Political Economy of Exchange Rate Policy in Nigeria and Indonesia: Investigating the Influence of Stakeholders on Policy Choices

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By

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Statement of Originality

Doshisha University

Graduate School of Global Studies

Shikokan Building

Kyoto, Japan

To whom it may concern

This statement informs and certifies that, to the best of my knowledge, this dissertation is the outcome of my efforts. I do hereby declare that the intellectual content of this dissertation entitled:

"Political Economy of Exchange Rate Policy in Nigeria and Indonesia: Investigating the Influence of Stakeholders on Policy Choices"

is the result of my research and has not been submitted in part or entirely to any degree program or other academic institution. Where assistance has been received, or third-party work has been used, it has been duly acknowledged using complete references.

Signed: ______

Date: November 28, 2023

Adamu Waziri Babagana

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Abstract

This thesis examines the political economy factors that explain exchange rate policy choices in Nigeria and Indonesia. To understand the similarities and differences in exchange rate management and its implications in the two countries, the study assesses how central banks use policy instruments to manage the foreign exchange market. It then employs the process tracing method to examine whether the exchange rate policies and management strategies reflect domestic and international political pressures or policymakers' discretion. Furthermore, the study evaluates the implication of the divergent exchange rate policies on the economic performance of both countries.

Chapter One is the introductory part of the thesis that provides the background to the exchange rate problem and the objectives of the study. The primary cause of Nigeria's exchange rate challenges is attributed to the country's numerous structural constraints. However, these challenges are exacerbated by the foreign exchange management strategy of the Central Bank of Nigeria, which entails exchange control and multiplicity of exchange rates. In Indonesia, a comparable country to Nigeria, the value of the foreign exchange is largely determined by market forces, with Bank Indonesia intervening only to correct significant volatility without (explicitly) targeting a specific rate. The aim of this study is to understand why Nigeria did not adopt a market-based exchange rate regime like Indonesia, given their comparative politics, economic structure, and institutions especially after their transition to democracy in the early 2000s. Specifically, the study tries to identify major determinants of the exchange rate policies implemented in Nigeria and Indonesia: the discretion of policymakers, the pressure of interest groups, the action of the political elite, or the influence of the international monetary system.

Chapter Two presents the methodological approach to address the research objectives using primary and secondary data. This is conducted within the framework of the process tracing method, which allows inferences to be drawn about causal links from the preferences of policy actors to policy outcomes. The process tracing method is used to analyze the interaction of domestic and international actors and factors that shape central banks' exchange rate policy decisions. Various sources of evidence are used. Primary

sources include semi-structured interviews and survey questionnaires. Secondary data consists of government records, policy documents, and statistical data from national authorities and international organizations.

Chapter Three reviews the available literature that has attempted to explain the divergent development paths of Nigeria and Indonesia. There seems to be a consensus among the previous studies that the influence of exchange rate policy was significant in Indonesia's economic take-off and Nigeria's stagnation between the1960s and 1990s. The chapter also discusses the theoretical link between exchange rate policy and economic development. A stable and competitive real exchange rate is important for economic development through its impact on investment, macroeconomic stability, and trade and as an instrument of industrial policy. This impact of the exchange rate on development implies that it is important to choose the appropriate exchange rate policy. In practice, the policy is implemented not only based on economic feasibility, but also because of political feasibility. Therefore, the political economy of exchange rate policy choices is discussed through a literature review in this chapter.

Chapter Four focuses on the exchange rate systems in the two countries, highlighting Indonesia's transition to a market-oriented system and the persistence of Nigeria's complex exchange rate system. Indonesia's economy is relatively more diversified, which suggests multiple channels for reserve accumulation. Nigeria's reserves typically track the rise and fall of crude oil prices. Although both countries use reserves to intervene in the foreign exchange market, there are differences in the nature and purpose of the intervention. Forex intervention in Indonesia is aimed at stabilizing the currency in the face of currency volatility, while in Nigeria, it is aimed at maintaining the official exchange rate. The official rate is then rationed to prioritized transactions and individuals, which opens the doors of rent-seeking and corruption.

Chapter Five presents the analysis of the interaction between central bankers and key stakeholders in exchange rate policymaking to identify who influences the two countries' divergent policies. The stakeholders include business interest groups, political elite, international financial institutions, and central bankers. Business interest groups are influential associations that seek favorable exchange rate policy based on the nature of their businesses. The political elite (president and members of parliament) are the veto players whose influence can change or maintain an exchange rate policy. The IMF (and the World Bank) are a major source of international influence on national economic policies including the exchange rate. All the stakeholders have a preferred exchange rate policy choice and attempts to influence the decision of the central bankers, who succumb to or resist the (political) pressure.

The results indicate that most CBN staff believe that political pressures tend to motivate exchange rate policy in Nigeria. This contrasts with Indonesia where the central bankers believe the policy decisions of BI are not influenced by political pressure arising from elections or other stakeholders' interests. However, it was the IMF programme necessitated by the Asian Financial Crisis (AFC) that motivated Indonesia's current liberalized exchange rate policy. IMF's coercion through the stabilization program created an enabling environment for the successful implementation of the nascent floating exchange rate regime introduced at the beginning of the AFC. Nigeria did not share Indonesia's experience of a severe economic crisis that warranted IMF intervention. CBN remains reluctant to implement a market-based exchange rate regime recommended by the IMF.

The results further reveal that some of the interest groups in Nigeria have had some of their policy preferences implemented by the CBN, except for exchange rates unification and removal of forex restriction. In Indonesia, there is little, if any, room for interest groups to influence the policy direction of BI. Bank Indonesia seems to be insulated from political pressures not only from interest groups but also the political elite. This has been influenced by the lessons of the Asian Financial Crisis (AFC). On the other hand, the Nigerian political elite have significant influence on CBN's exchange rate policies. Therefore, among the four policy stakeholders examined, the political elite can be said to have contributed greatly to the distortion in Nigeria's forex market.

Chapter Six discusses the political implications of exchange rate policy choices especially at the international level. Nigeria and Indonesia are actively involved in their respective regional economic agreements (ECOWAS and ASEAN), which include collaboration on economic policies. However, the exchange rate policies of the two countries tend to reflect national priorities rather than influenced by the need to comply with regional policy coordination and cooperation. This may likely change if the efforts by BRICS succeed in challenging the US dollar hegemony in international monetary relations. The chapter also evaluates some of the consequences that dirigiste and market-based exchange rate systems can have on economic performance, as illustrated by Nigeria and Indonesia. The adverse consequences of Nigeria's exchange rate system have manifested in macroeconomic instability, and poor trade and investment performance. On the other hand, Indonesia’s market-based exchange rate system tends to provide a more conducive macroeconomic environment that supports investment.

Chapter Seven summarizes the findings and draw conclusions based on the analysis in chapters 5 and 6. The study concludes that the non-implementation of a market-based exchange rate regime that exacerbated Nigeria’s longstanding exchange rate challenges cannot be attributed to the pressure of interest groups and international actors/factors, nor to the poor judgment of central bankers. Instead, the main obstacles to policy change during the escalation of exchange rate challenges since 2014 are the dominant influence of Nigerian President Muhammadu Buhari and the influential elite, especially members of parliament, who benefited from the system. The way forward is to adopt a mechanism of domestic restraint such that the power to oversee the affairs of the CBN, including the appointment of the Board of Governors, should be exercised not only by the President and the National Assembly but also by the 36 state governors of Nigeria.

Dedication

This dissertation is dedicated to my parents, my family, and to Adamu Fika.

Acknowledgement

In writing this dissertation, I owe a great debt of gratitude to many people who supported me in various ways. First and foremost, I am grateful to my advisor, Prof. Yoichi Mine, for first accepting me a year after my enrollment in the program and for his tireless guidance by patiently reading and commenting on several drafts of the project, as well as for his unwavering support in various ways. Most of the ideas that shaped various sections of the dissertation were actually inspired by my discussions with Mine sensei. My deepest gratitude goes to Prof. Seifudein Adem, through whom I was accepted into Doshisha University and Prof. Mine's seminar. I am eternally grateful to Prof. Adem for also encouraging me to study Africa-Asia and for many other things too numerous to mention that have influenced my intellectual development.

My studies would have suffered greatly without my wife Fatima Sambo's affectionate support. I truly appreciate her sacrifices and assistance in many ways, especially in taking care of the home and our sons, Abubakar and Muhammad.

In the process of collecting primary data for this research from Indonesia, I am deeply grateful to Prof. Oyamada for his support and for introducing me to people in Indonesia who helped me reach out to interviewees. I also received tremendous help from Fuady Ahmed Helmy, who connected me with interviewees and a research partner in Indonesia. I am grateful to Fuady for his unwavering support and the tremendous effort he put into facilitating my trip to Indonesia, which was unfortunately unsuccessful. The project benefited from the comments and advice of all the dissertation examiners, including the three professors mentioned and Prof. Shanping Yan. I express my gratitude to them all.

This research would not have been possible without the generous funding from the Japanese MEXT scholarship. I am grateful to the government and people of Japan for fully sponsoring my study.

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I am grateful to all my siblings and other family members for their tremendous support and encouragement. They are too numerous to mention individually, but I would like to single out my elder sister, Amina Babagana, for her financial support and assistance in data collection. I greatly appreciate her support in connecting me with interviewees at the CBN and providing me with all the necessary resources I needed during my stay in Abuja, Nigeria for the fieldwork.

My special thanks to all the research participants in both Nigeria and Indonesia whose insights were used to shape the argument of this research. I am particularly grateful to the people who helped me reach out to the interviewees and respondents in Nigeria, namely; Alhaji Yahya Inuwa, Sani Ahmed, Ahmed Wakil and Sadik Ahmed.

I am also grateful to my colleagues and friends who helped me in various ways both in my studies and in navigating life in Japan. The list is long, but to mention a few, I would like to thank Rangarirai Muchetu, Stephanie Èvora, Motoki Tomoyese, Ouadie Adimi, Mori Yasunori, and Asmao Diallo.

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List of Acronyms

ABCON	Association of Bureau de Change Operators of Nigeria
AFC	Asian Financial Crisis
ASEAN	Association of Southeast Asian nations
AfCFTA	African Continental Free Trade Agreement
BDC	Bureau de Change
BI	Bank Indonesia
CAN	Cocoa Association of Nigeria
CBN	Central Bank of Nigeria
ECOWAS	Economic Community of West African States
FDI	Foreign Domestic Investment
GDP	Gross Domestic Product
I & E	Investors and Exporters foreign exchange window.
IFIs	International Financial Institutions
IMF	International Monetary Fund
IPOA	Indonesian Palm Oil Association
MAN	Manufacturers Association of Nigeria
NACCIMA	Nigerian Association of Chambers of Commerce Industry Mining and Agriculture
NAFEX	Nigerian Autonomous Foreign Exchange Fixing
NSSAN	National Sesame Seed Association of Nigeria
OCA	Optimum Currency Area
SAP	Structural Adjustment Programme

Chapter One: Introduction

1.1 Background to the Study: Political Obstacle to Pragmatic Exchange Rate Policy

The question of how to stimulate economic development in developing countries has been a topical issue for many decades. While most African countries have yet to lay the foundations for structural transformation of their economies, comparable countries, especially in Southeast Asia, have made substantial progress in promoting long-term growth. The comparative studies of Africa and Southeast Asia has revealed different perspectives. At least five approaches have been used to explain the differences in economic performance between the two regions: historical, structural, policy choices, institutional, and political (Lewis 2013, 56-81). These broad categories encompass several factors proposed to explain the variation. Among these, economic policy choices play a significant role. Asia's success is partly attributed to investment in productive activities supported by conducive macroeconomic environment, including stable, competitive exchange rates. Exchange rate policy plays a facilitative role in economic development by boosting investment and macroeconomic stability. However, the wrong prescription of the policy can also have negative consequences.

Moving on, some Asian economies have used exchange rate (devaluation) policy as one of their industrial policy instruments to promote rapid growth in their tradable sectors. Conversely, many African countries tend to maintain an overvalued currency, to the detriment of their main tradable sector, agriculture (Bates 1981; 2008). Nigeria and Indonesia exemplify a notable example of this contrasting outcome. The two countries have comparable socio-economic, political, and geographical characteristics. They also share similar vulnerabilities to economic shocks and socio-political instability.

The procession of comparative studies on Nigeria and Indonesia has emphasized, among other variables, the importance of exchange rate policy in explaining the contrasting economic performance of the two countries between the 1960s and 1990s (see, for example, Pinto 1987; DeSilva 1996; Bevan, Collier, and Gunning 1999; Lewis 2007; Fuady 2012; Henley 2015). During this period, Indonesia's GDP per capita rose from $690 to $2,072, while Nigeria stagnated, with GDP in 2000 ($1376.4) almost identical to that in 1960 ($1360.4). Despite the similarities, Figure 1.1 shows that Nigeria has yet to experience sustained long-term growth like Indonesia.

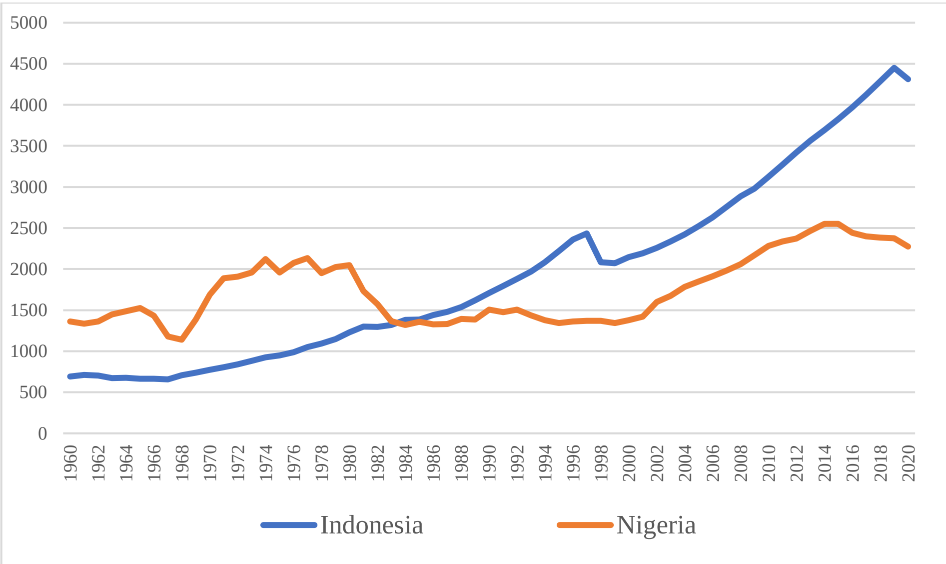

Figure 1.1 GDP per capita (constant 2010)
Source: Author based on World Bank data

The literature converges on the finding that the two countries' different exchange rate policies were among the key variables explaining their divergent developments since the 1980s (Figure 1.1). The differences were reflected in the repeated devaluation of the Indonesian currency (rupiah) and the failure to do the same for the Nigerian currency (naira) when the two countries faced similar economic conditions and were ruled by military regimes.

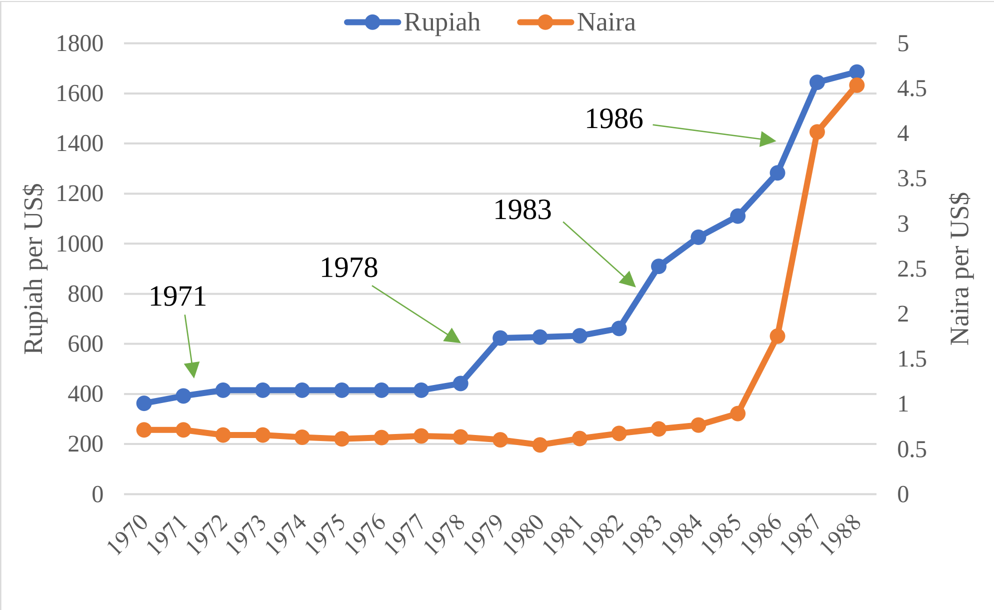

Figure 1.2 Rupiah devaluation and Naira overvaluation per US$
Source: Author's computation based on IMF data

The rupiah was devalued four times between the early 1970s and mid-1980s. It was devalued by 11 percent in 1971, 51 percent in 1978, 37 percent in 1983, and 45 percent in 1986 (Fuady 2012, 127–35; Warjiyo and Juhro 2019, 110). Figure 1.2 illustrates these devaluations, which reflect policy response to domestic and external economic circumstances and the need to boost Indonesia's non-oil exports. On the other hand, Nigeria maintained an overvalued currency during the same period while facing comparable conditions. This is evident in the flat line indicated in Figure 1.2 until 1986, when devaluation was necessitated by Structural Adjustment Programme (SAP). As the figure shows, the value of the naira has fallen sharply and continues to depreciate, especially in periods of dwindling international reserves due to falling oil revenues. The situation is further aggravated by the multiplicity of exchange rates created by the existence of an administratively controlled exchange rate and a parallel market exchange rate.

Choosing the appropriate exchange rate policy is a long-standing debate among Nigerian policymakers, international financial institutions, academics, and other observers. The International Monetary Fund (IMF) and the World Bank have consistently emphasized that unifying the multiple exchange rates and allowing greater flexibility to reflect market realities is necessary for Nigeria's economic revival. Although the Central Bank of Nigeria (CBN) has somewhat complied with this recommendation and taken steps to unify the exchange rate, there is still an official and a parallel market exchange rate. The spread between the two rates provides an avenue for arbitrage. Between 2016 and 2020 alone, there is an average margin of 20 percent between the official exchange rate and the Bureau de Change rate. One of the steps taken by the CBN to eliminate arbitrage and rent-seeking opportunities was the suspension of foreign currency sales to Bureau de Change operators in July 2022. However, such a policy has been implemented and later reversed before.[1]

The CBN has been trying different strategies to manage the naira exchange rate for more than three decades. However, the currency continues to depreciate unabated, and

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[1] In January 2016, the CBN implemented the same policy. In defense of the new policy, the CBN governor observed that "despite Nigeria being the only country in the world where the central bank sells [US] dollars directly to the BDCs, operators in this segment have not reciprocated the Bank's gesture to help maintain market stability. Instead, these operators have become greedy by selling dollars they bought from the CBN for 197 Naira at rates as high as 250 Naira / US dollar. Given this rent-seeking behavior, it is unsurprising that the number of BDC operators has risen from 74 in 2005 to 2,786 today." https://punchng.com/bdcs-leopard-changed-spots/. Ironically, the CBN is the only licensing authority for BDC, and yet, the governor is lamenting the exponential rise in the number of BDC operators. For more on this, see section 5.5.5.3 in Chapter five.

the impact on the economy continues to worsen. Given the reluctance of Nigerian policymakers to allow a market-driven value for the naira, the CBN continues to devise various approaches to intervening in the foreign exchange market to manage the currency. These interventions produce results where the costs of the policy are dispersed while the benefits are concentrated. For example, the negative effects may spread throughout the economy, but access to the officially managed exchange rate may depend on the extent of one's political connections or the political power of influential interest groups. The selective allocations are justified by good intentions, which are ostensibly meant to insulate the domestic economy from external shocks or to stimulate local production to promote economic development.

Nigeria's problematic exchange rate policies have often been attributed to lack of diversity in economic production, with the focus on exporting a few primary commodities while importing industrial and consumer goods (see Table 1.4). Policymakers justify their decision to maintain multiple exchange rates as a means of ensuring price stability. This argument suggests that a market-reflective exchange rate will trigger hyperinflation due to the significant demand for foreign currency, which exceeds the limited supply mainly derived from exports of energy products. However, an opposing perspective deems this explanation as incomplete. Floating the naira to bring the official and parallel market exchange rates closer could lead to substantial currency depreciation. However, it is unlikely to spark inflationary pressure since local goods prices already factor in the parallel rate (Pinto 1987, 2016; Gray 2021). Thus, the inflation that the CBN aims to curb has already been caused by the parallel market exchange rate (ibid). This perspective may be plausible because acquiring foreign currency at official rates is challenging, indicating that the parallel market is the most feasible option for meeting most foreign currency needs.

What could be hindering the Nigerian authorities from pursuing a market-based policy that is considered more appropriate given the country's circumstances? One possibility is that the appropriate policy may not be politically feasible, and policymakers may hesitate to enact it despite the central bank being, in principle, independent. Indeed, structural deficiencies related to the exchange rate issue in Nigeria receive significant attention. However, scholars, observers, and analysts commonly overlook political factors when analyzing the exchange rate policy. The policy implementation depends on the sentiments of the government's constituents, support or opposition from powerful groups, and international pressures. Political pressures can constrain policymakers, potentially explaining discrepancies in national currency policies among countries facing similar situations (Frieden 1994). Conducting a comparative analysis between Nigeria and Indonesia will aid in fully understanding this argument and may provide valuable insights for Nigeria to consider from Indonesia's experiences.

1.2 Research Problem: Unravelling the Forces Behind Exchange Rate Policy Shift

Exchange rate policy in Nigeria has remained a contentious issue for over three decades, dominating a significant portion of economic policy debates. This is not solely because of the influence of exchange rates on the internal and external balance of the economy but also because the challenges of managing exchange rates and their impact on economic performance have persisted for an extended period.

The primary cause of Nigeria's exchange rate issues can be traced back to the nation's numerous structural constraints, particularly the heavy reliance on imports with minimal economic diversification. Nonetheless, Nigeria's central Bank's exchange rate system exacerbates these challenges. Efforts to manage the exchange rate to prevent significant depreciation of the domestic currency and to promote growth in essential sectors by allocating foreign currency at subsidized rates have yielded minimal success. Some have argued that the iteration of exchange rate policies in Nigeria "has been at best dysfunctional, and at worst reinforced the mechanisms to support the extraction of rents by the politically powerful who have access to the attractive official exchange rate (Roy, Obidairo, and Ogunleye 2022, 22)."[2] Even Sanusi Lamido, a former governor of the Central Bank of Nigeria (2009 to 2014), observed that:

> These policies have been tried in different parts of the world and this country before, and they have just never worked. No matter what the stated intention behind them, they are wrong. The gap between the black-market rate and the "artificial" official exchange rate would keep widening until the Bank [CBN] adopts a more realistic policy or the price of oil climbed and dramatically increased reserves (Financial Times, February 8, 2016).[3]

Although many private sector participants and international financial institutions recommend eliminating the arbitrage opportunities shown in Figure 1.3 by allowing a more market-based exchange rate, some stakeholders inside and outside the policymaking circle remain skeptical.

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[2] This scenario is described in figure 4.5 (chapter four), drawing from what Robert Bates (1981, 98-99) aptly contextualized in illustrating how market intervention creates vested interest in policy programs.

[3] https://www.ft.com/content/c0c0876c-cd8a-11e5-831d-09f7778e7377

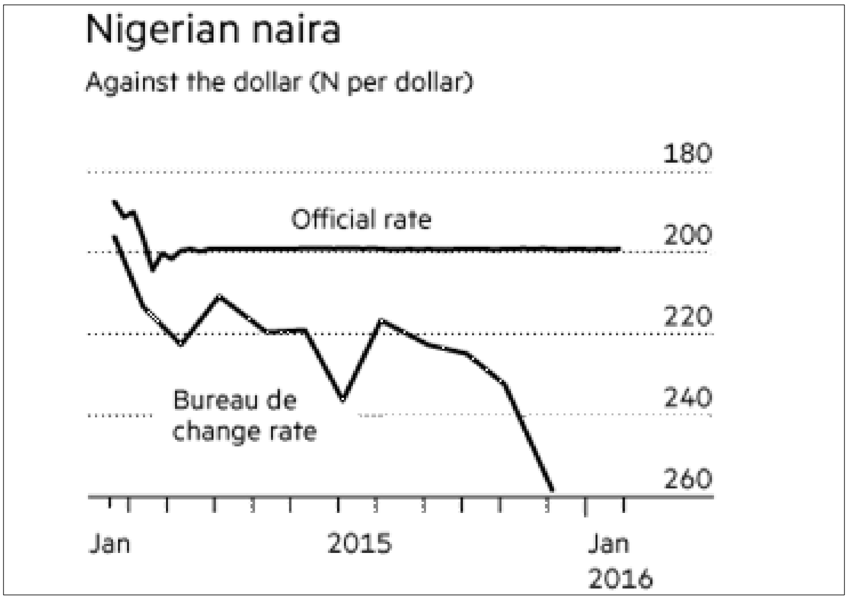


Figure 1.3 Multiple naira exchange rates
Source: *Financial Times,* 2016

The argument for a market-based exchange rate is that it can prevent malpractices in currency trading and attract investment, leading to economic growth. The malpractices arise from the large margin between the officially subsidized exchange rate accessible to privileged individuals and groups and the parallel market rate (see Figure 1.3). Whether Nigeria's policy is driven by political factors or bureaucratic mismanagement is unclear. Indonesia, a comparable country, once had various exchange rates but has since achieved exchange rate unification. The Indonesian currency is now primarily determined by market forces, and the central bank (Bank Indonesia) intervenes only to correct significant volatility without (explicitly) targeting a specific rate.

In many countries, an exchange rate challenge is often a temporary problem emanating from domestic or external shocks. However, this issue has persisted for an extended period in Nigeria, thus resulting in macroeconomic instability and a failure to stimulate productive investments in the real sectors of the economy. Why has Nigeria continued to struggle with managing the exchange rate despite having faced different political and economic environments over the years? What local and international political economy factors drive the choice and management of exchange rate policy in Nigeria? Are exchange rate policies influenced by domestic and international political elements or the policymakers' discretion based on their ideas? There is a need for thorough research to obtain a comprehensive understanding of these crucial issues. It is imperative to get the exchange rate and other complementary policies right to ensure economic growth and stability in Nigeria.

1.3 Objectives of the Study

This study aims to understand why the challenges of exchange rate policy and its consequences on development persisted in Nigeria, as compared to Indonesia, which has comparable political and economic conditions. My central focus is to analyze the extent to which interest groups, political elite pressure, adherence to the international monetary system, or the discretion of policymakers influence the exchange rate policies implemented in Nigeria and Indonesia. Political economy research on exchange rate policy has highlighted how political considerations influence policy decisions in developed and developing economies. These studies show that in the formulation and implementation of exchange rate policies, politicians usually succumb to the demands and pressures of powerful interest groups (Frieden 1994, 2015; Leblang 1999). The policymakers may also seek to align with international monetary commitments. Conversely, the monetary authority may have some insulation from local and international pressures, allowing for greater discretion of central bankers in policy decisions. Therefore, the specific objectives of this study are to:

1. Analyze the exchange rate systems and management strategies of the two countries.
2. Determine the influence of interest groups and political elites on the choice of exchange rate policies.
3. Assess the role of the international monetary system in exchange rate policymaking.
4. Examine the extent of central bankers' discretion on exchange rate policy decisions.
5. Evaluate the consequences of exchange rate policy choices on economic development.

