2024

SPECIAL RESEARCH REPORT

THE NIGERIAN ECONOMIC SUMMIT GROUP

MAY 2024

Pricing of Exchange Rate
Sustaining the initial gains

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Context Setting

The pursuit of exchange rate stability is one of the critical macroeconomic objectives of every country. Meanwhile, developing countries, including Nigeria, have struggled to achieve this objective due to persistent exchange rate volatility driven by domestic and external economic conditions, thereby stoking macroeconomic instability. In Nigeria, exchange rate volatility is exacerbated by the country's over-dependence on imports, limited foreign exchange (FX) earning sources due to the overreliance on crude oil exports, FX market illiquidity, high inflation, and speculative activities.

Meanwhile, the Central Bank of Nigeria (CBN) has allowed the Naira to trade more freely on a willing-buyer, willing-seller basis since June 2023 and leaned towards inflation targeting instead of controlling the money supply. In March 2024, the Apex Bank declared that it had cleared a US$7 billion backlog of demand for FX. In April 2024, the CBN offered to sell dollars to the country's Bureau de Change (BDC) at market-reflective rates and announced that it would ban the use of dollar collateral for Naira loans, except for government Eurobonds and foreign bank guarantees.

The International Monetary Fund (IMF) and World Bank have lauded these FX management measures, even though Nigerians continue to face skyrocketing fuel and food prices. The headline inflation stood at a record high of 33.2 percent in March 2024, primarily driven by exchange rate depreciation and higher gasoline prices. Following the exchange rate adjustments, the Naira has lost more than 30 percent of its value against the dollar at the official market since June 2023. However, the Naira has been tagged as the world's best currency performer since the beginning of March 2024, as it appreciated from over N1,800/US$ and over N1,600/US$ to N1,150/US$ at both the parallel and official markets.

Despite these initiatives especially as they relate to the demand side, the limited FX earnings from non-oil exports have given rise to an unfavourable net trade balance position across many products. Based on the National Bureau of Statistics (NBS) data, the net import value of agricultural products stood at N1.3 trillion and N1.0 trillion in 2022 and 2023, respectively. Similarly, the net import value for solid minerals stood at N67.3 billion and N53.1 billion in 2022 and 2023, respectively. The net import value for raw materials increased by 57.1 percent to N2.2 trillion in 2023 from N1.4 trillion in 2022. Similarly, Nigeria's net import value for manufactured goods jumped to N17.6 trillion in 2023 from N10.2 trillion in 2022. This raises more concern regarding the sustainability of the recent Naira appreciation over an extended period.

While the Naira appreciation is a welcome development, there exists a perennial challenge of FX shortage in Nigeria, despite the country having great potential to enhance the productivity and export volumes of the non-oil sector activities, including agriculture and manufacturing. To this end, this Report analyses the FX market, particularly with respect to the recent Naira appreciation and its drivers, addresses issues around the sustainability of the gains and proposes strategies for the government and the Central Bank of Nigeria (CBN) to sustain the gains in the country's FX market over an extended period.

Performance of the FX Market

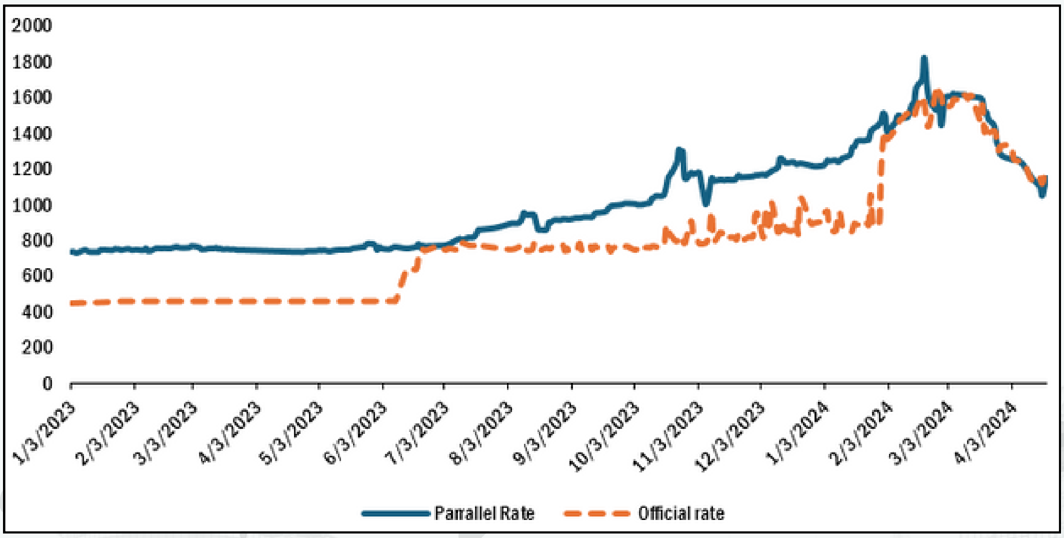
The recent foreign exchange (FX) reform and other accompanying policies prompted an appreciation and a convergence of the exchange rates

