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## **Revolutionizing Nigeria's Economy: The Impact of Unified FX Rate on Startups and Exchange Rates**

### **Introduction: Overview of the policy**

Nigeria's decision to float the naira marks a significant shift from its longstanding policy of maintaining a fixed exchange rate. This move comes after years of rigid currency controls that had adverse effects on investor confidence and hindered the flow of dollars into the economy. With the official exchange rate now subject to market forces, buyers and sellers of foreign currency can determine rates based on their own assessments, rather than being dictated by the Central Bank of Nigeria (CBN).

The Investors & Exporters (I&E) window, an important foreign exchange market, is already reflecting this change, with quoted rates ranging between N750 and N755/\$. This represents a notable 21 percent decline in the value of the naira compared to the previous fixed rate of N463/\$. While the CBN is still displaying the outdated rate on its website, the floating rate in the I&E window is expected to bring about greater alignment between the official and parallel exchange markets.

Converging exchange rates is a positive step, but further efforts are necessary to enhance the market's functionality. The subsequent steps should include establishing a hedge mechanism aligned with market dynamics, ensuring attractive market yields for Foreign Portfolio Investors (FPI), promoting transparency, removing controls on domiciliary accounts, and resolving the dollar backlog to attract foreign investments.

Market participants and analysts have expressed optimism about the move to float the naira, emphasizing that it is a bold step in the right direction. However, to sustain this positive momentum, it is essential to lift capital restrictions for investors and create an environment that allows the free flow of capital. The effective harmonization of Nigeria's exchange rates, driven by market forces, is expected to narrow the spreads between the official and parallel exchange rates, ultimately restoring stability and stimulating economic growth.

### **Implications of the Unification & What Happened in 2016: Positive & Negative Effects**

In a significant move to address Nigeria's fragmented foreign exchange (FX) markets, President Bola Ahmed Tinubu has embarked on macroeconomic initiatives aimed at improving the country's economic landscape. Two key initiatives highlighted by President Tinubu are *the removal of government subsidies on Premium Motor Spirit (PMS)* and *the unification of the*

country's exchange rate. These policies have both positive and negative implications for the Nigerian economy.

The immediate impact of these policies on the average Nigerian will be felt through a rise in the cost of living. Essential commodities such as food and transportation are particularly vulnerable to price shocks. However, these policies have been well-received by investors who view them as necessary steps to curb public waste, reallocate resources more efficiently, increase investor confidence, and drive overall productivity.

In the end, these changes have established a clear direction for Nigeria's exchange rate policy. However, the specific outcome –whether it will result in a freely floating exchange rate, a managed float, or a policy reversal similar to what occurred in 2016, will depend on the political determination and the extent to which these reforms attract essential foreign currency into the country. The recent reforms can be viewed as a process of discovering the appropriate value of the naira by enabling market forces of demand and supply to determine the exchange rate. This journey undertaken by the Central Bank of Nigeria (CBN) is aimed at finding a fairer valuation for the national currency.

