

Nigeria's naira

Moving to a flexible exchange rate

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Key messages

- Nigeria's economy is in recession and experiencing credit tightening. Full liberalisation of the naira will help support growth beyond the oil sector.
- President Buhari expects the economy to recover, yet the outlook remains poor; and the Central Bank of Nigeria is still enacting a managed float.
- Policy-makers should focus on freely floating the naira, if reserve depletion is to be stemmed and the new regime is to gain credibility and catalyse inward investment.

Reverting to recession

The Nigerian economy is in recession, after having registered two quarters of negative growth in mid-2016.¹ Its foreign exchange reserves have declined from \$37.3 billion to \$25 billion between June 2014 and September 2016 alone, and its current account is now in deficit, with the IMF expecting it to be 2.8% of GDP in 2016 – its lowest level since 1998.² The slump in oil prices has been a key driver as petroleum exports represent 90% of Nigeria's total export revenue.³ This economic predicament is exacerbated by policy uncertainty regarding liberalisation of the naira exchange rate.

President Buhari recently stated that he anticipates an economic recovery.⁴ Yet the composition of the Nigerian economy has left Nigeria with a growing oil-related external imbalance, suggesting that prospects for growth, and employment, will remain poor. The Central Bank of Nigeria (CBN) would like to foster greater exchange rate flexibility to facilitate a new phase of growth and development. This would enable a diversified growth path away from the oil sector following Nigeria's slow economic transformation.⁵

Meanwhile, speculative inflows into Nigeria will continue to exert a downward pressure on the currency unless there is a strategy to fully liberalise the naira to improve Nigeria's external position and to rebuild foreign exchange reserves. Following the flexible naira exchange rate regime announcement,⁶ policy-makers should now focus on freely floating. This is essential if the new currency regime is to gain credibility, catalyse confidence and complement any growth transition to non-oil manufacturing sectors.

The naira's managed float

In May 2016, the CBN announced the reintroduction of a flexible exchange rate. In large part, this was intended to stem the decline in foreign exchange reserves that has been, to some extent, the result of the CBN's policy of maintaining the naira-US dollar peg. The details of the new policy specified a 'purely

market driven' exchange rate with the proviso that the bank could intervene periodically, 'as needed'.⁷ In practice, in addressing the liquidity shortages in the market, the CBN also introduced new financial instruments that could moderate naira volatility and shift non-urgent FX demand to the futures market.⁸

While currency intervention can reduce volatility or price variation over a specified time, in Nigeria's case, following the May announcement, the naira's volatility spiked higher and its value in the 3-month and 12-month forward market has reached a record low against the US dollar.⁹ This suggests further weakness is to come. In addition, the CBN may well be operating with a heightened concern that a further depreciation could fuel inflation at a time when the economy is contracting, therefore intensifying stagflation. This would result in damage to real incomes, with evidence suggesting that some depreciations over 10-20% can cause longer-lasting inflation episodes.¹⁰

Operationalising a new naira regime has, therefore, been problematic. Nigeria has seen some inflows: in August 2016, there was a \$270 million inflow into local currency bonds, over five times the average daily trading in the naira market (typically at \$50 million).¹¹ Yet despite this, there is a continued shortage of dollars in the official and parallel currency markets. Intermittent CBN US dollar selling (reaching as much as \$60 million per day) continues to be the only real support for the naira, despite appointment of FX primary dealers.¹² This has led to a crucial uncertainty, particularly in financial markets, over the timing and extent to which the CBN actually plans to let the naira float.

Moving to a pure free float

Fully floating the naira is not a silver bullet to Nigeria's economic recession, though it will be a feat in overcoming political fear around reducing purchasing power. The challenge ahead is significant given that it will bring, among other things, short-term volatility. However a gradual free-float is worse: Nigeria's economy needs liquidity and investment inflows, to help the economy out of its credit crunch and recession.¹³ In order to facilitate that, it needs to gain the confidence of markets to benefit from global finance on cost-effective terms.

The opportunity cost of not re-building precautionary reserves, to safeguard against future crises and for longer-term investment, is also high, particularly as the outlook for oil prices is for a muted recovery at best, offering Nigeria little in the way of export revenue. In the absence of a clear and credible message regarding its exchange rate policy, speculation will prevail, to the detriment of Nigeria's financial system and its public finances.

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- 1 *Nigerian Capital Importation Report*, September 2016, National Bureau of Statistics (Nigeria).
 - 2 'IMF Executive Board Concludes 2016 Article IV Consultation with Nigeria' press release, 31 March 2016, IMF.
 - 3 'Nigeria facts and figures', 2015, Organization of the Petroleum Exporting Countries.
 - 4 'Economy will bounce back', 11 September 2016, *Vanguard*.
 - 5 Te Velde, Dirk Willem; Booth, David; Leipziger, Danny and Uneze, Ebere (2016) 'Supporting Economic Transformation in Nigeria', May, London: ODI.
 - 6 'CBN MPC Communique No 107 of the meeting held on May 23 and 24, 2016', Central Bank of Nigeria.
 - 7 'Final Governor's speech on New FX Framework', June 2016, Central Bank of Nigeria.
 - 8 In addition to FX forward contracts of 6- to 12-months, this included non-deliverable, over-the-counter, naira-settled futures, with daily rates on the CBN-approved FMDQ trading and reporting system, which is a new instrument.
 - 9 Onu, Emele; Wallace, Paul (2016) 'Naira Forwards, Volatility Surge as Nigeria Removes Spread Limit', 18 July, Bloomberg.
 - 10 Caselli, Francesca G.; Roitman, Agustin (2016) *Non-Linear Exchange Rate Pass-Through in Emerging Markets*, IMF Working Papers.
 - 11 'Foreign investors boost Nigeria's FX market with \$270mn transaction', 29 August 2016, *Financial Nigeria*.
 - 12 Lewin, Joel (2016) 'Nigerian currency slump sharpens focus on central bank', 25 July, *Financial Times*.
 - 13 Tyson, Judith (2016) *Shockwatch report: sub-Saharan Africa's economic downturn and its impact on financial development*, July, London: ODI.



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