# PURSUIT OF THE LINK BETWEEN NIGERIA-CHINA CURRENCY SWAP STRATEGY AND THE GROWTH PATH OF TRADE BALANCE IN NIGERIA

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**Abstract**
*This work investigates the dynamics surrounding the probable nexus of the Nigeria-China currency swap policy and the growth path of the Nigerian's trade balance between China as well as other major trading partners to include Germany, United Kingdom (UK), Italy, France, Japan, United States of America (USA), Economic Community of West Africa States (ECOWAS) and Africa. The work in the adoption of the LN-LOG modeling technique found out that the currency swap strategy between Nigeria and China had led to marginal improvement in the growth path of trade balance between them but skewed against Nigeria. This strategy further led to a decimation of the positive trade gap balance earlier recorded between Nigeria and her other major trading partners. The implication is that the Nigeria economy is becoming more dependent on China as such is awash with cheap Chinese products. The study recommended that the government should see the currency swap policy as a short-term measure that can temporarily reduce deficit trade balances in an effort to garner and channel foreign reserves into areas that will enable diversification of the economy for long term gains.*

**Keywords:** Currency Swap, Trade Balance, Growth Path.

## INTRODUCTION

The paucity of foreign exchange reserves, negative economic growth rate and pressure on the naira, which effortlessly have caused a free fall of the Nigerian currency as such leading to the spiral increase in domestic prices is the narrative noticed with the Nigerian economy. Commentators on this issue such as Ibikunle and Isaac(2011); Andohol(2013); Enebeli-Uzor(2013) have alluded to the fact that the Nigerian economy, which is mono-cultural in nature due to its dependence on oil, is intricately connected to the international vagaries of volatility in oil prices. It is worthy to note that the Nigerian monetary authorities, having hindsight of the negative spill over effects, from

the overdependence of the country on oil, had started a China-Nigeria currency-swap policy in 2011 to serve as a trade balance buffer to assist equilibrate the economy, whenever a shock does occur in international oil prices.

The 2016 Report of the Nigeria Export –Import Bank asserts that the currency swap deal consist of an agreement between two central banks, at least one of which must be an international currency issuer, to swap their currencies. The Central banks party to the swap transaction can lend the proceeds of the swap, against collaterals they deem adequate, to the commercial banks within their jurisdiction, so as to provide them with temporary liquidity in foreign currency. In the same vein the Report discusses a trade balance as the gap between export and import in international trade transactions.

A currency swap is primarily the exchange of domestic currency by trading partners at a predetermined rate conceived by the forces of demand and supply for trade, which minimizes the usage of an intermediary currency especially the dollar. Its merits which is primarily couched within short-term basis has Buraimoh(2016), Olatujoye(2016) and Adamu(2016) observing that the swap enables the elimination of challenges associated with transactions with the dollar; promote business flexibility and has the capacity of increasing investment into the country from China. In other words, the Currency Swap deal has the capacity to stabilize the international market but also facilitate bilateral trade and investment in a structurally conducive economic environment.

However, other commentators such as Chukwu(2016), Chima(2016) have pointed out the major drawback of the currency swap deal to be the unrestricted access to Yuan, at an overvalued naira exchange rate, which has the capacity to encourage importation as such stifling local production.

Towards this connection, in an effort to reconcile these conflicting viewpoints, the question to ask is to what extent has the Nigeria-China Currency Swap strategy assisted in restructuring Nigeria's trade balance between China as well as the country's other major trading partners. In other words, this thesis seeks to give an empirical dimension of an appraisal of the Nigeria-China currency swap policy and the extent which this policy is instructive in restructuring trade interactions with China as well as providing spillover insight to the dynamics of the growth path of some selected major trading

partners of Nigeria.

