Of the Exchange Rate and Devaluation

Eromosele Abiodun examines the recent arguments for and against the naira devaluation and the solutions proffered by a former a Minister of Finance

President Buhari

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Several economic theories posit that devaluation will most likely improve a nation's trade balance. However, there are different schools of thought with divergent explanations of how devaluation improves or dampens a country's economic fortune.

Developing countries often face a major decision in reducing large trade deficits and in order to achieve this, they are faced with challenging policy decision of whether to devalue exchange rate or embark on internal/external debt financing.

There are arguments whether a long-run relation exists between the trade balance and nominal effective exchange rate in Nigeria.

Before independence, the Nigerian government adopted the Nigerian pound until 1973 when it was changed to naira. In 1971 the Nigerian authorities chose not to devalue its Nigerian pound during the devaluation process of the American dollar and this resulted in the appreciation of the Nigerian pound dollar exchange rate $2.80-$3.80 to the naira pound.

In 1973 the naira replaced the Nigerian pound and then Nigeria devalued at the same rate with the United States (US) which caused the exchange rate to be $1.52. However, the year 1986 was a transformational year in the exchange rate policy of Nigeria due to the structural adjustment programme (SAP) that was put in place to address the structural imbalance in the economy in order to attain a structural transformation in the economy.

By 1994, the federal government fixed the exchange rate at $22 to a US dollar, which implied a shift from the flexible regime of 1986. The foreign exchange market was liberalised in 1995 and it saw the introduction of autonomous foreign exchange market (AFEM) for sale of foreign exchange dedicated to this market by government as well as purchase of foreign exchange by the Central Bank of Nigeria (CBN) from the oil companies.

An Inter-Bank foreign Exchange Market (IFEM) was introduced on October 25, 1999. The operation of the IFEM, however, experienced similar problems and setbacks as the AFEM. The CBN thus, re-introduced the Dutch Auction System (DAS) to replace the IFEM.

The back and forth moves by the CBN continued until the 2008 global financial crisis. Luckily, Nigeria had enough foreign reserve and huge cash in the excess crude account, a development that helped in the stability of the exchange rate.

Another oil crisis

While Nigeria was still basking in the euphoria of oil trading at $100, another crisis erupted, following oversupply of crude oil. Suddenly, Nigeria's crude oil-Bonny Light, which traded at $110.2 per barrel in January, last year, rose to $114.6 per barrel by June same year. Between the end of last year and February this year, it traded below $35 per barrel before the recent upsurge which took it to $45 per barrel.

Before the recent crisis that has fuelled the devaluation debate, the naira was devalued in November 2014 during the Monetary Policy Committee (MPC) meeting. The midpoint of the official window of the foreign exchange market was moved from N155/$ to N168/dollar. The committee also widened the band around the midpoint by 200 basis points from plus or minus three per cent to plus or minus five per cent.

Today, though the naira goes for N197 at the official market, it sells for N320 to a dollar in the parallel market, a difference of about N125.

The debate

Consequently, analysts and many multilateral institutions have called for the devaluation of the naira. But the government has insisted it is not going to devalue. Just last week, a former minister of finance, Dr. Anthony Ani joined the debate calling on the federal government not to devalue the naira.

In his keynote address at the induction ceremony of new members of the Institute of Chartered Accountants of Nigeria (ICAN), he stated categorically, "I hold the view that our naira is even undervalued and should not be devalued."

"President Buhari should continue to resist the pressure to devalue. There is nothing to gain from devaluation since we do not export anything significant except our crude oil. Any devaluation will further worsen our economic situation and will send the cost of all our imported goods to the skies.

"Already, our imports are the most expensive in the world. Nigeria was removed from the community of nations that adopts letter of credit for its export business and as a result no bank in Nigeria (not even our CBN) can operate letters of credit. We have to do this through correspondent banks and this means paying for our imports upfront with the attendant commission, fees and interest charged by the correspondent banks. Devaluation in addition to the ban on letter of credit will greatly increase the cost of imported goods," he said.

