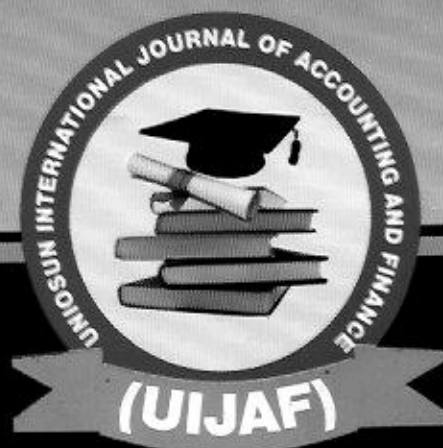




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EXCHANGE RATE MANAGEMENT IN NIGERIA: A STUDY OF THE DUTCH AUCTION SYSTEM

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Abstract

The quest for a stable and realistic exchange rate for the Naira with a view to achieving the overall macroeconomic stability has led to series of reforms in the Nigerian foreign exchange market. This paper examines the contribution of one of such reforms, the adoption of the Dutch Auction System (DAS) towards the achievement of the stated macroeconomic objectives. This was achieved by comparing the stability of the exchange rates in the Nigeria foreign exchange market over a period of twenty-four years split into two equal halves; one half representing the period prior to the adoption of DAS and the other half post the adoption of the DAS. Wilcoxon signed rank test was employed as the statistical tool for testing the null hypothesis at 5% level of significance. The result of the test shows that there is a significant difference in the pre and post DAS exchange rate stability. The study concludes that the adoption of DAS has significant influence on the stability of exchange rate in Nigeria.

Keywords: Balance of Payment, Exchange Rate, Dutch Auction System, Foreign Exchange Market

1. Introduction

Nigeria, as a developing country, shortly after independence in 1960 has been going through series of reforms in the management of her foreign exchange market. These reforms are tailored towards a realistic exchange rate for Naira with the ultimate aim of achieving domestic macroeconomic stability. A realistic exchange rate is a stable rate at which a country's currency is neither overvalued nor undervalued relative to foreign currencies. According to Aliyu (2011), both overvaluation and undervaluation are not desirable if the country is to attain long run real exchange stability as well as the general macroeconomic stability. The foreign exchange market was at inception operating in regulated environment. That is, the exchange

rate was at that time fixed against the pound sterling at one time and US dollar at another period. These periods spanned between 1970 and 1985 (Auwal & Hamzat, 2009) and it is referred to as the fixed exchange regime. During the fixed exchange era, the naira exchange rate fixed against the US dollar was N0.71/US\$ on annual average between 1960 and 1970. The naira exchange rate remained in the range of N0.61/US\$ and N0.89/US\$ from 1971 to 1985. This indicates that value of naira was high against the USD during the fixed exchange regime; although there was a claim of overvaluation of naira exchange rate (Aliyu, 2011). In 1986, the market shifted to the flexible rate system as part of the Structural Adjustment Programme (SAP) which was introduced in July 1986.

"The main objectives of exchange rate policy adopted under the Structural Adjustment Programme (SAP) were to preserve the value of the domestic currency, maintain a favourable external reserves position and ensure external balance without compromising the need for internal balance and the overall goal of macroeconomic stability" (Omojimite & Akpokodje 2010:55). The SAP objectives regarding the foreign exchange cannot be said to be fully realised. This is because even though there was a breath of stability in the market, the naira exchange rate has, until recent years, depreciated on a steady trend. In 1986, the market determined exchange rate was N2.02/US\$ and the rate has increased by 75% by the end of year 1990; showing the declining trend of the naira exchange. By the year 1994, the exchange rate on annual average has moved to N21.89/US\$ (CBN, 2010). Undervaluation of exchange rate was also reported during the flexible rate regime as Aliyu (2011) posited that the naira was undervalued even after the implementation of SAP.

Following the shift to the flexible exchange rate regime in 1986, Nigeria has introduced two different auction systems to her naira exchange rate determination which aimed at finding a stable exchange of naira to Dollar. These are the Retail Dutch Auction System (RDAS) introduced in the year 2002, the Wholesale Dutch Auction System (WDAS) which replaced the RDAS in 2006 and the reintroduction of the RDAS in September 2009.

