Exchange Rate Unification in Nigeria: Benefits and Implications

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Abstract

This paper explores the recent unification of exchange rate in Nigeria. Recently, Nigeria unified the exchange rate and adopted an imperfect free float exchange rate system that is based on the willing buyer willing seller principle. The exchange rate regime is slightly close to a free float exchange rate system. Multiple factors led to exchange rate unification in Nigeria such as exchange rate price arbitrage and the market distortion it created. The unification of exchange rate is expected to yield potential benefits such as fewer government intervention in the foreign exchange market, improve price discovery, greater foreign exchange supply, higher capital importation, reduction in budget deficit, increased investor confidence, improved sovereign credit rating, increased transparency in the foreign exchange market, improved business environment and greater competition. Adverse effects are expected in the short-term, but these effects will dissipate in the medium to long-term.

Keywords: exchange rate, unification, parallel market, official exchange rate, Nigeria.

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1. Introduction

Just like many developing countries, Nigeria has a long history of economic reforms. The most notable economic reforms are the 1986 structural adjustment programme (SAP), the 2003 Nigerian Economic Empowerment Development Strategy (NEEDS), and the 2023 exchange rate unification reform. This article focuses on the 2023 exchange rate unification reform.

The Central Bank of Nigeria (CBN) introduced multiple exchange rates under the managed float exchange rate regime between 2014 to mid-2023. The purpose of the multiple exchange rates was to allocate foreign exchange to exporters and SMEs under different foreign exchange rate windows such as the CBN exchange rate window, the Investor & Exporter (I&E) exchange rate window, and the Bureau de change (BDC) exchange rate window during between 2014 to 2022. This exchange rate system had positive and negative effects on the Nigerian economy. It was abandoned in mid-2023 following the unification of all exchange rates by the President Tinubu Administration. The exchange rate unification reform of 2023 was intended to unify all exchange rates into a single market-determined exchange rate to promote transparency and price discovery in the foreign exchange market, among other benefits.

Nigeria is not the only country to unify exchange rate. Countries like Cuba, Australia, Canada, Chile, Japan, Mexico, Norway, Poland, and Sweden have also unified exchange rate. The literature report mixed effect of exchange rate unification on the economy of countries that have unified exchange rate (see, for example, Sanusi, 2010; Parvin and Banouei, 2020; Fleming, 1971; Kim, 2003; Sundararajan, Lazare, and Williams, 1999; De la Torre and Ize, 2013), and these studies suggest that the effect of exchange rate unification on countries is country-specific and is dependent on each country's economic fundamentals, economic policies, and implementation. In the case of Nigeria, it is difficult to determine the exact impact of exchange rate unification because Nigeria unified exchange rate at a time when the country was experiencing high inflation, large balance of payment deficit, large budget deficit, high government borrowing, high energy prices due to fuel subsidy removal, low government revenue and low foreign exchange (FX) supply. These unfavourable economic fundamentals may affect the success of the exchange rate unification process in Nigeria. Notwithstanding, economic analysts have begun to predict the potential effects of exchange rate unification in Nigeria. In this paper, I identify the potential benefits and implications of the unification of exchange rate in Nigeria and argue that the success of exchange rate unification will depend largely on effective implementation, sound economic policies, and the roll out of proactive measures to address any potential challenges or risks associated with exchange rate unification.

This article contributes to the literature in the following ways. First, it contributes to the economic literature that examine the effect of exchange rate reforms on economic performance (e.g., Zhang, 2000; Twarowska, 2019; Omojimite and Akpokodje, 2010). Second, the study contributes to the literature that examine the effect of central bank actions on markets (e.g., Lubik and Schorfheide, 2007; Aguilar and Nydahl, 2000; Beine, Lahaye, Laurent, Neely, and Palm, 2007). Third, the study contributes to the literature that examine the role of free markets in resource allocation. The present study contributes to this literature by identifying the potential effect of a market-determined exchange rate on foreign exchange allocation (e.g., Aliber, 2019; Jiang and Wu, 2022; Fatin and Wijayati, 2023).

The rest of the study is organized in the following way. The literature review is presented in section 2. A concise summary of Nigeria's exchange rate regimes is presented in section 3. The benefits of exchange rate unification are identified in section 4. Section 5 presents the implications of exchange rate unification in Nigeria while the conclusion is presented in section 6.

