A LIBERALIZED FOREIGN EXCHANGE MARKET

A PROPOSAL FOR A LIBERALIZED FOREIGN EXCHANGE MARKET IN NIGERIA AND ITS ECONOMIC BENEFITS

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LIBERALIZATION OF THE FOREIGN EXCHANGE MARKET

We have been challenged by the level of poverty in the midst of abundant human and material resources in our land to take a close look at our economic and monetary policies over the years and assess how these could have impacted on our current parlous state and attempt to uncover what may indeed be the principal causes of our economic condition!

1. In our analysis, we shall take a cursory look at the **salient determinant indices and features** in our current economic and monetary systems.

2. We shall proceed to describe the **principal practices in the framework** of the monetary and fiscal policies which have induced our poor and unyielding state of underdevelopment.

3. In the light of the failed monetary policies of the past, we shall propose a review of the structure of our economic and monetary systems, based on the liberalization of the foreign exchange market.

4. Finally we shall examine the favourable dividends which the new approach will deliver and compare the anticipated economic indices with what obtains under our current monetary dispensation. In the process we shall expose the contradictions in the effects of the current economic policies and lay bare the fallacy of our blind adherence to traditional economic frameworks which are out of tune with our current aspirations as a nation.

1. SALIENT FEATURES IN THE NIGERIAN ECONOMY

The Nigerian economy has remained stunted for the last two decades and all attempts to revitalize it have so far failed. The prevailing **fiscal and monetary policies** of the administrations in that period have brought about a national economy that is characterized by **the following resilient features:**

1.1 LOW INDUSTRIAL CAPACITY UTILIZATION /HIGH UNEMPLOYMENT

Low industrial capacity utilization has been resistant around 30% over the years as a result of high manufacturing costs and high interest rates in the face of continuously dwindling personal disposable income! A weak social and industrial infrastructure base has further compounded the startup and operational costs of all projects.

1.1.2 Increasingly, high level of unemployment persists in defiance of the huge billions of naira annually spent by the different administrations to promote agricultural and industrial activity and generate employment. A relatively low level of aggregate demand due to low purchasing power has continued to be a stumbling block in our path to industrial and economic growth.

1.2 HIGH INTEREST RATES

High interest rates which have hovered around 20-35% over the last 20 years have ensured that only 'quick profit buying and selling' activities are favoured by our monetary policies. Agricultural and industrial enterprise with greater linkage and employment potentials with value added are considered unattractive and risky ventures because of the long gestation to profitability. The CBN's monetary instruments of treasury bills and certificates which are expected to define the path for the money market in the direction of people and welfare development oriented policies have indeed become veritable tools that fuel anti-development economic systems with the indiscriminate issue of treasury bills and CBN certificates attracting interest of over 20%.

1.2.1 Indeed the MRR on which interest rates are determined has often risen to between 19 and 20%! Rates which can only barely be sustained by trading activities but which spell doom for genuine entrepreneurs with interest in the agricultural and industrial sectors have evolved and commercial interest rates have stabilized around 30%. In this regard, the executive's admonition to the banks to reduce their lending rates appear to be misdirected when it condones the CBN's high minimum discount rates; the bench mark rate for money market operations!

1.2.2 The tragedy of our interest rate structure is made more glaring when considered and compared with the average interest rates of **2-4% of focused economies**! It is unrealistic to expect genuine industrialists and agricultural investors in Nigeria to be competitive against the offerings from countries with such low capital and infrastructural costs! It may require a magician's wand!

1.2.3 The use of supplementary CBN instruments such as the Savings Certificate (NSC), Investment Notes, foreign guarantees for naira denominated loans and an **upwardly mobile minimum rediscount** rate *(MRR)* have tended to stimulate consistently very high interest rates with attendant anti-development and anti-industry impetus in the national economy.

1.3 UNTAMED LIQUIDITY AND INFLATION

Untamed liquidity in the financial system has become a permanent feature in our economy as a result of generally conflicting monetary and fiscal policies of the executive and the CBN. The system often becomes awash with 'excess liquidity' with the irregular and often unpredictable disbursements of statutory allocations to the tiers of Government and other beneficiaries. **This naira rain is usually immediately followed up with CBN's anti-growth and industry control measures to mop up the so-called 'excess liquidity' which had been 'unavoidably'**

unleashed in their attempt to simultaneously provide naira cover for the amount of dollars converted and paid to beneficiaries of the dollar component of federal revenue!

1.3.1 Indeed, we now have the dismal reality of the greater the excess liquidity problem *(i.e. the more we earn in foreign exchange from whatever source converted to naira),* the higher the rate of exchange at which dollar revenue is converted before sharing to constitutional stakeholders and the higher also is the MRR and consequently the commercial banks lending rates and ultimately the lower the value of the naira against stable currencies.

1.3.2 The net result is inevitable cycle of high inflation continuously fuelled by high manufacturing costs which are in turn primarily induced by a steady **regimented** depreciation of the naira over the past 20 years by the authorities despite relatively **stable balance of payments with our major trading partners!** Economically speaking, the naira has no business losing over 98% of its value over the last 20 years when the country has continued to earn from export more than it had ever imported for 95% of this period.

1.4 CAPITAL FLIGHT AND DIVERGENT EXCHANGE RATES

The irregular and unpredictable payment of **statutory allocations entirely in naira** to the constitutional beneficiaries of the federation pool and the unbridled diversion of the bulk of the naira flood into a monopolistic forex market have led to a continuous downward pressure on the value of the naira! **The lack of adoption of a truly transparent and liberalized market mechanism to govern forex transactions has led to the emergence of a self-servicing parallel market**. The result is unstable and relentlessly depreciating exchange rate with its attendant adverse consequences such as capital flight and round-tripping which have in turn contributed in no small way to the gradual loss of confidence in the naira with an unfettered parallel market ready to lead the way to further devaluation! **A persistent vicious cycle of destruction of the national currency and economy is our reward for a faulty monetary framework**.

1.4.1 A thriving and uncontrolled parallel market has ensured an ever-increasing margin between official exchange and parallel rates. Attempts by the authorities to reduce this margin by an official devaluation of the naira have generally met with predictable failure. The gap would close briefly before it begins to widen once again! An endless cycle that can only kill the naira and pauperize our people over time; a cycle sustained by our current monetary framework of irregular injections of inordinate quantum of **naira** into the pockets of the beneficiaries of the federation pool. Ultimately, a large spread of the 'spasmodic' naira rain would expectedly **return** to the CBN as payment for forex required for the imports bills of various stakeholders in the economy via **a forex market that is structured to produce a black market** by its lack of transparency and adherence to the principles of a liberalized market.

