Mini Report
SERIES

THE NIGERIAN ECONOMIC SUMMIT GROUP

Reforms Towards Resolving Foreign Exchange Challenges in Nigeria

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1. UNDERSTANDING THE CONTEXT

Nigeria has had a long history of strong domestic currency whereby the Naira-Dollar exchange rate was less than par, particularly in the 1960s through the 1970s until the mid-1980s. However, this is not unprecedented as the country's sub-regions specialised in distinct agricultural activities. During this period, the Nigerian economy was driven mainly by a boom in the agricultural sector. Meanwhile, the discovery and commercial exploration of crude oil resulted in the neglect of the agricultural sector, which predisposed the country to the massive importation of many agricultural products till date. However, the oil boom-bust era was marked by a weak currency whereby the exchange rate depreciated sharply to a three-digit number since 1999. As a result, the current exchange rate is more than threefolds of its level in the early 2000s. This suggests that the issue of foreign exchange (forex) availability and appropriate pricing are as important as the level of productivity of any country. Going by the adage that "you cannot give what you do not have", it is essential to note that the import-dependent nature of the country has heightened the volatility of the external reserves and exchange rates (see Figures 1 and 2). According to the National Bureau of Statistics (NBS), Nigeria's import trade accounts for 52 percent of total external trade in 2021.

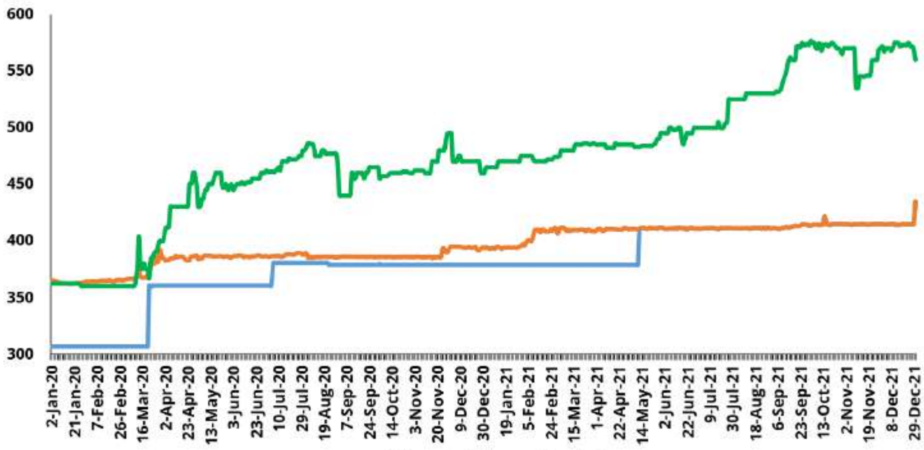
The problem of forex shortage and inappropriate forex pricing is largely attributable to weak productivity across the various activities in the non-oil sector, despite their huge potential to contribute significantly to forex earnings in Nigeria. The trade statistics showed that Nigeria is a net importer of agricultural products, raw materials, semi-finished and finished manufacturing goods. This suggests the structural challenges limiting the growth of employment-elastic sectors, including agriculture, manufacturing, construction, and trade, among others.

- Based on the data from NBS, the net import value of agricultural products rose sharply by 77.5 percent to N1.5 trillion in 2021 from N823.6 billion in 2020.
- The net import value for raw materials increased by 11.1 percent to N1.4 trillion in 2021 from N1.3 trillion in 2020.
- Nigeria's net import value of manufactured goods jumped to N9.4 trillion in 2021 from N6.2 trillion in 2020.

The unfavourable net trade position across commodities could be reversed if the productivity and export potential of the non-oil sector activities could be enhanced and leveraged for improved foreign exchange earnings. In this way, Nigeria could outsmart shocks emanating from huge dependence on crude oil for fiscal revenues and export earnings.

Owing to the deteriorating trade balance position, the country is increasingly exposed to external borrowing through Eurobonds and multilateral loans to shore up its external reserves. In 2021, the trade deficit widened to N1.9 trillion from N178.3 billion in 2020. The country had persistently recorded a trade deficit since the fourth quarter of 2019 when the land borders were shut. However, maintaining a trade surplus consistently coupled with adequate inflows of foreign investments will contribute significantly to improving the net flows of forex through the economy – which crashed from US$100.8 billion in the first three quarters of 2014 to US$44.5 billion in the corresponding period of 2021. Meanwhile, the massive dependence on imports has constrained the CBN's ability to manage forex demand by prohibiting certain commodities that could otherwise be produced locally from accessing forex at the official market since 2015. The result of this policy action has heightened demand pressures in the parallel market, leading to a wide gap between the official exchange rate (now the I & E Window exchange rate) and the parallel market exchange rate. The parallel market premium averaged N104.7/US$ in 2021, 64.9 percent higher than the average premium of N63.5/US$ in 2020 (see Figure 1). As part of efforts to boost forex liquidity, the CBN introduced the RT200 forex policy with the overarching goal of incentivising exporters in the non-oil sector to repatriate and inject their foreign exchange earnings into Nigeria's forex market (that is, Investors and Exporters' window).

