FDC Economic Bulletin

May 24, 2016

CBN adopts a flexible exchange rate policy

The monetary policy committee adopted a flexible exchange rate policy as a panacea for addressing market imbalances and weaknesses that had plagued the naira in the forex market for the last 18 months. It kept all other parameters unchanged in spite of the temptations to tighten the monetary stance in the face of a spike in inflation to 13.7%. The real challenge is the introduction of another exchange rate segment for critical transactions. This ostensibly creates a dual exchange rate which is open to abuse. Depreciation in the exchange rate will increase the quantity of dollars supplied to the market. However, the market structure changes, which should lead to an outward shift in the short-run aggregate supply curve, will take a little longer.

The change in ideological slant from a rigid and fixed exchange rate, driven mainly by economic patriotism to the explicit acceptance of market forces is a welcomed development. This is also likely to lead to a sharp increase in foreign direct investment as well as foreign portfolio investment and Diaspora flows. Nigeria had been starved of international trade and investment flows after sticking dogmatically to a fixed exchange rate policy. In spite of deteriorating terms of trade and a vulnerable trade balance, it refused to change the policy. It instead increased exchange controls by restricting imports of many items.

The month of May was crunch time where a spike in inflation, dwindling reserves, high unemployment and negative growth in real GDP served as a rude awakening. First was a tacit removal of petroleum subsidies and next the adoption of a flexible exchange rate policy.

Outlook

The MPC's decision to adopt a flexible foreign exchange framework indicates the CBN's

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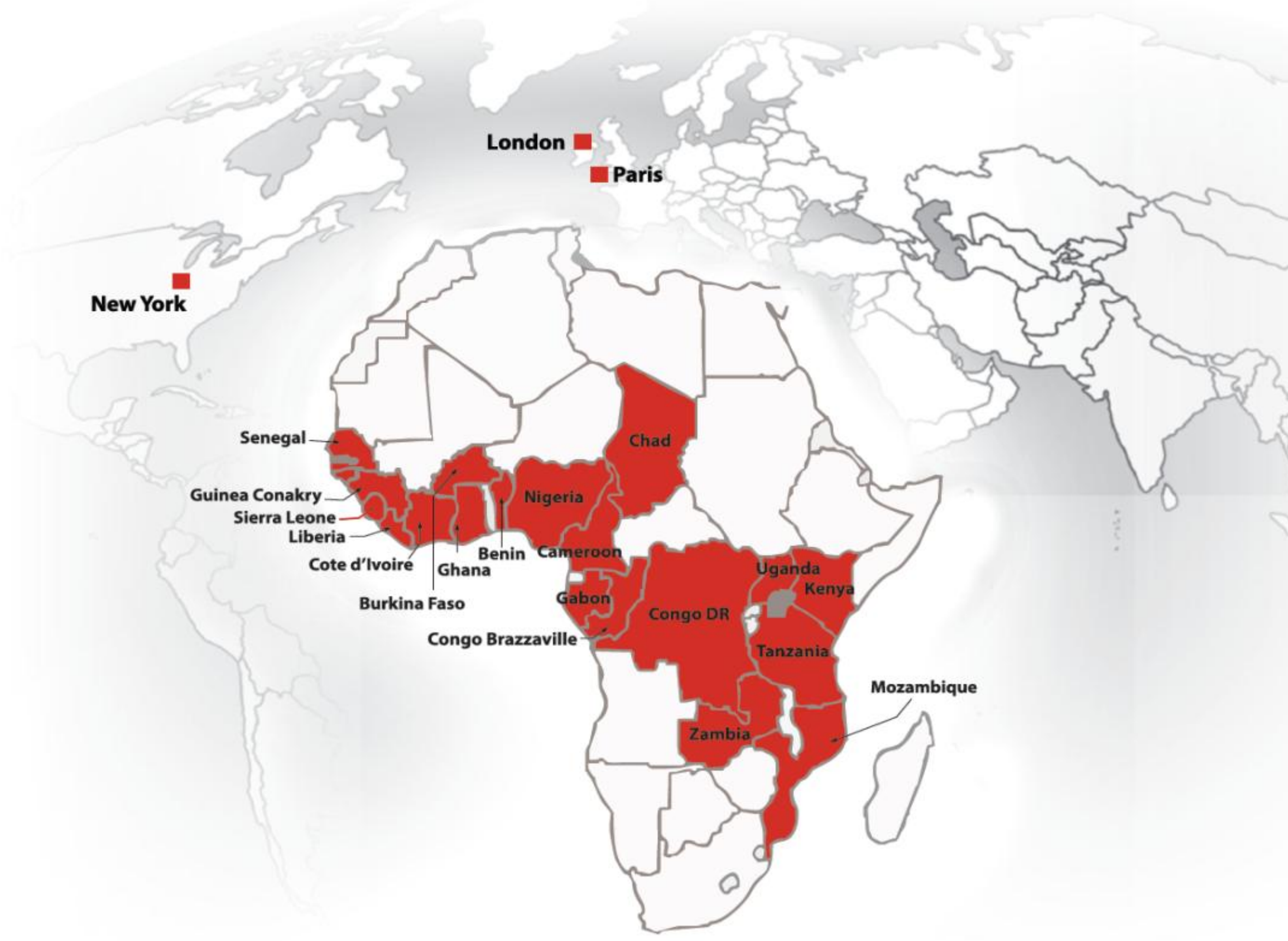

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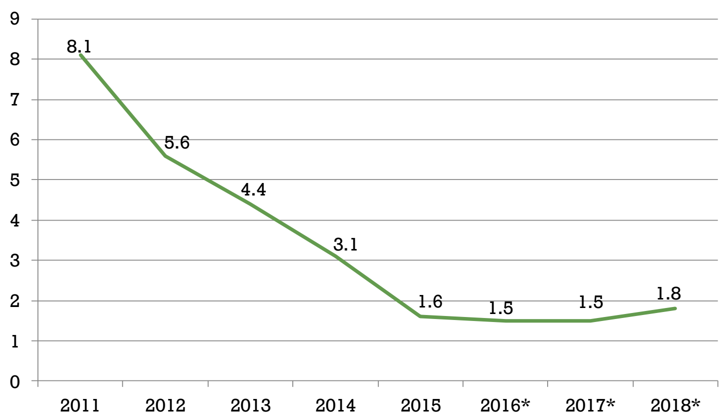
www.ubagroup.com e-Mail: cfc@ubagroup.com *Africa's global bank* acceptance of market realities. We expect increased dollar inflow in the next few days as the CBN announces the new market guidelines.

Though an adjustment to the naira will likely have a short-run inflationary impact, we expect increased forex supply and reduced uncertainty will reduce the unintended consequences and the exchange rate pass through effect. In the end, an efficient market structure and a transparent process are likely to keep Nigeria on the real equilibrium exchange rate path (REER).

FDI flows set to increase

Chart 1: FDI flows (US$'Bn)



* EIU Forecast