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Nigeria Announces New FX Policy

June 20, 2016

Summary

- On June 15, Nigeria's Central Bank abandoned its currency peg, easing foreign exchange restrictions that were widely blamed for exacerbating Nigeria's economic difficulties. The announcement, a surprise to many analysts who have spent months calling for monetary reforms, was welcome news in international markets, with Nigerian stocks and bonds rallying behind it.

- The global downturn in commodity prices has severely affected oil-rich Nigeria, exposing the lack of economic diversification in Africa's largest economy and most populous nation. In January 2016, Nigerian stocks hit a three-year low as oil prices fell below $30 per barrel for the first time in 12 years. As a result, the Nigerian economy saw its first contraction in over a decade in the first quarter of 2016.

- Nigerian President Muhammadu Buhari has been in office just over one year and has identified fighting corruption and improving government accountability, restoring Nigeria's hard-hit economy, and investing in critical infrastructure that will support economic diversification as key priorities for his administration. Though long an opponent of easing currency restrictions, Buhari called the Bank's move to introduce flexibility in exchange rate policy a "down payment on the Nigerian people's ability to succeed."

- While investors welcomed the new monetary policy, market risks remain. The country faces a serious and long-standing terrorist threat from ISIS-aligned Boko Haram in northern Nigeria and a recent resurgence of violence in the Niger Delta, significantly weakening Nigeria's oil output.

Nigeria abandons FX peg

On June 15, the Central Bank of Nigeria (CBN) unveiled the broad framework and guidelines of a long-awaited, flexible exchange rate, switching course from the restrictive monetary policy pursued over the first year of President Muhammadu Buhari's tenure in office. The policy pivot, which goes into effect on June 20, removes government-induced controls on the naira and is widely expected to boost Nigeria's dollar supply, encourage foreign investment, and revitalize an economy on the verge of recession.

Hit by the global fall in oil prices, Nigeria turned inward

Since late 2014, Africa's largest economy and second-biggest crude oil producer has grappled with the monetary effects of a dramatic drop in the price of crude oil, the slowdown in global commodity prices, and the normalization of monetary policy as the United States' Federal Reserve began to remove the accommodations put in place to ease the impact of the financial crisis. The result was a decline in Nigeria's foreign exchange earnings coupled with continued high demand for foreign exchange within Nigeria, setting in motion a significant reduction in the nation's FX reserves. In February 2015, in response to the approaching crisis, the CBN responded with a number of protectionist and neutralizing strategies. These included pegging the naira-dollar exchange rate at roughly N197/USD1 and largely restricting access to foreign exchange, although exceptions were permitted for matured letters of credit from commercial banks, importation of raw materials, plants, equipment, and petroleum products, and payments of school fees, business travel allowances, personal travel allowances, and related expenses. Aiming to spur internal production and manufacturing, the CBN, under the newly-elected Buhari administration, also introduced a list of 41 items no longer valid for foreign exchange allocation. An attempt to increase domestic production, the move also contributed to a growing black market for imported items on the list, such as tomato paste, rice, and toothpicks. While the naira's black market exchange rate rose, analysts watched Nigeria's foreign reserves fall as the CBN continued to hold the naira peg steady.

The Nigerian Central Bank alters course

Over the past year, President Buhari and his administration have remained resolute in the face of mounting local and international criticism of the country's restrictive monetary policy. Last year, visits from U.S. Secretary of Commerce Penny Pritzker and IMF Managing Director Christine Lagarde, amongst other high-level international officials, appeared to do little to convince the government to budge on its strategy. Many analysts were surprised when Central Bank Governor Godwin Emefiele announced that it is now time to restore the flexible inter-bank exchange rate market, and with it, the market's automatic adjustment mechanism. In an op-ed in the *Wall Street Journal* last week, Buhari explained his position reversal in support of the Bank's move to introduce flexibility as a "down payment on the Nigerian people's ability to succeed."

While Emefiele suggested that the CBN's tight controls had yielded their intended results by ridding the foreign exchange market of "speculators and rent-seekers" and boosting domestic production, analysts argue that the policy change is more likely a realization that the current system was unsustainable. In order to maintain its peg of the naira, the country was forced to use its scarce foreign reserves, which have fallen to $26.7 billion from $42.8 billion in January 2014. In addition, the naira peg created a tiered foreign exchange system with a parallel (black) market in which currency buyers could take advantage of the discrepancy between the naira's official and black market exchange rates. In this environment, uncertainty around Nigeria's foreign exchange policy and its implications for business impeded investment. Several multinationals including United Airlines and Iberia, have stopped operations in Nigeria, partly because currency controls prevented the companies from repatriating revenue from Nigeria, while others delayed investment. The country's monetary restrictions were also blamed by many for causing undue hardship to Nigerians by making critical imports like fuel and food even more expensive.

For the first time in over a decade, Nigeria's economy contracted in the first quarter of 2016, and analysts expect it to do so again this quarter. Many Nigeria experts hope this abrupt change in policy will help prevent a looming recession and restore investor confidence.

Free trade in the Naira returns but challenges remain

The international market responded positively to the announcement, with Nigerian stocks and bonds rallying in reaction to a market-based currency. The new system will operate as a managed currency float, returning the naira to a market-based exchange rate, with a single window, market-determined pricing, and ten primary dealers with whom the CBN will deal directly. Emefiele also left room for periodic but limited intervention by the CBN "as need arises." The forty-one items classified by the CBN as not valid for foreign exchange, including rice, tomato paste, cement, toothpicks, and other products which the government has targeted for local production remain inadmissible. While this suggests a parallel market will continue, analysts suspect it will operate in a diminished form and with a decreased spread between the official and black market naira rates.

Despite these developments, there are concerns that a weakened naira, expected to fall against the dollar, could force the CBN to raise interest rates in an effort to fight inflation, potentially carrying negative impacts on to investors and domestic companies. Skittish investors may also continue to be wary of Nigeria due to the continued low price of oil, a resurgence of violence in the oil-rich Niger Delta, and ongoing corruption challenges. The private sector will be closely watching the policy rollout over the coming weeks. Nonetheless, most analysts point to the reforms as an important step in resetting Nigeria's economy.

Key Aspects of the New Policy Regime:

- All existing market segments will be merged into a single market.
- Nigeria's exchange rate will be market-driven using the Thomson-Reuters Order Matching System and Conversational Dealing Book.
- The CBN can make periodic but limited interventions by buying or selling FX.
- Primary dealers will be required to deal in large trade sizes with a minimum ticket size of $10 million.
- There will be 10-12 secondary dealers.
- No predetermined spread on FX spot transactions between the CBN and primary dealers.
- The forty-one items not valid for foreign exchange remain inadmissible.