Figure 1: Exchange Rate Movements (NGN/US$)

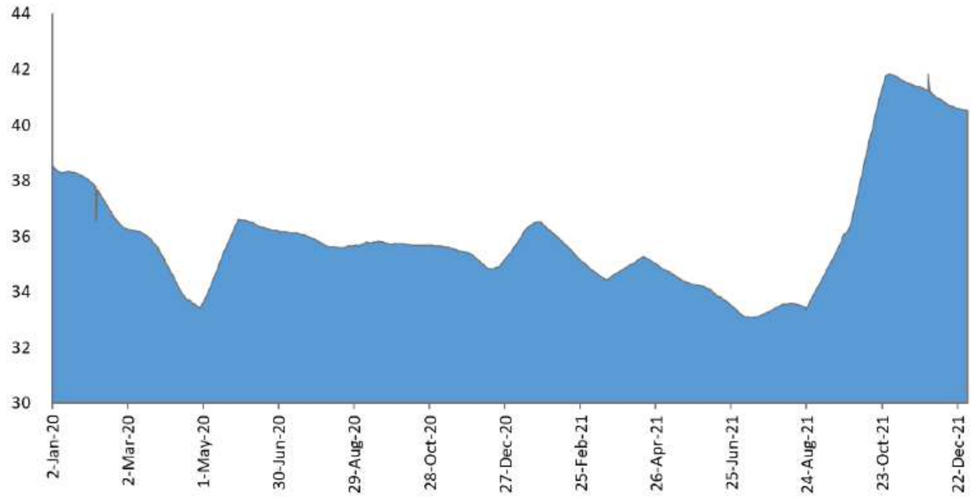


Source: Data: FMDQ, Nairametrics; Chart: NESG Research

The key factors limiting the availability of forex in Nigeria are:

- the lack of diversification of forex sources, with massive dependence on crude oil export proceeds.
- waning investors' confidence leading to a fall in foreign investment inflows.
- the frequent intervention of the CBN at the forex market, which exerts intense pressure on the country's external reserves.

Figure 2: External Reserves Movement (US$ Billion)



Source: Data: CBN; Chart: NESG Research

Faced with the continued dwindling of the external reserves, the Apex Bank resorted to exchange rate devaluation (three episodes were witnessed in 2020) and forex rationing among end-users. These challenges send wrong signals to prospective investors who are more concerned about the safety of their investments (particularly forex repatriation at maturity of investments, in addition to returns on investment). To this end, we propose that reforms to address Nigeria's foreign exchange problems should focus on two key areas: the need to boost forex availability and guarantee appropriate forex pricing.

2. DOUBLE-EDGED FOREIGN EXCHANGE REFORMS

Reform 1: Need to boost Foreign Exchange Availability

The availability of forex sends a signal to foreign investors of the safety of their funds and seamless repatriation at the maturity of their investments. To this end, the key considerations that matter for improved forex availability in Nigeria include:

- ***Leveraging the African Continental Free Trade Area agreement (AfCFTA) for diversified revenue base and new markets:*** The AfCFTA presents an opportunity for Nigeria to improve the export potentials of her non-oil sector as this will pave the way for improved revenue diversification and to target new markets on the continent. To achieve this, there is an urgent need to promote value chain development in industries such as agro-allied and light manufacturing. Besides, to fully harness the benefits of the African trade pact, there is a need to improve logistics at the country's seaports, as a considerable amount of forex is lost due to delays in consignment clearance and damages experienced during the process. Additionally, there is a need to address the porous nature of Nigeria's land borders as this will help improve custom duties collection. Effective border control will also ensure that smuggling activities are drastically reduced.

- ***Removing capital controls and encouraging the inflow of stable investments:*** Stiff controls on capital inflows occasioned by market illiquidity and forex rationing constitute a stumbling block to substantial foreign investment inflows into Nigeria. This has led to the predominance of hot money or foreign portfolio investment, which is highly prone to capital flight. Hence, the country needs to implement investment-friendly policies that will encourage stable investments such as Foreign Direct Investment (FDI). There is a need for improved compliance of the authorities with contractual agreements. This is important for attracting higher foreign investments, thus contributing significantly to infrastructural development via the Public-Private Partnership framework. This channel will also boost the availability of forex in the country.