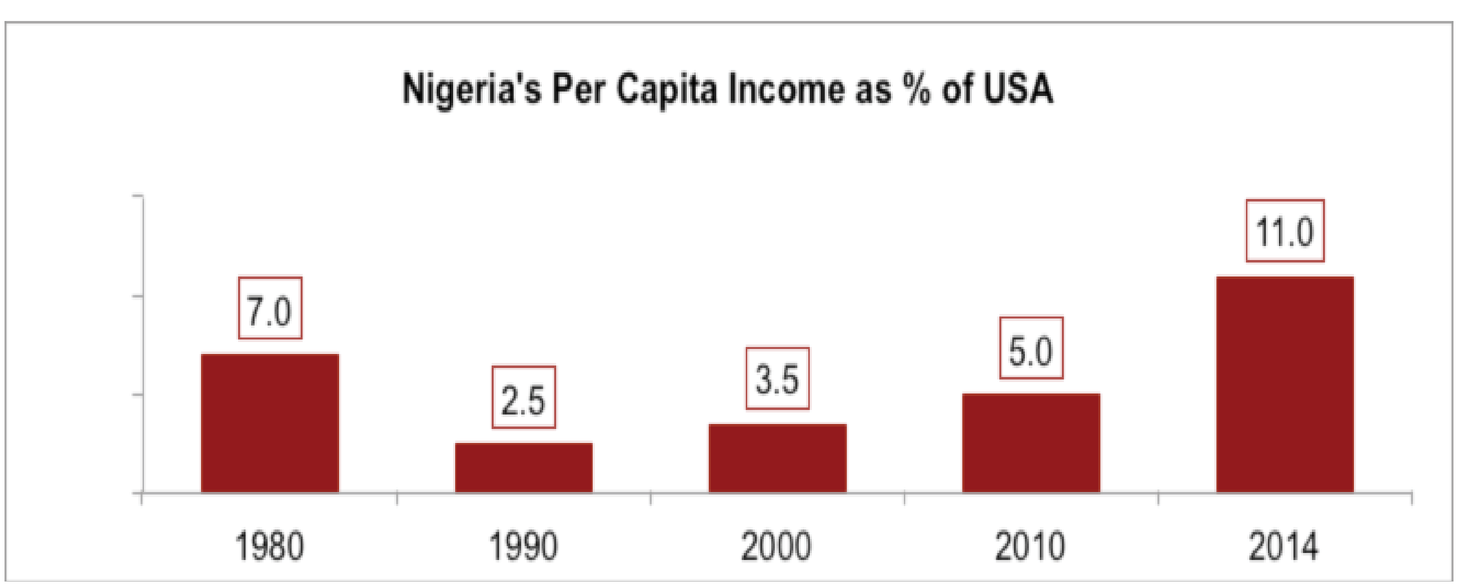
He added, "We are an import dependent nation and since exchange rate is the price of our currency in terms of the dollar which we use to pay for our imports, it must impact on the economy, Apart from this, our exchange rate has moved from $2 per N1 to N199 to $1 between 1985 and 2016 yet, the International Monetary Fund (IMF), United States of America and other international Banks have urged Nigeria to further devalue our naira."