Before the harmonisation of the FX rates in June 2023, the FX market was characterised by distortions emanating from inappropriate pricing, multiple FX windows, institutional weakness and huge parallel market premiums, which encouraged round tripping and arbitrage practices. However, the FX reform, which narrowed the parallel market premium, engendered a 39 percent depreciation in the official exchange rate between June and July 2023 (see **Figure 1**).

Remarkably, the exchange rate crossed N1000/US$ in September 2023 at the parallel market and reached over N1800/US$ by the end of January 2024, whereas the official market posted an exchange rate that is less than N1000/US$. This lasted until December 2023, although the exchange rate again dropped below N1000/US$ at the official market in most of December 2023.

While the official exchange rate peaked at N1662.9/US$ on February 26, 2024, the parallel market exchange rate hit a record high of N1,825/US$ on February 20, 2024. Against the backdrop of buckets of policies deployed by the CBN between January and February 2024, there has been another convergence of the official and parallel exchange rates to date, eliminating arbitrage opportunities completely as the official exchange rate depreciated from an average of N941.2/US$ in January 2024 to N1506.9/US$ in February 2024. Moreover, the recent FX policies also resulted in the appreciation of the Naira, with the exchange rate falling sharply to N1,150/US$ as of April 19, 2024, at both the official and parallel markets. This has been preceded by little divergences between the official and parallel exchange rates.

FIGURE 1: TREND OF EXCHANGE RATES AT THE PARALLEL AND OFFICIAL MARKETS (N/US$)



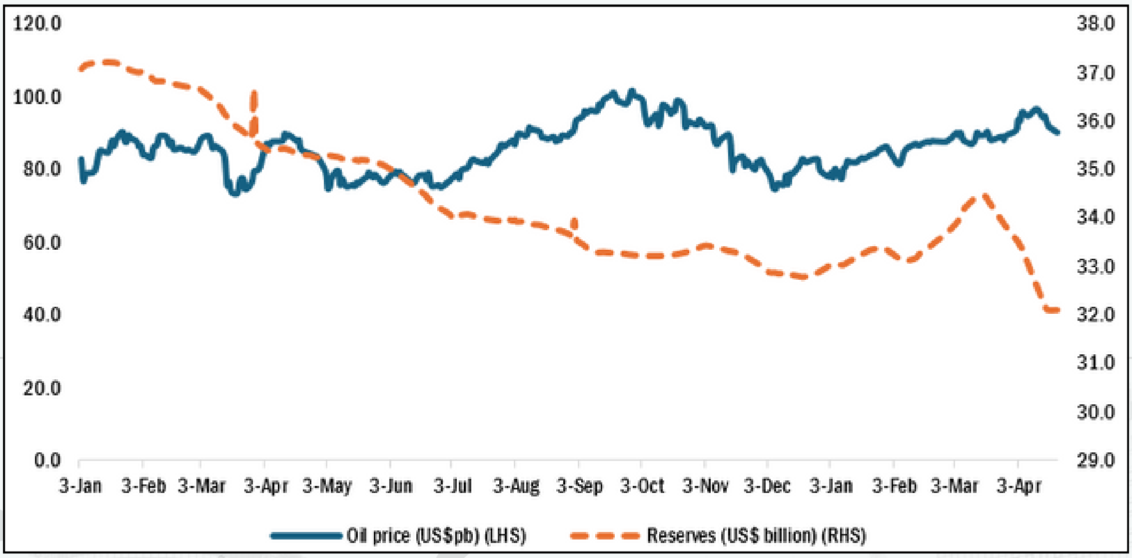
Data: CBN; Chart: NESG Research

Performance of the FX Market

The FX market remains illiquid amidst dwindling external reserves.