1.4 Justification of the Study: Filling the Knowledge Gap with Political Economy Insight

The ongoing debate regarding Nigeria's exchange rate policy indicates that it has a significant impact on the country's economy. The fact that this issue has persisted for a lengthy period suggests that there is currently no sustainable solution despite policymakers' experimentation with various remedies over the past thirty years. Much empirical research has been conducted regarding the relationship between the exchange rate and the economy. Structural and macroeconomic factors indeed play a significant role in determining exchange rate policy. However, such factors alone do not provide a comprehensive explanation because the distributional consequences of different exchange rate policies create political pressures for policymakers. The pressures stem from the varied preferences of economic actors that shape the choice of exchange rate policy.

This study seeks to understand the influence of political economy factors on exchange rate policy and the resulting economic development outcomes by comparing

Nigeria with Indonesia, which appears to have managed exchange rate policy more effectively in response to external shocks and other domestic challenges. Differences in policy choices due to domestic and international political influences have been recognized as essential factors in explaining economic growth challenges in developing countries. As argued by Drazen (2008,19), "the failure of some countries to grow is certainly related to policy choices, both of governments in those countries and to external decision makers, such as International Financial Institutions (IFIs). There is a wide agreement that politics matters a lot in developing countries, implying that the study of political economy is crucial to the study of economic development."

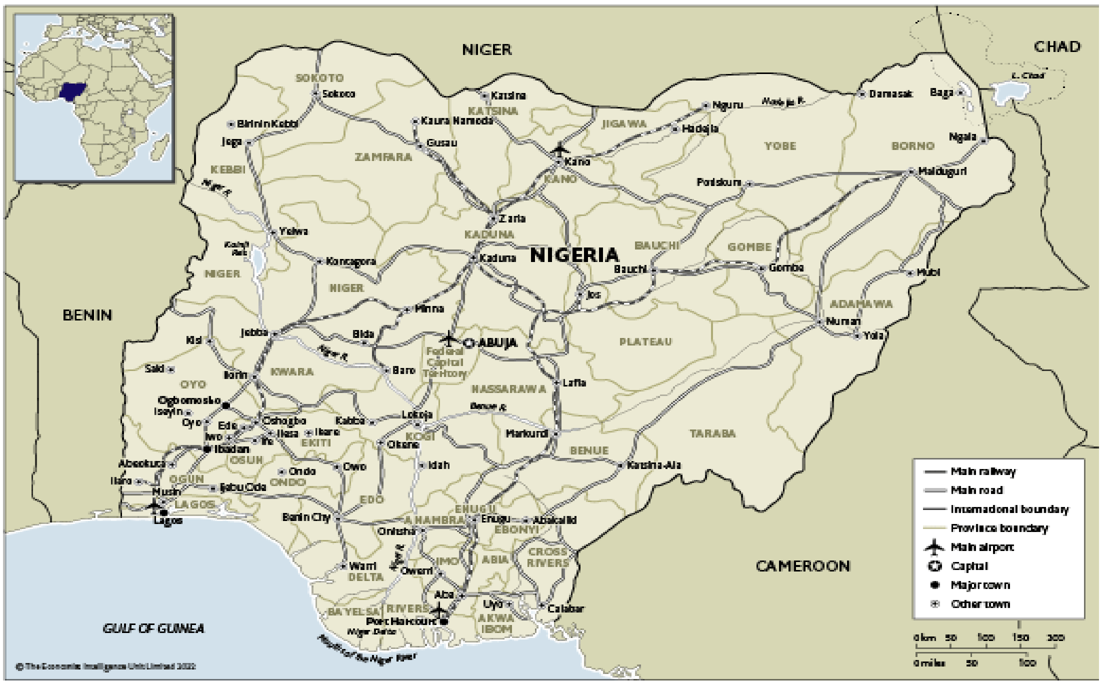
The available comparative studies of Nigeria and Indonesia generally provide insights into the causes of development divergence between the two countries (see Chapter Three). One aspect of the explanation analyzes how differences in exchange rate policy affected the two economies and why technocrats or policy elites choose contrasting policy options. Indeed, the policy elites were highly influential in the period analyzed by the previous comparative studies. However, policymaking in these countries has become more complex due to political changes since 1999. Political pressures may hinder technocratic decisions from within and outside the countries. This implies that the structure of incentives and constraints of policymakers in a more democratic system and the dynamics of the global political economy require an in-depth analysis to understand the persistence of exchange rate challenges in Nigeria.

1.5 Why Compare Nigeria and Indonesia?

Nigeria and Indonesia exhibit similar characteristics common to developing economies, including natural resource endowments, reliance on primary commodity exports, societal diversity, and socio-political dynamics. These two countries hold the distinction of having the largest populations and economies in their respective regions of Africa and Southeast Asia. In addition to sharing structural and historical features, Nigeria and Indonesia have faced similar political and economic challenges between the 1960s and 1990s. However, despite these twin-like similarities, the two countries have achieved vastly different levels of development. This phenomenon has spurred academic inquiry into unravelling the puzzle of why these differences exist.

Since Pinto's (1987) early comparison of the two countries' policy responses to the oil shocks of the 1970s and 1980s, numerous comparative studies have been conducted on Indonesia and Nigeria. The overall aim of these analyses is to explain the disparate economic development outcomes of the two nations despite their similar characteristics. The studies identified various factors contributing to this outcome, with the exchange rate policy being a significant one (refer to Chapter Three).

Although the previous studies' time-frame ended in 1998, the turn of the new millennium paved the way for significant transformations in the political economy of these countries. In the early 2000s, numerous similar reforms were implemented to create the necessary institutional framework for economic policymaking. This included the introduction of laws promoting central bank independence. Although the economic policies in both countries share similarities and have been implemented within comparable institutional settings over the last twenty years, the outcomes diverged. To further demonstrate the appropriateness of the two nations as candidates for comparative analysis, let us briefly examine their political development and socio-economic trends over time. Table 1.1 provides an overview of the key information regarding the two countries, serving as a starting point for such a comparison.



Map 1.1 Map of Nigeria
Source: *Economist Intelligence Unit* (2022)

Map 1.2 Map of Indonesia
Source: *Economist Intelligence Unit* (2022)

Table 1.1 Basic data

<table>
<tr><th colspan="2"></th><th colspan="2">Nigeria</th><th colspan="2">Indonesia</th></tr>
<tr><td colspan="2">Independence from colonialism</td><td colspan="2">October 1, 1960</td><td colspan="2">August 17, 1945</td></tr>
<tr><td rowspan="2">Two watersheds</td><td>Military regimes</td><td colspan="2">1966-1998</td><td colspan="2">1967-1998</td></tr>
<tr><td>Democratic transition</td><td colspan="2">1999</td><td colspan="2">1999</td></tr>
<tr><td rowspan="3">Political system</td><td>Type</td><td colspan="2">Presidential republic</td><td colspan="2">Presidential republic</td></tr>
<tr><td>Executive</td><td colspan="2">Headed by the President</td><td colspan="2">Headed by the President</td></tr>
<tr><td>Legislature</td><td colspan="2">Bicameral assembly</td><td colspan="2">Bicameral assembly</td></tr>
<tr><td rowspan="2">Geography</td><td>Total area</td><td colspan="2">923,768 sq km</td><td colspan="2">1,904,569 sq km</td></tr>
<tr><td>Climate</td><td colspan="2">Tropical, Equatorial, arid</td><td colspan="2">Tropical; hot, humid</td></tr>
<tr><td colspan="2" rowspan="2">Population (millions)</td><td>1960</td><td>2020</td><td>1960</td><td>2020</td></tr>
<tr><td>45,138,460</td><td>206,139,587</td><td>87,751,006</td><td>273,523,621</td></tr>
<tr><td rowspan="3">Religion</td><td>Muslim (%)</td><td colspan="2">53.5</td><td colspan="2">87.2</td></tr>
<tr><td>Christian (%)</td><td colspan="2">45.9</td><td colspan="2">9.9</td></tr>
<tr><td>Other (%)</td><td colspan="2">0.6</td><td colspan="2">2.9</td></tr>
<tr><td colspan="2">Ethnicity</td><td colspan="2">Hausa 30%, Yoruba 15.5%
Igbo 15.2%, Other 39.1</td><td colspan="2">Javanese 40.1%, Sundanese 15.5%, Malay 3.7%, Batak 3.6%, Madurese 3%, other 34.1%</td></tr>
<tr><td colspan="2" rowspan="2">GDP per capita ($)</td><td>1960</td><td>2020</td><td>1960</td><td>2020</td></tr>
<tr><td>1,360.4</td><td>2,396</td><td>690</td><td>4,312.4</td></tr>
<tr><td colspan="2">Currency</td><td colspan="2">Naira</td><td colspan="2">Rupiah</td></tr>
<tr><td colspan="2">Monetary authority</td><td colspan="2">Central Bank of Nigeria</td><td colspan="2">Bank Indonesia</td></tr>
</table>

Source: *World fact book*, CIA; *World Development Indicators*, World bank

Source: Economist Intelligence Unit

1.5.1 Parallel Political Trajectories

Nigeria and Indonesia obtained independence from British and Dutch colonial rule in the first half of the 20th century. By the mid-1960s, both countries were mired in political unrest, which led to military regimes that endured for thirty years. Although the 1967 military intervention started a period of development for Indonesia, it caused a three-year civil war in Nigeria. The three decades of military administration have arguably shaped the disparate paths taken by Indonesia and Nigeria – one towards economic transformation and the other towards prolonged economic decline. The countries recorded another historical juncture as they transitioned to democratic governance around the same time in 1999. Emerging from authoritarian regimes, economic crisis (Indonesia), and prolonged economic decline (Nigeria), the countries were confronted with similar challenges of political and economic reforms to revitalize their economies and promote national unity and cohesion.

Nigeria

Nigeria's political development since independence in 1960 has undergone several political transitions, alternating between civilian and military regimes. The country's initial endeavor with a parliamentary system of governance was cut short by a military coup in 1966. The military continued to hold sway until 1979 when a democratically elected president emerged through a presidential system. In December 1983, the military once again returned and removed the democratically elected president while dissolving the civilian government. This military regime persisted for less than two years before being toppled by another military coup in August 1985.

The 1985 coup reflected an ideological shift within the military towards a market economy. Subsequently, attempts were made to pursue economic reforms to shift the economy's orientation towards a more market-based approach, promoting private ownership and investment. This goal provided the impetus for adopting and implementing the IMF's Structural Adjustment Program (SAP). Unfortunately, the program was unsuccessful and may have worsened economic difficulties. The economic malaise persisted during the subsequent military administration of General Abacha whose reign in power ended with his sudden death in June of 1998. The newly appointed head of state vowed to pursue democratic transition, resulting in the election of a new president in May 1999. For more information on political transitions in Nigeria, see Elaigwu (2012), pages 216–235.

Indonesia

The 1960s represent a watershed moment in Indonesia somewhat equivalent to Nigeria's. Although the causes of the political chaos were slightly different, the outcomes were the same: military intervention in politics. Indonesia faced the challenge of deteriorating economic conditions and political chaos. The economy was characterized by output stagnation, widespread poverty, infrastructural decay, and a hyperinflation of almost 600 percent (Wie 2012, 69). This poor economic performance made President Sukarno's government increasingly unpopular, leading to an attempted coup in 1965. The military intervened and assumed full executive authority. By 1968, General Suharto became Indonesia's president. He held onto power for the next thirty-two years under the rubric of what is known as the "New Order" (Orde Baru) – a broad program of reform to instill macroeconomic stability, attract foreign capital and investment, and promote sustained economic growth with poverty reduction (Rosotti 2019).

Indonesia had experienced a remarkable economic performance in the three decades before the Asian financial crisis in 1998, lifting millions out of poverty. The crises led to social unrest and forced Suharto to resign in May 1998. Elections were held the following year and a new president assumed power. Hence, economic crises accelerated Suharto's ascendancy and decline. The year 1998/1999 marked a significant turning point for Indonesia and Nigeria, as the countries experienced a sudden and dramatic political transformation. This shift to new governance structures had a profound impact on their policymaking environments, institutional arrangements, and approaches to the global system.

A cursory look at the economic and political trajectories of Nigeria and Indonesia in the last two decades shows some signs of convergence in terms of institutional reforms and economic policymaking. However, the economic performance is different despite the parallels observed in their political economies and policy choices. Although Indonesia is still grappling with many challenges, it exhibits greater resilience and dynamism in economic management than Nigeria. Lewis (2007, 3) argues that the "different initial endowments in both countries suggest separate trajectories of reform, and the legacy of earlier developmental efforts will strongly influence distinctive political and [socio-economic] development over the longer term." The merits of this argument may, in part, be assessed by examining the socio-economic indicators of the two economies.

1.5.2 Socio-economic Dynamics

1.5.2.1 Bane and Boon of Demographic Changes

Nigeria and Indonesia have a total population of 206,140 million and 273,524 million in 2020 (Table 1.2), constituting the most populous countries in their respective regions. The proportion of this population living in the urban areas between 1960 and 1990s was about 40 percent. However, the distribution of urban and rural inhabitants in 2020 is almost at par in the two countries. Before 1980, the population grew at a faster rate in Indonesia than in Nigeria. The trend inverted in the subsequent years, with Nigeria's population growing at a rate like Indonesia in the 1970s. There are at least two possible explanations for this outcome. First, the population policy of Suharto's New Order in Indonesia brought about fertility changes through family planning programs, which is different in Nigeria. Secondly, economic development tends to be accompanied by demographic transition to lower fertility and mortality rates.

Table 1.2 Demography

	Total population (millions)		Population change (%)		Urban population (%)	
Year	Nigeria	Indonesia	Nigeria	Indonesia	Nigeria	Indonesia
1960	45,138	87,751	-	-	15.4	14.6
1970	55,982	114,793	2.21	2.71	17.8	17.1
1980	73,424	147,448	2.94	2.41	22.0	22.1
1990	95,212	181,413	2.61	1.90	29.7	30.6
2000	122,284	211,514	2.49	1.43	34.8	42.0
2010	158,503	241,834	2.65	1.33	43.5	49.9
2020	206,140	273,524	2.59	1.14	52.0	56.6
2038	315,215	315,300	2.19	0.57	62.2	65.6
2050	401,315	330,905	1.91	0.32	69.9	72.8

Source: Author based on *World Population Prospects 2019*, UNDESA.

Indonesia has achieved a sustained reduction in infant mortality and significant improvement in life expectancy, especially after the 1980s (table 1.3). Nigeria was making rapid progress in tackling infant mortality in the 1960s through the mid-1980s. However, this pace was slowed in the succeeding decades. Life expectancy in Nigeria sharply contrasted with that of Indonesia. While the trend in Indonesia reflects continuous improvement over the years – from 48 years in the 1960s to 71 in 2020 – Nigeria has achieved very little gain in life expectancy over the past six decades (table 1.3).

The implication of population growth rates is reflected in the annual stock of the population. As Table 1.1 shows, the annual size of Indonesia's population has doubled that of Nigeria for several decades. The gap has narrowed to about 52.6 percent in 2010. It is estimated that the population of Nigeria and Indonesia will be identical by 2038, and the former may exceed the latter by about 22 percent in 2050 (table 1.2).

Table 1.3 Health Development

	Infant mortality rate[1]		Life expectancy[2]	
Period	Nigeria	Indonesia	Nigeria	Indonesia
1960-1965	173	139	38	48
1970-1975	147	105	42	54
1980-1985	125	79	46	59
1990-1995	126	56	46	63
2000-2005	104	37	47	66
2010-2015	75	25	52	70
2015-2020	62	19	54	71

Source: Author based on *World Population Prospects 2019*, UNDESA.
Note: (1) Infant deaths per 1,000 live births for both sexes. (2) Life expectancy (years) at birth for both sexes.

The population dynamics can present an opportunity or a challenge, especially for Nigeria. Investment in human capital is an indispensable public policy priority if Nigeria is to take advantage of the growing population to stimulate sustainable economic growth. The rural-urban influx also requires a coordinated urban development initiative to prevent the emergence of congested and heavily polluted cities.

Indonesia has recently embarked on an ambitious project of moving its capital city from Jakarta to Kalimantan. This becomes necessary because Jakarta is too congested and is sinking below sea level at a rapid pace, which, if unaddressed, can have deleterious consequences. Although Nigeria had also relocated its capital from the coastal city of Lagos to the country's center in Abuja since the late 1980s, the shrinking economic opportunities and deterioration of living standards in the countryside are driving massive migration to the Capital and other major cities. The primary sectors (agriculture and mining), which still employ many of the populace, are challenged by security and environmental problems as well as the volatility of the international market.

1.5.2.2 Economic Structure and Trade

The economies of Nigeria and Indonesia are dominated by agriculture and related activities. As of 1965, agriculture contributed more than half of the total output in both countries (table 1.4). Oil production and export have altered this agrarian status by the early 1970s. In 1975, agriculture accounted for about 30 percent of GDP in both countries. The manufacturing sector increased its share of GDP in Nigeria until the second half of the 1980s, when it began to decline continuously, thereby contributing less to the economy. By contrast, Indonesia's manufacturing performance has been steady since 1985.

It is noteworthy that manufacturing was more export-oriented in Indonesia than in Nigeria, as reflected in the proportion of manufactured goods in total exports (table 1.5). Therefore, manufacturing activities in Nigeria seem largely non-tradable when we juxtapose the size of manufacturing output (table 1.4) with manufactured goods exports (table 1.5).[4] The implication of this outcome for exchange rate policy is that rather than

[4] This should, however, be interpreted with caution because the high level of informal trans-border trade between Nigeria and other African countries is largely unaccounted for in official statistics.

the local manufacturers demanding a depreciated currency, they prefer an overvalued currency. This preference is informed by the need to remain competitive in the domestic market because they depend on imported inputs and perhaps foreign debt.

Table 1.4 Sectoral share of output (value added as a percentage in GDP)

	Nigeria			Indonesia		
	Agriculture	**Manufacturing**	**Service**	**Agriculture**	**Manufacturing**	**Service**
1965	55	5	-	56	8	-
1975	32	5	-	30	10	-
1985	18.2	21.1	47.3	23.8	16.4	41.9
1990	21.6	17.8	42.0	21.5	19.9	39.1
1995	25.5	20.0	37.0	17.1	24.1	41.1
2000	21.4	13.9	43.8	15.7	22.7	33.4
2005	26.1	10.1	44.7	13.1	27.4	40.3
2010	23.9	6.6	50.8	13.9	22.0	40.7
2015	20.6	9.4	58.1	13.5	21.0	43.3
2020	24.1	12.7	46.4	13.7	19.9	44.4

Source: Author based on *World Development Indicators* (1985-2020); Lewis, 2007 (1965 and 1975).

External trade is the major channel through which the impact of an exchange rate is transmitted to the domestic economy. Indonesia's rapid growth in the 1970s and 1980s was linked to exports of both primary commodities and manufactured goods, which was supported by a strategic devaluation of the rupiah to maintain the competitiveness of domestic producers. However, as revealed by Fuady (2012), the agricultural sector benefited more from the devaluation, while other compensatory trade and fiscal policies supported manufacturing.

Within three decades, Indonesia has raised its share of manufactured goods in total exports from only 1 percent in 1970 to about 36 percent in 2000 (table 1.5 panel b). Although the proportion of energy products in Indonesia's total exports rose sharply from

33 percent in 1970 to 72 percent in 1980, it declined in the subsequent decades, indicating less dependence on hydrocarbons, which contrasts the case of Nigeria. Except for the mid-2000s, perhaps due to moderate structural reforms, energy products have constituted more than 90 percent of Nigeria's exports. In what seems to be the peak of the economic decline of the 1990s, Table 1.5 shows that Nigeria exported almost nothing apart from oil products in the year 2000.

Table 1.5 Composition of exports

Panel A- Nigeria

	1970		1991		2000		2010		2020	
Category[2a]	value	%	value	%	value	%	value	%	value	%
1	235	19	182	1	8	0	2,246	3	674	2
2	218	18	78	1	32	0	2,585	3	440	1
3	55	4	54	0	28	0	4,646	5	204	1
4	714	58	12,396	97	26,981	100	75,429	87	30,957	89
5	0	0	32	0	3	0	528	1	227	1
6	-	-	4	0	27	0	1,021	1	2,396	7
7	6	0	81	1	1	0	113	0	2	0

Panel B- Indonesia

	1970		1990		2000		2010		2020	
Category[2b]	value	%	value	%	value	%	value	%	value	%
1	128	12	2,426	9	3,738	6	8,991	6	15,855	10
2	557	53	2,390	9	6,089	10	36,878	23	36,621	22
3	11	1	8,506	33	22,287	36	36,178	23	48,426	30
4	346	33	11,239	44	15,682	25	46,765	30	25,574	16
5	5	1	620	2	3,167	5	8,164	5	9,745	6
6	4	0	370	1	10,769	17	19,622	12	21,419	13
7	3	0	124	0	392	1	1,181	1	5,666	3

Source: Author based on United Nations *Comtrade* database.

Note: [1] Total value in US$ millions and percentage share of export commodity in total exports.

[2] The categories are based on the Standard International Trade Classification (SITC), *Comtrade*. (1) Food, Beverages, and tobacco (2) Raw materials (3) Manufactured goods (4) Energy products (5) Chemicals (6) Machinery & transport equipment (7) Others.

Economic diversification of tradable goods remains elusive in Nigeria. Table 1.5 clearly shows the dominance of hydrocarbons in the composition of Nigeria's exports since the 1970s. At the same time, the Indonesian economy appears relatively diversified, with the share of manufactured goods contributing a more significant amount in total exports. Nigeria's oil exports 'addiction' and its importance in the Nigerian economy has even qualified as the best example to explain one of the meanings of the word 'staple' in the Longman Dictionary of Contemporary English.

Table 1.6 Geographical distribution of trade (top five trading partners)

	Destination of exports				Origin of imports			
	1970	**%**	**2020**	**%**	**1970**	**%**	**2020**	**%**
Nigeria	UK	28	India	15	UK	31	China	29
	Netherlands	17	Spain	11	USA	14	USA	9
	USA	11	Netherlands	9	Germany	13	India	8
	France	9	South Africa	8	Japan	6	Netherlands	8
	Germany	7	China	5	Italy	5	Belgium	4
Indonesia	Japan	33	China	19	Japan	29	China	28
	Singapore	16	USA	11	USA	18	Singapore	9
	USA	14	Japan	8	Germany	9	Japan	8
	Malaysia	9	Singapore	7	Singapore	6	USA	6
	Netherlands	6	India	6	Netherlands	5	Malaysia	5

Source: Author based United Nations *Comtrade* database.

There are also similarities and differences in the trading partners of both countries. Based on Table 1.6, Indonesia trades more with Asian countries, as evidenced by the proportion of imports and exports in total world trade. Nigeria's trading partners reflect the limited volume of trade among African countries. However, China and India are significant trading partners for both countries.

Chapter Two: Investigative Approach: Tools and Methods

2.1 Introduction

The objective of this research is to analyze both domestic and political factors that contribute to the decision-making and outcome of Nigeria's exchange rate policy issues compared to those of Indonesia. This chapter discusses the approach and procedure employed in pursuit of the research objectives. The study utilizes qualitative and descriptive analyses, drawing on primary and secondary data sources. The study's primary data consists of interviews and survey questionnaires, with numerical data, documents, and other written materials comprising the secondary data. Participants were selected from key stakeholders and policymakers in exchange rate policymaking based on the literature. To empirically analyze the interaction among these actors in determining policy directions, I employed the process tracing method.

2.2 Research Design

The study follows the critical realist approach or critical realism philosophical research paradigm. This method emphasizes identifying the underlying mechanisms and observable effects of a phenomenon (Matthews and Ross 2010, 30). Philosophical assumptions guide the data collection and analysis process and the mixing of quantitative and qualitative research techniques (Molina-Azolin 2017, cited in Saunders, Lewis, and Thornhill 2019, 181).

The study utilizes both primary and secondary data to assess whether the discretion of policymakers, domestic political pressures, or the international monetary system influences the exchange rate policies in Nigeria and Indonesia. It analyzes the preferences of policy actors and their influence on the adoption of specific exchange rate policies by the monetary authority. By comparing Nigeria and its comparator country, Indonesia, we can identify the factors that explain the differences in exchange rate policies under similar political and economic conditions. This study follows the most similar systems design in line with Lewis's (2007, 24) approach "to understand different outcomes in comparable social, political, and economic contexts." The countries provide an optimal sample for comparative analysis based on their similarities regarding various features. These common characteristics are held as controlled variables while assessing the role of stakeholders in shaping the exchange rate policies of the two countries.

The analysis looks at the historical context of the exchange rate issues in the two countries, but the main emphasis is on the period between 2000 and 2022. As discussed in Chapter One, Nigeria and Indonesia transitioned to a democratic system of governance in 1999. This period set the stage for significant transformations and institutional reforms, such as central bank independence. Democratization paved the way for greater freedom and political contestation over public policies.

The research considers policymakers (central bankers) as key actors who implement exchange rate policies to reflect their ideas of optimal policy or in response to political pressures. The policymakers' selection of exchange rate policy (exchange rate control or liberalized system) can be influenced by interest groups, political elites, and international institutions. The framework used here allows analysis of the interaction between domestic and international actors and factors influencing exchange rate policy decisions made by central banks. Business interest groups aim to influence policy options through direct lobbying or advocacy, while powerful political elites in the government's executive and legislative arms may also seek favorable exchange rates. At a separate level, international institutions aim to implement changes in fiscal and monetary policies by using loan conditionalities and economic stabilization programs.

To analyze the interaction of these factors and determine the most likely explanation for policy decisions, I utilized the process tracing approach, which "attempts to identify the intervening causal process – the causal chain and causal mechanism – between an independent variable(s) and the outcome of the dependent variable (George and Bennett 2005, 206)."

2.2.1 Process Tracing Method

The process tracing method seeks to demystify how policy preferences of actors translate to policy outcomes. For instance, the proposition of the interest group theory of exchange rate policy is that the preferences of these groups condition them to demand or lobby for favorable exchange rate policies. Through the process tracing approach, I attempted to empirically trace the causal linkages from the preferences of policy stakeholders to policy outcomes. The goal is to link the cause and the outcome and unpack the activities performed by actors in the policymaking process. According to Beach and Pedesen (2013, 29), "the mechanism linking a cause and outcome can be understood using a machine analogy. Each part of the theoretical mechanism can be thought of as a toothed wheel that transmits the dynamic causal energy of the causal mechanism to the next toothed wheel, ultimately contributing to producing outcome". Using a car as a practical example, where X could be the motor, and Y is the movement of the car. The motor requires a driveshaft and wheels to produce motion. These drive shafts and wheels can be conceived as a causal mechanism that transmits forces from X (motor) to produce Y (movement) (30).[5]

In this study, X1= Domestic politics, X2= International institutions, X3= Central bankers, and Y= Exchange rate policy choice. Figure 3.1 illustrates the conceptualized causal chain, with each part consisting of entities engaging in activities to influence policy. Thus, entities correspond to our analogical toothed wheel, while the activities through which influence is transmitted cause the movement of the wheels.

