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Nigeria Foreign Exchange Experience: Challenges, Prospects and Options for Optimal Performance

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ABSTRACT
International trade which makes available greater variety of goods and services to consumers in different countries, warrants each trade party to exchange their commodity for a given currency at a particular rate. This rate is determined and regulated by several indicators and trade policies. In Nigeria, before the Structural Adjustment Programme, overvaluation of the Naira exchange rate, high demand for foreign currency, large scale corruption and high demand for foreign product were among a few reasons adduced to fluctuation in Naira exchange rate before the SAP. Thus, this paper seeks to investigate Nigeria's foreign exchange experience: challenges; prospects and options for optimal performance. A major evil perpetuated by the Central Bank of Nigeria, and forex market regulators is designing and implementing policy when volatility associated with exchange rate must have lingered causing great aggravations and discomfort in the economy. This is a major finding that originates from this paper. In order to reduce economic uncertainty associated with exchange rate fluctuation and for optimal performance to be achieved both in the medium and long-term, this paper strongly supports the need for financial engineering as this will go a long way to mitigate problems that might arise in responding to exchange rate adjustment/fluctuation.
Keywords: Exchange Rate, Fluctuation, Performance, Era, Devaluation.

INTRODUCTION

Over the past decades, nations have been encouraged to specialize in the production of goods and services they can easily produce with minimum cost of production, and at cheaper rate. This principle and ideology, according to Ufoeze, Okuma, and Nwakoby, (2018) encourages economic liberalization which is explicitly explained by Ricardo's, (1819) comparative advantage open economy model. Hence, the concept of exchange rate which represents a means of effecting payment for international transaction and perhaps a major macroeconomic indicator crept into the analysis, especially in a highly import dependent economy. Thus, Oyovwi, (2012) opined that exchange rate becomes an incentive in shifting resources and boosting national income. This exchange rate serves as a means of payment/settlement for international transactions (Nwaoba, 1999). Simply put, exchange rate is the monetary value or ratio at which one currency is exchanged for another, according to Jhingan, (2005) exchange rate stability plays an important role in economic stability. Business entities take into consideration the movement of exchange rate before making investment decisions. Exchange rate has undergone substantial transformation from the period when a fixed parity was maintained with the British Pound to the floating era. In the fixed exchange rate regime, exchange rate uncertainty increased the cost of hedging, reduced return on investment and Nigeria's trade output while the floating exchange rate regime is attributed with volatility and the degree of volatility is dependent on economic fundamentals. Abina and Mogbeyiteren, (2021) discovered that the very first fluctuation as regards exchange rate, can be traced to the collapse of the Bretton Woods System. The collapse led to high volatility which further made forecasting exchange rate difficult for arbitrage traders.

Nigeria, being the largest lucrative trade nation in Africa, is endowed with abundant natural resources, varied landscape, abundant labor, and large commodity market, which offer her huge potential business opportunity amongst other African countries in international trade. The demand and supply of goods and services across borders has great implication on exchange rate. Net exporting countries tend to have higher exchange rate relative to their trading partner. The foreign exchange (FX or FOREX) aids international trade and investment by enabling currency conversion.
But the Nigeria forex market is constrained by many structural issues few of which include: high tariff, inadequate infrastructure, low liquidity, high-interest rate, and corruption, (Ajayi, Abina, & Ijomah, 2019) other problems associated with forex market include; limited export earnings, excessive demand for foreign exchange, weak accretion to Naira exchange rate and many more. All these have greatly affected the way and manner in which Nigeria trades with other countries. Increase in the price of commodity, wages and interest rate are few of the universal consequences that arise as a result of fluctuations in exchange rate (Abina & Mogbeyiteren, 2021). These offsetting movements have relative competitive position on both domestic firm and foreign competitors.
The implementation of financial and economic policies which range from deregulation of financial market to exchange rate liberalization has brought about unified exchange rate and improved fiscal management. Concomitantly, this has dramatic impact on major financial fundamental elements. The latter which entails devaluation of local currency against that of trade partners, while the former involves the complete removal or reduction of government legislation and laws in the financial market. All these policies were designed and deployed to ensure stable realistic exchange rate. Exchange controls were also employed in extreme persistent volatile circumstances such as the devaluation and appreciation of the local currency (Obaseki, 1991), leading to overvaluation or undervaluation of exchange rate. Exchange rate is said to be overvalued when it appreciates more than its equilibrium while it is undervalued when it depreciates below its equilibrium which could lead to economic overheating. However, when a currency deviates from its long run equilibrium path, the currency is then termed misaligned which is then identified as an obstacle to sustained economic growth of nations. Against this backdrop, the Nigerian foreign exchange market has experienced notable challenges few of which include; overdependence on oil proceeds, fluctuation/volatility of exchange rate flows which is caused by market forces of demand and supply, monetary expansion, debt service burden, environmental and political instability. These are amongst the few challenges that will be discussed in this paper, and plausible solutions to these problems will be suggested towards the tail end of this opinion paper.