While the current FX policies and reforms have closed the gap between the official and parallel market exchange rates and contributed significantly to the recent Naira depreciation, they have only resulted in the external reserves depletion as the CBN clears the valid FX backlogs and sells FX to the legalised BDC operators. The supply-side contributors to external reserves accretion have also disappointed. On the one hand, the recent increases in export earnings - thanks to elevated global oil prices and an improvement in domestic crude oil production – failed to translate to external reserves accretion. Similarly, the persistent drop in foreign investment inflows since 2019 has also contributed to the weak external reserves, which stood at US$32.1 billion as of April 22, 2024, falling from US$35.3 billion in the corresponding period of 2023 (see **Figure 2**). The depletion in external reserves could be attributed to CBN's intervention in the FX market as it has resumed the sale of FX to BDCs at a market-determined rate. Meanwhile, the external reserves rose steadily from February 5, 2024, until March 18, 2024, when it stood at US$34.4 billion. This rising trend is largely attributed to the increase in remittance payments from Nigerians abroad and heightened interest from foreign investors in local assets, including government debt securities, as well as, the improvement in domestic crude oil production and the ongoing FX reforms. Remarkably, in recent times, the external reserves have continued to be insensitive to the increases in global oil prices, which averaged US$85/barrel and US$86/barrel in 2023 and the first quarter of 2024, respectively (see **Figure 2**). This suggests the urgency to diversify the sources of foreign exchange earnings towards non-oil exports, Foreign Direct Investment (FDI), and remittances to shore up the country's external reserves and insulate the economy from shocks.

FIGURE 2: TREND OF EXTERNAL RESERVES & OIL PRICE



Data: CBN; Chart: NESG Research

Drivers of the Recent Naira Appreciation

The Naira rose to unprecedented heights following the recent FX interventions of the CBN, specifically through the sale of FX to the BDC operators. While this is a welcome development, there are concerns regarding the sustainability of this approach over an extended period amidst the country's weak external reserves position. Meanwhile, other factors contributed to the strong Naira in recent times. These drivers are multifaceted and sometimes intertwined. These contributory factors include:

Reforms and Regulatory Guidelines

- In a circular titled "Harmonisation of Reporting Requirements on Foreign Currency Exposures of Banks," the CBN stated that banks' Net Open Position (NOP) must not exceed 20 percent short (owning more than owed) or 0 percent long (owning no more than the bank's shareholder funds not reduced by losses) of the bank's shareholders' funds.

- The share capital of BDC operators was increased to N2 billion and N500 million for Tier 1 and Tier 2 licenses, respectively. This recapitalisation exercise was followed by revoking over 4,000 BDC operators' licenses.

- A cap has been placed on FX purchases for school fees at US$10,000 per customer annually. This process requires the transaction to be conducted through the BDC's domiciliary account with a Nigerian bank, ensuring direct payment to the educational institution.

