FOREIGN EXCHANGE RESERVES DYNAMICS AND MONETARY POLICY STANCE IN RECESSIONARY PERIOD IN NIGERIA

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ABSTRACT

The Nigerian macroeconomic crises have continued to assume different and disturbing dimensions to the astonishment of technocrats and policy makers. This development has also put analysts on constant watch and a search for the causes and possible cure. The recent economic recession is not an exception, for the problem has been a source of national discourse among stakeholders in terms policy prescriptions. The phenomenon that have described the economy particularly for the late part of 2016 reflect the consequences of severe structural disequilibrium that has engulf the economy into a deep seated economic recession and precipitated other instability in the key macroeconomic variables like unemployment, national output, exchange rate, inflation rate as well as downward fluctuation trend in foreign exchange reserves. This development has direct link to the implementation of monetary and fiscal policy regimes during recession. The paper examines the trend in foreign exchange reserves and the type of monetary policy implementation during recession in Nigeria. The paper adopted descriptive analysis to draw its conclusions from diverse opinions of analysts. The findings from the study shows that the type of monetary policy adopted during the recessionary period of recent in Nigeria represent a mixed grill of expansionary and contractionary policies. During the expansionary policy, instead of interest rate to decrease, following increase in money supply, it remain rather high for the period and that crowds out the private sector in economic activities and the ultimate collapse of small and medium enterprises that brought about the unemployment and inflation situations. On the other hand the contraction in the monetary policy comes in the form of stringent foreign rate exchange policy in the bid to stabilise the market, but further worsen the already battered system which resulted in the drawing down of foreign exchange reserves. On the basis of these findings, the study recommends the following: Though theory has set a template upon

which adjustments will be made to achieve targets variables, doing so will depend on the state of the economy, an economy that is largely made up of informal sectors requires the use of discretion rather than policy norm in the implementation of monetary policy. The recession that occurred in Nigeria was largely caused by fiscal policy management; therefore any form of monetary policy should always be followed by a counter balancing fiscal policy. In all it will be suggested that a quick return on sectors that will be boost non-oil export will address a twin problems of foreign exchange shortage as well as building the reserves level.

. **INTRODUCTION**

Nigeria officially entered into recession in 2016 having witnessed significant decline in economic activities spread across the economy and lasting for more than a few months. According to the National Bureau of Economic Research this became visible in Nigeria following a fall in industrial production, rise in unemployment as more workers were retrenched, which led to a fall in real income as inflation rose to higher figures; all these indicators were captured eventually as negative growth rate in the Gross National Product. Where such decline in economic activities continue over a long period it will be referred to as depression and the degree of manifestation of some of the economic indicators above become excessive and could dangerously lead to serious economic deprivation and social dislocations. The recession in Nigeria started with the neglect of the economic management for politics towards the end of 2014 as the positive growth rates started declining it went down to 1.5% in 2015 and declined further to -0.36 in the first quarter of 2016, -1.5% in the second quarter; and then went down to over -2.38% in the third quarter (Sanusi, 2016).

The decline became more pronounced as the tension that followed the elections led to capital flight as sensitive capital decided to relocate to "safe havens" following the strong political rhetoric that depicted ethnic and religious colouration of the elections with strong gravitation towards crises of dimensions that were estimate to be easily catastrophic. This was followed immediately by massive divestments by other businesses following the victory of the opposition and the possibility of the recurrence of the early 1980s experiences where businesses lost huge resources following the economic policies of the Military government at that time headed by the Muhammad Buhari. Apparently, a survey of the factors responsible for the recession has

