

Charles C Soludo: Strategic Agenda for the Naira

Briefing by Professor Charles C Soludo, Governor of the Central Bank of Nigeria, on the “Strategic Agenda of the Naira”, Abuja, 14 August 2007.

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I: Introduction

It is my pleasure to welcome everyone to this important briefing on the “Strategic Agenda for the Naira”. As you may recall, it is about three years since we launched (in this very Auditorium on July 6, 2004) the 13-point reform agenda designed to restructure, refocus and strengthen the Nigerian banking and financial system. At that meeting, I observed that the agenda constituted “Phase One” of the reforms. We have since introduced other complementary reforms designed to stabilize the exchange rate, reduce inflation, reform microfinance, restructure the lower denominations of our currency and re-introduce coins, as well as promote the efficiency of the payments system. We have also launched the design of a comprehensive long-term reform agenda for the financial system (the Financial System Strategy 2020 – FSS 2020).

All these reforms are driven by our medium and long-term objectives to ensure economic prosperity of Nigeria, and for Nigeria to become the Africa’s financial hub by the year 2020. Only a sustained stable macroeconomic environment and a sound and vibrant financial system can propel the economy to achieve our national desire to become one of the 20 largest economies in the world by the year 2020.

The Strategic Agenda for the Naira is therefore being launched today as “Phase Two” of our reform agenda, and as a necessary complement to the 13-point agenda of Phase One and other reforms. Phase Two of the reforms has become all the more imperative given the progress so far on Phase One, as well as the emphasis of the new Central Bank of Nigeria Act on ensuring monetary and price stability. According to the “Central Bank of Nigeria Act, 2007”, (Section 2) the key objects of the Central Bank shall be to: (a) ensure monetary and price stability; (b) issue legal tender currency in Nigeria; (c) maintain external reserves to safeguard the international value of the legal tender currency; (d) promote a sound financial system in Nigeria; and (e) act as banker and provide economic and financial advice to the Federal Government. The Phase Two, by focusing on the Naira, means that the Central Bank intends to give greater emphasis to the most important function of central banks everywhere in the world namely, to issue legal tender currency and to defend its value (domestically by ensuring low inflation and externally by ensuring appropriate and stable exchange rate regime). Our specific objective in Phase Two of the reforms is to make the Naira the currency of reference in Africa, and thus a strategic catalyst for achieving the goal of an international financial centre as well as promoting Nigeria’s rapid economic development. We also need the Phase Two to ensure that the results being achieved under Phase One are deepened and sustained.

II: Overview of the reforms since 2004 and outcomes

Before we outline the elements of the Strategic Agenda, it is germane to briefly review our progress so far. As you are aware, most of our reforms have focused on structural and institutional reforms, and have included the following:

- Strengthened the institutional framework for the conduct of monetary policy
- Bank recapitalization/consolidation
- Programme to possibly eliminate or reduce government ownership of any bank (to no more than 10 percent)

- Improved transparency and corporate governance
- Zero tolerance to misreporting and data rendition, and strict adherence to the Anti-money laundering regulations
- Implementation of Basel II Principles and Risk-based supervision
- Payments system reforms for efficiency – especially the e-payment
- Reforming the Exchange rate management system – adoption of the Wholesale Dutch Auction System (WDAS) and increased liberalization of the forex market (which since 2006 led to the convergence of the parallel and official exchange rates for the first time in 20 years).
- Restructuring the Nigerian Security Printing and Minting, Plc;
- Addressing issues of technology and skills in the banking industry especially in risk management and ICT.
- Launching of a new Micro finance policy and regulatory framework to serve the un-served 65 percent of the bankable public
- Ongoing Pension, Consumer credit, and Mortgage system reforms
- Forging strategic alliances and partnerships between Nigerian banks and foreign financial institutions especially in the area of reserve/asset management
- Establishment of Africa Finance Corporation (AFC), as first private-sector led African Investment Bank
- Encouragement of Nigerian banks to go global, leading to more than doubling of branch network in West Africa since 2004; setting up of subsidiaries in London as well as Nigerian banks successfully issuing Eurobonds and getting listed on the London Stock Exchange.

