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# Economic Newsletter

## *The Naira's Conundrum*

### *Explaining the Basics*

Nigerians are like other rational economic agents across the globe who will seek to arbitrage on opportunities that promise significant financial returns. It is only logical that the cassava or even cat fish business will attract more investors as the returns on these ventures increase. This rational behaviour is typical of human character across times, cultures or geography leading to the California Gold Rush of the mid-19th Century or the sub-prime mortgage binge of this millennium.

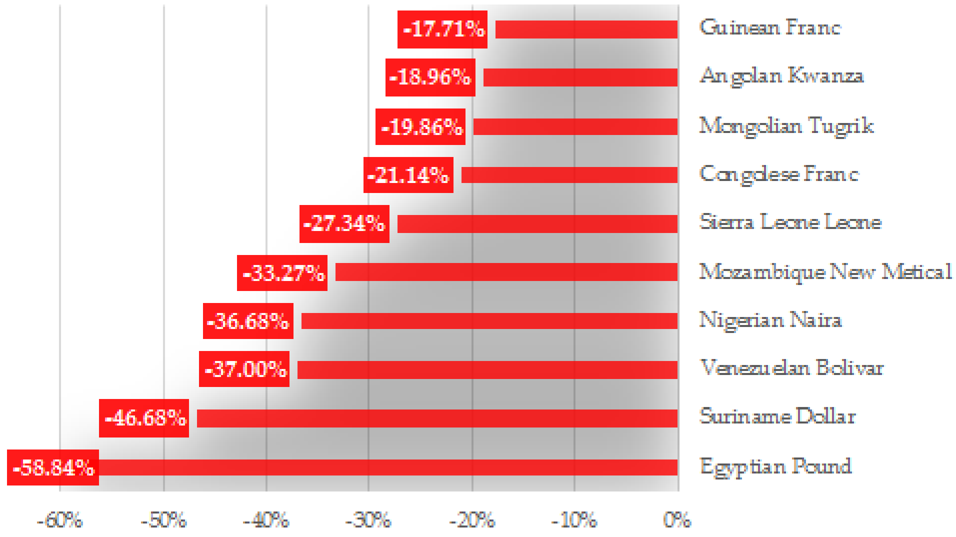
Nigeria's current FX spreads (official—parallel market premium) fit perfectly into these scenarios that have long been attractions to speculators seeking arbitrage gains. George Soros—the US hedge fund investor wrote his name in Investment Management folklore with his 1992 short sell on the British pound.

However, not all investors are into the speculative gambit. But, the Naira's woes still entraps other categories of investors. Investors who hold their assets in Naira have genuine cause to worry about valuations. Inflationary headwinds have eroded the value of Naira assets causing investors to lose out. Investors lose in a high inflationary environment as inflation outstrips returns thus leading to a negative rate of return. These investors have been more attracted to holding dollar assets as a means of hedging especially with the naira's poor performance.

Foreign portfolio investors (FPIs) who once bought into the Nigerian narrative as the country's sovereign debt instruments were added to the indexes of major international investment banks have also grown weary of Naira assets. The lack of liquidity in the country's foreign exchange (FX) market has led to significant capital flight. This liquidity crunch in the FX market creates a disincentive even for the most daring yield hunters.

Even foreign direct investors (FDIs) who seek to go long on Nigeria are not insulated from the weak markets. Foreign direct investments are booked at the official rates upon receipt in Nigeria. The wide and incredulous premium between the parallel and official market creates a major disincentive for FDIs. A foreign direct investor can lose as much as ₦180—₦200 per dollar on just the first day of booking the investment in the Nigerian economy due to the premium between the parallel and official markets.

**Figure 1: World's Worst Spot Returns in 2016 (%)**




*Source: Bloomberg*

*"The CBN guidelines of June 2016 which ought to have led to the liberalisation of the FX market needs to be diligently implemented."*

## *Why Policy Matters*

The Naira's current woes were initially triggered by the drop in crude oil prices in 2014. However, the drop in crude oil prices has paled into an over-used cliché and the Naira's current troubles are more as a result of policy shortfalls. These policy shortfalls have been characterised by the babel of forward guidance, unhelpful political rhetoric and the timid approach towards broader macro reforms.

Political rhetoric reminiscent of decrees and pledges of patriotism are proving to be inadequate policy tools to restore stability in the FX market. The resultant effects of these policy tools made the Naira the fourth worst performing currency in the world in 2016 and increasing comparisons to basket cases like Venezuela (which may be far-fetched for now).

