THE NIGERIAN FOREIGN EXCHANGE MARKET:
A CRITICAL EVALUATION OF THE NAIRA EXCHANGE RATE

B Y

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Z A R I A .

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D E C L A R A T I O N

I hereby declare that this thesis was written by me and that it is a record of my own research work, and has to the best of my knowledge never been published before.
It has not been presented in any previous application for a higher degree. All borrowed ideas have been duly acknowledged by means of reference and quotation marks.

Signature ..... Date October 1994

C E R T I F I C A T I O N

This thesis tittled "The Nigerian Foreign Exchange Market: A Critical Evaluation of Naira Exchange Rate" by Emmanuel Wada Arome meets the regulations governing the award of the degree, Master in Business Administration of Ahmadu Bello University, and is approved for its contribution to knowledge and literary presentation.

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D E D I C A T I O N

This thesis is dedicated to the memory of my parents, Mr. Arome Okokogwu and Mrs. Fati Arome for their fruitful sacrifices and commitment to my training. To God be the glory, for their labour is not in vain.

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A B S T R A C T

The Nigerian foreign exchange market as well as the value of Naira exchange rate to other International Currencies have caused a lot of concern to warrant academic discussions. The structural imbalances, distortions and general recession in the world economy affected Nigeria's external reserve, balance of payment, Naira exchange rate, external debt, trade and_export promotions. Inspite of the various exchange rate regimes operational world over, Nigeria adopted fixed or administratively controlled exchange rate from 1958 to September 1986. However, with the operation of SAP from September 1986 to December 1993, free (floating) market determined exchange rate was adopted. The management of foreign exchange market in Nigeria, has left much to be desired. This is because, Naira witnessed the worst degree of devaluation among the world currencies since the operation of SAP.
At the expense of Nigerian economy, the paralled market was the only source for obtaining sizeable volume of foreign currency at prohibitive costs. This position dealt immensely with the manufacturing sector which consumed about 60%, but contributes insignificantly to the source of forex supply.

From the study, demand far outstrips the level of supply or *forex* thus creating undue pressures on the value of Naira. The market forces of free supply and demand of forex could not operate, to give a realistic exchange rate of Naira during the SAP period, and_even after. The search for a meaningful exchange rate of Naira would be inconclusive unless a courageous and stable

government at the centre Initiates adequate operating policies and at the same time monitorstheir implementations for desired results. The market determined exchange rate appear to have failed the Nigerian economy. The moderated purchasing power parity and managed or controlled exchange rate regime would be adequate as a solution for reasonable Naira exchange rate .

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CHAPTER ONE

THE NIGERIAN FOREIGN EXCHANGE MARKET A CRITICAL EVALUATION OF NAIRA EXCAHNGE RATE

1.1 INTRODUCTION

The down-turn of the Nigerian economy and the fast depreciating value of Naira since the 1980s naturally generate a lot of academic interests. Nigeria is heavily dependent on oil, and with the glut in the world oil market in the early 1980s coupled with the general recession in the world economy, distortions and bad signals of structural imbalances manifested in the economy. As a result of servere balance of payment difficulties and huge external debts, Naira exchange rate was felt to be grossly over-valued. It was believed that there was lack of effective allocation of resources due to exchange control restrictions on Capital Movements. In 1986, Structural Adjustment Programme (SAP) was introduced with the aim of improving overall economic performance. Free Markets were to be encouraged to ensure optimal allocation and utilization of resources.

At this end, the fixed exchange rate hitherto adopted in Nigeria, was discountinued to give room for competitive Market determined Naira exchange rate. The flexible exchange rate to correct the over-valued Naira, and ensure a stable exchange rate, became the Corner Stone of Federal Government fiscal policies, hence the introduction of SAP. This had a lot of consequences on external reserves, External debt, Export promotion, Trade and exchange controls.

1.2 The Statement of the Problem

The Naira exchange rate has not stablized after years of operating a free floating exchange market in Nigeria. Neither did it stablize even after the SAP. The problem of determining a stable Naira exchange rate in Nigeria, is still unsolved, largely due to inconsistent fiscal polices and their poor implementation.

1.3 Objective of Study

The purpose of this study is to dwell on Nigerian foreign exchange market, exchange rate determination, effect of declining Naira exchange rate and in addition the issues of Stable exchange rate shall be focussed in order to prescribe adequate solutions to revive the ever depreciating Naira value.

1.4 Significance of the Study

The relevance of this study is to critically examine how the Nigerian economy has faired during this period in its efforts to determine a stable Naira exchange rate. It is difficult to estimate with accurate measurement whether the solutions to Naira exchange rate determination as well as the Nigerian economy has been palliatory. The Naira exchange rate has been on the decline since in 1980s. It requires proper diagnosis and bold steps on the part of Government to initiate realistic policies that will guide the exchange rate of Naira. The resuscitation of Naira Value is mandatory for the survival of the Nigerian economy.

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1.5 Methodology

In line with the focus of this study, the method adopted is to examine the trend in demand and supply of foreign exchange as well as trends in foreign exchange rate in relation to the trend in other Macro-economic variables of relevance during the period - 1970 to June 1994. This is done with a view to identifying the extent to which the exchange rate of Naira has been, over the years considering the critical factors that affect it. In the study, secondary data obtained from Central Bank of Nigeria (CBN), Finance houses, Finance and Commerce Alamanac, on supply and demand of foreign exchange, and general forex scenario would be analysised.

1.6 Scope of Study

Following the brief introduction, objective of the study and its significance, this project, shall be divided into six parts while Chapter I, deals with the introduction. Chapter II, shall discuss the literature review on foreign exchange market and the exchange rate determination. Chapter III & IV would highlight the foreign exchange Management prior to and under the Structural Adjustment Programme (SAP) with a br remark on the trends after the SAP. This chapter also, would examine the devaluation of naira and its impacts on the economy. Chapter V would analyse the various variables for a stable exchange rate, while, finally Chapter VI shall deal with summary, conclusions and recommendations.

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1.7 Limitations

In the process of this study, the major constraints were time, source of data and finance. It required series of trips to Central Bank of Nigeria and other financial institutions in Lagos and Kaduna. These trips cost a lot of money given the circumstance of high cost of air faires in Nigeria. The depening political crises coupled with the Industrial Strikes embarked upon by some labour Unions in Nigeria at the time of compiling the necessary data for this project was yet another major limitation for one to reach the source of data. At last it became necessary to use telephone calls to reach the source of data collection, as a less costly alternative.

1.8 Defination of Terms

The terms frequently used in this project are explained as follows:

a) Exchange Rate
Is the price of one currency in terms of another This is the rate at which one currency will exchange for another.

b) Forex
Foreign Exchange indicates a currency other than Nigerian Currency and includes any notes which have at any time a legal tender in a territory outside Nigeria.

c) SFEM
Second tier Foreign Exchange Market established by law for the buying and selling of foreign exchange at market determined rate.

d) IFEM

Interbank Foreign Exchange Market is a medium through which Banks bid for foreign exchange supplied by Central Bank of Nigeria.

e) Devaluation of Currency

This is a reduction of a currency to a lower fixed value in a country experiencing balance of payment deficit. It is a tool for correcting disequilibria in the balance of payments (Ibrahim Ayangi 1990).

f) Parallel Markets

This is foreign exchange a black market which was developed because of the scarcity and official rationing of available foreign currencies by CBN. The Naira is exchanged for other currencies at higher rates than the official rate.

g) Letters of Credit (L/Cs):

A letter of credit is an undertaking (credit pledge) by a bank accepting to redeem the liability of its customer on an import contract if the importer fails to make payment on maturity date and in accordance wi all the terms of the credit purported in the L/C. They are opened for bank customers after they would have processed Forms 'M' which serve as the intention to import. L/Cs guarantee that foreign exporters would get their money from the issuing bank through their correspondents abroad when such L/Cs are confirmed. The tenure or life span of an L/C is initially 180 days, but could be renewed for another period of 180 days.

.../6.

h) Open Account and Bills of Exchange:

In open account transactions, the importer and exporter enter into a mutually acceptable contract involving the settlement of a debt at a future date. The exporter ships specified amounts of goods to the importer based on trust and the assessment of the importer's credit-worthiness. On shipment, the exporter has no further recourse. He counts on the sincerity of the importer to effect payment.
The exporter sends the documents in respect of goods shipped directly to the buyer or importer.

i) Bills for Collection

Bills for collection are negotiable instruments. They are drawn by the exporter on the importer who is required to pay a stated sum representing the value of goods shipped to the importer at a specified date. On shipment of goods to the importer, the exporter may send the accompanying document direct to the importer or to his bank. In the event that the exporter requires his banker to collect proceeds of goods shipped on his behalf, he will draw a bill of exchange on the importer and this will be attached to the shipping documents.

These will be deposited with the exporter's bankers as bills for collection.

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CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

The performance of the External Sector of the economy demonstrates an unhealthy performance. The balance on Nigeria's current account remained remarkably unfavourable occasioned by urge external debt. This trend has imposed enormous costs on the economy in terms of debt service burden, thus leaving very little forex investment.

Foreign Exchange is the means of effecting payments for International transactions. It is made up of convertible Currencies that are generally accepted for settlement of international trade and other obligations. Such Currencies are usually those of Industrialized Countries such as:

United States Dollars, British Pounds Sterling, German Deutsche Mark, Japanese Yen, French France and Italian Lira.

In Nigeria, the approved money market instruments are denominiated in a convertible foreign currency. These instruments include:
Foreign Bank Notes, Foreign Coins, Travellers Cheques, Bank Drafts and Mail or Telegraphic Transfers.

The Market is the medium of interaction between the sellers and buyers of foreign exchange in abid to negotiate a mutually acceptable price for the settlement of international transactions.

The objective of the Market include the provision of an avenue for the exchange of national currencies into those that are acceptable for international transactions and the emergence of effective Mechanism for exchange rate determination and allocation of foreign exchange.

2.2 THE FOREIGN EXCHANGE MARKET

The Background:

The evolution of the foreign exchange market up to its present state was influenced by a number of factors which include the changing pattern of international trade, institutional changes in the economy and structural shifts in production.

Before the creation of Central Bank of Nigeria (CBN) and the enactment of the Exchange Control Act of 1962, forex was earned by the private sector and held in balances abroad by Commercial Banks which acted as agents for local exporters. During this period agricultural exports represented the bulk of forex receipts and holding of forex was largely private. The need to develop a local foreign exchange market distinct from those in the major international centres became paramount, with the creation of Central Bank of Nigeria.

The agricultural exports contributed immensely to forex earning in the 1960s. But soon after, in the 1970s this was displaced by Crude Oil exports owing to the sharp rise in pertroleum prices.

Most of the economic agents had to patronize the CBN for forex allocation to pay for international transactions. The increase in economic activities beginning from the early 1970s following enhanced forex receipts and the high demand for forex to fund heavy capital projects provided boost for the forex market.

