverty. While poverty in the developed countries is basically income determined, in the developing countries, it is, in addition, the result of deprivation and lack of access to basic services (e.g. safe drinking water, health care, education and housing). Other dimensions of poverty are cultural, climatic, ecological and historical.

The relative conceptualization of poverty is largely income based. Accordingly, poverty depicts a situation in which a given material means of sustenance, within a given society, is hardly enough for subsistence (Townsend, 1962). It is important that poverty must be conceived, defined and measured in absolute quantitative ways relevant for policy analysis. Poverty in Nigeria is widespread and deep. The country progressively slipped from being one of the middle-income oil producing countries in the late 1970s and early 1980s to one of the lowest-income countries in the early 1990s. Moreover, the 2004 edition of the UNDP's Human Development Report placed Nigeria in the 151st position, based on the Human Development Index. Casual evidence of the growing intensity of poverty in the country can be glimpsed from rising incidence of mass unemployment, urban vagrancies and homelessness among the poorest groups, diminished access to quality foods and nutrition, health-care and educational facilities, and the rising incidence of street begging, among others. Other factors that encourage and can aggravate poverty, especially in low-income countries include poor governance and corruption.

Concern about poverty in Nigeria is very great: The Nigerian situation is a paradox. It is a rich country inhabited by poor people-poverty in the midst of plenty. The country is richly endowed with a diversity of human and natural resources from which the bulk of its wealth is derived. The immense waste of human resources in Nigeria due to poverty can be partly attributed to the unhealthy state of the Nigerian economy. The growth rate of the real gross domestic product of Nigeria since the early 1990s has not been encouraging. The rates have been very low in the last five years. From the rate of 8.3 percent in 1990, it declined to 1.0 percent in 1994 and then rose to 2.2 percent in 1995 and to 3.7 percent in 1997. By 1998, it dropped to 2.6 percent and gradually increased to 3.9 percent in 2001, but by 2002, it had dropped again to 3.3 percent, (see table 2.2). These figures, when viewed in comparison to the population growth of an average 2.8 percent (UNSN, 2001) per annum, leave little room for substantial improvement in living standards. A petroleum and gas producing country, Nigeria has, since the mid-1970s, been heavily dependent on revenue from crude oil for much of its domestic and foreign expenditure requirements. As Table 2.2 illustrates, crude oil export has accounted for over 95% of the country's total export earnings over the past two decades. The country currently (2004) produces 2.65 million barrels of crude oil per day, which, at the prevailing international prices of $53-$54 per barrel, represent a huge resource inflow. The contribution of the primary sector has remained relatively stable over the period, 52.2 per cent in 1990 to 52.3 percent in 1999 and 47.8 percent by 2002, while that of the secondary sector has consistently declined from 1991 except for 2002 when it rose slightly to 10.5 percent. The tertiary sector's contribution has increased marginally over the years, from 37.2 per cent in 1990 to 39.4 percent by 1999. It rose to 45.2 percent in 2000 before declining to 41.7 percent by 2002. The diversification index has remained relatively stable, suggesting that no fundamental structural changes have taken place in the country.

Causes of Poverty

The worsening of poverty in Nigeria has been traced to several factors: poor and inconsistent macroeconomic policies, weak diversification of the economic base, gross economic mismanagement, weak intersectoral linkages, persistence of structural bottlenecks in the economy, high import dependence and heavy reliance on crude oil exports, are high on the list of its causes. Other factors include the long absence of democracy and the usurpation of political power by the military elite, lack of transparency and high level of corruption, declining productivity and low morale in the public service, as well as ineffective implementation of

relevant policies and programmes (UNSN, 2001).

The basic causes of poverty in Nigeria have been identified to include, inadequate access to employment opportunities for the poor, lack or inadequate access to assets such as land and capital by the poor; inadequate access to the means of fostering rural development in poor regions; inadequate access to markets for the goods and services that the poor produce; inadequate access to education, health, sanitation and water services; the destruction of the natural resource endowments which has led to reduced productivity of agriculture, forestry and fisheries; the inadequate access to assistance by those who are the victims of transitory poverty such as droughts, floods, pests and civil disturbances and inadequate involvement of the poor in the design of development programmes. These multidimensional causes of material and non-material deprivation make poverty to be very endemic in Nigeria (FOS, 1996)

.

Similarly, poverty in Nigeria has geographical and gender perspectives. According to the UNDP (2001), the poverty level in Nigeria is lowest in South East (53.5 per cent), and highest in the North West (77 per cent). The agricultural sector has the highest population of poor people, increasing from 31.5 per cent in 1980 to 70 per cent in 1996 (FOS, 1999). Findings from the poverty and development study conducted by the CBN/World Bank (1999) indicated that women are more prone to poverty than men. The study asserted that the consequences of being a woman in Nigeria include the following: the likelihood of having fewer opportunities than men; of coping with the material aspects of well being; of having very limited strategies and safety nets; and of constantly living with a sense of insecurity. While poverty tends to cluster geographically, there are other macroeconomic shocks that affect poor households in every region. Among them, inflation has been identified as one significant cause of poverty deepening. The inflation rate has been growing rapidly since 1990, as shown in Table 2.2. From a figure of 7.4 percent in 1990, it increased to 72.8 percent in 1995. The rate dropped substantially to 6.6 percent in 1999 and by 2002, it had increased to 12.9 percent, which was still lower than the 18.9 percent recorded in 2001(CBN, 2002). The implication of this is that the purchasing power of the poor has been eroded over the years and consequently aggravated the poverty phenomenon among the poor. The continued pressure on the price level may be attributed to the high government fiscal deficit financed largely by the CBN2, which resulted in excess liquidity in the banking system and a substantial increase in domestic aggregate demand. Other factors were increases in production costs, including interest rates and high transportation costs, arising from a sharp rise in the price of petroleum products. The rise in the price level was mainly induced during this period by the depreciation of the Naira exchange rate and the excessive growth in domestic liquidity (CBN, 2002).

According to the NLSS 2004, the incidence of poverty in Nigeria, using the three objective measures, viz: relative poverty line, absolute poverty line and one dollar per day measure, declined compared to the 1996 figures. The three measures show the incidence of poverty as ranging from 51.6 per cent (one dollar per day measure to 54.7 per cent (absolute poverty line). The incidence of poverty (also known as poverty headcount) is the proportion of the population whose consumption falls below the poverty line.

The poverty incidence reduced from 65.6 per cent in 1996 to 54.7 per cent in 2004 but the number of poor people increased substantially from about 67 million to 71 million using the absolute poverty line index. Moreover, the results of the people's self-assessment of their own poverty status indicate over 75.0 per cent poverty incidence. In other words, three out of every four Nigerians believe that they are poor, thus creating doubts on the observed poverty reduction.

