Unification of FX Markets – A Long overdue Exercise

Following the swearing in of the President Elect, Asiwaju Bola Ahmed Tinubu, two major long overdue policies have come to the fore. The first being the removal of fuel subsidy which has already taken effect and the second being the unification of exchange rates across FX markets. The removal of subsidy has seen the price of Petro Motor Spirit (PMS) spike from NGN185/L to around NGN490/L.

The second policy is the unification of exchange rates across the official and parallel market rates. Although this policy has not been effected yet, it is the focus of this report.

For years now, Nigeria has operated a multiple exchange rate system where one market was created to meet the FX needs of importers, exporters and other entities as proscribed by the CBN (I&E FX Window), while all other FX needs were to be met by the parallel market. Thus, the ever-growing demand for FX has left a wide gap between rates in both markets. However, this dichotomy has caused more negative consequences for the economy than expected.

On one hand, supply push inflation has soared over the years as many manufacturers were forced to source for FX from the parallel market as the CBN restricted access to the I&E FX market for manufacturers of certain items. In the same vein, all other users of FX had to seek FX from the parallel market for their FX needs as supply was concentrated with the commercial banks and queues stretched for weeks and many customers were still unable to receive FX at the bank rates, leaving them to source for FX in the parallel market.

When this exercise is caried out, we expect the currency to sit between NGN650-700/USD. A major concern however is the ability to sustain this rate given the high FX demand and low supply of FX. Oil export remains Nigeria's major FX source of which Nigeria is still producing 1.51bpd (Q1:2023) against a quota of 1.89mbpd and this quota is set to reduce following expected production cuts from OPEC countries. If the country is unable to drive FX accretion, we can anticipate some scarcity of FX and a potential return of the parallel market.

Potential Impacts of Unification/Devaluation

We expect the unification and ultimate devaluation of the currency to pose both positive and negative impacts on the Nigerian economy some of which are:

- **Cheaper Exports, Expensive Imports –** Devaluing the currency will cheapen the Naira compared to other currencies, making exports cheaper and boosting Nigeria's export earnings. On the flipside, imports become more expensive, reducing import demand but encouraging domestic production.
- **Increased Foreign Debt Servicing Cost –** Devaluing the currency will raise the cost of servicing Nigeria's rising external debt stock. Currently, the debt servicing to revenue ratio stands around about 96% and will rise further upon devaluation.
- **Increased FDI and FPI Flows –** Following the devaluation, we expect the peg on the currency to be lifted, switching to a floating exchange rate regime meaning market rates will be determined by market forces. This exercise is also set to remove limitations on free capital mobility which has been a major impediment to foreign investment flows to the country.

Expected Impact on Markets

The decision to unify rates and devalue the currency is expected to have net positive impacts on the investment climate in the country. The inability to repatriate investment proceeds has been a major reason for the exodus of foreign investments. In the absence of any limitations, we expect to see strong boost to domestic and foreign investor confidence in Nigeria. Thus, we expect increased participation on the domestic and international fronts. We expect to see an increase in foreign participation in the equities market which had declined to a record low of 4.43% as of April 2023. We also expect to see Eurobond and domestic bond prices rise in the coming weeks as the decision signals a step in the right direction for the country.

With the perception that the government is making steps in the right direction, we expect investor's reaction to be reflected fully in the market. Thus, we expect a strong bullish reaction in the coming trading sessions and recommend a strong tilt towards stocks with a strong fundamental justification.