A Move Toward a 'Crawling Peg' Exchange Rate System in 2023

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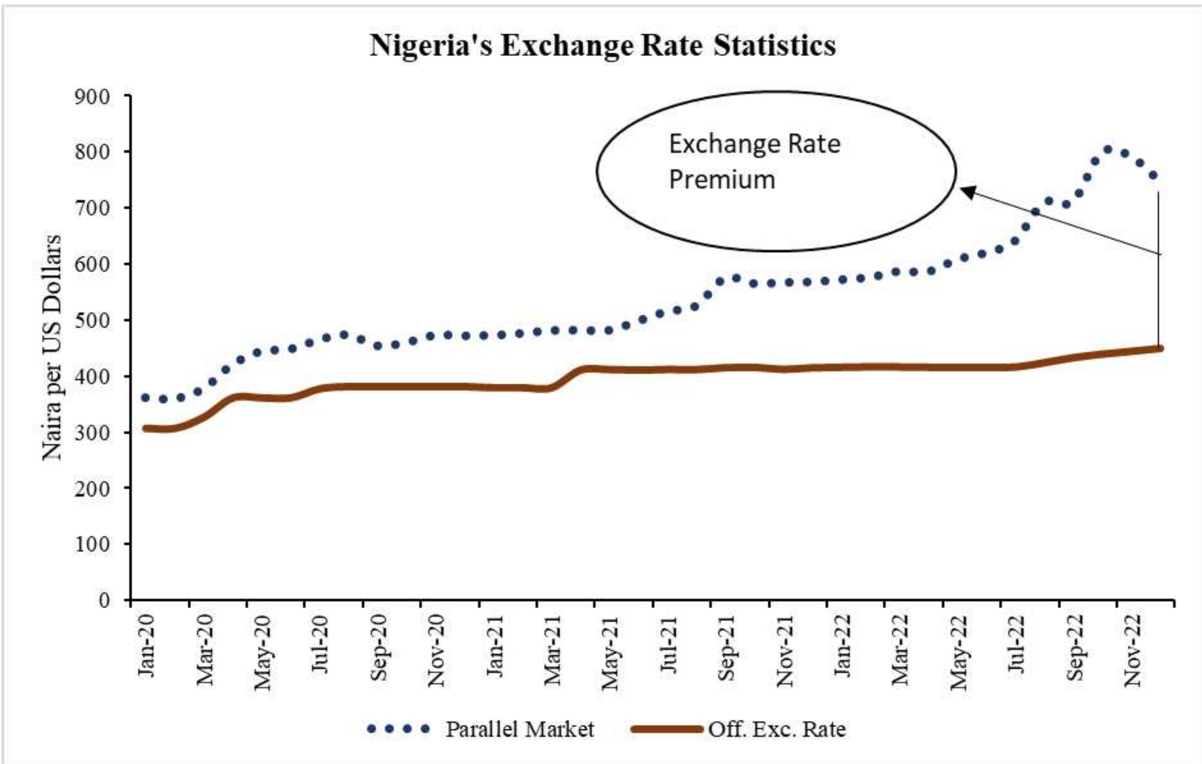
What you should know

i. **The premium between the official exchange rate and 'black market rate' continues to widen.**
ii. **Nigeria's fixed foreign exchange policy is not sustainable going forward.**
iii. **An alternative arrangement, whereby the Naira is allowed to crawl around a band may be able to solve the exchange rate quagmire and may allow businesses to better plan their activities.**

Context and Rationale

As of the last working day of the year 2022 (30th December 2022), the official exchange rate against the US dollar (USD) was 448, while the naira USD exchange rate at the black market traded at 748—a premium of 300. The dollar had already peaked above 800 on the black market during the year 2022, when there were pressures on foreign exchange (FX) due to elevated demand from individuals, students traveling abroad, and businesses that needed FX to produce their goods and services. Given the continuous depreciation of the naira exchange rate against the USD, caused by a scarcity of foreign exchange, pegging the naira against the USD despite a high rate of inflation may not be the solution to the country's exchange rate maladjustments.

Furthermore, the scarcity of foreign exchange has continued to widen the premium between the official exchange rate and the black-market rate. By implication, Nigeria's exchange rate crisis can't be fixed by tying the naira to the US dollar at a fixed price. This is because the demand for foreign currencies outstrips the current supply in Nigeria. Also, Nigeria, as an import-dependent economy, would always need US dollars to import goods and services into the country, while we do not attract enough foreign exchange because we depend mainly on crude oil for our exports. In essence, Nigeria should not be maintaining its peg against the US dollar because the policy has never been sustainable even in the short term, not to mention over the long run due to our economic fundamentals.



'Crawling peg' – the solution to exchange rate maladjustments

A suitable solution would be to adopt a 'crawling peg' to effectively manage the exchange rate crisis in Nigeria. A crawling peg is an exchange rate adjustment method in which a currency with a fixed exchange rate is permitted to vary within a band rate. As a result, adopting a crawling peg for Nigeria would mean setting the country's official exchange rate near the true market value of the naira per dollar (LCY/USD) and allowing the naira to depreciate or appreciate against the USD by roughly the difference in annual inflation, which is approximately 10%. This implies that starting today at around 748 and then allowing the naira to depreciate by around 10% per year would reflect the true value of the naira. Lastly, using a "crawling peg" would let people and businesses plan for changes to the exchange rate and would make Nigeria's system for managing exchange rates more open.

Season’s Greetings!