Our grand objective in the banking sector reforms was to re-engineer and fast-track a system that will engender confidence and power a new economy. So far, the grand objectives of that policy are being achieved, and our consolidation programme has been adjudged about the most successful and at least cost to the tax payers in the world. The total deposits trapped in the failed banks as percentage of GDP is about 0.7% (the lowest in the world), and no private sector depositor would lose a kobo of his/her deposit. The banking system is the safest and soundest it has ever been in history. Deposits and credits have more than doubled, and non-performing loans as percentage of total loans have gone down from about 23% before consolidation to about 7% currently. Individual banks now finance big projects valued at hundreds of millions of dollars and also operate in the oil and gas sector – a feat they never could do before now. Interest rates are gradually coming down (with average lending rate at about 16.9%, down from 25%). Currently, commercial bank branches have gone up from about 3,200 before reforms to over 4,100, and total employment in the sector has gone up from about 55,000 before reforms to over 61,000 currently. The world is celebrating Nigeria's success, and over \$1.5 billion of foreign investment has gone into the sector since 2005. By end 2007, there will be about 7 or more banks with shareholders fund in excess of \$1 billion and over 10 banks with market capitalization of over \$2 billion each (there was none in 2004). In 2004, there was no Nigerian bank in the top 1000 banks in the world. As at the end of 2006, there were 12 banks in the top 1000, with one ranked 355th (top 500 in the world). Our banking system is powering the Nigerian Stock Exchange. Today, Nigeria has the fastest growing banking system in Africa, and one of the fastest in the world. As seasoned commentators have observed, it has taken Nigeria less than three years to achieve what it took South Africa 20 years to achieve in the area of banking. To put it succinctly, a new banking system has emerged, and will only get stronger for the benefit of

the Nigerian economy. We firmly believe that with the sustenance of the reforms as the CBN is determined to do, the best is yet to come.

On the macroeconomic front, double-digit and volatile inflation rate (which used to be the norm) have been subdued as inflation rate has remained at single-digit since last year. However, inflation risks remain high. The Naira/US dollar exchange rate has remained stable (with steady appreciation of Naira against the dollar) since 2004, and the GDP has maintained a robust growth rate of over 6% per annum since 2003.

III: Matters arising and challenges ahead

Despite progress on a number of fronts, there are still enormous challenges and unfinished business. At the economy-wide level, there are still chronic challenges of insecurity of lives and property, infrastructure deficiency (especially power and transportation), education crisis, among others.

At the level of the financial system, we have the huge task of effectively implementing the FSS 2020. There is still the risk of fiscal dominance and volatility in the fiscal operations of government. Evolving Fiscal Responsibility arrangements and framework for managing highly volatile oil revenues will be critical. Other unfinished business in the reforms includes:

- Risk-based, consolidated and strengthened banking supervision
- Mortgage, SME, and consumer credit reforms
- Adherence of States and LGs to the requirement under the Micro Finance policy to devote at least 1 percent of their annual budget to micro credit
- Continued reform of the payments system, especially the e-payments system and enforcement of the Dud cheque offences Act.

Efforts will continue to be made to address these unfinished issues.

IV: The Strategic Agenda

The thrust of the agenda focuses on the Naira as our national currency – to realign its denominations, ensure its stability and global integration. These will help to deepen the reforms of the financial system and national economy, and make the Naira the currency of reference in Africa thereby facilitating our quest for international financial status.

The new focus is an extension of our previous currency redesign and re-issuance of the lower denominations and attempt to re-introduce coins. Our goals were to redesign the currencies after 23 years (contrary to the international norm of currency redesign after 6-8 years), drive down the cost of currency printing and experiment with the polymer substrate. Our objectives are largely achieved and we have learnt a lot from the exercise. However, in the light of the new mandate by the CBN Act (2007) to “ensure monetary and price stability”, as well as the vision articulated under the FSS 2020, it has become imperative for us to evolve a more comprehensive strategy for the Naira as a reference currency.