Nigeria: Population and Poverty Incidence Trends

Year	Estimated Total Population (million)	Poverty Incidence (Per cent)	Population in Poverty (million)
1980	65	28.1	18.26
1985	75	46.3	34.73
1992	91.5	42.7	39.07
1996	102.3	65.6	67.11
2004	126.3	54.4	68.70

Table 2: Nature of Poverty Incidence[3]

	Extreme poor	Moderate poor	Non poor
National	22.04	32.38	45.58
Urban	15.64	27.54	56.81
Rural	27.08	36.19	36.73

Table 3: Poverty Incidence by Gender of Household Head[4]

	Male Headed		Female Headed	
	Poor	Non Poor	Poor	Non Poor
All	56.49	43.51	36.54	63.46
Urban	44.28	55.72	34.77	65.23
Rural	65.90	34.10	38.23	61.77

[3] *Table 2 shows that both extreme poverty and moderate poverty are higher in the rural sector than in the urban sector.*

[4] *Table 3 shows that male-headed households have more poverty on the average than female-headed households at the national level as well as in the rural and urban sectors*

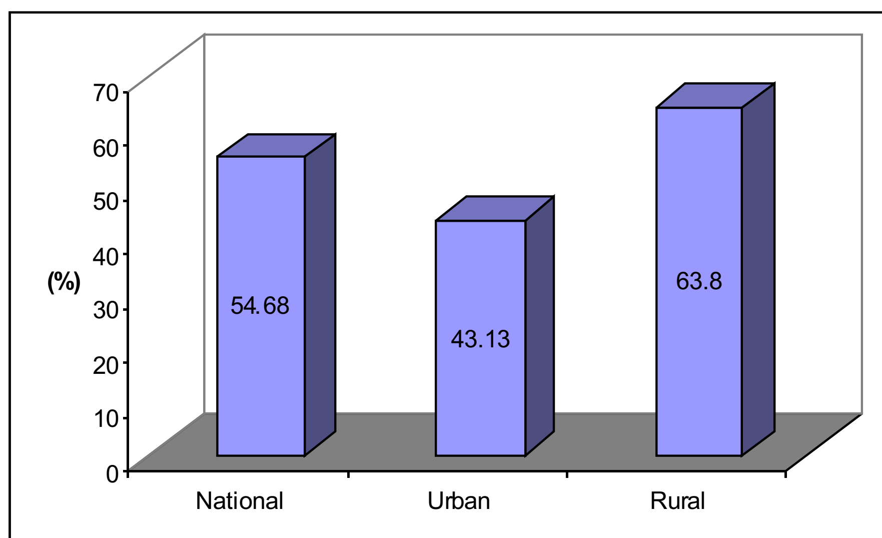
Table 4: Poverty Incidence by Different Poverty Lines

Poverty line	Poor	Non-poor
Relative poverty line	54.41	45.59
Absolute poverty line	54.68	45.32
One dollar per day poverty line	51.55	48.45
Self Assessment	75.50	24.50

Nevertheless, perhaps, the reduction in poverty incidence is due to the observed improved growth rate in recent years. But in the absence of time series data on inequality, it is not clear if improvement in inequality contributed to the observed reduction in poverty. Also, data limitation prevents a definitive statement as to whether or not the growth is pro-poor. The point though is that the relatively high economic growth between 1997 and 2004 succeeded in lifting out of poverty only 17 persons out of every 100.

Poverty in Nigeria is largely a rural phenomenon. The incidence of poverty as well as its depth and severity are higher in the rural areas then in the urban areas. More than half of rural households are absolutely poor while the proportion is much less in the urban areas. The high incidence of poverty in the rural areas is due to their dependence on low productivity agriculture, lack of access to opportunities and poor social and economic infrastructure.

Figure 2:1 Poverty Incidence in Nigeria



Exchange Rate Stability

Exchange rate stability refers to the lack of movement over time (usually two years) of the exchange rate of a country. It requires the observance of the normal fluctuation margins provided by the Exchange Rate Mechanism for at least two years, without devaluing against the currency of any other member state, on its own initiative, and without severe tensions. Exchange rate stability is one of the principal factors for any successful effort to increase private sector development, economic growth and macroeconomic stability. Although it is difficult to prove, macroeconomic instability has generally been associated with poor growth performance. Without macroeconomic stability, without exchange rate stability, growth in

investment will be frustrated because foreign investors will stay away and resources will be diverted elsewhere.

Macroeconomic policies influence and contribute to the attainment of rapid, sustainable economic growth aimed at poverty reduction in a variety of ways. By pursuing sound economic policies, policymakers send clear signals to the private sector. The extent to which policy makers are able to establish a track record of policy implementation will influence private sector confidence, which will, in turn, impact upon investment, economic growth , and poverty outcomes.

Macroeconomic volatility and high output fluctuation, resulting from exogenous shocks and instable policy regimes, may impact on poverty (Breen/Garcia-Penalosa 1999). The income of the poor may be affected by a negative impact of macroeconomic volatility on investment and growth due to distorted price signals and expected rate of return. Increased precautionary savings caused by higher uncertainty about future income may also lead to either decreased or increased economic growth. In addition, credit market effects, i.e. higher incidence of credit rationing or increased risk premium and borrowing rates for private firms may negatively affect the income of the poor.

Identifying the predominant economic shocks and the structural features of a specific country and choosing the exchange rate regimes which best insulates the economy against shocks could be seen as one reason for different impact of exchange rate arrangements on pro-poor growth. This is based on the assumption that exchange rate regimes dampen or amplify the negative effects of exogenous shocks and adjustment processes. From Mundell-Flemming framework, fixed exchange rate regimes are assumed to stabilize output in case of nominal shocks to domestic asset markets, while real shocks are more easily absorbed by flexible exchange rate regimes.

Prudent macroeconomic policies can result in low and stable inflation. Inflation hurts the poor by lowering growth and by redistributing real incomes and wealth to the detriment of those in society least able to defend their economic interests. High inflation can also introduce high volatility in relative prices and make investment a risky decision.

