Perchstone & Graeys

REVIEW OF THE CENTRAL BANK OF NIGERIA (CBN) OPERATIONAL CHANGES ON THE FOREIGN EXCHANGE MARKET

WRITTEN BY: THE BANKING TEAM.

Background

In a bid to address the extant economic gaps that exist in the Nigerian Foreign Exchange Market (the **"FX Market"**), the Central Bank of Nigeria (**"CBN"**) released a circular dated June 14, 2023 titled "Operational Changes to the Foreign Exchange Market" (the "**Circular**"). This Circular introduces notable changes to the country's FX Market and its operations. The purpose of this paper is to highlight the changes and impact of the introduced changes on the foreign exchange market as well as its interplay with the Nigerian economy.

Notable Changes

1. **Collapsing Foreign Exchange Market Segments**

   The Nigerian FX Market consisted of various segments based on products, user types or transaction type, each with its own special requirements for trading or exchanging currency. In addition to the Bureau De Change (**"BDC"**) market which caters to retail and small-sized FX transactions, there exists the Investors & Exporters (I&E) window which was established by the CBN in 2017 vide a circular dated April 21, 2017. The I&E window is the trading window meant for investors, exporters and end users and it allows stakeholders and participants exchange foreign currency at a market determined rate as against a regulator-fixed rate.

   More importantly, there was also, the intervention window which comprised of specialised windows through which CBN sold FX to authorised dealers at a fixed rate to fulfil certain demands. An example of this intervention window is the window that facilitates payment for Personal or Business Travel Allowances (**"PTA/BTA"**); International School and Medical Fees etc. This window was introduced in a bid to ease the difficulties encountered by Nigerians in obtaining funds for some invisible transactions.

   However, by the issuance of the Circular, "*all segments are now collapsed into the Investors and Exporters Window",* the CBN has collapsed all of these specialised segments into the I&E window. It follows that, henceforth, anyone seeking to carryout out eligible transactions under any of the former specialised transactions will now be subject to the rules that govern the I&E window. It is important to also note that the Circular retains the requirement that applications for BTA/PTA, Medicals, School fees etc., should be made through Deposit Money Banks, albeit under the rules that regulates the I&E window.

2. **Unification of Foreign Exchange Market Rates**
   Prior to the issuance of the Circular, Nigeria practised a dual FX Market regime. On the one hand, there was the Currency Pegging regime whereby the government regulated and fixed the rate upon which Naira would be exchanged in the market i.e., the CBN official exchange rate; and on the other hand, we had the (unofficial) unregulated parallel market where the exchange rate was allegedly subject to market forces of demand and supply.

The availability of FX at the CBN official rate was quite limited and as such, customers in demand for foreign currency would usually head to the parallel FX Market to carryout transactions due to challenges associated with getting foreign exchange through the banks. This of course led to arbitrage, i.e., the markup between the official and the parallel market exchange rate. This also led to round-tripping where banks obtained FX at official rate and diverted it to the parallel market that in turn, bred artificial scarcity. One of the recommendations made to the CBN, by the World Bank, to solve these issues was the unification of the exchange rate window to tackle the issue of supply of FX in the market.

This unification is one of the new policies introduced by the Circular. Following the collapse of all the specialized windows into the I&E window, the Circular reaffirms the effectiveness of the CBN-issued circular dated April 21, 2017 which established the I&E FX window (the **"I&E Circular"**); and states that all the operations of the collapsed windows, shall now be guided by the provisions of the I&E Circular. By virtue of paragraph 5.0 of the I&E Circular, the exchange rates of the transactions in the I&E window <u>shall be as agreed between Authorised Dealers and their counterparties i.e., on a willing-buyer and willing-seller basis</u>.

Based on the above provision and the spirit of the provisions in the Circular, the CBN has effectively abolished currency pegging. In simple terms, there will no longer be regulator-fixed rates in the FX Market. The rates applicable to eligible transactions carried out on the I&E window will be determined strictly by the market forces. Banks and other financial institutions which are licensed by CBN are allowed to carry out foreign exchange transactions at the market determined-rates. With this policy in place, there is expected (though not certain) to have a sufficient supply s of foreign currency to the FX market. This is because commercial banks will now actively compete with players in the parallel market for customers. This competition may give rise to favourable FX rates and help to reduce/close the wide margins/gaps between the I&E rate and the parallel rate. .

3. <u>Government-Related Transactions</u>

The Circular also prescribes the operational rate for all government-related transactions in the FX Market. By virtue of the Circular, the rate of government-related transactions shall be determined by a weighted average rate of the preceding day's executed transactions on the I&E Window. This means that, just like the other collapsed windows, there is no longer a currency peg in respect of government-related transactions since such transactions are also now subject to the market forces. However, the circular still seems to have retained a bit of control in terms of how to determine the exchange rate that will be applicable for government-related transactions, hence, the provisions for *'weighted average rate'*.

4. <u>Abolishment of RT200 and Naira4Dollar Schemes</u>

The RT200 and Naira4Dollar schemes were introduced by the CBN to incentivise inflow of remittance of foreign currencies into Nigeria. The RT200 initiative was designed with the aim to raise about 200Billion USD in Foreign Exchange over a period of 3-5 years from non-oil proceeds. As such, for every $1 repatriated and sold to Authorised dealers and on the I&E window, the exporters would be paid ₦65 and ₦35, respectively. These incentives cost the Nigerian government billions of naira since their inception. With the new policy in place, which is hoped to improve the supply of FX in the system, it only makes sense that these schemes be abolished.

CONCLUSION/CONSIDERATIONS

This policy has been commended by stakeholders in the industry and the Nigerians as a step in the right direction to addressing the multifarious issues in the FX market, however, it does not provide a guarantee that there would be a sufficient FX supply in the market. Before this unification, the CBN already had a backlog of unsettled FX Forward contracts of over USD2BN that matured from foreign investors that want to repatriate their profits/revenues. The effect of this is that potential foreign investors may not be willing to bring in their money despite the introduction of this FX unification until the Federal Government is able to demonstrate to them how they intend to settle these pending FX contracts. On the other hand, some stakeholders are of the opinion that the unification will mean that the official market supply will gradually equate demand and sellers at the parallel market will be willing to seller at a lower margin/profit to attract more FX consumers and subsequently, this will reduce the value of the FX due to excess in the market. Naira in turn will appreciate as a result of this.

On the flip side, this policy will affect foreign loans repayment. The floatation of FX at a unified rate which is about 40 percent above the actual official rate will affect the repairment of loans taken by the government (that are to be made in FX equivalent) that were obtained prior to this time.

The unification of the FX market is a welcome development; hence it comes with a lot of speculations and scepticisms. Whilst we hope that this will aid in addressing the issues in the FX market, we also note that there is still more that needs to be put in place for this policy to achieve the desired results.

Lagos: 1, Perchstone & Graeys Close, off Remi Olowude, Lekki Epe Expressway, Lagos; Tel: +234- 1-3429131, 7611051

Abuja: D3, Jima Plaza, 1627 Ahmadu Bello Way, Area 11, Garki Abuja; Tel: +234 92919191, 07045984792

Benin City: 40, Adesogbe Road, Benin City, Edo State; Tel: +234 7068518650, 07045984776

Email: editor@perchstoneandgraeys.com; counsel@perchstoneandgraeys.com

Website: www.perchstoneandgraeys.com