**Review of Related Literature**

The theoretical perspective of this work is anchored on the Classical economist perspective of the existence of the laissez-faire economy where the forces of demand and supply act as automatic equilibrators of the market system. In other words, given the foreign exchange (FOREX) market, money will flow to wherever it can get the highest return with the least risk. An economy with a wide variety of competitive goods and relative stability in prices will see its currency in more demand than the economy that is in political turmoil, high inflation and few marketable exports. (Brown 2016). This presuppose that in the long run exchange rates prices would reach an optimal level that will necessitate the adoption of other forms of foreign exchange transactions for net exports other than the spot foreign exchange transaction (this entails the agreement by two parties to trade currencies at the existing rate); forward transaction( this entails the exchange of FOREX, using current rates for an agreed future date regardless of what the market rates are then); futures( a variant of forward transaction knitted as a standard contract size set up with separate exchange rate for that purpose with a maturity date); Swap(another variant of forward transaction that entails two parties exchanging currencies for a certain length of time to reverse the transaction at a later date); Options(addresses the inflexibility of forward transactions as the owner has the right to buy or sell the FOREX at any specified time before the expiration of the maturity date).

Bartolini (2002) on his views regarding Foreign Exchange Swaps as an interventionist tool for liquidity control and enhanced trade highlighted that in a survey of 7 out of the 14 industrial countries. The study found out that 5(Austria, Belgium, Germany, Italy and Netherlands) discontinued foreign exchange operations when they became part of European Monetary Union. Of the remaining two Australia and Switzerland, only the latter had used foreign exchange swaps extensively. The reason adduced for why Foreign Exchange (FX) Swaps have not been particularly popular as tools for monetary control is that FX transactions normally are settled on the second business day following the trade. In other words, the transfer of liabilities between Central banks may be in different time zones as such causing a delivery lag which makes ill-suited for swift action. In addition the scarcity of banks endowed with foreign currency on one hand to act as counterparties has also affected adversely the diffusion of FX swaps as instruments for liquidity control.

In this connection, Kuti(2011) while writing on the role currency swaps play in the domestic banking system especially during the global financial crisis for Hungary, employed trend analysis to observe a direct effect of the financial crisis on the domestic foreign exchange swap market. This led to foreign currency liquidity becoming more expensive, the limits of market participants contracted, turnover became extremely volatile and the maturity of transactions shortened significantly. The study concluded that the decline of exposure to swap market turmoil and risks to financial stability was by domestic subsidiary banks ability to increase maturity of transactions concluded with parent banks primarily through cross-currency swap transactions with intra-group counterparties, as well as non-group counterparties concluding transactions with longer maturity with domestic banks.

Ho, Stapleton and Subrahmanyam (2000) in their study on the risk of a currency swap between Germany Dutch Mark and the Japanese Yen between 1995 to 1998, while using the binomial methodology found that the value of a currency swap on a future date depends on a number of variables which include interest rates in the two currencies and the foreign exchange rate.

On the other hand, Anella and Wooldridge (2007) in highlighting the motivations for swap-covered foreign currency borrowing for a panel 26 countries currency during the period 1995 t0 2007 recognized that sound macroeconomic policies is a necessary condition for countries to borrow in their own currency. The study further revealed that issues surrounding price stability, fiscal prudence and transparency in exchange rate regime impeded swap covered foreign currency borrowing for some of the countries as such suggestive of the presence of certain microeconomic constraints like domestic capital market development.

Furtherance to this discourse, lin, wenjie, and cheung(2016) in their working paper on china's bilateral currency swap lines, employing the Heckman two-stage framework established economic factors, political considerations, and institutional characteristics including trade intensity, economic size, strategic partnership, free trade agreement, corruption and stability affect the decision of signing a swap line agreement.

Analysing via Historical analysis on Central Banks Currency Swaps (CBCS) and the international Monetary system for a group of economies to avail the rationale for Currency Swaps agreements, Destais(2014) noticed that the US

Federal Reserve Swaps aim at shielding the US economy from financial instability that might result from the international use of the US dollar while the Peoples Bank of China Swaps are designed to foster Internationalization of the Renminbi. Despite the acknowledgement that a smoothly integrated currency swap within a coherent international monetary system will likely lead to a deadlock, they recommend that the G20 should promote a more transparent use of CBCS

Amatatsu and Baba(2007) observations on price discovery from cross-currency and FX Swaps between Japan Yen and USA dollar using structural analysis that the currency swap market plays a much more dominant role in price discovery, which is seen by Lehmann(2002) as the efficient and timely incorporation of information implicit in investor trading into market prices ) than the FX swap market. In essence the Forex (Foreign Exchange) swap prices tend to under-react to the efficient price changes, while the cross-currency swap prices almost exactly react to them.