Exchange rate instability may impact the poor through the following: (a) inefficient allocation of resources between foreign and domestic goods and price distortions due to misalignments. It could also lead to reduced investment and competitiveness of the tradeable sector with its negative impact on the poor. Furthermore, the cost to the poor may be increased by the extent of financial integration in the international capital markets. Inappropriate exchange rate policies distort the competition of growth by influencing the price of tradeable versus nontradeable goods. Apart from distorting trade and inhibiting growth, an overly appreciated exchange rate can impair the relative incomes and purchasing power of the poor

Exchange rate policies can affect the poor through three channels: inflation, output, and the real exchange rate. Inflation hurts the poor because it acts as a regressive tax and curbs growth. Fluctuations in output have direct impact upon the incomes of the poor. Also a chosen exchange rate regime can buffer, or amplify, exogenous shocks. The real exchange rate can affect the poor in two ways first, it influences the country's external competitiveness and hence its growth rate; secondly, a change in the real exchange rate (through, for example, a devaluation of the nominal rate), can have a direct impact on the poor.
Specifically, exchange rate instability can affect the poor through the following channels:

- Investment growth. Instability tends to distort price signals and the expected rate of return for investors; in the presence of irreversibility effects, the decision to wait may lead to lower private investment and lower growth rates.

- Precautionary savings. The propensity to save for both rich and poor households may increase if exchange rate instability or macroeconomic instability translates into higher income uncertainty or an increased probability of facing borrowing constraints in "bad times". However, higher savings may also increase resources available for financial intermediaries to lend to potential investors, thereby stimulating growth.

- Credit market effects. A higher degree of exchange rate or macroeconomic instability may heighten the perceived risk of default by lenders and increase the incidence of credit rationing, or lead to a higher risk premium and borrowing rates for private firms. This may have adverse effect on labor demand and the poor.

- Distributional effects. High and variable inflation may explain large changes in the distribution of income and wealth; such effects may be of considerable importance. Inflation affects income distribution through the relative value of different assets and liabilities may be by lowering the real value of both nominal assets and liabilities; favors debtors and holders of real equity over lenders and owners of nominal assets; could also affect negatively suppliers of labor locked in long-term employment contracts. The poor may suffer from inflation through an erosion of their nominal assets, whereas the middle class may benefit from an erosion of its nominal liabilities. High inflation may also affect income distribution indirectly by lowering output and employment

through a variety of channels, including distortions in relative price signals and their effects on allocative efficiency.

Exchange rate instability impacts on the poor through unemployment, higher price of foodstuffs, pressure on the employed to accept lower or no wage increases, higher costs of borrowing, reduction in the purchasing power of financial assets. It could also mean increased return for the goods of those households in the tradeable sector. It is also well known that macroeconomic volatility, high output fluctuation and unstable exchange rate regime impact on poverty. For instance, the income of the poor may be affected by a negative impact of macroeconomic volatility on investment and growth due to distorted price signals and expected rate of return. Increased precautionary savings caused by higher uncertainty about future income may also lead to either decreased or increased economic growth.

Some Recommendations and Conclusion

The worsening of poverty in Nigeria has been traced to several factors: poor and inconsistent macroeconomic policies, weak diversification of the economic base, gross economic mismanagement, weak intersectoral linkages as well as persistence of structural bottlenecks in the economy. The basic causes of poverty in Nigeria have been identified to include, inadequate access to employment opportunities for the poor, lack or inadequate access to assets such as land and capital by the poor; inadequate access to the means of fostering rural development in poor regions; inadequate access to markets for the goods and services that the poor produce; inadequate access to education, health, sanitation and water services. Exchange rate instability fuels other macroeconomic shocks including inflation. The implication of this is that the purchasing power of the poor is eroded and consequently aggravates the poverty phenomenon among the poor.

Most studies on poverty in Nigeria have not, as such, examined the impact of macroeconomic shocks on the welfare of the poor. Yet, macroeconomic shocks have a direct effect on the livings standards of poor households, through the goods, services and financial markets. Furthermore, the Nigerian economy is highly susceptible to exchange rate changes because of the import-dependent nature of its largely uncompetitive manufacturing industries. There is a negative relationship between exchange rate, depreciation and poverty. For instance, a depreciated exchange rate could boost exports and the expansion of import competing industries; it could raise the cost of living for consumers, including the poor. The overall expected effect is increased employment, greater output and consequently improved welfare for the poor. But exchange rate instability or unwholesome exchange market behavior in the country tend to aggravate poverty. Persistent depreciation of the currency exchange rate has led to considerable capital flights in recent years. It also resulted in round-tripping activities by some of the financial houses generating opportunities for corruption. The implication is that the poor is made to suffer.

Some Recommendations

Macroeconomic stability is a key component of a growth-promoting environment and is indirectly, therefore, a foundation for any successful poverty reduction strategy. The link is that macroeconomic stability encourages investment and promotes productivity growth and employment creation. In this sense, macroeconomic stability is a public good. In recent years Nigeria's macroeconomic environment has been relatively volatile and, unfortunately, trapped in an adverse loose fiscal/tight monetary policy mix.

A labor-shedding restructuring and reforms in both the public sector that was not matched with an environment conducive to employment creation by the private sector (particularly by small and medium enterprises) on the demand side, as well as the unchecked access to social safety nets amidst increasing population growth rate on the supply side, have contributed to a dramatic worsening of labor market conditions, a consequent rise in unemployment, and the resulting poverty increase.

Hence, a return to robust growth (as the main factor in poverty reduction) requires a stable macroeconomic environment with a balanced fiscal-monetary policy mix and stable exchange rate regime. To prevent the re-emergence of economic imbalances, a fiscal consolidation and the reduction of overall deficits are needed to complement the recent monetary policy measures. A parallel reduction in the size of the government budget would provide greater space for private sector development. Together with an additional and necessary recomposition of government expenditures from consumption to investment, these policies would significantly strengthen Nigeria's growth prospects.

In order for growth to be poverty-reducing, the link between economic development and labor market improvement must be strengthened significantly (or perhaps even re-established). In other words, the growth environment must be made more labor-friendly. In the short to medium term this would involve a necessary reduction in the tax wedge (payroll taxes) as well as an increase in the flexibility of the labor market. In the longer run, policies are needed that will close the mismatch of skills between labor demand and supply, which means promoting investment in human capital and education.

Price stability is an essential component of a poverty alleviation policy. Inflation predominantly hurts the poor, who have little opportunity to protect their assets. For this reason, low inflation in general, and particularly low food price inflation, should be perceived as a genuine achievement of recent years. In addition, the decline in nominal and real interest rates brought about by the monetary easing should work to the advantage of the poor by increasing their capacity to smooth consumption.

Fiscal policy works best if it is pro-poor. Since the poor have a higher propensity to spend, leaving more resources with them during hard times provides an effective tool against cyclical downturns of the economy, contributes to the well-being of the vulnerable, and feeds back positively to overall macroeconomic stability.