1.5 LOW SAVINGS AND INVESTMENT

The savings culture has received a severe battering in the last two decades. The continuous decline in the value of the naira has discouraged savings. Indeed under our current monetary system, it can be expected that only beneficiaries of 'easy' or unearned income would be happy to earn a yield that is below the expected annual rate of depreciation on the value of the naira on their savings. The public sector has consequently provided the little savings that exist in the economy. The level of savings has continued to hover regrettably below 15% of gross domestic product and this scenario will remain for as long as **deposit rates** remain unattractive vis-à-vis the unyielding fall in the nominal value of the naira.

1.5.1 The paucity of savings as can be expected has resulted in lack of available funds for investment and employment generating activities. All attempts by government to stimulate investment and employment have failed because of high lending rates, which have remained a threat to the survival of local industry as our experience has shown.

1.6 DEFICIT BUDGETING AND NATIONAL DEBT

1.6.1 In spite of the gigantic quantum of naira annually budgeted by the tiers of government there has been no significant positive impact on people's welfare. Consistent budget deficits have almost become a permanent feature of fiscal policy even though in real terms, these large naira sums become 'peanuts' when converted to the US dollar, and comparisons made with the budgets of other countries in our development bracket! The inflationary push of this abiding deficit budget policy is not lost on the economy especially as recurrent expenditure continues to eat up increasing portions of federal, state and local government budgets.

1.6.1.1 The temptation to resort to **money creation** or **excessive borrowing from the capital market** has often proved irresistible as a means of financing government deficits, the inflationary pressure caused by such action notwithstanding.

1.6.2 An external national debt level of about US$30 billion has become resistant to any downward movement in spite of huge provisions for debt servicing in the budget of most of the past administrations. Meanwhile, the domestic debt component has risen beyond a trillion naira.

1.7 INADEQUATE STATISTICS FOR FISCAL PLANNING AND MONETARY CONTROL

Lack of authenticity of monetary data and financial information supplied independently by the financial institutions remains a bane in the ability of the government and the CBN to formulate and prosecute people oriented **and welfarist monetary** and fiscal policies. Recent CBN investigations into the activities of commercial banks have revealed the extent to which the sharp practices of most banks have negated CBN's monetary objectives.

1.7.1 The framework for banking **supervision and control** to ensure strict adherence by financial institutions and the money market to CBN monetary policy **remains slow, weak and ineffective.** Indeed, the CBN's role of fine-tuning economic/monetary policy for economic advancement has been drowned by its complete involvement in the buying and selling of foreign exchange on a day to day basis.

1.8 MONO-CULTURAL EXPORT ECONOMY

A mono-cultural export economy has since become inevitable as high interest rates and very high manufacturing costs coupled with poor infrastructure and unstable government policy make export of agricultural and industrial finished goods uncompetitive and impractical. The inability of our industry to match the quality and price of imported finished consumable goods has made Nigeria a dumping ground for goods from all over the world. In other words, our national wealth is being used to further stimulate the economies of our competitors. Our wholesale acceptance of the WTO agreement on trade and tariffs has further reduced the potential for the growth of local industry.

1.9 DISBURSEMENT OF FOREIGN EXCHANGE EARNED FROM EXPORTS

The policy regarding exporters' accessibility to foreign exchange which they legitimately earn has fluctuated over the years. The current situation where private sector exporters have full and unrestricted access to their foreign exchange earnings appear to be satisfactory to all stakeholders. Indeed the current policy is consistent with the practice in progressive economies over the world.

1.9.1 The national revenue profile over the years has shown that almost 90% of foreign exchange revenue is derived from the export of crude oil. Constitutionally, **the dollars earned belong to the people of Nigeria** and disbursement is **facilitated by the issue of naira warrants** to the accounts of statutory beneficiaries by the CBN. However, the agents of the owners of the dollar proceeds from the export of crude oil i.e. the statutory beneficiaries *(Federal, State, Local governments and corporate bodies)* do not currently have the same direct access to their portions of this export revenue as independent private exporters. The dollar revenue is first exchanged into a quantum naira value at **a rate unilaterally determined by the CBN without any pretensions to the open market forces of demand and supply** before the resultant naira equivalents are paid to statutory beneficiaries who would **return to the same CBN to re-exchange their naira for the same dollars** if they required forex for their own corporate import needs.

1.9.2 OFFICIALLY INDUCED ROUND TRIPPING!

Under the current revenue allocation system, the beneficiaries from the federal pool who have to place orders for public requirements from abroad for their development projects would seek to **re-convert** part of their gargantuan naira allocations into dollar at **any rate** independently assessed and prescribed by the CBN at a regular auction that bears no semblance to liberalization or the market forces of demand and supply. The system facilitates the diversion of public allocations into the black market to satisfy "unofficial" needs of beneficiaries. Thus in this system, **the CBN is the only seller** and price controller of all public sector crude oil dollar earnings; the CBN is at the same time the only provider of all naira in the economy. Such a system as can be expected will be liable to abuse in its operation, even in an economy operated by monks!

1.9.3 The net result of the above system for disbursement of federal revenue and the obtuse foreign exchange market for public sector dollar earnings is a steady depreciation of the naira at a rate that is **inconsistent** with the real local purchasing value of the naira vis-à-vis defined basic parameters such as food, shelter, and transport indices in a comparative basket.

1.10 MAINTENANCE OF LARGE FOREIGN RESERVES AS AN INSTRUMENT OF INTERNATIONAL CREDIT WORTHINESS AND DEBT MANAGEMENT

Our creditors and international finance agencies have relentlessly encouraged our government over the years to continue to build up our foreign reserves *(mainly held in US$)* as a way of proving our credit worthiness, so the argument goes; these huge reserves currently approaching over US$10 billion are **saved** in foreign vaults attracting annual net earnings of less than 2% after the usual management expenses have been debited offshore! It seems odd that despite our increasing huge 'idle' foreign reserves, we still have a need to seek for fresh international loans with unfavourable rates of interest and anti-people and anti-welfare conditionalities.

1.10.1 The value of the naira compared to the dollar and other major currencies continues to **dwindle against realistic expectation in view of favourable trade balances over many years! Events have exposed the anomaly of a stronger naira rate of exchange *(about ₦22 - $1 in 1993)* when our foreign reserve was less than 50% of what it is today. Our reserves have since doubled to about $10 billion and our exchange rate has fallen to N130 to the dollar as at end of July 2002.**

1.10.2 International credibility remains a dream on the horizon despite extensive and expensive image building overseas trips by the executive.