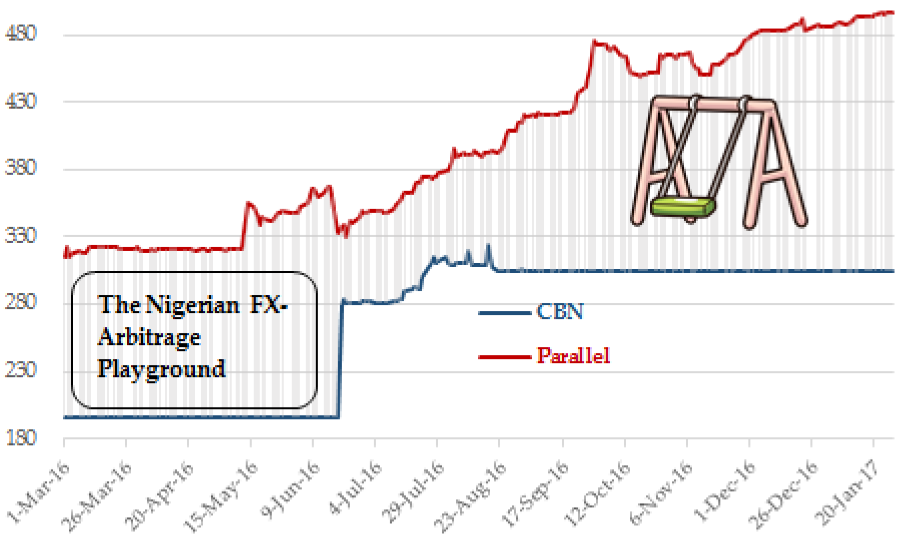
Overall, the failings of demand management policy tools coupled with other knee-jerked actions—such as the arrest of currency traders selling above ₦400/US$ clearly indicate that there's need for a rethink of initiatives.

With the failings of the current policy environment, benign motives such as maintaining a strong currency have not been achieved. We believe that monetary authorities should be bolder in pursuing reforms in the FX market.

The CBN guidelines of June 2016 which ought to have led to the liberalisation of the FX market needs to be diligently implemented. While this may lead to further devaluation of the currency on the official market—in the short term—it will help restore investor confidence in the Nigerian market, stimulate FX inflows from FPIs and FDIs and eventually moderate the premium between the parallel and official markets from the current highs.

By pursuing sound monetary policies and upholding the independence of the Central Bank, the Russian Ruble – which experienced commodity induced woes like Nigeria – emerged as the best performing currency in 2016 appreciating by over 21% last year.

**Figure 2: Foreign Exchange Market: Official Rates vs Parallel Market Rates**




*Source: CBN, Aboki Fx*

*"The special windows for FX supply for sectors defined as priority sectors is a stop-gap measure with significant handicaps."*

## *How to eliminate the FX Parallel Market Premium*

Restoring investor confidence and stimulating FX inflows through investments will be a more logical path to eliminating the FX market premiums than simply waiting on a wing and a prayer for oil prices to rally once again.

By opening the Nigerian economy once again to increased supply of FX, monetary authorities will succeed in paring the premiums between the official markets and the parallel market and restoring stability in the exchange rates. The CBN can achieve this by simply relaxing its controls on the market, and follow through on its June 2016 policy for a free float market. This will also help eliminate devaluation risks that have stifled investment inflows.

While we recognise constraints with modelling Nigeria's FX numbers, we estimate that based on inflation differentials to the US dollar, the naira should trade at about ₦370/USD if the CBN eases capital controls and opts for a free float. While this may be weaker than the current CBN (₦305) and the interbank rates (₦314.75), it indicates that the Naira should be trading at a much stronger value than the current parallel market rate (₦496.50).

For now, the special windows for FX supply for sectors defined as priority sectors is only a stop-gap measure fraught with significant handicaps. Firstly, it fails to appreciate the dynamism of the Nigerian economy as the largest on the continent by creating unorthodox red tapes, multiple exchange rates and inevitably promoting rent seeking. It also fails to pare the spreads between the parallel and official markets. These spreads will remain an arbitrage playground that will continue to attract rational economic agents seeking big financial gains.

Overall, policy makers need to appreciate that however compelling Nigeria's investment case may be, capital is like a bride that will go to the suitor who woos the best. Secondly, capital comes at a cost and investors need to earn returns and add value to defray this cost. For now, Nigeria's investment case is being eroded with the prolonged and needless FX policy conundrum that leads to capital flight and a higher cost of capital.

Notes

Bloomberg: Here Are the Best and Worst Performing Assets of 2016 by Julie Verhage

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