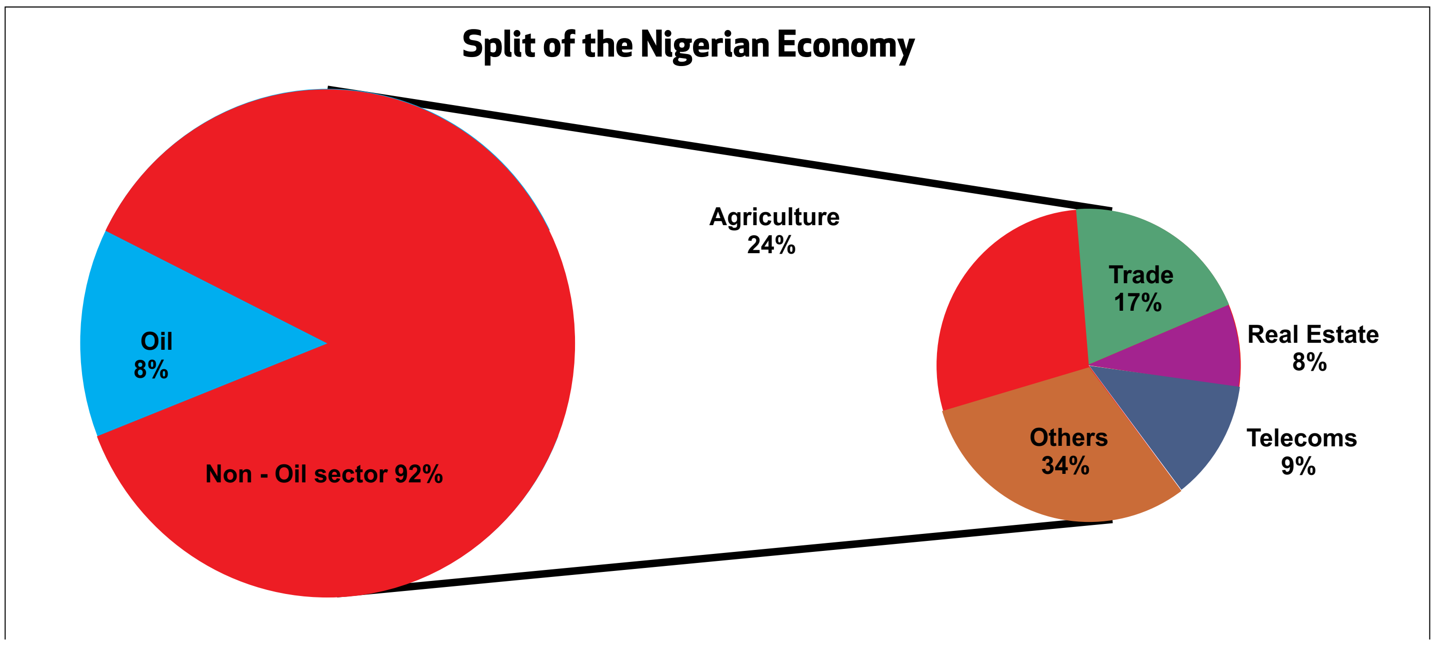
He argued that the central policy instrument in most economic programs is the exchange rate.

According to him, "It is a key policy variable in the realignment of currencies and relative prices also in developed economics. A viable, stable and realistic exchange rate through impact on relative prices acts as supply incentives for needed adjustment in production structures ensures judicious use of resources attracts capital inflows and directs other foreign exchange transactions from parallel market. A good exchange rate mechanism therefore augurs well for price stability and international trade.

"Many countries have faced difficulties to maintain exchange rate mechanism. We remember vividly the collapse of the British exchange rate mechanism (ERM) in the 1980s and this caused a lot of problems for the world economy. The Asian Tigers (Philippines Malaysia, Singapore, Indonesia) tried in the late 1990's to set up an exchange rate mechanism in order to enhance trade between their countries but this collapsed after the destructive intervention of a George Soros working for the Bretton Woods Institutions.

"As for the United States, the dollar is always





the dollar and cannot be affected by any world economic turbulence. The dollar is protected to such an extent that the developing world must restructure their economies and devalue their currencies so as to protect the dollar.

In so far as the US is concerned, he said the currencies of the developing economics are always over valued and must be devalued vis-à-vis the dollar. sHe added that the only currency that has overcome overvaluation from the point of view of the US is the Chinese Yuan, "for which the US is now seeking a revaluation just because the Chinese exports to US are cheap. On this basis when all world exchange rates collapse the dollar will be the only currency standing.

"In Nigeria, between 1995 and 2003, we tried to build and maintain a realistic exchange rate mechanism and develop a viable and stable exchange rate but our efforts were thwarted by the IMF when as a conditionality for debt forgiveness, it forced the country to change its policy and depend on commercial banks for our exchange rate management."

This, he added, is precisely the cause of Nigeria's present predicament in the wild and inappropriate exchange rate of N350 to one U.S dollar in the parallel market.

"I submit that neither devaluation nor flexibility of the exchange rate is the answer to our problems. Our exchange rate mechanism was destroyed when we were cajoled into debt cancellation programme. We must restore this mechanism and adopt a realistic exchange rate.

"We must make the naira to be internally convertible again; we must realize that the naira had in the past been over-devalued with no corresponding production or productivity to follow. I hold the view that Nigeria must not devalue and that President Buhari is right in resisting devaluation,"he stated.