1.10.3 Our foreign debt level seems stuck at about US$30 billion despite huge debt payments over the last 20 years! The greater portion of this debt is public sector incurred and most of the projects on which the funds were expended have since become non-performing. Meanwhile, most of our current state political administrators have expressed surprise at their current debt levels despite the constant deductions made directly from their share of statutory allocation by the central government.

1.10.4 **There is still no clear definitive statement on the true debt profile of the country and as far as we know there is no developed strategy towards debt management**.

2. THE FRAMEWORK FOR FISCAL AND MONETARY POLICY IN THE LAST TWO DECADES

2.1 SHARING OF FEDERAL REVENUE

The major contributive sources of Federal Government revenue are crude oil export, excise duties, Value Added Tax, corporate and personal taxes, petroleum sales tax and licence/registration fees. All the revenue sources except crude oil are derived in our national currency, the 'naira'. Revenue derived from crude oil export which annually amount to over US$7 billion *(about ₦1000 billion at present rate of exchange)* still account for over 85% of federally collected revenue.

2.1.1 The recent Supreme Court ruling on resource allocation has declared that the National Assembly would approve the mechanism for the disbursement of federal revenue. This role appears to have been currently usurped by the CBN!

2.1.2 The Federal Government through the CBN is expected to follow laid down constitutional provisions in determining and sharing the federally collected revenue to the three tiers of government and other corporate beneficiaries. In the days of the military, the sharing was done arbitrarily and basically the Supreme Military Council decided who got what and when! The current democratic dispensation has brought about 'closer' adherence to constitutional provisions in the sharing of the federal revenue. However, the pattern of release of the naira allocations to the tiers of government and other beneficiaries are for inexplicable reasons often irregular and erratic creating wildly **fluctuating** liquidity cycles and attendant disruptions in the national economy.

2.2 DETERMINATION OF THE NAIRA RATE OF EXCHANGE

The current practice of sharing federally collected revenue follows a procedure whereby both naira derived and dollar earned revenue are **accounted for in quantum terms as naira** before the **constitutional ratios** of sharing are applied. In order to facilitate sharing, the government on the advice of the CBN *(or is it the other way round)* converts the huge dollar earnings from crude oil and gas export to naira at a unilaterally declared rate of exchange which make no pretensions as to some play of the open market forces of demand and supply!

2.2.1 Indeed it may be correct to say that **the CBN declared rate is determined by the following factors**:

2.2.2 The advice by our foreign creditors and international agencies that the naira is overvalued.

2.2.3 An unbridled self-serving parallel market fuelled by the ever-widening gap between the official and parallel/black market rates as a result of lack of transparency and the monopolistic role of the CBN in the supply of both the naira as well as the dollar.

2.2.4 The **higher the value of the dollar vis-à-vis the naira** the larger the optical value of the naira allocations to constitutional beneficiaries; the higher also will become the quantum of naira required for this purpose. Thus, a hard to resist **temptation arises to increase money supply through new note issue in exchange for dollar values or massive borrowing from the capital market at destabilizing rates as a means of meeting obligations to beneficiaries of the federation pool from time to time notwithstanding** the inflationary pressure that this type of action causes.

2.3 MONETARY/FISCAL CONTROL

The CBN over the years has become fixated on a continuous battle to control liquidity in the system and an indulgence in the monopolistic auction of foreign exchange earnings. The prime instruments usually adopted in these battles and their operational framework are outlined below:

2.3.1 **Causes and Control of Excess liquidity**

We have indicated earlier that apparent excess liquidity in our system occurs largely as a result of the irregular and unpredictable disbursements of revenue allocations to the tiers of government and other beneficiaries of the federation pool the bulk of which is bloated as a result of a faulty exchange rate. We recall that the current framework adopts a system of conversion of the dollar earnings from crude oil export into naira at a unilaterally and politically predetermined rate of exchange and consolidating the resultant sum with the local revenue from VAT, petroleum, tax, licences, corporate tax etc before distribution to constitutional beneficiaries of federal revenue. The optically larger the quantum of naira allocation to the three tiers of government, the greater the expectation of the masses! In real terms however, the gargantuan allocations will buy less and less with every fall in the value of the naira and the federal, state and local governments are unable to do much more than pay staff salaries and other recurrent expenditure. Capital projects, most of which are import dependent become minimal in view of the meager dollar equivalent of the balance revenue after the disbursement of recurrent expenditure.

2.3.2 The net result is a contraction of industrial activity and a severe blow to growth of our national economy

2.3.3 **Discordant Interest Rates and CBN Monetary Policy**

The usual CBN's instruments for the mop up of the excess liquidity (i.e. high MRR and very high interest yielding certificates) produce the predictable effects of

sympathetic high commercial bank lending rates, and increased industrial costs in the face of contracting employment and aggregate demand. The final result is a matrix of high inflation, low demand and falling industrial capacity utilization. It is clear that the problem of **excess liquidity** and usually higher interest rates as they appear in our monetary system **will never be satisfactorily tackled with current conventional instruments** so long as we maintain a monetary system **which discourages the utilization of increasing export earnings** for local development for fear of fuelling inflation in the system! The issue, last year, of the oil windfall of over $1 billion and the debate on whether or not to spend it is a case in point. It is another paradox that while we went cap in hand in search of new loans from international agencies and investors, we had decided that our $1 billion windfall be kept as further reserve at a time when the economy was crying for financial booster to stimulate demand and jumpstart the economy!

2.3.4 There are indications that all federal governments *(or is it CBN governors)* to date have often found it convenient to convert the value of distributable dollar revenue to a naira base before paying statutory allocations. The naira equivalent had always been consolidated either through **new note issues** and/or heavy borrowing from the financial market; the inflationary push of these courses of action notwithstanding.

2.3.5 The instruments of high minimum rediscount rates and the issue of other such bills and certificates are commonly adopted by the CBN as supplementary tools to consolidate sufficient quantum naira to meet obligations of the dollar conversion of federal revenue. **Indeed the higher the rates and returns on these instruments, the easier it is for CBN to corner the country's stock of naira from the reach of serious entrepreneurs in agriculture and industry who wish to borrow at 'sensible rates' for medium to long term investments**.

