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THE NEW NORMAL: The Nigerian Foreign Exchange & Fuel Crisis

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Recent figures from the National Bureau of Statistics show that annual inflation in Nigeria is running at 15.6%, reaching a 6-year high. This hike in inflation was driven by the ripple effect of a weak foreign exchange policy, an increase in petrol price also driven by the exchange rate and a surge in food prices. Amid acute foreign exchange shortages, businesses were deprived of the ability to import inputs, ultimately resulting in a contraction of the economy in Q1 2016, the first such contraction since 2010. Within a new environment of the higher price of petrol brought on by the government's recent decision to remove fuel subsidies, the impact on the average Nigerian has been harsh.

At the core of this new normal, there is a pressing need for consistent communication from government officials and a streamlining of its core messaging. If the government have not removed the subsidies but raised the price of fuel instead, then we are in a situation of simply kicking the can down the road and the intended purpose of these subsidies – to ameliorate the difficulties of life for the general public – is not being achieved and they should be removed to divert resources to other purposes.

Below are some highlights and effects on the Nigerian economy of this new regime:

1. **A single market with "uncapped" and flexible prices**

In, the Monetary Policy Committee of the CBN announced that it would introduce flexibility in the pricing of the Naira, which at the time exchanged for the US dollar at an artificial rate of circa N199/$1, which had been set by the CBN. After a lengthy waiting period, the CBN finally unveiled the details of the so-called flexible exchange rate policy. The policy was dramatic in terms of how far it went in overhauling the foreign exchange market. For starters, it discarded the artificial exchange rate peg, and effectively floated the Naira. It also established a single market for foreign exchange – The Nigerian Interbank Foreign Exchange Market (NIFEX), thus putting paid to the speculations about the possibility of there being one or more special windows through which subsidised FX would be made available to a select class of users, such as petroleum products importers and marketers, or other supposedly economically critical users of FX. So the NIFEX brings together the full range players including banks, exporters who generate and sell FX, importers looking to purchase FX to fund imports, other end users, the Central Bank itself (which has the powers to intervene in the market from time to time), and a new category of players known as FX Primary Dealers, which are essentially banks that meet certain qualifying criteria.

The new regime has also introduced a market for Naira Futures, hence parties with future FX needs could purchase futures rather than put pressure on the spot market by frontloading their demand. The new regime went live on Wednesday June 15th 2016, with trading being carried out on the FMDQ Thomson Reuters FX platform. Having now seen it in practice for a 2-week period, one must say it has been largely a positive development. There have of course been a few whispers here and there about the seen and unseen hands of the CBN trying to manage the market, but one can always view those as part of the usual teething problems that attend reforms of this nature. Aside from the whole talk about possible “management” of events on the market by the CBN, one thing that should concern market watchers is the risk of policy inconsistency and reversals on the part of the CBN. For example, after several months of arguing, correctly in my view, that bureau de change should be restricted to the retail end of the FX market – rather than be given access to subsidised FX from the CBN, we have started to hear that CBN suggest that bureau de change may in fact be let back into the market at some point soon. The danger here is of course that they have tended in the past to purchase FX at a controlled price on one market and then resell with a huge margin on the parallel market, thus perpetuating a huge disparity in rates between both markets.

2. The root cause of the FX liquidity crisis in Nigeria

The liquidity crisis that we have faced in the FX market in the past year is simply and squarely a fallout of the sharp drop over the past year plus in the global prices of crude oil. Because the crude oil exports account for over 70 percent of the revenue of the Nigerian government, there has been an inevitable sharp drop in public revenue since crude prices began to fall. The problem has been exacerbated by the significant production cuts that have followed in the wake of the renewed militancy and pipeline vandalism in the Niger Delta. As the pot continues to shrink, insufficient, CBN continues to have fewer dollars to sell to the tons and tons of users in need of the grrenback . With the exchange rate peg now gone and the NIFEX expected to continue to be market driven, coupled with the OTC futures element, it is expected that more liquidity would be introduced into the F market by for example foreign investors who had hitherto kept away from market necuase of the price peg and the general opaqueness in the system.