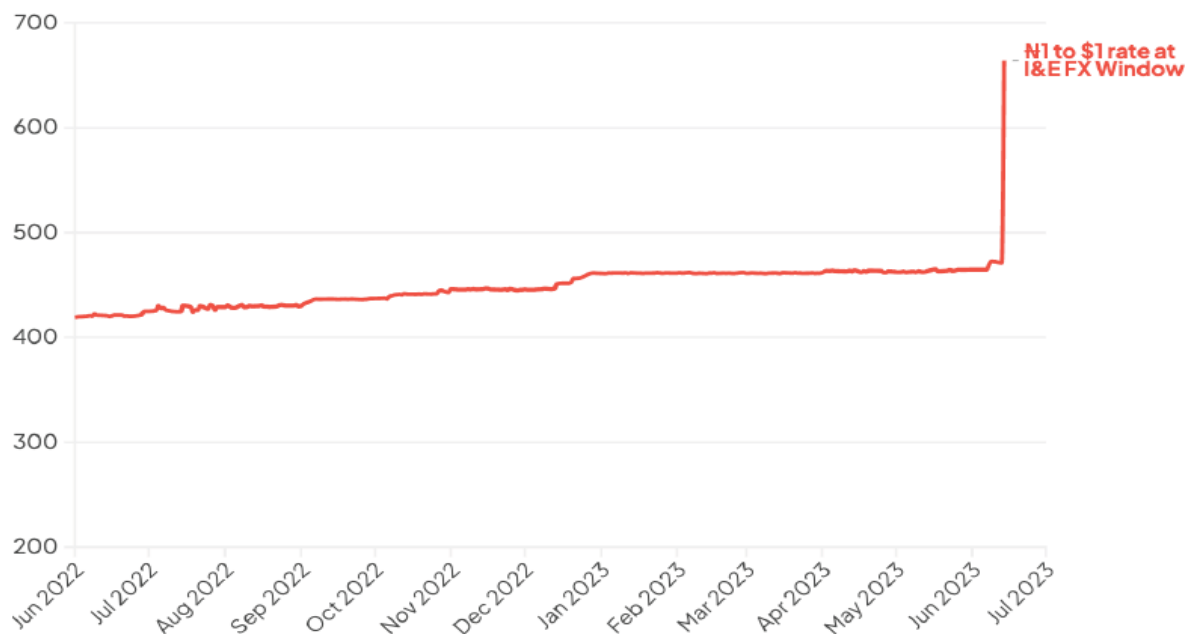
#### *What this means*

- The exchange rate unification will lead to improved price discovery. By unifying and increasing the transparency of prices across the multiple FX markets, it will reduce the opportunity for arbitrage. This means that influential individuals will no longer be able to exploit different rates across various windows for personal gain. As a result, more dollars will be available for legitimate use, benefiting the overall economy.
- A resulting increase in FX supply: With restrictions on purchasing and hoarding dollars lifted, more dollars will circulate in the market. Moreover, both local and foreign institutional investors will feel more confident about bringing their dollars into the Nigerian economy for trade. Likewise, individuals receiving salaries from abroad will prefer depositing their funds in local banks' domiciliary accounts rather than using offshore wallets or cross-border apps.
- FX accessibility for the average Nigerian: The existing scarcity of foreign currency has made it challenging for individuals to meet international financial obligations, such as paying school fees abroad. Additionally, many Nigerians with domiciliary accounts have faced difficulties accessing their hard-earned foreign currency deposits. Through increased transparency and improved availability of dollars across different FX windows, retail consumers will have easier access to dollars at fair values through licensed Bureau De Change operators (BDCs), which are the main FX window for the average consumer.

It is important to note that the unification of the exchange rate may initially lead to a temporary rate hike as a reaction from the market. However, with increased competition and the influx of dollars, rates are expected to eventually stabilize. Recent data from FMDQ, the authorized organization for publishing I&E rates, shows that the dollar traded at ₦790, although this should be considered an outlier. The median rate remains at ₦476, with a few occurrences (8% of recorded rates) surpassing ₦700.

### The naira fell 22% in a day, as the CBN allows exchange rate trade freely

Exchange rate trend at the Importers and Exporters (I&E) FX Window



Source: FMDQ

Stears

While the short-term effect may include a rise in the cost of living, if the policy is effectively executed, the benefits mentioned above are expected to materialize, leading to a more robust Nigerian economy.

So, what are its implications?

#### Positives

1. The devaluation of the naira is expected to provide a boost to government oil revenues, leading to reduced fiscal deficits and a decreased reliance on borrowing. Additionally, state governments will benefit from higher FAAC (Federation Account Allocation Committee) allocations.

2. The depreciation of the currency, coupled with enhanced transparency and stability in the foreign exchange (FX) market, has the potential to make Nigeria a more attractive investment destination for foreign investors. This, in turn, could result in increased investment flows, particularly from Foreign Portfolio Investment (FPI) and Foreign Direct Investment (FDI).
3. The influx of higher investment flows would contribute to the accumulation of foreign reserves, enabling the Central Bank of Nigeria (CBN) to better defend the naira and ensure an adequate supply of foreign exchange to support the real economy.
4. The positive impact of increased FPI flows extends to the capital market, which has been adversely affected by waning interest from foreign investors. Notably, there is already a growing sense of optimism in the stock exchange, with a 3.13% rise observed on Wednesday (representing a 17% year-to-date increase).

### **The Nigerian Stock Exchange (NGX) is up about 8% in June 2023 (17% YtD) as investors welcome President Tinubu's bold reforms**

NGX All Share Index (ASI)



Source: Nigerian Stock Exchange

Stears

5. By discontinuing FX interventions such as the Naira4Dollar scheme and RT200 FX rebate program led by Godwin Emefiele, which have incurred substantial costs for the government, there will be significant savings in expenses.
6. A relaxation of capital control measures, coupled with improved foreign exchange inflows and a stronger fiscal position, could lead to a positive revision of Nigeria's sovereign credit rating. This, in turn, may result in a potential re-inclusion of Nigeria into

global indices like the MSCI and JP Morgan indexes. Such developments would have a positive impact on investment flows.