2.4 CONTROL OF CAPITAL MARKET

The capital market literally consists of the activities of all financial institutions in the country including the commercial and merchant banks, mortgage institutions, stock exchange and insurance companies. The CBN has the responsibility for marshalling the activities and operations of the institutions in the money market in line with federal government, people oriented, industrial and agricultural development policies. To this end the CBN has on paper, guidelines for the operations of the institutions in the money market. The adoption and adherence to these guidelines by the financial institutions has been suspect as recent events have shown! The revelation of financial malpractices in these institutions particularly the commercial banks is an indication that the CBN current mechanism for supervision and control of the money market may be considerably inadequate and or inappropriate!

2.4.1 The operation of the major instruments at the disposal of the CBN have been examined in section 1 of this paper. Suffice it is to reiterate that the major ones are:

- The minimum rediscount rate
- Treasury Bills
- National Certificates
- Liquidity Ratios
- Cash/Asset Ratios etc.

The long and short of it is that the application of a combination of these multiple instruments at various times has not achieved the desired results on our economy.

2.5 NATIONAL BUDGET

Year in and year out the annual budgets of various tiers of government have failed to have the desired impact on our economy and the welfare of our people. The budget phenomenon has become a ‘religious ritual’ rather than an expression of a true plan of government action. The usual delay of 2 – 4 months before budget approval during the years of military rule was considered bad enough, but the hopes that the national budget for each year would be approved before the end of the preceding year or even early in the budget year have now become a mirage in our democratic dispensation. Needless to remind ourselves that the budget for the current year 2002 is yet to be approved eight months into the year! The characteristic wide gap between plan and implementation will certainly be a feature of this year's budget.

2.5.1 The lion's share of successive budgets in the last 20 years has been consumed by recurrent expenditure and only modest capital value added to our worth at the end of every year. This is basically the result of a bloated and ineffective bureaucracy at all levels of governments. The wealth sustaining areas of agriculture, education, health and industry are yet to be squarely tackled within the framework of an approved blueprint while the generous votes for the sustenance of an overindulgent military apparatus over the years may in fact have impacted negatively on the life of our nation.

2.5.2 The current process of budget consolidation promotes standard statistical upward reviews annually without an inherent transparent system for evaluation and implementation of earlier expenditures. The rush to spend 'surplus' votes every year end has become part of our implementation process.

2.6 TAXATION (VAT, CORPORATE TAX IMPORT DUTIES AND FEES, ETC.)

The value of the receipts from taxation and related government imposed tariffs and fees is currently about 15% of federally derived revenue. The objective of taxation remains primarily that of generation of revenue into the federation pool rather than its use as a fine instrument of monetary policy. The mechanism for collection of taxes such as VAT corporate taxes and government fees still appears largely defective and porous and has not been an effective tool against inflation. The enthusiasm of the states and local government authorities towards internally generated revenue has been relatively dampened by the over-reliance on payments of federal allocations.

3. A RESTRUCTURED FRAMEWORK FOR MONETARY AND FISCAL POLICY

It is evident from the foregoing passage that the current framework of our monetary and fiscal policies is grossly defective, as it has failed to provide fertile ground for the improvement of the welfare of our people and the successful development of industry and agriculture. The failure of the current monetary and fiscal controls as described in section 2 of this paper can be traced to our reluctance to accept the inclusion of unadulterated economic concepts in formulating the framework for development and fine-tuning of the economy especially in our management of the foreign exchange market.

3.1 LIBERALIZED ECONOMY

The government appears to have only partially imbibed the virtues of liberalization as a tool for transparent and rapid economic growth. To this end, the government has privatized a handful of erstwhile inefficient corporations and agencies and liberalized activities in some critical areas of industry, agriculture and commerce in line with the prescriptions of international trade and economic agencies.

3.1.1 The market for foreign exchange, however, remains a critical area where the authorities are yet to accept and incorporate the dynamics of liberalization in the regular operations of this particularly crucial market. The result is the economic quagmire in which we find ourselves today in this country. The ubiquitous market woman *(uneducated as they may come)* will tell you that where there is a single market supply channel for an essential commodity, the retail price of that commodity will become so adversely distorted against the consumer that government intentions at price control and availability become unattainable! A parasitic supply chain will emerge and sharp practices will become the order of the day! Everywhere in our economic system where free market forces are not allowed to play on the field, serious price distortions, lack of transparency and dislocation to our economy will occur. Examples of such dislocations abound in our economic history; petrol, milk, sugar, rice vegetable oil, fertilizers etc. The foreign exchange market is not an exception to this rule!

3.2 LIBERALIZED FOREIGN EXCHANGE MARKET

In sections 1 and 2 of this paper, we highlighted the salient aspects of the operation of the current foreign exchange market and indicated the major price determining factors of the naira value to principally the dollar and by extension other international currencies. It is clear from all the various **formulations** that have been adopted by the CBN in arriving at trading rates for the national currency, the naira, over the last 20 years, that the true market forces of demand and supply have taken the back seat as market exchange rate determinant. The CBN has always adopted a defective contrivance in semblance of a free or open market with the forces of demand and supply in full sway! In every system practised so far, the CBN has remained the sole provider to the market of over 85% of the total value of foreign exchange traded on the market! The forex market has, thus, taken on the toga of a controlled market for essential commodities where there is only one outlet and the results are the attendant price distortions, parasitic chain and economic dislocation that result.

3.2.1 The Nigerian economy will right itself **if and only if** there evolves and exists a stable and realistically valued naira. A stable and realistic rate of naira will guarantee stable prices and efficient allocation of productive resources in the economy. A stable and realistic rate of naira will only emerge when the market for foreign exchange is liberalized.

3.3 LIBERALIZATION OF THE SUPPLY SIDE OF THE FOREIGN EXCHANGE MARKET.

The defence of the national currency of a nation from unguided free falls and maintenance of stability in value over time are two major functions of central banks universally.

3.3.1 A currency whose value is relatively unstable and cannot be guaranteed to be resilient as a store of value for the holders, will remain a currency without dignity! It is the role of the Central Bank to provide dignity to our naira, but the CBN has failed to do this and seems more concerned at defending the value of the dollar against the naira! We have heard of the Federal Reserve Bank of America, the Bank of England and other European Central Banks buying up their **own currencies** in the market whenever the need arises to do so for reason of exchange rate stability and in line with national aspirations. We cannot recall our own CBN's patriotic fervour along the same lines bringing forth such salutary results! Instead its actions champion the reverse.