Currency redenomination and liberalization are not without risks especially for small open economies such as Nigeria. However, we believe that the time is auspicious for such reforms especially in the light of the following enabling conditions:

- Overall commitment of the Federal Government under Alhaji Umaru Musa Yar'Adua (GCFR) to sustaining macroeconomic and other structural reforms
- A robust external reserves to meet almost 20 months of foreign exchange disbursements and 25 months of imports
- Stronger banking system powering a new economy and capital market

- Inflation down to single digit, and robust GDP growth of about 6% and above
- Exchange rate stability and elimination of multiple currency practices that had been prevalent before now
- Strong capital inflows (with Central Bank as increasingly marginal player in the forex market)
- Debt relief: Nigeria without a debt burden
- Non-oil exports growing strongly (24% in 2006)
- Nigeria de-listed from the FATF list
- New CBN Act not permitting CBN to grant ways and means advances to Government exceeding 5% of previous year's revenue provided such financing is retired before end of the financial year. Indeed, CBN is not positively disposed to granting any ways and means advances.

It is in the view of the foregoing enabling conditions, and our vision for a Naira that is the currency of reference in Africa that the Board of Directors of the Central Bank of Nigeria has approved the following agenda for the Naira:

A: *Currency re-denomination*

Here, we intend to restructure the entire currency by dropping two zeroes or moving two decimal points to the left from the currency, and issuing more coin denominations. This would entail a total currency exchange and phasing-out of all the existing denominations from August 1, 2008. Effectively, at the current exchange rate, this policy would mean that the Naira/US dollar exchange rate would be around N1.25 to US\$1 then. All Naira assets, prices and contracts will be re-denominated by dropping two zeroes or two decimal points to the left with effect from this date.

The proposed currency structure is as follows:

- Coins:
 - 1 kobo
 - 2 kobo
 - 5 kobo
 - 10 kobo
 - 20 kobo
- Notes:
 - 50 kobo
 - 1 Naira
 - 5 Naira
 - 10 Naira
 - 20 Naira

Effectively, our plan will restore the value of the Naira (in the short-term) close to what it was in 1985 before the commencement of the Structural Adjustment Programme (SAP) in 1986.

Re-denomination and re-introduction of totally new currency structure (notes and coins) following the progress so far with other reforms and the enabling conditions in the economy today are designed to better anchor inflationary expectations, strengthen public confidence in

the Naira, make for easier conversion to other currencies, reverse tendency for currency substitution, eliminate higher denomination notes with lower value, reduce the cost of production, distribution and processing of currency, promote the usage of coins and thus a more efficient pricing and payments system, and lay the foundation for the convertibility of the Naira as well as make it the “Reference currency” in Africa. The African Union has granted Nigeria the right to host the Headquarters of the African Central Bank when the common currency in Africa materializes. We must therefore lead the way in terms of properly aligned currency structure and sound monetary policy framework.

Several countries in the world have undertaken currency re-denomination at various times and for different reasons, including: Afghanistan (2002); Germany (1923, 1948); Argentina (1970; 1983; 1985; 1992); Bolivia (1963, 1987); Brazil (1967, 1970, 1986, 1989, 1990, 1993, 1994); China (1955); South Korea (1962); Mexico (1993, 1996); Ghana (2007); Israel (1948, 1960, 1980, 1985); Turkey (2005); Angola (1995, 1999); and others. Evidently, many countries have had to undertake the re-denomination more than once. In the case of Brazil, it had to do it many times before it got it right. The major challenge is to undertake other complementary reforms, particularly macroeconomic reforms that will underpin price stability and continuing confidence in the economy. This is where we believe Nigeria’s experience is likely to be different from others, having learnt from the experiences of other countries.