Ani gets support

Ani is not alone in his opposition to devaluation. At the maiden edition of the Cable Colloquium, with the theme,"The Naira on Trial: To Devalue or Not," Edo State Governor, Adams Oshiomhole and former Vice President of the Nigerian Labour Congress (NLC), Isa Aremu, vehemently rejected devaluation.

Oshiomhole, who opened the discussion, traced the history of crude oil price fall from $148 per barrel to the current price of about $30. He said when things were perfect with crude oil at $148 per barrel; there was no debate on whether naira should be devalued or not adding that unfortunately, government didn't take a deliberate action to save for the rainy day.

"Suddenly, oil price dropped to N110, N50 and N30 in quick sequence, with the consequence being the drop in the monthly earning accrued to the nation and the depletion of the country's foreign reserve."Given the sharp drop in the price of crude oil, the three tiers of government now find it increasingly difficult to meet their monthly obligations as the amount shared on a monthly basis dropped significantly. This has resorted to the current situation where state governments now owe their workers," he said.

Quoting a CBN figure, Oshiomhole observed that the foreign reserve was $42.8billion as at 2014, "and it dropped at the beginning of 2015 to $37.3 billion. Currently, it is about $28billion."

He said foreign reserve was coming down because while the earning from oil dropped, Nigerians' appetite for imports and foreign goods had not reduced.

He warned that the reserve would be totally depleted in the next one year unless drastic actions were taken to reverse the current trend.

There is the need, according to Oshiomhole, "to curb the demands for imports and reorder our consumption pattern."

He, however, said the naira was on trial and those prosecuting it were investment bankers and currency speculators, adding that devaluation would hurt the poor, especially workers. According to him, those who looted government treasury are unconcerned about devaluation.

He urged the CBN to remain firm in its current stand not to devalue the naira, even as he suggested that the list of items banned from accessing official foreign exchange rate should be increased to include medical tourism and foreign study.

He said,"We have one million Nigerians studying abroad and consuming about half a billion."

A CBN director, who agreed with the submissions and figures reeled out by Oshiomhole, said devaluation would definitely come, but it would be anchored on the premise of strong industrial policy.

He said there was the need for Nigeria to make the investment climate attractive for foreign direct investment (FDI). Giving the history of devaluation, which he defined as "a deliberate action of the central bank or the monetary authority of a country to reduce the value of a currency," he disclosed that in 1986, the naira was depreciated by 71.5 per cent; 1989, 23.9 per cent; March 1992, 42.1 per cent; January 1999, 74.65 per cent; January 2001, 3.18 per cent; December 2008, 7.73 per cent; January 2013, 13.23 per cent, November 2014, 5.58 per cent, and February 2015, the country devalued by 14.25 per cent.

He said:"These are the episodes of devaluation of the currency since the Structural Adjustment of 1986. All these have been anchored and premised on the issues raised by His Excellency, the foundation with the hope that if we depreciated, we could accommodate current pressure and build on it. But we have not built on our devaluation overtime. Now is the time. Devaluation is absolutely sound if the fundamentals are right.

"What we are simply saying is that now, let us lay the foundation, let us initiate development in such a way that when we devalue, there could be a rider, a basis on which the economy can take off to higher heights. Devaluation may come someday, but it will be on the basis of a strong industrial policy."

Aremu, was more concerned about the plight of the Nigerian workers, saying any attempt to devalue again would lead to demand for wage increase.

Monetary independence

Last year, a key member of the MPC, Dr. Doyin Salami, called on the CBN to make public its view on its monetary policy dilemma before the end of the year.

Salami stated this while delivering his key note address at the Standard Bank West Africa investors' conference, tagged: 'Nigeria: From Promise to Progress'.

For Nigeria to transit from promise to progress in the immediate short-term, he said among other steps to be taken, the CBN must choose two of the three options before it, which he said, are: fixed exchange rate, maintain monetary independence, and capital mobility

"No monetary authority as far as we understand in economics is able to maintain a fixed exchange rate, maintain monetary independence and also maintain capital mobility at the same time. The first question therefore is what do we choose? You are allowed to choose two out of the three; the key question is which two should Nigeria choose?