3.4 DEMYSTIFICATION OF THE DOLLAR

In section 2 we indicated how the naira was rated about ₦22 to a dollar about 10 years ago, while our foreign reserves and revenue were much less than current annual earning of about nine and eight billion US dollars respectively. **If we are truthful to ourselves, we have to admit that it is the framework for the disbursement of foreign exchange earnings that is the major problem and not the available amount and the current demand** by the productive sector. The revelations of staggering wealth diverted into private foreign accounts underline the reality that demand for forex for economic use has not been the real villain in the foreign exchange treasury.

3.4.1 The dollar has become a rarity, an essential commodity made so by the CBN's hold to the key to the vaults containing the constitutionally distributable portion of our foreign exchange earnings and its unilateral declaration of exchange rates based on a formula best known to itself but certainly devoid of a true market mechanism. We recall the trying era of 'petrol scarcity', the NNPC and other distribution companies often asserted that they were supplying sufficient petrol to cater for the needs of Lagos metropolis, yet the 'scarcity' would remain; the queues would continue to move at snail speed, prices would multiply as people are forced to pay more, a black market would evolve and a parasitic supply chain would emerge because those who make a living from market dislocations would have cornered the bulk of supply of petrol to prolong the period of scarcity for their own maximum gain!

3.4.2 In the case of the foreign exchange, the **CBN alone** has cornered the supply side of the market and hence the price distortions, dislocations and a thriving self serving black market. The scenario would be different if the dollar component of the federal revenue enters into a foreign exchange market through separate price negotiations between each constitutional beneficiary of the federal pool and their respective bankers!! This should be the foundation and framework for a truly liberalized foreign exchange market governed by the market forces of supply and demand.

3.5 OPERATION OF FOREX MARKET IN A LIBERALIZED SYSTEM

The current market structure creates a system where **too much naira** always '**appears'** to be chasing the **too few dollars** available. Such a system can only result in a continuous downward slide in the value of the naira vis-à-vis other stable and convertible currencies, because by the nature of this system the available dollars will **no matter the quantum** always continue to remain **TOO FEW,** since its control and disbursement remain in the same hands that also control the volume of our own naira in circulation! A case of a prosecutor and defender being one and the same person!

3.6 HOW THE MARKET WILL OPERATE

The CBN will consolidate the distributable portion of the dollar earnings monthly *(or at worst bimonthly)* in arrears. The realizable values will be published in appropriate government bulletins monthly.

3.6.1 The CBN would issue **warrants denominated in dollars** monthly without fail to each beneficiary of federally **derived dollar** revenue according to constitutional provisions with regard to sharing of such revenue.

3.6.2 The beneficiary of the dollar warrant **(strictly not cash)** (federal, state, local governments, statutory agencies etc) will approach their separate bankers with their dollar warrants for conversion of all or part of the dollar warrant into naira for its corporate budgetary obligations which cannot be paid in dollars ***(since the dollar is not legal tender in Nigeria)***

3.6.3 All buying and selling of currencies will be carried out through a bank or any other such denominated financial institution. The local bank officer on receipt of the request would seek current rate confirmation from its head office before concluding a deal. In any event, all banks now have improved telecom/online access with their head offices!

3.6.4 The local branch of each bank would be required to display the daily exchange rates of major currencies against the naira in their branch after the receipt of the certified daily/hourly advice from the forex department at the head office of his bank.

3.6.5 The CBN's ruling rate on any particular day will be determined by the weighted average of various negotiated prices on the preceding day. A true naira rate would emerge from the aggregates of rates adopted in all such exchange transactions in the federation. Negotiated naira buying and selling prices of dollar from the numerous outlets or sources would stabilize within a narrow band and produce an effective market determined naira exchange rate made up of the composite or weighted average of various prices.

3.6.6 The rate that would emerge would be dependent on the **CBN's management of the naira supply** in the economy through the various traditional instruments which had remained ineffective and counterproductive in the past – viz:

- Minimum Rediscount Rate
- Commercial Bank Liquidity Ratio
- Treasury Bill Issue
- Asset Ratios etc, etc, etc.

3.6.7 This system will create a scenario **where too much dollars** 'appear' to be chasing **too few naira** as the CBN guides the value of the naira towards a level that would be consistent with dignified expectation through appropriate regulations and fine tuning of traditional Central Bank instruments worldwide – without jeopardizing liquidity and the adoption of other drastic measures *(such as high MRR etc)* which are retrogressive to the economy to tame sham excess liquidity! A realistic and stable exchange rate would drastically check inflation and encourage industrial capacity utilization and expansion.

3.7 PAYMENT FOR IMPORTS AND FOREX AUCTIONS

All foreign exchange revenue derived from the federation will continue to be domiciled with the CBN.

3.7.1 Each financial institution involved in forex business, particularly the commercial banks and all beneficiaries of statutory allocation will maintain a domiciliary account with the CBN.

3.7.2 Purchase of forex under this system will be for payment for goods and services approved as per the current CBN import guidelines.

3.7.3 All importers *(including manufacturers, traders, etc)* who require foreign exchange to pay for their import bills would approach the local branch of their (buyers) bank and submit their request for purchase of forex at the prevailing/negotiated exchange rate. With the full naira cover in their account, a letter of credit will be opened on their behalf with the overseas correspondent bank of the local bank. The usual CBN's Forms 'A' and 'M' will of course be completed for monitoring and statistical purposes.

3.7.3.1 Details of each transaction will be filed with the CBN so that the domiciliary account of each bank with the CBN will be updated and further instruction on disbursement effected when received.

3.7.4 **Private sector importers** with dollar denominated domiciliary accounts *(for example exporters)* will complete necessary import documentation at their banks. Copies of the documents will be forwarded to the CBN for statistical consolidation. Their dollar accounts with their banks will be debited with the import value. Records of daily balances and movements in the domiciliary accounts in the private sector will be filed with the CBN.

3.7.5 **Public sector importers** with balances on their dollar warrants will similarly complete necessary import documentation at their banks (for goods and services that are in conformity with CBN import guidelines). Receipt of completed forms by CBN will serve as instruction for their domiciliary accounts with the CBN to be debited to the import value.

3.7.6 All exporters with dollar denominated accounts would not be required to sell their dollars on receipt only to repurchase the same dollars through the exchange market for their import requirements.

3.7.7 Prime import documents such as Bill of Lading, Packing List and Original Invoices must be attested by the customs authority from the country of shipment or origin as the case may be before shipment to Nigeria. In addition, all imports will be subject to 100% physical destination inspection to check misappropriation of forex purchased.

3.7.8 There would no longer be a formal elaborate central bidding system under any guise whatsoever for the determination of the naira rate of exchange.

3.7.9 Banks will only earn a commission or a spread between buying and selling rates and all transactions must be properly documented and returns provided to the CBN daily.