- ***Prioritising non-oil forex sources:*** While the non-oil sector contributes 90 percent to Nigeria's Gross Domestic Product (GDP), it only accounts for about 10 percent of export earnings, according to the NBS data. There is an urgent need to boost the production of non-oil export products, particularly value-added agro-based products. One way to achieve this is to develop a home-grown quality control system to ensure that Nigerian-made products become attractive to foreign buyers. The lack of standardisation in Nigeria also partly explains why Nigerian products must be exported to Ghana first for repackaging before being re-exported to the rest of the world. If this re-exportation business could be eliminated, the foreign exchange inflows from value-addition will accrue to Nigeria. Also, there is an increasing need to boost the inflow of remittances inflows via the formal channel, largely banks, to complement the International Monetary Transfers Operators' (IMTOs) efforts by reducing the high transfer costs.

- ***Enhancing the production of quality import substitutes:*** Many Nigerians patronise foreign-made products due to the low quality of local products. However, a considerable portion of the country's foreign exchange could have otherwise been saved if domestic consumers patronise Made-in-Nigeria products. For example, patronising locally-made products could improve the job retention rate and unlock more job opportunities for the unemployed youths in the country. Unfortunately, one more job is likely created in foreign lands for every US dollar spent on imported products. Improving the quality of local products will reduce the forex demand backlogs and moderate the pressures on Nigeria's external reserves.

- ***Fixing the local refineries and constructing new ones:*** The much-awaited 650,000 barrel-capacity Dangote Refinery project — the largest in Africa — is expected to start operations by the second quarter of 2022. The US$15 billion refineries would reduce petroleum importation, which accounts for about 80 percent of total fuel consumption in Nigeria. When implemented, the deregulation of the oil and gas sector, as specified in the Petroleum Industry Act (PIA), is expected to attract more investments into the downstream oil and gas sector. Reduced dependence on petroleum imports would boost forex savings and guarantee improved forex availability for other priority uses.

Reform 2: Need to ensure Appropriate Pricing of Foreign Exchange
It has been argued in some quarters that the exchange rate in Nigeria is overvalued, that is, the exchange rate is below the level determined by the forces of demand and supply. This has, in turn, generated hot debates around what the central exchange rate should be in the face of the current multiple exchange rate regime. External agencies such as the IMF and World Bank have called for unification and flexibility of the exchange rate regime in Nigeria. Notwithstanding, the key considerations that matter for appropriate forex pricing include:

- ***A clear forex policy is needed to build investors' confidence and trust:*** The multiplicity of exchange rates brings about uncertainty in evaluating the profitability of alternative investment opportunities. Hence, there is a need for clarity and consistency in rolling out foreign exchange policies. A transparent exchange rate policy would also attract more stable foreign capital inflows, such as foreign direct investments, which remain very low compared to foreign portfolio investments. In this way, there is a need to alleviate investors' panic that new forex inflows from the Special Drawing Rights (SDRs) of US$3.5 billion and Eurobonds valued at US$4 billion will be judiciously used to meet forex demand obligations. This will also help to restore their confidence in the economy. A transparent exchange rate policy will also limit arbitrage practices in the country.

- ***Need to determine the fair value of the Naira:*** The argument for undervaluation or overvaluation of the Naira could be proved from the computation of the Real Effective Exchange Rate (REER) or trade-weighted exchange rate. The REER is the weighted average of a country's currency about an index or basket of other major currencies. The merit of this measure of the exchange rate is that it reflects the magnitude of trading activities between Nigeria and its major trading partners. The IMF Staff estimates suggest an overvaluation of the real effective exchange rate (applied on the level of the official exchange rate in 2020) of 18.5 percent[1]. This estimate is expected to be much higher now that the CBN has adopted the I&E Window exchange rate as its official rate. In addition, an appropriately valued exchange rate would foster domestic industrialisation more effectively than a system of forex rationing. Moreover, country experiences have shown that four considerations are essential for a successful transition to exchange rate flexibility, and they include[2]:

- A deep and more liquid foreign exchange market;
- A coherent policy governing the Central Bank's interventions in the foreign exchange market;
- An appropriate alternative nominal anchor to replace the fixed exchange rate system; and
- Effective systems for reviewing and managing the exposure of both the public and the private sectors to exchange rate risk.