Consequently, as necessary complements to the currency re-denomination, we intend to introduce three additional measures:

- Adoption of Inflation-Targeting Framework for the conduct of monetary policy
- Sharing Part of the Federation Account in US Dollars to deepen the Forex Market and for Liquidity Management
- Current Account Liberalization/Convertibility and Accession to Article VIII of the IMF.

B: *Adoption of inflation-targeting framework for the conduct of monetary policy: to commence from January 1, 2009*

In the light of the new mandate as contained in the new CBN Act (2007) urging the CBN to “**ensure monetary and price stability**” as well as the need to provide a **transparent, credible** framework to lock-in inflationary expectations, the CBN will adopt **inflation target** as the **nominal anchor** for monetary policy with effect from January 1, 2009. Low and stable inflation will be our monetary policy’s primary long-term goal. Focusing on inflation targeting does not mean that the CBN will not be interested in other broader objectives of macroeconomic policy – output growth, employment, exchange rate, and balance of payments. Rather, an inflation-targeting framework will enable CBN to pursue these objectives in a more disciplined and consistent manner rather than the ad-hoc processes of the past. Locking-in inflationary expectations is one effective way of ensuring that the currency re-denomination will be sustainable. The outcome of this new framework will greatly improve the credibility of the CBN as the Monetary Authority, as well as deepen the financial markets and promote rapid development of a private sector-led economy.

We will use the next 16 months to fully prepare for the introduction of this framework especially in the light of the deep technical issues involved. The CBN would collaborate with the National Bureau of Statistics in significantly improving the availability of high frequency and reliable data especially those of the GDP and more robust measures of the price indices.

C: *Sharing part of the federation account allocation in US dollars to deepen the forex market and for liquidity management: to commence from September 2007*

Given the structure and development of the financial system, the underdeveloped nature of the Forex markets, as well as the restrictions on foreign exchange transactions, the CBN has

traditionally fully monetized the foreign currency receipts in the Federation Accounts, to be shared by the three tiers of government. Initially, the CBN also maintained the accounts for all the tiers of government – as part of the liquidity management framework. Subsequently, as the banking system developed, the CBN allowed the share of the states and LGs to be deposited with the commercial banks.

Recently, following the reforms in the banking sector and the further liberalization of the Forex market, both the financial system and the forex market have deepened and become increasingly sophisticated. Since 2006, the CBN adopted the Wholesale Dutch Auction System (WDAS) in the forex market and significantly liberalized the forex market. Furthermore, Nigeria has exited the debt trap, built up significant external reserves, and the autonomous inflows into the Forex market are such that the CBN has become a marginal player in the forex market. The forex market has become so efficient that Nigeria no longer has multiple currency practices (as defined by the IMF). In the last two years also, the CBN has consistently intervened in the forex market through the increased sale of foreign exchange as an instrument of liquidity management (the so-called special auctions). In December 2006, the CBN introduced the Monetary Policy Rate (MPR) with the corridor, and this has eliminated the high volatility in the money market interest rates. The money market is deepening, and the bond market is also evolving.

The above conditions indicate that the private financial markets are getting deeper and sophisticated enough to warrant further steps on the part of the Central Bank to gradually withdraw as a dominant player in the forex market. The inter-bank forex market is now the dominant segment of the market, and needs to be deepened.

Consequently, the Monetary Policy Committee (MPC) of the CBN has approved the sharing of part of the Federation Account allocation to the Federal Government and the State Governments in US dollars. The Local Governments are excluded in this phase. For the Central Bank, this could also provide an additional instrument for effective liquidity management as we migrate to inflation-targeting framework.