the following: The sudden fall in the global crude oil price precipitated the situation. Owing to the fact that the economy is mono-product dependent is easily susceptible to the fluctuation in global economy, thus the 2016 budget benchmark was readjusted to reflect the current realities and this latter translated into restrictive budgetary allocation as well as contractual Monetary and Fiscal policies. There was a delay in forming the executive cabinet. This has undermined international best practice, gave room for leakages and sent wrong signal to prospective investors both at home and abroad. There was the introduction of Treasury Single Account (TSA) intended to block loopholes, minimise corruption, but ended up in mopping up liquidity, thereby stifling credit creation and eventually slow economic activities. This was made even more difficult for operators as the largest contributor to the nation's activities, the public sector, became grounded by the said "Treasury Single Account" policy (TSA) and saw the pooling of all government revenues and deposits to a single account domiciled at the Central Bank. The immediate impact was the drastic fall in the deposit levels of the commercial banks and lack of resources for the government offices to function. Government revenue was further affected as the Niger Delta Militants made real their threats to the crude oil production as it fell from 2.2million barrels per day to almost 1.2million barrels per day (NNPC, 2016). As if to make things worse, the price of crude oil in the international market fell from over US$100/barrel to less than US$35/barrel causing a serious strain on the domestic government revenues, and the country lost a whopping over US$80billion as well as foreign exchange reserves. (Okonjo-Iweala, 2016)

Subsidy removal added its toll to the problem. Since oil is central to what we do this country, the removal of oil immediately translated into increase in price of goods and services occasioned by corresponding increase in transportation. The delay in signing the appropriation bill added and impetus to the situation. Lastly, there was a paradigm shift in exchange rate policy by the CBN. As a result, government issued directives on foreign exchange receipts and disbursements that sent even greater panic in the market which witnessed an accelerated fall in value of the local currency. The recession fact started becoming real as consumers saw a drastic fall in the value of their income due to inflation that had gone above the double digit level (17.38% August 2016) and more unemployment followed. Manufacturing declined by 3.4% in the first quarter of 2016 and further in the second and third quarters; construction activities were put on hold as thousands of workers were

rendered unemployed; and where any form of activity was going on at all, it had declined by 6.3%.

It was towards the fourth quarter of 2016 that government began to embark on measures that were aimed at reversing the process through more fiscal interventions that saw government expenditure, especially capital expenditure, grow to over a trillion naira by the second quarter of 2017 and the recession started receding.

The issue of interest in this paper is to ascertain the dynamics of foreign exchange reserve management in a recessed economy like Nigeria as witnessed during the outgoing recession (outgoing given that figures show that the recession is almost being overcome). This becomes more imperative if the concern that no country can meaningfully engender a growth process if it has a distorted foreign exchange market as depicted by a falling foreign exchange reserves (Rodrik, 2006) and/or a volatile foreign exchange market characterised largely by declining value of the local currency. In this regard, this paper is aimed at investigating the extent to which the monetary authorities have carried out the required treasury function through careful management of the foreign exchange reserves thereby ensuring a return to growth pattern following the recent recession.

In the following sections the paper will review the dynamics of foreign exchange reserves management especially through monetary policy measures in an economy going through recession. The paper ends with policy recommendations.

Literature Review

The economic literature is replete with concepts that depict the relative importance of foreign trade to economic growth and development, especially in developing countries. In this regard, a number of empirical studies on the determinants of export and import demand functions have been carried out to ascertain the nature of each variable in the trade matrix and thus help policy makers' work out the best fit mechanisms for ensuring the use of these concepts to engender development. As reported by Aliyu (2007), the models that explain the determinants of exports and imports include those by Olayide (1968), Rhomberg (1968), Maizels (1968), Houthakker and Magee (1969), Khan (1974), Ajayi (1975), Ajakaiye (1985), Goldstein and Khan (1978), and Goldar (1989). Some of these empirical studies on the nature of exports

supply

and imports demand functions were carried out by Khan (1974), Ali (1987), Reinikka (1994), Ajayi (1975), Yekini (1999), Egwaikhide (1999), Aliyu (2005), and yielded varying results with interesting findings on the nature of the variables and levels of their influence determining the level of Exports and Imports. This makes it imperative that further studies needed to be carried out to bring to light some of the key variables that could influence the nature of foreign exchange reserves management that could be put in place in the face of a recession in other to ensure a return to equilibrium in the shortest possible time.

The nature of the disequilibrium is usually measured by the concept of Balance of Payment (BOP). Indeed, Balance of payments viability is essential to foreign trade sustainability in any economy. Literature is replete with theoretical discussions on how adjustment processes work to restore equilibrium condition in a country's BOP especially in a competitive market situation. One of these postulations is the concept of Marshall- Lerner condition (Jhingan, 2013). Marshall and Lerner independently worked out conditions under which exchange rate changes restore equilibrium in BOP by devaluing a country's currency. The Marshall – Lerner condition is often stated as:

When the sum of price elasticity of demand for exports and imports in absolute terms is greater than unity, devaluation will improve the country's BOP, i.e. ex + em > 1; If the sum is equal to unity, devaluation will have no effect on BOP, and; BOP disequilibrium will worsen when the sum (absolute) is less than unity.