In its efforts towards the reform of the country's rate market, the Central Bank of Nigeria (CBN) has over the years pursued different policies for the stabilization of naira exchange. In 1995, the Autonomous Foreign Exchange Market (AFEM) was introduced and later followed by the Interbank Foreign Exchange Market (IFEM) on October 1999 (Oyediran & Afieroho 2012). In July 22 2002, the Dutch Auction System was introduced to replace the IFEM. This was reported to have contributed to the relative stability of naira vis-a-vis the US dollar (Sanusi, 2004). The DAS was meant to achieve three purposes: reducing the parallel market premium, conserve the dwindling external reserves and the realisation of realistic exchange rate for the Naira. The system according to Akpan and Attan (2012) has helped to some extent in

the achievement of the purposes for which it was adopted particularly the stabilization of Naira and it was even pointed out that the foreign exchange market has been relatively stabilized since 2003 (Akpan & Attan, 2012)

Several studies have been carried out on the foreign exchange reforms in Nigeria and their contributions towards economic stability. Obadan (2006) posits that the notable appreciation and stability of exchange rate that started stability in the Nigerian economy since the year 2005 were not unconnected with the foreign exchange market reforms entailing the wholesale Dutch Auction System. The wholesale DAS was said to have contributed to the stability of the Nigerian Naira in the foreign exchange market. Despite the numerous foreign exchange market reforms, strategies and exchange rate determination, empirical literature concerning detailed assessment of DAS still remain sparse particularly in Nigeria. More so, the study takes the advantage of availability of recent data to extend the scope covered by previous researchers.

This study therefore seeks to assess the Dutch Auction System as an exchange rate determination method with the objectives of determining the performance of the foreign exchange market in terms of exchange rate stability in the pre and post DAS implementation periods. To achieve this, the following hypothesis was formulated:

Ho: There is no significance difference between the pre and post DAS exchange rate stability in Nigeria

The remaining parts of this work review the relevant past literature, present the methodology for the study, analyse the results and discuss findings and draw conclusion based on the findings.

2. Literature Review

2.1 Conceptual Framework

2.1.1 Foreign Exchange Market

For effective functioning of the international commodity market (International trade), there is a need for an efficient and a stable foreign exchange market where currencies of different countries involved in international trade with the local/domestic country(trading nation) could be obtained at a relatively stable rate of exchange. A Foreign Exchange Market according to Jhingan (2011) is the market in which different currencies are bought and sold for one another and the national currencies of the trading nations are the stock-in trade. Ilesanmi (2000) defined a foreign exchange market as that market for the sale and purchase of foreign currencies. Ishola (2011) stated that foreign exchange market is a place where the buying and selling of foreign currencies takes place and that the purpose of doing so is to transfer funds from one nation to another. It should be noted however that, a

foreign exchange market is not a physical place like the floor of the Nigerian Stock exchange but a network of internet/telephone connections among banks and dealers in the world economies. In fact, foreign exchange market remains the largest market to be found around the world which functions in every country (Jhingan, 2011).

In Nigeria, like other open economies, foreign exchange market plays significant roles in stabilizing the domestic economy and achieving balance of payment equilibrium. This is because international transactions form a major part of economic activity, and therefore call for a foreign exchange market (Lawal & AbdulKadir, 2010). Thus, the market functions in direct proportion to the volume of international trade. Based on this, it is obvious that the market serves the international business activities and needs of various economic units (governments, firms or households).

The Federal Government through the Central Bank of Nigeria intervenes in the market from time to time in order to smooth out the fluctuations in the exchange rate so as to stabilize the market and general economic condition. This is because the government is fully aware of the role of the market in the economy. The financial sector especially the Banking sub-sector is greatly affected by the activities in the foreign exchange market primarily due to the significant role it plays in financial intermediation (Ani, Ugwunta & Okanya, 2013). Furthermore, firms during transactions will always have to settle their import transactions, payment of interest on foreign loans, conversion of export receipts and hedging of receivables and payables. These will no doubt pass through the foreign exchange market as the medium of interaction between sellers and buyers of foreign exchange (Ani, Ugwunta & Okanya, 2013).

From the foregoing, the functions of the foreign exchange market include; transfer of funds denominated in one country's currency to another, provision of short-term credit to finance trade between countries through various instruments and reduction of foreign exchange risk (Jhingan, 2011). The market occupies a central position in any economy and as such its management cannot be over emphasised. In Nigeria, particularly since the independence, there have been two regimes of exchange rate management in the effort to strengthen the market and stabilise the exchange rate for naira. These are fixed and flexible rate regimes.