2.0 Conceptual Review

2.1.1 Brief History of Nigeria's Foreign Exchange

Exchange rate serves as a means of effecting payment between residents of two or more countries in their respective currency. Exchange rate regimes are typically directed into three categories. On one end of the spectrum there are hard exchange rate pegs and on the other end there are flexible exchange rate regimes. Between the period 1928–1929 forty European countries defined what constituted currency unit which mainly consists of gold weight, prior to independence. During the colonial era, the administrative fixing of Naira exchange rate at par with the British pounds sterling between the period 1959-1967 tended to encourage large scale outflow of domestic currency which influenced distortionary practices in the official forex market. Fiscal viability could no longer be guaranteed in this era. The British Pound sterling was used for foreign trade not until 1973 when the British pound was changed to Naira. In this period, Nigeria reverted to a fixed floating regime. In this regime, risk and transaction costs applicable to international transactions were reduced to the barest minimum. Nigeria practiced one currency intervention system where the quoting of Naira determines the exchange rate. The floating/flexible exchange rate regime was adopted in Nigeria in 1986. In this era, the market dictates movement with exchange rate. There is free movement of the currency price relative to other country's currencies, and the government has no influence on exchange rate. In this regime, the real interest rate differential and rate of

inflation were factored into what determines exchange rate in the economy, and the natural force of demand and supply of forex in the market determines the value of exchange rate. The managed/dirty floating allows the central bank and market regulators intervene in forex market, they effectively do this by using unofficial pegging, smoothing out daily fluctuations, or leaning against the wind. Any of this approach will help in reducing uncertainty associated with forecasting exchange rate in the clean float while the central bank also intervenes by buying and selling currency valuables.

In order to prevent arbitrage prevalent in the currency basket and determine appropriate exchange rate, Nigeria practiced different types of floating regimes. The fixed parity system was practiced in 1959-1967 fixing exchange rate with British Pounds Sterling (GBP). In the following year, the GBP was devalued and a stronger US dollar emerged. In the year 1972, the British pound parity was suspended after the US dollar was devaluated and in the following year exchange rate reverted to the fixed parity system which was earlier practiced. The fixed parity to US dollar and the GBP basket was later reinstated in order to maintain the effect of the devaluation of basket component in 1974. This system determined exchange rate till 1978 when the Import Trade-Weighted basket of currency determined exchange rate which was determined by seven currencies. In 1986, the Second-tier Foreign Exchange Market (SFEM) was introduced under the SAP, while in the year 1987, a merger took place between the first and second tier markets. In the year 1995, the Autonomous Foreign Exchange Market (AFEM) was in use while in 1999, the Inter-bank Foreign Exchange Market (IFEM) was introduced. In July 2002, the Retail Dutch Auction System (RDAS) was adopted, while in 2006, the Wholesale Dutch Auction System (WDAS) came on board. The RDAS was later reintroduced with the IFEM in 2013. Shortly after oil price recovered in 2014, the CBN restored the Interbank and WDAS to determine exchange rate in Nigeria. In order to get the economy back on track from constant fluctuation of crude oil price in the international market, the CBN employed the managed-floating exchange rate policy in the year 2015. In the year 2016, a two-way quote interbank foreign exchange was introduced. This made agent banks play the role of middlemen in international trade, while in 2017, the CBN introduced Investors and Exporters (I&E) foreign exchange market and released guidelines to ease their stringent regulations and supervision on pervious policies. In 2018, the CBN intervened by injecting huge sums of money into the forex market through the interbank market. This helped in mopping up liquidity and stabilize exchange rate across major market segments in the economy. The CBN introduced the Naira for Dollar scheme in 2019. This policy is expected to curtail demand and improve forex liquidity, while in 2020, the CBN minimized the sales of dollar to BDCs and adopted a unified exchange rate system for inter-bank and parallel market rate due to the impact of Covid-19 pandemic on the economy. In the year 2021, the CBN released new guidelines on the procedure of how diaspora remittances should be paid, coupled with several other policies that designed to combat the high demand for foreign exchange supply. In 2022, the CBN banned the sale of forex to Bureau de Change as well as kicked against the dollarization of the Nigerian economy. The CBN also passed several circulars at the end of 2022 stating that they would stop selling foreign currency to the Deposit Money Banks (DMBs) henceforth. Despite the unprecedented changes that keep occurring in international financial system, periodically, Nigeria monetary authority intervenes in the economy to determine and ensure stability of exchange rate till date.