The Operation of the Forex

During the period when foreign exchange was in abundance, the need to design an appropriate mechanism for determining the exchange rate for the allocation of foreign exchange was not given adequate attention. The prevailling exchange control mechanism then was based on administrative controls. Thus, foreign exchange allocation was not based on any formalised criteria. The foreign exchange crisis that erupted in 1982 as a result of the oil glut of the preceeding year was a major challenge to foreign exchange managers. The nation had accumulated payments arrears that could not be settled as a result of declining foreign exchange earnings. The situation thus reached a critical level. Letters of Credit (L/Cs) already confirmed were revoked by the CBN and banks were disallowed from opening new ones since many countries refused to extend further credit to Nigeria at that time. Also the international community stopped guaranteeing imports coming into Nigeria. The foreign exchange situation was very tight and exchange control measures were reactivated and made more stringent.

Some of the measures were advance deposit requirements for imports, and import licensing requirements for a large number of imported items. These measures, in addition to the scarcity of foreign exchange, increased activities in the foreign exchange market. The activities of speculators and numerous middlemen increased during this period. The increasing demand for foreign exchange at a time when the supply was shrinking encouraged the development of a flourishing parallel market for foreign exchange in 1987 and Bureaux de change in 1989.

Although the exchange control system continued to be applied to allocate foreign exchange, attempts were made to depreciate the exchange rate and reduce pressure on the external sector, when it became clear that is was overvalued. The parallel market premium that emerged over time as a result of the disequilibrium in the official foreign exchange market led to various abuses including under-invoicing of exports and over-invoicing of imports. It also led to capital flight and diversion of official foreign exchange to the parallel market.

The exchange control system was unable to evolve an appropriate mechanism for foreign exchange allocation in consonance with the goal of internal balance. This led to the discontinuation in September 1986 of the rigid official control of the foreign exchange market. With the inception of the Second-Tier Foreign Exchange Market (SFEM), determination of the naira exchange rate and allocation of foreign exchange were based on market forces.

The former system, were the CBN determined the exchange rate and allocated foreign exchange as it deemed fit, was discarded. Under the market system, foreign exchange was allocated based on the supply by the CBN, demand made by the banks, including their bid rates and the price arrived at during auction session. Thus, both buyers (banks) and seller (CBN) interact and to determine a mutually acceptable price.

With the inception of the SFEM and up to the time the inter-bank market for trading in authonomous funds was merged with the SEFM into an enlarge inter-bank foreign exchanged market (IFEM), developments in the parallel market did not constitute very serious threat to the attainment of the goal of internal balance.

The introduction of bureaux de change into the system in 1989 was meant to increase the scope of the foreign exchange market, and accord access to small users of foreign exchange thereby reducing speculative tendencies. However, the parallel market continued to move independently most of the time. As efforts were made to improve the value of the naira in the official market, the parallel market premium increased sharply.

Foreign exchange malpractices became rampant as some authorised dealers charged premium on official foreign exchange which they sold to their customers.

For example, while the official rate was ₦10.5564 to 1.00 US Dollar, as at end of February 1992, the corresponding parallel market and Bureaux de change rates were ₦16.550 to 1.00 Us Dollar.

The wide differential in the official and the parallel market/Bureaux de change rates were unhealthy for the forex market. In order to reduce the wide divergence between the rates in the various markets and eliminate the need for foreign exchange abuses, a more deregulated market-based system was introduced on March 5, 1992. Hence the official exchange rate change from ₦10.5564 to ₦18.0000 to 1.00 US Dollar.
The CBN floated the Naira, discountinued the system of pre-determined quotas for Banks and allowed allocations to be based on rates which emerged in the market.
As a result of difficulty in continuing to supply forex to meet increasing demand backed by naira covering the face of low external reverses and declining forex receipts, the system was again discontinued on December 15, 1992.
Investigations revealed that most of demand pressures were due to payments on open account and bills for collection.
Payments on these categories were accordingly suspended effective from February 24, 1993. The CBN also introduced a pro-rata system of forex allocation to ensure that all participating Banks get some allocations of forex.
Yet in 1994 budget, through the Persistential pronoucement, the forex market became regulated and the official exchange rate was fixed at ₦21.9960 to $1.00 US Dollar.
By the mid-year, 1994 the assessment of regulated forex market did not improve the over-all performance of the economy. The sectorial forex allocation was fraught with poor handling and control. The forex supply was far below the budgeted figures.

The demand continued to rise over above supply. Many industries were at the verge of collapse as forex were not available for continuous payments on raw materials and spare-parts. Many of them were forced to patribuzed the unofficial source (the black market) at the rate of ₦45.00 to ₦52.00 per Dollar.

Exchange Rate Determination

An exchange rate is the price of one currency in terms of another. A strong economic indicator for assessing the overall performance of an economy is exchange rate apart from others such as interest rate, unemployment rate, inflation rate, money supply and so forth. Exchange rate is one of the macro-economic variables that reflect the strength or otherwise of an economy. A persistently strong currency is a reflection of strong economy while the reverse is the case for a weak economy. Exchange rate is also used to achieve certain economic objectives of a country including balance of payment equilibrum.

The following factors may influence the exchange rate applicable in a country.

(a) Balance of payments

The balance of payment could be used as a barometer of the forces of demand for and supply of foreign exchange in the market. Specifically the current account balance is often considered to be a measure of these forces. For example in 1980 the United States' Current Account balances showed a surplus of 3.72 billion US Dollars.

This indicates that the supply of foreign currency is in excess of the demand for foreign currency used to trade foods and services between America and the rest of the world. This means that there would be pressure on depreciation of foreign currencies relative to the US Dollar.

(b) Purchasing Power Parity Theory

This is the most famous and the oldest form of exchange rate. The theory asserts that the exchange rates will adjust to maintain constant purchasing power for a currency accross different countries. Simply put, this theory assets that commodity prices, after adjusting for transportation and other costs, should be the same in different countries. This means that the exchange rate between two different countries should be such that would provide the same purchasing power for each country. The purchasing power parity (PPP) believes that the exchange rate between two countries should reflect the price levels in both countries.

For a country, P.P.P. involves the comparism of aggregate inflation rates or aggregate changes in price. At this aggregate level, PPP postulates that if the inflation rate in a given country accelerates relative to other countries, the country's currency would tend to depreciate relative to the other currencies.

(c) Market Expectations

Market expectations can be a very important factor in determining exchange rates since it contributes a factor which affects financial returns.

(i) The Forward Rate

Market participants who are capable of bearing exchange risk are capable of doing exchange transactions in two different ways: Covered and uncovered. For example the person who borrows sterling today planning to repay the loan with US DOllar in three months time has an exchange risk. If the dollar depreciates against pound sterling during the intervening period, there will be an exchange loss. To avoid this risk, the borrower may enter into a forward exchange transaction. In this transaction, the borrower will sell us Dollar against sterling for delivery in 3 months, say at a discount on the dollar of 2% per annum. If the borrower thinks that it is unlikely that the US Dollar will depreciate by 2% per annum in the next 3 months the borrower will prefer to bear the exchange risk and not cover the borrowing in the forward market.

If many sterling borrowers think the same, soon we will see a decline in sales of dollar against sterling in the forward market for delivery in 3 months. Other thins being constant, this will end to decrease the discount of the forward dollar against sterling.

(ii) Technical and psychological factors:

It is not uncommon for professional market participants to have two options at the same time regarding the trend of a specific currency in the exchange market. One opinion may relate to the long term trend which is based on the fundamental economic forces. The other opinion may be concerned with the very short term trend of a currency which is based on the technical and psyschological conditions of the market. Whenever, there is a discrepancy between the previously held expectation of a given economic event and the actual outcome of that event, exchange rates will usually be effected. For example, the market may expect trade figures for a specific month for a country like west german to be a surplus of a 1.5 billion U.S. Dollar. However, when the actual figures are announced, they report a surplus of only 1.0 billion U.S. Dollar. This surplus still represents a historical positive payments.

This means an increase in demand for deutsche mark (DM). Furthermore, to the extent that this trade surplus will continue in the long term, the Deutsche Mark will tend to continue to increase in value relative to other currencies.

However, the immediate reaction of the market to the market to the announcement will probably be negative. The exchange rate before the report of the actual surplus was based on the expectation of a demand for Deutsche Mark, that is, of a trade surplus even larger than the one actually reported. The adjustment of expectations to reality will tend to depress the price of the Deutsche Mark temporarily.

(d) Other Factors

Other factors affecting exchange rate of currencies are:

(i) Expectations About Economic Conditions:

Participants in foreign exchange markets may anticipate the likely effects on the balance of payments of actual or expected events, and hense, currencies may strengthen or weaken even before the events may have any noticeable effects on the balance of payments.

(ii) Relative Interest Rates

Changes in interest rate differentials between countries may cause a reallocation in international investment portfolios.

However, raw norminal rates of interest have to be taken with the expected relative inflation rates and exchange rate changes to form a meaningful calculation of real yields on investments.

(iii) Government Policies

A government may have significant effects on exchange rates not only through the broad stance of its monetary and fiscal policies, but also through the specific effects of policies directed towards the domestic demand for imports, the supply of exports, the general of inflation and so on.

(iv) Non-Economic Factors

Actual or expected changes in the political or social environment may have implications for a country's future economic and trading position, and hence for balance of payments flows and exchange rate patterns. For example political or industrial unrest may undermine the confidence of foreign investors, and may drive domestic capital overseas, thus placing downwards pressure on exchange rates.

2.3.1 Forms of Exchange Rate

In reality various exchange regimes exist and they include the following.

(i) Fixed Exchange Rate

This exchange rate typifies a situation in which the exchange rate is determined and fixed by the Government through monetary authorities. Under this arrangement, all foreign transactions of such an economy will have to be conducted at the prevailing exchange rate. The exchange rate also changes only at the instance of government and this is when it is believed to be over or under-valued to achieve balance of payment objective.

For example prior the introduction of structural adjustment programme in Nigerian, the fixed exchange rate was applicable in Nigeria.

(ii) The Flexible Exchange Rate

This allows the free market forces of demand and supply to interact to determine the equilibrum or prevailing exchange rate. The theory in this respect says that the intersection of the aggregate demand and supply schedules for foreign exchange at a point in time determines the equilibrum exchange rate. This reflects the purchasing of the domestic currency in terms of the foreign one.

(iii) The Managed "Float" Rate

On April 1, 1974, the Naira was set free to float upwards. This amounted to a de facto upvaluation against the dollar, an action which created an effective rate for the unit.