The tax component of fiscal policy appears to perform its anticipated stabilization role. Any changes to the system to improve its pro-poor impact should be considered carefully, so that they do not further increase the distortions that taxes bring to the economy, particularly that they do not increase the overall tax burden. The elimination of exemptions (tax expenditures are directed mainly toward the rich) complemented by an overall reduction in payroll taxes in at least a budget neutral way is a plausible recommendation.

The social transfers mechanism is still underdeveloped in Nigeria but when properly harnessed and efficiently managed, could play an important role in poverty alleviation. Currently, the major part of the resources is not going to the most needy. If these funds were targeted properly, rather than being spread more or less uniformly over the entire consumption distribution, they could eradicate poverty completely twice over. Therefore, improving the targeting of social transfers should be an immediate necessity. Poor targeting not only leaves many of them vulnerable without the help of the state, but it also skews incentives to work and poses a significant burden on government finances.

Given the revenue flows from oil exports, the Nigerian economy is becoming wealthier but at the same time more polarized. Therefore, there is a strong case for good poverty/social monitoring that involves going beyond aggregations and applying more complex analytical tools, such as various decompositions, growth incidence, benefit incidence, etc. Such monitoring can provide both the public and policymakers with a better knowledge of whether and how the economy is changing, and with the ability to identify the sources of such changes. It can also make it possible to assess winners and losers, and, in particular, it can become a basis for judging whether these inequalities are acceptable or not. Moreover, an ex ante assessment of the impact of social programs on income distribution and poverty could become a valuable tradition.

An efficient exchange rate regime is that which promotes economic growth and addressing employment policies for poverty reduction. This is because the essence of the poverty reduction is to encourage (a) a high rate of labor-absorbing growth; (b) promoting the self-employment of the poor by converting them into productive entrepreneurs; (c) increasing the productivity of the poor workers both in wage employment and in self-employment; (d) ensuring favorable terms of exchange for the products of the poor's labor; and (e) specially designed employment opportunities for the households with unusual and/or unfavorable labor endowment.

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RECENT REFORMS IN THE NIGERIAN BANKING INDUSTRY: ISSUES AND CHALLENGES

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1.0 INTRODUCTION

The banking industry around the world has witnessed remarkable changes in recent decades, given the increasing wave of globalization, structural and technological changes, and integration of financial markets. As McKinnon and Shaw (1973) observed in their seminar work on the key roles of banks as propellants of growth and development in developing economies, a feeble banking system is repressive, distortionary and dis-connects the intermediation process thereby precipitating macroeconomic instability. This requires that policy makers, as Nnanna (2005) opines, must articulate robust policies that will deepen the financial system to enable banks play their roles most efficiently.

In Nigeria, the ability of the banking industry to play its role has been periodically punctuated by its vulnerability to systemic distress and macroeconomic volatility, making policy fine-tuning inevitable. Nnanna (2005) showed that, historically, the Nigerian banking industry had evolved in four stages. The first stage can be best described as the un-guided laisez faire phase (1930-59), during which several poorly capitalized and unsupervised indigenous banks failed in their infancy. The second stage was the control regime (1960-1985), during which the Central Bank of Nigeria ensured that only "fit and proper" persons were granted banking license, subject to the prescribed minimum paid-up capital. The third stage was the post Structural Adjustment Programme (SAP) or de-control regime (1986-2004), during which the neo-liberal philosophy of "free entry" was over-stretched and banking licenses were dispensed by the political authorities on the basis of patronage. The emerging fourth stage is the era of consolidation (2004 to a foreseeable future), with major emphasis on recapitalization and proactive regulation based on risk-based or risk-focused supervision framework.

Consequently, the banking system reforms were focused on further liberalization of banking business; ensuring competition and safety of the system; and proactively positioning the industry to perform the role of intermediation and playing a catalytic role in economic development.

This paper is therefore aimed at reviewing the various reforms in the Nigerian banking industry since 1986. In particular, the complementary policies and outcomes of the recent reforms in the industry as well as the issues and challenges will be highlighted. The paper therefore has seven main sections. Following this introduction is section 2 which presents the experience of other jurisdictions in consolidation, while section 3 reviews reforms in the Nigerian banking industry in two parts: early reforms 1986, 2003 and the recent reforms 2004 to date. Section 4 presents the actions taken by the CBN toward ensuring a successful consolidation of the banking industry. Section 5 x-rayed the outcome of the consolidation exercise, while section 6 analyses the main issues and challenges of the recent reforms in the sector. Finally, concluding remarks are presented in section 7.

2.0 COUNTRY EXPERIENCES

The financial services industry is restructuring and consolidating at an unprecedented pace around the globe, particularly in the United States, Western Europe and Asia. Specifically, in the period 1997-1998, 203 bank mergers and acquisitions took place in the euro area. In 1998 a merger in France resulted in a new bank with a capital base of US$688 billion, while the merger of two banks in Germany in the same year created the second largest bank in Germany with a capital base of US$541 billion. In Japan, a spectacular merger has produced the new Tokyo-Mitsubishi bank with over $700 billion in assets.

In many emerging markets, including Argentina, Brazil and Korea consolidation has also become prominent, as banks strive

to become more competitive and resilient to shocks as well as reposition their operations to cope with the challenges of the increasingly globalized banking systems. Each continent except Africa (with possible exception of South Africa) has had a fair share of merging banks. In Africa where many banks are small in size in terms of their market capitalization, mergers in terms of volume and value have been relatively low. The five largest banks in Africa Standard Bank Group, Amalgamated Bank of South Africa (ABSA) Ltd, Nedcor Ltd , First National Bank Ltd and Investment Group Ltd are based in South Africa and are all the result of mergers and consolidations. Standard Bank Group is the largest banking group in South Africa and Africa as a whole, and was the result of the consolidation of several financial institutions over a period of ten years. As at end- December 2003, its shareholder funds totaled R28, 667 million or $4.6 billion. Similarly, the Amalgamated Banks of South Africa Limited is the second largest in the country and Africa as a whole with a shareholder fund base of R19,350 million or $3.1 billion. The bank was the result of the merger of over fifteen commercial banks, whole banks, finance houses, insurance companies and advisory services across South Africa, Namibia, Tanzania, Mozambique and Zimbabwe. As a result of the merger, the bank has been able to create a powerful financial base that enables it to provide services to selected markets in the UK, and USA.