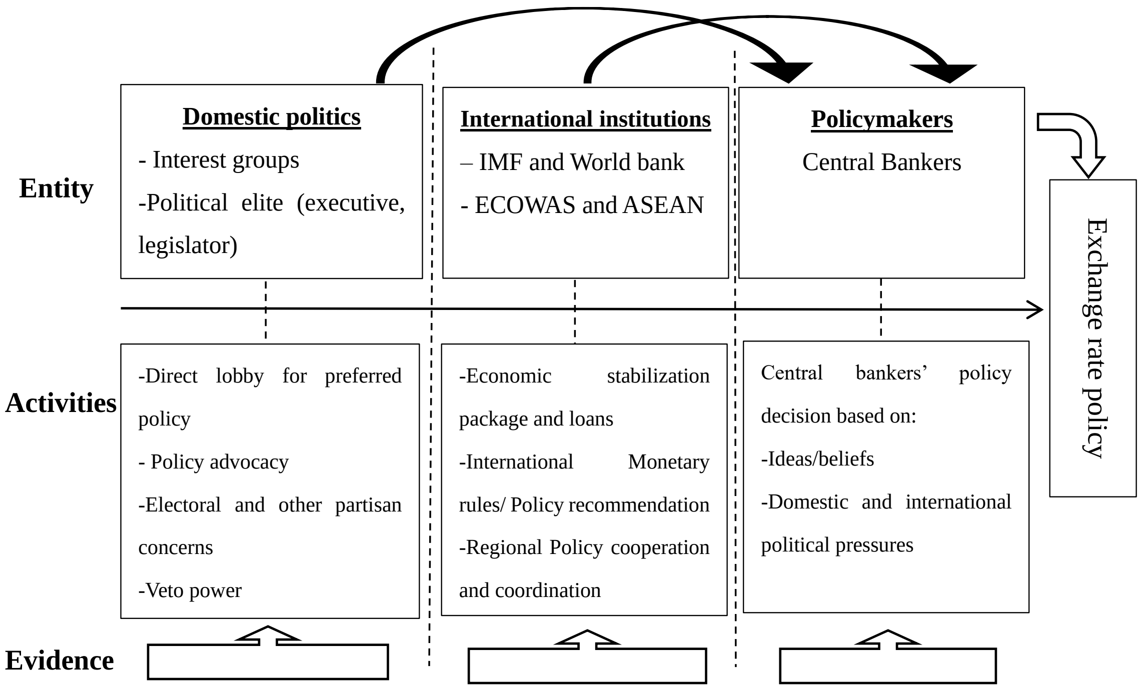


Figure 2.1 Causal chain tracing exchange rate policy choice
Source: Constructed by author based on Beach and Rasmus (2013, 29)

5 The ambition is to go beyond correlations and associations between X and Y, opening up the black box of causality to study more directly the causal mechanism whereby X contributes to producing Y (Beach and Rasmus 2013, 11).

The empirical evidence in process tracing makes causal inferences on the presence of the hypothesized mechanism and whether the mechanism functioned as predicted or only some parts were present in the case. I collected data through Interviews, survey questionnaires, and documents to generate evidence on each part of the mechanism.

2.2.2 Research Participants

The main subject of investigation in this research centers on exchange rate policy choice as an outcome of interaction among key stakeholders – policymakers, political elite, business interest groups, and international institutions. Research participants are therefore selected purposively based on their supposed role in the policymaking process. According to Matthews and Ross (2010, 225–226), "in selecting research participants, people are chosen 'with purpose' to enable the researcher to explore the research questions or develop a theory. The participants are selected based on characteristics or experiences that are directly related to the researcher's area of interest and her research questions and will allow the researcher to study the research topic in depth. Usually, semi-structured interview participants are chosen who have something to talk about."

The stakeholders involved in the exchange rate policymaking process constitute the target participants of this research. These include government officials at the Central Bank of Nigeria (CBN) and Bank Indonesia (BI), leaders of business interest groups, and international financial institutions. [6] Identifying exchange rate policymakers is

[6] The selection criteria of the research participants include: 1) The policymaker must be a serving or former staff of the central bank. 2) The leader of the selected interest group or member of the executive committee of the association that is in position to talk about the activities of the group.

straightforward. However, determining the relevant interest groups to serve as units of analysis is potentially challenging given the large number of business associations in both countries.

Guided by the interest group literature (see Chapter 2), I employed a purposive sampling method in selecting some of the associations representing the most important sectors of the economy, since they are expected to have greater political clout to influence policies. Additionally, the association of money changers (Association of Bureau de Change Operators of Nigeria) was also included. The dominance of agricultural products in Nigeria's nonoil exports informed the selection of the associations representing the top tradable products such as sesame seed, cocoa, and ginger (refer to the appendix for a list of interviewees).[7] In Indonesia, some potentially influential associations were chosen, but only the Indonesian Palm Oil Association (IPOA) or *Gabungan Pengusaha Kelapa Sawit Indonesia* (*GAPKI*) participated in the research. Palm oil is Indonesia's leading export commodity, suggesting that GAPKI can provide a relatively modest indication of the political influence of business interest groups on exchange rate policy in Indonesia.

Most empirical studies of exchange rate politics measure the degree of a group's importance to the national economy by its contribution to national output. However, some groups can be politically influential even with a low GDP share. One reason could be due to the government's economic policy objective. A classic example is the attempt to develop import substitution industries in developing countries which entails local manufacturing of imported goods. This government priority could potentially increase the

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[7] For ginger, the Interviewee participated in the research as a major exporter, not on behalf of the ginger association.

manufacturing sector's political influence in the policy arena, despite its limited performance. The Manufacturers Association of Nigeria (MAN) appears to exemplify this scenario and is therefore a significant participant in this research.

2.3 Data Collection

Both primary and secondary data were utilized to address the research objectives. I conducted semi-structured interviews with interest groups to trace their influence on policy decisions. Further, the role of international institutions is analyzed using documents. To evaluate the agency of central bankers – ideas and response to political pressure – I used semi-structured interviews and survey questionnaires in both countries. The secondary data consists of government records, policy documents, and statistical data from national authorities and that of international organizations. Other materials include books, journal articles, newspapers, magazines, as well as online videos. Most of these data are available on the internet.

2.3.1 Interviews

In both Nigeria and Indonesia, I conducted semi-structured interviews with central bank officials and selected business interest groups. Interviews used in process tracing studies can provide richer insights that may not be obtained from relying only on surveys and document analysis because the researcher can probe the interviewee with additional questions (Dür 2008, 563). The interviews are semi-structured in the sense that there are predetermined interview guide questions that attempt to measure the influence of interest groups. These interview questions are formulated in line with the suggestion by Dur (2008), that, measuring interest group influence using the process tracing method involves asking questions about "groups' preferences, access to decision-makers, influence attempts, decision-makers responses to the influence attempts, the degree to which groups' preferences are reflected in outcomes, and groups' statements of (dis-) satisfaction with the outcome" (562).

Research interviews are typically conducted one on one or via telephone and computer-aided channels. Although the latter lacks the nonverbal communication hint that may be useful in the analysis of Interviewee responses, Berg (2001, 82) argues that "under certain circumstances, telephone interviews may provide not only an effective means for gathering data, but in some instances – owing to geographic locations – the only viable method. The primary reason that one might conduct a qualitative telephone interview is to reach a sample population that is in geographically diverse locations." The research participants in this study are dispersed across different geographical locations in Nigeria and Indonesia, and reaching out to them face-to-face is almost impossible, especially due to the additional constraints imposed by Covid 19 pandemic. I therefore conducted almost all the interviews through telephone and other online communication mediums such as Zoom.

The interviewees comprise two experienced staff of Nigeria's central bank and one from the Indonesian central bank. These policymakers have at least two decades of working experience at the central banks and could give insightful information on exchange rate policy. The interest group interviewees are leaders and key executives of their respective business associations who can share valuable information about their policy preferences and interaction with policymakers.

2.3.2 Questionnaires

The questionnaire is specifically designed to survey central bankers in Nigeria and Indonesia to understand their views about exchange rate management and their perceived responses to political pressures. Thus, the questionnaire captures not only the ideas and beliefs of policymakers but also how they react to the issues of domestic and international political actors' involvement in the policymaking process.

The questionnaire consists of four sections. The first section collects basic information about the respondents. The second section on exchange rate management measures central bankers' perceptions of their degree of autonomy in making policy decisions and whether their inputs are used in those decisions. It is important to establish this at the outset because we are attempting to measure the central banker's agency in making policy choices based on his or her background, work experience, and policy preferences. The questions on the exchange rate system in the second section of the questionnaire are informed by the discussions in Chapter four. The subsequent three sections focus on the central banker's interaction with domestic and international political actors in setting exchange rate policy and whether political influence explains the exchange rate policies implemented. The questions in these sections are constructed based on the literature on the political economy of exchange rates (Chapter two). By asking respondents to place themselves along a continuum of agreement and disagreement, the questionnaire elicited the perceptions of central bankers in Nigeria and Indonesia on exchange rate management and the extent of stakeholders' involvement, and their possible influence on the policymaker's choice of exchange rate policy.

Like the interviews, questionnaire respondents (central bankers) were reached online, using Google Forms to obtain responses. In both countries, I contacted central bank officials to help me circulate the questionnaires among their colleagues at the headquarters of CBN, Abuja, and BI, Jakarta. The questionnaire went through different stages of development before it was finally administered. The first version of the questionnaire benefited from suggestions and recommendations from my academic advisor and colleagues before it was pretested with eleven respondents at CBN. This pilot study provided the impetus to revise the questions and improve the instrument in general. In fact, the recommendation to prepare the questionnaire in an online format came from the pilot study.

2.4 Data Analysis

The type of data collected in this study require the use of qualitative and descriptive data analysis methods. The qualitative analysis proceeds by first coding the interview data to generate categories and themes according to the guidelines (questions) provided by (Dur 2008) for measuring interest group influence using the process tracing method. Each of these questions constitutes a theme, and my interview questions were formulated in line with these broad process-tracing questions (see, Section 3.3.1). I then discussed the themes accordingly. Documents (IMF reports) were also coded and analyzed to trace the evidence of IMF influence. The survey questionnaire was analyzed using simple descriptive statistics to elicit the perception and agency of central bankers in the exchange rate policymaking process.[8] The questionnaire consists of Likert-type items rather than a Likert scale. Boone and Boone (2012) provide an important clarification of the distinction between the two and recommend appropriate descriptive statistical tools for each. This informs my use of mode to measure central tendency and frequencies to measure the variability in responses.

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[8] This is in line with the approach employed by Schulz (2017) in quantifying the ideas of central bankers and the impact on policy choices. The questionnaire design of the present study also benefits from the work of Schulz (2017).

Chapter Three: Literature Review

3.1 Introduction

This chapter reviews the available literature that explains the divergent development paths of Nigeria and Indonesia. Most of the explanatory factors are rooted in policy choices and institutional characteristics. A key policy with significant influence on the performance of the two economies is the exchange rate policy. The chapter, therefore, seeks to understand the channels through which the exchange rate stimulates economic development. The impact of the exchange rate on development implies that it is important to choose the appropriate exchange rate policy. In practice, the policy is implemented not only based on economic feasibility but also based on political feasibility. The political economy of exchange rate policy choices is also discussed in this chapter.

3.2 Explaining the Development Divergence between Nigeria and Indonesia

The motivation for comparing Nigeria and Indonesia was mainly sparked by an inquiry into the factors that explain the differential economic performance of the two countries, given their similarities in many dimensions. The policy responses to the oil shocks of the 1970s and 1980s and the resulting outcomes in both countries provided the initial impetus for academic research to unravel how Indonesia escaped Dutch disease, while it infected Nigeria. Subsequent research has sought to understand why policymakers in the two countries chose different policy options in the face of comparable challenges.

In a seminal study of Nigeria and Indonesia, Pinto (1987, 419-20) analyzed the policies adopted in Nigeria during the oil boom of the 1970s in comparison to Indonesia. Pinto highlighted the similarities between the two countries not only in their economic structures but also in their trade policies. However, they differ in their approach to fiscal, exchange rate, agricultural, and external debt policies. The study illustrates how these differences manifest in contrasting outcomes for borrowing and spending priorities and agricultural development, all of which are linked to the exchange rate.

Moreover, De Silva (1996) used the case of agricultural protection through macroeconomic policies in Nigeria and Indonesia during the oil boom to examine why countries choose different policies and achieve contrasting economic performance while facing similar external shocks and structural problems. The study concludes that the evolution of formal and informal institutions over time and the resulting impact on political and economic actors provide a good explanation for the different performance of the two countries under similar circumstances. Along the same line of argument, but with an emphasis on the role of the institutional base of development drawn from North (1990), Thorbecke (1998) argued that economic performance depends on macroeconomic policies and stability, which in turn depend on broader social, political, and economic institutional factors.

Additionally, according to Thorbecke, the differences in institutional foundations are reflected in Indonesia's adherence to macroeconomic rules that instill fiscal and monetary discipline, in contrast to Nigeria's misguided policies, such as the fixed exchange rate. Direct and indirect policies towards the agricultural sector are another important difference between the two countries: Indonesia directly supported the sector with fiscal instruments such as infrastructure and agricultural inputs, while Nigeria heavily taxed the sector. Indirectly, exchange rate policies stimulated agricultural production in Indonesia but suppressed it in Nigeria (134). Eifert, Gelb, and Tallroth (2002) also found that part of the reason Indonesia was able to manage the macro economy better than Nigeria was because of differences in their political economies.

These political economies were shaped by some of the similar initial socio-economic conditions and collective action initiatives within and among groups that Thorbecke (1998, 112-116) analyzed.

In addition to the traumatic economic conditions inherited by Suharto in 1967, sound economic management in Indonesia was further enhanced by the consensus built around the distribution of oil revenues focused on rural development (Eifert et al., 2002). "Even in an autocratic environment, the non-oil tradable sector, agriculture, and increasingly labor-intensive industry, constituted an important political interest group with a direct stake in the quality of public spending and in avoiding extreme appreciation of the real exchange rate. In contrast to Nigeria, Indonesia thus had the benefit of the first oil windfall in the form of effective agents of restraint" (ibid). Bevan, Collier, and Gunning (1999, 418 - 423) attribute Indonesia's success and Nigeria's failure in achieving equitable growth (from the 1970s to the 1990s) to differences in agricultural pro-poor policies and the interrelated industrial, trade and exchange rate policies. These policy differences can be explained to some extent by initial conditions, social structure, and other random events.

In a book-length comparative study of Nigeria and Indonesia, Lewis (2007) leaned towards the institutional explanation for the economic divergence of the two countries by examining the relationship between policy, institutional change, and economic growth. The analysis of the two cases under study expounded and applied some political factors and or foundations of institutional change that influence economic performance through the provision and sustenance of credible commitments (incentives) by the state to private economic actors. Lewis noted the distinct differences between Nigeria and Indonesia in elite orientation, coalition formation, and policy choices as reflected in their approach to the global economy, the relationship between state officials and the private sector, and macroeconomic management (271-276).

However, the extensive state control over the Nigerian economy and the attitude towards the international system in general have changed dramatically since the country transitioned to democracy in 1999, as Lewis (2007, 273) also acknowledges. Trade and investment are relatively more liberal, and private ownership is prioritized in many policy reforms and initiatives. There has also been some progress in macroeconomic management, but some old challenges still need to be solved, such as those related to exchange rate management, despite greater autonomy for the central bank.

A potential alternative to the institutional explanation for the differential economic performance of Nigeria and Indonesia, and more broadly between Southeast Asia and Sub-Saharan Africa, was provided by the Tracking Development Project (hereafter TD Project), sponsored by the Dutch government in 2006. The project compared four countries in Southeast Asia with four in Sub-Saharan Africa to explain why the former region has developed rapidly over the past half-century and the latter has not.

An excerpt from the TD project (Henley, Tirtosudarmo, and Fuady 2012) proposed an alternative perspective to challenge Lewis's (2007) view that Nigeria's failure to use its oil wealth to promote national prosperity was due to social, political, and institutional fragmentation. The paper explored the policy contrasts between Nigeria and Indonesia, which can be seen in the countries' different agricultural strategies, economic systems (market versus state), and exchange rate policies. Each corresponds to one of the preconditions for sustainable growth identified by the TD project; "pro-poor, pro-rural public spending, economic freedom for farmers and entrepreneurs, and appropriate macroeconomic management" (Henley 2015; Henley et al. 2012, 52). The factors cited as possible explanations for these different approaches are the political interests and constituencies of technocrats, their social origins, intellectual backgrounds, and experience in dealing with the complex political economies of these countries (Henley et al. 2012, 59 - 66).

A Ph.D. dissertation by one of the TD project researchers, Fuady (2012), was devoted to the comparative analysis of the economic policies (rural-agricultural, industrial, and exchange rate) of Indonesia and Nigeria and why the countries' elites faced with similar economic challenges, chose different policies that led to the countries' contrasting development trajectories from the mid-1960s to the mid-1990s. While reinforcing the opposition to the institutional argument, Fuady (2012) suggested that it is misguided policies rather than socio-political fragmentation and institutional arrangements that explain Nigeria's economic failure. "The political elites in the two countries had different visions of development which determined the design and implementation of economic policies. [The] educational background and life experiences of economic policy elites are an important determinant of the policy contrast between Indonesia and Nigeria" (Fuady 2012, 1-3).

Consistent with other studies, the TD project also identified differences in exchange rate policies as one of the key factors explaining the divergent economic performance of the two countries. Indonesia took a decisive step to devalue its currency several times in response to the oil booms of the 1970s and 1980s. As highlighted in Chapter One, when economic fundamentals for most of the period did not indicate the urgency for this action (at least based on conventional wisdom), the policy decision later proved to be a remarkable strategy to escape Dutch disease. It helped to maintain the competitiveness of the agricultural sector, raise rural incomes, and achieve a favorable balance of payments. Nigeria's experience has been the opposite.

What could explain why policymakers in Indonesia decided to devalue the currency while their Nigerian counterparts did not? Fuady (2012, 2013) argues that the decision to devalue or not can be partly explained by the personal background of policymakers in terms of education and socio-cultural origins. Economic policy in Indonesia has had a strong rural bias, while Nigerian policymakers rushed to urban modernization, a fact that arguably persists to this day. Fuady also noted the differential impact of devaluation on different groups in Indonesia. It benefited the agriculturally based outer islands as opposed to manufacturing-based Java. Though, these effects on the manufacturing sector were cushioned by tax cuts and import exemptions on imported materials.

However, Fuady's view in the case of Nigeria seems contradictory. He acknowledges that in the absence of a strong agricultural export base, it is hard to make sense of a devaluation. At the same time, he maintained his argument in favor of devaluation given that the agricultural sector was not able to benefit from the competitive advantage of a devalued currency. Additionally, suppose the personal backgrounds of Indonesian policymakers influenced their decisions to devalue the currency in that period. How would one explain the reasons why economic policymakers in Nigeria over the past two decades persistently rejected devaluation despite sharing somewhat similar backgrounds with the Indonesian technocrats, as alluded to by Fuady? Nonetheless, even if Fuady's argument is plausible, it is important to note that the policy arena has changed. One departure from the past is that, ever since the democratic transitions in the early 2000s, exchange rate policy has been conducted by 'independent' central banks in both countries. In principle, this is meant to protect the institutions from political interference. However, political contestation over public policy in the context of democratic governance may leave little room for discretionary decisions by technocrats.

Synthesizing the findings of the TD project in his book Asia-Africa Development Divergence: A Question of Intent, David Henley (2015) completes the critique of the institutional approach to explaining the contrasting development of Indonesia and Nigeria. Henley concludes that it was the lack of developmental intent of the political elite in Nigeria and other African countries that hindered their economic success. Henley argues that, as opposed to Africa, the role of intention was demonstrated by the different policy choices of the ruling elites in Southeast Asia, which were in favor of state-led, pro-poor, and pro-rural agricultural development. According to Henley, the simultaneous achievement of macroeconomic stability, rural agricultural development, and economic freedom for peasants were the three preconditions for sustained growth with poverty reduction in Southeast Asia. Sadly, these conditions were never met in any Sub-Saharan African countries studied by the TD project.

To summarize this section, the comparative studies of Nigeria and Indonesia identified several factors that could explain the development divergence between these comparable countries. The first attempt at this research effort focused on examining the countries' policy responses to the oil shocks of the 1970s and 1980s. In this regard, different approaches to macroeconomic management in the two countries, especially exchange rate, fiscal, and trade policies, were crucial in explaining the contrasting economic performance. The importance of these policy variables largely resulted in agricultural development. With a devalued currency, high public spending, and trade openness, the agricultural sector contributed to Indonesia's rapid economic growth. This promising growth potential attracts investment to Indonesia, much of it in the labor-intensive manufacturing sector. In contrast, Nigeria has applied the flip side of the same policies in favor of industrialization, unfortunately at the expense of rural and agricultural development. This has laid the groundwork for economic decline with the spillover effect of high poverty incidence.

Some of the explanations for these different policy directions under similar conditions suggest that the focus on rural development and macroeconomic stability in Indonesia was because it had experienced social instability and economic crisis on a scale not comparable to Nigeria. In other words, the adoption of prudent macroeconomic policies was due to the experience of hyperinflation and mass poverty, which paved the way for the advent of Suharto as president. As noted by Fuady (2012, 12), the economic stabilization programs initiated at the beginning of Suharto’s regime were specifically aimed at controlling inflation, ensuring food security, and relieving the debt burden.

In general, previous studies have provided different insights into the causes of the contrasting economic performance of Nigeria and Indonesia. However, there seems to be a consensus that the influence of exchange rate policy was significant in Indonesia's economic take-off and Nigeria's stagnation. The plausibility of this argument stems from the strategic devaluation that supported Indonesia’s agricultural exports and the subsequent competitiveness of other manufactured goods in the period before the Asian financial crisis. What the literature tells us is how different exchange rate policies affected the two economies and why technocrats chose different policy options. The “how” question focused on the Dutch disease effect, and the “why” question focused on institutional variables and the characteristics of technocratic elites.

Political elites were highly influential during the period analyzed in the previous studies, but policymaking in these countries has become more complex due to political changes. Technocratic decisions can be hampered by political pressures from inside and outside the country. Indeed, political contestation was not entirely absent in Nigeria and Indonesia before and after independence. However, the structure of incentives and constraints for policymakers in a more democratic system, as well as the dynamics of the global political economy, require in-depth analysis to understand the persistence of exchange rate challenges in Nigeria.

A large number of studies on the exchange rate in Nigeria largely focuses on the effect of exchange rate policies on specific economic sectors such as the agricultural sector (see, for instance, Essien et al. 2011; Ammani 2012; Oyinbo, Abraham, and Rekwot 2014; Okorie 2017; Adekunle and Ndukwe 2018; Mbam et al. 2020; Obiageli 2020; Ogunjimi 2020), or the manufacturing sector (David, Umeh, and Ameh 2010; Uzochukwu and Emmanuel 2014; Orji et al. 2018; Ezenwakwelu et al. 2019; Kenny 2019; Akeem 2019). Other studies examine the relationship between exchange rate volatility or misalignment and Nigeria's economic growth (Akpan and Atan 2011; Ali et al. 2015; Amassoma 2017; Ehikioya 2019; Moses et al. 2020).

There is a growing scholarly interest in understanding the political dimension of exchange rate policy, especially in new democracies and transition economies. However, it is an area of research that is still under-explored in Nigeria despite the intense debate on the appropriate policy for setting and managing the exchange rate. Nevertheless, there have been attempts to analyze the political logic underlying Nigeria's exchange rate policy reform and how political considerations affect exchange rate policy and capital controls in the country following the structural adjustment program in the late 1980s

(Uzodike 1999) and how political considerations influence exchange rate policy and capital controls in the country (Urama and Iloh 2018).

Uzodike (1999) explained the preferences of influential interest groups and actors in exchange rate policy in Nigeria. The study provided some important insights into the politics of the exchange rate regime in Nigeria, especially the role and consequences of elite pressure on policymakers during the military regimes between 1987 and 1995. Many of Uzordike's arguments still have merit. However, the analysis did not link the exchange rate problem to development outcomes in Nigeria, let alone attempt to compare with similar countries to draw lessons. Moreover, the time frame was limited to the military period, during which the Central Bank of Nigeria was less independent and economic policymaking was generally concentrated in the hands of a few elites.

Urama and Illoh (2018), on the other hand, only highlighted the theoretical prediction of political influence on exchange rate policy and capital controls and policymakers' responses to political pressures but did not prove such a scenario in the case of Nigeria. The study conjectured that politics, institutional incentives, and group interests play a significant role in determining Nigeria's exchange rate regime without providing evidence to support this assertion. Unlike Uzodike (1999), who discussed specific interest groups and their possible influence, Urama and Illoh (2018) did not mention any interest group.

A working paper by Roy et al. (2022) analyzes the link between exchange rate "(mis)management" in Nigeria and illicit financial flows. The paper focuses on the consequences of foreign exchange controls enforced by the CBN, which open the floodgates of corruption and illicit gains to powerful political interests. Roy et al. (2022) provides some valuable insights into the weaknesses of exchange rate management by the

CBN, particularly the abuse of the multiple exchange rate system. The focus of the paper is not on the developmental outcomes of exchange rate policy but on how the CBN's exchange rate management strategy facilitates corruption and illicit financial flows.

There is still a dearth of systematic studies on the political economy drivers of exchange rate policy in Nigeria beyond the technical, economic modeling, and empirical analysis of exchange rate policy choices that dominate the literature. It is essential to conduct an in-depth study through a political economy lens that integrates international factors and domestic sources of exchange rate policy decisions. This will help in understanding the complex exchange rate challenge and its implications for Nigeria's development.

3.3 Theoretical Literature

It is important to clarify the theoretical postulation of how exchange rate policy affects development through different channels and how politics impact the policy. This section explains the logical connection between exchange rate policy and economic development. It then examines the political economy of exchange rate policy choice, zooming in on the factors influencing the policymaker.

3.3.1 The Link Between Economic Development and Exchange Rate Policy

Economic development involves a process of structural change in the production pattern or the transformation of a country's economic structure as influenced by policies and institutions. Countries that achieve structural transformation have diversified their productive activities and attracted investment in high-productivity sectors. The bulk of these activities are usually in modern industrial sectors that produce for domestic and international markets. Whether these sectors succeed in boosting economic performance depends on the atmosphere of the local environment and the state of the international economy. More specifically, the role of productive investment in promoting economic growth is influenced by the incentive structure of the government and the prevailing opportunities or challenges in the global environment.

A conducive macroeconomic environment, including a stable and competitive exchange rate, is important for fostering new productive sectors. It is noteworthy that the real exchange rate played no role in the analyses of most of the early-generation models of economic growth and development (Eichengreen 2008, 1). Little attention was paid to the role of the exchange rate in promoting growth because conventional macroeconomic theory considered it as an endogenous variable determined in a general equilibrium framework by other factors – preferences, factor endowments, and productivity (Razmi, Rapetti, and Skott 2012, 152). Evidence in the literature based on the experience of some countries suggests that the real exchange rate is important for growth if it is stable and maintained at a competitive level. However, Eichengreen (2008, 4) argues that a stable and competitive real exchange rate can only help a country unleash its growth and development potential if the country has a reputation as an investment destination, a high savings rate, and a disciplined workforce. This means that the presence of these fundamental factors is a precondition for the success of an exchange rate policy, implying that the exchange rate plays only a facilitating role in the development process.

