



## Why has Exchange Rate Policy Failed in Nigeria?

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### Executive Summary

This policy brief examines the primary cause of the exchange rate policy failure in Nigeria by evaluating the motivating factor for exchange rate regime changes in the country and reviewing the role of politics and interest groups in the Nigerian exchange rate management. The findings show that politics, institutional incentives, and group interest mostly play a significant role in Nigeria's exchange rate and exchange rate regime determination, leading to a high level of inconsistency that contributes significantly to the policy failure.

### Introduction

In the Vision 2020:20, the Nigerian economy desires to be among the 20 largest economies by the year 2020. Statistical evidence, however, shows that the Nigerian economy has not been moving towards achieving this target. Instead, it moved from the 22nd position in the world country ranking by GDP in 2015 to 27th position in 2016 and recorded a high level of economic recession between 2016 and 2017. This raises very huge and important question and concerns.

Rather than moving closer to achieving its vision 2020:20 target, Nigeria is consistently moving further away from it.

Most policy analysts point to poor macroeconomic policies and management as the leading causes of the problem and, therefore, believe that the solution still lies in reasonable, realistic, and feasible macroeconomic policies. Given that Nigeria is an

import-dependent nation, one important macroeconomic policy that should be given proper attention is that of the exchange rate. According to Obadan (2009), the choice of exchange rate regime by developing countries is of crucial importance to their self-protection from speculative attacks and currency crises as well as achievement of long-term growth.

Since independence in 1960, Nigeria's exchange rate regime has been oscillating between fixed and flexible system as shown in the table below.

**Table 1: History of the exchange rate system in Nigeria**

Year	Exchange rate system	Event/ remark
1959-1967	Fixed parity with British Pounds Sterling (GBP) only	
1968-1972	US Dollar (US\$) included in the parity exchange	The 1967 devaluation of the British pounds and emergence of a strong US Dollar
1972	British Pounds parity suspended	
1973	Reverts to fixed parity with the British Pounds	Devaluation of the US Dollar
1974	Fixed parity to US\$/ GBP Basket reinstated	To minimise the effect of the devaluation of basket components
1978	Import Trade-Weighted basket of currency	Tied to 7 currencies: GBP, US\$, German Mark (DM), French Franc (FFR), Japanese Yen (JPY), Dutch Guilder (NLG), Swiss Franc (CHF)
1985	Referenced to the US Dollar	To prevent arbitrage prevalent in the currency basket
1986	Adoption of a Second-Tier Foreign Exchange Market (SFEM) for Private Sector rates determined by Dutch Auction calculation methods	Deregulation of the Economy under the Structural Adjustment Program (SAP)
1987	Consolidation of the First and Second-Tier FX Markets	The merger of official Exchange Rates
1988	Establishment of the Interbank Foreign Exchange Market (IFEM)	The merger of Autonomous and Official Exchange Rates
1994	Fixed Exchange Rate	Regulate the economy
1995	Introduction of Autonomous Foreign Exchange Market (AFEM)	"Guided deregulation."
1999	Re-introduction of IFEM	The merger of the Dual Exchange Rate, after the abolition of the Official Exchange Rate on 1 January 1999
2002	Re-introduction of the Dutch Auction System (DAS)	DAS determined FX rate-setting implement for CBN retail sales through Authorized Dealers (i.e. banks)
2006	Introduction of the Wholesale Dutch Auction System (WDAS)	DAS determined FX rate-setting for wholesale CBN sales of currency reserves to Authorized Dealers (i.e. Banks & Bureau de Change (BDCs) with indirect controls via Bank Net Open Position Limits (NOPLs).
2009	RDAS re-established	WDAS suspended. Banking crisis precipitates trading counterparty issues in the Interbank FX market
2011	WDAS suspension lifted	Removal of CBN Interbank settlement guarantees
2013	Re-introduction of Retail Dutch Auctions (RDAS)	WDAS suspended. To check potential speculative arbitrage between official and parallel markets for Foreign Exchange

Source: Coronation Capital (2015, p.96)

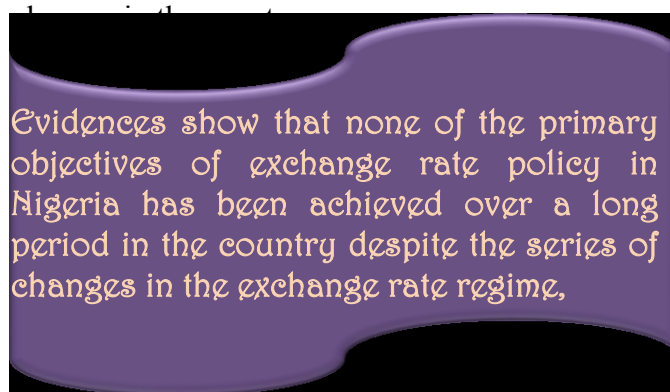
The management of Nigeria's foreign exchange is the responsibility of the Central Bank of Nigeria (CBN). This role is explained in Section 16 of the CBN Act 2007, which states that "the Naira exchange rate would be determined, from time to time, by a suitable mechanism devised by the Bank for that purpose." The CBN on some occasions has employed capital control measures to intervene in the foreign exchange market, mainly to check inflation and the depreciation of Naira. In late 2014, following persistent and continuous drops in the price of crude oil globally, the value of the currencies of virtually all oil-dependent countries began to experience significant downward pressure. Naira was one of the worst hit of these currencies, and since then, the CBN has been employing some measures to at least sustain the tempo. These include direct intervention through the sale of foreign exchange, currency devaluation as well as the introduction of a series of restrictions on the sale and use of foreign currencies to control currency depreciation.