2. Literature Review

Gray (2021) clearly showed that a parallel market emerges and develops when the central bank's foreign exchange supply is unable to meet legitimate demand for current account transactions at the official exchange rate. Gray analysed the exchange rate unification in Algeria, Argentina, Burundi, Ethiopia, Lebanon, Nigeria, Sudan, South Sudan, and Venezuela, and found that when the spread between the official and parallel market exchange rate is both substantial and sustained, the price levels in the economy would reflect the parallel market exchange rate, not the official exchange rate. Gray further show that allowing economic agents to use the parallel market rate as the market clearing rate benefits economic activity without leading to high inflation, but a unified market-clearing exchange rate itself will not bring stability to the foreign exchange market without sound fiscal and monetary policies.

De la Torre and Ize (2013) reviewed the challenges faced by Cuba during its unification of exchange rate. They showed that the unification of exchange rate brought transitional pains to citizens such as loss of jobs, fiscal revenue losses, productive dislocations, and rising inflation. They argued that subsidies and lump-sum taxes should be introduced to ease the transitional pains. Pinto (1989) showed that the premium on the foreign exchange, i.e., the difference between the official and parallel exchange rates, is an implicit tax on exporters and should be reduced at all costs. They showed that the presence of a premium on the parallel market exchange rate without increase in taxes or decrease in government spending could increase inflation.

Kiguel and O'Connell (1995) showed that official and parallel market exchange rates are common in developing countries. They showed that the high premium in the parallel market exchange rate had damaging effects on resource allocation and growth in developing countries mostly because the premiums were excessive and overextended, for instance, in Venezuela it was maintained for eight years, Mexico for five years, and Argentina for eight years. Agenor and Flood (1992) showed that many developing countries unify the official and parallel markets for foreign exchange by floating the exchange rate. They also showed that the behaviour of parallel market premium in periods leading to the unification depends on market expectations about the post-reform policy stance on exchange rate.

Kaufmann and O'Connell (1999) investigated the exchange rate unification in Tanzania and found that trade and financial portfolio factors were significant determinants of the parallel market premium. They also found that a more aggressive move towards exchange rate unification has fiscal benefits, and it reduced monetary growth and inflationary pressures. Aron and Elbadawi (1997) showed that despite the reforms and aggressive policies aimed at unifying the exchange rate in Zambia during the 1964 to 1990 period, the black-market premium remained high during this period, indicating that efforts to unify exchange rate failed in Zambia. Meanwhile in the case of Burundi, Nkurunziza (2020) showed that the parallel market premium is determined by the expected rate of devaluation, trade policy variables and GDP growth.

Nkurunziza (2020) also argued that political stability is needed for the success and sustainability of the current foreign exchange reforms in Burundi.

Pinto (1989) criticized the World Bank's support for unification of the official and black-market exchange rate in African countries. Pinto examined the case of Ghana, Sierra Leone, and Nigeria, and argued that the World Bank's policy advice in favour of unification overlooks some important consideration such as situations when multiple exchange rates are a means of taxation and situations when the widened deficit from unification increases inflation. Yavari (2002) showed that the exchange rate unification policy of Iran in 1993 was in the right direction, but it failed due to the inconsistency between the official exchange rate policy and the other macroeconomic policies. Yavari also showed that the unification policy reduced black market premium but at the cost of higher inflation rate. The unification should have been preceded with some reforms in the structure of public budget to minimize the inflation cost.

The above studies suggest that the effect of exchange rate unification on countries is country-specific and is dependent on each country's economic fundamentals, economic policies, and implementation. However, these studies did not examine the case of Nigeria's unification of exchange rate.

3. Nigeria's exchange rate regimes

The Central Bank of Nigeria (CBN) is the only institution in Nigeria mandated by law to manage Nigeria's foreign exchange reserves and determine the exchange rate regime to be adopted in Nigeria.

3.1. Managed-float exchange rate regime

The CBN operated a managed-float exchange rate regime between 2014 to mid-2023. Simply put, a managed float exchange rate system is an exchange rate regime in which the exchange rate is neither entirely floating nor fixed, thereby allowing the central bank to keep the exchange rate within a range of another currency or keep the exchange rate at a level determined by the central bank. In 2014, the CBN adopted the managed float regime because it enabled the CBN to set the exchange rate at a level that would support the attainment of sustainable economic growth, low inflation and to boost non-oil revenue. During this period, there were multiple exchange rates (i.e., the CBN exchange rate, the Investors and Exporters (I&E) FX rate, and the parallel market exchange rate). The CBN also engaged in quasi-fiscal activities through extensive development finance interventions. The intervention activities led the CBN to fix the exchange rate at a level that would support the attainment of the goals of CBN at the time, including its development finance intervention goals. The CBN offered a cheaper exchange rate to non-oil exporters while oil exporters had to source for foreign exchange at a higher exchange rate. Although it led to price distortions in the foreign exchange market, it also revived non-oil export activities and led to an exponential increase in non-oil GDP. The managed float regime was strongly criticized for creating price distortions and for forcing oil importers to access foreign exchange at a higher rate which translated to higher fuel subsidy payment which amounted to over N7 trillion (US$15.2bn) in 2022. While the managed float exchange rate regime was not bad in itself, the major criticism levelled against the managed float exchange rate regime was that the CBN did not put in place appropriate controls to prevent price arbitrage in the foreign exchange rate market. As a result, the managed float regime encouraged unproductive arbitrage, rent seeking, round tripping and unfair competition which had adverse effects on the Nigerian economy.

