Managing a Liberalised Exchange Rate System in Nigeria: Lessons from Indonesia

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Abstract

This paper examines Indonesia's exchange rate management experience following the 1997/1998 Asian financial crisis to draw useful lessons for Nigeria's recent transition to a liberalised exchange rate regime. It describes one of Nigeria's historical exchange rate policy challenges, emphasising the role of rent-seeking behaviour and corruption. Drawing on Indonesia's successful adoption of a floating exchange rate regime, the paper highlights vital lessons Nigeria can learn, such as central bank independence, a managed floating exchange rate regime, and effective foreign exchange supply and demand management. The analysis also underscores the importance of private sector engagement with the central bank for sustainable exchange rates and macroeconomic stability.

Introduction

The Exchange rate policy has been a crucial issue in Nigeria for about three decades. The Central Bank of Nigeria (CBN) has tried various strategies to manage the exchange rate of the Naira in line with domestic developments and international dynamics. The exchange rate system is characterised by an administratively controlled official exchange rate and a parallel market rate. As foreign exchange (Forex) shortages persisted significantly since 2016, the gap between the two rates widened significantly. This situation has led to rent extraction by politically powerful individuals with access to the attractive official exchange rate, thereby discouraging investment, fuelling corruption, and exacerbating macroeconomic instability. To address these challenges as part of the broader macroeconomic reform agenda of President Bola Tinubu's administration, on June 14, 2023, the CBN made changes to liberalise Nigeria's Forex market, including the elimination of multiple exchange rates.

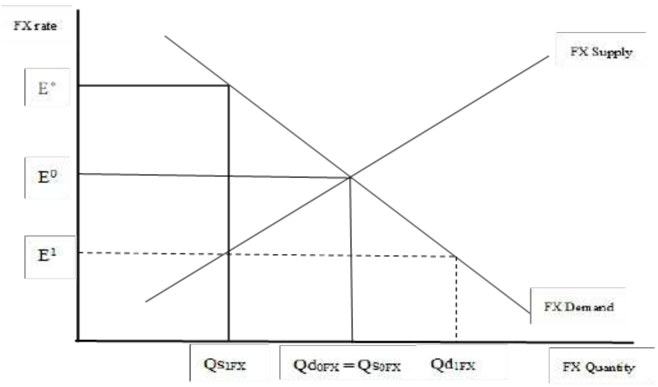
However, there is scepticism about the new policy's sustainability for political and economic reasons and concerns about the expertise to manage the new system. For example, the Economic Intelligence Unit predicted that Nigeria may revert to tighter exchange controls to stem the decline in the value of the Naira. It noted that the CBN lacks experience in conducting monetary policy under a floating exchange rate regime. As the CBN is committed to pursuing reforms towards full liberalisation of the Forex market, it is imperative to draw lessons from comparable countries with similar experiences. This paper analyses Indonesia's exchange rate management strategy following the Asian Financial Crisis (AFC hereafter), which necessitated the floating of the rupiah (Indonesian currency) and highlights what Nigeria can learn in managing a market-based exchange rate regime.

Defending the Naira and Vested Interests: The Nature and Consequences of Nigeria's Exchange Rate Dirigisme Before the Recent Forex Liberalisation

Given the dominance of petrodollars as the primary source of Forex in Nigeria, the CBN has, for several years, managed Forex supply and demand through administrative restrictions and selective allocation to specific sectors and individuals. However, access to the official exchange rate can often depend on the political clout of influential interest groups and individuals. This type of intervention and its adverse consequences epitomise how government intervention in markets to influence prices creates vested interests and opportunities for rent-seeking and corruption (Bates, 1981). It is a system of exchange control that involves the rationing of limited Forex to "preferred customers" (Todaro & Smith, 2011, p.607). Let us draw from Bates (1981, pp.97-99) and Todaro & Smith (2011, pp.607-608) to illustrate one of the challenges of Forex management in Nigeria.

Government intervention in the Forex market reduces the exchange rate (price) for foreign currency. The currency adopts a new exchange rate below the market clearing rate. This creates excess demand for the currency in question, which becomes scarce to the extent that the monetary authority resorts to rationing. Figure 1 describes the process that leads to the emergence and persistence of exchange control, which creates vested interests.