Thus, for a good part of the floating period, the official inoperative naira rate with the dollar remained at 0.65789 whereas the effective rate for all transactions fluctuated around 0.61728. What happened therefore was that instead of the naira floating freely in response to the determinants mentioned earlier, the exchange values of the unit were carefully managed. In fact, few countries in the world can afford to freely float their national currencies. The reserve losses that could result from such an action would be intolerable. It is for this reason that the regime of floated currencies has been pupularly called the regime of managed floating, in view of Central Bank's periodic intervention to stabilize currency exchange rates. Attempts have been made to manage naira exchange values to minimize or eliminate arbitrage arising from differing cross rate.

(iv) <u>The Open Interest Parity (O.I.P.)</u>

The open interest parity (OIP) theory in its most popular version, in the explanation of exchange rate determination emphasises the high mobility of short-term capital, which produces open interest parity (Allen and Stein, 1990). In a way similar to PPP, OIP guarantees equal expected returns on assets in two currencies, adjusted for expected appreciation or depreciation.

Under this hypothesis investors rationally expect PPP to hold in the short-run; that is, they expect a depreciation or appreciation of the domestic currency that just equals the difference between foreign and domestic rates of price inflation. Stated alternatively, this hypothesis maintains that short-term real interest rates are equal.

(v) The "News" Model of Exchange Rate

The new model of exchange rates results from the fact that the current exchange rate reflects all relevant and available information. The implication of this is that the only thing that can cause a change in the currency exchange rate is unforeseen events otherwise called 'news'. Put differently, exchange rate changes which occur now must be the result of random disturbances or news. Since news is by definition unpredictable and exchange rate changes depend on news, to that extent exchange rates are themselves unpredictable. In line with the OIP, they can be expected to be highly variable and volatile.

(vi) The Speculative Dynamics Model

Exchange rate models of speculative dynamics have been developed as an alternative. The model assumes two classes of market actors, the 'Chartists' and the 'fundamentalists'. The exchange rate is shown to be dependent on the interaction between the behaviours of these actors.

Actors classified as 'chartists' are those who analyse the past behabiour of the exchange rate and project past trends into the future while the 'fundamentalists' compute the equilibrum rate and forecast the exchange rate to decline (increase) in the future if it is above/below today's equilibrium rate. In the speculative dynamics models the effect of government interbention in the forex market towards fostering the stability and consequent improved predictability of the exchange rate was simulated.

2.3.2 Conclusion

Finally, due to the fact that a market determined exchange rate system does not necessarily produce and continuously maintain an equilibrium exchange, the monetary authorities do not always believe in the market determined rate (Oyejide 1989).

Quite often government reserves the right to "correct" the market so as to nudge the system in the "right" direction. Any regime adopted should be aimed towards ensuring a realistic naira exchange rate. Therefore the naira should not be permanently undervalued or highly depreciated as we have withnessed in naira in the relevant years.

2.3.3 Summary

This chapter introduces the literature review of the subject matter "the Nigerian Foreign Exchange Market".

The meaning objective and back ground of the subject matter, is fully explained. The chapter further examines the summary of operations of the foreign exchange market. Step was taken in the chapter to identify various economic factors responsible for determining a foreign exchange rate in any country. These factors among others including balance of payments. Market expectation, purchasing power parity theory, external reserves, interest rates, and political considerations.

In addition to above, various forms of exchange rate applicable in any economy were intermized to include, Fixed, flexible, managed floating, open interest and parity rates. This chapter concludes that while fixed exchange rate system encourages inefficiency and market movement towards short-run equilibrium impossible, a freely floating exchange rate system is usually unstable, informationary and impairs corporate decision making if not subjected to some form of regulation.
The exchange rate therefore, should be allowed to float within a regulated band. The divergence between the upper and lower band should be narrowed to allowable level so as not to exceed 5 per cent.

CHAPTER THREE

3.0 The Foreign Exchange Market Prior Structural Adjustment Programme

3.1 Introduction

The main objectives of Foreign Exchange Market during the period was to harness Foreign Exchange resources, prevent disequilibrium in Foreign Exchange movements, preserve the Nation's Foreign Exchange reserves and the international value of the domestic currency. During this period, Foreign Exchange control was the main instrument adopted to manage Foreign Exchange resources. The exchange rate was administratively determined but this had its short-comings as it failed to isolate the economy from the vagaries of International Trade, International price movements and made it impossible for independent monetary policy initiatives to be effective.

The basic framework of Forex management was the Exchange Control Act of 1962 and Economic stabilization Act of 1982. In assessing these policies under this period, the following sequents shall be looked into:

- trade and Exchange Controls
- export promotion
- external reserves diversification
- external debt and exchange rate determination

3.2 Trade and Exchange Controls

These were meant to manage judiciously available Foreign Exchange, promote production and consumption of home-made goods and ensure that forex reserves are adequate to guarantee balance of payments stability. Successful operation of trade and exchange controls, require massive policing and complex administrative framework. However, controls may be more effective ordinarily in an environment where corruption is resisted and people are dedicated. Principally the 1962 Control Act was enacted to tighten the outflow of Foreign Exchange. This requires that Central Bank centralizes all receipts of Foreign Exchange and deliberately limits the expenditure.

3.3 Export Promotion

Exports constitute the major determant of Forex inflow. There was high dependence of the economy on the external factor. For a sustainable economic growth, exports were enhanced by the authorities. The export promotions Council decree of 1976 was promulgated to give legal backing to further incentives already in place.

During this time, the oil sector forms about 85% of the total inflows of Forex. The Council was charged with the responsibility of promoting non-oil exports base. To boost this operation, the Marketing Boards were desolved in 1977. Export free zones were established and import duty concessions were given on manufacturing of goods for export.

However, most of the incentives to promote non-oil exports were not implemented. Export promotion which was mean to raise the level of export production, turn-out to be a Unit of Forex expenditure. Forex supply had started falling short of demand requirement.

3.4 External Reserves Diversification

Diversification of external reserves means optimally apportioning of the Nation's reserves assets among various currencies so as to ensure that liquidity problems and losses are minimized while enhancing maximum returns on currencies. From the data available, in 1976, Nigeria's Forex reserves which were hitherto held in four currencies were diversified into nine as a result of increased Forex receipts on oil. In the year, oil forms 82.8% on total Forex receipts. During the year, pound sterling ceased to be the major component of Nigeria Forex reserves.

3.5 External Debt

After the Civil War in the 1970s, there was the need to fund adequately the reconstruction efforts of the Federal Government. This led to huge outflows of Forex. With the emergence of trade arrears in 1982. Due to the inability of Federal Government to finance payments on currency basis, external debt bacame the focus of National Policy. As a result of building up of payment arrears and persistent dwindling of external reserves, Federal Government entered into refinancing agreements in 1983 and 1984.

3.6 Exchange Rate Determination

Under the Exchange Control System (1962 - 1986), economic objectives played a major role although ad-hoc measures were used to determine the Naira Exchange rate. Central Bank of Nigeria applied the basket of currencies approach from 1978 as a guide in determining the direction of Exchange rate movement. Others were the State of the balance of payments. Level of reserves, Foreign Exchange supply and demand relationship, rate of inflation and domestic output.

The Nigerian Currency was pegged to the pound sterling on a 1:1 ratio from 1960 till 1973 when it was devalued by 10% and allowed to move independently of the pound sterling. The Naira was progressively appreciated to source imports cheaply and to implement development project, after 1973. This encourage imports which eventually led to the depletion of external reserves. This witnessed gradual depreciation of Naira on the long run e.g. Naira exchange rates to U.S. Dollar were as follows:

Year	Average Exchange Rate
1973	0.6573
1982	0.7631
1985	0.8924
1986	1.7323

3.7 Counter Trade

Nigeria was faced with dwindling oil revenue. As a strategy for national survival, a counter trade was evolved by the Federal Military Government under Maj. Gen. Buhari (Rtd). It was a policy of bartering the Nigeria's crude oil for needed goods and services. Crude oil was required to service external debt, pay for machinery and spare parts, pay for imported goods and services. As a reuslt of obvious possibilities of over invoicing by trade partners, dumping inferior products at low prices by advanced countries, counter trade was not the best substitute for foreign exchange. Hence the administration of General Babangida discontinued the trade and embarked upon fulfiling the conditionalities of International Monetary Fund (IMF) with the Introduction of SAP.

3.8 Summary

Despite its obvious administrative advantages, the major short-coming of the exchange control system was its inability to achieve internal balance in the short-run and guarantee external equilibrium in the long-term. Over-valuation of the currency under the system was a major obstacle that made the achievement of internal balance difficult. Specifically, the problems with the administration of exchange control system are:

- increased expenditure on imports
- depletion of external reserves
- encouragement of parallel market activities, reduction of competitiveness in export activities, reduced capital inflow and inability to pay on current basis.

This led to accumulation of payment arrears which compounded the external debt problem. Exchange control was discarded in September, 1986 to pave way for exchange rate mechanism that could be more responsive to prevailing economic conditions.

CHAPTER FOUR

4.0 FOREIGN EXCHANGE MARKET UNDER STRUCTURAL ADJUSTMENT PROGRAMME (SAP)

4.1 INTRODUCTION

With the introduction of SAP in September, 1986, the Second-tier Foreign Exchange Market (SFEM) came into being when the determination of the naira exchange rate was made to reflect market forces. Under the system, the exchange rate became an active instrument of Economic Management and the rate derived in the market, served as the means for the allocation of foreign exchange as opposed to the former system of exchange control.

Under SAP, the rate of exchange was intended to eliminate the over-valuation of the naira and reduce the drain on forex reserves thereby reducing pressures on balance of payment which arose partly from unrealistic pricing of imports and exports.

4.2 Exchange Rate

The frame - work for Foreign Exchange Market (FEM) under SAP, was a mechanism for determination of an approprate rate for the naira in order to reduce the pressure on Foreign Exchange resources and stabilize the balance of payments. The exchange rate mechanism was expected to result in a more rational allocation, thus utilization of forex resources and forex market would be smoothly operational.

The major source of forex to the market was Central Bank of Nigeria, while the main users were the manufacturer who ironically contribute little to the pool of forex resources.

Since the inception of the market-determined system, in September, 1986, the naira has under gone substantial devaluation.

Within the frame-work of market determined naira exchange rate, various methods and adjustments were applied.

(i) Dual Exchange Rate System

At the commencement of SFEM, a dual exchange rate system for allocation of forex was adopted. First-tier rate was applied on transaction involving debt service payments, contribution to international organisations, expenses of embassies and other government transactions. This naira rate was government fixed rate of ₦1.5691 to US Dollar applicable prior SAP in August, 1986.

Other transcations went via SFEM at an exchange rate of ₦3.7258 to 1.00 US Dollar at the inception of SAP in September 1986.

The essence of the dual exchange rate system was to avoid a delibrate uniform and sizeable devaluation of the naira but to allow it to depreciate in the SFEM while continue in an upward adjustment of the first-tier rate until the two rates converged to produce a more realistic rate.