The postulation highlights the fact that devaluation reduces the prices of exports in terms of foreign currency while at the same time it cheapens exports. Thereby reducing demand for imports while raising the demand for domestic goods as exports which leads to the much needed correction of the disequilibrium. However, devaluation makes the BOP to worsen in the short run and then improves it in the long run giving the J-curve effect of devaluation. If the country is on a flexible exchange rate, BOP will get worse (Jhingan, 2013) when there is devaluation of the domestic currency which invariably was caused by excess supply of currency that fuelled the extra demand for foreign exchange whose supply has dwindled or remain static. Such devaluation force may continue to exert on the local currency unless the

monetary authorities' step in to control the process by using monetary measures.

Foreign exchange reserves

Nations have different resource endowments and they trade with each other in other to balance product availability and raise the composite welfare function higher. As observed by Egwailkhide (2000), the import of capital goods is considered essential in the trade amongst nations given that such capital goods add to investment which is more critical for development as it expands the nation's capacity for further production. The process of such trade requires that each nation accumulates the medium of exchange that is acceptable to its trading partner in order to facilitate such trade. The more a nation is able to accumulate such assets of exchange at the international level through a positive balance of payment mechanism the better for the nation. This asset is often referred to as foreign exchange reserve. Foreign-exchange reserves (also called forex reserves or FX reserves) is money or other assets held by a central bank or other monetary authority so that it can pay, if need be, its liabilities. According to Roger (1993), quoting IMF, Reserve management is a process that ensures that adequate official public sector foreign assets are readily available to and controlled by the authorities for meeting a defined range of objectives for a country. In this regard, foreign exchange reserves management is akin to treasury management in a big conglomerate that ensures it has enough liquidity to take advantage of emerging economic opportunities as well as mitigate losses (Soenen and Aggarwal, 2006). This may sound ordinary but if you consider what Feldstein (1999) concluded based on the aftermath of the Asian Financial crises that developing countries cannot rely on the International Monetary Fund or some other forms of reforms in the financial architecture to protect themselves from such crises; nor do they need to rely on sound macroeconomic policies since even well managed economies can still be affected by the epidemic started elsewhere. He reasoned that the key for survival depended on self-protection through increased liquidity. That this could be achieved by a countries ensuring that they maintained a high level of liquidity with regards to foreign assets which would enable them be able to withstand huge capital flows. Adding that liquidity could be achieved by reducing short term debts, creating a collateralized credit facility, and increasing foreign exchange reserves of the Central Bank (Feldstein, 1999). However, foreign exchange reserves happened to be the strategy that most developing countries have found attractive but

which also has posed a serious challenge. This challenge was observed by Rodrik (2006) when he noted that good as it may sound the accumulation of foreign reserves has its social costs compared to the cost of foreign borrowing which he estimated to be in the neighbourhood of 1% of GDP of emerging countries and wandered whether this cost could not be mitigated through a reduction in short term liabilities in order to achieve good level of liquidity thereby paying smaller costs through reserve accumulation compared to the cost of foreign borrowing. Thus this shows that the programme of foreign exchange reserves management is dynamic in nature and would require substantial understanding of the rudiments of financial management at the international level.

This sounds more like the portfolio management of a corporate outfit being upgraded to the needs of country since the same objectives that treasury managers in these big companies pursue are almost the same objectives being advocated in the management of the nation's foreign assets. This is because the financial market has become so integrated that risks by both companies and nations appear very similar and requiring the kind of managerial acumen that top flight financial gurus are known for. This makes the study of this problem even more crucial for country that is depended on a single commodity and is in recession like Nigeria.

 Invariably, Foreign Exchange reserves management desirable as it is, has some costs attached to it and thus make it more desirable if the economy is in recession given that utilization at such periods become even more compelling to ensure a quick return to positive growth. It is in this regard, that this study is aimed at ascertaining the extent to which the government had utilized the opportunity of the recession to ensure an optimal use of the dwindling foreign exchange reserves in Nigeria.