3.7.10 The permissible arbitrage payable to banks for buying and selling of foreign exchange should not exceed what obtains in capital market internationally. This figure will be specified by the CBN.

3.7.11 The central bank will retain an audit team in banks and other financial institutions to collect data on all transactions of interest to CBN operations to ensure commercial practices are in line with Central Bank regulations and expectations.

3.7.12 The CBN audit officers will be expected to send daily audit returns to the appropriate CBN dept responsible for monitoring and evaluating forex transactions as well as other such specific information required by the CBN from time to time.

3.7.13 The presence of the above resident audit officers is without prejudice to the existence of other CBN investigative and monitoring teams dedicated to ensure compliance in the money market.

3.7.14 The portions of the public sector dollar warrants which have not been sold to the banks in any month would remain as reserve or savings in their domiciliary account with the CBN and the beneficiary can convert such into naira at any time the agency chooses at whatever the prevailing rate of exchange with the dollar at his local bank after the usual offer and acceptance process, accompanied with the appropriate import documentations properly completed.

3.7.15 If and when it promotes desired economic objectives or targets, the CBN can draw on the foreign reserves by selling part of its **earned** dollars to meet any unsatisfied demand for foreign exchange at the exchange rate set by the market.

3.7.16 Commercial banks as well as selected bureau de change will be co-opted to buy and sell **travellers cheques** demanded by the travelling public.

3.7.17 Denomination of payments for all government tariffs and fees should be strictly in naira.

4. THE DIVIDENDS OF A LIBERALIZED FOREIGN EXCHANGE MARKET

The main dividend to be derived from the adoption of a liberalized foreign exchange market as proposed in section 3 of this paper is the quick evolution of a realistically priced naira that will infuse the positive multiplier effects inherent in a free market economy dictated by the dynamics of demand and supply. Indeed the defects of the current system; viz lack of transparency, parasitic chain, price distortion and economic dislocation; would be cleansed by a liberalized market; the **inherent features and desirable benefits may be summarized as follows:**

4.1 A NEW IMPROVED CBN!!

The CBN would emerge unencumbered by the distraction of forex hawkings and intrigues and assume its role as a patriotic custodian of the naira and a nimble and effective policeman of the money market in line with national aspirations.

4.2 BREAKING THE JINX OF EXCESS LIQUIDITY

The mirage of excess liquidity whenever the federal pool is disbursed and the regressive reflex of mop-up activity inherent in the current system will disappear forever!! In other words, the CBN would not have to plead with beneficiaries of the federation pool to desist from spending their income even when the economy is crying out for a dose of public expenditure to stimulate demand and investment.

4.2.1 The ghost of excess liquidity in the system will be laid to rest in the proposed liberalized foreign exchange market because of the following factors inherent in its operation:

4.2.1.1 The bulk of all foreign exchange earnings is expended in its original form *(without any prior conversion into naira to needlessly and vastly swell money supply)* to pay for the nation's **total import needs,** that is, industrial goods, finished goods, contractors' imports, services, every permissible "importable", name it. This insulates the economy from a deluge of naira with extensive money creation possibilities by banks as at present.

4.2.1.2 Foreign exchange not required for domestic transactions by governments, public agencies and private sector operators will remain in the owner establishments' domiciliary accounts with the CBN and will not be regarded as part of commercial banks' liquidity base.

4.2.1.3 A substantial proportion of foreign exchange converted into naira for domestic transactions is likely to be taken up by economic operators utilizing naira already in the system.

4.2.1.4 Thus only a small portion of foreign exchange earnings may translate into injection of fresh money.

4.2.1.5 The subsequent arrival of imports paid for with the bulk of foreign exchange earnings especially consumer goods implies the introduction of additional physical goods which entails stretching the relatively unchanged money supply in the system to absorb the new imports. This situation will tend to leave prices at moderate levels. Inflation will therefore be at minimal levels that are conducive to economic growth.

4.3 REDUCTION OF PRESSURE ON THE NAIRA VALUE AND GENERAL STABILITY OF THE NAIRA

The effect of tamed excess liquidity on the industrial sector will be as follows:

4.3.1 Industrialists will obtain cheaper dollars and consequently be able to bring in more raw materials and machinery with the same outlay as hitherto.

4.3.2 Prices of locally manufactured goods will fall

4.3.3 Industrial capacity utilization will improve

4.3.4 Increased employment generating opportunities will evolve

4.3.5 Disposable income will increase and overall demand will expand

4.3.6 Demand for imported consumer goods will reduce as local manufactures will rise up to the challenge of filling the gap.

4.3.7 The above will lead to a reduction in demand for foreign exchange and consequently stabilize the exchange rate.

4.4 REDUCTION OF THE PRESSURE OF COST-PUSH INFLATION ON THE ECONOMY

Similarly an improvement in the value of the naira will be reflected in reduced and stable costs of imported raw materials. As noted, investors in the real sectors of industry and agriculture can bring in **more** machinery and raw materials for production with **less amount of naira**. Industrial and agricultural capacity will expand with the positive linkages in areas of employment generation, food sufficiency and generally improved welfare of the Nigerian masses

4.5 INTEREST RATE REDUCTION AND STABILITY

The CBN Minimum Rediscount Rate *(the Commercial Bank Base Rate)* need not be excessively weighted upwards in order to mop up excess liquidity caused in the current system by the conversion of dollar revenue to naira before sharing to constitutional beneficiaries of the federation pool. Lower interest rates would stimulate investment and enhance employment and generate aggregate demand with other salutary benefits in tow!

4.6 DEFLATION OF SPECULATIVE EARNINGS FROM THE FOREX MARKET

Speculative demand for forex at any cost from the CBN will disappear as the CBN will no longer sell dollars and any foreign exchange for that matter at a local bazaar! The erstwhile parasitic chain, round-tripping, excessive arbitrage income, dollar hoarding, artificial scarcity and the search for dollars at any cost will evaporate. Naira will be king and CBN will be well positioned to manage its good health! The parallel or black market will now provide less attraction and may be expected to gradually disappear as the dollar will be available everywhere in the money market!

4.7 EFFECTIVENESS OF CBN MONETARY INSTRUMENTS

The erstwhile discordant monetary instruments of the CBN can now be used to fine tune the money market and bring harmony to our country’s monetary and fiscal policies; for example, the CBN will not have to impose an MRR of 20% on the banks while government is at the same time pressurizing the banks to lower their commercial lending rates!