[1]See the IMF's Article IV Review for Nigeria, retrievable via: https://www.imf.org/en/Publications/CR/Issues/2021/02/05/Nigeria-2020-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-50064
[2] ibid

Foreign Exchange Reforms in Egypt: Lessons for Nigeria

Following the Global Financial Crisis in 2008 and the Egyptian Revolution in 2011, the economy of Egypt experienced severe economic vulnerability, which manifested into an acute shortage of foreign exchange. This was associated with a drastic decline in foreign reserves, large fiscal deficit, growing public debt and 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 at the heights of the COVID-19 pandemic. To achieve this feat, the government of Egypt put in place the following economic reforms:

- **Liberalisation of the forex market:** Following the adoption of the floating exchange rate in 2016, the Egyptian currency was officially devalued, and the premium between the official and parallel market rates shrunk. Before the floating currency system, the parallel market exchange rate was close to doubling the official exchange rate. As a precondition to access an IMF loan of US$12 billion over a period of three years, the Central Bank of Egypt liberalised the exchange rate[3]. The aftermath of the policy shift was the 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. The liberalisation policy also boosted investors' confidence in the economy. It was reported that Egyptian banks facilitated forex inflows of over US$400 billion between November 2016 and November 2020. It also improved the confidence of the migrant workers to route remittances via banks. In the 2019/2020 fiscal year, foreign remittances rose to a record high of US$28 billion after retreating to US$18 billion before the forex market liberalisation[4]. The liberalisation policy reduced pressures on the country's external reserves, which stood at US$35 billion as of July 2020, up from US$15 billion in January 2015. It 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 when deemed necessary.

- **Investment Law:** In 2017, the government of Egypt enacted the Investment Law, which demonstrated the high priority that the government places on promoting and facilitating private sector investment and fostering economic growth. The legislation introduced an incentives regime that helps to encourage local development in the country's poorer regions and gives rise to one-stop shops to support business processes. This law has enhanced the inflow of FDI, which stood at US$13.7 billion in 2020, making Egypt to be ranked the most profitable investment destination in Africa. The favourable investment climate in Egypt is also reflected in establishing seven economic zones. Collectively, the zones account for over 10 percent of FDI stock and 2 percent of the workforce in Egypt[5]. They also generate more than half of the country's non-oil export proceeds. The coexistence of investment and a business-friendly environment unlocked massive investments in the country's natural gas sector.

- **Removal of Subsidies on Energy products:** Another structural reform introduced in Egypt is the removal of subsidies on fuel and electricity. This was a step taken to reduce the fiscal deficit and keep public debts downward to free more funds for developmental purposes. The energy subsidy reform has enhanced electricity supply and natural gas exports. It has also opened up the country's energy market for private sector participation and incentivised renewable energy investments.

[3]PwC (2017). ERP Devaluation: A New Beginning. Retrieved from: https://www.pwc.com/m1/en/publications/documents/the-egp-devaluation-a-new-beginning.pdf
[4]Mounir, H. (2020). After four years, Egypt's exchange rate liberalisation proves its economic boon. Retrieved from: https://dailynewsegypt.com/2020/11/07/after-4-years-egypts-exchange-rate-liberalisation-proves-its-economic-boon/
[5]OECD (2020). OECD Investment Policy Reviews: Egypt 2020. Retrieved from: https://www.oecd.org/countries/egypt/oecd-investment-policy-reviews-egypt-2020-9f9c589a-en.htm

3. CONCLUSION AND OUTLOOK

The monolithic nature of the Nigerian economy has subjected both external reserves and the domestic currency to intense pressures arising from global oil price volatility. While global oil price was very high in 2021, the external reserves were under pressure to meet backlogs of forex demand. This suggests that Nigeria can no longer continue to depend on crude oil proceeds if the country is to achieve stable inflows of forex. Therefore, the fiscal and monetary authorities must work in unison to boost forex supply, especially from non-oil exports and from stable foreign investment inflows (FDI and remittances). Moreover, increasing the supply of foreign exchange is the only way to narrow the widening parallel market premiums. Also, adopting a more flexible exchange rate system that adjusts with changing macroeconomic conditions will enhance the attractiveness of Nigeria as a profitable investment destination. It is expected that as the general elections are fast approaching, the liquidity injections of forex would strengthen the Naira and reduce the widening parallel market premium. Since the effect of this event is just temporary, the sure bet for the country is to enhance the productivity of the non-oil activity sectors and boost their export potentials for improved generation of forex revenues.

ABOUT NESG

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

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