2.1.2 Exchange Rate Regimes and Reforms in Nigeria

A fixed exchange rate is a system in which all exchange transactions take place at exchange rates determined by the monetary authority. The authority may fix the exchange rate by legislation or intervention in the currency market (Jhingan, 2011). Flexible or floating rate on the other hand, is an exchange rate regime under which rates are determined by the forces of demand and supply with little or no

intervention from the government. Both the systems had been adopted in Nigeria. The exchange rate system in Nigeria evolved in stages. It started as fixed when the Naira was tied to the British pound. This was suspended following the devaluation of the pound and with the emergence of a stronger US dollar; the Naira was then tied to US Dollar. The country reverted back to a fixed parity with the British pound in the year 1973 (Eze&Okpala, 2014). Nigeria transited from fixed exchange rate regime of 1960s to floating system in 1986 following the adoption of Structural Adjustment Programme (SAP). According to Sanusi (2004) the fixed rate regime caused the naira to be overvalued and was supported by such control regulations that distort the economy. These and many other problems informed the adoption of a more flexible (floating rate regime) exchange rate regime in the context of SAP in 1986 (Sanusi, 2004). The mechanism put in place in 1986 was to allow the foreign exchange to be allocated based on market forces (Lawal & Abdulkadir, 2010). According to Fapetu and Oloyede (2014), fixed system was in operation in Nigeria between 1960 and 1986 and because of the inability of the exchange rate system to achieve the policy objectives, flexible rate system was adopted between the year 1986 and 1993. Different flexible or floating systems have been adopted in the Nigerian exchange market. These include free float, adjustable peg, managed or dirty float and so on (Bakare & Olubokun, 2011). In its effort to reform the exchange rate management for the achievement of a stable exchange rate in the country, the CBN, over the years, has introduced a variety of policy reforms.

In the years between 1986 and 1994, the country adopted the second-tier foreign exchange market (SFEM). SFEM which started as a dual exchange rate system produced the official first-tier exchange rate and the SFEM or market determined exchange rate (Aliyu, 2011). According to Ngerebo-a and Ibe (2013) the rationale for this was to avoid a deliberate uniform and sizeable depreciation of the naira but to allow it to depreciate in the SFEM as the monetary authorities saddled with the downward adjustment of first-tier rate until the two rates converge to produce a realistic exchange rate. The introduction of SFEM was to ensure short term stability of exchange rate as well as long term equilibrium position in the country's balance of payment (Eze & Okpala, 2014). Another objective of SFEM was a realistic exchange rate of the naira which was expected to reduce the excess demand for foreign currency to import finished goods and services, as well as stimulate non-oil export earnings (Obadan, 2006). Under the SFEM, both the allocation of foreign exchange and the determination of exchange rate for Naira were carried out by the market forces. According to Ogiogio (1996) no restrictions were put on the functioning of the SFEM and for the purpose of ensuring equity in the foreign exchange allocation, dealers (banks) were initially classified into big banks and small banks such that each successful big bank could purchase a maximum of 10%

and small banks a maximum of 7% of the total foreign exchange allocation. SFEM later metamorphosed into the Foreign Exchange Market (FEM), and later the autonomous foreign exchange market (AFEM) due to the several modifications to the objectives of SFEM (Eze & Okapla, 2014). Obadan (2006) states that AFEM was first adopted in 1987 as part of foreign exchange market (FEM) for private trading in foreign exchange. He states further that the exchange rate then was market determined and that any government intervention through the CBN would only be for the stability of the exchange rate.

In 1995, the AFEM was re-introduced to operate on the basis of market principles in order to achieve a stable exchange rate. The policy was abandoned in 1999 due to its failure to achieve the policy objective and was replaced by the interbank foreign exchange market (IFEM) in 1999. This was meant to diversify the foreign exchange supply in the economy by giving opportunity for the interbank operations (Sanusi, 2004). The IFEM was operated by the CBN as a managed float-market with interbank exchange as the 'focal point' (Akanji, 2006). The IFEM had its own flaws which called for its replacement. IFEM was dropped for various reasons including persistent high demand for foreign exchange, continued depreciation of the Naira, among others (Nigeria High Commission, 2006). In the second half of 2002, the CBN introduced the Dutch Auction System (DAS) to replace the IFEM. DAS was barely in operation for about three and half years, when the CBN introduced the Wholesale Dutch Auction System (WDAS) which has since being in operation (Asaolu, 2011).

2.1.3 The Dutch Auction System

The DAS is a method of exchange rate determination through auction where bidders pay according to their bid rates and where the ruling rate is arrived at with the last bid rate that clears the market (Batini, 2004). In Nigeria, the Dutchauction system was first adopted in April 1987. This system permitted bids to be settled at bid rates which ensure that those unrealistic bids that had nothing to do with actual demand are controlled, and there were as many rates as there were successful bidders (Ogiogio, 1996). One problem of the system however, was the wide divergence of exchange rate indicating distortions in the resources allocation. The system was then dropped but later reincarnated.