4.8 CONVERTIBILITY OF THE NAIRA

A stable and vibrant economy with a stable and resilient currency would give the naira the elite status and the prospect of transforming into a convertible currency. Naira convertibility would engender confidence in the country and the foreign direct investment that we have sought unsuccessfully so far in far away lands, the same foreign investors will enthusiastically beat a path to our doors voluntarily! Convertibility will also transform Nigeria to the engine of growth for the ECOWAS sub-region in particular and a leading emerging industrial nation.

4.9 AVAILABILITY OF PROMPT AND ACCURATE INFORMATION

The late and often inaccurate returns which characterize the current system will disappear under the proposed liberalized foreign exchange market. As in advanced economies the CBN will have a fairly good picture of the state of the economy within a lag of no more than two days.

4.9.1 The CBN audit officers located in financial institutions will be expected to send correct returns of each institution's transaction in forex activities as well as other financial transactions of interest to the CBN every day. Availability of such database would enhance the CBN's ability to perform its statutory job of policing the banks to ensure that their operations are in line with policy.

4.10 MANUFACTURING FOR EXPORT

The presence of a transparent and level playing field and a liberalized foreign exchange market will provide additional motivation for foreign direct investors who recognize the huge opportunity presented in a market of 120 million people with rising disposable income. The net result will be an expansion in industrial capacity and ultimately the satisfaction of local demand for erstwhile imported consumer goods. Excess output from such production will become available for export.

4.10.1 Foreign direct investors will be encouraged to show interest in the commercial development of areas of infrastructure that have retarded our social and economic growth. This will supplement the services provided by the public sector and reduce the pressure on public sector capital votes.

4.11 CONCLUSION

The advantages of the liberalized foreign exchange market as espoused above are overwhelming. The CBN's market-based approach to fixing the exchange rate via SFEM, IFEM, AFEM, FEM and DAS over the past two decades has succeeded in under-developing and ruining the economy. The economy, Sphinx-like will be resurrected through the instrumentality of a realistically valued and stable naira arising from the proposed liberalized foreign exchange market. We therefore recommend it for immediate adoption and implementation.

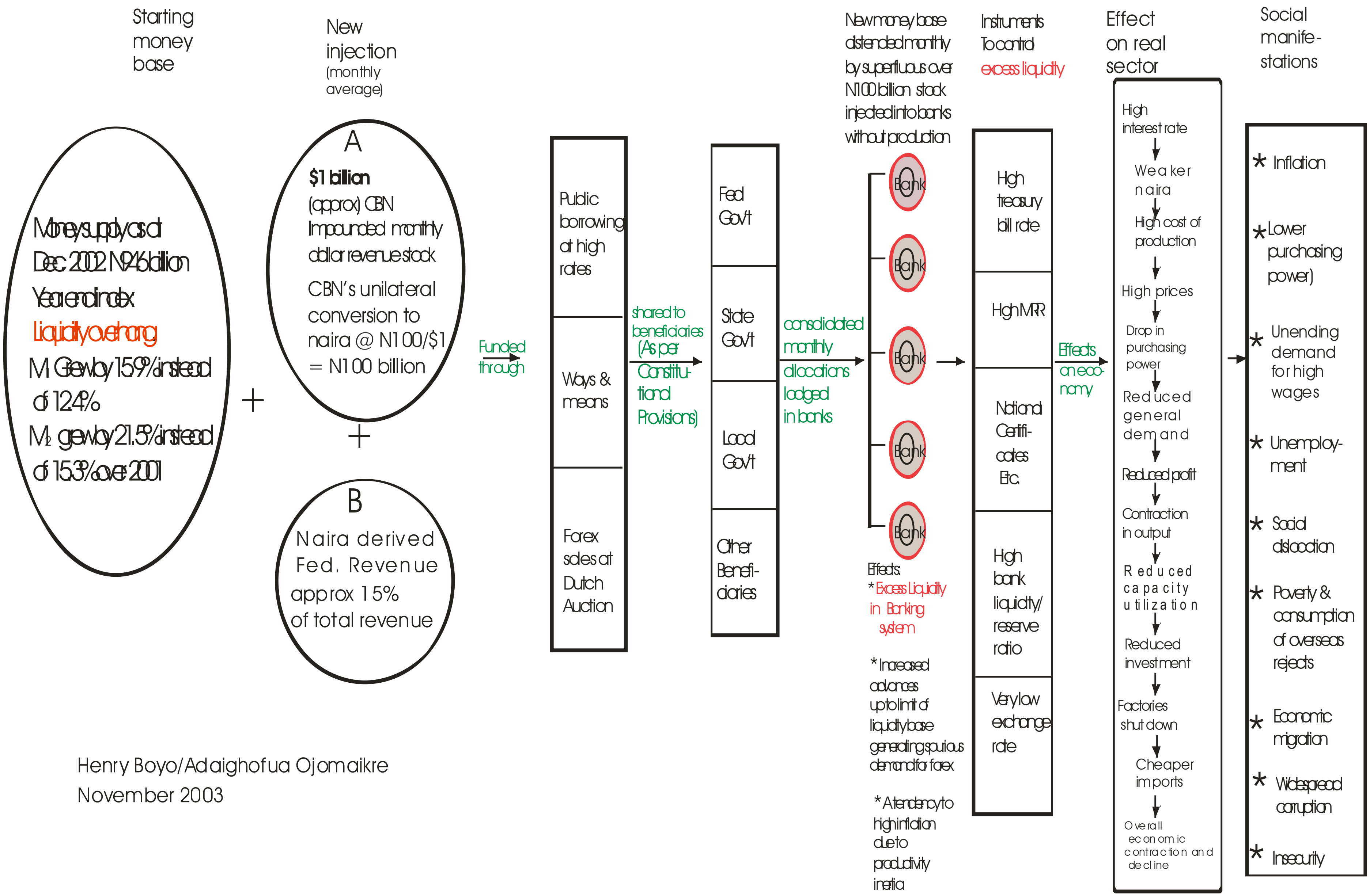
4.12.1 Certainly the operation of an economy does not follow exact and fixed laws as we have in the physical sciences. So we concede that there might well be other approaches that may lead to success. Those options do not include the route taken by the CBN over the last two decades. We shall welcome alternative suggestions that are as viable as the approach offered by the liberalized foreign exchange market or better.