Figure 1: Central Bank forex intervention and vested interests



Source: Constructed by the Author based on Bates (1981) and Todaro & Smith (2011)

At the market-clearing exchange rate E0 in Figure 1, the demand for and supply of foreign exchange is in equilibrium (Qd0FX = Qs0FX). When the central bank intervenes in the foreign exchange market, for whatever reason, the exchange rate is lowered to E1, the official exchange rate. E1 causes the demand for foreign exchange to increase to Qd1FX. Since there is insufficient supply to meet the increased demand, this creates excess demand for Forex, making it difficult to continue trading at E1. Therefore, the Forex is selectively allocated by rationing. The scarcity of the currency at the limited supply Qs1FX gives it a higher value at E*, where most excess demand is absorbed. This is the parallel market exchange rate. E* is higher than the official exchange rate (E1) and the market clearing rate (E0). The spread between E0 and E* represents what Bates (1981, p. 99) called the "administratively generated rent", a premium that results from the creation of the official exchange rate. The immediate implication is that the rent (E1) is allocated to those with privileged access to the government, and most, if not all, is resold at the parallel market rate (E*) in a process called round tripping. This selective allocation may initially be well-intentioned to insulate the domestic economy from external shocks or to stimulate local production and promote economic development. However, the policy can lead to unintended consequences, as the situation in Nigeria, especially between 2016 and 2023, clearly illustrates.

Bank Indonesia's Autonomy and Exchange Rate Management Strategy Post-AFC

In response to speculative attacks in the foreign exchange market during the 1997/1998 Asian Financial Crisis (AFC), Indonesia adopted a floating exchange rate regime in August 1997. This policy was introduced due to the crisis and had to be maintained as part of the conditions of the IMF's post-AFC stabilisation program for Indonesia. With this development, the rupiah's value moves according to market demand and supply. However, Bank Indonesia (BI hereafter) intervenes in the foreign exchange market to stabilise the rupiah when there are disorderly market conditions and large fluctuations that could be transmitted to inflation or when there is a need to promote export competitiveness by preventing currency appreciation (Warjiyo & Juhro, 2019; Edwards & Sahminan, 2008).

With the enactment of Law No. 23 of 2004, BI has full autonomy as an institution to formulate and implement policies without any interference (Ascarya, 2011). Independence is determined by the extent to which the Bank can operate by setting policy goals/targets, applying appropriate policy instruments, and managing the institution's internal governance (Soekarni & Syarifuddin, 2011).

The law establishing BI provides five meanings of independence as elaborated by Ananta, Soekarni, & Arifin (2011) and Ascarya (2011), namely: institutional, objective, personal, financial, and instrumental independence. Institutional independence means that BI can independently design and implement policy goals without interference from the government or other parties. The authority to set targets (albeit in consultation with the government) to ensure the stability of the rupiah value gives the Bank objective independence. Personal independence allows BI to operate independently and has the 'right' to resist the undue influence of any organisation on its responsibilities. However, appointing the governor, deputy governors, and board members is subject to parliamentary approval. Also, the Bank's annual budget is subject to parliamentary scrutiny.

Nevertheless, the Bank has the financial independence to implement the budget without further parliamentary approval. In pursuing its monetary policy objective, the Bank can adjust interest rates as it deems fit. This is instrumental independence. Different instruments are used for various purposes. Policy instruments to support the stabilization of the rupiah include interest rates, open market operations and Forex intervention. Forex intervention is particularly useful in stabilizing market expectations and limiting the impact of temporary shocks on exchange rate fluctuations.

Bank Indonesia decides whether to use an open method to intervene directly in the foreign exchange market or a closed method through agent banks as intermediaries. The choice of either method is based on market sentiment and whether information about the intervention should be disclosed to market participants (Ferry, 2015; BIS, 2005). Another consideration is whether there is excess demand but a limited supply of US dollars. According to Warjiyo (2013, p.181), the BI's strategy of Forex intervention, which involves buying and selling foreign currencies through agent banks, is to curb excessive exchange rate volatility. These transactions often take place in the spot market. However, depending on the availability of Forex, the central bank also engages in swap and forward transactions. In addition, BI's intervention is conducted from a strategic and operational point of view. The strategic aspect includes the objective of the intervention and the policy direction. The operational element deals with the policy implementation strategy based on market conditions as determined by the relevant units of BI (Ferry, 2015).

