Central Bank of Nigeria floats naira

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[Banking] [Nigeria]

Introduction

The Central Bank of Nigeria (CBN) recently lifted its peg on the naira after about 18 months. The CBN had been under pressure from investors and critics to lift the peg which had long been maintained by the bank. It had pegged the naira at N197 to $1, which put a strain on Nigeria's foreign exchange reserves following the drop in oil prices.

Unquestionably, commodity price volatility has affected government revenue, similar to other resource-dependent economies. In light of this, the government has introduced several capital control measures.

Naira float

After much deliberation, the CBN decided to float the naira on June 20 2016. The floatation exercise resulted in the clearing of a backlog of $4 billion in demand. On the same day, the CBN sold $500 million in spot trades and over $3 billion in forwards. The breakdown of the forwards was:

- $697 million (one month);
- $1.2 billion (two months); and
- $1.3 billion (three months).

Foreign exchange trading system

The CBN released guidelines for the operation of the Nigerian Interbank Foreign Exchange Market. The CBN operates a single market structure through the interbank market. In an effort to improve the dynamics in the foreign exchange market, the CBN introduced foreign exchange primary dealers, which are registered authorised dealers who work with the CBN on large trade sizes on a two-way quote basis.

Participants in the interbank foreign exchange market include:

- authorised dealers;
- authorised buyers;
- oil companies;
- oil service companies;
- exporters;
- end users; and
- any other entity designated by the CBN.

Notably, the CBN will intervene in the interbank system as it sees fit. It reserves the right to undertake foreign exchange transactions on receipt of valid two-way quotes. This has happened numerous times since the introduction of the new foreign exchange interbank trading market.

Authorised dealers trade in the foreign exchange market on the FMDQ Over-the-Counter Thomson Reuters Trading System (Conversational Dealing)

Foreign exchange futures

Foreign exchange futures are a way of hedging foreign exchange risk. Companies can benefit by entering into futures contracts, whereby the parties will agree to an exchange rate for a pre-determined date. Foreign exchange futures contracts are for defined tenors in multiples of 30 days (ie, 30 days, 60 days, 90 days or 120 days)

Comment

Despite the floatation of the naira, which in effect is a devaluation, the foreign exchange market has experienced a high rate of volatility. The naira was traded at N282 to $1 on the first day of trading. It hit a record low of N362.15 to $1 on August 18 2016. As of August 23 2016, it is trading at N315.93 to $1.

Critics have stated that this volatility stems from the fact that there is still not enough dollar liquidity in the system. Criticisms have been levelled against the CBN for not intervening enough in the foreign exchange system to provide much-needed liquidity. The demand for dollars is still high. The first foreign exchange futures trade further depleted foreign exchange reserves to about $25.7 billion, the lowest levels in over a decade.

It remains to be seen whether the effective devaluation of the naira through the introduction of the Nigerian Interbank Foreign Exchange Market was the right move as, in effect, Nigeria is still a heavily dollarised economy. A strong economic policy and high investor confidence will be key factors in determining whether the economic slump can be abated.