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COMMERCIAL CONSIDERATIONS ON THE ABOLITION OF SEGMENTATION IN THE NIGERIAN FOREIGN EXCHANGE MARKET

Introduction

The Central Bank of Nigeria ("CBN") is saddled with the responsibility of maintaining Nigeria's external reserves in order to safeguard the international value of the national currency. In line with this mandate, the CBN is responsible for the operation of the Foreign Exchange Window and the formulation and implementation of monetary and financial policies aimed at ensuring price stability in the market.[2] The CBN operates the Window to supply foreign currency to Authorised Dealers, Bureau de Change, and other licensed financial institutions, and by extension, ensuring its regulated circulation into the economy. To achieve market efficiency, the apex bank strives to achieve a balance between market illiquidity and excess volatility. This article undertakes a review of the CBN's abolition of segmentation in the Nigerian Foreign Exchange Market.

Abolition Of Segmentation in The Foreign Exchange Market

One fundamental function of Nigeria's apex bank is ensuring liquidity in the market through proactive FX policies. In June 2023, the apex bank abolished segmentation in the Nigerian Foreign Exchange Market by collapsing all the windows into the Investors and Exporters

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2 Ben C. Onyido (2004) "The role of the Central Bank in the Nigeria financial system," Bullion: Vol. 28: No. 1, Article 3, available at: https://dc.cbn.gov.ng/bullion/vol28/iss1/3. See also, section 1(2) of the Foreign Exchange (Monitoring & Miscellaneous Provisions) Act, 1995, Cap. F34, Laws of the Federation of Nigeria, 2004.

(I&E) Window. The unified market has been described as an imperfect free float exchange rate regime.[3] Under the new system, the exchange rate will be determined by market forces re-introducing the "willing buyer, willing seller" model into the market. The operational rate for all government-related transactions remained set at the weighted average of the previous day's closing rate, rounded to two decimal places. In addition, and in line with the Revised Foreign Exchange Manual 2018, trading limits on oversold FX positions were prohibited.

Prior to this policy, there were various segments or windows in the Nigerian FX Market, namely the CBN Official Window or CBN exchange rate, the Parallel Market (Black Market), the I&E Window,[4] established primarily to settle wholesale transactions by investors and manufacturers, etc. The CBN had introduced the multiple exchange rates under the managed float regime between 2014 to mid-2023 to allocate foreign exchange to exporters and SMEs under different exchange rate windows

A Little Background on the I&E Window

The I&E Market was first introduced by the CBN in April 2017 to provide more liquidity in the market, ease the demand for foreign currency in the parallel market, and reduce the downward pressure on the Naira exchange rate.[5] The window serves as the market trading segment established primarily for investors and exporters with little to no intervention from the CBN. The exchange rates for transactions in the I&E Window is as agreed upon by authorised dealers and their counterparties. To support appropriate benchmarking in the Window, the FMDQ developed a new fixing, the Nigerian Autonomous Foreign Exchange Fixing (NAFEX), to provide price discovery for the market. The FMDQ does this by polling and publishing the buying and selling rates from major participants in the market. This means that the FMDQOTC will be asking banks and other authorised FX dealers how much they bought or sold dollars daily and then use that information to determine the band or the average rates of the market.

The Nigerian Autonomous Foreign Exchange Market

In a press release titled "Operational Changes to the Foreign Exchange Market" issued on 14th June 2023, the CBN replaced the market terminology, I&E Window with the Nigerian Autonomous Foreign Exchange Market ("NAFEM").[6] This name change was essentially to

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3 Ozili, P.K. (2024). Exchange Rate Unification in Nigeria: Benefits and Implications. Recent Developments in Financial Management and Economics. *IGI Global.*

4 The I&E Market was first introduced by the CBN in April 2017 to provide more liquidity in the market and to ease the demand for foreign currency in the parallel market. It was also conceived to reduce the downward pressure on the Naira exchange rate.

5 Circular dated 21st April 2017, Ref: FMD/DIR/CIR/GEN/08/007 titled "Establishment of Investors' & Exporters' FX Window.

6 See, https://nairametrics.com/2023/10/19/fmdq-changes-ie-window-to-nafem/, accessed 23 October 2024. See also, https://www.cbn.gov.ng/IntOps/FXMarket.asp, accessed 23 October 2024.

ensure consistency in market references and to influence the perception of market participants as to the purport of the unification.

Commercial Considerations

The most compelling justification for the unification of the exchange rates is that it will eliminate the market distortions prevalent under a multiple exchange rate system. The unification will eliminate or reduce the incidence of arbitrage, rent seeking, unfair competition within the market. Without these market distortions, a unified exchange will promote transparency and lead to improved price discovery. A transparent and stable FX market will promote trust in the financial market. With increased investors' confidence, more foreign investments will be attracted leading to a stronger market.

Nonetheless, a unified exchange will also provide the perfect market for increase in capital importation through higher foreign direct investment, foreign portfolio investment and other capital inflows. These inflows in turn lead to higher liquidity within the market creating a domino effect across the economy.

An important consideration for investors and their counterparties is in relation to the repatriation of profit. With a volatile regulatory regime, an investor must keep abreast of FX thresholds and restrictions on repatriation of profits and proceeds of disinvestments. Also, due to the unpredictability of the regulatory regime due to reduced government and regulator's intervention[7], contracting parties may want to negotiate clauses that provide flexibility in the event of regulatory restrictions and FX illiquidity. As a result, investors and contractual parties have to grapple with the market instability in their transaction structuring. A party could suffer significant loss in a transaction if the value of the currency in which the payment of the consideration is to be made depreciates in the course of the transaction. With FX fluctuations, it therefore becomes necessary for parties to include FX adjustment provisions to mitigate the rate volatility by prescribing pricing formula in relation to the FX differentials.[8]

However, in spite of CBN's efforts to ensure liquidity and stability in the market, the jury is still out on the efficacy of most of the policies leading to a depression of the Naira and diminishing investors' confidence. A unified market may exacerbate inflation through an increase in importation of finished goods, raw materials and essential commodities.[9] While FX liquidity and increased access to raw materials may facilitate local production and boost international trade, there is the risk of exerting undue inflationary pressure on an economy

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7 An underpinning objective of the market unification is the reduction of government intervention in the foreign exchange market.

8 This could also be mitigated using forward contracts, swap contracts, etc.

9 Recall that concurrent with the unification of the FX market exchange rates, the CBN in XX also lifted its ban on the importation of 42 items.

already grappling with a low productive base. This is where the apex bank would need to step in, through the roll out of proactive measures aimed at diversifying the economy to promote domestic production and export-oriented industries in order to generate significant foreign exchange revenue.

Conclusion

The unification of the Nigerian FX market exchange rates is expected to yield potential benefits such as improved price discovery, higher foreign exchange supply, increased capital importation all of which will help create a stable market with fewer government intervention that will facilitate an improved business environment for international trade. There is also the risks of a higher cost of living induced by inflation and excessive importation. Therefore, while the unification of the exchange rates is a good decision, its success depends on effective implementation of other sound economic policies and proactive measures to address the potential risks.

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