SUMMARY OF MAJOR ISSUES IN THE CURRENT AND PROPOSED METHODS OF FIXING THE NAIRA EXCHANGE RATE

S/N	CURRENT MONETARY FRAMEWORK	S/N	LIBERALIZED FOREX FRAMEWORK
1.	Unilateral conversion of dollar revenue to naira	1.	Market determined rate for conversion of dollar revenue required for domestic use only.
2.	CBN really determines exchange rate during auctions as it fixes quantity to be sold.	2.	Market determines exchange rate based on demand and supply.
3.	CBN seller of bulk of dollar.	3.	Earners of dollar *(public and private)* to sell dollars when necessary.
4.	CBN is effectively the protector of the dollar.	4.	CBN becomes protector of naira as it is totally disengaged from selling dollar except to clear naira glut as last resort.
5.	All dollar revenue converted to naira before disbursement	5.	All dollar revenue to be disbursed as earned with only the portion needed for domestic obligations to be converted to naira
6.	Discordant monetary instruments	6.	Monetary instruments will have appropriate effects.
7.	Incessant mop-up of liquidity at expense of real sector.	7.	Liquidity levels will promote vibrant real sector.
8.	Tax/tariffs used solely as instrument for revenue generation	8.	Sector variable taxes/tariffs to support specific policies of government.

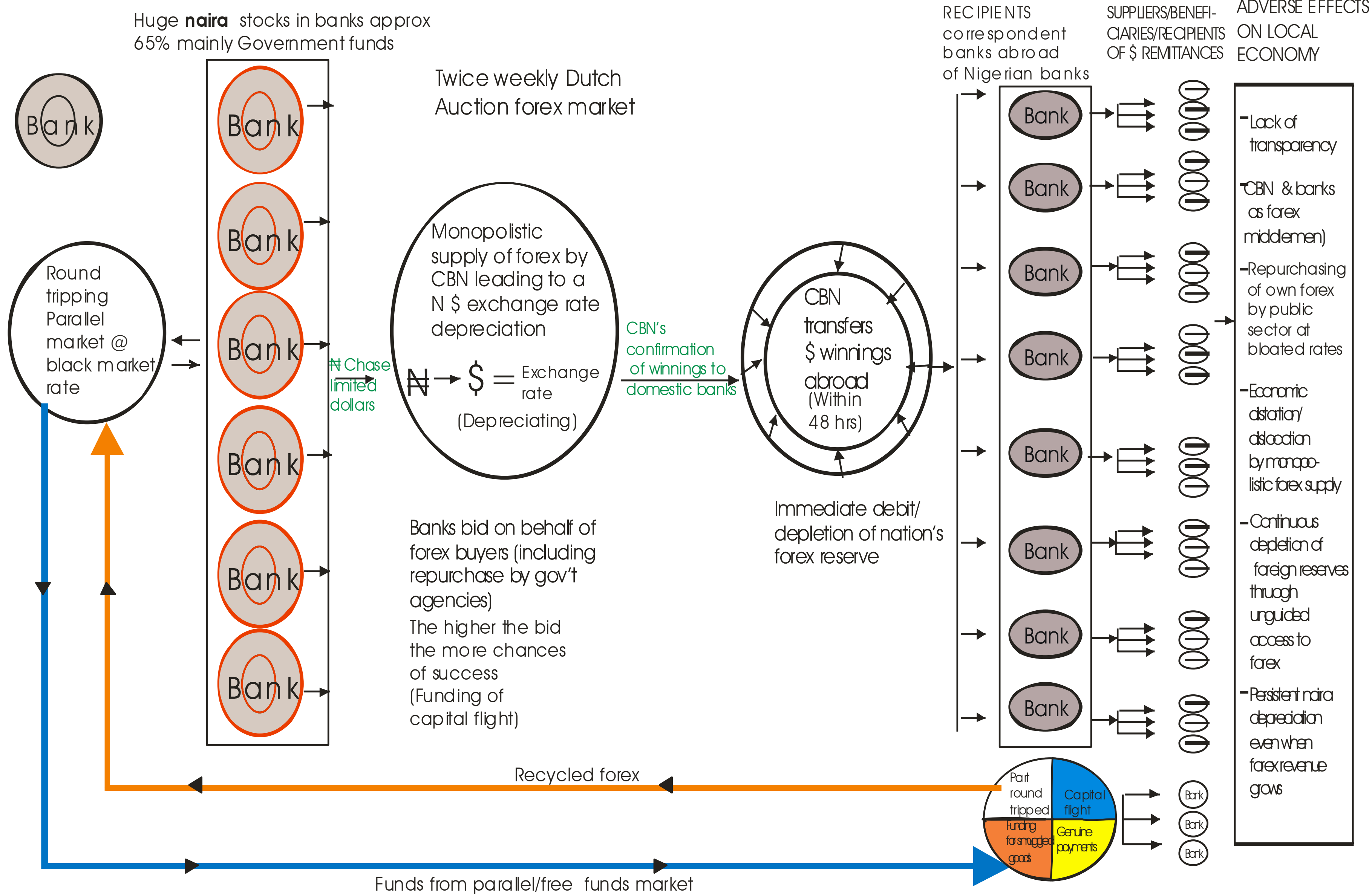
S/N	CURRENT DIVIDENDS	S/N	EXPECTED DIVIDENDS
1.	Low industrial capacity utilization and high unemployment.	1.	Increased capacity utilization and expansion
2.	High interest rates	2.	Realistic interest rates and exchange rates
3.	Untamed liquidity and inflation	3.	Tamed liquidity and conducive level of inflation
4.	Capital flight and divergent exchange rates	4.	Discouragement of capital flight and divergent exchange rates.
5.	Low savings and investment	5.	Healthy climate for savings and investment.
6.	Deficit budgeting without concrete impact on economy.	6.	Reduction of excessive deficit budgeting through stronger value of naira.
7.	Unstable economic environment for fiscal planning and monetary control.	7.	Transparent and stable environment for fiscal planning and monetary control.
8.	Mono-cultural export economy	8.	Prospects for export and foreign direct investment.
9.	Defective disbursement of foreign exchange earned from exports	9.	Correct disbursement of federal revenue.
10.	Maintenance of large but idle foreign reserves.	10.	Moderate level of reserves consistent with the economic activities.

1. SCHEMATIC FLOW OF CURRENT INFUSION PROCESS OF FOREX EARNINGS INTO THE ECONOMY



Henry Boyo/Adaighofua Ojomaikre
November 2003

2. EFFECTS OF CBN'S MONOPOLY OF FOREX MARKET



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3. SCHEMATIC FLOW OF PROPOSED CORRECT INFUSION PROCESS OF FOREX EARNINGS INTO THE ECONOMY USING DOLLAR CERTIFICATES