3. A downstream petroleum market governed by the market

Among other things, the removal of subsidies would enable the downstream petroleum market to be market governed, rather than being dependent on or determined by the Nigerian government. This would foster and encourage competition and possibly result in a price reduction sometime in the future. Freed of the burden of the subsidies, the government would at least in theory, have more resources to spend on social goods and infrastructure, and, that way catalyse economic activity and growth. The sector will attract more foreign investment if it is clear that the price of petroleum products is market governed, resulting in renewed interest in investments in refining crude oil locally. It goes without saying that refining locally rather than relying predominantly on imported products would significantly reduce the pressure on foreign exchange supply in the local market. That said, one thing that is critical at this stage is for the government to ensure that the subsidies have indeed been discontinued and also that the pump price of petrol in Nigeria is truly liberalised. The messaging from the government on these points have at best been contradictory. Hence it's not entirely clear whether what has happened was a mere hike in the pump price still within a controlled price regime, or a removal of subsidies and price control so that the pump price may vary from supplier to supplier, all thanks to the forces of demand and supply. The former is obviously less desirable than the latter.

4. Alleviating the harsh impact of subsidy removal on the public

Every government that increased the controlled price of fuel in the past has tended to offer the labour unions some purported improvement in public transportation and increase in public sector wages. In reality, increasing wages in the hope of enabling public sector workers to cope with higher prices that have been occasioned by the increase in the price of fuel ends up pushing up inflation further. The end result is a disproportionate increase in the prices of goods within the market – essentially going back to square one. In order to cushion the effects of the accompanying hardships that the removal of subsidies and price increase will bring, the government should spend sensibly and channel the savings towards public goods such as infrastructure. The gimmick of introducing a bunch of labour union – branded public transit buses and raising the public sector minimum wage would not cut it.

5. Target low hanging fruit to reflate the economy

The government should focus on ensuring clarity of policy and legislation, as well as strengthening institutions, dealing with capital controls and foreign exchange policy. With a government that doesn't have sufficient funds to meet its expectations to the country, there should be renewed interest in how infrastructure development can be funded. In order to recover the economy, there needs to be a development plan for the short, medium and long term. For an investor looking to invest in the country, the faith and comfort to do so will only come from the reassurance that judgement would be obtained within a reasonable period of time if ultimately there were a claim before a court. Having that assurance and confidence, would spur investment and in turn propel the market to grow. The government should also encourage PPP's and privatisation, and private capital will come in to develop much-needed infrastructure and catalyse other areas of the market.

Historically, commodities such as cocoa, palm oil, rubber and groundnut were foreign exchange earners. In order to revive the economy, the government needs to remove the overreliance on oil revenue and unleash the capacity of the Nigerian entrepreneur and the Nigerian masses, making the country more attractive to foreign capital. These necessary changes will not happen overnight, but rather incrementally through re-education and re-conditioning of both the government and the governed. Reflating the economy will involve fundamental changes the power sector for example. Improvements in the power sector alone would be sure to grow the Nigerian economy exponentially.

Conclusion

In this new climate, the Nigerian government needs to think outside the box, asking the question of whether there are other things that can be promoted that may also be foreign exchange earners other than oil. Targeting low hanging fruit and overhauling underdeveloped sectors of the economy would ultimately result in many more individuals entering into business. The point is not for the government to create new sources of making money for Nigeria, but to enable Nigerians and foreign investors to look at the market and not be dissuaded by the various obstacles and challenges of doing business in Nigeria.

Shifting focus towards creating jobs and creating value, rather than an overdependence on government revenue has to be the starting point. With improved foreign exchange liquidity coupled with clearer and disciplined fiscal policy, the stifling effects of the now abandoned pegged dollar regime and incoherent economic policy of this government will begin to pale.