In conducting Forex interventions, BI recognizes the importance of understanding and monitoring international investors' perception of markets based on the type of investor (hedge fund or long-term) and the factors that influence their behaviour (Warjiyo, 2013). For example, hedge funds are short-term investors seeking quick profits, and their portfolio decisions are influenced by the slightest hint of a domestic or external shock. On the other hand, long-term investors tend to be more stable because they seek higher returns based on their judgment of economic fundamentals and are unlikely to be affected by short-term fluctuations.

In addition to intervention, BI also engages in Forex supply and demand management to stabilize the rupiah, especially in the face of mounting pressures that lead to currency depreciation. For example, in 2015, BI introduced a rupiah stabilization policy package in coordination with other government policies to support macroeconomic stability and inclusive economic growth (see Bank Indonesia, 2015, pp.181-185). The Forex supply and demand management pillar of the policy package includes tax breaks on fixed deposit interest rates to exporters who deposit their export earnings in domestic banks or convert their export earnings into rupiah. The policy also includes controlling the demand for Forex not directly related to the 'real economy' by reducing the limit on spot foreign exchange transactions from US$ 100,000 per customer per month to US$ 25,000. The restrictions did not apply to transactions related to the payment of school fees, the payment of imports, the cost of medicines abroad, and the servicing of foreign debt.

Conclusion and Policy Recommendation

Nigeria and Indonesia share similar characteristics regarding natural resource endowments, dependence on commodity exports, societal diversity, socio-political dynamics, and the trajectory of institutional reforms. However, Indonesia has grappled with the Asian Financial Crisis, which necessitated IMF intervention with its attendant conditionality, particularly on central bank independence and exchange rate liberalisation. Over the past two decades, Indonesia has effectively managed the exchange rate in the face of several external shocks, which holds important lessons for Nigeria as it embarks on a liberalised exchange rate regime. Based on the brief analysis of Indonesia's experience, this paper makes the following recommendations.

- **Central bank independence** – CBN's acquiescence to pressure from the executive to finance the budget deficit and take on non-traditional central bank functions (especially between 2015 and 2022) is a clear manifestation of the apex bank's lack of autonomy. While the Bank needs to be insulated from such political interference, institutional independence can grant excessive discretionary powers that are prone to abuse by the governor and management of the bank. This is the dilemma of central bank independence in Nigeria. Nevertheless, the central bank must be allowed to operate professionally to pursue its mandate, although this ultimately depends on the political elite (the president and National Assembly). There should also be a clear definition of independence, as in Indonesia.

- **Maintain a de facto managed floating exchange rate regime**– The CBN should sustain a de facto managed floating exchange rate regime like Indonesia's, which requires central bank intervention only to stabilise the currency rather than selectively allocating Forex to individuals and businesses. This will create transparency that will enhance market confidence and help maintain the harmonisation of official and parallel market exchange rates.

- **Managing foreign exchange supply and demand** – Emerging and developing economies do not have the luxury of implementing fully flexible exchange rate regimes, mainly because of their economic structures. This implies the need for the central bank to discourage frivolous demand that could distort the Forex market and stimulate forex inflows. In attempting to boost inflows by repatriating export earnings, Nigeria can take a cue from Indonesia's strategy of providing tax incentives to exporters, as highlighted earlier.

- **Private Sector Engagement** – BI's Monetary Policy Department has four to five divisions. In the macroeconomic department, there are many subdivisions, including one that focuses on private-sector monitoring. Their job is to get all the information on specific issues, such as inflation (BI interviewee). Indonesia has a national program to reduce inflation under the coordination of BI. The program has members from relevant government ministries and departments, through which BI liaises with business associations. BI invites influential associations such as the Indonesian Palm Oil Association (IPOA) every three months to discuss the development of the palm oil sector (IPOA interviewee). The CBN has also engaged groups such as the Manufacturers Association of Nigeria (MAN) and other commodity exporters. However, it should be strengthened and conducted regularly, as in Indonesia.

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