2.1.2 Foreign Exchange (FOREX) Market and Policy Administrations

The forex market is a place where different currencies are bought and sold. It is also a medium through which market forces interact to determine exchange rate. The forex market helps corporate organizations and multinational companies move capital and raise fund in massive amounts at the speed of light. The forex market consists of two types of investors - the arbitrageurs and other investors. They both use various techniques to forecast future return in the market. The arbitrageurs are also called smart money. They gain social opportunity cost from valuable humans (Melvin, 1988). Their activities drive price towards fundamentals while other investors are also known as noise/liquidity traders.

The noise-trader approach is an alternative to efficient market approach. The former accounts for gradual swing of price away from its fundamentals and there are basically two assumptions to this approach. The first assumption is based on the fact that only few investors are rational in their investment decision making and it is believed that their expectations and beliefs affect the demand for risky assets while the second assumption is that arbitrage traders do not subject themselves to the whims of investor sentiments. Taking the two assumptions together, it implies that changes in investor sentiment are not fully countered by arbitrageurs and so affect asset returns. Thus, a complete reversal is needed for optimal trading to be made possible by rational agents, as persuasive as these arguments may sound.

Through various multilateral and bilateral trade agreements with other nations, Nigeria is able to comfortably trade to earn foreign currencies and it became necessary to manage Nigeria's foreign exchange. The fluctuation/instability associated with Naira exchange rate shortly after the oil boom triggered market interventions and a conscious attempt to harness and deploy foreign exchange resources to meet international commitments was put in place by the then Federal Government known as foreign exchange management. The Nigeria foreign exchange management department was established under the Exchange Control Act of 1962. The department helps in preserving foreign exchange reserve, preventing foreign exchange disequilibrium, increasing foreign exchange resources, reducing disbursement of foreign exchange and preserving the value of domestic currency. In 1982, the department was later reinforced by the Economic Stabilisation Act. In order to achieve their objective, the Nigeria foreign exchange management department till date applies policies such as the trade and exchange control, diversification of external reserve, exchange rate administration and export promotion. The trade and exchange control is described as fire extinguisher, as it helps in tightening and loosing the economy during the period of crises and relative ease. This policy was designed to ensure stability in balance of payment, and promote consumption of home-made goods. In 1976, the Nigeria Export Promotion Council was established. The Council was given legal backing in promoting and diversifying Nigeria's non-oil exports. The Council also brought about the establishment of export free zones, export credit guarantee, liberalization of export and import and import duty concessions. However, inadequate implementation of this policy limited the full realization of this policy. The external reserve diversification is another strategic policy that is employed to ensure liquidity in the forex market and minimum loss in the event of fluctuation. The external debt management department was introduced under the SAP to help determine appropriate exchange rate and stabilize balance of payment. The increase in oil receipt in the year 1976 made Nigeria exchange rate management department redistribute her foreign exchange reserves held in foreign currency to gold trench, Dutch Guilder and other currencies. Pressure is exerted on foreign exchange reserves whenever there is disequilibrium in the forex market. All these were policies administered at one point or the other to ensure timely execution, settlement and liquidity for both foreign investors and exporters.