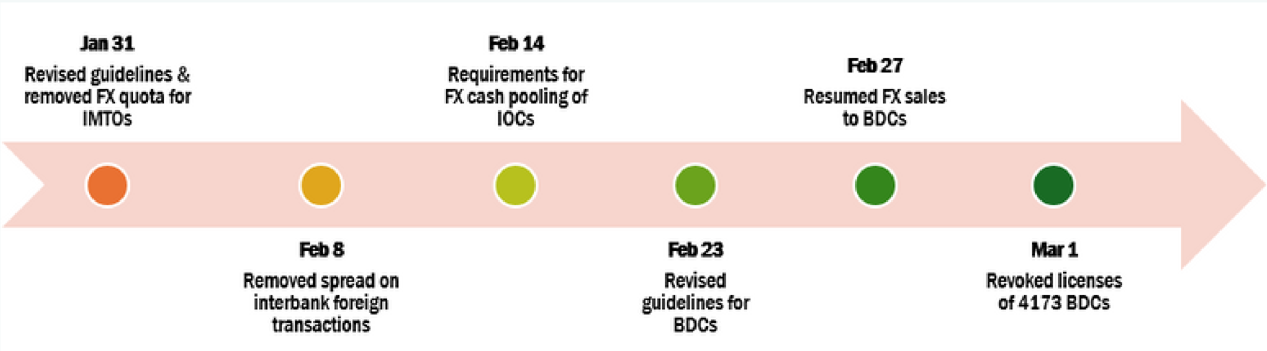
- There was a clamp down on cryptocurrency exchange Binance for supposedly amplifying the Naira's weakness by fueling demand for the dollar-pegged USDT coin, and this exercise has prompted some stability in the exchange rate[1].

- Restrictions have been placed on International Oil Companies (IOCs), allowing them to immediately repatriate only 50 percent of their FX profits while requiring them to wait for 90 days before transferring the remainder[2].

[1] See, https://www.semafor.com/article/04/03/2024/why-nigeria-naira-rebounding-dollar
[2] See, https://nairametrics.com/2024/04/08/customs-exchange-rate-for-import-duties-falls-below-official-market-rate/

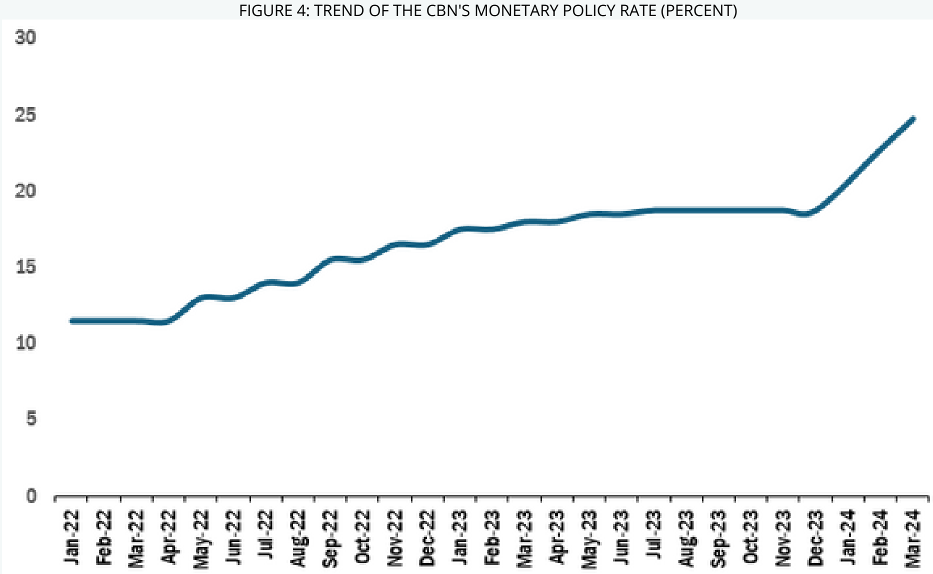
Drivers of the Recent Naira Appreciation

FIGURE 3: TIMELINE OF KEY FX-RELATED POLICIES BY THE CBN



Elevated Interest Rate: The recent rise in the Naira's value is largely due to the CBN's policies, including the increase in the Monetary Policy Rate by 600 basis points over a two-month period to 24.75 percent as of March 2024. While the CBN's hawkish stance constitutes an attraction point to foreign portfolio investors, it has kept the cost of borrowing elevated, which could, in turn, stifle investment and economic growth.

FIGURE 4: TREND OF THE CBN'S MONETARY POLICY RATE (PERCENT)



Data: CBN; Chart: NESG Research

External Reserves Depletion: The role of external reserves in defending the Naira cannot be overemphasised. External reserves constitute the low-hanging fruit in the CBN's pursuit of exchange rate stability. The external reserves fell to US$33.8 in 2024Q1 from US$35.5 billion in 2023Q1.