Foreign exchange reserve management

The international Monetary Fund was established ostensibly to ensure a smooth settlement process as well as programmes of remediation through the settlement process as to make international trade relations more cordial. According to Nugee (2000), Central Banks usually hold reserves for the following reasons, to:

a. ensure that they maintain confidence in their policies for monetary and exchange rate management including the capacity to intervene in support of the national currency;

b. limit external vulnerability by maintaining foreign currency liquidity to absorb shocks during times of crisis or when access to borrowing is curtailed and in doing so;

c. provide a level of confidence to markets that a country can meet its external obligations;

d. demonstrate the backing of domestic currency by external assets;

e. assist the government in meeting its foreign exchange needs and external debt obligations; and

f. Maintain a reserve for national disasters or emergencies.

Nugee (2000) further asserts that sound reserve management practices are important because they can increase a country's or region's overall resilience to shocks. Through their interaction with financial markets, reserve managers gain access to valuable information that keeps policy makers informed of market developments and views on potential threats. The importance of sound practices has also been highlighted by experiences where weak or risky reserve management practices have restricted the ability of the authorities to respond effectively to financial crises, which may have accentuated the severity of these crises. Moreover, weak or risky reserve management practices can also have significant financial and reputational costs. Several countries, for example, have incurred large losses that have had direct, or indirect, fiscal consequences. Nugee also argued that sound reserve management policies and practices can support, but not substitute for, sound macroeconomic management. Moreover, inappropriate economic policies (fiscal and monetary) can pose serious risks to the ability to manage reserves due to the fact that the process is not static but dynamic. Moreover, there are several policy issues that can affect the state of the dynamism especially with regards to monetary policy. The extent to which the monetary authorities are able to comprehend and thus put in place measures that ensure smooth running of the process will determine the success of the dynamic exchange reserve management mechanism or otherwise the creation of serious economic problems that will have serious consequences for the economy. For instance,

where the monetary authorities are supposed to operate an expansionary monetary policy so as to enable producers import vital raw materials for production that would bring the economy out of the recession, but instead embark upon a restrictive policy that squeezes the productive sector thereby leading to further reduction in the productive capacity of the economy, would worsen the recessionary process. However, such tendencies tend to present themselves in such a way that policy makers are expected to adopt processes and mechanisms that would ensure a better run economy that allows economic agents to maximise the gains of their activities. It is this dynamism that makes the process of foreign exchange management very easily susceptible to wrong interpretation which calls for purposeful research into this area of economic management on a regular basis.

Reserve management should seek to ensure that: (i) adequate foreign exchange reserves are available for meeting a defined range of objectives; (ii) liquidity, market, and credit risks are controlled in a prudent manner; and (iii) subject to liquidity and other risk constraints, reasonable earnings are generated over the medium to long term on the funds invested (Nugee, 2000).

In Nigeria, this process has become very necessary considering the dependent nature of the economy on imports and its consequences on unemployment, inflation, unfavourable balance of payment problem, growth and development. Thus, it becomes imperative that an empirical analysis of this phenomenon be carried out to enable the authorities comprehend the dynamics of the exchange reserve market and how to efficient utilised for the growth and development of the country.

Essentially, this paper will review the determinants of the components of Nigeria's foreign exchange reserves, the dynamics of its accretion and disbursement and how all these are affected by the regimes of monetary policy in Nigeria.

Imports Trends and the need for Foreign Exchange Reserves Management

Aliyu (2007) had shown that since the advent of crude petroleum into the international trade matrix of Nigeria, it had accounted for between 20 and 25 per cent of the country's total GDP, 90 per cent of foreign exchange earnings and up to 70 per cent of budgetary revenue (Iyoha 1996). It had also been

shown by Aliyu (2001) that non-oil exports continued on a downward decline in significance since crude oil debut into the trade scene such that it reached a mere 17 per cent of total exports in 1992 from 97.3 per cent in 1960. Invariably, crude oil exports have become the dominant source of foreign exchange reserves for the nation. The flip side of the coin showed that the Nigerian economy is highly import dependent for all kinds of goods ranging from capital goods, intermediate goods, raw materials and even food items.