2.1.3 Challenges/Problem Associated with Nigeria Foreign Exchange

Overdependence on Oil Proceeds and Import

The Nigeria export sector also experienced its own share of fluctuation in the forex market. Knowing fully well that Nigeria is a mono-product economy, where rate adversely distorted proceeds from crude oil accounts for about 90% of her total export revenue, and fluctuation in exchange and affected revenue projections since international oil price is determined by cartels outside the control of the country. Thus, proceeds earned in foreign currency that come from oil export contribute little to stabilizing her exchange rate since oil producing countries are given specific quotas in terms of production. Besides, exports are slow compared to import in responding to exchange rate adjustment and prices of primary produce have been on the downward trend due to uncontrollable exogenous factors. The continuous value of increase in the price of petroleum product led to increase in minimum wage, inflation rate which correspondingly increases the Naira-Dollar exchange rate. Nigeria's economy is heavily dependent on import for both production and consumption, as major industrial raw materials and capital goods are sourced abroad. It is

of note that lower oil price and production translate into lower revenue for public sector which in turn, intensifies exchange rate depletion. According to Babatunde, (2015) oil accounts for the largest share of Nigeria's total foreign exchange revenue. Nigeria trades worldwide with about 100 countries since the colonial era and the World Trade Organization (WTO), Economic Community of West African States (ECOWAS), Trade and Investment Framework Agreement (TIFA), African Growth and Opportunity Act (AGOA), European Free Trade Area (EFTA), African Continental Free Trade Area (AfCFTA), Trade and Investment Framework (TIFA), ECOWAS Trade Liberalization Scheme (ETLS), and many other trade agreements at one point or the other have significantly helped to improve trade and investment opportunities between Nigeria and other trade partners. The crave for foreign product and heavy-duty equipment increases the demand for foreign currency which eventually leads to the depreciation of home currency. In the same vein, the depreciation of home currency will lead to contraction/decrease in import, since more local currency will be used to purchase foreign goods. As a result of this, there is a diversion of income from importing countries to exporting countries and there is a likely chance that demand will shift from foreign goods to domestic goods. The incessant fluctuation in the volume of oil export and non-oil import exposed the country to external shocks and contributed to the frequent volatility in the Naira exchange rate, which according to Ogunbiyi, and Abina, (2017) gradually affect the prices of goods and services. Abed, Amor, Nouira and Rault, (2016) stated that there is a transfer of wealth from oil importing nations to oil exporting nations when oil price increases, this in turn affects the value of exchange rate in the country. Finally, how to increase oil export, production of quality product and diversification of domestic economy remains the most critical challenge since higher productivity will put less pressure on the Naira exchange rate.

2.1.4 External Debt/ Debt Service Burden

Over time, external debt has recorded continuous increase, especially when the country is faced with economic crisis such as the insurgence of the Niger Delta militants and the recent Covid-19 pandemic, forcing the Federal Government to increase her financial obligations by acquiring external debt to supplement national resources. The debt relief package received by Nigeria in the year 2006, from Paris Club creditor has had significant considerable effect on the Naira exchange rate in the country making the Federal Government to effectively re-allocate part of the nation's income that should have been used to service debt for other re-productive use which immediately led to a noticeable appreciation of the Naira. Thus, the demand for foreign currency and external debt servicing has corresponding effect on domestic exchange rate. According to Devereux, Lane and Xu (2006), in developing the economy, exchange rate depreciation in the foreign exchange market increased external debt. In the short run, repaying external debt obviously puts presume on foreign exchange market thereby leading to Naira exchange rate fluctuations in the country. In summary, foreign reserve and gain from international trade are used in financing external payment, of which the proceeds are used to intervene in foreign exchange market which dampens exchange rate volatility. Thus, it is crystal clear that as debt service surges, the burden of servicing external debt has also contributed to exchange rate depreciation as foreign exchange in-flows have not been adequate in servicing foreign debt commitment. Increase in foreign interest rate, endemic inflation, low capacity utilization and appreciation of exchange rate are among the few attendant possible effects of increase in external debt in Nigeria.