DAS was re-introduced in 2002 with the purposes of determining the exchange rate for naira through the market forces, conserving the country's external reserve, reducing premium between official rate and that of the parallel market and/or the bureau de change rates to the barest minimum and most importantly to ensure the stability of the naira exchange rate in the market (Mojekwu, Okpala & Adeleke, 2011). The policy reform of 2002 was on a retail basis, but the policy was

later reviewed in the year 2006 and this led to the introduction of wholesale Dutch Auction System (WDAS). During the retail Dutch auction system (RDAS), clients and other end-users were allowed to bid for foreign exchange through their banks. This is quite different from what is practicable under the WDAS where banks or the authorised dealers bid in their own names and the successful ones then sell to their customers. Mojekwu et al (2011) opined that exchange rate obtained under the new WDAS has stabilised and continued to improve the performance of the foreign exchange market.

In Nigeria, DAS bidding involves the dealers to submit the quantity they want and the price they are willing to pay on each, after which the ranking will be done based on the price quoted by each bidder and the final selling price is determined based on the lowest of the winning bids (Lawal & Abdulkadir, 2010).

2.2 Theoretical Framework

The balance of payment (BOP) theory is employed in this study. According to Ishola (2011), and Jhingan (2011), the theory holds that the exchange rate of a country's currency depends upon its balance of payment. When Nigeria reports a favourable balance of payment, it implies demand for foreign exchange is less than supply at a given exchange rate. This gives a rise in external value of naira in relation to the foreign currency with a resultant rise in exchange rate. Unfavourable balance of payment on the other hand, implies that the demand for foreign exchange is more than its supply, which makes the external value of domestic currency (Naira) to fall, in relation to other currencies in the market. This in turn leads to fall in exchange rate as more quantity of naira will be required to buy a given quantity of foreign currency. The demand for foreign exchange is a derived demand because it arises from the importation of goods and services from another country; the importer will have to make payment through the currency of the exporting country. Supply of foreign exchange arises from the export of goods and services. It is the quantity of foreign exchange to be supplied to the market by foreign importers to obtain the domestic (naira) equivalent. The BOP theory thus implies that the exchange rate is determined by the demand and supply of foreign exchange.

Economic literature has established a sound and stable balance of payment position as a key macroeconomic indicator of economic stability, growth and development of a nation. The BOP theory asserts that achieving a stable balance of payment depends on the existence of a relatively stable market determined exchange rate. This study therefore attempts to provide empirical content to the theory of balance of payment (BOP) by examining the effect of the introduction of the DAS to the Nigerian foreign exchange market in the year 2002.

2.3 Empirical Review

Several works have been carried out on the foreign exchange market and reforms both locally and internationally, though works on DAS still remain scanty in Nigeria. Auwal and Hamzat (2009) studied the exchange rates in Nigeria to know whether they converge or diverge from the long run equilibrium. The study made use of foreign exchange rates and quantity traded during period between 2000 and 2008. The data for the study was obtained from the 2006 CBN statistical bulletin. Auto regressive Distributed Lag (ARDL) model was adopted to explain the long run relationship between exchange rate and quantity of exchange traded. It was concluded that long run relationship exist when DAS is the arrangement for foreign exchange allocation. Bakare (2011) examined the consequences of foreign exchange rate reforms on the performances of private domestic investment in Nigeria from 1978 to 2008, where time series secondary data were collected and analysed. The least square multiple regression method was adopted for the analysis of data. The study suggested that the government should find an alternative to the floating rate system such as adopting the purchasing power parity for the determination of realistic exchange rate for Naira.

In their study of the effect of foreign exchange reforms on financial deepening in Nigeria, Ani, Ugwunta and Okanya (2013) assessed the overall effect of foreign exchange reforms on the financial depth of the Nigeria economy over a twenty- nine year period from 1982 to 2009. Data used for the study were obtained from the CBN statistical bulletin and annual reports of the apex bank. Bank assets to GDP ratio (BA ratio), bank deposits to GDP ratio (BD ratio) and loans and advances to GDP ratio (BL ratio) were used to proxy financial deepening while the test variable that is the foreign exchange reform was taken as the prevailing exchange rate at the each year end. OLS regression was applied to analyse the data. The regression results suggested that the foreign exchange reforms in Nigeria have not yielded the desired positive effect on the depth of the financial sector. Eze and Okpala (2014) studied the impact of exchange rate policies on the Nigerian economic growth. The Chow test was used to determine the structural stability of the relationship between the exchange rate and economic growth proxy of output of goods during both the fixed and floating regimes. The study found that exchange rate is highly significant in the determination of the country's economic growth. This is however inconsistent with a panel study which showed the existence of a strong negative relationship between exchange rate stability and economic growth for 12 countries over a period of 120 years (Eichengreen & Leblang, 2003).