3.2. Willing-Buyer and Willing-Seller Exchange Rate Regime

In mid-2023, the CBN ended the managed float exchange rate regime. The CBN also lifted the ban on 43 items from accessing the foreign exchange market and announced the unification of the official and parallel market exchange rates so that the exchange rate would be determined based on the Willing Buyer – Willing Seller principle which is an imperfect type of the floating exchange rate regime. The purpose of these policies was to ensure stability, curb speculation, and restore confidence in the foreign exchange market. The President Tinubu administration unified the exchange rate to ensure that the dollar sells at the same price in all recognised segments of the foreign exchange markets. Unifying the exchange rate will make the low official exchange rate to converge towards the high parallel exchange rate, leading to a high unified exchange rate. It is expected that a high unified exchange rate will attract foreign investments, increase foreign exchange inflows, lead to reduced demand in the parallel market and lead to decrease (currency appreciation) in the exchange rate.

4. Benefits of exchange rate unification

Unifying the exchange rate will bring some benefits to Nigeria. Below are some of the potential benefits of exchange rate unification in Nigeria.

4.1. Reduce government intervention in the market – Unifying the exchange rate will reduce government intervention in the foreign exchange market. The cost savings can be allocated to other priority areas such as education, welfare, healthcare, and agriculture.

4.2. Lead to price discovery – During the managed-float exchange rate regime, there were several exchange rates (i.e., the CBN rate, the Investors and Exporters (I&E) FX rate, and the parallel market rate). The multiple exchange rate encouraged unproductive arbitrage, rent seeking, unfair competition, and more importantly, the multiple exchange rate made it almost impossible to discover the exchange rate that was determined by market forces in Nigeria. The recent unification of exchange rate will lead to a more efficient price discovery in the Nigerian foreign exchange market by collapsing the official and parallel exchange rates into a single market-determined exchange rate, thereby making it easier for market participants to discover the true exchange rate in the market.

4.3. Increase in foreign exchange supply – Unifying the exchange rate in Nigeria will increase access to foreign exchange based on a single-known exchange rate. More access to foreign exchange will encourage import substitution among SMEs and stimulate export of Nigerian goods and services to international markets. Higher export will increase foreign exchange receipts and revenue and increase the supply of foreign exchange into the Nigerian foreign exchange market.

4.4. Increase in capital importation – Unifying the exchange rate can accelerate and encourage capital importation into Nigeria through higher foreign direct investment (FDI) inflows, higher foreign portfolio investment inflows, and higher remittances. These capital inflows, particularly FDI, can lead to job creation for citizens living in Nigeria, and it may encourage exited foreign businesses to return to Nigeria.

4.5. Reduction in budget deficit – Unifying the exchange rate, overtime, can make government's foreign exchange revenue exceed its foreign currency obligations. This will potentially reduce the budget deficit and put Nigeria on the path to budget surplus. It can also lead to better fiscal management.

4.6. Increased investor confidence - The unification of the exchange rate will increase investor confidence in Nigeria by reducing uncertainty and creating a predictable foreign exchange market which are essential to attract foreign investments and attract multinational companies to invest in Nigeria.

4.7. Improved sovereign credit rating - A unified exchange rate that is accompanied with sound economic policies can enhance Nigeria's sovereign credit rating because a unified and stable exchange rate will attract lenders to Nigeria. It will reduce Nigeria's cost of borrowing and increase access to international capital markets.

4.8. Increased transparency - Unifying the exchange rate would eliminate the multiple exchange rate that exist in Nigeria which are the official rate, the parallel market rate, and the Investors and Exporters (I&E) window rate. Unifying the exchange rate would bring greater transparency to the foreign exchange market and reduce opportunities for corruption and speculative activities.

4.9. Improved business environment - Unifying the exchange rate will provide a predictable foreign exchange market for businesses. It will reduce uncertainty and aid businesses in financial planning, budgeting, and decision-making. Unifying the exchange rate will provide confidence to local businesses and attract foreign businesses to operate in the Nigerian market.