In Nigeria, before the recent reforms, the minimum capitalization for existing banks stood at $7.53 million, while new banks were required to have a minimum capitalization of $15.06 million, as against $526.4 million minimum capitalization in Malaysia. The largest bank in Nigeria before the consolidation exercise had a capitalization of $240 million, while the total capitalization of the then 89 banks stood at $3.0 billion.

3.0 REFORMS IN THE NIGERIAN BANKING INDUSTRY

3.1 The Early Reform Measures in the Nigerian Banking Industry: 1986 - 2003

Empirical evidence has shown that environmental dynamics occasioned by globalization, the changing international financial architecture and technological innovation have necessitated financial sector reforms and the fine-tuning of rules guiding the practice of banking in many jurisdictions. In Nigeria, prior to the reforms of 1986, the banking sector was highly repressed. Interest rate controls, selective credit guidelines, ceilings on credit expansion and use of reserve requirements and other direct monetary control instruments were typical features of the financial sector in Nigeria. Entry into banking business was restricted and public sector-owned banks dominated the industry.

The neo-liberal era witnessed the dismantling of the prolonged regime of economic and financial controls to make way for increased reliance on market forces in 1986 in line with the general philosophy of economic management under the Structural Adjustment Programme (SAP). The major reform measures implemented included, deregulation of interest rates and exchange rate, removal of sectoral credit allocation and free entry into banking business subject to satisfaction of condition for obtaining a banking licence. Other measures implemented were the establishment of the Nigeria Deposit Insurance Corporation (NDIC), strengthening the regulatory and supervisory institutions, upward review of capital adequacy standards, capital market deregulation and introduction of indirect monetary policy instruments. Besides, in 1991 the government promulgated the Central Bank of Nigeria (Act No.24) and the Bank and Other Financial Institutions Act (No.25) which spelt out comprehensive guidelines for bank regulation, supervision and liquidation. To achieve increase in financial savings during the reform period, the community banks and the People's bank were established. The two set of institutions were established to enable rural dwellers and the poor save and have access to credit at rates lower than the market rates. All these structural changes were aimed at enthroning a market-oriented financial system for effective mobilization of financial savings and efficient resource allocation in the economy.

The liberalization of the banking industry resulted in the establishment of many new banks. The number of operating banks almost doubled within three years into the reform (from 45 in 1987 to 76 in 1989) and tripled in the fifth year (119 in 1991). It required official re-imposition of embargo on bank licensing in 1991 to halt this growth. Profitability of investment and access to credit and foreign exchange were among the major motives for bank ownership. The competition that resulted from the entry of new banks and the liberalization of interest rates brought about sharp rise in nominal deposit and lending rates. The average deposit and lending rates doubled in the third year of the reform.

The banking environment that emerged from the reform was inefficient, riskier, illiquid and generated lower return on assets relative to the pre-reform period (Sobodu and Akiode 1994). The incidence of fraud and of non-performing loans also increased with the reform as revealed by a CBN/NDIC study of Distress in the financial system. The quality of management which is a major determinant of bank's long-term survival (Siems 1992; Pentalone and Platt 1987) and the dearth of qualified personnel to meet the challenges of sudden growth in the industry contributed to the poor health of the banking industry (Ikhide and Alawode 1994). Thus, the incidence of distress in the industry was rampant during the period. Mindful of the negative effects of the banking system distress, the supervisory authorities adopted various distress resolution options including contingency framework for distress resolution in order to safeguard the system from systemic failure. In this context, problem banks were encouraged to promptly correct deviations from sound banking practices and failing banks were made to exit before they infected the system. The monetary authorities also adopted the code of good practices in monetary and financial policies, the international accounting and auditing standards, as well as initiated a private sector-funded “lifeboat” facility accessible to all DMBs in temporary liquidity problem. The role of market discipline was enhanced through the enforcement of necessary disclosure requirements that ensured timely publication of credible information to guarantee safe and sound banking practice in Nigeria. The reforms had some salutary effects on the banking system although some weaknesses persisted.

Following further efforts at liberalization of the financial sector, the universal banking scheme was introduced in 2001 by the Bank to create a more level-playing field for financial sector operators, encourage greater efficiency through economies of scale and foster competition by opening up various areas of entry to banks. Again, in line with international best practice, the CBN adopted the core principles of the Basel Committee on Banking Supervision, including the prudential guidelines for licensed banks to promote banking soundness and financial sector stability. The supervisory role of the CBN, aimed at promoting sound banking and financial system, was also statutorily expanded to cover non-bank financial institutions. Consequently, activities of all the regulatory and supervisory authorities in the Nigerian financial sector were coordinated through the Financial Sector Regulation and Coordinating Committee (FSRCC) under the chairmanship of the CBN. Furthermore, relevant banking laws were amended to provide additional safeguards against insider abuse and promote good corporate governance by defining the functions and responsibilities of a director and stipulating the procedures under a director or he/she or his/her related parties could obtain credit.

In the first few years of the reform, the share of the banking system's credit to the private sector improved and superseded the flow to government for the first time in five years. Later, government's reliance on the Central Bank of Nigeria for financing the soaring deficits overturned the table to its favor. From an annual average of 50.7% before the reform, the share of the private sector in the total credit declined to 49.7% after the reform. In 1993 and 1994, only 34% of the total credit went to the private sector. The bulk of the credit that was channeled to the private sector was mainly directed toward short-term investment. Between 1987 and 1994, 50% of the private sector credits went to call money, 32.5% to lending maturing within 12 months, 12% for 1-5 years maturity (medium-term) and only 4.8% for long-term commitments exceeding five years.

3.2 Recent Reforms in the Nigerian Banking Industry: July 2004 Date

3.2.1 Background to the Recent Reform Measures

In spite of the efforts itemized in the preceding section, there were still pockets of distress; over-dependence of many Nigerian banks on public sector deposits and government revenue collection. Although the distribution among banks is not uniform, the dependency ratios of some banks were in excess of 70 per cent as at June 2004. The implication was that the resource base of such banks was weak and volatile, rendering their operations highly vulnerable to swings in government revenue. Many banks had abandoned their traditional intermediation role of mobilizing savings and inculcating banking habit at the household and micro enterprise levels. In addition, the apathy of some banks towards small savers, particularly, at the grass-root level, had not only compounded the problems of low domestic savings and high bank lending rates in the country but had also reduced access to relatively cheap and stable funds that could provide a reliable source of credit to the productive sectors at affordable rates of interest. Savings mobilization at the grass-root level was inadvertently discouraged following the unrealistic requirements by many banks for new accounts. The summary from

the foregoing was that the Nigerian banking system faced enormous challenges which needed to be addressed urgently to enable them perform their catalytic role of enhancing the growth process in the economy. Furthermore, a surveillance report by the CBN as at end-March 2004 indicated that 62 banks out of 89 were classified as sound/ satisfactory, 14 as marginal, while the position of unsound banks had deteriorated from 9 at end-December 2003 to 11. The report further indicated that 2 of the banks failed to render statutory returns during the period.