When the initial devaluation in 2014 failed to checkmate the depreciation in the value of the naira, the CBN in February 2015 intervened by closing both its retail and wholesale auction windows, efficiently ceasing its routine direct intervention in the Nigerian foreign exchange market. It also sought to limit the categories of eligible transactions for which foreign currencies could be procured directly from the CBN. These measures could not, however, stem the depreciation, instead, the gap between the interbank and the parallel market exchange rates widened. The CBN, therefore, turned to domiciliary accounts and requested that commercial banks supply details of their corporate and individual domiciliary accounts.

Despite these interventions, the value of the Nigerian naira continued to depreciate, and the interplay between reduced foreign exchange supply and rising foreign exchange demand continued to result in substantial reductions in the foreign exchange reserves. Thus, in June 2016, the CBN re-introduced the managed float exchange rate system titled "Flexible Exchange Rate Inter-bank Market." This

policy shift was meant to avoid further depletion of foreign reserves, the prioritisation of the critical needs for foreign exchange, and maintaining stability in the exchange rate. This policy was also meant to restore the automatic adjustment mechanism of the exchange rate, as well as enhance efficiency and facilitate a liquid and transparent Forex Market.

Evidences however show that none of the primary objectives of exchange rate policy in Nigeria -- preserving the value of the domestic currency, maintaining favourable external reserves position, and ensuring external balance without compromising macroeconomic stability-- has been achieved in the country, and this raises the question of what is (are) the force(s) behind exchange rate policy regimes



### **Political Economy of Exchange Rate Policy and Capital Control in Nigeria**

Review of existing literature and date reveals that political factors have largely influenced Nigeria's economic policies, including exchange rate and capital control measures. The policymakers respond to political pressures and roll out policies that reflect the choices of their political paymasters rather than economic realities. Hence, some of the exchange rate policies and capital control measures introduced by the apex bank in Nigeria since independence are the outcome of political preferences or expediencies. Indeed, the different, and sometimes conflicting, exchange rate policies and policy regimes in the country are mainly due political realities of the time

and this explains the high rate of instability and inconsistency in foreign exchange policies by different government regimes in the country.

The policymakers respond to political pressures and roll out policies that reflect the wishes of their political paymasters rather than those that will address the prevailing economic realities.

Resulting from the above facts, exchange rate policies are likely to be affected by varieties of political factors, including election timing. The real exchange rate affects broad economic aggregates like the purchasing power, the cost of export and hence, the price level and the real wage, which are all relevant to elections as some voters use them as indices for selecting their leader. Indeed, governments tend to appreciate currencies before elections, delaying a depreciation/devaluation until after the election (Klein and Marion, 1997). Given the political unpopularity of a devaluation-induced reduction in national purchasing power, governments may refuse to devalue the currency, not because of any economic reason but purely on political consideration.

Exchange rate policies and capital control measures in Nigeria have also been influenced by the nature and character of the political leadership. Regimes/administrations that are pro-west tend to key in to the global trend towards greater economic liberalisation as prescribed by the IMF and the World Bank. These regimes pursue floating or market-based exchange rate system. Two regimes that stand out in this regard are those of General Ibrahim B. Babangida and Chief Olusegun Obasanjo. On the other hand, administrations that are not necessarily anti-west but do not subscribe to the global trend towards economic liberalisation tend to pursue a fixed exchange rate system. An example is the government of General Sani Abacha.

## Conclusion

The Nigerian economy has the vision of being among the 20 largest economies of the world by the year 2020, but rather than progressing towards achieving this goal, statistics show that the economy is moving backwards. Most literature and policy analysts point to poor macroeconomic policies and management as the primary cause of the problem. One of such policies is the foreign exchange policy, which has witnessed a series of inconsistency and failure in its management. The primary cause of the inconsistency in the management of Nigeria's foreign exchange policy is the influence of politics and interest groups. Thus, politics, institutional incentives, and group interest mostly play a significant role in Nigeria's exchange rate regime determination.

The primary cause of the inconsistency in the Nigeria's exchange rate regime is the influence of politics and interest groups.

## Recommendation/ Policy Options

Political interference in economic matters, especially in the determination of the exchange rate policy choices and capital control measures in Nigeria has led to frequent changes in policy regimes. It has also led to a reduction in the positive impact of such policies on the economy since they are often subjected to the whims and caprices of the political leadership. There is, therefore, need for de-politicisation of the economic system. Though humans are by nature, political animals, there should be a limit to what should be determined by the political pressure in the country. Some of the measures that could help in achieving this include:

1. Economic decision-makers should be legally insulated from political pressures.

2. For there to be any significant change in the exchange rate and capital control policies in the country, the relevant policy unit should tender a proposal justifying such change and there should be a panel of experts outside the Central Banks that should be set up to evaluate such proposal in line with the economic realities of the time.
3. The panel should be selected based on qualification and experience, and their findings and comments should be made available to the public through the media.
4. The Central Bank of Nigeria should be made purely independent such that they will be free from political pressure. Although currently, the President needs the approval of the Senate to remove a CBN Governor, the fact that the President can suspend the CBN Governor without the approval of the Senate as happened in 2014 makes the Governor answerable to the President, which ought not to be.

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