For the real exchange rate to facilitate development, it needs to be competitive and less volatile. Both domestic and international factors can influence the volatility. However, at what level can the real exchange rate be considered competitive? Bresser-Pereira (2012) states that a competitive exchange rate is not necessarily an undervalued exchange rate. Rather, it is the industrial equilibrium rate that allows technologically endowed firms to be internationally competitive. In other words, it is a realistic exchange rate that stimulates entrepreneurs to trade in the world market, which then expands their investments and employment, leading to economic growth (Bela Balassa 1982, 1993 cited in Williamson 2003, 4).

The competitive exchange rate is not necessarily synonymous with a relatively undervalued exchange rate, but it is certainly that which is not overvalued. An overvalued exchange rate makes it more difficult for export-oriented firms and entrepreneurs to access international markets and finance. In addition, overvalued currencies, especially in developing countries, can be detrimental to growth by increasing current account deficits, creating shortages of foreign exchange for international settlements, and leading to widespread rent-seeking and corruption (Rodnik 2008, 366). An artificially overvalued currency raises the price of domestic goods relative to foreign goods, leading to an excess of imports over exports. Moreover, the overvaluation is administratively mediated through a multiple exchange rate system. The official and parallel market rates of foreign exchange are rationed to specific sectors and activities. This can create an avenue for rent-seeking and other corrupt practices. In commodity-exporting countries, overvaluation is often a direct consequence of the Dutch disease phenomenon. The immediate effect is a shift in domestic demand to foreign goods and a reduction in foreign demand for domestic goods, ultimately stifling economic growth and development. However, this can be mitigated by a strategic exchange rate policy aimed at nominal currency depreciation to maintain a positive balance of payments position. In general, a country's development requires a combination of several macroeconomic policy variables, such as prudent public finances, moderate interest rates, and a competitive exchange rate. The most strategic of these three, according to Bresser-Pereira (2012), is the exchange rate because it not only affects international trade but also determines wages, consumption, investment, and savings.

The degree to which the exchange rate influences the macroeconomic environment through multiple channels suggests that exchange rate policy has important consequences for development (Levy Yeyati 2019). Unlike most theories of economic growth and development, structuralism development macroeconomics emphasizes the central role of the exchange rate in economic development theory (Bresser-Pereira 2012). Structuralism development macroeconomics pays more attention to macroeconomic prices, such as the exchange rate and interest rate, and less attention to the traditional process of industrialization (which involves the movement of labor to higher-value sectors) in economic development (7).

The recognition of the exchange rate as a key variable in development policy has motivated theoretical and empirical research on the relationship between the former and the latter. Gala (2008) provides a theoretical analysis and empirical evidence on the relationship between real exchange rates and development. The study presents a model of the exchange rate effect on long-run growth through the possible channels of investment (capital accumulation) and technological change. Investment in the tradable sector tends to decline because of the effect of an overvalued exchange rate on profits. On the other hand, an undervalued exchange rate is often associated with higher levels of investment (275). Excessive overvaluations in a developing economy can shut down industries, thereby preventing the productivity gains that could be generated by labor movement into the high-productivity manufacturing sector that would otherwise leave the economy with surplus labor (275).

Gala argues that a competitive exchange rate could stimulate the industrial production of manufactures for the international market. This boost in manufacturing will help accelerate technological progress. This development of manufacturing will help accelerate technological progress through learning by doing, especially in resource-rich countries where commodity exports lead to currency appreciation that tends to impede industrial development and associated technological spillovers (276). Therefore, the exchange rate can serve as an effective tool of industrial policy if overvaluation is avoided. This view highlights the role of the exchange rate as an instrument of industrial policy used to promote economic diversification in manufacturing and modern services sectors characterized by activities with high technological content (Guzman, Ocampo, and Stiglitz 2018, 51). While the experience of East Asian economies provides a good reference for this diversification, many resource-dependent countries have failed to transform their export structures and, in most cases, face premature deindustrialization. Nigeria is a good example of this, as discussed in chapter one, section 1.5.2.2.

Guzman et al. (2018) developed a small open economy model to demonstrate the logic of using the real exchange rate as an instrument of industrial policy. The model predicts that in circumstances where it is difficult to implement first-best policies that reallocate resources (subsidies) to tradable sectors with learning spillovers, real exchange rate policy can provide the second-best solution (52). However, since a competitive exchange rate implies an implicit subsidy to tradable sectors, achieving the optimal outcome means only sectors with learning spillovers should retain the implicit subsidy while others are taxed (52). This proposition implies that the exchange rate should target specific sectors perceived to have innovative potential that enhance productivity, thereby increasing investment and profitability in these tradable sectors.

Pursuing this policy is likely to face some constraints, and Guzman et al. (2018) analyzed three caveats (and a fourth that requires further work to discuss in more detail) related to this proposition. Firstly, there are important conditions, including traditional industrial policies that need to complement the competitive exchange rate. The second caveat concerns the challenge of channeling the benefits of the competitive exchange rate to the right sectors. This requires the creation of a multiple exchange rate system. Thirdly, there is the issue of political trade-offs due to the distributional effects of adopting a competitive exchange rate. The fourth caveat (mentioned but not discussed by Guzman et al.) relates to the international dimension of the policy, especially from the perspective of regional and international trade.

As mentioned earlier, the competitive real exchange rate is a facilitating factor in achieving structural transformation. In most developing countries with a large share of the population employed in the primary sectors, transformation involves labor movement into high-productivity industrial sectors. The urban industrial sectors in some of these countries are concentrated in coastal regions, implying that the labor movement originates from the rural hinterland, as in the case of China, where millions of workers were mobilized to the southern and southeastern coastal provinces (Razmi, Rapetti, and Skott 2012, 151). However, this labor mobility may be hindered in countries like Nigeria in part due to the disparate socio-economic composition of different regions of the country. A cursory look at Nigeria suggests that the few available industrial investments are mostly located in coastal communities, and there is little labor mobility from the predominantly agrarian northern region to the south to take advantage of job opportunities. However, this may change if full-fledged industrialization takes place.

Razmi et al. (2012, 152) present a small open economy model that predicts how changes in the real exchange rate can "promote sustained capital accumulation and economic growth by affecting the level and composition of employment." The main implication of the model is a positive relationship between real exchange rate undervaluation and investment growth. An empirical test of the model shows that it is only in developing countries that real exchange rate undervaluation appears to drive investment growth. The paper, therefore, argues that this result supports the model's prediction: that where capital goods must be imported because there is limited industrial capacity to meet domestic needs, exchange rate undervaluation in developing countries can be used effectively to promote capital accumulation and balance the external account (152 & 167).

Rodnik (2008) provides evidence that undervaluation stimulates growth in developing countries through its positive impact on the tradable (industrial) sectors of the economy. This real exchange rate effect is partly transmitted to growth through the expansion of the tradable sector, hence suggesting that countries can experience rapid growth when currency undervaluation leads to resource allocation to the tradable (industrial) sector (389). The results underscore the importance and special status of tradable sectors in developing countries. Rodnik further explored why these sectors tend to be special in these countries by examining the medium through which an increase in the size of the tradable sector increases growth. One of the two theories that emerged from this analysis suggests that tradables are special because they are more affected by the institutional weaknesses prevalent in low- to middle-income countries. One of Rodnik's findings is that the channels which undervaluation affects growth in developing countries are not period sensitive. This means that the operational channel of the undervaluation effect has little to do with the changing global economic environment. The estimated impact after the 1980s, when globalization made markets in rich countries more open, is not significantly different (if not smaller) than the period before (Rodnik 2008, 374).

This finding has implications for a country like Indonesia, which experienced sustained growth over a long period with an undervalued exchange rate as part of the success story, but subsequently, the growth rate slowed. The share of exports of goods and services in Indonesia's GDP before and after the Asian financial crisis averaged 27.9 percent in 1980-1996 and 28.5 percent in 1999-2020. This is despite the changes in the global environment, especially the weak demand in rich countries and the related effect on commodity prices, as well as the rise of China, which reduced the competitiveness of manufactured goods from Indonesia and other developing countries.

Summary

What we have learned from the previous section is that the exchange rate is important for economic development through its impact on investment, macroeconomic stability, and a country's external balance. It can be used as an instrument of industrial policy to facilitate structural transformation through investment in tradable sectors. Tradable sectors, in turn, drive technological innovation and industrial upgrading through learning spillovers. This could promote economic diversification into medium to high-value activities in manufacturing and services, thereby raising productivity and growth.

The exchange rate can promote industrial development if it is relatively stable and competitive enough to stimulate investment (Bresser-Pereira 2012; Gala 2008; Guzman et al. 2019). However, some studies (Razmi et al. 2012; Rodnik 2008) argue that exchange rate undervaluation tends to support growth effectively only in developing countries and is only the second-best solution (Rodnik 2008; Guzman et al. 2019). The experience of many countries that have successfully used the exchange rate to promote exports suggests that this strategy may not be effective in the long run. Moreover, there is a debate about whether developing countries can adopt the export-led strategy today with an undervalued exchange rate as a facilitating instrument. To the extent that the exchange rate is relevant to economic development, the policy choice of the regime and level of the exchange rate adopted in a country is important. The next section discusses the nature of these policy choices and how they are influenced by structural and political factors.

3.3.2 The Choice of Exchange Rate Policy

Frankel's (1999) view that no single exchange rate policy is appropriate for all countries at all times is widely accepted in the literature. In choosing an exchange rate policy, it is essential to consider first and foremost the characteristics of a country in terms of its institutions, its economic structure, and the prevailing economic and political conditions (Barth 1992). These circumstances may vary from country to country and from period to period. However, Barth (1992, 35) noted that developing countries share some common characteristics that have implications for their exchange rate policies: "the composition of exports dominated by primary commodities (such as natural resources and agricultural crops); low production of import-competing products; reliance on imports for essential intermediate and capital goods; the importance of foreign direct investment for capital inflows; and underdeveloped financial markets". Countries sharing these commonalities should ideally adopt similar exchange rate regimes, though when other factors and national objectives overlap. According to Dornbusch (1994), three important factors should be considered in the search for an appropriate exchange rate regime. The first is the extent to which the currency can be traded in the foreign exchange market with limited or no restrictions. The second factor is the relationship between the central bank and the foreign exchange market. Third is the relationship between the exchange rate regime and trade policy.

Kettell (2004) analyzed three main theoretical approaches to exchange rate policymaking in the existing literature and proposed an alternative approach that considers the social form of society based on an ‘open Marxist’ methodology. First, the rational choice approach is concerned with selecting an exchange rate regime based on an ‘optimal policy rule’ that ensures policy credibility by constraining the discretion of economic policymakers. The constraint in question is that once the government commits to a particular policy, there are consequences and perhaps reputational damage if it deviates. According to Kettell, there are two competing views among rational choice theorists as to which exchange rate regime provides the optimal policy rule. On the one hand, some believe that a fixed exchange rate can visibly discipline authorities to maintain policy consistency and commitment to low inflation. On the one hand, there is an opposing view that it is a floating exchange rate regime that provides the optimal policy rule. By allowing the currency to be determined by the market, market participants can easily detect incipient inflation. The fear of a sharp fall in the exchange rate “forces the authorities to adopt a sound anti-inflationary stance (11)”.

The second theoretical perspective is based on the view that exchange rate policy is a “technocratic decision about the costs and benefits of available options at a given point in time” and depends on the structural, economic, and political characteristics of the country (12). This is the country characteristics approach.

The third approach is the interest group approach. It is based on the perspective that different groups have different preferences for exchange rate policy, which are determined by the nature of their economic activities and the degree of vulnerability to the effects of currency movements. Accordingly, exchange rate policy is formulated to reflect the demands of the influential economic sectors. Kettle (2004) notes that it is not clear "how policymakers reconcile these competing preferences and which of the sectors or groups is more influential" (14). In contrast to this statement, studies have proposed some theoretical models of group competition over exchange rate policy and how this shapes the policymaker's choice (see Section 3.3.5.1).

3.3.3 Choosing the Regime and Level of the Exchange Rate

Policymakers responsible for exchange rate policy are faced with the option of choosing both the level (price) and the stability (regime) of the currency (Frieden 2015; Walter 2014). The level of the exchange rate indicates the value of the currency, i.e., the rate at which a domestic currency is exchanged for a foreign currency. This is known as the nominal exchange rate. However, it is more meaningful to consider the real exchange rate, which adjusts for inflation by measuring the relative prices of a similar basket of goods in domestic and foreign currencies (Steinberg 2016; Frieden 2015).

The exchange rate regime broadly implies a choice between monetary stability and flexibility or a mixture of the two. The two extremes are either fixing the value of the currency at a predetermined rate against a foreign currency or allowing it to float and letting the market determine the value of the currency. However, there are intermediate regimes ranging from managed floats to crawling pegs which allow for some degree of exchange rate volatility (Walter, 2014; Broz et al. 2008; Yagci 2001). Policymakers implement policies to influence both the level and the regime of the currency's exchange rate. For example, the central bank may intervene directly in the foreign exchange market by buying or selling a foreign currency to influence the value of the domestic currency

(Quinn and Weymouth 2017). It should be noted that the regime and the level of the exchange rate are interrelated, as depreciation and appreciation are mainly associated with a flexible currency. At the same time, the terms revaluation and devaluation are used when dealing with a fixed regime.

In determining the level of the exchange rate, Steinberg (2016) highlights two factors that policymakers may consider. First, most policymakers would like to adopt an exchange rate policy based on good economic ideas, such as an undervalued currency, which is generally expected to promote economic growth, at least in the early stages of development. Indeed, this should depend on the structure of the economy and the extent to which the country is integrated into the international economy. The second factor concerns the political imperative of maintaining a political office. For example, if the manufacturing sector is the most powerful interest group, policymakers are likely to lean toward policies supported by such groups to maintain their political power.

There are both economic and political explanations for why countries choose either a fixed or a flexible exchange rate regime. The usual starting point for analyzing the economics of exchange rate policy is the celebrated Mundell-Fleming trilemma, widely known as the 'impossible trinity'. It states that a country cannot have a fixed exchange rate, free capital mobility, and monetary policy autonomy at the same time. Only two are possible. With capital mobility and a fixed exchange rate, the interest rate cannot be used to adjust the domestic economy. There must be a trade-off between stabilizing the currency and maintaining policy autonomy.

Another related approach to studying the choice of exchange rate regime is the Optimum Currency Area (OCA) theory, originally postulated by Mundell (1961). The main argument of the theory revolves around the desirability of monetary union within a region based on certain criteria. The theory suggests that trade integration increases the tendency of countries to adopt a single currency or a fixed exchange rate regime. This implies currency stability on the one hand and loss of monetary policy autonomy on the other, suggesting a benefit-cost scenario. The benefits stem from increased trade and investment among member countries because of reduced currency volatility and other related factors. When countries experience asymmetric (similar) shocks, the absence of an exchange rate-targeting monetary policy as an adjustment mechanism may prove costly. This currency arrangement is likely to be more desirable when there is less need for monetary autonomy due to common external shocks among member countries or the existence of alternative adjustment mechanisms in place of an independent monetary policy, such as interregional labor or capital mobility, the availability of fiscal transfers, and wage flexibility (Fernandez-Albertos 2007, 10-11; Setzer 2006, 15).[9]

3.3.4 Political Economy of Exchange Rate Policy

The decision to fix the exchange rate of a country's currency against one or more major currencies or to allow market forces to determine it is a crucial policy decision, especially in developing countries. For an open economy connected to and largely influenced by its relationship with the international economy, exchange rate policy may be the most important economic policy of a government because it is the most important price in an economy (Frieden, 2015; Yagci, 2001). The exchange rate is "recognized as the crucial link between the domestic economy of a country and the international economy"

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[9] The concept of an optimum currency area therefore has direct practical applicability only in areas where political organization is in a state of flux, such as in ex-colonial areas and in Western Europe. (Mundell 1961, 661)

(Williamson 2009, 124). This makes it a contentious policy issue because of the multiple outcomes it produces, ranging from distributional concerns to the pursuit of economic growth and stability goals or even the popularity of a government. Scholarly research on the political economy of exchange rates seeks to examine the rationale for government action to keep the currency at a fixed or floating exchange rate, adjust the currency's value, or to conform to certain international exchange rate rules (Hall 2018). Such research examines how interest groups, political institutions, and electoral periods may affect exchange rate policy (Bodea 2010).

Changes in the exchange rate or currency valuation reflect the prevailing economic and political conditions at a given point in time. A better appreciation of the constraints and incentives facing policymakers is important for understanding the timing and rationale of exchange rate policy (Bodea 2010). The constraints and incentives facing policymakers in economic policymaking have generally changed in most countries because of increased democratization. The implementation of important policies such as the exchange rate depends not only on economic efficiency but also on political feasibility.

Leblang (1999) argues that "policymakers in developing countries choose an exchange rate regime not only because of the economic characteristics of their country's market, but also because of political considerations" (600). Exchange rate policy is therefore economically and politically important because of the distributional consequences of a devalued or overvalued currency (Quinn and Weymouth 2017). Because the associated costs and benefits of the policy create winners and losers, the key actors responsible for making such policies must evaluate the trade-offs and consider the impact of their actions on different groups (Frieden 2015).

The fact that exchange rate movements have different effects on economic agents has been recognized in academia and policymaking (Egan 2017). Just as policymakers need to pay attention to "the attitudes of powerful constituencies toward exchange rate policy, it is also important for scholars to better understand the nature of these attitudes and how they are expressed" (Broz, Frieden, and Weymouth 2008, 3). While most of the exchange rate policy advice received by the government has focused on "technical solutions to technical economic problems" (Frieden 2008), the policy is often pursued in a political environment where political institutions, elections, interest pressure groups, and other factors play an important role in policymaking (Frieden, Leblang, and Valev 2010). The impact of the policy on the diverse group of economic actors drives their preferences for favorable policies, which leads to enormous pressure on the government (Broz, Frieden, and Weymouth 2008). It is important to understand the magnitude of this pressure that policymakers face from their constituents to understand the motivation behind certain policy decisions (Frieden 2015). This suggests the need for international policy advisors, such as the IMF, to consider the political constraints on policymakers and the extent to which policies are politically feasible depending on the environment and societal needs (Walter 2008, 433).

The vast literature on exchange rate policy has mostly focused on the economic explanation of policy rationale and choice. However, there is a growing scholarly interest in understanding the political dimension of exchange rate policy, especially in new democracies and transition economies. Using a simple model to analyze the choice of countries for a fixed or flexible exchange rate regime, Edwards (1999) argues that the choice of exchange rate regime is largely related to the political structure of the country. Accordingly, politically unstable countries are more likely to opt for a flexible exchange rate. This gives the monetary authorities greater discretion, which, if abused, could undermine the credibility of policy and, for example, make it difficult to promise low inflation (Yagci 2001). Nevertheless, there are some episodes (e.g., Nigeria, Mexico, and Turkey) where commitment to a fixed exchange rate failed to prevent inflation and balance of payments crisis because the countries pursued expansionary policies while maintaining fixed exchange rates (Corden 1993).

In a study of the political economy of exchange rates in 26 developed and 154 developing countries, Berdiev, Kim, and Chang (2012) show the importance of government ideology, political institutions, and globalization in determining the choice of exchange rate regime. Their results show the differences between developing and developed countries in exchange rate policies. While the probability of choosing a flexible regime is high in developing countries with a left-wing government, it is low in developed countries. However, in some Latin American countries, the same exchange rate policy is used by both right-wing and left-wing governments (Suggett 2016). In this case, political ideology does not necessarily matter.

With the increased connectivity of countries to the world economy due to globalization, economic agents (firms, investors, workers) are more sensitive to the impact of exchange rates on capital mobility and trade (Frieden 2015). Therefore, developed economies tend to prefer a fixed regime, while developing countries prefer a flexible regime (Berdiev, Kim, and Chang 2012). The preference for the flexible regime is because it provides policymakers with room to adjust the exchange rate to achieve domestic economic objectives.

Leblang (1999) shows that in addition to the tendency of developing countries with democratic governments to adopt a floating exchange rate regime than those with autocratic structures, the tendency is even greater in countries with proportional electoral systems than in those with majoritarian systems. This suggests heterogeneity of choice within democracies depending on the electoral system. However, this contrasts with the findings of Bernhard and Leblang (1999, 90): In a sample of twenty industrialized democracies examined in the study, “proportional systems are the most likely to fix their exchange rate, while majoritarian systems are less inclined to a fixed exchange rate regime”. According to Leblang (1999), one possible explanation for the divergence in the choice of exchange rate regime between proportional systems in industrialized and developing countries may be due to the constraint placed on the authority of policymakers with respect to monetary policy by the existence of independent central banks. However, Leblang (1999) clearly states that his analysis “ignores the role of central banks in developing countries” (614).

Steinberg (2010) analyzed why most developing countries have an overvalued exchange rate despite its impact on the competitiveness of domestic goods relative to foreign goods. The results show that overvaluation prevails because different sectors benefit from a “compensatory policy package” in the form of subsidies and other incentives that accompany the overvaluation policy, as well as the political gains for politicians in terms of coalition building across both the tradable and non-tradable sectors. The support for overvaluation by the non-tradable sector is of course, to be expected. However, a more striking finding is that exporters and import-substitution industries, which are expected to prefer undervaluation, also favor overvaluation for the reason mentioned above (compensation package).

Moreover, the extent to which an export-oriented industry supports or opposes currency undervaluation or overvaluation typically depends on whether the competitive parameter of its product is based on price or quality (Walter 2014). Exporters of standardized goods face price competition, while exporters of specialized goods compete based on quality. The former are likely to benefit from a depreciated currency and thus have a higher preference for it than the latter (Walter 2014; Frieden 2015).

In addition to a sector's export orientation, other macroeconomic and trade policies affect the sector's preference for the level of the exchange rate. As noted above, interest groups have different preferences regarding exchange rates, but there is no single boundary for these preferences, as they may change over time to reflect changing policy environments and economic circumstances (Klein and Shambaugh 2010; Steinberg and Walter 2013). During a relatively stable period in the exchange rate market with little or no speculative tendencies, Walter (2008) argues that the preferences of some economic agents tend to shift from stability to depreciation of the currency, compared to when there is excessive pressure on the exchange rate leading to tight monetary policies. Building on the electoral and interest group politics of exchange rate policy, Frieden et al. (2010) examined the impact of political institutions (depth of democracy) on exchange rate policy in transition economies. They discovered that democratic countries with a high degree of openness to the international economy would likely prefer a fixed exchange rate regime.

3.3.5 Factors Influencing Exchange Rate Policymaking

This section zooms in to take a closer look at the factors influencing exchange rate policy – from the preferences of interest groups to veto powers (the political elite) and the discretion of policymakers, as well as the international monetary system.

3.3.5.1 Interest Groups' Exchange Rate Policy Preferences

Some studies (Kettell 2004; Walter 2014; Frieden 2015) have described at least four different interest groups whose exchange rate policy preferences vary according to the nature of their business and the degree of exposure to foreign competition. The first group is those likely to prefer a fixed exchange rate because their activities are global market-oriented and thus have a greater risk of exposure to currency volatility and international competition. Secondly, those groups whose businesses are primarily domestic will tend to prefer a floating exchange rate because monetary authorities will have the freedom to make necessary policy adjustments when the need arises. The third group would prefer currency appreciation because they rely on foreign inputs and materials for production. The fourth group is those who compete with foreign producers in the domestic market. Therefore, they will prefer a depreciated currency to make the prices of their products lower than the imported ones.

The business groups are not the only economic agents concerned about the effect of the exchange rate on their activities. The working-class citizens of a country are also vigilant about currency movements and the effects of one or the other exchange rate policy. Suggett (2016) included the status of individuals as workers and consumers in the role of interest group preferences for exchange rate policy. On the one hand, higher unemployment is likely to increase the preference for a floating regime, as it allows for a stimulus package. On the other hand, consumers may prefer a fixed exchange rate due to concerns about their income and savings when inequality and poverty are rising.

Frieden (2015) provides a formal explanation of the preferences of domestic socio-economic groups (firms, industries, and other groups) with respect to exchange rate policy, focusing specifically on the formation of these preferences. The framework considers the group's exposure to exchange rate volatility, tradability, and pass-through as factors explaining much of the preferences for the two dimensions of currency policy – exchange rate regime and level. On the one hand, the analysis predicts a stronger preference for a depreciated currency when a firm or industry uses non-tradable inputs to produce tradable outputs. On the other hand, a firm or industry with a contrasting input-output structure will have the opposite preference – a strong currency. Furthermore, the extent of a firm's foreign currency debt determines its preference for the level of the exchange rate. Those with large foreign liabilities are likely to favor a stronger currency. These two preferences, based on international exposure and the tradability of products, are affected by the degree of pass-through, or the extent to which currency movements affect domestic prices, such that the greater the pass-through, the weaker the preferences for both the stability and the level of the exchange rate (Frieden 2015, 48). Exporters face the greatest dilemma regarding preferences for the stability and level of the exchange rate. This is because they have an international interest in which a stable (fixed) currency is preferable. While being tradable producers means that a weak currency enhances their competitiveness, it is not easy to have a depreciated currency under a fixed regime.

Walter (2008) proposed an explanation of the dynamic formation and change of preferences for exchange rate levels that focuses on the choice between currency stability and depreciation. Considering the interrelationship between exchange rate and monetary policy resulting from international capital mobility, Walter argues that the propensity of individuals and firms to support or oppose a currency depreciation depends on their vulnerability to this adjustment relative to other policies that seek to maintain exchange rate stability or raise the interest rate. Vulnerabilities are reflected in the impact of price changes (imports and exports) on agents' competitiveness and purchasing power and the impact of exchange rate and interest rate changes on the value of their assets and liabilities (407). All these vulnerabilities are determined by the degree of a country's trade integration and the vagaries of the international market.

Fernandez-Albertos (2007) develops an institutional theory of exchange rate regime preferences to explain why trade integration leads internationally oriented sectors to prefer a fixed exchange rate in some contexts but a flexible regime in others. The theory predicts that the exchange rate regime preferences of exporting sectors depend on two domestic institutional arrangements: the degree of centralization of wage bargaining and the conservatism of the central bank. When the former is centralized and coordinated at a higher level, and the latter maintains an anti-inflationary stance, exporters tend to prefer a fixed exchange rate regime, and trade integration would likely lead to this type of exchange rate regime. The reason for this, according to Fernandez-Albertos, is that with greater economic integration, exporting sectors become more politically powerful, and thus their preferences seem to influence the choice of exchange rate regime. The case of Mexico in the 1990s and Europe during the monetary unification process were used by Fernandez-Albertos to empirically test and support the hypothesis derived from the theory.

Faia, Giulodori, and Ruta (2008, 2) present a political economy model of exchange rate policy that shows that the aversion to exchange rate fluctuations observed in emerging market economies may be related to pressure from influential groups (the financial and manufacturing sectors) on policymakers. The model assumes that these sectors are politically organized in the form of lobbies, and each will try to influence the government to implement its preferred policy choices. The two sectors have different interests in the level of the exchange rate, but they are both averse to currency volatility. Since they are both adversely affected by volatility, the model predicts that each group will exert political pressure (in a non-cooperative manner) on the government to minimize currency volatility. This strengthens the government's incentive to stabilize the exchange rate (4). An equilibrium exchange rate policy is thus determined by the weighted average of the two groups' preferred policy choices and the effect of volatility on their welfare (4).

The relative weights (economic and political) considered in the Faia et al. (2008) model do not predict what determines the economic and political power of the groups, and how it varies across political regimes and over time. Group preferences are also dynamic depending on local and international conditions at any given time. For example, Kinderman (2008, 873) shows that internationally exposed and export-oriented German industries were consistently opposed to the appreciation of the Deutsche Mark in the 1960s and 1970s, while in later decades, this preference seems to diminish even in the face of currency volatility and appreciation.