This had prompted a number of empirical studies on the nature and influence of certain variables on imports and exports in Nigeria. For instance, Aliyu (2001), based on a three disaggregated import demand models for the Nigerian economy between 1970 and 1998, showed the influence of real income, real exchange rate level of foreign reserves, imports capacity and taste have varying degrees of influence on imports. Indeed, the obtained that results that showed that these variables depicted inelastic demand behaviour with regards to imports.

On the exports demand model, Iyoha (1995) reported that crude oil exports had a powerful influence on foreign trade and economic growth. Similarly, Yekini (1999) showed that exchange rate, lending rate, gross domestic product and capacity to Import were good determinants of imports and exports demand in the Nigerian economy. Again the inelastic nature of import demand was shown to be pervasive with regards to all segments of imports ranging from raw materials, capital goods and to consumer goods. The exogenous nature of the crude oil and primary raw materials market which largely characterised the domestic export basket also meant that the domestic economy had little or no control over the export market.

Given that the Nigerian economy is highly import dependent the process of deregulation coupled with an appreciable degree of openness during the Structural Adjustment Programme (SAP) era made the economy vulnerable to international trade shocks and the widening of the size of disequilibrium in balance of payments (BOP). Egwaikhide (1999) showed that between 1953 and 1989, imports as proportion of GDP did not fall below 10 per cent except for 1974 and 1986. On the degree of openness, Aliyu (2001) reported that the measure of openness was 40 per cent in 1989, 64.8 per cent in 1992, and 86.9 per cent in 1995 and then fell to 73.6 per cent in 1997. The study further showed that for ten years, that is, from 1989-1998, except for 1993, 1995 and

1998 the BOP balance was consistently in deficit. The trend was not very

different between 1999 and 2016 except that due to rising price of crude oil within the review period, Nigeria recorded positive BOP until it entered recession. From the table below, balance of Trade in Nigeria averaged 194863.11 NGN Millions from 1981 until 2017, reaching an all-time high of 2177553.08 NGN Millions in October of 2011 and a record low of -592200.72 NGN Millions in March of 2011.

Table 1: Nigerian Trade and Other Accounts Balance 2014-2017(January)

Nigeria Trade	Last	Previou	Highest	Lowest	Unit
Balance of Trade	14175612	2230868	217755308	-59220072	NGN Millions
Exports	92904962	9814811	264888176	322.93	NGN Millions
Imports	78729350	7583943	155473290	167.88	NGN Millions
Current Account	3248.86	-48.89	9455.37	-5695.2	USD Million
Current Account to	-1.80	-3.10	32.80	-18.70	per cent
Terms of Trade	100.23	102.71	160.25	49.48	Index
Foreign Direct Investment	1269.22	1386.21	3084.90	501.83	USD Million
Capital Flows	-1277.50	-5821.99	20302.97	-15439.5	USD Million
Gold Reserves	21.37	21.37	21.37	21.37	Tonnes
Crude Oil	1640.00	1404.00	2475.00	675.00	BBL/D/1K
Terrorism Index	9.31	9.21	9.31	3.86	
External Debt	13807.9	11406.8	13807.59	3627.50	USD Million

Source: TradingEconomics.com and National Bureau of Statistics, Nigeria 2014 to January 2017.

Thus the size of the openness of the economy and the pattern of disequilibrium in BOT explained how this disequilibrium in the external sector was transmitted promptly and widely to the rest of the economy. Again as a way of response, government resorted to the usual curtailment of imports by announcing the ban on some 41 items from the import list while allowing the domestic currency to freely float to unprecedented levels; it reached N500 to the US$ in the month of Februarys 2017 and demand for foreign exchange was still very strong.

Trend in Foreign Exchange Reserves and Monetary Policy Stance in Recessionary Period in Nigeria: The Outcome

The monetary policy regime during recession will often be determined by the nature of the recession and ostensibly what caused it. In the case of Nigeria, the recession was caused by a number of factors and the main factors being the misalignment of fiscal policy exemplified by the misallocation of resources, government's insensitivity to the economic situation by resorting to fiscal measures that encouraged capital flight as well as the non-responsiveness of monetary authorities to the situation as and when required due to political pressures (Sanusi, 2016). The huge fiscal expenditures in the previous years were largely due to the political process, led to huge internal liquidity. Following this, there was the collapse of crude oil prices in the international market and the incessant disruption of crude oil production domestically. This led to low exports as well as reduced foreign exchange earnings as depicted by the falling external reserves which fell from over US$45billion in 2014 to as low as US$23billion in October 2016 (as shown in the graph below) when the economy was already in recession. Suppressed demand through restrictions allowed the reserves to commence a build-up which subsequently received a boost following government interventions in the Niger Delta area which allowed crude oil production and exports to resume as well as the gradual return of international crude oil prices to higher figures.