Drivers of the Recent Naira Appreciation

Increase in Foreign Private Investment Inflows: Investors remain concerned about the ongoing volatility in the FX markets. A stable Naira would allow them to return to the country's local-currency financial instruments (Treasury Bills, Government bonds, and Equities), thereby reducing the country's dependence on foreign-currency borrowing. According to the Nigerian Stock Exchange Limited, foreign portfolio investment inflows surged to N93.4 billion in the first quarter of 2024 from N18.1 billion in the corresponding period of 2023.

Prospect for favourable external trade balance position: The country recorded a trade surplus in 2023, and it is on course to maintain an improved trade balance position going into 2024. This is because global oil prices remain elevated, and domestic crude oil production is gradually improving. The global oil prices averaged US$86 per barrel in 2024Q1, rising from US$85 per barrel in 2023Q1. Similarly, the CBN data showed that average domestic crude oil production increased to 1.4 million barrels per day (mbpd) in the first two months of 2024 from 1.3mbpd in the corresponding period of 2023.

Is the Current Naira Appreciation Sustainable?

As much as the Naira appreciation over an extended period is desired, some underlying factors are required to achieve and sustain currency stability and appreciation. The Naira appreciation is only sustainable over the short term due to factors such as the sale of dollars to the BDCs and settling valid FX backlogs, which will come at a cost of external reserves depletion. The long-term sustainability of exchange rate appreciation or, at best, alleviation of Naira weakness remains a great concern and is hinged on the following crucial factors:

Mitigate all disruptions to domestic crude oil production to minimise the impact on oil revenue flow: Crude oil accounts for over 80 percent of total merchandise exports annually, underscoring its significant contribution to FX inflows. However, numerous challenges must be tackled to boost revenue in the oil sector. These include oil theft, corruption, pipeline vandalism, and environmental degradation. Implementing vigilant monitoring and evaluation of the oil sector would facilitate increased production, consequently attracting investors, bolstering FX inflows, and strengthening the Naira.

Enhance the non-oil sector to bolster FX inflows: Expanding FX revenue sources is crucial for alleviating strain on external reserves. A robust non-oil sector could lessen Nigeria's reliance on petrodollars, promoting non-oil exports and supporting a favourable trade balance position. Also associated with this is the need to enhance sectoral productivity, which will also translate to improved export volumes of non-oil commodities. Proceeds from non-oil exports would also compensate for possible FX revenue losses from crude oil sales.

Implement bank Recapitalisation: The CBN recently published a circular for bank recapitalisation, potentially attracting foreign portfolio and direct investors, especially targeting commercial banks with international authorisation. Consequently, this move is expected to enhance foreign exchange liquidity and ultimately enhance the stability of the Naira.

In addition, if these factors/conditions are not accomplished, there could be a reversal of the Naira appreciation or a reversion to currency weakness. The factors that could prompt Naira depreciation include Euro-bond sales, continuous disruption of domestic crude oil production through pipeline vandalism and crude oil theft, the neglect or non-pursuit of non-oil sources of FX earnings, and non-intensification of bank recapitalisation that could, in turn, cripple foreign investment inflows.

Box 1: Foreign Exchange Reforms in Egypt: Lessons for Nigeria

Following the Global Financial Crisis in 2008 and the Egyptian Revolution in 2011, Egypt experienced severe economic vulnerability, which manifested in an acute shortage of foreign exchange. This was associated with a drastic decline in FX reserves, a large fiscal deficit, growing public debt, and an overvalued exchange rate, which induced macroeconomic instability.

With tough reforms in place, the country transited into a stable macroeconomic environment, as reflected in low inflation and sustained economic growth, even during the COVID-19 pandemic. To achieve this feat, the Government of Egypt deployed the following economic reforms:

- **Liberalisation of the FX market:** Following the adoption of a floating exchange rate in 2016, the Egyptian currency was officially devalued, and the premium between the official and parallel market rates shrunk. Before the currency floating system, the parallel market exchange rate nearly doubled the official exchange rate. The floating exchange rate system, which was a precondition to access an IMF loan of US$12 billion over a period of three years, resulted in a sharp rise in inflation to 33 percent in July 2017, which subsequently reduced sharply to a single digit at 4.2 percent in July 2020. On the positive side the FX liberalisation policy boosted investors' confidence in the economy as Egyptian banks facilitated FX inflows of over US$400 billion between November 2016 and November 2020. It also improved the confidence of the migrant workers as remittances rose to a record high of US$28 billion after retreating to US$18 billion before the FX market liberalisation (Mounir, 2020). The liberalisation policy reduced pressures on the country's external reserves, which rose to US$35 billion as of July 2020, up from US$15 billion in January 2015. The FX liberalisation policy also reduced the jurisdiction of the Central Bank of Egypt to a monitoring role and obliged the Bank to intervene in the foreign exchange market only when deemed necessary.

- **Investment Law**: In 2017, the government of Egypt enacted the Investment Law, demonstrating the high priority placed on promoting and facilitating private sector investment and fostering economic growth. The legislation introduced an incentive regime that encourages local development in the country's poorer regions and gives rise to one-stop shops to support business processes. This law enhanced the inflow of FDI, which stood at US$13.7 billion in 2020, making Egypt the most profitable investment destination in Africa. The favourable investment climate in Egypt is also reflected in establishing seven (7) economic zones. The zones account for over 10 percent of FDI stock and 2 percent of the workforce in Egypt (OECD, 2020). These zones also generate more than half of the country's non-oil export proceeds. The coexistence of an investment and business-friendly environment unlocked massive investments in the country's natural gas sector.

Policy Recommendations

Achieving exchange rate stability hinges on many factors, most especially FX availability or improvement in FX liquidity. In order to reverse exchange rate instability and sustain the gain emanating from the recent FX reforms, the following measures are imperative:

Improving logistics to explore the benefits of the African Continental Free Trade Area agreement (AfCFTA): To harness the benefits of the Free Trade Area fully, there is an urgent need to improve logistics associated with clearing consignments at the country's ports. Unfortunately, only two out of the six seaports in Nigeria are fully operational. A considerable amount of FX is lost due to delays in consignment clearance and damages experienced during the process. When the other four ports are revitalised, there would be a reduction in consignment spoilage and an increase in proceeds from speedy clearance.

Enhancing the patronage of import substitutes: Many Nigerians patronise foreign-made products due to the low quality of local products. A considerable portion of the country's FX could have otherwise been saved if domestic buyers were to patronise goods produced in the country. There is an increasing need for widespread sensitisation of Nigerians, particularly the elite and high-income class, on the benefits of patronising local products in terms of increased job creation for the teeming unemployed if the local industries were operating in good working conditions.

Prioritising non-oil FX sources: While the non-oil sector contributes over 90 percent to Nigeria's Gross Domestic Product (GDP), it only accounts for a meagre 10 percent of export earnings, according to the NBS data. Given the country's output potential, there is an urgent need to boost the export of non-oil products, such as value-added agro-based products and light manufacturing goods. One way to achieve this is to develop a home-grown quality control system that aligns with global standards. According to the National Agency for Food and Drug Administration and Control (NAFDAC), about 70 percent of Nigeria's food exports are rejected in some European countries and the United States due to low quality. Hence, this issue needs urgent attention.

Rehabilitation of the local refineries and flexibility in payments for crude oil: The Port Harcourt refinery is still being revitalised, while the other local refineries are in a poor state. When all refineries are up to speed, this would reduce petroleum importation, which accounts for about 80 percent of total fuel consumption in Nigeria. In addition, the International Oil Companies (IOCs) have demanded crude oil purchase payments by local refineries should be made 80 percent in dollars and 20 percent in Naira. This creates payment flexibility and would contribute to exchange rate stability.

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About the NESG

The NESG is an independent, non-partisan, non-sectarian organisation committed to fostering open and continuous dialogue on Nigeria's economic development. The NESG strives to forge a mutual understanding between leaders of thought to explore, discover and support initiatives to improve Nigeria's economic policies, institutions and management.

Our views and positions on issues are disseminated through electronic and print media, seminars, public lectures, policy dialogues, workshops, specific high-level interactive public-private sessions and special presentations to the executive and legislative arms of government.

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