An overview of the industry at end-December 2003 further revealed that the industry was dominated by the top 20-30 banks, with 69 banks out of the 89 licensed banks operating as marginal players, while about 60-70 per cent of total deposits are short-term (30-90 days), and little wonder why banks were not lending to the real sector. Other features included extension of barely 3- 5 per cent of total banks' credit to agriculture and manufacturing sectors; and 89 banks in operation having a total asset of $18.0 billion, compared with 58 banks in South Africa, with a total asset of $146 billion. Also, over N373.1 billion was outside the banking system due to the failure of banks to mobilize savings by offering reasonable interest rate to small depositors. Savings deposit rate averaged 3 5 per cent; while lending rate averaged 21- 32 per cent.

Quite a number of the banks examined had revealed severe weaknesses, including weak corporate governance, evidenced by high turnover in the Board and management staff, inaccurate reporting and non-compliance with regulatory requirements, falling ethics and de-marketing of other banks in the industry; gross insider abuses, resulting in huge non-performing insider related credits. Other indicators were late or non-publication of annual accounts that obviates the impact of market discipline in ensuring banking soundness; insolvency, as evidenced by negative capital adequacy ratios and complete erosion of shareholders' funds by operating losses; over-dependence on public sector deposits, and neglect of small and medium class savers.

3.2.2 The Recent Reform Measures (The 13-point Agenda)

Mindful of the deteriorating condition of the industry, the regulatory authorities decided to streamline the regulatory framework and strengthen its supervisory capacity in order to forestall the re-emergence of systemic distress and facilitate the attainment of the vision of strong, competitive and reliable financial markets that meet international best practices. To this end, the CBN on July 6, 2004 announced a 13-point agenda to reform and reposition the Nigerian banking industry.

Key Elements of the Reform

- Requirement that the minimum capitalization for banks should be N25 billion with full compliance before end December 2005 (that is 18 months notice rather than 12 months normally given in many countries).

i) Only banks that meet the requirement can hold public sector deposits, and participate in the DAS auction by the end of 2005

ii) Publish the names of banks that qualify by 31 December, 2005.

- Phased withdrawal of public sector funds from banks, starting in July, 2004.
- Consolidation of banking institutions through mergers and acquisitions
- Adoption of a risk focused, and rule-based regulatory framework. The rules of the game will always be announced in advance and these will be respected. Arbitrariness will be reduced to the barest minimum. More often, operators who run foul of the rules plead for 'political solutions' to otherwise strictly economic and financial problems should understand the damages that such arbitrariness can do to the system and the wrong signals and moral hazards that it creates. Once a 'political solution' is introduced, there is no end to it and the system would suffer. In the interest of preserving the integrity of the system, transparency and probity, we will insist on the rules and regulatory framework, in the interest of Nigeria and Nigerians.
- Adoption of zero tolerance in the regulatory framework; especially in the area of data / information rendition/ reporting. All returns by banks must be signed by the MDs of the banks. The so-called 're-engineering' or manipulation of accounts especially in hiding of information under 'other assets or liabilities' and off-balance sheets will henceforth attract serious sanctions.
- The automation process for rendition of returns by banks and other financial institutions through the Electronic Financial Analysis and Surveillance System (e-FASS) will be completed expeditiously.
- Establishment of a hot line, confidential internet address (Governor@cenbank.org) for all

Nigerians wishing to share any confidential information with the Governor of the Central Bank on the operations of any bank or the financial system. Only the Governor has access to this address.

- Strict enforcement of the contingency planning framework for systemic banking distress.
- Work towards the establishment of an Assets Management Company as an important element of distress resolution.
- Promotion of the enforcement of dormant laws, especially those relating to the issuance of dud cheques, and the law relating to the vicarious liabilities of the Board Members of banks in cases of failing by the bank. A situation where a bank collapses due to negligence and mismanagement and the bank directors move about in their limousines while the poor depositors languish in pains is just and unfair. There is a law which makes the Directors and management liable and will henceforth be enforced.
- Revision and updating of relevant laws, and drafting of new ones relating to the effective operations of the banking system.
- Closer collaboration with the Economic and Financial Crimes Commission (EFCC) in the establishment of the Financial Intelligence Unit (FIU), and the enforcement of the anti-money laundering and other economic crime measures. Greater transparency and accountability will be the hallmark of the system.
- Rehabilitation and effective management of the Mint to meet the security printing needs of Nigeria, including the banking system which constitutes over 90 percent of the Mint's businesses. In due course, there will be no need to print bank cheques abroad.

3.2.3 GOALS/OBJECTIVES OF THE REFORM

The reform was designed to ensure a diversified, strong and reliable banking sector, which will ensure the safety of depositors' money, play active developmental roles in the Nigerian economy, and be competent and competitive players in the African, Regional and Global financial system.

The goal of the reform was to help banks become strong players, and in a manner that will ensure longevity and hence high returns to their shareholders over time and promote greater impact on the Nigerian economy. The ultimate beneficiaries of this policy are the ordinary men and women who can put their deposits in the banks and have a restful sleep; the entrepreneurial Nigerians who can now rely on a stronger financial system to finance their businesses and economy which will benefit from internationally connected and competitive banks that would also mobilize international capital for development of the country. This measure is about the Nigerian people. It is about meeting their NEEDS. It is about positioning Nigeria and Nigerians to become competitive players in the 21st century.

4.0 ACTIONS TAKEN BY THE CBN TOWARDS ENSURING SUCCESSFUL CONSOLIDATION OF THE NIGERIAN BANKING INDUSTRY

The CBN was committed to a safe landing of the consolidation process in which the cost of consolidation would be moderate, while guiding against the trigger of systemic distress. Consequently, the Bank issued guidelines and provided incentives to banks, particularly, weak banks to facilitate their consolidation efforts; set up a Technical Committee on Banking Sector Consolidation and established a Help Desk in Lagos.

