OPINION

Funmi Adebayo

Associate, Exotix Capital

THE GREAT NAIRA DEBATE – TO FIX OR FLOAT

The battle lines in the long-running naira wars are drawn by politics as much as by economics. In the right corner is the 'float the naira' lobby. Its strategists concede that to let the naira float is to take a leap of faith in market economics, but they insist it will be richly rewarded.

A more competitively-priced naira – that is, a devalued naira – will spur local production and push out all those unnecessary imports of foodstuffs and light manufactures into Africa's biggest market. And then, the investors' dollars will come sluicing into the financial system, cutting interest rates. Then the naira will find its level underpinned by market forces, not administrative fiat.

Both Ghana and Egypt, heavily encouraged by the International Monetary Fund (IMF), have taken that path with mixed results. So far, the inflationary effects of the devaluation have outweighed any boost to local producers. But the governments say the production boost is coming.

In the left corner, the anti-devaluation lobby reject their opponents' economic and political arguments. They point out that floating and devaluing the naira will inevitably stoke runaway inflation because of Nigeria's economic structure: heavily import-dependent with oil exports still generating 95% of foreign exchange. Cheap – that is, subsidised – fuel is every Nigerian's birthright as the country is one of the world's biggest oil and gas producers. Floating the naira is politically toxic because it will hit the poor hardest.

There is what we can call an uneasy truce in the naira wars. Both sides have given a little ground. Since mid-2016, Nigeria has had a multiple exchange-rate system. That means one rate for anxious parents paying school fees overseas, another rate for local manufacturers buying approved raw materials and spare parts, and presumably another rate for Hermès handbags.

Initially, the floating of the naira saw it depreciate by 30% in June 2016. After the Central Bank of Nigeria (CBN) intervened by introducing different rates according to the end-use of the foreign exchange, we saw the parallel and official market converge.

Prior to the devaluation, investors were unwilling to bring dollars into Nigeria, through the formal financial system at least, due to the lack of naira convertibility. Why risk bringing in dollars and converting to naira to make investments if you cannot convert the naira back into dollars and repatriate the funds? And what sort of liquidity premium should these investors add considering that many others were in a queue at the CBN for well over a year trying to convert their naira earnings into dollars? The CBN's argument in support of currency controls was that they were protecting Nigeria from 'hot money' and forex speculators.

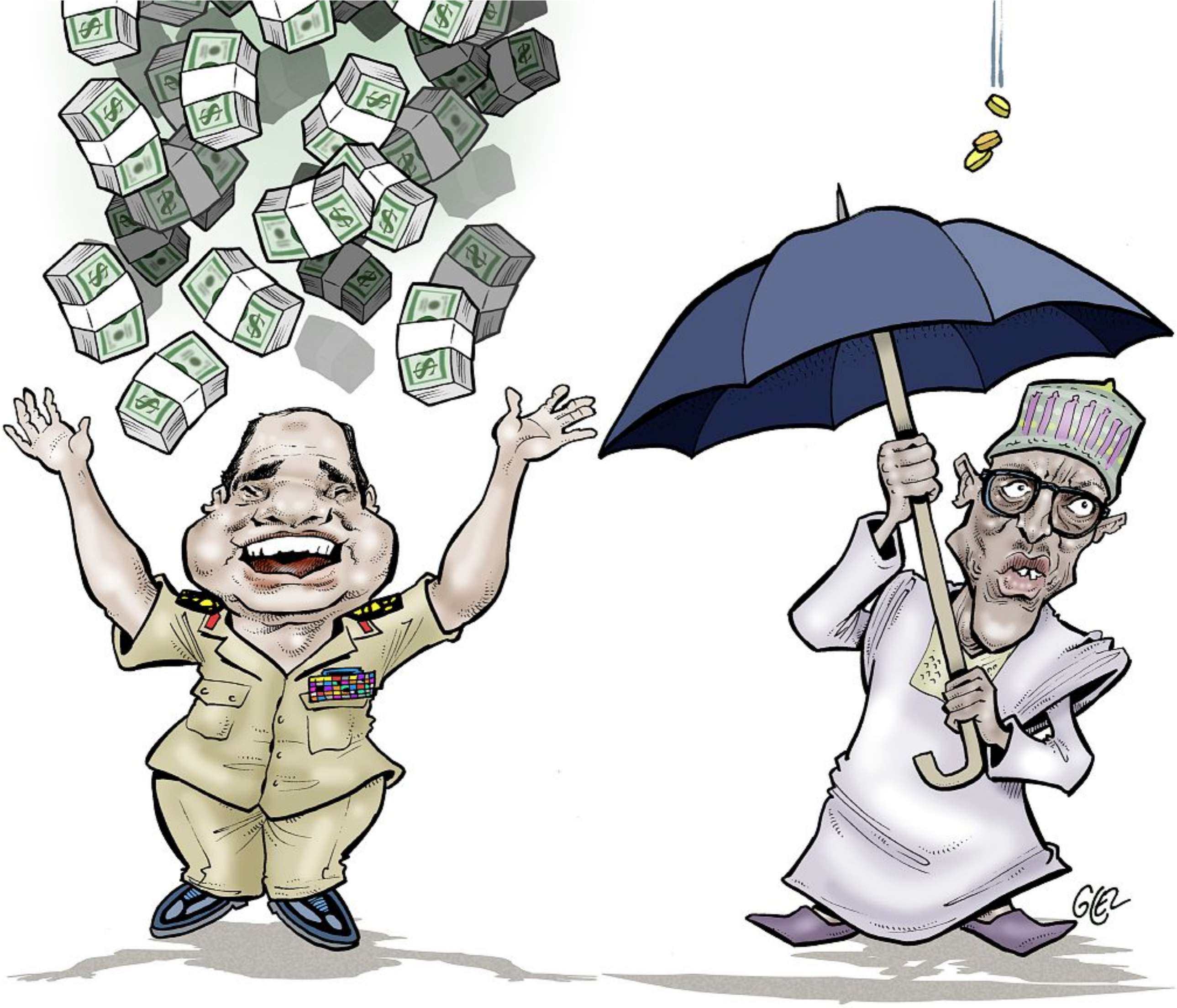
In the current state of affairs, investors, banks and the government have reached an impasse. Although the floating of the naira has made local-currency instruments more attractive and encouraged more positive sentiment towards Nigeria, again, hopes of a massive uptick in dollar inflows are largely unfulfilled.