NIGERIA FOREIGN EXCHANGE RESERVES

SOURCE: TRADINGECONOMICS.COM | CENTRAL BANK OF NIGERIA

Furthermore, when the government got its their bearings right and commenced the process of fiscal intervention through active expenditures on infrastructure by the release of capital budgets up to N1trillion (Adeosun, 2017) the economy began to record positive results as the trend of negative growth was reversed. In addition, further interventions in terms of monetary policy reviews as well as foreign exchange releases to the critical areas of demand while highlighting the 41 materials that will not be financed by the Central Bank, further enhanced the foreign reserves situation as the pressure began to abate. The policy targeted both industry and retail side of the market by operating two windows. Industries were taken care of through Class "A" (banks and non-bank public) while individuals were taken care of through Class "B" being sales to the Bureau de Change (BDCs). The crux of the new policy can be summarised as follows:

There was the supply of FOREX to end users on a sustained basis such that forward sales tenor for the banks was reduced from the previous maximum 180 days to no more than 60 days from the date of transaction which raised the level of certainty of transaction and relaxed the market. While all retail transactions were being settled at a rate not exceeding 20 % above the prevailing interbank market rate thereby making the official market a lot more competitive with the parallel market. This was further strengthened by the removal of the rule on previous allocation and utilisation rules on commercial banks (Udo, 2017). These interventionist stands was followed up with tight monetary policy as more liquidity was mopped up through treasury bills sales thereby creating the right balance between demand and available supply.

Komolafe, (2017), reported that since the CBN commenced active interventions from Tuesday 21, February 2017 up to May 1, 2017 the CBN had injected over $4.6billion translating to an average of $202million for each intervention. This was besides dollar sales to the real sector which has resulted in a much stable foreign exchange market. Indeed, the CBN through this process had shown a better commitment to managing the reserves of the nation by ensuring a more purposeful distribution of the scarce foreign exchange reserves with emphasis to the manufacturing sector.

The overall impact was that through the depreciation in the value of the domestic currency in the face of the right monetary instruments of interventions, domestic exports have begun to rise while imports have been curtailed as reported in table 1, above as exports grew from N929billion to N981billion and imports fell from N787billion to N758billion between 2014 and 2017. In addition, crude oil production and exports have also begun to rise with international prices also stabilising at above budget figures. All these developments point to the stability and appreciation in the value of the domestic currency which hovers around N365 to the US$. The dynamism of the foreign exchange reserves management has also showed up in the improved reserves situation as depicted in the graph above where in it has risen to over US$30billion in the month of April 2017.

Conclusion and Policy Recommendations

The review above presents a success story which is quite below the optimum result that should have been obtained if a conscious programme of foreign exchange management had been in place and not crafted when the situation became almost unmanageable. A proactive programme that is based on careful review of the demand pattern in the foreign trade segment of the Nigerian economy would have provided enough information that would have enabled the monetary authority's strategizing ahead of the unfolding demand scenarios. However, given the cheap source of foreign exchange through crude oil sales, there was laxity in planning ahead. This resulted into the panic measures adopted early 2017 following persistent fall in the value of the domestic currency and the attendant inflationary trend which also sparked social discontent; before any form of intervention could be quickly crafted out. This study recommends that the idea of careful management of the nation's foreign exchange should feature as a permanent item in the macroeconomic

management matrix of the country such that the allocation of scarce foreign exchange should be done as a matter of policy not happenstance.

In conclusion, it has become apparent that Nigeria had no carefully thought out policy embedded in the macroeconomic management programme of the country that could stem the tide of accelerated depreciation in the value of the domestic currency in a recessionary economy and that the policy crafted during the current period of recession has started yielding positive results that should be sustained.

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