The dual exchange rate was rather abandoned because International Monetary Fund (IMF), the advocates of SAP prohibits it.

Under SFEM, the average pricing rate method, marginal rate, and Dutch Auction system were variously adopted to determined the naira exchange rate. This created problem of multiplicity of rates while naira depreciated further.

(ii) Unified Exchange Rate System

By July 1987, the first and the second-tier markets were merged into an enlarged "Foreign Exchange Market" (FEM), where all transactions were subject to market forces. At this time the average rate was ₦4.2073 to US Dollar . The merger increased demand pressures and contributed to the persistent depreciation of the naira exchange rate.

In 1988, the inter - Bank Market, where banks were allowed to transact official foreign exchange between themselves was separated from official market, and an autonomous market for privately sourced foreign exchange emerged with its independent rates. The autonomous market further depreciated naira exchange helplessly. e.g. In December 1988, while the official naira exchange rate at FEM was ₦5.5530 to US Dollar, the naira exchange at the autonomous market was ₦8.3500 to [illegible]ar .

A yawning gap of ₦3.0030.

This further resulted in subsequent merger of autonomous market with the rate the FEM to form Inter-Bank Foreign Exchange Market (IFEM) in January 1989. Under this regime the exchange rate was determined by either of the following:- Marignal rate pricing highest and lowest bid, and weighted average pricing. This, system was further modified, yet naira exchange further depreciated. To arrest the situation temporarily, Dutch Auction system was re-introduced in August, 1990. Under this system, rate tending the mode was applied to determined the market exchange rate.

(iii) Completely Deregulated Exchange Rate

As earlier highlighted there was persistent instability in the foreign exchange market. This was witnessed in the wide divergence of the rates between the official and parallel markets.

As a result of these inconsistencies, C. B. N. completely deregulated the system of foreign exchange market trading on March 5, 1992. This action was because the parallel market premium was as high as 79.2% in February 1992 as compaired to 20% in 1990, 35.2% in 1991 and the universally recommended limit of 5%. The aim of this operation is to narrow the parallel market premium and enhance the operational and allocative efficiency of the forex market. Hence the official naira exchange rate was moved from ₦10.5564 to ₦18.00 per U.S. Dollar.

This resulted to declined premium in the parallel market, while effective demand by banks fell short of forex supply. Some of the reasons advanced for continuous depreciation of naira exchange rate were itemized as follows:-

- There was excess liquidity in the Banking system due to high money supply.
- Expansion of Banks in the Economy
- High but relatively constant interest rate
- Constant reduction in the supply of forex as a result of decline in oil revenue.
- Increased rate of inflation
- Excessive demand for forex leading to high importation of consumer goods. While the industrial sector consumed about 60% of the nation forex and contributes little to the source of supply.

As a result of the unhealthy developments in the decline of foreign exchange and market disequilibrium in macro-economic management, Government adopted series of fiscal policies to correct the imbalance. Some of the policies adopted to revive the value of naira were:

- Constant mopping-up of excess liquidity in the banking system.
- Constant modification in the operations of forex market to determine naira exchange rate.

- Increase in forex supply to FEM to improve the aggregate supply.
- Introduction of various fiscal measures to discourage exessive demand of forex.

However most of the policies adopted were defective in themselves, while improper policies of forex guidelines coupled with large scale corruption did not allow these measures to resuscitate the naira value via-a-via the entire economy.

4.3 Trends in the Parallel Market

The development of parallel market otherwise known as black market or informal market is as old as the financial system in Nigeria. With the institutionalization of FEM in 1986, the parallel market became equally an extension of the official market.

In order to encourage further, private participation in forex market and to boost the supply of forex to meet up the ever increasing demand, Bureau De Change also was established. The objectives among others were to improve fiscal efficiency and provide free access to forex by small buyers.
It was expected that this step would arrest further depreciation of naira. The analysis of naira exchange rate during the various period can be stated thus:

In 1988, the average exchange rate in the parallel market was ₦8.3500 as compared with FEM average official rate of ₦5.3530.

The exchange rates thus recorded premium of ₦2.99 (55.98%) over the FEM rate.
This is far in excess of permissible margin of 5%.

In 1989 the average exchange rates in parallel market and Bureau de change were ₦9.4600 and ₦9.4800 respectively compared with the FEM average rate of ₦7.6221. The rates implied premiums of 24.11% and 24.37% respectively in the parallel market and Bureau de change over the FEM rate.

In 1991 the average exchange rates in parallel market and Bureau de change were the same - ₦15,4500; while the Foreign Exchange Market rate was ₦9.9095. This indicates a margin of 55.91% in both parallel market and Bureau de change over the FEM rate. Still this is above the internationally acceptable margin of 5%.

In 1994, the forex market was again regulated. The official exchange rate was pegged at ₦21.9960 to US Dollar. The parallel market was abolished and Bureau de change were required to sell their forex only to Central Bank of Nigeria on a commission. The operations of this policy so far, has not stopped naira from further depreciation.

The black market, i.e. the unofficial exchange rate rate since the operation of the 1994 Federal Government Budget has remained ₦45.00 - ₦55.00 to U.S. Dollar. This shows a market premium of 104.5% - over the official Exch rate of naira.

The private sector were reluctant to comply with Central Bank of Nigeria directives to sell their currency at Government - determined reate based on the regulation. The supply of forex is still falling below expectation.

Industries who are the major consumers of forex are forced to buy from the unofficial source at the rate of ₦45 - ₦55.00 to 1.00 U.S. Dollar. This further compounded industries capacity utilization as forex were not available to pay for raw materials, spare parts and machinery. Finished goods were in short supply within the economy. Price level rose rapidly.

4.4 Devaluation of Naira

The introduction of SAP and the operation of FEM in Nigeria since 1986 witnessed extreme devaluation of National Currencies. Devaluation is a tool for correcting disequilibria in the balance of payments, in a country experiencing balance of payment deficit. It implies that the value of goods and services imported from other countries are greater than the value of those where the goods are being bought. Foreign goods would be less attractive to importers as they have to pay more of the local currency.

This will reduce expenditure on imports (Ayangi 1990).

The unrealistic high value of naira made foreign goods cheaper and more attractive hence the proposal for devaluation of naira and a market determined exchange rate of naira under FEM. There was no effect of devaluation on the balance of payment disequlibrium because the devaluation only affected imports and left the inflow of foreign revenue to be declining. Other economic variables were not effectively controlled so much so that the exchange rate had inflationary and destructive effect on the Nigerian economy (Ayangi 1990)

Devaluation involves, inter-alia a reduction in the price - adjusted value of an important component of the asset - portfolio of individual asset holders in the economy. In order words, it is a deterioration in the value relationship of domestic financial assets vis-a-vis non financial assets in the individuals holder's total portfolio.

The trapped economy by Ibrahim Ayangi 1990.

Mr. F. L. Osunsade (1983) examined the channels through which devaluation can produce significant impacts on major economic aggregates and in the process, correct financial and structural imbalances. In his paper, he opined that the effect of devaluation are as follows:

- It sets in motion a market driven process of reconsitution which can contribute to an improvement of the devaluing country's balance of payment through an increase in export earning.
- Devaluation - induced in the domestic prices of imports, stimulates increased production of import substitutes, thereby substituting the employment of domestic, for foreign labour in the production of such components of total internal demand. Devaluation induces an increase in Capital inflow.
- Devaluation can help redress deficits in external finance by raising the prices of imported goods, thereby curtailing the demand for them.
- Devaluation encourages efficiency in resource allocation and economices the use of foreign exchange thereby reducing the overall import bill.
- The upward impact of devaluation on the total cost of domestic industrial sector should be less than its impact on imported goods, thus resulting in domestically produced industrial goods being relatively less costly than comparable imports, leading to a switch of demand in the devaluing

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Exchange Rate in Action - A paper delivered by F.L Osunsade (Director CBN Lagos) at a foreign exchange seminar in 1993.

country, from imports to less costly domestic goods. It strengthens the industrial producers in the devaluing country to tap demand potentials abroad through export of non-primary goods.

- Employment in sectors with increased price of forex and reduced demand for output would be adversely affected, while it would expand in sectors experiencing increase in demand.

- In the area of government budget, the net budgetary impact of devaluation would depend on the relative magnitudes of outlays and receipts on external debt related operations. It assists government to spend less on imported items since they are costly, thus helping Government to reduce its expenditure on such items. It raises the domestic currency value of foreign - currency, grant inflows thus creating positive enteries in Government budgets. Finally, he concluded that devaluation could induce higher inflows of capital as it can encourage providers of previously curtailed lines of credit. As a pricing policy instrument, devaluation literally affects the value of financial and non-financial assets in the economy thus encouraging economic growth. Devaluation reduces the purchasing power of domestic money holding over internationally traceable goods and services. This encourages efforts to export commodities and capital inflows.

4.5 Summary

This chapter has essentially discussed the determinants and behaviour of exchange rates. It examined the exchange rate policies in Nigeria, under the Structural Adjustment Programme. It also focused the pricing methods with a summary of the naira exchange rate moverments from 1986 to June 1994.

The inclusion of exchange rate under parallel markets and Bureau de change becomes important as this topic cannot be wholly examined without it.

Nigerian is still in absolute search for a realistic naira exchange rate after the adoption of SFEM, 1986, FEM, parallel market and Bureau de change in 1989. The wide gap between the official rate and the parallel market rate is not desisrable. This shows that a realistic naira exchange rate cannot be objectively established under the current operations.

The chapter takes a further look at the effect of SAP and FEM which resulted in extreme devaluation of the domestic currency - naira. The devaluation of naira has therefore had its impact on exports, imports, domestic industrial sector, employment, government budget and capital flows.

CHAPTER FIVE

5.0 TOWARDS A STABLE EXCHANGE RATE

Basic economic theory stipulates that under ideal conditions of perfect competition, where there are large numbers of buyers (Banks) and seller (CBN) product homogeneity, perfect factor, mobility of product (forex) freedom of exit and entry and perfect dissemination of information (knowledge) a stable and reliable price (rate) is expected to prevail in the market in a given time and environment. The pricing efficiency in the forex market for determination of a realistic exchange rate of Naira has been based on a number of factors. These include demand, supply and operating efficiency of the guidelines.

In order to evolve a market determined exchange rate of Naira, SAP document specified 3 main areas; viz

(i) Adequate funding of the auction market
(ii) Strict control of budget deficits and
(iii) Tightening of monetary policy.

Indeed adequate funding and free market forces are tools for adoption in order to move the Naira exchange rate towards a reality.