In addition, the CBN set up the Banking Consolidation Implementation Committee (BCIC), whose membership was later enlarged, to include a Sub-Committee on Monitoring. The Sub-Committee monitored the progress of the Consolidation exercise in the banking industry on full time basis. Also, the CBN consulted with and contacted other stakeholders. Specifically, contacts were made with Securities and Exchange Commission (SEC), Nigerian Stock Exchange (NSE), Corporate Affairs Commission (CAC) and Federal Inland Revenue Services (FIRS), among others, for the purpose of ensuring their cooperation in the area of the promised incentives i.e. processing fees, tax concessions, etc. In a related development, retreat on Mergers and Acquisitions in the Nigerian Banking Industry was held with a view to sensitizing operators for effective implementation. During the retreat, observations and suggestions were made which touched on constraints, incentives, legal issues and information technology. Meanwhile, the Bank has intensified efforts towards the establishment of an assets management company as an important element of distress resolution, while revision and updating of relevant laws and drafting of new ones relating to the effective operations of the banking system are being facilitated.

The Bank is also in close collaboration with the Economic and Financial Crime Commission (EFCC) for the enforcement of the anti-money laundering and other economic and financial crime

measures. Other areas of emphasis include the promotion of the enforcement of dormant laws, especially those relating to the issuance of dud cheques, and vicarious liabilities of the board members of banks in cases of banks failures. There is a law which makes the Directors and management liable, which would henceforth be enforced.

Moreover, the CBN has adopted a zero tolerance in the regulatory framework; especially in the area of data/information rendition/reporting. All returns by banks must now be signed by the MDs of the banks. The so-called financial're-engineering' or manipulation of accounts, especially in hiding of information under 'other assets/liabilities' and off-balance sheet items now attract serious sanctions. The CBN now pre-announce the rules of the game and stick to them.

Furthermore, a risk focused and rule-based regulatory framework has been adopted and would take off later in the year. The Bank created incentives that involved writing off of 80 per cent of the debt owed to it by some banks subject to the banks recovery of existing bad loans within two months. The remaining 20 per cent was to be converted to a long term debt at concessional interest rate of 5 per cent and payable in seven (7) years excluding a moratorium of two (2) years.

The Bank intensified efforts to verify funds raised by banks to shore up their capital towards meeting the N25.0 billion. The capital verification exercise which is an on-going exercise is to ensure that no illicit funds or funds borrowed from the banking sector are used to finance the purchase of shares. Finally, in order to provide guidance to banks on the documentation and procedural requirements for consolidation, the Bank prepared and issued to all banks a manual incorporating detailed documentary requirements and steps needed to be followed at each stage of the consolidation process.

5.0 THE OUTCOME OF THE BANKING SECTOR CONSOLIDATION PROGRAMME

At the expiration of the deadline on 31st December 2005, twenty-five (25) groups emerged from seventy-five (75) banks out of the eighty-nine (89) banks that existed at end- December 2004. The successful banks accounted for 93.5 per cent of the total deposit liabilities of the banking system. Fourteen banks, which neither met the minimum capital of N25.0 billion nor found merger partners, had their licenses revoked by the CBN. Consequently, the Nigeria Deposit Insurance Corporation (NDIC) was directed to obtain court approval to commence the process of liquidation of the affected banks. The component members of the twenty-five consolidated banks are as shown in the table.

In the process of complying with the minimum capital requirement, N406.4 billion was raised by banks from the capital market out of which N360 billion was verified and accepted by the CBN as at end-December 2005. As a result, aggregate capital base of the sector rose from about $3 billion to $5.9 billion. The programme also attracted N350.2 billion (nearly US$3.0 billion) as new investment and US$500.0 million from Foreign Direct Investment (FDI) inflow. The banking consolidation programme has brought a number of positive developments to the banking sector in particular and the economy in general. The consolidation has produced relatively well capitalized banks, which has engendered greater public confidence in the system. It has also brought greater public awareness of and a deepening of the capital market.

Aggregate capitalisation of banks as a share of the stock market capitalisation rose from 24 per cent to 38 per cent. The resulting liquidity in the system also induced a significant fall in interest rates. Banks now have greater potential to finance large transactions with higher single obligor limit. Ownership of banks has been diluted and this will in no small way tame the monster of insider and corporate governance abuse as a new code of corporate governance had been issued and adopted in the industry. The banks will of course enjoy economies of scale and consequently, pass on the benefit in the form of reduced bank charges to their customers.

With virtually all the banks now publicly quoted, there is wider regulatory oversight, with Securities and Exchange Commission (SEC) and Nigerian Stock Exchange (NSE) joining the regulatory team. These regulators will oversee and focus on fewer banks thereby fostering effectiveness and efficiency in supervision. The programme has brought to an end the regionally/ethnically based banks while encouraging banks to go global.

6.0 ISSUES AND CHALLENGES OF THE POST-REFORM MEASURES IN THE NIGERIAN BANKING INDUSTRY

A post consolidation era poses

some enormous issues and challenges to virtually every stakeholder in the banking industry. On the part of banks, they will require strong management teams that are committed to bringing about overall performance improvements and capacity enhancements. Paradigm shifts would mean that new strategies would have to be conceptualised and articulated to address the increasingly complex issues that will arise during this post consolidation era. Specifically, some of the issues are as follow:

6.1 Increased Customer Orientation and Focus

As we move into the post-consolidation era, we can expect customers' expectations to take a quantum leap. Banking will no longer involve providing standard products to customers. In order to remain relevant as financial intermediaries, banking institutions would need to be sensitive to customer needs for greater efficiency and convenience. There would be need for financial products to be personalized and customized to the individual needs of corporate and retail clients. Banking institutions would therefore need to be more proactive and innovative in packaging and marketing their products. While customers will expect wider range of products to be offered, of greater importance is for the banking institutions to be able to provide these products at competitive pricing. As competition intensifies, banking institutions will have no option but to be more innovative in pricing which will result in further narrowing of margins. Furthermore, in such a new financial environment, the need to ensure adequate and effective consumer education and protection would also become even more crucial and challenging. The need to prevent any disruption in the level or reliability of services to bank customers and their protection from potential unfair practices can not be over-emphasized.

6.2 Strategic Business Alliance

At the industry level, it is not just a question of mega banks emerging, rather, the new financial landscape will compel the bank management to re-examine their existing business models to see where their strengths lie and to what opportunities these strengths can be applied to enhance returns. There may be the need to move towards strategic differentiation among the banks in order to better serve the relevant market segment or niches. This may involve market or functional specialization as banks decide which functional areas or combinations of risk management, customer services, product innovations, to exploit and maximize to their advantage. One way this can be achieved is through strategic alliances, which is already widely practiced by global players. Strategic alliances have become a viable strategy for banks contemplating new markets. Through these alliances, banks can complement their existing strengths with those of their partners' capabilities, distribution channels, and access to new markets.