Li (2019) employs the common agency model to provide a theoretical illustration of how interest groups influence bureaucrats in the exchange rate policymaking process. Like Faia et al. (2008), the model shows that the equilibrium exchange rate is determined by the weighted average of the rate the groups prefer. The assigned weights measure the relative influence of the group on policymaking, such that the equilibrium exchange rate is closer to the rate preferred by the more politically influential group (Li 2019, 419). According to this model, "interest groups can influence bureaucrats' policy choices through political influence and policy incentives." However, the measurement of political impact is incomplete, and it is not clear what specific incentives are offered by groups to influence policy.

The political impact argument is based on the notion that as internationally oriented sectors become more important in the economy, their political clout increases, and policies tend to align with their preferences. Can the same be said of state-owned enterprises? Ying Li's claim that the significant role of large state-owned enterprises (SOEs) in China's economy, which increased their political power to influence renminbi reform in 2005, may not be falsifiable. In other words, the SoEs do not need to gain political clout because the state makes the policies and is, therefore, likely to be designed in their favor. Moreover, the slight appreciation of the currency after the reform did not favor export-oriented foreign-funded enterprises (FFEs). Coupled with their diminished political influence on macroeconomic policy compared to SoEs, FFEs shifted from labor-intensive manufacturing to capital- and technology-intensive industries rather than trying to compete politically with SoEs (Li 2019, 425).

Further development of this model should provide a realistic indicator of the nature of political power and how it is deployed in specific contexts. In countries known for high levels of corruption, such as Nigeria and Indonesia, lobbying often translates into rent-seeking activities and bribery. Nevertheless, the goal of lobbying, regardless of how it is delivered, is to get policymakers to implement policies that benefit a particular interest group. However, the policymaker is also a 'natural person' with personality traits like other people (e.g., desires, emotions, and attitudes) that could influence the policymaker's judgment in decision-making.

Leblang (1999) argues that policymakers are as aware of the demands of their constituents as they are of their own goals. Thus, policymakers may have interests that differ from those of society, which then influence their policy preferences (Bernhard and Leblang 1999). It is also based on this latter argument that Leblang (1999), Bernhard, and Leblang (1999) observe that the explanation of exchange rate policy choice that focuses on the preferences of interest groups and economic agents pays little attention to the role of policymakers (politicians) in choosing the exchange rate. This is because there is a tendency in many countries for policymakers to adopt policies based on their subjective judgment of the issue at hand, hence suggesting that interest groups have little influence on policy. This is likely to be the case when monetary authorities have a high degree of independence and can resist political pressure.

Another possible reason for the weak influence of interest groups may be their inability to effectively mobilize and articulate their demands, given the complexity and uncertainty of the effects of exchange rate policy (Steinberg and Walter 2013, 30). Where interest pressure group appears elusive, more attention is paid to policymakers' ideas in explaining the factors influencing exchange rate policy.

3.3.5.2 Veto players and Exchange Rate Policy

The veto player theory developed by Geoge Tsebelis (2002) has important implications for economic policymaking. Tsebelis (2002, 20) defines veto players as individual or collective actors whose consent is necessary for a policy change. According to Tsebelis, a country's constitution can assign the status of veto player to an individual actor (the president) or collective actors (chambers of parliament). These are called institutional veto actors. There are also partisan veto actors who emerge from the political game within the institutional veto players.

The central proposition of veto player theory is that there is a positive relationship between the number of veto players and the preservation of existing policies. Countries with many veto players often face challenges in reaching political consensus, thus leading to prolonged periods of inaction and obstructed progress on various issues. In countries with separate branches of government, multiple political parties in the governing coalition, different legislative bodies, and regional authorities that handle money, taxes, and laws, it becomes difficult to quickly implement the necessary policies to maintain a stable exchange rate (Setzer 2006, 101-102). Decision-makers tend to have divergent views on the appropriate policy, leading to delays in action that can be costly when dealing with critical economic conditions or an unfolding crisis. However, with few veto players, policymakers can deal with sources of conflict more quickly and reconcile different opinions more easily (Setzer, 102-102).

Regarding the exchange rate policy choices of central banks, the argument of the inverse relationship between the number of veto players and policy change is based on the notion that the central bank's discretion in setting monetary policy increases with the number of veto players. That is, when there are more veto players, it becomes more difficult for the government to unite to reverse the central bank's decision (Hallerbverg 2002, 777). Keefer and Stasavage (2002, 751) examine whether the presence of multiple veto players in government makes it more difficult for governments to abandon exchange rate pegs or central bank independence. They find that the presence of multiple veto players in government increases the effectiveness of central bank independence in establishing the credibility of monetary policy commitments.

The relationship between veto players and economic policy may work better in developed democracies with well-established institutions. Newly democratizing countries such as Nigeria and Indonesia are making progress in building institutions and deepening the separation of powers at the national and sub-national levels. However, relics of the countries' neo-patrimonial political systems remain, suggesting that democratic institutions are present in principle but not fully functional in practice. As Purwatmoko (2022, 189) observed, "the democratization process in Indonesia has proceeded without leaving behind the elements of the old political oligarchy. The adopted multi-party system has led to fierce political competition among political parties for political careers. They are trapped in rent-seeking practices by tapping into government resources.” Purwatmoko uses the term ‘oligarchy’ in this context to describe a situation where power and authority within the democratic system are not fairly distributed among public officials, private individuals, and interest groups. The existing power structure remains dominated by an entrenched oligarchy with substantial resources. Interest groups lack the political influence necessary to shape the policymaking process. Instead, they must rely on a fledgling and small group of ideological political parties that constitute a new political oligarchy (189).

3.3.5.3 Discretionary Power of The Policy-maker: The Role of Ideas

Some scholars argue that interest group models of exchange rate preferences seem to overstate the influence of private interests on exchange rate policy. This is because in some countries, policymakers enjoy a degree of autonomy and insulation from political influence (Helleiner 2005, 30; Steinberg and Walter 2013) and can bring their ideas and discretionary choices to bear on policy implementation. According to Oatley (2019, 40), “ideas are mental models that provide a coherent set of beliefs about cause-and-effect relationships. In the context of economic policy, these mental models typically focus on the relationship between government policies and economic outcomes. Not surprisingly, therefore, economic theory is a very important source of ideas that influence how actors perceive and formulate their interests. By providing clear statements about cause-and-effect economic relationships, economic theories can create an interest in a particular economic policy.”

The ideational explanation of exchange rate policy emphasizes the role of such economic ideas of policymakers. This implies that policymakers’ ideas could take precedence over political pressures in selecting an optimal policy based on the economic objective function, including economic growth and overall macroeconomic stability. Helleiner (2005) notes that historical evidence suggests that Canadian policymakers have had considerable autonomy in deciding exchange rate regimes. Therefore, an ideational approach that examines policymakers' beliefs will be more useful in analyzing their preferences (Helleiner 2005, 31). This will help to understand the rationale for favoring floating exchange rate regimes in general. According to Helleiner, policymakers' support for floating exchange rates during the period under study was based on the idea that it can promote balance of payments adjustment and monetary policy autonomy. These two ideas can be said to inform the policymakers' choices in developing countries with open economies and a large share of primary commodities in total exports. Policy autonomy allows monetary authorities to adjust the interest rate to stimulate the domestic economy and to target the exchange rate to correct the balance of payments position resulting from shocks in the international market.

There are good reasons to speculate that in many countries, policymakers' ideas play a greater role in the choice of exchange rates and other economic policies. The academic and professional credentials of finance ministers, central bank governors, and other key policymakers in the field of economic management provide an implicit indicator of the potential influence they are likely to exert on policy decisions based on their ideologies.

However, Steinberg and Walter (2013) observed that ideational theories seem to exaggerate the ability of policymakers to choose optimal exchange rate policies on the one hand, while downplaying how political pressures condition policymakers' choices on the other. Another shortcoming of the ideational perspective has to do with the difficulty of measuring ideas and beliefs. It is also possible that the outcomes of similar ideas differ across societies. In addition, the perspectives of individual policymakers may not necessarily be based on the logic of the policy but may be influenced by partisan considerations (Levy Yeyati, Moscovich, and Abuin 2020).

3.3.5.4 International Monetary System

The extent to which economies are integrated is important in determining the exchange rate regime that is appropriate for those countries from the perspective of mutually beneficial trade relations. Based on the idea of an Optimal Currency Area (OCA), countries that satisfy the OCA condition can benefit from regional exchange rate policy cooperation through trade expansion resulting from lower exchange rate risks, interest rates, and other transaction costs (Yagci 2001). However, as emphasized earlier, economically viable policies may not be politically feasible. The local conditions of countries vary across time and space, and this has implications for adopting the type of policy that is supposedly optimal, such as a common regional currency. In regions where local politics prevent the emergence of a monetary union despite meeting the OCA conditions, McKinnon (1999), cited in Yagci (2001), recommends that countries cooperate on efficient exchange rate rules to maintain currency stability under a common arrangement and avoid competitive devaluation.

According to Yagci (2001), there are three options for this regional exchange rate cooperation. The first option involves mutual pegging of exchange rates within a certain band and economic policy coordination to collectively maintain fluctuations within the agreed band. Secondly, countries can abandon individual national currencies to form a monetary union with associated regional monetary institutions and policy coordination frameworks. The third option is establishing a regional monetary standard that links the countries' currencies to one or a basket of foreign currencies. Yagci suggested that this option might be more appropriate for the Association of Southeast Asian Nations (ASEAN) and the South American Economic Organization-MERCOSUR since these groups do not necessarily share the characteristics of Europe that could make a monetary union possible.

The preceding discussion of the viability of a single regional currency and the different approaches to achieving it underscores the importance of intergovernmental cooperation and policy coordination among member states. This is necessary not only for monetary unification but also to protect against shocks, such as speculative attacks on currencies.

Broz and Frieden (2006) analyzed the coordination and cooperation problems countries face in regional and international monetary relations. Coordination requires countries to agree on the third option for exchange rate cooperation discussed above, that is, pegging national currencies to a common anchor (gold, the euro, or the dollar). Even in regions where member states operate a floating regime, they benefit from adherence to payment standards and restrictions, such as prohibiting foreign exchange restrictions and rationing to citizens who need to pay for imports or foreign debt (589).

Cooperation implies aligning national policies to maintain the commitment to an exchange rate regime. This may sometimes involve adjustment policies in support of the regime that are painful and thus politically unpopular. In effect, international monetary coordination and cooperation depend on domestic policies that are constrained by both economic and political factors. According to the international system approach to exchange rate policy, cooperation among countries on common monetary principles can be influenced by a powerful international hegemon or interstate bargaining (Steinberg

2010, 36; Hall 2018, 7). The international hegemon can be a country or international financial institutions – the IMF and the World Bank.

3.4 Chapter Summary

The exchange rate is a policy variable influenced by political factors in many countries. The policymaker is constrained by political pressures in determining the appropriate policy among alternative options. Some variation in exchange rate policy responses to similar conditions may reflect differences in national political conditions over time (Frieden, 2004). The economic argument for the appropriateness of an exchange rate policy may have merit. However, the attention of policymakers is often focused on the electoral and other political implications of the policy (Frieden, 2015).

The main thrust of the political economy analysis of the exchange rate is to examine the demand-side determinants of exchange rate policy. The focus is on how pressure from interest groups and other constituencies influences policy direction. The nature and formation of the preferences of these groups and the political implications of policies provide both constraints and incentives for the policymaker in deciding on alternative policy options. Political economy approaches to exchange rate policy have developed since the work of Frieden (1991). Studies in this area have enriched an understanding of the political dimension of exchange rate policy. However, the groups considered in the analysis pay more attention to producers (of tradable and non-tradable goods) and, to some extent, to consumers – especially the urban population. Moreover, some of the empirical measures of interest group influence based on sectoral share of GDP as an indicator of political clout may be misleading. This is because some groups can have political influence with a GDP contribution of less than 10 percent. Meanwhile, other groups, such as those in the agricultural sector, with much higher contributions may lack the political clout to influence policy.

In Nigeria and other developing countries, there is another dimension of exchange rate policy and interest groups that are not adequately captured in these models. For example, the multiple exchange rate system, which some studies suggest is the second-best option for promoting the development of priority sectors, has created a parallel market that tends to distort the foreign exchange market in Nigeria. Bureau de Change (BDC) operators are the major stakeholders in this market. In Nigeria, BDCs are licensed by the Central Bank to provide foreign exchange to small users, but they are accused of being a source of malpractices harmful to the economy. Another nuanced dimension, at least in Nigeria, is that interest groups have a geographical and often ethnic composition, as opposed to pure economic specialization or other homogeneous economic interests. This will likely create a collective action problem among interest groups in pursuing a common policy preference. Moreover, exchange rate preferences can deviate from those predicted by interest group theory. That is, rather than competing over the regime or level of the exchange rate, groups may demand similar policies, such as a preferential allocation of foreign exchange.

3.5 Conceptual Framework

The relationships among the key concepts on which this study is based are described in the conceptual map in Figure 3.1. This conceptual framework is rooted in previous comparative studies of Nigeria and Indonesia and the literature on the political economy of exchange rate policy and the exchange rate policies implemented in the two countries. The study is motivated by the quest to explain the persistence of exchange rate challenges in Nigeria as compared to Indonesia, which has similarities in many respects but has been able to shift to market-oriented policies. Indonesia successfully moved from a complex multiple exchange rate system to one that reflects market conditions. On the other hand, Nigeria's exchange rate policy has remained dirigiste over the years and has persistent exchange control and multiple channels for foreign exchange transactions. This study seeks to understand the factors that account for the variation in exchange rate policies in Nigeria and Indonesia and the consequences for economic outcomes.

There are common and local factors that may explain the different policy approaches. The two countries share common socio-economic, political, geographical, and historical factors. The presence of these common factors should help compel the countries to choose similar sound development paths, including the design of institutions and economic policies such as exchange rate policy. However, some contrasting local factors may explain the variation in policy choices, as is the case of a dirigiste system in Nigeria and a liberalized system in Indonesia. There may be differences in the strength of interest group pressures in the two countries that influence the systems. As discussed in Chapter 2, political economy analysis of the exchange rate emphasizes the influence of political considerations, including interest groups and other societal pressures on policy choices. In addition to domestic politics, international institutions may also influence policy directions. Moreover, the nature and magnitude of domestic economic challenges could prompt different policies, exemplifying what has been described in Indonesia as Sadli's Law: that "bad times can produce good economic policies, and good times often the reverse. Finally, exchange rate policies may be driven by the government's development priorities, as reflected in economic policies for rural, agricultural, urban, and industrial development.

It is important to understand why different exchange rate policies are adopted in similar countries because of the developmental consequences that the different systems can have. A dirigiste system can be detrimental to trade and investment and macroeconomic instability, as well as creating vested interests. On the other hand, a liberalized market-based system tends to encourage capital inflows and macroeconomic stability.

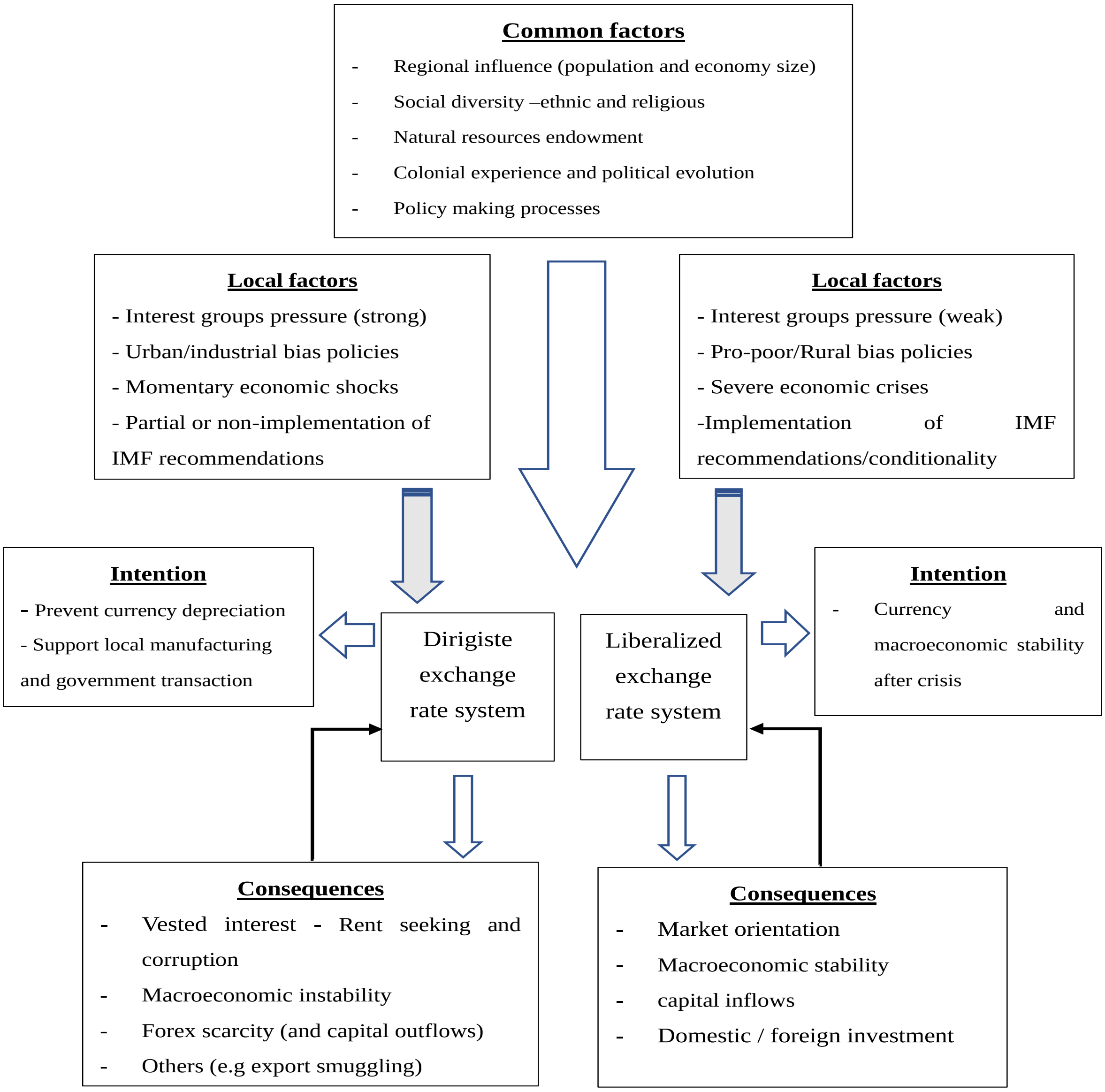

Figure 3.1 Concept Map
Source: Author

Chapter Four: Foreign Exchange Management in Nigeria and Indonesia: Of Dirigisme and Market-Orientation

4.1 Introduction

The dissertation's primary investigation is the political economy factors that shape exchange rate policy and management in Nigeria and Indonesia. To explain the factors that influence policy decisions, it is crucial to comprehend the policies' nature and implications. This chapter examines the development of exchange rate systems in both countries and how these policies work in practice. The design and implementation of the policies in question are the responsibility of the respective countries' central banks, which have been recognized as independent monetary authorities since at least the early 2000s. They have the authority to use various policy instruments to regulate both the flow and availability of foreign exchange within the foreign exchange market. This function aligns with other associated policies and explicit and implicit economic and political objectives. The chapter highlights Indonesia's progressive transition from a complex multiple exchange rate system to the current market-oriented system. Nigeria maintained exchange control and multiple exchange rates, and the transition process to a fully market-based system has been a relatively modest one.

4.2 Defining Exchange Rate Management

Exchange rate policy determines the rules and framework for establishing the regime and price of a currency's exchange rate at a specific time. The policy typically aims to maintain macroeconomic stability, stimulate productive sectors, increase exports, attract foreign investment, and other capital flows (Obaseki, 2001, 2). Given that international competitiveness should, in part, be determined by a country's exchange rate, and since exchange rate misalignment may be caused by various macroeconomic variables, it is essential to formulate an appropriate exchange rate management strategy that will correct such misalignment and return the economy to the path of competitiveness.

Just as there is no single exchange rate regime that is universally suitable for all countries (Frankel, 1999), there is no general formula for exchange rate management that applies to all developing and transitional economies (Ohno 1998). The effectiveness of fixed, intermediate, or flexible exchange rate regimes, for example, in relation to a country's size, cannot yield a precise conclusion. The debate on which regime has the advantage under what circumstance has been longstanding. Optimal conditions for exchange rate management vary depending on the economic structure of a country, the nature and origins of shocks, and the economic objectives of policymakers (Aghevli, Khan, and Montiel 1991, 5).

Exchange rate management involves applying official policies to ensure the optimal use of available foreign exchange resources while maintaining sufficient external reserves to respond to external shocks and prevent the consequences of decreasing foreign exchange receipts (Anifowose, 1994). The monetary authority implements strategies aimed at achieving the goals of exchange rate policy. These goals include maintaining a stable, realistic exchange rate, managing inflation, attracting foreign investment, and boosting exports to generate foreign exchange revenue. However, regional, and global interactions may constrain the pursuit of this policy, thus leading to multiple impacts on developing economies. This suggest the need for each country to be prepared to revise their exchange rate management strategy accordingly (Ohno 1998).

Exchange rate management can take at least three major forms. Firstly, the monetary authority may intervene in the foreign exchange market via the buying or selling of foreign currencies. Secondly, the central bank can utilize monetary policy tools, such as interest rates, to stabilize the exchange rate without changes to the external reserve. Thirdly, the central bank can restrict capital flows to achieve stability in both the volume of money and the exchange rate (Argy 1982, 5).

4.3 The Conduct of Exchange Rate Policy in Nigeria

The Central Bank of Nigeria (CBN) formulates and implements exchange rate policies in Nigeria. Since its establishment in 1959, the legal and institutional framework governing the CBN's operations has undergone various changes and amendments. With the enactment of the CBN Act 2007, the Bank was given greater independence to carry out its functions, which include, "maintaining external reserves to safeguard the international value of the legal tender currency" (Central Bank of Nigeria Act, 2007, p.A65). The Act's section 16 expressly mandates that the Bank establish a suitable mechanism for determining the exchange rate of Nigeria's currency. Therefore, the objectives of the exchange rate policy in Nigeria are to maintain a favorable external reserves position, ensure external balance, and preserve the value of the domestic currency, while also maintaining internal balance and achieving the overall goal of macroeconomic stability, as stated by the CBN (2021, 6).[10]

Exchange rate policy has been a prominent topic in Nigeria for more than 30 years due in part to the country's unchanging economic structure. Nigeria has tried various exchange rate policies to align with domestic development and international dynamics.

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[10] https://www.cbn.gov.ng/IntOps/FXManagement.asp. Accessed on 10/08/2021

The collapse of the Bretton Woods system in 1971 coincided with the end of Nigeria's civil war, which began in 1967. The country used the Nigerian pound as its currency until 1973, which was a relic of the British colonial monetary system. The naira was then adopted as the new currency. Since then, the exchange rate has been pegged to the US dollar, but in 1978, the pegging was expanded to include a basket of currencies consisting of the Pound Sterling, German Mark, Japanese Yen, French Franc, Swiss Franc, and Dutch Guilder (Fuady 2012, 138).

Since 1986 when Nigeria implemented the Structural Adjustment Programme (SAP), the country's exchange rate regime shifted from a fixed to a flexible system. Consequently, Nigeria has operated under various exchange rate regimes that have offered some degree of flexibility. The only exception occurred in 1994, when the exchange rate was pegged to the US dollar as a step towards sanitizing the foreign exchange market and promoting productive activities (Amaghionyeodiwe and Osinubi 2005).

The focus of exchange rate policy after shifting from a fixed to flexible regime is the determination of a realistic currency value in the foreign exchange market. The market relies heavily on CBN's supply as crude oil exports represent the main source of foreign currency receipts. Since the adoption of a flexible exchange rate in 1986, the naira has experienced significant volatility and a rapid decline in value, as illustrated in Figure 4.1. This demonstrates the country's susceptibility to external shocks, primarily resulting from fluctuations in crude oil prices on the global market. The presented figure depicts the fluctuations in the naira's value relative to the US dollar, including instances of sharp depreciation, particularly between 2014 and 2017, resulting in a roughly 93% decline in value. The outcome was the result of multiple factors, which we will explore in the following section.

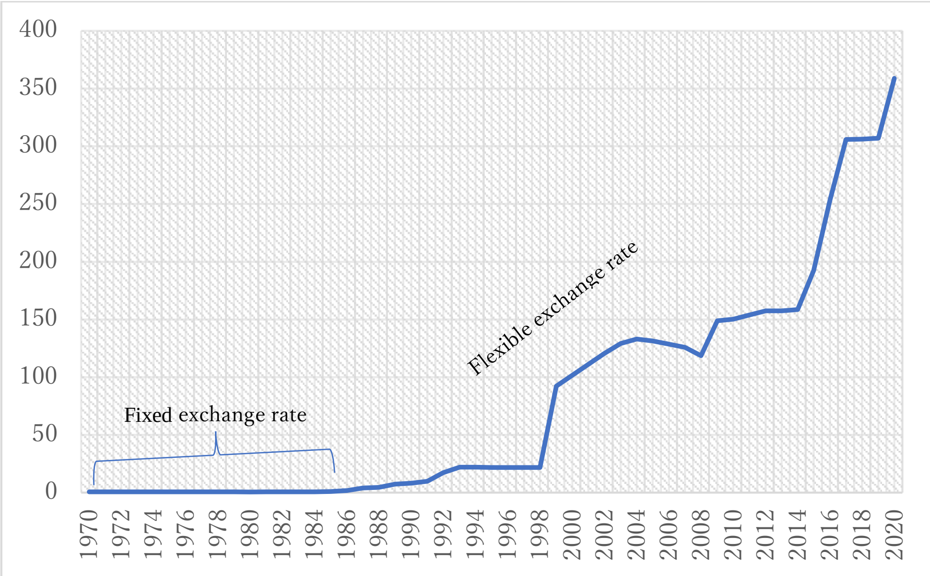

Figure 4.1 Naira per US dollar exchange rate (Annual average)
Source: Author based on IMF data

4.3.1 Exchange Rate Management in Nigeria Since the SAP: 1986-2022

The successive exchange rate policies of the CBN since 1986 have focused on prescribing the methodology for determining a 'realistic exchange rate of the naira' through the foreign exchange market. The initial strategy involves splitting the foreign exchange market into two. A new segment was introduced as the Second Tier Foreign Exchange Market (SFEM), where the exchange rate is to be determined by market forces (authorized dealers - banks) through the auction of foreign exchange by the CBN. The first-tier market, on the other hand, uses the official exchange rate at which priority transactions of the government are conducted (Research & Statistics Department, CBN, 2006; Amaghionyeodiwe & Osinubi, 2005). However, the two separate foreign exchange markets for public and private transactions were later merged into a single foreign exchange market. Two years later (1988), the Bureau de Change market was introduced to facilitate the supply of foreign exchange to small-scale users (Research & Statistics Department, CBN, 2007).

The CBN devised another method of selling foreign exchange directly to end-users with the introduction of the Autonomous Foreign Exchange Market (AFEM) in 1995. This was later replaced by the Inter-bank Foreign Exchange Market (IFEM) in 1999, in which the CBN and commercial banks conduct foreign exchange trading based on two-way quotes. The latter was intended to broaden the market by encouraging greater participation by banks and non-bank financial institutions, multinational (oil) companies, government parastatals, and other private companies (Research & Statistics Department, CBN, 2006). This system also gave way to the Dutch Auction System (DAS) in 2002, which was originally introduced in 1987 and 1990 (Obadan 2006).