5.1 ANALYSIS OF SUPPLY OF FOREX

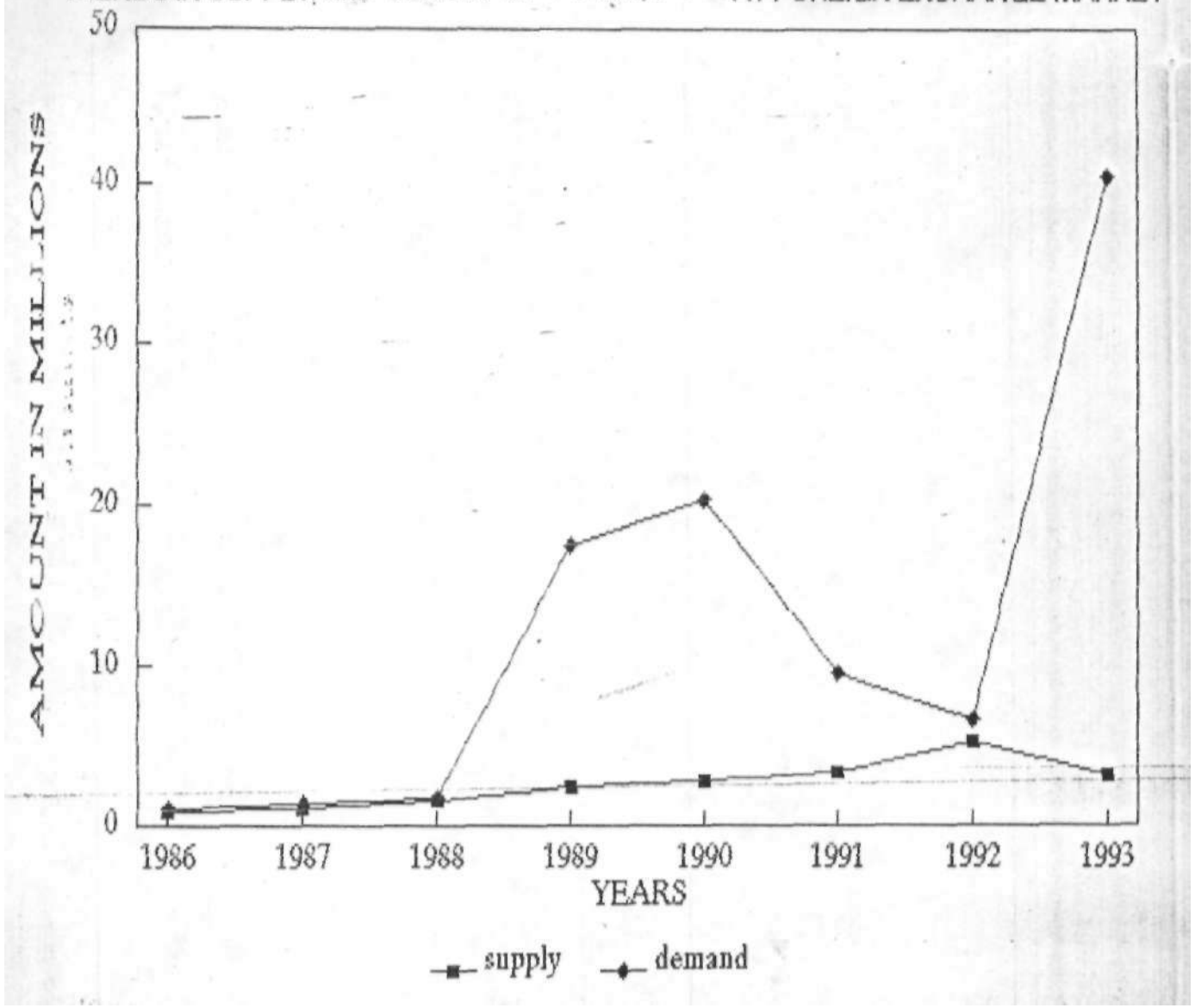
The trend in the supply of forex has not been smooth. It has been subject to a lot of variations and inconsistencies. For example, while a sum of $750 million was supplied to FEM in 1986, the supply increased slowly to $1010 million in 1987 representing 34.67% growth. In 1988 $1402.5 million was supplied to FEM, however, in 1989 a colossal sum of $2398 representing 70% growth in supply was released. However, in 1992 while a sum of $5080.4 million was supplied only, a sum of $3103 million came into the FEM representing a short fall of 38%.

See table 1.

YEAR	SUPPLY OF FOREX IN MILLION DOLLARS	PERCENTAGE OF GROWTH
1986	750	
1987	1010	34.67%
1988	1402.5	38.86%
1989	239.8	70%
1990	2646.1	10%
1991	3158.4	19%
1992	5080.4	60%
1993	3103.9	-38%

GRAGH - ONE

TRENDS IN SUPPLY, AND DEMAND OF FOREX AT FOREIGN EXCHANGE MARKET



In the similar manner, the supply of forex to Central Bank of Nigeria (CBN) did not help matters. These was a rapid inflow of foreign exchange from 1970 up to 1980 when CBN recorded an annual total receipt of $25,979.3 million. Out of this total receipt, contribution from the oil sector represented 88.3 per cent. Please see table 2.

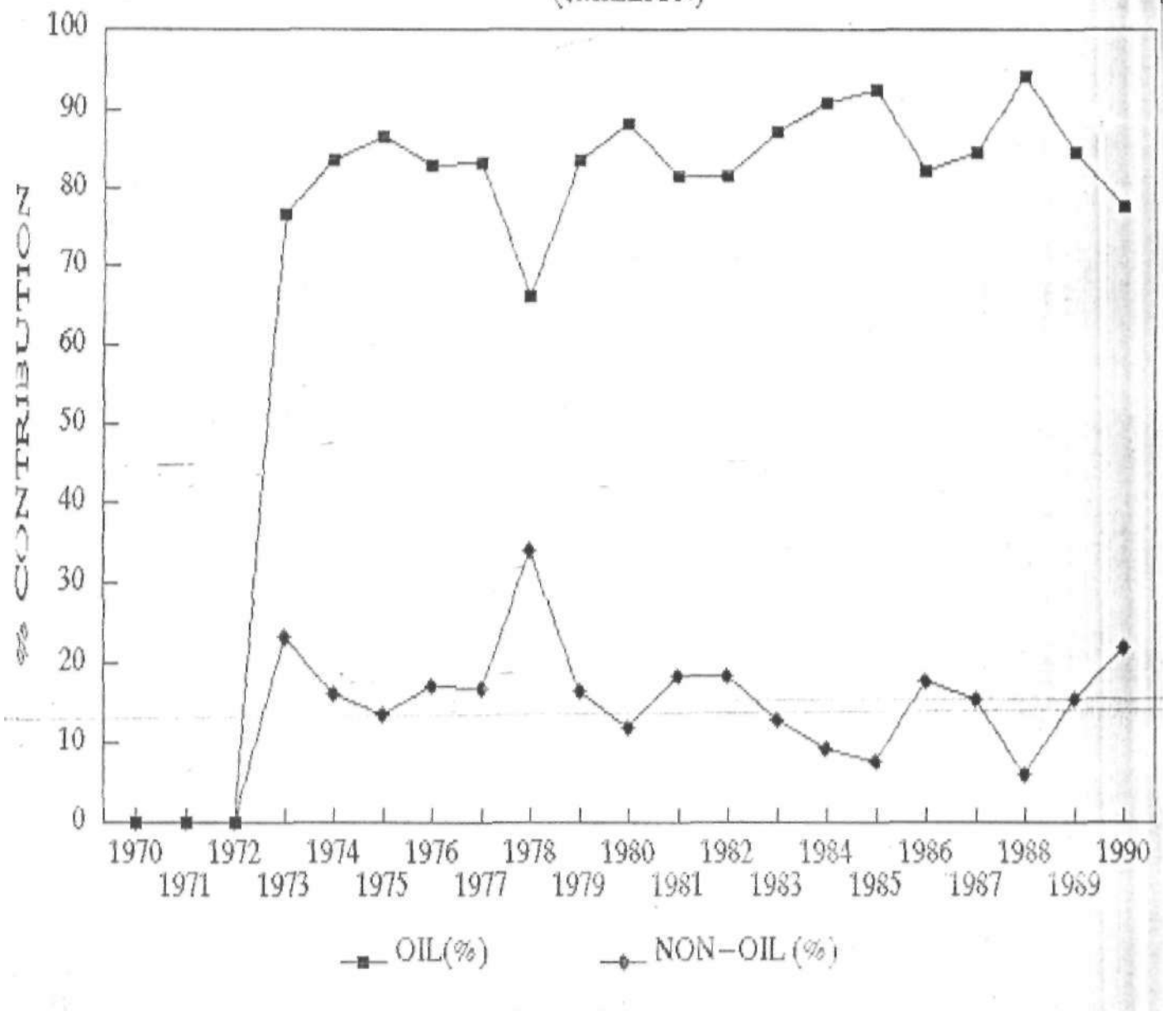
From 1981, Nigeria started experiencing dwindling inflow of foreign exchange as a result of a fall in the world oil market, in the 1980s. between 1981 and 1985 an average total inflow of $14,000 million was recorded with the oil sector contribution an average of 85%.

The forex inflow further slumped from 1985 to 1990 with an annual average of $7,000 million with the oil sector still contributing a colossal percentage. However, in 1991 total inflow appreciated to $12,264 million and $11,886 million in 1992 but crashed again in 1993 with a total inflow of $9,923.2 million. Oil sector still retain a very large portion with an average of 97% to total inflow over the years.

From the trends above, the supply of foreign exchange to the foreign exchange market has not faired well to support a perfect market for a realistic exchange rate. The supplies of currencies to the market are not consistently free because of the country's weak capacity to earn foreign exchange. Other products which would have been developed for world market were abandoned during th il boom.

GRAPH - TWO

FOREIGN EXCHANGE FLOWS THROUGH THE CENTRAL BANK
($MILLION)



As long as Nigeria continue to depend on oil as the only source of foreign currency generation and the advanced countries are only in the position to determine or rule the world price of oil, the hope for adequate supply of foreign currency remains unrealistic. This position has led to the spill-over of demand from official to the parallel market. It will not be out of place to point out that, the Government has limited control over the forex supply. The bulk of supply depends directly on oil proceeds which in turn depends on volume of output as well as oil prices both of which are outside the control of Government. Both of them are determined by the world body - Organisation of Petroleum Exporting Countries (OPEC).

5.2 Analysis of Demand for Forex

Paradoxically, the lower the capacity of a country to earn Foreign Exchange, the higher its demand or needs for Foreign Exchange. The Nigeria's needs for Foreign currency is geniune because as a developing country it lacks modern technology, spare parts, managerial/enterpreneurial skills and some essential consumer goods. It is more dependent on importation of these items to generate a fair internal growth. Such importation has to be paid for in foreign currency. The industrial growth and agricultural production is not encouraging. The agricultural commodities produced in Nigeria do not meet the consumption requirement of the population, let alone any surplus that might be left to support local industries as raw materials. The industries therefore account for high percentage of aggregate Forex demand

over the years. More than 60% of Forex supplied are demanded by the manufacturing sector.