4.10. Increase competition - The unification of exchange rate, combined with little government intervention in the foreign exchange market, will compel all foreign exchange dealers including deposit money banks to source their own foreign exchange privately and sell to users at their own rate and margin. This will lead to competition which may be effective in driving the exchange rate lower.

4.11. Other economic benefits - Unifying the exchange rate could lead to other benefits such as unlocking investment and jobs. It can also reduce government discretion in the allocation of forex and reduce corruption in the foreign exchange market. It will also reduce arbitrage, speculation, and curb multiple malpractices in the market.

5. Implications of exchange rate unification

The unification of the exchange rare has several implications for households, businesses, and the government. They include the following.

5.1. Implications for individuals and households

Households and individuals will be affected by the unification of exchange rate because most goods and services are currently priced at the parallel market exchange rate. Higher price of goods and services will be expected in the short to medium term due to a higher unified exchange rate, but lower prices are expected in the long term. For instance, students seeking foreign education will have easier access to foreign exchange but at a higher unified exchange rate which will increase the cost of studying abroad. It also means that airlines and foreign businesses that have trapped funds in Nigeria will be able to repatriate their funds more easily but at a higher unified exchange rate.

5.2. Implication for businesses

Unifying the exchange rate will lead to a higher exchange rate because the official exchange rate will converge towards the parallel market exchange rate. Therefore, the unification of exchange rate will lead to a higher unified exchange rate and will lead to increase in the cost of imported goods and raw materials for businesses. The increase in import costs will affect businesses that are heavily reliant on imported raw materials. It would lead to the collapse (or failure) of some businesses while other businesses will pay a higher cost to survive and the high cost will be passed on to consumers, thereby leading to cost push-inflation. However, a competitive unified (high) exchange rate may encourage some businesses to participate in export opportunities as a higher exchange rate (due to depreciation) would make Nigerian products more affordable in international markets.

5.3. Implications for government

Unifying exchange rate will decrease corporate tax collection in the short term if businesses face foreign exchange losses due to a higher unified exchange rate. However, government revenue in naira terms will increase due to the sale of foreign currency receipts. As a result, more funds will be available for sharing at the Federation

Account Allocation Committee (FAAC) meetings. The increased revenue can be used by States to embark on developmental projects that will improve the standard of living of people in each State. Exchange rate unification also has implications for the national debt. Unifying exchange rate will result in a unified higher exchange rate and may lead to increase in government (nominal) debt in naira terms. The increase in national debt due to exchange rate unification will increase the debt-to-GDP ratio and raise concerns about debt sustainability.

5.4. Other economic implications

In addition to the above implications, the unification of exchange rate may exacerbate inflationary pressures in the short term through an increase in the prices of imported goods, raw materials, and essential commodities. This will increase the cost of living in Nigeria and have an adverse effect on poor and low-income Nigerians. Unifying the exchange rate can also lead to short-term disruptions in the economy through unfavourable adjustments in prices, investments, and consumption patterns as households and firms adapt to the new exchange rate regime. Furthermore, the unification of exchange rate may have other short-term adverse effects such as rising poverty level, increasing hardship and high energy prices.

6. Conclusion

This paper explored the recent unification of the exchange rate in Nigeria. Recently, Nigeria unified the exchange rate and adopted an imperfect free float exchange rate system that is based on the willing buyer willing seller principle. The exchange rate regime is slightly close to a free float exchange rate system. Multiple factors led to exchange rate unification in Nigeria such as exchange rate price arbitrage and the market distortion it created. The unification of exchange rate is expected to yield potential benefits such as fewer government intervention in the foreign exchange market, improve price discovery, greater foreign exchange supply, higher capital importation, reduction in budget deficit, increased investor confidence, improved sovereign credit rating, increased transparency in the foreign exchange market, improved business environment and greater competition. The unification of exchange rate is also expected to have some positive and negative effects on individuals, households, firms, and the government in Nigeria. Adverse effects are expected in the short-term, but these effects will dissipate in the medium to long-term. While unification of exchange rate is a step in the right direction due to it many potential benefits, the success of exchange rate unification will depend largely on effective implementation, sound economic policies, and the roll out of proactive measures to address any potential challenges or risks associated with exchange rate unification. The Central Bank of Nigeria should carefully monitor emerging developments in the economy as the exchange rate unification process takes place and identify areas where interventions are needed. Finally, for the exchange rate unification policy to have a lasting impact, Nigeria needs to urgently diversify the economy and reduce its reliance on imports by promoting domestic production and export-oriented industries to generate significant foreign exchange revenue that can be used to provide a sustainable level of economic growth and development.

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