The main purpose of the reintroduction of the DAS was to minimize the widening gap between the official and market exchange rates. It was also an attempt to apply what had worked in other regions, as a similar system had successfully corrected the misalignment of the foreign exchange market in some Latin American countries (Sanni 2006). In the words of a former CBN governor, "the DAS was designed to achieve a realistic exchange rate for the naira ... and conserve the dwindling external reserves.... It was a two-way auction system in which both the CBN and authorized dealers would participate in the foreign exchange market to buy and sell foreign exchange. The CBN is expected to determine the amount of foreign exchange it is willing to sell at the price buyers are willing to buy" (Sanusi 2004, 7)[11]. The DAS has been credited for helping to minimize arbitrage opportunities and maintaining the relative stability of the naira against the US dollar (Research & Statistics Department, CBN 2007; Sanni 2006; Sanusi 2004). However, it is also characterized by some pitfalls, such as capital flight, speculation, and rent-seeking behavior (Akanji 2006).

To further liberalize and improve the framework for determining the exchange rate in the foreign exchange market, the procedures of DAS – which is in the form of retail transaction, i.e., RDAS – were modified with the introduction of the Wholesale Dutch Auction System (WDAS) in 2006 (Aliyu 2012; Research & Statistics Department, CBN 2007; Sanni 2006). This system changed the status of the CBN from being the main supplier to an active participant in the market that can buy and sell the foreign exchange (Sanni 2006). Under the WDAS, the CBN sells the foreign exchange to Bureau de Change in addition to the authorized dealers (banks), who are also allowed to participate in the transaction on their own accounts rather than on behalf of their customers, as was the practice before (Sanni 2006; Aliyu 2012).

In 2013, the CBN suspended the WDAS and reverted to the RDAS with new guidelines for the conduct of auctions in the foreign exchange market (Trade & Exchange Department, CBN, 2013). This lasted for about two years before it was also abolished. The CBN announced the closure of the RDAS/WDAS foreign exchange window in 2015, replacing it with the interbank foreign exchange market. The basis for this action, according to the bank, was due to the, "widening spread between the exchange rate in the

11 Chief Joseph Sanusi, CBN governor 1999-2004.

interbank and RDAS window", which opened the gates to malpractices (rent seeking) that put unbearable pressure on the country's foreign reserves, coupled with falling oil prices (Mu'azu 2015, 2).

This decision was taken in the run-up to the 2015 general elections, which in retrospect, were expected to be turbulent due to the political atmosphere at the time. In addition, the Nigerian economy continued to perform poorly due to the decline in oil prices that begun in 2014. Therefore, a combination of domestic challenges and external shocks pushed the economy into recession in 2016. As a result of this situation, the exchange rate policy became unsustainable and the CBN adopted a new strategy to stabilize the naira exchange-rate with the introduction of an interbank system based on two segments – interbank and autonomous segments, respectively (Tule 2018). This was followed by other changes to increase the availability of foreign exchange in the foreign exchange market, such as the introduction of the Investors and Exporters (I & E) foreign exchange window. The I & E window was established in 2017 as a special medium to boost foreign currency liquidity so as to accommodate foreign exchange obligations for eligible transactions (Central Bank of Nigeria, 2017).The benchmarking of the currency in this window is determined by a system known as the Nigerian Autonomous Foreign Exchange Fixing (NAFEX) developed and operated by FMDQ Securities Exchange Limited (FMDQ, 2020).

All the exchange rate arrangements discussed above were largely in the context of the officially managed multiple channels of foreign exchange supply at different rates. In what appears to be a decisive move to unify the multiple naira exchange-rates, the CBN abandoned the fixed official exchange rate and adopted the NAFEX rate used in the I & E window in May 2021. Figure 4.2 shows the adjustment of the fixed rate of 379 naira per dollar used for officially approved transactions to the relatively flexible investor and exporter exchange rate of 410 naira per dollar on average.

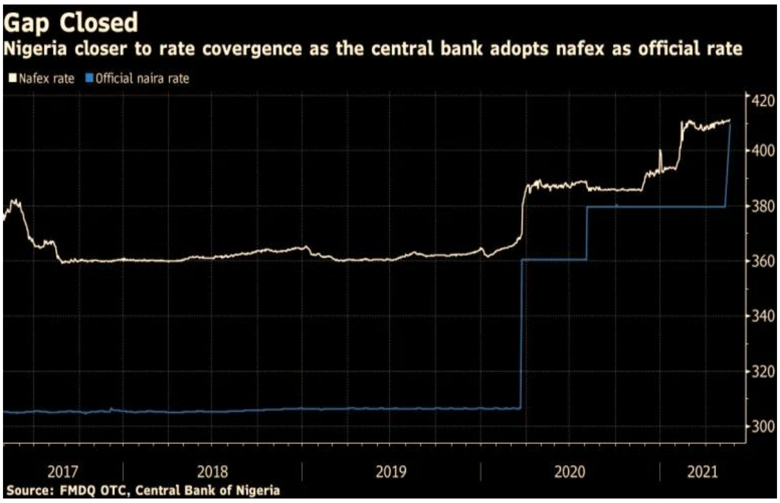

Figure 4.2 NAFEX and official exchange rate
Source: Culled from Aljazeera.com[12]

The naira exchange rates were thus reduced to two from the three or more rates that operated prior to this period, which included the CBN rate, parallel market rate, and NAFEX rate.[13] However, the dual exchange rate system still prevails. As shown in Figure 4.3, "the NAFEX rate, which becomes the leading exchange rate for the economy, continues to be managed and does not fully reflect market conditions. The parallel market premium over the NAFEX rate reached 29 percent in August 2021 after the CBN stopped its weekly supply of US$20,000 per Bureau de Change (BDC). The CBN has been

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[12] **https://www.aljazeera.com/economy/2021/5/25/nigeria-devalues-naira-as-part-of-path-to-single-exchange-rate**
[13] https://www.premiumtimesng.com/news/headlines/463669-cbn-devalues-naira-adopts-nafex-rate.html

intermittently supplying foreign exchange to BDCs since 2005, providing ample opportunities for currency round-tripping" (The World Bank 2021, 24).

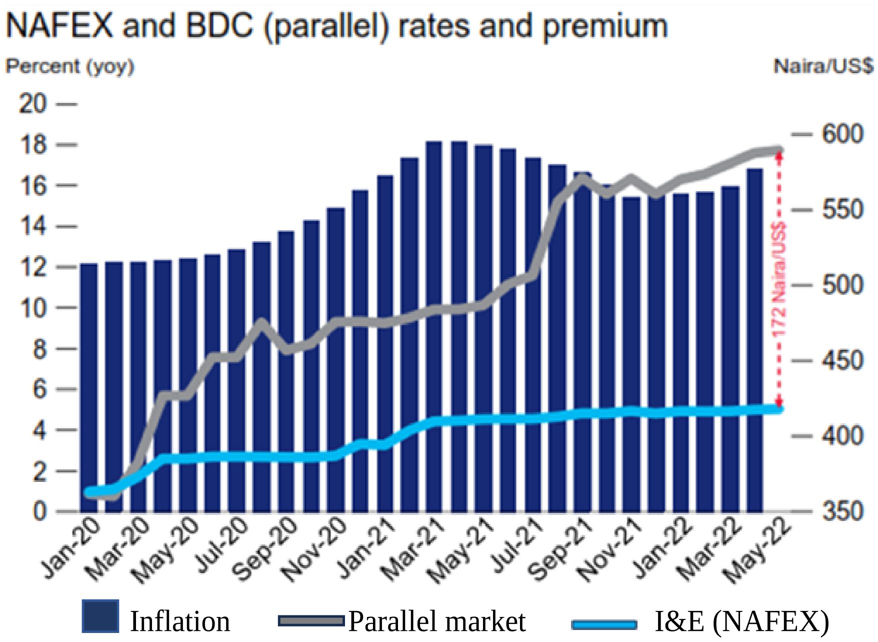

Figure 4.3 NAFEX and BDC premium
Source: *Nigeria Development Update*, World Bank, June 2022

4.3.2 Dispersed Cost, Concentrated Benefit: The Implication of CBN's Intervention

Foreign exchange management is a crucial component of monetary policy for many central banks in developing and emerging market economies. Maintaining price and overall macroeconomic stability is a key mandate of most central banks. The objectives of exchange rate management in Nigeria include ensuring price stability, maintaining external reserves to defend the value of the naira, supporting diversification of the economy by promoting non-oil exports and reducing the premium between the official and parallel exchange rates. Odusola (2006) classified these objectives as traditional and non-traditional. The management of external reserves is the traditional objective, while the management of excess demand for foreign exchange and the promotion of exports are the non-traditional objectives. To achieve these objectives, the CBN has, over the years, adopted different exchange rate arrangements or regimes in line with macroeconomic conditions. For instance, the aim of exchange rate management under the Structural Adjustment Programme (SAP) can, to some extent, reflect the need for a medium/long-term balance of payment equilibrium to minimize the impact of external shocks (Obaseki 2006).

Depending on a country's circumstances at a particular time and the availability of instruments at the disposal of policymakers, central banks intervene in foreign exchange markets to influence the level of the exchange rate. While there are some common principles for intervention, the timing and magnitude of intervention are determined by the central bank's discretion to assess market conditions better and allow for tactical maneuvering (Basu and Varoudakis 2013).

As indicated in the previous section, the intermittent changes in exchange rate policy in Nigeria have all been aimed at developing the CBN's intervention mechanism with the sole objective of preventing the depreciation of the naira against foreign currencies, particularly the US dollar. For the past four decades, the CBN has been the major supplier of hard currency in the foreign exchange market, and Nigeria's dominant source of foreign exchange earnings has been the sale of crude oil. Consequently, the CBN's ability to intervene and support the value of the naira is determined by the size of the country's foreign reserves, and the reserves are heavily dependent on crude oil revenues.

Figure 4.4 shows the co-movements of external reserves and crude oil prices to illustrate the strong correlation between the two variables. Foreign exchange reserves rise and fall with the rise and fall of crude oil prices. Lower oil prices imply that the CBN risks depleting the reserves to prevent a sharp fall in the value of the naira. The reserve is the financial muscle with which the CBN intervenes in the foreign exchange market to support the naira exchange rate.

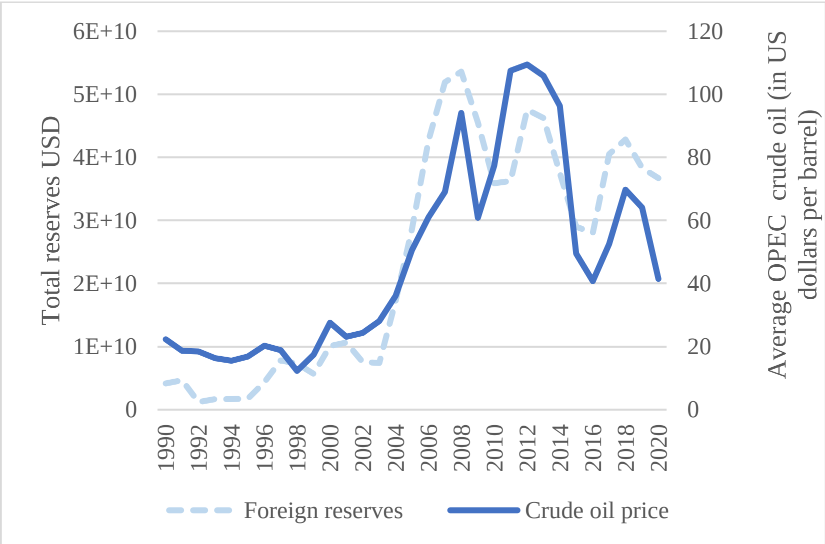

Figure 4.4 Crude oil prices and Nigeria's foreign reserves
Source: Author based on data from statistica.com (crude oil price); World Bank (Foreign reserves)

CBN intervention takes the form of allocation of foreign exchange to priority sectors and designated activities at the official 'subsidized' exchange rate. Second, the Bank engages in different initiatives and financing for various sectors such as agriculture, pharmaceuticals, and micro, small, and medium enterprises. Making these interventions in support of priority sectors has some political economy implications. The first implication is that the Bank's policy of providing subsidized foreign exchange to designated activities and sectors has created a new opportunity for rent-seeking behavior and arbitrage. Thus, there is a tendency for influential groups and individuals with access to the official rate to capture most, if not all, of the benefits of the initiatives.

Second, the preferences of different groups with respect to CBN policy may differ depending on how they may be affected. For example, investors and exporters have complained about the impact of the widening spread between the NAFEX window rate and the parallel market rate (see, for instance, Yusuf 2021[14]). This sentiment is supported by Nigeria's Vice President, Yemi Osinbajo, who called for a rethink of the CBN's foreign exchange demand management strategy during a government function on October 11, 2021.[15] The Vice President advocated for a market-reflective exchange rate to encourage foreign exchange inflows and eliminate opportunities for arbitrage and rent-seeking. However, this has led to many public outcries accusing the Vice President of calling for a devaluation of the naira.[16]

The third contentious CBN policy was the discontinuation of foreign currency sales to Bureau de Change operators (BDCs) and the suspension of applications for new licenses. Henceforth, the foreign exchange sales shall be channeled directly to commercial banks.[17] According to the CBN governor, this action is necessary because of

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[14] Channels TV, 30/07/2021: Impact of CBN's BDCs Ban on FX Supply - https://www.youtube.com/watch?v=b9Rz73OuNqs

[15] TVC news Vice President Osinbajo Calls for Devaluation of Naira https://www.youtube.com/watch?v=FNzyRlFjFU0

[16] Any attempt to devalue the naira tends to evoke the traumatizing experience of most Nigerians with the negative consequences of SAP on the naira.

[17] Channels TV: CBN Governor Emefiele Discontinues FX Sale to BDCs, Stops New Licenses https://www.youtube.com/watch?v=6MjoaFfFFlU

the malpractices in the market, as reflected in rent-seeking behaviors and corruption.[18] This policy also generated mixed reactions and divergent preferences, with some groups, including the Manufacturers Association of Nigeria (MAN), supporting the policy, while other groups and observers are skeptical about the role of banks in ensuring adequate supply – especially to small scale users – due to the stringent requirements for obtaining foreign currency from the banks.[19]

These interventions tend to generate outcomes in which the cost of the policy is dispersed while the benefit is concentrated. For example, the negative effects – inflation, for instance – may permeate the whole economy. However, access to the official exchange rate may depend on the extent of one's political connection or the political clout of influential interest groups. This type of intervention and its detrimental consequences epitomizes how government intervention in markets to influence prices creates vested interests and opportunities for rent-seeking and corruption (Bates 1981). It is a system of exchange control involving the rationing of limited foreign exchange to 'preferred customers' (Todaro and Smith 2011, 607).[20]

Let us draw from Bates (1981, 97-99) and Todaro and Smith (2011, 607-608) to illustrate the foreign exchange challenges in Nigeria. Government intervention in the

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[18] While announcing the new policy, the Governor noted, "given this rent seeking behavior, it is not surprising that since the CBN began to sell forex to BDCs the number of operators has risen from 74 in 2005 to over 2700 in 2016, and almost 5500 in July 2021. In addition, CBN receives not less than 500 new applications for BDC licenses every month."

[19] See for instance: https://dailytrust.com/man-backs-cbn-withdrawal-of-forex-from-bdcs ; https://guardian.ng/business-services/manufacturers-hopeful-cbn-forex-policy-will-check-rising-input-costs/; https://www.thisdaylive.com/index.php/2021/08/02/manufacturers-back-cbns-ban-of-fx-sale-to-bdcs/

[20] Todaro and Smith (2011, 607) defined exchange control as "a governmental policy designed to restrict the outflow of domestic currency and prevent a worsened balance of payments position by controlling the amount of foreign exchange that can be obtained or held by domestic citizens".

foreign exchange market results in a lower exchange rate (price) for foreign currency. The currency assumes a new exchange rate below the market clearing rate. This then creates excess demand for the currency in question, and it becomes scarcer that the monetary authority resort to rationing. Figure 4.5 describes the process that leads to the emergence and persistence of exchange control, which creates vested interests (refer also to section 4.5 below).

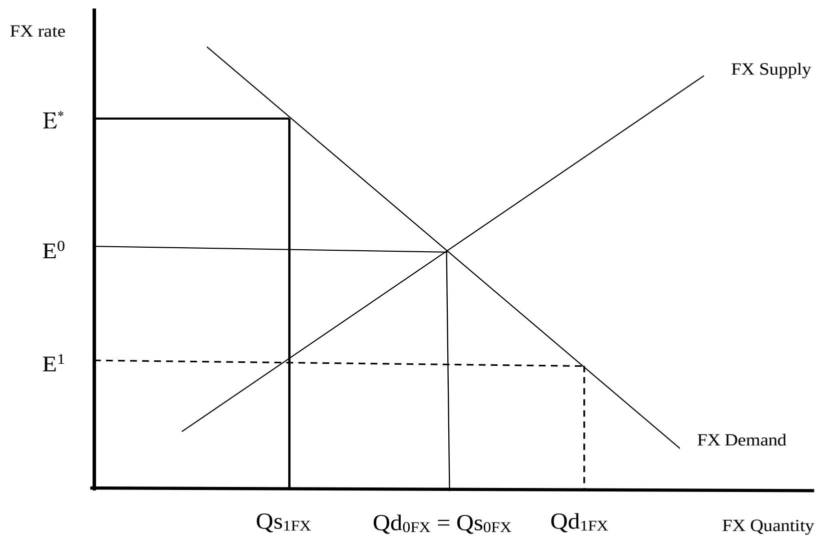

Figure 4.5 Central Bank forex intervention and vested interests
Source: Constructed by author based on Bates (1981) and Todaro and Smith (2011)

At E^0 in Figure 4.5, the market clearing exchange rate, the demand, and supply for foreign exchange are balanced (Qd0FX = Qs0FX). When the central bank, for whatever reason, intervenes in the forex market, the exchange rate is lowered to E^1 – that is, the official exchange rate. E^1 causes forex demand to increase to Qd1FX. Because there is not enough supply to meet the increased demand, this creates excess demand for forex, and it becomes difficult to continue transacting at E^1. The forex is, therefore, selectively allocated through rationing. The scarcity of the currency at the limited supply Qs1FX gives it a higher value at E*, where most of the excess demand is absorbed. This is the parallel market rate. E* is greater than the official exchange rate (E^1) and the market clearing rate (E^0). The margin between E^0 and E* provides what Bates (1981, 99) called the 'administratively generated rent,' a premium that emerges from creating the official exchange rate. The immediate implication is that the rent (E^1) is allocated to those with privileged access to government, and most, if not all, is resold at the parallel market rate (E*). The selective allocation may initially be for good intentions of insulating the domestic economy from external shocks or stimulating local production to foster economic development. But the action may result in unintended consequences, as exemplified by the Nigerian case.

4.4 Economic Policy in Indonesia in the Democratic Era: Exchange Rate Policy

The processes of economic policymaking in Indonesia are not fundamentally different from those in Nigeria over the past two decades. Many of the factors that could influence economic policymaking in Indonesia, which I will discuss in this section, are also applicable to Nigeria. Moreover, both countries embarked on many similar institutional reforms after their democratic transitions, amending existing laws and enacting new ones. This implies that the policymaking processes and institutional settings are the same in both countries.

The political and economic transformation that has accompanied Indonesia's transition to a decentralized democratic country has brought about institutional reforms and a new arena for economic policymaking. Multiple stakeholders and different levels of processes are now involved in the design and implementation of public policies. As such, the political environment plays a crucial role in policy making, approval and implementation.

Aswicahyono, Bird and Hill (2009) examined seven important factors that characterize the policymaking environment in Indonesia after the Asian financial crisis compared to the previous New Order regime. First, the departure of Suharto as Indonesia's president after thirty-two years of consolidating power has opened the doors to competition for the presidency, resulting in frequent changes in power through periodic elections or impeachment. This means that the power of the president is relatively weak compared to Suharto's reign. Mcleod (2005, 368) argues that "with Suharto's demise, Indonesia gained a democracy in which people have the opportunity to change governments at regular intervals, but lost effective government – effectiveness in the sense of doing what is necessary to promote rapid growth".

Second, the diverse interests and backgrounds of cabinet members make it difficult to reach consensus on a particular course of action, leading to internal disunity.

A third factor is that the legislature (Indonesia's parliament) has become more influential and powerful, as opposed to the "rubber stamp" it was under Suharto. This means that when the president's party has fewer seats in parliament, the passage or amendment of government bills is more likely to be delayed or rejected. This means that members of parliament must be constantly prodded to consider the executive's requests.

Fourth, a more active civil society has emerged, thanks to the freedom of press and association that democracy has brought. Interest groups keep a watchful eye on government actions to prevent outright abuse of discretion.

Fifth, the bureaucracy, which previously operated with limited or no constraints from parliament, is now subject to legislative oversight and often suffers from political interference that can negate bureaucratic efficiency.

The sixth factor has to do with the lack of capacity of the legal system to handle the enormous task of administering justice, especially in matters involving large-scale disputes in the financial system, for example. Under Suharto, cases of this magnitude were resolved at higher levels of the political hierarchy, without necessarily going through the legal system.

Finally, the decentralization program has devolved power and resources from the central government to subnational governments. This creates the need to coordinate the roles of different levels of government in implementing national policies, which can sometimes prove difficult.

These features of Indonesia's political landscape illustrate the complexity of pursuing economic policies, especially those involving radical reforms whose benefits are likely to be realized only in the long run. Unlike during Suharto's reign, when a small circle of technocrats designed policy goals and implementation strategies and needed only the president's approval, economic policy now involves multiple actors. It must be supported by many other stakeholders, which often leads to delays and uncertainties (Aswicahyono et al. 2009).

However, despite these changes, Indonesia's key economic management institutions, such as the central bank (Bank Indonesia) and the Ministry of Finance, continue to be led by competent, 'nonpartisan' professionals with the necessary expertise to effectively oversee the policymaking process (Basri 2017; Basri and Hill 2020). Furthermore, with the independence of Bank Indonesia, the law (Law No. 23 of 1999, amended as Law No. 23 of 2004) prohibits the central bank from financing the government deficit through the purchase of government bonds in the primary market, and instead should primarily focus on achieving and maintaining the stability of the domestic and external value of the Indonesian currency, the rupiah (Nasution 2015).

4.4.1 Indonesian Exchange Rate Systems: From Fixity to Flexibility

The choice of exchange rate policy in Indonesia can be influenced by some of the country's economic and political structures. First, the economy is open to international capital flows, which means that investors may be attracted by profitable investment opportunities in the financial markets. This leads to capital inflows and can cause the currency to appreciate. The opposite will happen if a higher-yielding financial instrument is offered elsewhere, such as an interest rate increase in the United States. Thus, a sudden outflow of capital can cause the currency to depreciate dramatically.

Second, primary commodities make up a significant portion of Indonesia's export composition, which is prone to fluctuations (boom and bust cycle) in the international market. A commodity boom could generate windfalls that could be reflected in currency appreciation.

Third, in addition to the manufacturing sector's dependence on imported inputs and raw materials, Indonesian manufactured goods face stiff competition from cheaper products from China and other Asian neighbors such as Vietnam (Wie 2012). Indeed, some studies blame Indonesia’s deindustrialization on the simultaneous appreciation of the rupiah and the ‘undervalued’ Chinese currency, the yuan (see, for example, Nasution 2015). However, given rising labor costs and development patterns in China, there is potential for some foreign direct investment to flow into Indonesia in the foreseeable future.

Fourth, as noted above, democracy has given the people a greater voice and space for political contestation. Thus, political considerations in the policymaking process, such as election cycles and pressure from interest groups, could have an impact on exchange rate policy.

Indonesia has historically implemented different exchange rate systems. Until 1967, the system was characterized by a complex and multiple foreign exchange arrangement, featuring regimes such as the special currency with a unitary exchange rate operated in the Island of Sabang – Sumatra and West Irian – New Guinea (Glassburner 1970). The exchange rate system was gradually reformed since the 1970s, evolving through fixed, managed, and floating exchange rate regimes (Rusydi and Islam 2007, 103; Warjiyo and Juhro 2019, 110). From 1973 to March 1983, a fixed exchange rate was implemented. This was changed to a tightly managed exchange rate system from March 1983 to September 1986. Under these two arrangements, the rupiah (Rp) was devalued three times: “devaluation in November 1978 from Rp 425 per USD to Rp625 per USD; from Rp625 per USD to Rp825 per USD in March 1983; and from Rp1,134 per USD to Rp1,644 per USD in September 1986” (Warjiyo and Juhro 2019, 110; see also, Fuady, 2012, 127-135 for discussion on each of the three devaluations).

Bank Indonesia (BI) minimized the tendency to intervene in the foreign exchange market after the two major devaluations in 1983 and 1986 to promote the development of a more independent foreign exchange market and the stability of the monetary system (Saxena 2002). From 1986 to 1997, the managed floating exchange rate became increasingly flexible. However, Bank Indonesia continued intervening in the foreign exchange market to maintain the rupiah’s value within a specified band. The foreign exchange market continues to evolve along the dynamic exchange rate regime.

Thus, "the foreign exchange system has evolved from tight government control to a free foreign exchange system, gradually moving from a fixed exchange rate to a flexible exchange rate regime at a pace consistent with prevailing economic conditions" (BIS 2005, 177).

In response to speculative attacks in the foreign exchange market during the 1997-98 Asian Financial Crisis (AFC), Indonesia adopted a floating exchange rate regime in August 1997. This policy was introduced because of the crisis and had to be maintained as part of the conditions of the IMF's stabilization program for Indonesia in the aftermath of the AFC. As noted by Nasution (2015, 9), "the IMF program of 1997-2003 forced Indonesia to adopt strict macroeconomic policies to control inflation and stabilize the exchange rate and restore economic growth. In addition to monetary and fiscal policies, structural reforms are equally important to achieve these objectives. Short-term macroeconomic policies included changing the exchange rate regime from a managed float or peg to an independent float." With this development, the rupiah value moves according to market demand and supply. However, BI intervenes in the foreign exchange market to stabilize the rupiah when there are disorderly market conditions and large fluctuations that could potentially pass through to inflation or when there is a need to promote export competitiveness by preventing currency appreciation (Warjiyo and Juhro 2019; Edwards and Sahminan 2008).

4.4.2 Bank Indonesia's Autonomy and Strategy of Exchange Rate Management

Prior to the Asian financial crisis, monetary policy was implemented by the Monetary Board, whose members included cabinet ministers and the governor of Bank Indonesia (Basri 2018; Nasution 2015). However, with the enactment of Law No. 23 of 2004, Bank Indonesia has full autonomy as an institution to formulate and implement policies without any interference (Ascarya 2011). Independence is determined by the extent to which the bank can operate in terms of setting policy goals/targets and applying appropriate policy instruments, as well as managing the internal governance of the institution (Soekarni and Syarifuddin 2011).

The Law Establishing Bank Indonesia provides five meanings of independence. Ananta, Soekarni, and Arifin (2011) and Ascarya (2011) elaborate on these meanings of Bank Indonesia independence, namely: institutional, objective, personal, financial, and instrument independence. Institutional independence means that Bank Indonesia can independently design and implement policy goals without interference from the government or other parties. The authority to set targets (albeit in consultation with the government) to ensure the stability of the rupiah value gives the Bank objective independence. Personal independence allows Bank Indonesia to operate independently and has the 'right' to resist the undue influence of any organization on its responsibilities. However, personal independence is limited for two reasons. First, the appointment of the governor, deputy governors, and board members must be approved by the parliament. Second, the bank's annual budget is also subject to parliamentary scrutiny. Nevertheless, the bank has the financial independence to implement the budget without further parliamentary approval.