There has been constant rise in the demand for Forex over the years.

Example:

YEAR	AMOUNT DEMANDED IN MILLION & DOLLARS	PERCENTAGE INCREASE IN DEMAND
1986	940.23	-
1987	1,224.22	30
1988	1,684.36	37.58
1989	17,337.2	929
1990	20,196.0	16.5
1991	9,452.3	53
1992	6,434.6	31
1993	40,641.9	531

The demand rose in 1987 and 1988 by 30.2% and 37.58% respectively. However, in 1989 the demand rose to $17,337.2 million representing 929% increase over the previous year 1988 which was $1,684.36 million only. In 1991 and 1992, the demand fell to $9,452.3 million and $6,434.6 million, respectively although it skyrocked in 1993 to $40,641.9 million. The 1993 demand represented 531% increase over and above the 1992 demand. Some immediate and remote causes must have accounted for this. There was no tight monetary policies in place to check the demand for Foreign currencies. The Federal Government of Nigeria continue to engage in extra-budgetary spending. To w[illegible]n the situation, the Commercial and Merchant Bank[illegible]ave excessive credits.

There was too much Naira in circulation, thus worsening the exchange rate. Aggregate credits to the economy over the years were as follows:

YEAR	TOTAL CREDIT TO THE ECONOMY (IN MILLION NAIRA)	NAIRA EXCHANGE RATE TO US DOLLAR
1989	49,259.1	7.3651
1990	57,657.0	8.3469
1991	70,666.8	9.9095
1992	1,274,730	17.2984
1993	2,239,836	21.9960

From above data, the Naira exchange rate worsens as the aggregate supply of credits to the economy increases. Simple economic principles imply that too much Naira chase very few foreign currencies. This results in continuous depreciation of Naira against the foreign currencies. For example, in 1991, while the aggregate money supply to the economy was ₦70,666.8 million, average Naira exchange rate to U.S Dollar was 9.9095. However, with the alarming jump in credit supply to ₦1,274,730 million and ₦2,239,836 million in 1992 and 1993 respectively, the average Naira exchange crashed to 17.2984 and 21.9960 during the years respectively.

5.3 Demand and Supply Relationship

The relationship between the demand and supply is far from achieving a reality. The demand outstripped the supply helplessly between 1986 and 1993. Only an average of 48.69% of total demand was met during the period. It was worst in 1993 when only 7% of the total demand was

satisfied at the Foreign Exchange Market. The gap between the supply and the demand levels continue to widen over the years. The market was fraught with problems of fraud and innefficient allocation policies. This position further depreciated the Naira exchange rate. Rates in both autonomous market and the FEM gradually shot up to as high as ₦22.00 and ₦48.00 to the Dollar in the autonomous market as at December, 1993. The net results of this was depression of the already low capacity utilisation in industry and increase in inflation rate. See Graph One on - Trends in Supply and Demand at Foreign Exchange Market.

5.4 Operation of the Market

The Exchange Act of 1962 provided a precautionary measure designed to check and forestall any balance of payment crises. The balance of payment was under pressure and there were signs of imminent economic down turn. After the attainment of independence in 1960, there was high scale importation of capital goods.

Although the overall authority for the administration of the Act was invested in the Minister for Finance, the bulk of it was delegated to Central Bank of Nigeria. All the authorised dealers in Foreign Exchange were under the supervision of CBN.

As a result of inadequacies and abuse of the Act Bribery and Corruption in the operation of the system, coupled with dwindling position of Nigeria's external reserve, Exchange Control (Anti-Sabotage) was promulgated in 1977. This was to control th ctices and

provide stronger sanctions in the operation of Foreign Exchange Market.

During the 2nd Republic, 1978 - 1982 the operations of Foreign Exchange Market did not help matters. Malpractices in Foreign Exchange continued unchecked. The import license regulations were seriously abused. Compliance with the requirement of Form 'M' were neglected.

Yet in 1984 another Foreign Exchange Anti-sabotage Decree was promulgated by Buhari Administration. The Decree prohibited private transaction in Foreign Exchange which were not authorised by the control authority. During this period, the exchange rate was not left to be determined by the market forces of demand and supply, rather efforts were concentrated on rationing and allocation to check-off all excess demand for Forex. With the introduction of SAP in 1986, varied attempts were made to revive the value of Naira in the FEM. Various modalities were adopted by CBN at several intervals to restore confidence in the exchange rate of Naira. However, despite adjusted mode of operation of the Market, value of Naira still depreciated. FEM operating guidelines could not be effectively operated because of the following reasons:

Competent Government: A competent and fearless Government would initiate policies that would put the economy on course. This is done to check inflation, unemployment, rise in the value of money

Volatile Business Environment: In any economic environment, where information on the future on the of business cannot be predicted with certainty, investment decision making will be irrational.

Trade Unionism: Where increases in wages in are demanded by trade unions to compensate for any slight increase in prices, it aggrevates inflation and bring about further reduction in the value of money. This brings about uncertainty and inefficient investment decisions. The problems of approaching a realistic value of Naira were not sincerely tackled the past administration of General Babangida. Policies were changed harphazardly from one system to another. Foreign Exchange policy guidelines were not strictly enforced.

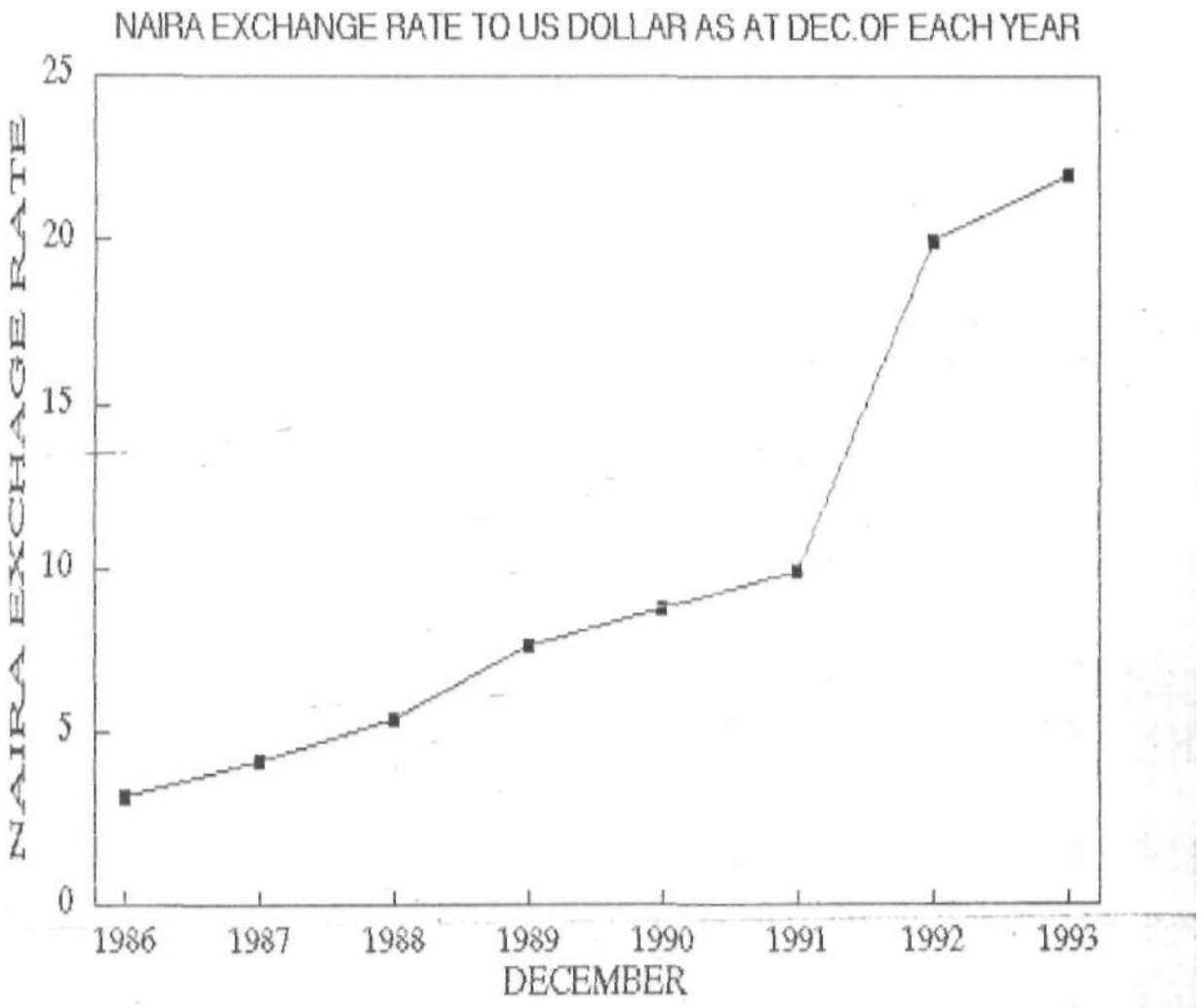
5.5 Exchange Rate

The exchange rate of Naira to U.S Dollar has undergone rapid depreciation over the years. For example:

Year	Average Exchange Rate Naira to U.S Dollar
1985	0.8924
1986	1.7323
1990	8.3469
1991	9.9095
1992	17.2984
1993	21.9960