The proportion of the Federation Account to be distributed in dollars will be determined from time to time, but largely dependent on the assessment of the forex market as well as the liquidity management requirements of the CBN. Both the States and Federal Government will be required to open “Special Domiciliary Accounts” with commercial banks of their choice. The special account can only be accessed by monetizing the balances into Naira. In other words, the Governments cannot withdraw dollar cash but may also utilize part of their domiciliary accounts for settlement of external obligations (e.g. opening of letters of credit). From September 2007, the exchange rate that will be applied in the monetization of Federation Account as well as the “Special Domiciliary Accounts” will be the inter-bank rate on that day.

As the market deepens, the CBN will gradually withdraw from the WDAS, and only intervene in the market (buy or sell forex) as may be required to achieve defined policy objectives.

This new policy thrust is expected to deepen the forex market, promote financial market development, and improve the degree of integration among the domestic markets and with international markets. This policy will complement the ongoing programme of allowing Nigerian banks to manage part of our external reserves in collaboration with foreign asset managers. The net effect of these will be to create and deepen capacity within our banks. All these will also provide important building blocks for the external current account convertibility and attainment of the IMF Article VIII status. The challenge here is that both the CBN and the commercial banks would have to manage the risks inherent in foreign exchange trading and deploy a sound system of monitoring foreign asset-liability matching. The CBN in particular, would need to sharpen its skills to monitor and regulate the use of domiciliary accounts in accordance with the international best practices as well as the rules and guidelines governing the anti-money laundering laws and regulations. The Governments too would

need to be on top of the risk management techniques for optimal management of their portfolios.

The CBN is conscious of the risks of dollarization of the economy and will take steps to avoid such. Also, we are conscious of the dangers of the Dutch Disease and hence the need to avoid the repeat of history in terms of high overvaluation of the Naira in real effective terms as happened during the 1970s until early 1980s. Non-oil exports have begun to recover and grew by 24% in 2006. Also, capital inflows have been growing rapidly and highly overvalued exchange rate would hurt these trends. More fundamentally, without a currency redenomination/realignment, a significant appreciation of the Naira/dollar exchange rate would lead to fiscal crisis given that much of the revenue is dollar denominated, and such appreciation would also significantly deplete our external reserves. Thus, while we deepen the forex market and effectively manage our liquidity, we would not lose focus on ensuring appropriate exchange rate regime for macroeconomic balance.

D: *Current account liberalization/convertibility and accession to Article VIII of the IMF: to commence January 1, 2009*

As a necessary complement to the foregoing policy initiatives, and to further deepen the integration of our financial system and economy into the global economy, we intend to embark upon full current account liberalization/convertibility by January 1, 2009. This would entail that Nigeria eliminates all restrictions on current account transactions, and accession to Article VIII of the IMF means that the policy is not easily reversible. Out of the 185 member countries of the IMF, 167 have acceded to the Article VIII on current account convertibility. It is our belief that the conditions are right for Nigeria to now join the world league. The timing is proposed to coincide with the commencement of the inflation-targeting framework.

V: *Conclusion*

These measures constitute a key component of the FSS 2020 agenda: our quest to become an international financial centre and Africa's financial hub. They will complement and deepen the ongoing financial system reforms. The conditions are now right, and despite the challenges, we are determined to ensure effective design and implementation.

Furthermore, we are working towards greater transparency in the formulation and implementation of our monetary policy. A new Monetary Policy Committee (MPC) will soon be reconstituted in accordance with the new CBN Act, and Minutes of the MPC shall be made public. We also intend to undertake greater public education about what we do and why we do them the way we do.

Are these policies consistent with the drive towards a single currency in West Africa? Yes: Nigeria remains committed towards the ECOWAS goal. Currently, the Nigerian economy constitutes about 70 percent of the entire ECOWAS economy and accounts for about 80 percent of the total external reserves. It therefore goes without saying that if the Naira is properly aligned and can become the "Reference Currency", the goal of a monetary union becomes all the more credible and sustainable. Nigeria has met all the primary convergence criteria and hopes that the other countries will do same on a sustained basis. In the meantime, Nigeria must continue to make progress.

I thank you all for listening.