While Bank Indonesia seems to have demonstrated its ability to exercise its authority and resist parliamentary pressure (Hamilton-Hart 2019), at one point, it was asked to reduce interest rates to single digits to expand credit and stimulate the economy. This is indicative of executive interference, which may affect the independence of the central bank if such a practice is repeated on a sustained basis. In pursuing its monetary policy objective, the bank has the freedom to adjust interest rates as it deems appropriate.

This is instrument independence. Different instruments are used for different purposes.

Policy instruments to support the stabilization of the rupiah include interest rate policy, open market operations, foreign exchange intervention, and other management tools. Foreign exchange intervention is useful in stabilizing market expectations and limiting the impact of temporary shocks on exchange rate fluctuations. However, intervention is not a stand-alone policy instrument, as it is only effective with macroeconomic policies to address internal and external imbalances. The effectiveness of the intervention is determined by currency volatility, which, in the case of the rupiah, has been minimized since adopting the floating exchange rate regime (BIS 2005, 179).[21] In 2003, for instance, "foreign exchange intervention operations proved effective in minimizing excessive exchange rate volatility (Bank Indonesia 2003, 44)".

Bank Indonesia decides whether to use an open method to intervene directly in the foreign exchange market or a closed method through agent banks as intermediaries. The choice of either method is based on market sentiment and whether information about the intervention should be disclosed to market participants (Ferry 2015; BIS 2005). Another consideration is whether there is excess demand but a limited supply of US dollars. According to Warjiyo (2013, 181), Bank Indonesia's strategy of foreign exchange intervention, which involves buying and selling foreign currency through agent banks, is to curb excessive exchange rate volatility. These transactions often take place in the spot market. However, depending on the availability of foreign exchange, the central bank also engages in swap and forward transactions.

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[21] Nguyen (2018) analyzed the application of interest rate and foreign exchange intervention to stabilize the rupiah. Changes in the value of the rupiah accompanied by interest rate and reserve movements may indicate a weak correlation, because BI does not publicly announce the strategy, timing, and volume of foreign currency intervention.

BI intervention is conducted from a strategic and operational point of view. The strategic aspect includes the intervention's objective, the legal framework (BI Act and regulations on exchange rate management), the policy direction, and the operational guidelines. While the operational aspect deals with the policy implementation strategy based on market conditions as determined by the relevant units of BI (Ferry 2015).

Capital flows across international borders strongly influence the movement of exchange rates. The perception of markets by international investors determines how much and where this capital is invested. In conducting foreign exchange interventions, the BI recognizes the importance of understanding and monitoring this behavior in terms of the type of investor (hedge fund or long-term) and the factors that influence their behavior (Warjiyo 2013). For example, hedge funds are short-term investors who seek quick profits, and their portfolio decisions are influenced by even the slightest hint of a domestic or external shock. On the other hand, long-term investors tend to be more stable because they seek higher returns based on their judgement of economic fundamentals and are unlikely to be affected by short-term fluctuations.

In addition to intervention, BI also engages in foreign exchange supply and demand management to stabilize the rupiah, especially in the face of mounting pressures that cause the currency to depreciate. For example, in 2015, BI introduced a rupiah stabilization policy package in coordination with other government policies to support macroeconomic stability and inclusive economic growth (see, Bank Indonesia 2015, 181-185). The forex supply and demand management pillar of the policy package includes providing tax breaks on fixed deposit interest rates to exporters who deposit their export earnings in domestic banks or convert their export earnings into rupiah (185). The policy also includes controlling the demand for foreign exchange not directly related to the 'real economy' by reducing the limit on spot foreign exchange transactions from USD 100,000 per customer per month to USD 25,000. The restrictions did not apply to transactions related to the payment of school fees, the payment of imports, the cost of medicines abroad, and the servicing of foreign debt (183).

4.4.3 The Target of Intervention: Macroeconomic Stability Versus Competitiveness

Central banks generally intervene in foreign exchange markets to control inflation, maintain financial stability, or promote export competitiveness. The target of any objective policy intervention is determined by a country's level of development, exposure to shocks, and the degree of financial market development and integration (Moreno 2005, 4). The precise objectives of intervention are difficult to determine across countries and over time due to the diversity of exchange rate regimes. However, the rationale emphasized by most central banks includes minimizing exchange rate volatility, managing foreign exchange reserves, and ensuring adequate liquidity in the foreign exchange market.

The main objective of foreign exchange intervention in Indonesia is to stabilize the exchange rate 'along its fundamental path,' focusing on price stability and financial system stability rather than external competitiveness. "Under these circumstances, Indonesia views exchange rate policy as an integral part of an overall monetary and macro prudential policy mix aimed at achieving price stability while paying due attention to economic growth and monetary and financial system stability" (Warjiyo 2013, 179).

While adhering to the de jure 'free' floating exchange rate policy, Bank Indonesia's mandate is to ensure the stability of the rupiah in terms of domestic prices of goods and services and the exchange rate of the currency against other currencies. Therefore, the Bank implements the exchange rate policy to align the rupiah exchange rate with its market value and to minimize supply and demand imbalances in the foreign exchange market. BI uses a dual strategy of stabilizing the rupiah by buying and selling foreign currency through agent banks and buying tradable government securities in the secondary market (Bank Indonesia 2015, 182). “The implementation of the foreign exchange intervention policy [is] conducted at random intervals, both in terms of timing and size, to avoid predictability. As a result, intervention operations [are] carried out in a measurable and prudent manner, bearing in mind the importance of the adequacy of foreign exchange reserves” (Bank Indonesia 2003, 44).

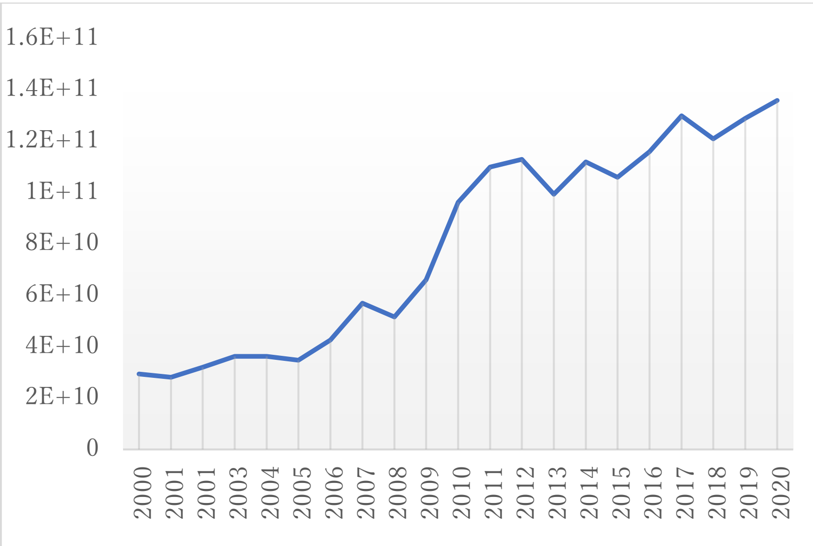

Figure 4.6 Indonesia foreign reserves (US$ Billion)
Source: *World development indicators*, World Bank

In principle, a floating exchange rate system does not require large external reserves because there is little need for market intervention by the central bank. However, because Indonesia is a primary commodities exporter, BI continues to “accumulate large foreign reserves to respond to sudden shocks emanating from the international market” (Nasution

2015, 16). The reserves rose to US$130.5 billion in May 2020, and exactly twelve months later – by the end of May 2021 – the amount stood at US$136.398 billion.[22]

Figure 4.6 shows the growth of foreign reserves for the past two decades, which indicates the readiness of Bank Indonesia to absorb external shocks that may cause sharp currency volatility. A noticeable sharp increase in the reserve between 2008 and 2012 may have been accounted for by the commodity boom during that period. On the one hand, the accumulation of the reserves provides the buffer for BI to intervene in the foreign exchange market to prevent a rupiah depreciation and avoid inflation. On the other hand, the competitiveness of Indonesia's exports in the international market may be affected by an appreciated rupiah.

Indonesia's impressive growth in the decades before the Asian financial crisis has largely been attributed to exporting agricultural and manufactured goods stimulated by a devalued rupiah. However, recent studies have revealed mixed evidence on the effect of rupiah value on Indonesia's exports in the past two decades. Calì and Nedeljkovic (2018) argued that the major factor responsible for the decline in Indonesia's manufacturing exports between 2005 and 2012 was the appreciation of the rupiah exchange rate caused by the commodity boom. The currency, however, began to depreciate after the boom in 2012, as depicted in Figure 4.7. An upward movement indicates the depreciation of the currency. That is, the rupiah exchange rate per unit of the US dollar has increased significantly.

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[22] See, www.bi.go.id. Accessed on 19/7/2021

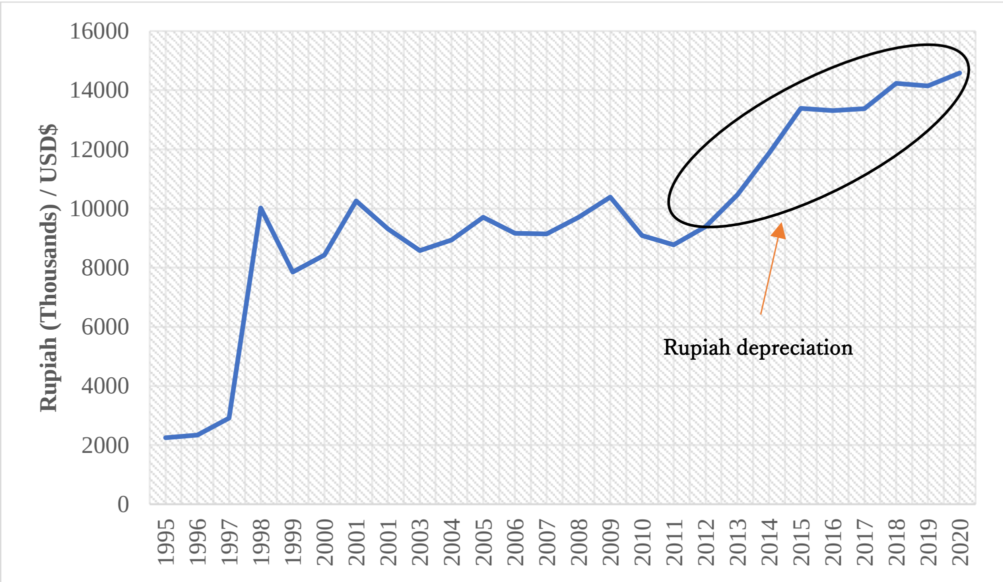

Figure 4.7 Nominal exchange rate of rupiah to US dollar (annual average)
Source: International Monetary Fund (IMF) data.

Putra and Narjoko (2019) found that the level of the exchange rate and its degree of volatility affected Indonesia's exports from 2008 to 2012. The authors suggest that the volatility of the rupiah has a greater impact on exports than the level of the currency's value. Currency depreciation makes export goods cheaper and thus more competitive. On the other hand, high currency volatility tends to reduce the value of exports due to uncertainties in the valuation of exchange rate risk. In contrast, Rasbin et al. (2021, 19) found no effect of the exchange rate level on exports of 22 Indonesian manufacturing firms between 1990 and 2015. The authors bluntly conclude that "exchange rate manipulation policy is not an important factor in strengthening the competitiveness of Indonesia's manufacturing exports." Rasbin et al. (2021) suggested that other policy variables – domestic interest rate, real wages, and conducive business climate – appear more important in promoting manufacturing exports. While these factors are arguably important in fostering a viable manufacturing sector, the benefits of these policies remain at the level of increasing industrial productivity. In other words, the alternative policies proposed by Rasbin et al. (2021) are necessary conditions for industrial growth and development. However, the exchange rate remains a sufficient condition for them to compete in the international market. This is because most export commodities compete based on price, not necessarily because of some unique characteristics.

On March 13, 2015, the Wall Street Journal published an article titled "Weak rupiah helps Indonesia's manufacturing goals: currency's decline helps Indonesia-manufactured products regain competitiveness in overseas markets" (Otto and Sentana, 2015). On the one hand, the authors noted that the weakening rupiah could be important in promoting manufacturing exports, at least from Bank Indonesia's perspective. On the other hand, the government was concerned about the impact of rupiah depreciation on inflation, especially since many firms rely on imported raw materials. This scenario illustrates one of the conflicting interests in exchange rate policy. As with many other policy decisions, there is always a trade-off between competing options, creating winners and losers.

Contrary to the previous strategy of export-led growth in Indonesia, which involves keeping the rupiah low against other currencies, especially the US dollar, BI has intervened in the foreign exchange market to ensure that the rupiah does not depreciate. It is difficult, if not impossible, to obtain the exact data on Bank Indonesia's foreign exchange intervention. However, some studies (see, for example, Edwards and Sahminan 2008) try to measure the extent of this intervention by relating the movements in the value of the rupiah (depreciation/appreciation) to changes in foreign exchange reserves. This is, of course, problematic because many other factors could explain the fall or rise of the reserves than a deliberate action of the monetary authority. Although Edwards and

Sahminan (2008) also acknowledged the problem of using reserves as a proxy for intervention, they argued, based on 'anecdotal evidence,'[23] that some part of the reserve movements can be explained by Bank Indonesia's motive to intervene in the market. In sum, "Bank Indonesia does not announce foreign currency intervention to the public, reserving to itself information regarding volume, strategy, and timing. Given that maintaining exchange rate stability is the prime objective of foreign exchange rate intervention, volatility is the main criterion in determining the volume and timing of intervention. For this reason, the volume of foreign currency intervention significantly increased following the implementation of the free-floating exchange rate policy in August 1997. At the same time, periods of intervention became more sporadic" (BIS 2005, 178).

The immediate observation that can be drawn from central bank intervention in the foreign exchange market in Nigeria and Indonesia is that the size and sources of reserves matter significantly. However, there are some fundamental differences in the nature and purpose of the intervention. Bank Indonesia typically sells foreign exchange (forex) to banks when excessive volatility or low inflows threaten the rupiah's value. This intervention does not necessarily involve allocating foreign exchange for different purposes at different rates. In contrast, the Central Bank of Nigeria allocates forex to different windows at different rates. Until 2021, forex will also be sold to the Bureau de Change, as discussed earlier. Although the multiple rates have largely been eliminated, the I & E rate, the only forex market officially recognized by the CBN, continues to coexist with the parallel market rate.

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[23] Both authors are central bankers, at Reserve Bank of Australia and Bank Indonesia respectively.

4.5 Multiple Exchange Rates System: Nigeria in the Mirror of Indonesia

Multiple exchange rates mean that the same foreign currency is exchanged at a fixed rate through officially administered channels and an open market where the forces of demand and supply determine the exchange rate. Dual or multiple exchange rate systems are usually implemented to correct economic misalignment, such as a balance of payment problem. But they are often maintained for a long period and become difficult to reverse, as illustrated by Nigeria. Indonesia, too, used to have a multiple exchange rate system prior to 1973. The foreign exchange system in Indonesia during the regime of Sukarno was characterized by overvalued and multiple exchange rates system. There were Capital controls and a requirement to surrender exporter proceeds (White 1972).

Indonesia's *New Order regime* inherited a serious political and economic challenge, with inflation at its peak in 1966. The government embarked on economic stabilization and restructuring, emphasizing dismantling excessive government control of the economy, including the exchange rate policy. The initial step taken was issuing October 1966 regulations, which sought to remove controls on foreign trade and address the multiple exchange rates (Sutton 1982). Before this regulation, exporters receive a specified percentage[24] of their foreign exchange proceeds in the form of BE (*Bonus Ekspor* or export bonus) certificates, while the remainder is converted to rupiah based on the lower official exchange rate (Sutton 1982; Kanesa-Thasan 1966). The exporter could use the certificate to pay for specific categories of imports or sell them to other importers through the organized market operated by Bank Indonesia (Glassburner 1970). Imports outside the designated BE list must be settled with the DP (*Devisa Pelengkap*) rate, which

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[24] 20% (traditional exports); 60% (primary exports); 100% (non-traditional exports)

is a market-determined rate that is higher than the BE rate. The system underwent modifications to gradually narrow the gap between the two rates before they were finally unified in 1970, and the rupiah was pegged to the US dollar. The exchange rate liberalization policy in Indonesia effectively increased the export proceeds recorded in official statistics due to reduced export smuggling (Bevan et al. 1999, 239). The policy also helped to boost the confidence of investors and aid donors to repatriate their capital.

In many developing countries, foreign currency transactions occur in a parallel exchange system[25] where officially pegged and controlled exchange rates coexist with market-determined rates (Kiguel and O'connell 1995). Transactions at the officially pegged exchange rate is restricted to designated purchases and activities adjudged by the monetary authority as necessary for economic development, such as the importation of essential capital goods for local production (Agenor 1992). This creates excess demand for the currency at the official window, and some of the supply is illegally diverted and sold at the higher parallel market prices (2).

The expansion of the parallel currency market depends on (or is accelerated by) the extent to which the central bank can meet the demand for foreign exchange and narrow the spread (or premium) between the official and parallel rates. In addition, the nature of the restrictions imposed by the monetary authorities influences the sources of supply and demand for foreign exchange. There is a greater tendency to develop various sources of

[25] Parallel here is interchangeable with fragmented, informal, or black market (Agenor 1992).
"A parallel foreign exchange market system is one in which transactions take place at more than one exchange rate and at least one of the prevailing rates is a freely floating, market-determined rate (the parallel exchange rate). Parallel market systems represent a subset of the broader category of multiple exchange rate regimes, which refer to any regimes in which two or more exchange rates are applied to the same currency" (Ghei and Kamin 1996, 499).

informal foreign exchange inflows due to exchange control and restrictions. Some potential sources are the "smuggling of exports, under-invoicing of exports, over-invoicing of imports, and diversion of remittances through unofficial channels" (Agenor 1992, 8).

One of the main reasons for the emergence of parallel market systems, through an officially pegged exchange rate for some transactions, is to prevent the transmission of exchange rate fluctuations resulting from financial market shocks to domestic prices (Ghei and Kamin 1996). The logic is that a fixed and often overvalued domestic currency, at least in the official channel, is associated with low imported inflation. The notion is that "dual rates combine the advantages of both floating and fixed exchange rate regimes. The pegged segment can insulate commercial transactions from exchange rate fluctuations, while the floating segment reflects market forces and gives monetary authorities some flexibility in implementing monetary policy" (Fan 2004, 2).

Another related motive for adopting dual exchange rates is to manage capital outflows triggered by sudden economic shocks that threaten to deplete foreign exchange reserves (Fan 2004). Theoretically, a country's foreign exchange reserves can be better preserved with a dual system than with a single pegged or managed exchange rate (Kiguel and O'connell 1995). The dual system appears effective because it can minimize the inflationary impact of capital outflows since current account transactions in goods and services use the pegged exchange rate. However, Ghei and Kamin (1996) argue that the parallel systems practiced in developing countries, especially in Africa, differ from the rationale for fighting inflation.

Some African countries impose exchange controls because of excess demand for foreign exchange resulting from persistent overvaluation of the official exchange rate.

The controls are, therefore, not designed to insulate the domestic economy from the impact of external shocks but rather to maintain the artificial value of the currency. As the overvaluation persists, rationing becomes more rigid. As a result, "importers, unable to access increasingly scarce foreign exchange through official channels, turned to the parallel market to obtain foreign exchange for trade transactions. The parallel premium grew to very high levels and remained there as the official rate became increasingly overvalued" (Ghei and Kamin 1996, 503). Nigeria's current situation epitomizes this scenario, as illustrated using Figure 4.5 above.

The experience of many countries suggests that dual and multiple exchange rates are ineffective in solving the balance of payments and other related economic challenges (Fan 2004). In most cases, the system has not only failed to achieve the outcomes that policymakers intended (Kiguel and O'connell 1995), but has also had unintended adverse consequences for developing economies. A growing number of countries have liberalized and unified their exchange rates. However, parallel foreign exchange markets still prevail in some countries. Ghei and Kamin (1996) noted that "Nigeria, which has never successfully unified its exchange rate, is a prominent example in Africa." Two decades after this observation, Nigeria is still a prominent example of how exchange rate unification remains elusive, and the detrimental effects of the system on the country's economic development outcomes continue to manifest.

Whether to continue to control the naira exchange rate at an overvalued level or to allow the currency's value to reflect market forces has been a hotly debated issue in Nigeria, given the dilemma it poses. Proponents of control argue that removing the official exchange rate and other administrative restrictions would be disastrous given the country's foreign trade structure, which is dominated by crude oil exports. On the other hand, proponents of liberalization view the official exchange rate as a 'currency subsidy' that benefits only those with privileged access and should, therefore, be abolished. The legendary champions of this liberalization perspective are the international financial institutions (the World Bank and the International Monetary Fund). Other private sector actors in Nigeria also share this view.

4.6 Foreign Exchange Control, Liberalization, and Fear of Policy Transition in Nigeria

Nigeria's foreign exchange market has evolved through episodes of de jure liberalization and administrative control since 1986, as noted earlier. The exchange rate policies have all been geared towards developing a dirigiste mechanism by the CBN to control the supply and manage the demand for foreign exchange, mainly the US dollar. After all the intermittent changes in exchange rate policy over the past three decades, "exchange rate policy in 2022 remains focused on keeping the IEFX [Investors and Exporters] rate and the official exchange rate artificially stable through foreign exchange restrictions and administrative measures" (The World Bank 2022, 4). While the demand for foreign exchange by individuals and businesses continues to rise in the wake of declining inflows, the World Bank's June 2022 report also noted that the supply of foreign exchange for importing about 45 products (including some raw materials) is still restricted by the CBN. This has led to widespread outcry from affected businesses (4).

What constitutes exchange rate restriction in Nigeria?

Nigeria maintains three dimensions of foreign exchange restrictions and a complex multiple exchange rate system, although some of the complexities were addressed in 2022. The IMF's 2021 country report on Nigeria describes the restrictions as follows: First, there is a prohibition on access to foreign exchange through official channels to import more than 40 items. Second, the available foreign exchange is rationed according to what the CBN defines as priority categories of transactions. Third, there are limits on the maximum amounts of foreign exchange available for business and personal travel allowances (IMF 2021).

The multiple exchange rate system has three features: (1) There is an official exchange rate for government and other transactions set by the CBN that differs by more than 2 percent from the rate used by commercial banks in other CBN foreign exchange windows and by money transfer operators. (2) There is a wide spread between the exchange rates used by the CBN in its forex windows and the rates in the parallel market because the CBN limits the availability of foreign exchange to meet various demands. (3) The potential spread of more than 2 percent in the exchange rates at which the CBN sells foreign exchange to successful auction bidders in the secondary market intervention sales window (IMF 2021, 76).

What does liberalization imply?

Exchange rate liberalization means loosening the monetary authority's grip on the foreign exchange market. Accordingly, it should abandon the interventionist regime characterized by multiple windows with an opaque foreign exchange allocation mechanism and move to a unified market-clearing rate that eliminates multiple exchange rates (IMF 2021). It is important to note that a market-clearing rate does not necessarily imply a free-floating exchange rate and may not necessarily cause a free fall in the value of the currency, as the experience of some countries in the last decade has shown (Gray 2021, 16). Pursuing a market-driven exchange rate policy has at least two advantages. First, "an appropriately valued exchange rate would promote domestic industrialization more effectively than a system of foreign exchange rationing where winners are chosen and protected. Second, a clear exchange rate policy would also help attract larger capital inflows, including foreign direct investment, which has declined significantly in recent years" (ibid). See, also chapter six.

As noted in Section 4.3.1, the CBN's adoption of the NAFEX rate is a notable step in the liberalization process to unify the multiple exchange rates. However, different windows still exist, and the parallel market premium widens. The CBN continues to supply foreign exchange to at least four windows at different rates. These windows include the investors and exporters window, secondary market intervention sales retail, small and medium enterprises, and the window for invisibles (The World Bank 2022, 18-19).

Fear of transition to pragmatic exchange policy: The question of political consideration

The structure of incentives and constraints of economic policymakers varies across political systems, structural features of the domestic economy, and the state of the global political economy. In addition, political contestation over policy tends to be more prevalent in a relatively democratic system than in autocracies. Political pressure from powerful groups and individuals can be a fundamental obstacle to policy reform, such as a market-driven flexible exchange rate system. Gray (2021) highlights some reasons why monetary authorities (central banks and finance ministries) may be reluctant to pursue market-based exchange rate policies. The main concerns relate to uncertainties about the transition process and its impact on other important variables, such as the national budget. The budgetary impact would be partly determined by the government's need for foreign exchange to service debt and subsidize imported fuel and food. This apparent anxiety about the policy transition may be based more on political considerations than on the economic risk concerns expressed by the authorities.

4.7 Conclusion

This chapter has compared the exchange rate regimes of Nigeria and Indonesia, looking closely at how the policies work and their implications. Indonesia has successfully transformed its exchange rate regime from a multiple exchange rate system to a unified, market-reflective exchange rate system. This type of policy transition is yet to be fully achieved in Nigeria. Administrative control of the exchange rate and the requirement to surrender export proceeds have been abolished in Indonesia but are still active in Nigeria. The objective of maintaining an official exchange rate has been defeated, and many stakeholders and observers have recommended that the exchange rate system be shifted to a market-based orientation. While the potential risks associated with moving to a market-based exchange rate are recognized, it is possible that the obstacles are more politically motivated or that policymakers have chosen to stick with misguided policies. The next chapter will attempt to unravel the interaction between the Central Bank of Nigeria and key stakeholders in exchange rate policy to examine who influences policy in comparison with Indonesia.

Chapter Five: Exchange Rate Policymaking in Nigeria and Indonesia: Stakeholders' Preference and Influence

5.1 Introduction

This chapter provides a political economy explanation for exchange rate policies in Nigeria and Indonesia. The focus is on whether and how exchange rate policies reflect political pressures, especially from interest groups, international financial institutions, or the ideas of central bankers. Typical public policymaking involves the interaction of different stakeholders and actors to achieve some policy result. Although exchange rate policy does not necessarily require the cumbersome implementation processes of other economic policies (for example, the national budget), it could also emerge from political bargaining with special interest groups and foreign actors. The stakeholders in exchange rate policy discussed in this chapter include business interest groups, international financial institutions, and central bank officials, and political elite. I used semi-structured interviews to trace the preferences and influence of interest groups in the policymaking process. The themes I discussed emerged from these interviews. The chapter also assesses the role of international institutions in exchange rate policymaking. The analysis focused on the IMF's recommendations for policy reform. Finally, I examined the views of central bankers on the political constraints they face and their ideas on optimal exchange rate policy. This allows us to infer whether they conduct policy in response to political pressures or otherwise.

5.2 The Path to Interest Group Influence on Exchange Rate Policy in Nigeria

There are different channels through which interest groups can influence policy decisions. Business interest groups may lobby for a favorable exchange rate policy or engage in advocacy through media campaigns. Whether the demands of such interest groups are reflected in policy outcomes depends on the central bank's final policy decision. In Nigeria, I interviewed five interest groups and one major exporter to determine their policy preferences, the extent of their engagement with the central bank, and whether they succeeded in influencing the CBN to implement or change an exchange rate policy.