That leaves many Nigerians asking what is holding up the foreign investors. This is where the distinction between free-floating and floating gets important. Many investors want the CBN to step back from any intervention in the forex market. That, they say, would allow an efficient and fair forex market to function, setting the real price of the naira.

> Trading in the Nafex window has increased, but investors are reluctant to bring in fresh dollars

Initially, investors were frustrated by the multiple exchange rate system and blamed its complexities for causing more confusion around the value of the naira. Such concerns have ebbed as investors are now using the price of the Nafex window – created in April 2017 for use by portfolio investors – to value their naira holdings.

The volume and liquidity of trading in the Nafex window has steadily increased, with hundreds of millions of dollars being sold each week. You would think these are welcome developments, but foreign investors are still reluctant to bring in fresh dollars.



Context matters here. Nigeria and many other oil exporters have never had a free-floating currency. Egypt, with the 48% devaluation of the pound last year, is the new belle of foreign investors. Some are advising Nigeria to follow its example. Yes, Egypt got a jumbo IMF loan of around $12bn and is attracting some fresh investor funds. But inflation is roaring, and living standards are facing ever heavier pressure.

However, Egypt's position is very different from Nigeria's. It is getting massive financial support from its allies in the Gulf, and President Abdel Fattah al-Sisi runs a far more authoritarian regime than President Muhammadu Buhari. Nigeria's economic structure is also very different from Egypt's. Nigeria is much more import-dependent and its consumers would suffer even more than Egypt's from a full-throated devaluation.

With foreign reserves of $30.8bn in April, the CBN may worry that it would not be able to manage a massive surge in demand for dollars. This has political implications, given that campaigning for the elections in 2019 will start next year. The government wants to avoid any policies that will hurt the electorate in the short term.

Nigeria's government does not want an IMF programme. Given Nigeria's success in tapping the eurobond market for billions of dollars, it could be argued that those calling for a free float are setting up a moral hazard: that is, investors are protecting themselves and leaving Nigeria to bear the entire risk.

With low oil prices and elections coming, calls for a free float are losing steam. We are seeing more investment in naira stocks and local-currency instruments. With stocks at unprecedented low prices and treasury bill yields in the double digits, it is hard to ignore Africa's biggest markets when investors have stockpiles of cash.

So why haven't we seen a surge of fresh dollars into the system? In one word: confidence. Investors have bitter memories of capital locked in Nigeria. Some still cannot repatriate their funds. Policy stability and trust in the institutions that dictate policy are becoming more important to investors, particularly in emerging markets.

It will take a while before investors believe that Nigeria has demonstrated enough stability, consistency and transparency to justify a new wave of dollar investments. For now, they see other emerging markets providing comparable returns and with lower risk.

The next few months will test the nerves of the CBN and the government. The convergence of the parallel and official market suggests there has been an effective clampdown on rent-seeking. By the end of the year, Nigeria's authorities could see those elusive investor dollars start to return. ●

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