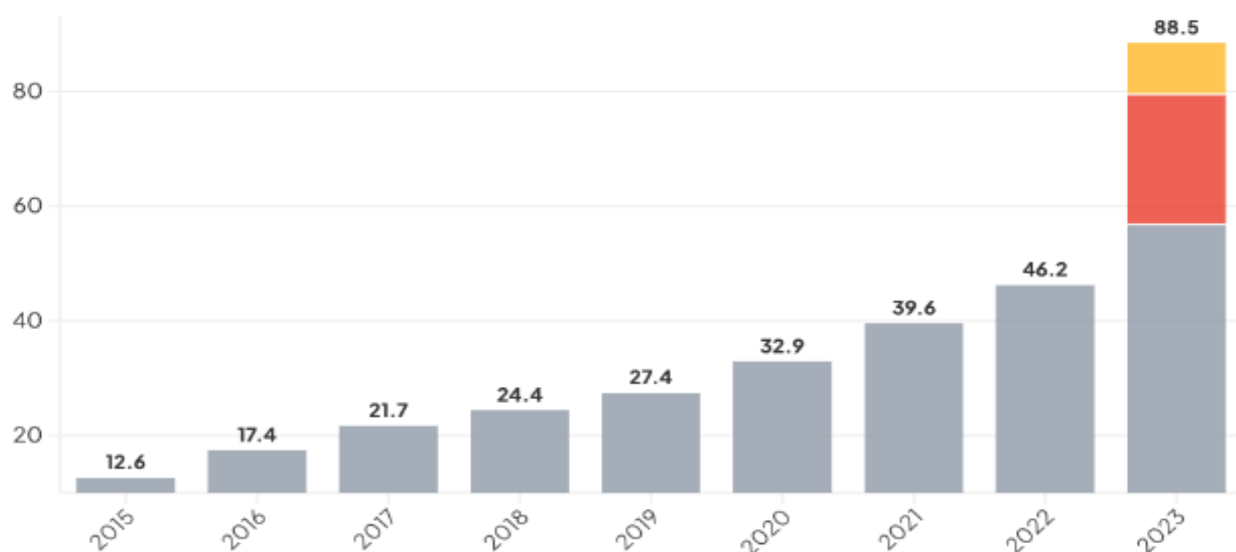
## **Negatives**

1. Naira depreciation implies a significant increase in government debt. Nigeria's external debt stock for FY2022 is set to rise by about ₦9 trillion in naira terms, resulting in a total public debt stock of approximately ₦88.5 trillion in 2023, compared to ₦46.2 trillion in 2022.

### **Naira devaluation and ways & means securitisation boosts Nigeria's total debt stock by 91% in one year**

Total public debt stock (₦' trillion)

■ Total Debt Stock (₦' trillion) ■ Ways and means ■ Impact of naira devaluation



Source: Debt Management Office, Stears

\*2023 value = Dec. 2022 debt stock + securitized ways and means financing+ 2023 planned borrowings



2. Consequently, the debt to GDP ratio will hit the fiscal cap of around 40%, constraining the government's borrowing capacity.
3. This will adversely affect debt servicing costs, especially considering the anticipated rise in global interest rates, potentially resulting in a 50% increase in foreign debt repayment by 2023.
4. The elimination of fuel subsidies, combined with the devaluation of the naira, will lead to higher fuel prices. NNPC Limited reportedly calculated current petrol prices using the official exchange rate at the beginning of June. As a result, transportation costs, food prices, inflation, and ultimately, consumer disposable income will face additional strain.

## The Implications of Exchange Rate Unification on Nigerian Startups

Nigeria's move towards a unified exchange rate has brought about significant implications for startups, particularly those reporting their revenue to investors in US dollars. This shift presents both challenges and opportunities for the tech ecosystem, shaping the way startups operate and report their financials. Some of the effects include:

1. Revenue Reporting Hurdle:

Previously, startups reported their revenue using Nigeria's official exchange rate of \$1/₦462. However, with the unification, the Naira experienced a considerable loss in value, leading to a significant increase in reported revenue in Naira terms. Startups that reported their revenue at the official rate are most affected, as the unified rate alters their previously calculated revenue figures.

2. Valuation and Investor Confidence

The unification of the exchange rate has implications for the previous valuations of startups, potentially requiring adjustments. The unified rate may enhance investor confidence, making it easier for them to repatriate their profits. The unification contributes to improved financial transparency, fostering trust and clarity for startups reporting to investors.

3. Long-Term Stability and Adaptation

The move towards a unified exchange rate brings stability to the market, which benefits businesses in the long run. Regular access to foreign currency enables startups to plan their finances and operations more effectively. By operating in a more predictable environment, startups can adapt their strategies to optimize growth and navigate economic uncertainties.

4. Challenges and Opportunities:

The exchange rate unification necessitates a reevaluation of revenue generation approaches by many Nigerian startups. Startups will need to find innovative solutions and create strategies to ensure continued growth and success amidst evolving economic policies. While challenges lie ahead, this transition also presents opportunities for startups to thrive in the ever-changing tech ecosystem.

5. Implication on specialized startups

The unification of the exchange rate in Nigeria carries significant implications for specialized startups, such as virtual card providers.

