MPR: 18.50%   May'23 Inflation: 22.41%

Q1'23 Real GDP Growth: 2.31%

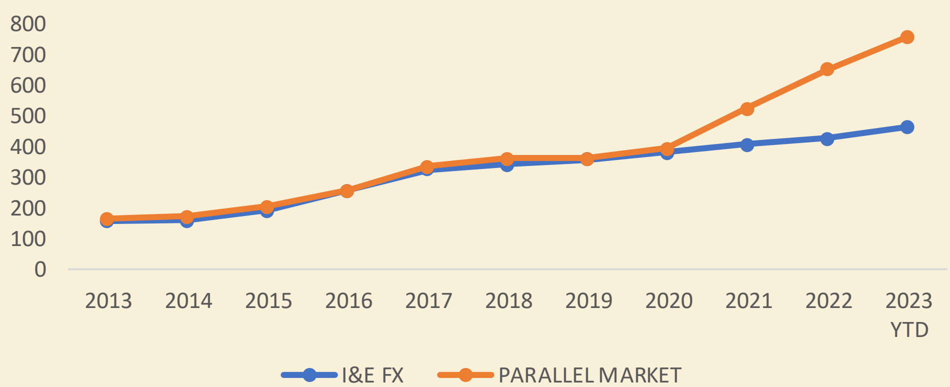
CBN's Policy on Less Restrictive FX Trading: A Policy Milestone or Mirage?

A significant shift to a less restrictive fx policy came into force on Wednesday as the CBN, under the recent administration, granted banks the autonomy to determine their foreign exchange trading rates. The decision to float the naira became effective with the collapsing of the existing market segments into the Investors and Exporters window, the reintroduction of the 'willing buyer, willing seller" model, 2-way based quotes with a bid-ask spread of N1, and an order book to ensure transparency of orders and seamless trade executions.

Although the decision to float the local naira has been met with mixed reactions, it is widely believed that this step was a necessity in order to improve the country's economy. The strong argument for this new development still holds that the free market will be able to determine the naira's true value, leading to more investment inflow and economic growth. On the contrary, there may be, in the short term, FX market instability emanating from the inability of the free market to determine the naira's true value.

In 2016, the CBN introduced a managed floating exchange rate regime, which replaced the previous fixed exchange rate regime. The managed floating regime allows the naira to fluctuate freely within a band set by the CBN. This policy was implemented in an effort to improve the transparency and efficiency of the foreign exchange market and make the naira more competitive. However, the policy was marred by racketeering, speculative rip-offs, and incoherent FX policies. Data showed that the value of the naira depreciated at the official rate by 233.1% between January 4, 2016 and June 14, 2023. This means that Naira traded between N199.37/$1 and N664.04/$1, with a loss of N464.67 in value under 7 years.

Annual Average FX Market Rates



Source: CBN, FMDQ, Abokirates.com

Over the years, Nigeria's foreign exchange market has operated a multi-tiered system that includes the official market, the parallel market, and the Bureaux de Change (BDC) market segments. The central bank has been heavily involved in the regulation of these markets as well as managing the value of the naira across all markets to keep the naira at a fixed rate. While it is too early to ascertain the long-term impact of the free-float decision, there is a clear indication that it is a significant policy shift with major economic impact.

However, we have asserted in our foreign exchange outlook for 2023 that further pressure from the dollar in the fx market will remain unabated due to limited FX inflows from exports and foreign investments as a result of the stewing business environment. We still maintain our position for the exchange rate to trade on an average of N438/USD in the best-case scenario and N570/USD in the worst-case scenario at the official I&E market, while the rate of exchange at the parallel market remains the major talking point, as we anticipate that the apex bank manages that segment of the market by ensuring mechanisms to aid the unification or convergence of the various units for the adoption of a unified exchange rate across the board. Thus, we see N725/USD in the best-case scenario and N855/USD in the worst-case scenario.

In examining the attendant impact of this decision on various sectors of the Nigerian economy and the FX market, we opine that a key benefit will be the elimination of losses ensuing from the arbitrage spread. This could help alleviate pressure on the foreign reserves. Also, we can tilt a bit of our focus on the banks (especially the Tier-1 banks) that hold fx-denominated assets as key beneficiaries of the devaluation, as those in long positions may likely record gains from asset revaluations. i.e., converting to naira from dollars. Then, Nigerian manufacturing firms, which are heavily reliant on imports of raw materials, may encounter some challenges, which include pressure on operating and profit margins.

In our opinion, we expect to see the foreign exchange market remain volatile in the near term as we begin to see market participants position themselves to determine the fair exchange price levels and, in the medium to long term, ascertain the true value of the naira against the dollar in the market.