3. Methodology

The study employed secondary data sourced from the CBN's statistical

bulletin of different years. The data collected is the average official exchange rate of Naira vis-avis the US dollar (N/US\$1.00). The study covers a period of twenty-four years spilt in two equal halves; the pre and post introduction of DAS and the exchange rate stability was measured over the two periods.

In testing the formulated hypothesis, the data distribution was subjected to some preliminary tests to determine whether the assumptions of parametric test such as normality and homogeneity of variances are fulfilled. Kolmogorov-Smirnov and Shapiro-Wilk test were employed for the normality while the Levene's test was carried out to determine the possibility of equal variance. Although the data set satisfied the assumption of normality with Kolmogorov-Smirnov, Shapiro-Wilk reports a non-normality of the data. As a result of the conflicting outcome of Kolmogorov and Shapiro-wilk test of normality, the study could not conclude that the data was normally distributed. More so, there was no clear evidence of constant variance. Since some of the assumptions of parametric statistics were not adequately satisfied, the study opted for a non parametric test. Wilcoxon sign rank test was consequently applied. All the data analyses were carried out using the Statistical Package for Social Sciences (SPSS).

4. Results and Discussion of findings

Kolmogorov-Smirnov and Shapiro-Wilk tests of normality were carried out, but both reported different results as regards the normality of the distribution. Kolmogorov-Smirnov with p-value of 0.054 ($p > 0.05$) implies that the distribution is not significantly different from a theoretical normal distribution; that is, the distribution is assumed to be normal. The Shapiro-Wilk test on the other hand, gives a p-value of 0.03 ($p < 0.05$); this indicates that the distribution of data is significantly different from normal. Thus, the normality assumption was violated. Although Shapiro-Wilk normality test does much the same thing with the Kolmogorov-Smirnov, it has more power to detect differences from normality (Field). Based on the result of Shapiro-Wilk test, the study could not assume the normality of the study data. Hence, the study adopted Wilcoxon signed rank test, a non-parametric counterpart of paired-samples t-test.

The Wilcoxon signed rank test was conducted using the SPSS and the results (see Table 2 and 3 in the appendix) are as thus analysed. Table 2 shows the mean rank of exchange rates before (pre DAS) and after (post DAS) the adoption of Dutch auction system in the Nigeria foreign exchange market. The mean of positive rank of 12 compare to the mean of negative rank of 0.00 implies that the market has experienced more stability after the adoption of DAS than it was before. This is also the implication of the sums of positive and negative ranks reported in the table.

Table 3 depicts the result of the wilcoxon signed rank tes of the hypothesis of the study. The null hypothesis is rejected at 5% level of significance as the p-value

(0.002) is less than 0.05. It implies that there is significant difference between pre and post introduction of DAS. Thus we conclude that there is a significant difference between pre and post DAS exchange rate stability. In other words, the adoption of DAS in the exchange rate determination contributes significantly to the naira exchange stability in Nigeria. This is in consonance with the submission of Sanusi (2004), and Obadan (2006:5). This was also the position of Akpan and Attan (2012) who stated that the DAS has helped the country in the exchange rate stability. Auwal and Hamzat (2009) also supported the argument when they concluded that long run relationship exist between the exchange rate and quantity traded when DAS is the arrangement for foreign exchange allocation.

5. Summary, Conclusion and Recommendations

The need for a realistic exchange rate for naira has led to series of reforms in Nigeria since shortly after independence. The Country, in the year 2002 re-introduced the Dutch auction system (DAS) as an exchange rate determination method. The argument put forth was that DAS was introduced because of the failure of the earlier reforms to achieve the stated objective. The question that came to the mind however was "has the country been able to achieve a stable and realistic naira exchange rate since the adoption of DAS?" In our effort to answer this question, the study was conducted on a two-period comparative analysis of the foreign exchange market (in terms of the official exchange rate of naira vis-avis the US dollar) before and after the introduction of DAS.

The study concludes that the introduction of DAS in 2002 has significant impact on the stability of the exchange rate in Nigeria. The study therefore recommends that the monetary authority should put in more effort in reforming the market so that the stability objective will be fully realised.

It has also been established that exchange rate, according to the BOP theory, depends upon the balance of payment position. A favourable position raises the exchange rate as few domestic currencies will be required to buy foreign currency and vice-versa. The study therefore employs the Government to embark on policies and programmes that will boost export and as a result strengthen the country's balance of payment position. By so doing, a sound and stable exchange rate will be realised; this in turn will enhance economic growth as balance of payment is a key macroeconomic indicator.

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