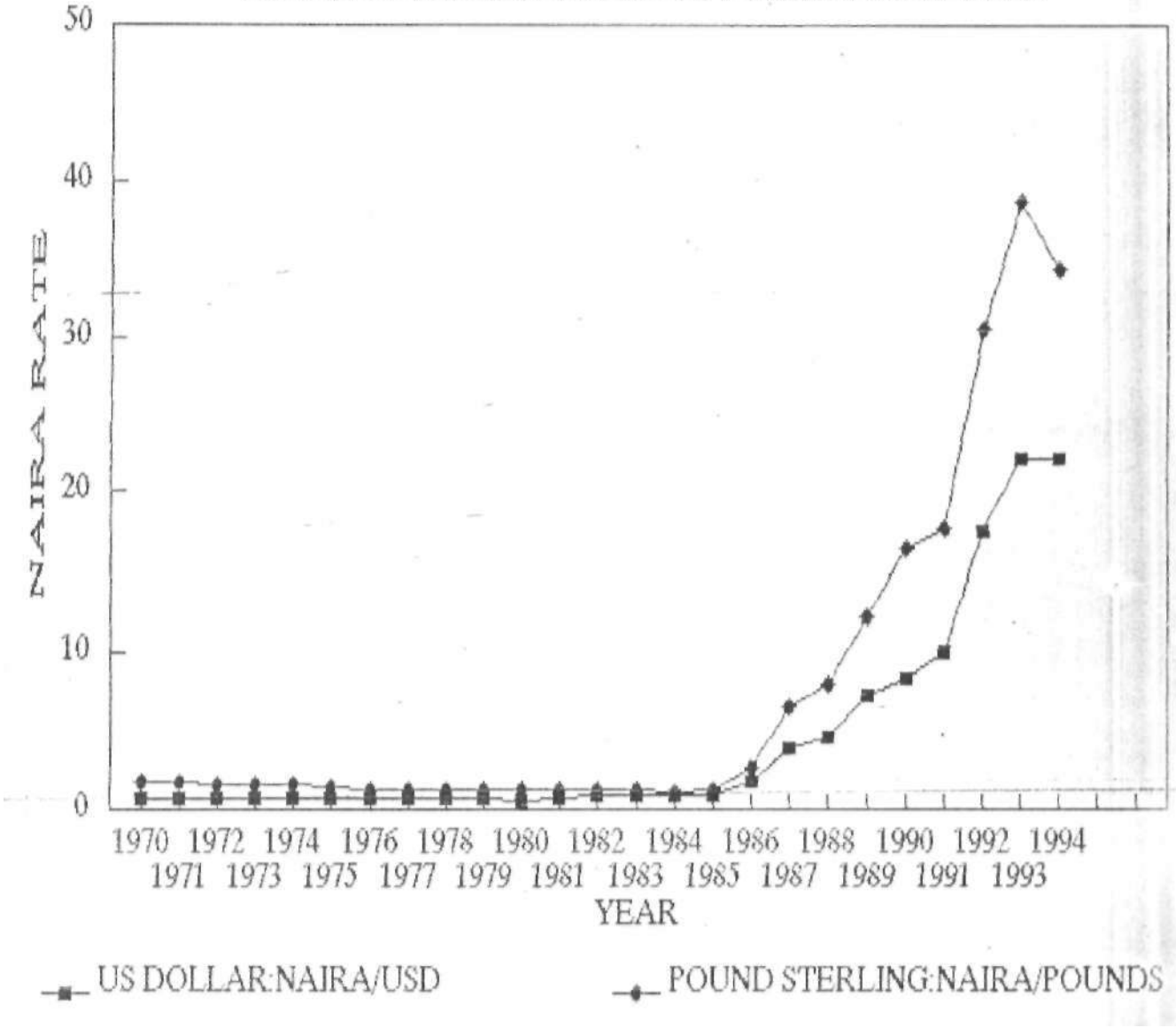
The degree of depreciation is beyond any comparable rates adopted in any developing co[illegible]y. The above rates 1986 to 1993 were the effec[illegible]mpetetive market determined exchange rate adopted under the

GRAPH - THREE


NAIRA EXCHANGE RATE TO US DOLLAR AS AT DEC.OF EACH YEAR
NAIRA EXCHAGE RATE
25
20
15
10
5
0
1986
1987
1988
1989
1990
1991
1992
1993
DECEMBER

GRAPH - FOUR

AVERAGE NAIRA EXCHANGE RATES TO MAJOR CURRENCIES



operations of SAP. It is generally believed that the exchange rates of Naira is under-valued. This means that the realistic exchange rate should be lower in Naira to Dollar terms, than the actual equilibrum rate determined by full market forces and the official rate determined by the current market arrangement. The current official exchange rate (₦21.9960) is so far from the theoretical equilibrum exchange rate derived from the purchasing power parity (PPP). By implication, the realistic rate is one close to the equilibrum rate derived from the 'PPP' (Omoruyi 1989).

An alternative view of the realistic exchange rate should be that of SFEM rate, which certifies that SFEM eliminates the opportunities for profitable parallel market transactions (Oloponia 1986). In establishing the Bureau de Change, the monetary authorities expectation was that the activities of parallel dealers will be deminished or eliminated. While this seems reasonable, (Oloponia 1986) ignored the fact that the emerging rate at the FEM varies and is highly dependent on the auction system, adopted. This implies that this system already adopted are not capable of yielding a realistic rate since the parallel market is still in existence and is thriving. Under the specification of SAP, the realistic exchange was based on Government's commitment to adequately fund the FEM. However, the supply side of the market has made the realistic rate unattainable in Nigeria. The Government's actual support to the market was much less than it committed itself to over the years. For example:

Year	Budgeted Forex Inflow	Actual Disbursement to Forex Market
	$'million	$'million
1989	6.679.1	5.413.1
1990	6.679.1	7.553.1
1991	11.8550	9.349.7
1992	8.998	8.369.9
1993	9.230	5.621.4

The inadequate supply of Forex coupled with the excess demand has not only kept the parallel market going but has also depreciated Naira continuously. As pointed earlier, the bulk of the forex supply is from oil proceeds which in turn depends on the volume of output as well as the price, but alas, both of these are outside the control of the Government. The problem of Naira exchange rate exists. The rates have been subject to instability variability and generally volatile. The application of various exchange rate regimes such as:

- the news and speculative dynamics model,
- flexible exchange rate,
- dutch auction have been largely unrealistic.

However, (Ojameruaye 1991) suggested that an auction method based on the idea of the realistic rate is within the neighbourhood of the 'PPP'. He maintained that:

(i) both the Banks and Bureau de Change be allowed to participate in the FEM.

(ii) a "reference" rate be defined at each session with the restriction that the rate which emerges at the market should not exceed 10% of the 'PPP'.

In this auction, CBN is to continue adjusting the "reference rate" while the Banks will adjust their demand, also, until excess demand is zero. This may still be subject to problems as long as the supply of Forex is not consistent.

In the light of above, given the nature of Nigeira circumstance exchange rate determination may be highly 'volatile' and unpredictable. The instability of Naira is still a cause for concern, the need for and development of highly efficient and sophisticated foreign exchange markets cannot be over-emphasised.

Summary

This chapter has attempted to analyse the Foreign Exchange Market based on the data available. The Naira exchange rate is determined by the interplay of market forces as well as other variables mentioned.

The supply of forex to the FEM has been irregular, due to the declining oil revenue. The growth of supply of forex does not correlate with the demand. The Government had not met its obligation to supply enough forex in line with budgeted figures. On the other hand, demand for forex had always outstripped supply. The demand increases geometrically. About 60% of forex demand came from the manufacturing sector while the same contribute

so little to the source of supply. It was discussed that the high demand for forex is due to excess credits in the economy including extra-budgetary expenses over the years.

The exchange rate of Naira depreciated because of the wide gap between the supply and demand. The operations of forex has been subject to a lot of variations because of the use of different types of allocation policies. There were corrective steps to revive the value of Naira but the impact was felt only on the short run.

Various exchange rate regimes were analysed. Given the Nigerian environment that is ridden with corruption, politiecal instability and general economic depreciation, the most favoured exchange rate should be that which is under the serious vigilance of the Government.

CHAPTER SIX

6.1 Summary and Conclusion

The Foreign Exchange market in Nigeria and indeed other developing countries has been under extreme pressures in the recent years. There has been general economy depression in Nigeria. The down-turn of the Nigerian economy has series of consequencies on the external reserves, external debt and export promotion, interest rate, unemployment, inflation, trade and exchange controls, among others.

The main focus of the study is to identify whether in spite of various policies adopted in the operation of foreign exchange market, considerable improvements were recorded in the balance of trade as well as value of Naira. Various exchange rate regimes were examined thus: flexible exchange rate, fixed exchange rate, purchasing power parity, the managed "float" rate and open interest parity. Others were News model of Exchange rate, speculative dynamics model including various factors that affect them. The operation of foreign exchange market in Nigeria was examined in periodic stages. These were the SAP period, SAP period and Over-view of the post SAP era.

The 1962 Exchange Control Act made provision for measures designed to increase Foreign Exchange resources, reduced disbrusement of Forex and preserve the nations Forex reserves. During this period, Exchange Control

were not tightened consistently. The administration of Exchange rate backed up by series of controls that were often circumvented, led to the over valuation of the Naira exchange rate and a massive outflow of Foreign Exchange.

Under the SAP period, a market determined system replaced the rigid controls applied during the pre-SAP era. The objective of SAP include the achievement of balance of payments, fiscal viability and sustained economic growth. To achieve these objectives, a Market determined exchange rate mechanism was adopted with the commencement of Foreign Exchange auctioning through Forex Market in September, 1986. Complementary monetary and fiscal policies were also applied to enable the Naira attain a realistic level. The Exchange Controls were dismantled and the exchange rate became flexible.

The supply and demand of Forex had no corrolation for the normal interplay of market forces to determine the exchange rate of Naira. The Forex was far in short-supply as compaired to their demand. The Government could not meet up its obligation in the supply as little revenue was being generated on oil.

The quantity of oil to supply in the world market and the selling prices both of which determined the level of revenue, were outside the control of Nigerian Government. Hence the continuous dwindling of oil revenue as well as the Naira exchange rate.

Oil accounted for an average of 85% - 92% of Nigeria's foreign exchange inflow, while the non-oil sector contributes the little balance of 8% - 15%. There was no impact on the efforts of Government to generate high revenue on non-oil exports. In fact, these were not encouraged generally.

The consequences of low supply of Forex in the economy were: under utilization capacities in industries, low production, lack of raw materials and spare parts and further depreciation of Naira.

On the other hand, the demand of Forex was abnormally high, due to the influence of speculators. This attitude did not improve the market. Most of the companies that could not get Forex through the official source for importation of spare parts. Machineries and raw materials were forced to patronize the parallel market. The parallel markets charged arbitrary rates on foreign currency. The parallel markets then flurished at the expense of the economy. No specific yardstick were applied for rates charged. Manufacturers were held to ransom because of their desperate need for Forex. Equally, contributory to the depreciating rate of Naira was the high level of Bank credits to the economy. The Government financing of deficit budgets also encouraged the decline of Naira value. The manufacturing sector that contributes little or nothing to the supply of Forex consumes about 60% of Forex inflow in the economy

The depreciating value of Naira has consequencies on inflationary rate. Imports, exports, employment, external reserve and Government budgets.

As a pricing policy, devaluation literally affects the value of financial and non-financial assets in the economy thus encouraged economic growth marginally.

The Nigerian Foreign Exchange Market and the value of Naira is still subject to instability and variability. The operation of Foreign Exchange Market has left much to be desired.

The low Forex supply coupled with complex restrictions in the operations of the Market resulted in the active black (parallel) Market for Foreign Exchange.

6.2 Suggestions and Recommendations

(i) Exchange Rate

A more enduring solution should involve working out an appropriate and a more supportable rate for the Naira, using either of the following options:

(a) Controlled (Fixed) Exchange Rate:
The Federal Government of Nigeria should peg the value of Naira within a middle course. That is to say , between the existing paralled Market rate of ₦50 and the official pegged rate ₦21.996.