"That is the question that I dare say will have to be answered in the coming months. Our exit from the JP Morgan index is unfortunate, as some say perhaps even an own goal, potentially has the silver lining of enabling us to ignite a conversation around which two of these three options should Nigeria take,"he said.

Salami added, "Do we go for independent monetary policy and loosen exchange rate? Do we go for capital mobility and independent monetary policy? This is a very important question and it is even made more important when you bear in mind that at some point in not too distant future the US Federal Reserve will begin the normalisation (unwinding quantitative easing).

"I am pretty clear in my mind that I will rather Nigeria maintain independent monetary policy because that gives us the capacity to react to domestic exigencies and a market determined exchange rate. I will rather that the price of currency is determined by demand and supply rather than any administrative determination.

"There are different shades of capital controls and capital account arrangements, as I tell people, South Africa is Africa's biggest financial hub, finance in is not a problem, finance out is a different matter entirely. One of the fundamental questions that the CBN must answer very quickly at least by the end of this year, is its view on the dilemma, which two of these three will it choose. That for me will set the tone as far as the ability of monetary authority in Nigeria to aid the process of promise progress."

Nigeria, he said, is one of the few countries that potentially could be self-sufficient adding that to do this we must produce.

"If we are going to make progress, we need to skew relative prices and economic conditions such that they make producing Nigeria profitable and attractive. I am one of those that have argued that the naira value should be market determined and a lot of people say that is going to be devaluation.

"Currency policy is not a silver bullet, it cannot take Nigeria anywhere. We will continue simply to devalue the currency. Nigeria's economy has to be competitive; we cannot continue to be 170 out of 189 countries on the ease of doing business report.

Nigeria is too large, too well endowed that its leadership should not continue to accept a position where we are almost at the bottom quarter. A competitive economy has to be built and regulation is part of that," he said.

Devaluation advocates

Head, Africa Strategy at Standard Chartered Bank, Samir Gadio, had argued that though a further devaluation of the naira may not happen soon, an adjustment is imminent."

"Despite the CBN's resolve, markets observers believe that it will eventually succumb to pressures and devalue the currency (again)," he said.

Also, Bond Fund Manager, Standard Life Investments, Kieran Curtis, had stated that a further devaluation would restore the economy to competitiveness and promote more capital inflows.

"It will take a combination of weaker currency and higher interest rates to get us back to Nigeria," he said, arguing that when Nigeria is compared to other oil exporters, it hasn't had enough of a currency adjustment.

The way out

As a way out, Ani proposed that all the excess liquidity in the banking system arising from foreign exchange operations should be mopped up and retained by the CBN at zero per cent interest.

"This amount may be used for development while being retained by the CBN. The CBN must continue to play the central role in the Autonomous Foreign Exchange Market. The CBN must fund the real sector of the economy without exception for its foreign exchange requirements. Any prohibition should be done by tariff adjustment. Commercial banks will fund the other sectors.

"All foreign exchange earnings in respect of for the nation's oil and gas operations will be retained by the CBN while remittances and non-oil imports earnings will be retained by the commercial banks for their operations at AFEM," he said.

He added that the CBN must allow the Bureau De Change (BDG) to operate on its own and must stop funding them.

"All their deposits should be returned to them. The parallel market rates must be crashed and a more realistic and sustainable rate ascertained for the Naira with an overage of not more than two per cent.

He said:"Nigeria must find its way back into the community of nations operating letters of credit. A situation where we operate through correspondent banks makes our imports to be expensive and have adverse impact on the generality of Nigerians.

Our motto should be production, production, production. We must repair our refineries and produce all our petroleum product needs. We must produce our food requirements. We must diversify our economy."

Ani said the re-exporting of remittances from Nigerians in Diaspora must stop.

"CBN must rescind and repudiate the Outbound Money Transfer Service as this is the window for the re-export of remittances. The CBN should enter into wider consultation with the Minister of Finance and the Minister of Planning before introducing schemes that appear to authorise capital flights and disgrace to the nation. The schemes of dealing in naira denominated bonds with J P Morgan and Outbound Money Transfer are shameful and unacceptable," he said.