- Fluctuating exchange rates may lead to additional transaction costs and the need to actively manage currency risks, affecting operational expenses and profitability.
- Customer demand for virtual card providers may be influenced by significant depreciation of the naira, prompting them to seek alternative foreign currency transaction options with greater exchange rate stability.

- Market competition for specialized startups may intensify, necessitating differentiation through value-added services and innovative features to cater to evolving customer preferences.
- Regulatory changes may occur, requiring startups to comply with new regulations and adjust operations to align with updated foreign exchange policies from the Central Bank of Nigeria, ensuring compliance and adherence to the legal framework.

### ***Implications of Unification of Exchange Rate on our Portfolio Companies in Different Segments***

#### **1. Food & Distribution:**

- Increased import costs: Portfolio companies relying on imported raw materials may experience higher costs. – Adjusted pricing strategies: Companies in this segment may need to reassess their pricing strategies to account for the exchange rate changes and maintain profitability.
- Supply chain challenges: Fluctuating exchange rates can affect supply chain operations, potentially leading to disruptions in the food and distribution sector.
- The unification of the exchange rate has the potential to drive increased demand for local raw material production, benefiting companies like Releaf. This can be attributed to factors such as competitive pricing, import substitution strategies, and government support for domestic industries. As businesses seek to reduce costs, enhance supply chain resilience, and comply with the government's objectives of economic diversification, the demand for locally sourced raw materials is expected to rise, presenting growth opportunities for companies like Releaf.

#### **2. Finance & Wealth:**

- Portfolio valuation adjustments: The unification of the exchange rate may require a reevaluation of the valuation of financial and wealth management companies, potentially impacting their balance sheets and investment portfolios.
- Opportunities for investment: As investor confidence improves, there may be increased opportunities for portfolio companies in finance and wealth to attract investments.
- As the Nigerian naira stabilizes and potentially strengthens against the US dollar, there is a possibility that investor balances on wealth management platforms may decline when measured in naira terms. This decrease in value could potentially discourage the culture of saving in dollars among investors.

#### **3. Essential Services:**

- Cost implications: Portfolio companies offering essential services such as healthcare, utilities, and telecommunications may face increased costs for imported equipment, supplies, and technology.

- Operational Adaptation: Companies in the essential services sector may need to adapt their operations to meet the changing demands and requirements resulting from the exchange rate unification. This could involve optimizing supply chains, adjusting production processes, or exploring alternative sourcing strategies to maintain operational efficiency and ensure uninterrupted service delivery to consumers.
- Demand stability: Essential services typically have relatively stable demand, which can provide a buffer against the potential negative impacts of exchange rate unification.

#### 4. Media & Culture:

- Investment and advertising revenue: The unification of the exchange rate may influence advertising budgets and investment decisions of companies in the media and culture sector.
- Impact on international partnerships: Changes in the exchange rate may affect partnerships and collaborations with international media and cultural entities.

#### 5. Real Estate & Retail:

- Property valuations: The unification of the exchange rate could lead to adjustments in property valuations, impacting real estate portfolio companies.
- Retail pricing dynamics: Retail companies may need to reassess their pricing strategies to accommodate the changes in exchange rates, considering potential impacts on consumer purchasing power.
- Demand fluctuations: The effects on consumer spending power resulting from exchange rate unification may lead to shifts in demand for real estate and retail offerings.

#### 6. Financial Market:

- Investor sentiment: The unified exchange rate can contribute to improved investor confidence, potentially leading to increased investment activities in the financial market segment.
- Foreign investment opportunities: As currency risks are reduced, foreign investors may be more inclined to invest in Nigerian financial markets, creating opportunities for portfolio companies in this sector.
- Regulatory adjustments: Regulatory frameworks may need to be adapted to align with the new exchange rate regime, impacting the operations of financial market portfolio companies.

#### 7. Logistics:

- Cost of transportation: Portfolio companies in the logistics sector may experience increased costs due to higher import expenses and fluctuating fuel prices.



- Supply chain efficiency: Companies in this segment might focus on optimizing supply chain processes to mitigate the impact of exchange rate fluctuations on transportation and delivery costs.
- Technology adoption: The unified exchange rate may incentivize logistics companies to invest in digital infrastructure and innovative solutions to enhance operational efficiency and cost management.

#### 8. Digital Infrastructure:

- Investment opportunities: The exchange rate unification can create favorable conditions for portfolio companies in the digital infrastructure sector to attract both local and foreign investments.
- Technological advancements: With increased stability, companies may have greater confidence in investing in digital infrastructure projects, leading to improved connectivity and technological advancements in Nigeria.
- Collaboration with startups: Portfolio companies can explore partnerships and collaborations with startups in the digital infrastructure space to leverage their innovative solutions for mutual growth.

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