6.3 Continuous Investment in Human Capital

Towards this end, training and development of employees must also be seen as a contributing factor towards value creation within the banks rather than merely to comply with regulatory requirements or as a non-revenue function that is costly and unnecessary. Only with both competence and commitment from the organization's workforce, and their continuing training and development, will real strategic change take place.

6.4 Increased Access to ` Information and Communication Technology (ICT)

In this changing economic landscape, banks would need to recognize the greater role of knowledge and ICT. There are some clear benefits including increased convenience, increased access to information, speed of transactions, and enhanced control and management of personal finances. The new innovations will be an integral part of the financial landscape. A more logical response would perhaps be the full integration of high technology systems into the brick and mortar facilities that banks already offer. With online technology, new levels of customer segmentation can be achieved. In this context, close coordination between the existing channels and the electronic channel is needed to fully optimize an integrated multi-channel approach.

6.5 Post-Consolidation Integration

The issue of integration of IT, people, processes etc poses a great challenge for the post consolidation banks. The different IT soft wares and hard wares formerly used by the banks now coming together need to be integrated for effective service delivery. In additions, directors, staff and processes of the emerging banks need to be integrated in the new banks and be orientated in the business environment.

6.6 Liquidation of the Failed Banks

Conclusion of the liquidation of the

fourteen (14) failed banks constitutes a great challenge for the CBN as a group of eight banks (Alliance Group) has gone to court to challenge the revocation of their licences. Even when final court order might have been gotten for their liquidation, the issue of the disposal of their assets for the settlement of the poor depositors is another problem that may have take sometime. This brings to the fore the issue of expediting action on the establishment of the Assets Management Company (AMP) as well as the revision of the necessary laws that will make it possible for both the CBN and NDIC to liquidate failed bank (s) without litigation action by the bank (s) involved.

6.7 Sound Ethical Banking Practices

As we undergo the transition towards a consolidated banking industry, strong corporate governance and risk management become key part of successful institutions. With the larger pool of resources after the merger process, banks are expected to further enhance these capabilities. Specifically, the adoption of best practices with regard to credit practices would be monitored, consistent with the requirement of the credit risk management guidelines issued by the CBN.

6.8 Improved regulatory Framework

The regulatory authorities, on their part, would be required to further streamline their regulatory framework as well as strengthen their supervisory capacity to ensure a smooth transition. In this regard, there would be need to properly monitor the activities and performance of emerging mega banks to prevent distress and failures in the post-consolidation era.

6.9 Legal Reforms

Although a number of legislative iniatives had been taken during the early reform years to address the problems in the financial sector and the economy at large, such as the review of the Central Bank of Nigeria, Act (1991) and subsequent amendment Act of 1998 and 1999; Banks and Other Financial Institutions Act (1991) and subsequent amendment Acts of 1998 and 1999; Failed Banks (Recovery of Debts) and Financial Malpractices in Banks Act of 1994, among others, there is need for these legal processes to be further reinforced in order to complement the efforts of the regulatory authorities in realizing a sound and stable banking system. We are also aware that there is a law regulating the issue of dud cheque in the country but the implementation of this law has not been effective. In the wake of growth in the volume and complexity of financial transactions involving both local and foreign investors after the consolidation exercise, there is need for both the legislature and the judiciary to cooperate as well as work closely in the implementation of the existing law on dud cheque in order to engender some confidence in the new financial landscape that will eventually merge.

With respect to loans recovery within the framework of the banking industry, the challenges posed by this is not only for the regulators and operators in the industry, but also for the judiciary who must be at the fore-front in ensuring that cases bordering on loan recovery are promptly disposed of, bearing in mind that justice delayed is justice denied. To this end, special courts that will handle cases of loan defaults and credit fraud with dispatch need to be considered in the present banking policy reforms.

7.0 CONCLUDING REMARKS

The new agenda in the Nigerian banking industry has identified the building blocks for an effective and efficient financial system that will meet international best practice. The various initiatives (the 13-point agenda) that are required to realize this vision constitute the building blocks. It needs to be recognized, however, that the realization of the vision involves the cooperation of all the stakeholders in the industry. While the foundations are being laid and plans are in place to pursue the agenda to a successful end, the future is by no means secure. It is only with the combined efforts of all that the probability of achieving a virile banking sector in which depositors can have confidence in, will be realised.

Component Members of Consolidated Banks		
	Bank Name	**Members of the Group**
1	**Access Bank Plc**	Marina Bank, Capital Bank International, Access Bank
2	**Afribank Plc**	Afribank Plc, Afrimerchant Bank
3	**Diamond Bank Plc**	Diamond Bank, Lion Bank, African International Bank (AIB)
4	**EcoBank**	EcoBank
5	**ETB Plc**	Equatorial Trust Bank (ETB), Devcom
6	**FCMB Plc**	FCMB, Co-operative Development Bank, Nig-American Bank, Midas Bank
7	**Fidelity Bank Plc**	Fidelity Bank, FSB, Manny Bank
8	**First Bank Plc**	FBN plc, FBN Merchant Bank, MBC
9	**FirstInland Bank Plc**	IMB, Inland Bank, First Atlantic Bank, NUB
10	**Guaranty Trust Plc**	GT Bank
11	**IBTC-Chartered Bank Plc**	Regent, Chartered, IBTC
12	**Intercontinental Bank Plc**	Global, Equity, Gateway, Intercontinental
13	**NIB**	Nigerian International Bank
14	**Oceanic Bank Plc**	Oceanic Bank, In't Trust Bank
15	**Platinum-Habib Bank Plc**	Platinum Bank, Habib Bank
16	**Skye Bank Plc**	Prudent Bank, Bond Bank, Coop Bank, Reliance Bank, EIB
17	**Springbank Bank Plc**	Guardian Express Bank, Citizens Bank, Fountain Trust Bank, Omega Bank, Trans International Bank, ACB
18	**Stanbic Bank Ltd**	Stanbic Bank
19	**Standard Chartered Bank Ltd**	Standard Chartered Bank Ltd
20	**Sterling Bank Plc**	Magnum Trust Bank, NBM Bank, NAL Bank, INMB, Trust Bank of Africa
21	**UBA Plc**	STB, UBA, CTB
22	**Union Bank Plc**	Union Bank, Union Merchant Bank, Universal Trust Bank, Broad Bank
23	**Unity Bank Plc**	New Africa Bank, Tropical Commercial Bank, Centre-Point Bank, Bank of the North, NNB, First Interstate Bank, Intercity Bank, Societe Bancaire, Pacific Bank
24	**Wema Bank Plc**	Wema Bank, National Bank
25	**Zenith International Bank Plc**	Zenith International Bank Plc

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