Writing on Currency swaps as a hedging technique for an international real estate investment in USA, using the Monte Carlo simulation, Worzala and Lizieri(1997) showed that currency swap has some potential for protecting the investor from adverse currency fluctuations if an international real estate investment is made. This suggests that diversification strategies in international property investment have become more effective as opposed to previous research in this regards.

However, Berrgijot and Li (2010) work averred their opinions on the implications for financial and economic stability using FX(Foreign Exchange) swaps as a source of funding as well as a hedging tool in times of market stress or crisis given the 2008 global financial turbulence opinionated that the use of Forex swaps for funding and hedging purposes is not infallible especially during periods of market stress.

In a survey of 441 non-financial firms in United Kingdom, using logistic regression to find out how firms hedge foreign currency exposure, Amit and Ephraim (2004) in their preliminary draft paper found that firms prefer to use foreign currency debt rather than foreign currency derivatives to hedge foreign currency exposure arising from foreign assets located in foreign locations. Conversely, the evidence shows that firms engaged in exporting prefer the use of foreign currency forwards and or options to the use of

foreign currency debt. The study also found that issuing foreign debt is not a substitute

strategy for firms that swap foreign debt into domestic debt; however, it is for firms that swap into foreign debt. The study concluded that foreign debt is not an effective substitute for currency swaps for highly geared or small firms.

**China Currency Swap Deals.**

China been the second largest economy that is well managed, has been allocated 12% Special Drawing Rights(SDR) by International Monetary Fund(IMF) as such making the YUAN or Renminbi (China's domestic currency) to become a foreign reserve currency or a global convertible currency. This has given China leverage in international trade and economics as such ignoring China will be at one's Peril. This argument is reinforced by the several Currency Swap agreements between China and 31 other countries presented on table 1, which has authenticated China's increasing dominance in world trade transactions.

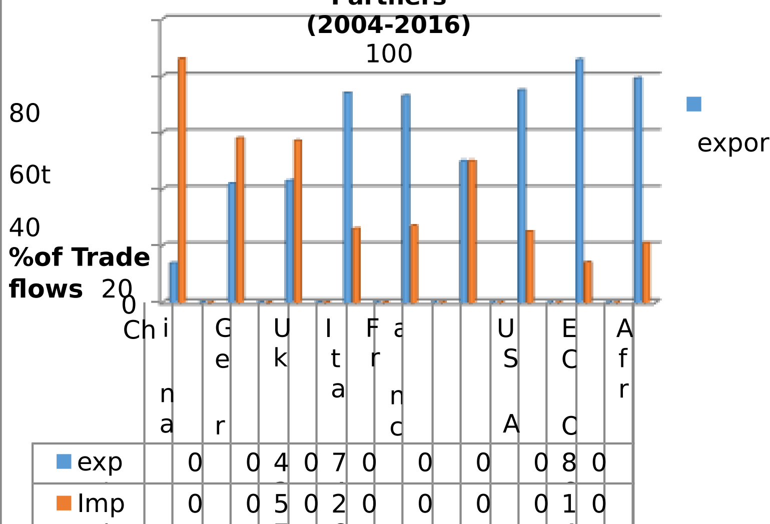
Table 1 has further revealed an aggregated Currency SWAP deal of RMB 3,137.2billion given a total trade volume of RMB10, 747.2 billion with the 31 countries that China carried out the Swap deals. However, it should be noted that the volatility in Foreign exchange rate as captured by the 2016 Brown consultancy Reports allude to the fact that rates respond directly to both tangible and psychological determinants to include business cycles, balance of payments statistics, political developments, new taxes, stock market news, inflationary expectations, international investment patterns and Central Bank policies. These determinants are basically the rationale governing the appreciation and depreciation of domestic currencies in relation to their trading partners as such causing the relative prices of net exports and the subsequent balance of trade and payments disequilibrium. This argument presupposes the increasing adoption of currency swap policy by China with other countries as presented on table 1, which Nigeria is a late comer, given its recent Swap deal proposal in June 2016 with China of RMB50billion,that is about N1.98trillion($10billion) but with a likely outcome of RMB20billion, about N797billion to N990billion($4 to $5billion)