2.1.5 Unrealistic Financial and Economic Policies

The spectrum or degree of exchange rate rigidity is determined by the extent at which government intervenes to affect exchange rate with different reforms and policies. Given the sporadic movement in the Naira exchange rate and the sharp practices perpetrated by dealers and end-users in the forex market, the CBN and various regulatory institutions employ several policies few of which were earlier mentioned under the various regimes and mechanisms for determining Naira exchange rate in this paper. Through various monetary intervention policies and actions, the Central Bank and monetary authorities get their

hands dirty by manipulating the forex market. All these are done with the aim of influencing exchange rate movement and to sustain competitiveness in the domestic economy. Several factors such as the internal and external economic environment fundamentals, inflation rate and many more influence the choice of policy to be implemented. Regardless of whichever policy is to be implemented, all structural rigidities facing the economy have to be reduced to the barest minimum in order for such policy to achieve its desired objectives. The CBN employed the purchasing power parity (PPP), interest rate parity (IRP), fisher effect (FE), international fisher effect (IFE) and other models in determining what led to exchange rate deviations from equilibrium and how it can be corrected, since exchange rate management is an evolving process. But the CBN and other regulatory authorities are noted for their slow and untimely policy interventions. Thus, lack of continuity, corruption perpetuated by policy implementers, insufficient financial resource, lack of ongoing research and policy evaluation makes it difficult and challenging for forex market regulators to choose and effectively implement the right policy which eventually becomes a major bone of contention. Finally, a major evil perpetuated by CBN and forex market regulators is designing and implementing policy when volatility associated with exchange rate must have lingered causing great aggravations and discomfort in the economy.

2.1.6 Volatility of Exchange Rate

Exchange rate volatility refers to the deviation of official exchange rate from a benchmark. It also refers to fluctuation or swing in exchange rate over a period of time. Mathematically, the co-efficient of variation is used to measure exchange rate volatility. Excess volatility leads to destabilizing speculative activities or bandwagon effect (Melvin, 1988). It also imposes large cost on producers, making them have less efficient allocative decisions (Froot & Thaler, 1990). According to Friedman, (1953) exchange rate volatility hinders trade as it imposes additional cost on traders. Ogiogio (1994) discovered that speculations by dealers in the forex market determines the movement of nominal exchange rate, Friedman, (1953) proposed that activities of speculators in the forex market greatly determine currency value. Investors and multinational companies are confronted with future uncertainty. It also affects their future cash flows which makes them adopt a wait and see method when confronted with uncertain future exchange rate. Over-invoicing of imports led to the first official exchange rate crisis which can be traced to 1982. The crises led to decline in the inflow of foreign exchange receipts. This brought about the enactment and establishment of the Economic Stabilization Act, the Second-Tier Foreign Exchange Market (SFEM) and the Structural Adjustment Programme (SAP) in 1986. These arms were expected to ensure internal balance, reduce the demand pressure on foreign currency, manage unprecedented capital inflows. They were also expected to explore other sources of inflow of foreign exchange into the country. In 1995, the Autonomous Foreign Exchange Market (AFEM) was established to meet the foreign exchange demand of end-users and in the year 2000. The Naira was further devaluated to attract foreign investment, but there have been records of serious strains on the Naira exchange rate, real wages and consumer price index each time Naira is devaluated either through exchange liberalization or market devaluation. Exchange rate volatility results in persistent depreciation of the home currency, which invariably affects the relative prices of goods and services on both tradable and non-tradable goods of countries which in turn determine economic performance of countries. It also exposes economic agents to risk. According to Abina and Mogbeyiteren, (2021) fluctuation in exchange rate affects virtually all sectors in Nigeria.