This will reduce the unreasonable margin between the two rates. After some level of success in reducing the premium, the rate should be adjusted downwards on a continuous basis until a more realistic rate is attained. Indeed, no meaningful degree of development would be attained easily in a nation that leaves its currency exchange rate to the determination of market forces which are unpredictable in the least.

(b) Purchasing power parity:

This theory could be adopted in the case of Nigeria because it believes that Exchange Rate between two currencies should reflect the price levels of both countries. This is to say that the price of an item in country (A) should be equal to the price of the similar item in country (B) given allowance for variations in cost of transportation and handling charges. It holds therefore that the price levels of the item in country A and B would reflect the rate at which the currencies would exchange. Where this is well managed in Nigeria, stable and realistic value of Naira would be attained.

(ii) Increase Supply

The major way we can increase the Foreign Exchange earnings is through increased exports, particularly, the non-oil sector. Local raw material utilization may strenghten the exporting abilities of manufacturing companies, not only to save the Foreign Exchange spent on imports but also earn some Foreign Exchange.

Nigeria should develop its existing several tourist attractions to earn significant Foreign Exchange from tourists who spend larger sums of money on accommodation, transport, food, sourvenirs and other leisure activities.

Another source of Foreign Exchange is the repatriation of the holdings of private citizens from the foreign accounts. Many Nigerians who have foreign exchange accounts should be prohibited from operating it and such funds should be repatriated, to creat additional access to foreign exchange. Companies that earn a good percentage of foreign exchange should be encouraged through priority allocation of foreign exchange.

Petro-chemical and natural gas projects should be encouraged to earn more foreign exchange instead of the existing pattern of exporting crude oil whose price is solely determined by the international communit

Exportation of semi-processed agricultural goods and Nigerian made goods should be encouraged to generate additional foreign exchange.
Reduced cost of production would encouraged domestic industrial growth. A healthy industrial growth would encourage foreign exchange earning.

(iii) Decreased Demand

If Nigerian bumper foreign exchange earnings in the early 1970s of the oil boom, have been used in a such a way as to reduce her dependence for foreign food, chemicals, textiles, and even capital goods the demand for foreign exchange would have been reduced today.

The manufacturing industries should source for local raw materials to reduced the demand for foreign exchange. To tackle this properly, government should give more incentives such as liberal tax deductions to companies for expenses or research and development.
In order to reduce excessive demand for foreign exchange the following steps should be taken by the government

- charge high tariffs on imports to discourage non-essential imports,
- Debt service would be less burden some if it is re-negotiated for rescheduling and reduction concessions.

- Stabilization securities within the frame-work of open market operation should be put in place to reduce excess naira chasing few dollars.
- Tight liquidity measure should be in place to mop-up excess liquidity.
- Government should discourage extra-budgetary expenses.

(iv) Operating Efficiency:

As pointed earlier, various allocation methods used in Foreign Exchange Market in Nigeria was subject to abuse, arbitratiness, and corruption. Political patronage was the yardstick used for the allocation of foreign exchange during second republic.

Under SAP, the operations of Second-tier Foreign Exchange Market (SFEM) and inter-Bank Foreign Exchange Market (IFEM) and the Dutch Action system under the Foreign Exchange Market (FEM) did not reflect the objectives of the country. It thus require that a National economic objectives should be reflected in the allocation of foreign exchange resources. For example, a sector which contributes to the fulfilment of National economic objectives - "greater self reliance" should have a higher portion of foreign currency allocation.

Foreign exchange should be sold to essential preferred sector, while the non-essential users should be allowed to fetch their needs from the parallel market which might be relatively higher rates.

Although it is impossible to eliminate all abuses in forex market, a carefully work-out monitoring and supervision system would reduce the incidences.

The operations of foreign exchange budget did not achieved the target or objectives, therefore strick adherance to forex budgets should be properly enforced.

Closer monitoring of all official foreign accounts should be put in place especially that of NNPC Accounts to assess the actual position of forex inflows to ensure a better planning of the allocation.

The normal operation of Bureau de change should be reinstated and monitored under the CBN guidelines.

The present controlled interest rates of 12% - 15% P.A. on deposits is not feasible where the inflation rate increased to about 20%.

The interest rates should be relaxed to attract more deposits. This will reduced excess fund in circulation out-side banks' operations.

Above recommendations could be achieved under a committed non-currupt government at the centre and in an enviroment that is politically and economically stable.

TABLE I

TRENDS IN SUPPLY, AND DEMAND OF FOREX AT FOREIGN EXCHANGE MARKET

YEAR	SUPPLY OF FOREX IN US DOLLARS(MILLION)	DEMAND OF FOREX IN US DOLLARS (MILLION)	EXCESS DEMAND IN US DOLLAR (MILLION)	DEMAND MET % STAGE	GROWTH IN DEMAND %TAGE	GROWTH IN SUPPLY %TAGE
1986	750.00	940.23	190.23	79.77	-	-
1987	1,010.00	1,224.22	214.22	82.50	30.20	34.67
1988	1,402.50	1,684.37	281.87	83.27	37.59	38.86
1989	2,398.00	17,337.00	14,939.00	13.83	929.29	70.98
1990	2,646.10	20,196.60	17,550.50	13.10	16.49	10.35
1991	3,158.40	9,452.30	6,293.90	33.41	(53.20)	19.36
1992	5,080.40	6,434.60	1,354.20	78.95	(31.93)	60.85
1993	3,103.90	40,641.90	37,538.00	7.64	531.62	(38.90)

SOURCE: 1. CBN PUBLICATIONS (ADOPTED)
2. NIGERIAN FINANCE AND COMMERCE ALMANAC (ADOPTED)

TABLE II

FOREIGN EXCHANGE FLOWS THROUGH THE CENTRAL BANK (1970 - 1993)
($' MILLION)

YEAR	OIL	NON-OIL	TOTAL	OIL(%)	NON-OIL(%)
1970	N/A	N/A	901.60	N/A	N/A
1971	N/A	N/A	1,495.30	N/A	N/A
1972	N/A	N/A	1,818.50	N/A	N/A
1973	2,605.60	793.70	3,399.30	76.65	23.35
1974	7,067.40	1,374.80	8,442.20	83.72	16.28
1975	7,719.70	1,197.60	8,917.30	86.57	13.43
1976	8,698.00	1,804.00	10,502.00	82.82	17.18
1977	9,975.90	2,027.90	12,003.80	83.11	16.89
1978	8,287.50	4,250.90	12,538.40	66.10	33.90
1979	14,503.50	2,847.50	17,351.00	83.59	16.41
1980	22,932.60	3,046.70	25,979.30	88.27	11.73
1981	17,471.50	3,977.70	21,449.20	81.46	18.54
1982	12,178.50	2,772.70	14,951.20	81.46	18.54
1983	10,192.50	1,486.70	11,679.20	87.27	12.73
1984	11,016.10	1,105.30	12,121.40	90.88	9.12
1985	11,367.20	943.00	12,310.20	92.34	7.66
1986	5,742.50	1,234.00	6,976.50	82.31	17.69
1987	4,659.30	851.00	5,510.30	84.56	15.44
1988	4,924.90	304.30	5,229.20	94.18	5.82
1989	5,912.30	1,072.40	6,984.70	84.65	15.35
1990	7,437.10	2,125.00	9,562.10	77.78	22.22
1991	11,792.30	472.00	12,264.30	96.00	4.00
1992	11,641.70	244.40	11,886.10	98.00	2.00
1993	9,696.60	226.20	9,923.20	97.70	2.30

N/A: NOT AVAILABLE
SOURCE: CBN PUBLICATIONS (ADOPTED)

TABLE III

NAIRA EXCHANGE RATE TO US DOLLAR AS AT DECEMBER EACH YEAR.

NAIRA/US DOLLAR: MONTHLY AVERAGE EXCHANGE RATE

	1986	1987	1988	1989	1990	1991	1992	1993
JAN		3.64710	4.17490	7.03890	7.86210	9.23110	9.56440	20.21770
FEB		3.70140	4.26110	7.38280	7.90090	9.66430	10.19950	22.10920
MARCH		3.92130	4.66300	7.58710	7.93880	9.87900	18.78640	24.99000
APRIL		3.90540	4.20230	7.58080		8.78840	18.78600	22.64670
MAY		4.16170	4.10930	7.50510	7.94000	9.40940	18.73550	21.99600
JUNE		4.05060	4.19160	7.34770	7.94240	10.23380	18.72200	21.99600
JULY		3.80810	4.60870	7.13880	7.95230	11.10800	18.71550	21.99600
AUGUST	1.56910	4.08090	4.58300	7.25930	7.96230	11.41390	18.71550	21.99600
SEPT	4.61740	4.20730	4.71670	7.34290	7.97430	10.24150	19.86090	21.99600
OCT	4.12030	4.27610	4.77480	7.39340	8.00890	9.88580	19.66240	21.99600
NOV	3.53110	4.28900	5.14790	7.50370	8.32000	9.86460	19.80950	21.99600
DEC	3.18280	4.16650	5.35500	7.62210	8.70710	9.86500	19.95730	21.99600

SOURCE: FOREIGN OPERATIONS CBN LAGOS (ADOPTED)

TABLE IV

AVERAGE NAIRA EXCHANGE RATES TO MAJOR CURRENCIES(1970-1994

YEAR	US DOLLAR: NAIRA/USD	POUND STERLING: NAIRA/POUNDS
1970	0.7142	1.7114
1971	0.6944	1.7156
1972	0.6579	1.6289
1973	0.6573	1.6289
1974	0.6293	1.4795
1975	0.6158	1.3618
1976	0.6266	1.1317
1977	0.6466	1.1671
1978	0.6067	1.2238
1979	0.6027	1.2628
1980	0.5469	1.2647
1981	0.6052	1.2495
1982	0.7631	1.1734
1983	0.7506	1.1216
1984	0.7672	1.0765
1985	0.8924	1.1999
1986	1.7323	2.5554
1987	3.9691	6.5926
1988	4.5367	8.0895
1989	7.3651	12.2419
1990	8.3469	16.2419
1991	9.9095	17.4954
1992	17.2984	30.4034
1993	21,996	38.6598
1994 (UP TO JUNE)	21.996 (PEGGED)	34.4287

SOURCE: CBN PUBLICATIONS(ADOPTED)

TABLE V

FOREIGN EXCHANGE FLOWS THROUGH THE CENTRAL BANK (1970 - 1993)
($' MILLION)

YEAR	OIL	NON-OIL	TOTAL	OIL(%)	NON-OIL(%
1970	N/A	N/A	901.60	N/A	N/A
1971	N/A	N/A	1,495.30	N/A	N/A
1972	N/A	N/A	1,818.50	N/A	N/A
1973	2,605.60	793.70	3,399.30	76.65	23.35
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SOURCE: CBN PUBLICATIONS (ADOPTED)

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