**China-Nigeria Currency Swap and the Trade Implication**

The Swap mandate is to primarily encourage exports to China so as to reduce the trade imbalance between Nigeria and China that is skewed to China's favour. A fact attested by Proshare(2017) that the Swap deal will eliminate challenges arising from transactions with the US dollar and promote business

flexibility between Nigeria and China. A cursory look at Fig 1 and table 2 has shown that out of the total average trade volume of N1.2trilion between 2004 to 2016 there was trade imbalance skewed in favour of China with her imports from Nigeria averaging a paltry N198.5billion (14% of total trade volume of the period), while China's exports to Nigeria stands at N998.8billion representing a whopping 86% of the average trade volume within the stated period.

**Fig1:Trade flows between Nigeria and its Major Trading Partners (2004-2016)**




**Country/Region**
**Source: Author's Compilation**

Further observations from table 2 and Fig 1 have reported that the overall mean effects within 2004 to 2016 has shown that despite deficit trade imbalances existing between Nigeria, Germany and then United Kingdom, the extent of the imbalance is greater in trade transactions with China. This fact is acknowledged by Fawehinmi(2016) who stated that the trade imbalance between Nigeria and China is significant, as Nigeria is a major export market for China absorbing $14.9billion worth of Chinese goods in 2015. Within the same period China also buys some Nigerian crude of about $2.4billion and probably half the figure as at 2016. In addition, it is also

noticed from these

mean statistics that in other climes such as Italy, France, USA, ECOWAS and Africa there is surplus trade balances in favour of Nigeria, while in Japan it is even.

In furtherance to the analytical framework on the Statistical trend in table 2, it is also deduced that the Swap deal cannot completely mitigate the problem of inflation. This is because aside the scarcity of foreign exchange been one of the determinant of spike in consumer prices, there are other major cost push factors as articulated by lin, wenjie, and cheung(2016). The implication associated to this means the inability of the Currency Swap to change exchange rate transactions and composition in the purchases made from other countries, which is in dollar as this will have a neutrality effect on the economy as regards the payments made therein to these countries.

Despite the fact that bilateral trade between Nigeria and China has increased substantially in the last decade, showing increasing trade volume of about $2.8billion in 2005 to $14.9billion in 2015, leading to instantaneous and compounded trade balance growth rate improvements from -0.31 to -0.2 (for 2004 to 2010) and -26.66 to -18.13 (for 2011 to 2016) respectively as articulated on table 3, it can be deduced that the Currency Swap deal will concentrate trade in the hands of China, leading to the reduction in Nigeria's dollar income, since China will use the Yuan to buy Nigeria's crude oil, which she might sell later at higher dollar rates to other countries. Furtherance to observations presented on table 3 as regards to the other major trading partners, it is deduced that there is the reduction of imports of Nigerian goods from her other major trading partners except for Japan as reported by the reducing instantaneous and compounded growth rate of the trade balances between the period 2004 to 2010 and 2011 to 2016, this is expected to decimate the foreign reserve of the Nigerian economy.

**Conclusion/Recommendation**

Summarily, the crux of the matter is to ascertain the growth path of Nigerian's trade balance with China after her adoption of the Currency Swap policy as a development trade strategy in 2011, in an effort to de-dollarized the economy, enhance trade and economic growth, as well as the accompanying spill-over trade implications with the other major trading partners of Nigeria. It is acknowledged from the results that there are improvements in the growth pattern of the trade balances between Nigeria and China in favour of Nigeria, even though the overall trade balances is skewed against Nigeria. The

ancillary spill over implications for the other major trading partners for Nigeria have reported majorly negative growth patterns, signifying deficits in trade balances with these countries, which has enormous negative implication on Nigeria's foreign reserve. In this connection, it is recommended that the government should see the currency swap policy as a short-term measure that can temporarily reduce deficit trade balances in an effort to garner and channel foreign reserves into areas that will enable diversification of the economy for long term gains. In essence once there are prolonged structural economic defects that hinder economic diversification then the marginal gains recorded from currency swap deals will decimate.

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