2.2. Empirical Review

Abina, (2019) explored the inter-relationships between external debt, exchange rate, foreign investments on economic growth, using time series data between 1981-2018 using ARDL for empirical analysis. The study revealed that foreign direct investment contributes positively to Nigeria's economy both in the long and short run while exchange rate does not contribute positively to the economy in the long run. The study further explains that proceeds from foreign investors boost the value of Nigeria's domestic

currency. This means the more foreigners invest in the economy the more Nigeria's currency attains stability on the long run. In Nigeria, Abina and Mogbeyiteren (2021) examined how exchange rate affected five different sectors in the country between the period of 1985 and 2020. The study made use of error correction estimates for empirical analysis, within the period of review. The result revealed that exchange rate was a bit stable within the review period, which results to optimal productive capacity and as such, economic distortions associated with exchange rate should be mitigated by monetary authorities. Aigbedion, Iyakwari and Mairana (2020) employed annual time series data between 1986 to 2018 on exchange rate, external debt, foreign reserve and foreign debt service in Nigeria to investigate the impact of foreign debt on exchange rate using error correction model for analysis. It was discovered that the ECM analyzed that external debt, foreign reserve, and foreign debt service has positive and statistically significant relationship on exchange rate. This implies that the more government increase her foreign debt, the more Naira exchange rate depletes. Thus, it was recommended that serious caution is needed when government resorts to borrowing externally. Nwaoba (1999) examined factors affecting foreign exchange flows between 1987-1997 in Nigeria. The result of the regression analysis pointed out that debt servicing, fiscal imbalance, excessive demand for foreign currency and capital flight were identified to be factors that affect foreign exchange market, the study further suggests that appropriate realistic exchange rate management strategy that will curtail capital flight and encourage repatriation of export proceeds is needed. In the quest to search for trend in exchange rate, Hamilton (1989) discovered that speculative activities are significant in determining the movement of exchange rate. There have been mixed and conflicting results and opinions regarding the effect of exchange rate fluctuation. Scholars such as Akpan (2008); Aliyu (2009); Ettah, Akpan and Etim (2011); discovered a positive relationship between exchange rate volatility and economic growth in Nigeria. As anticipated, Akpokodje (2009); Polodoo, Seetanah and Padachi (2011) discovered a negative effect on exchange rate volatility and Nigeria economic growth.

Prospect and Opinion for Optimal Performance

The prospect of the Nigerian forex market leans toward market inefficiency as the Central Bank and regulatory authorities occasionally intervene in the market with stringent policies making market operators cut corners and mine loopholes just to stay in business and remain profitable.

In conclusion, the massive importation of finished goods, heavy debt service burden, capital flight, excess liquidity, unstable business, economic and political environments, limited sources of foreign exchange supply and many other problems have brought incalculable damage to the Naira exchange rate, causing great aggravations and discomfort in the economy. The persistence of this problem is traceable to fiscal indiscipline, improper allocation and misuse of foreign and domestic credit, amongst many other problems that have been earlier over-sighted and discussed.

This paper further proffers solution to the divergence of findings and challenges which were earlier discussed. In order to reduce economic uncertainty associated with exchange rate fluctuation, and for optimal performance to be achieved both in the medium and long-term, there is urgent need to address issues relating to low productivity in local firms and diversification of the economy needed in agro-allied industries, agro-investment, and oil allied industries. This will resultantly help in stabilizing exchange rate and increase foreign exchange earnings. It therefore becomes very urgent for the Federal Government to build up reserve when oil price is high, since the oil sector contributes more than 80 percent of government revenue. This will help to cushion inspection effect on government budget. There is also need to expediently resolve and reduce external debt burden, since a huge portion of her inflow which is presumably meant for investment and consumption is used in servicing debt in another denomination. We cannot ipso facto conclude that countries should not borrow, but peradventure there is need to borrow, more caution is needed such as the debt buy-back and debt conversion strategy should be given adequate consideration, as this will help to reduce the perceived riskiness of future cash flows that affect investment behavior. Furthermore, attitudinal disposition of policy implementation and ongoing research and policy evaluation needs to be placed at utmost priority for exchange rate policies to achieve its

desired goal and objective. Finally, for optimal performance this paper strongly supports the need for financial engineering which involves redesigning existing financial instruments into more desirable and beneficial financial products. This will to a great extent help in correcting and stabilizing fluctuations associated with exchange rate in the future.

Future research could focus on how incorporating digital currency, and financial engineering in Nigeria forex market will help in improving market efficiency which at the same time might help in mitigating potential problem that might arise from arbitrage trading in the market.

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