5.2.1 Exchange Rate Preferences

The preferred exchange rate regime or currency value of individuals and groups is determined by how exchange rates affect them. All the stakeholders interviewed are affected by exchange rates through different channels. For for-profit businesses, the impact of exchange rates, whether positive or negative, ultimately affects their profitability. In large groups such as the Chamber of Commerce and Industry, which encompasses diverse activities spanning international trade, manufacturing, and other sectors of the economy, most of the members are affected by Nigeria's foreign exchange challenges through loss of profit (Interview 1). Each member operates as a profit-making enterprise, and profitability can be achieved through two approaches: increasing revenues or reducing production costs. The issue of foreign exchange affects both aspects, although not necessarily in the same way. Due to the nature of the Nigerian economy, many of these businesses rely heavily on imported raw materials, intermediate products, and other critical items. Even if they do not directly import these goods, they may be affected by importing other items. For example, many companies rely on diesel to power their electrical generators. They do not directly import diesel, but they are inevitably affected by fluctuations in the price of diesel when import costs increase due to currency depreciation.

The major impact of the forex on businesses, especially local manufacturers, is linked to Nigeria's heavy dependence on imported raw materials and intermediate inputs.

Thus, the continuous depreciation of the naira has, in part, brought local manufacturing to a standstill as it has severely affected the ability of most manufacturers to import critical raw materials and machinery. Manufacturers are faced with the difficult decision of either going out of business or struggling to stay afloat by curtailing production. According to the Manufacturers Association:

> The current [foreign exchange] situation has forced many manufacturers to cut down production or shut down completely because they depend mostly on forex, and the unavailability of the forex is challenging them. As a result, over 40% of manufacturers could not access forex to import raw materials, particularly in 2020 (Interview 4).

Nigeria's overdependence on a few sources of foreign exchange exposes the country to persistent difficulties, especially when external shocks cause a decline in foreign exchange inflows. The shortage of foreign exchange necessitates strict foreign exchange management in the form of rationing of a scarce, administratively controlled foreign exchange by the central bank. The priority of interest groups then focuses on accessing foreign exchange at the official exchange rate, which is overvalued relative to the market-determined rate. In the absence of an official exchange rate, the preferences of interest groups should depend on who benefits from an overvalued or devalued currency.

"They are having a good time": Beneficiaries of a devalued currency?

The nature of the policy preferences of interest groups in Nigeria tends to favor a high-valued naira. None of the groups expressed a preference for a devalued currency, including the exporters. The general feeling towards the depreciating exchange rate is not positive because even those who are expected to benefit from a lower-valued currency, the exporters, are not getting the benefit as expected (Interview 2). Some of the reasons why exporters may not benefit from a depreciated naira are due to a combination of regulatory and structural factors. The requirement to remit export proceeds and other bureaucratic obstacles are the regulatory factors. While the structural factors include market conditions where local producers and farmers adjust their prices according to currency fluctuations. This is more evident in tradable agricultural commodities that comprise the bulk of Nigeria's non-oil exports, such as sesame, ginger, and cocoa. For example, a major exporter of ginger noted that:

> If the naira falls, those selling raw [commodities] raise their price. That is why ginger is 800,000 naira, and sesame seed is 960,000 naira per ton. Because the suppliers know that when you are buying 25 tons of ginger or sesame, you are going to export it, since it is an export product, as the naira depreciates, they also raised their prices. Therefore, it is the producers that should be benefiting, not the exporters (Interview 6).

Exporters of other commodities also believe that farmers are making more money. Farmers can pass on their higher prices relatively more easily than exporters, who seek to maximize profits from the margin between the domestic and international price of a commodity. The interplay between agricultural producers and exporters in a market affected by exchange rates suggests that farmers may have a greater advantage, at least from the perspective of exporters, as expressed in this transcript:

> To start from the bottom of the pyramid, the farmers are having a good time. Because prices keep going up. You will be surprised that the farmers, too, are well informed. Since they know, they adjust their prices accordingly. So, for them, it is a win-win situation. For example, just two weeks ago, the prices of sesame seeds rose to levels that were never seen

> before. It was sold around 980,000 to 1,000,000 naira per ton. It has never been seen before (Interview 3).

Contrary to the notion that higher international prices benefit commodity exporters, in Nigeria, exporters claim to make little profit margin. One cocoa exporter complains that "by all accounts, it is the farmers who are benefiting, the exporters are working for the farmers" (Interview 5). However, cocoa farmers also lament the rising cost of inputs because of the depreciation of the naira. A large proportion of the farmers are small-scale and subsistence farmers. These farmers tend to buy less than they need when the cost of inputs becomes prohibitive, which means that productivity is reduced. The higher prices result from exchange rate depreciation, as most inputs are imported.

Both input suppliers and farmers do not react positively to a devalued naira. According to Bashiru Akinwale, a cocoa farmer in southwest Nigeria, many farmers cannot afford to buy enough to treat their farms because of the high price of the chemicals they need, such as fungicides. On the part of chemical suppliers, Mr. Isaac Ashaolu said, "The low exchange rate of the naira is driving up the prices of cocoa inputs...we are seeing the increase in the prices of agrochemicals because they are all imported [using] the dollar."[26]

Regardless of the economic orientation of interest groups in Nigeria, there appear to be few or no beneficiaries of a devalued naira. However, since the overvalued, cheap foreign exchange is the one that is controlled and rationed by the central bank, the lobby for exchange rate policy may focus on efforts to obtain foreign exchange at the official

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[26] https://www.marketscreener.com/quote/commodity/NEW-YORK-COCOA-16214/news/Naira-Depreciation-Pushes-Up-Prices-of-Cocoa-Chemicals-in-Nigeria-Traders-36008824/

exchange rate. This is the preferred choice of local manufacturers, importers, and those involved in foreign exchange trading – the Bureau de Change (BDC) operators. Exporters, on the other hand, prefer to control their export earnings in terms of the rate at which they can sell the dollar proceeds. The extent to which these different groups can influence policy decisions in their favor depends on their connection and accessibility to policymakers – the Central Bank of Nigeria.

5.2.2 "We Have an Unhindered Access": (Dis-) Connection with Decision Makers

Interest groups could influence the exchange rate decision-making process through direct lobbying or media campaigns and policy advocacy. The political influence of these groups and their ability to lobby key government decision-makers for preferred policies may vary across groups and over time. Interest groups' access to the corridors of exchange rate decision-making is uneven. It depends, among other things, on the financial strength of the group, its importance to the national economy, representation of a large and influential segment of the population, and how well it is organized. The central bank retains the discretion to involve interest groups in the policymaking process or at least to respond to their demands on exchange rate policy. This suggests that the autonomous status of the central bank may reduce the extent of private sector engagement prior to policy decisions. In Nigeria, there have been instances where the central bank has engaged the private sector, but often after the policy has been implemented (Interview 2). Interaction with the CBN is, therefore, less than satisfactory for some stakeholders, who feel that the Bank's autonomous status allows it to implement policies without involving them (interview 2).

It is noteworthy that the accessibility of the interest groups to the CBN in terms of private sector participation in policymaking varies over time and under different governors. My findings indicate that some interest groups enjoyed a close relationship with the central bank during the tenure of previous Governors who served before Governor Godwin Emiefele (2014 to 2023). The BDC operators, for instance, confirmed that they have a cordial relationship with the CBN where they exchange ideas on policies and communicate their aspirations:

> From the days of Governor Soludo to Sanusi, we had a very perfect relationship with the central bank. We have unhindered access…they listen to our demands and consider our proposals. Nevertheless, when this man (CBN governor, Emeifele) was appointed, he came with disdain, hatred, and blackmail. He accused the BDC of this and that. He said he would reform the BDC, which was the basis upon which he raised the registration fees for licensing to 35 million naira to make them more effective and functional. But to this day, none of his promises is fulfilled (Interview 7).

The manufacturers' association also confirmed that they have a significant degree of accessibility when they knock on the CBN's door with their demands. However, the CBN's engagement with interest groups, including MAN, often occurs after public outcry over policy (Interview 4, Interview 3, and Interview 2). As highlighted above, this is because the CBN's independence allows it to make policy decisions without necessarily consulting the organized private sector or other government departments.

According to one interviewee, if the CBN had consulted with stakeholders, some forex policies would have been implemented differently (Interview 4). For example, in 2016, the CBN restricted 41 items from accessing foreign exchange at the official rate (see Chapter four). While some stakeholders support the policy as a necessary step to promote local content development and a strategic attempt to conserve scarce forex, others, especially manufacturers, are unhappy. Opponents of the policy argued that if the private sector had been consulted, the CBN would have been informed that the restricted items were 683 and not 41. In addition, most of the materials on the restricted list are unavailable locally, and those that are available require some investment to develop for use by industries (Interview 4). This evidence highlights the seemingly low level of participation of interest groups in the policy process, which further illustrates the independence of the central bank. However, it does not suggest a total absence of interest group engagement and possible influence, especially regarding policy reversal when it serves the groups' interests.

Some interest groups believe that Nigeria is different from developed countries like the US, where the Federal Reserve, for instance, consults with the private sector community before implementing major policy adjustments. Nevertheless, private sector participation is not completely absent, even though the monetary authority takes the final decision. Supporting evidence for this statement is provided in this transcript:

> In our country, you wake up in the morning and hear on television or read in the newspaper that there is a guideline…. Despite these challenges, we have been engaging [the] CBN. We win some, we lose some. In cases where we cannot find a middle ground, it is the monetary authority that implements what they want (Interview 4).

The opportunity to participate in a win-lose game with the central bank is uneven across interest groups. As mentioned earlier, there are certain determinants of influence, in particular, the political clout of different interest groups. Groups representing critical sectors of the national economy are prioritized over others. However, the Nigerian case may be counterintuitive, given, for example, the influence of Manufacturers relative to the paltry contribution of the manufacturing sector to GDP, which averaged 13 percent between 1987 and 2019. On the other hand, the Chamber of Commerce, which represents various sectors, including mining, agriculture, and industry, appears to have little interaction with the central bank:

> We are not on the board of the Central Bank of Nigeria. As far as I know, we have not had any interactions with the [CBN] to convey our perspective on the exchange rate policy. Coincidentally, the Monetary Policy Committee is meeting today to take a decision on the interest rates. So, we wait to see what happens (Interview 1).

There is, however, some evidence of engagement with the CBN, albeit not to the satisfaction of the chamber of commerce, as indicated in the following statement:

> In my experience at the chamber, we have tried to engage with the central bank, and we were only able to get an audience once out of five attempts. We do get an audience, but not as much as we want. There was a time we had a meeting with one of the deputy governors of the Central Bank, Aisha Ahmed. We eventually got an audience with her and expressed our views. But in my experience, all our effort to get audience with the governor of the central bank on issues pertaining to private sector was not successful (Interview 2).

The central bank governor referred to in the transcript above is Godwin Emiefele (2014 to 2023). As I mentioned at the beginning of this section, the CBN's engagement with interest groups varies under different CBN governors and perhaps economic and political conditions. CBN Governor Emiefele appears to be in the bad books of most interest groups. This may be because their access to the CBN has declined significantly during his tenure, implying a lesser tendency to influence policy decisions in their interest.

5.2.3 Attempts to Influence Exchange-Rate Policy

The degree of openness of the central bank to interest groups allows groups to lobby for their preferred policies. When attempts to directly influence policy decisions prove difficult, media campaigns and advocacy become viable options to express their demands and try to put pressure on policymakers to act in a particular way. The media campaign is more likely to occur when interest groups advocate for a policy change that serves their interests. Different interest groups typically represent competing interests, and each group tries to influence policies that match its preferences, such as exchange rate rigidity versus flexibility or an overvalued versus undervalued exchange rate. In Nigeria, this study finds that in addition to pursuing competing interests, interest group advocacy on exchange rate policy reflects common interests.

The convergence of interests highlights the multifaceted effects of Nigeria's exchange rate policy on different sectors of the economy. One aspect of the policy (arguably the most contentious) on which interest groups spoke almost with one voice is the issue of multiple exchange rates and the need to pursue exchange rate unification. The widening gap between the official and parallel market exchange rates motivates the common orientation of interest groups towards a policy shift in favor of a unified system.

The widening black market exchange rate premium affects not only importers of raw materials, mainly manufacturers, but also exporters. Between 2017 and 2022, more than 50 manufacturing companies shut down due to foreign exchange-related challenges associated with the lack of needed foreign exchange at the official rate, forcing them to resort to the black market (Interview 4). This is a major reason domestic prices largely reflect the parallel market rate. Exporters also suffer the consequences, as suppliers of commodities price their goods based on the parallel market rate, which tends to shrink the profit margin for exporters.

The call for abolishing multiple exchange rates is common to all the interest groups considered in this study. One of the reasons for opposing the multiple exchange rate system is that it encourages currency round-tripping (Interview 2). However, dismantling the system has its pitfalls, especially if the authorities are not sufficiently equipped to manage the consequences effectively. Therefore, some groups' support for the dismantling of the multiple rate system, as captured in the following transcript, is contingent on the government's ability to ensure a smooth policy transition:

> …Abolishment should be the solution if it [can] be well managed…if the government can do it in a way that if you close other windows and make it a single window, anytime manufacturers approach a bank, [they] will be able to get forex for their businesses, why don't we agree with that? (Interview 4).

Interest group advocacy favors unifying exchange rates for a more market-based exchange rate system. The central bank has made many efforts to move in this direction, but the system is, at best, dual, with officially managed and market-determined exchange rates coexisting. Since the system may not have achieved optimal results, even those who are beneficiaries of the official exchange rate, the Manufacturers' Association, believe that a gradual transition to unification should be pursued as it may guarantee greater benefits:

> On the unification of the exchange rate, our position as an association has been clear – it is the right way to go. This argument is out there that we are not ripe for that when one looks at the economy's structure.

> However, even if you are not planning to get there today, you can start the journey from somewhere (Interview 4).

The last sentence of the above transcript is consistent with the analysis in (Section 4.6), which recognizes the policy change as a transitional process. The recommendation to pursue the policy emphasizes the need for gradual efforts to reduce the parallel market premium before the gap is finally closed. The Manufacturers' Association, although probably the highest priority in terms of sectoral allocation of the scarce official exchange rate, foresees the beneficial effects of a unified exchange rate system and has advocated for the implementation of this policy:

> As an association, over the years, we have been advocating to have a unified exchange rate. Not because we just wanted a 'unified' exchange rate system but because we knew it would promote a market-friendly exchange rate. Moreover, this means it will facilitate stable production. Manufacturing requires planning, and you set your target ahead of time. When you have a unified exchange rate, one of the benefits is that it will promote a market-friendly rate. Secondly, it will engender sustainable economic growth (Interview 4).

Some reservations about a unified exchange rate are based on the inherent risk of possible hyperinflation associated with such a move. Nigeria has continued to delay this policy change even when the opportunities have been right. For example, during periods of relative stability and a benign atmosphere devoid of external shocks that could trigger naira depreciation due to foreign exchange shortages. One argument is that postponing exchange rate unification is analogous to delaying the intake of a necessary pill that a sick person inevitably needs to be relieved of persistent pain. The longer it is delayed, the more acute the illness and the more severe the treatment. The momentary pain of treatment in the early stages of the disease is mild compared to when the disease worsens, as one respondent argued:

> If we had deregulated and let the market [forces] decide [the currency's value] when the naira was 190 [per US$1], would we have reached 700 naira and above? We did not do it then, and even if we want to do it now, the [inflationary] spike that we are afraid of will still happen. We avoided it at 190, when it was 300, and if we continue to avoid it, the day it happens, that spike will necessarily take place.... We avoided the momentary pain, but we are now suffering for a long period (Interview 2).

5.2.4 Who Wins? Reflection of Policy Preferences in Policy Decisions

Interest groups are expected to have competing interests based on their characteristics and how they are affected by exchange rate policy. However, there is some variation in the preferences of interest groups, as I noted earlier. Some groups reported a positive response to their demands under certain circumstances, suggesting a case of 'winning,' as stated by Manufactures Association of Nigeria (MAN), for example, regarding the transparent allocation of foreign exchange at the official rate and the restriction of eligible items.

First, the demand for transparency in the disbursement of scarce foreign exchange resources was triggered by malpractices in the allocation of foreign exchange by commercial banks. It was observed that while traders in non-essential items such as apples, toothpicks, and other 'funny things' could access foreign exchange at the official rate, critical sectors such as manufacturing were having difficulty accessing foreign exchange to import essential raw materials (Interview 4). The request to the CBN was to instruct banks to publish in national newspapers how much they were giving to whom. "The CBN complied with the request by instructing banks to publish the use of forex they get from the CBN.... like I said, it is win some lose some" (Interview 4). Second, MAN also recommended a review of the categories of imports that are restricted to access the official exchange rate to remove some items from the list and include others that are available in abundance locally. The CBN also considered this request. Third, MAN also succeeded in securing preferential allocation of foreign exchange to small and medium enterprises (SMEs) and other manufacturers. The respondent explicitly stated this:

> …a kind of preferential arrangement was given to small and medium enterprises, and I think about 60 percent of the allocation was extended to manufacturers. All of that was in response to our advocacy and request. For the SME's, it is about 20,000 dollars. Nevertheless, for the generality of the manufacturers, there is no specific amount. What was agreed was that whatever forex intervention CBN is about to make, at least 60 percent of such should be made available to the productive sector (Interview 4).

Despite expressing the need for more attention to manufacturers' exchange rate demands by MAN, the preceding evidence highlights the influence of MAN on exchange rate decisions. At least prior to 2015, most groups also welcomed the central bank's response to some of their demands. The Associations of commodity exporters, for example, cited instances when they requested a reversal of an exchange rate policy regarding export proceeds, and the request was granted. The policy required exporters to sell their export proceeds to banks at the official rate. However, the commodity associations kicked against it and were subsequently allowed 'unfettered access' to their proceeds (Interview 3, Interview 5). This action was a clear result of interaction between policymakers and the private sector to reverse a policy following protests by affected groups.

The policy reversal occurred after the then Nigerian president, Olusegun Obasanjo, intervened in the issue following several complaints and outcries from commodity associations. The president met with the associations and the CBN governor, and after due consideration, it was decided to lift the restriction on export earnings. According to one interviewee, “The Obasanjo government gave instructions to the CBN to announce that exporters should have unfettered access to their funds, and that was done. Then, within four to five months, the inflow of foreign exchange was unprecedented” (Interview 5). This evidence not only illustrates an example of the CBN’s response to interest group agitation but also suggests the role of Nigeria’s president in the central bank’s decisions.

The involvement of the private sector in exchange rate policymaking largely occurs after the CBN has implemented a policy that is unlikely to be in line with the preferences of interest groups. However, it depends on who the CBN listens to. The interest groups in this study admitted to being invited by the CBN to a meeting with industry players (Interview 2). However, only a few people were allowed to speak (Interview 6). One interviewee even argued that those who speak are selected before the meeting: “Yes, of course he [CBN Governor Emiefele] will call you, but there are certain people he wants to speak. Because they already know those who will say things they do not want to hear, they will not even call them to speak” (Interview 5).

Some meetings or business summits with key players are intended to provide an opportunity for more informed policymaking through consultation with the business community. However, being present at the meeting does not necessarily mean one's voice is heard. For example, two commodity exporters complained that they were not allowed to speak or ask questions during a summit organized by the CBN in July 2022 on an export promotion initiative called RT-200 aimed at increasing foreign exchange inflows into Nigeria (Interview 6, Interview 3).

5.2.5 Interest Groups Statements of (Dis) Satisfaction with Policy Decisions

In addition to the last subsection, this final segment of the process tracing journey attempts to infer whether interest groups have succeeded in getting their preferred policy options implemented. This is inferred from their expressions of satisfaction or otherwise with policy decisions. In general, there are only expressions of dissatisfaction, especially from exporters and the BDCs.

5.2.5.1 Export Rebate Scheme: Incentive or Disincentive?

The CBN has engaged in 'non-traditional' central bank functions to stimulate economic activities, particularly in sectors that could generate foreign exchange through exports. As part of this objective, the CBN introduced the RT-200 scheme[27] in 2022 to encourage the repatriation of non-oil export proceeds. The goal of the initiative is to raise $200 billion in foreign exchange within five years through non-oil exports (see CBN circular, 2022).[28] The principal instrument of enticement for exporters is the export proceeds repatriation rebate for eligible beneficiaries.[29] The eligibility criteria stipulated that only exporters of semi-finished and finished goods and information technology/creative

[27] RT here is acronym for 'Race To'

[28] CBN RT-200 guideline https://www.cbn.gov.ng/Out/2022/CCD/Guideline%20on%20RT200%20Non-Export%20Proceeds%20Repatriation%20Rebate%20Scheme.Final.pdf

[29] The rebate amount to 65 naira for each dollar repatriated and sold to authorized dealer banks for use by other third parties at the I & E window. For exporter's own use the rebate is 35 naira, and only for eligible transactions.

business services are eligible for the incentive. This incentive is not welcomed by the stakeholders I interviewed. Commodity exporters expressed even greater dissatisfaction, not only with the amount of the rebate and the requirement to sell at the I & E exchange rate but also with the exclusion of their products from the transactions eligible for the incentive. The response of one respondent illustrates this sentiment:

> Does it make sense that CBN is giving rebate when you bring in certain amount of forex? And you will not even get it because some are categorized as exporting raw materials. So, it is only those exporting cement for example to Ghana or Cameroon that will get the 65-naira rebate, as if those exporting raw materials are not exporting anything (Interview 5).

Commodities such as cocoa beans, sesame seeds, and ginger were excluded from the eligible beneficiaries of the rebate scheme because the policy encourages not only exports but also value addition to locally produced agricultural and other natural resources. However, exporters argue that their products are also semi-processed before export. One of the interviewees questions the Central Bank's interpretation of what processing means, stressing that they carry out some processing activities before exporting the goods:

> ...you devise a policy that encourages local manufacturing or value addition, and you decide that certain categories of goods will benefit from the 65-naira rebate and not others. Moreover, you categorize sesame seed as a raw material, not processed. Now, you need to define what processing is. Do we take the goods from the farm, put it in the bag, and sell it? No! We buy cleaning machines [costing] millions of naira, and in some cases, we even use a sorter to remove the black seeds, and then we clean it, bag it, and export. Does that not qualify as processing? That is processing (Interview 3).

Another example of the semi-processing of export commodities was highlighted in relation to cocoa. The exporters argue that what the authorities classify as 'raw cocoa' goes through several processing stages, from harvesting to fermentation and cleaning before packaging. Therefore, according to the stakeholders, the cocoa does not necessarily have to be transformed into chocolate to be considered processed cocoa. This concern has been raised several times with the CBN to expand the scope of goods eligible for the incentive and to reclassify some of the products, but the CBN has yet to consider the request (Interview 3).

Some exporters are not keen about being included in the rebate scheme because they prefer to make profits rather than be incentivized (or subsidized) by the CBN with a rebate. One interviewee questioned the rationale of giving a rebate if a business venture is profitable:

> Why should I be given a subsidy if I am making a profit? Why do I need government money to subsidize my business? It means the business is not profitable, and if it is not profitable, I should change business and try something else (Interview 5).

Another exporter also expressed opposition to the rebate scheme, arguing that it is an indication that the official (I & E) exchange rate is not market reflective; otherwise, there would be no need to entice exporters with rebates to sell their proceeds in the I &E window:

> … they are giving a 65-naira rebate. To me, that rebate is an admission by the CBN that their rate does not reflect the true market situation, and they are just playing Nigerian politics. The official rate is an artificial

> value. Why are you giving me 65 naira if 423 naira [per US$] is the true value? (Interview 6).

Exporters' dissatisfaction with the rebate incentive stems from the large premium between the official and parallel market exchange rates. Export proceeds are required to be sold strictly at the official (I&E) rate, which averages 430 naira to US$1 until the last quarter of 2022. Meanwhile, the same US dollar is exchanged at about 700 naira on the parallel market. If the exporter buys the goods from a local supplier, the price will be based on the parallel rate, not the official rate. This means that an additional 65 naira to 430 is well below 700 and not enough to close the gap between the two exchange rates. The following transcripts illustrate the exporters' predicament:

> …goods are being priced using the parallel market, and that is why I give you the example of sesame seed. When you sell your sesame seed abroad and receive the proceeds, the CBN is adamant that you must sell it at 423 naira per dollar. How is that possible? You are losing 50 percent value... Meanwhile, when I was buying my goods, they were priced with the parallel market rate, and now you are forcing me to sell them at the official rate (Interview 6).

> Since you are not controlling the price that I buy the product at the market, why do you want to control the price I sell? (Interview 5).

> ...when the central bank says, sell your dollar at the I & E window at 400 naira, they give you an incentive of 65 naira. So, when you add 65 naira to that [I &E rate], it will barely [amount to] not more than 500 naira. Meanwhile, when you were buying the goods, it was priced at the black-market exchange rate of about 700 naira. When you analyze it, the incentive they are talking about does not exist (Interview 3).

The evidence presented above suggests that the export rebate may not be an adequate incentive to encourage export proceeds repatriation. It forces most exporters to seek alternative means of survival that mostly results in malpractice and violation of laws.

5.2.5.2 Coping with the Forex Challenges: Not-For-Profit Exports and Other Survival Strategies

One of the findings of this study is that not all exporters in Nigeria (and perhaps in other developing and emerging economies) are in business solely to make a profit. There are categories of firms that export commodities as the easiest way to either repatriate their earnings abroad or earn foreign exchange to pay for their imports. This tends to create unhealthy competition in the tradable commodities market, where profit-oriented exporters coexist with those not necessarily interested in making profits from the sale of commodities. The latter only want to meet their foreign exchange needs and, therefore, may buy the goods at a higher price than the former. It is pertinent to unpack this export complexity further, based on the narrative of one interviewee (Interview 3), to better understand the different categories of exporters and which category faces greater challenges.

As highlighted above, the category of exporters who need to raise foreign exchange to pay for the import of raw materials and spare parts for manufacturing because they could not access the official rate, resort to buying and exporting local commodities. They may not aim to profit from these exports but only to meet their foreign exchange needs. For example, if the total cost of exporting the goods is $1000, they are willing to sell the goods for $1000 or even less (Interview 3). The Manufacturers' Association corroborates this analysis in the following statement:

> … some manufacturers are looking inward by setting up companies that earn forex within the group. Some even have associated companies that export products, including agricultural products. [Others] export manufactured products. So, indirectly, as you know, they are earning forex... Furthermore, because of earning forex, if it is returned to their account as required by CBN it will be recorded in favor of that company, and when you need forex, you can access it (Interview 4).

The second related group to the one described above consists of importers, mainly foreign-owned companies registered in Nigeria. These companies bring in goods, sell them, and then try repatriating their earnings abroad to acquire more dollars for future imports. Unfortunately, they cannot obtain the necessary funds from the Central Bank. To obtain the necessary foreign exchange, they often resort to converting their money into goods that can be exported, even if this means losing up to 20 percent of the profit margin on such exports. Since they have already made a profit on their imports, they are willing to make this decision to get the foreign exchange they need (Interview 3).

Finally, there is a category of people in the export business who compete in the same market as the two categories mentioned above. Those whose goal is only to obtain foreign currency through exports could offer to buy the goods at a relatively higher price than the exporter who is seeking a profit margin based on domestic and international price differentials. "This is what people who are into exporting for business are facing in Nigeria" (Interview 3). This means that exporters must find an alternative strategy to stay in business, and the viable alternative for them is to violate the laws.

***"Your survival come first before loyalty to your country":* Exporters' alternatives.**

The major complaint of exporters is the requirement to surrender export proceeds at the official exchange rate, which is considerably lower than the parallel rate. This tends to force the exporters to circumvent the law by false declaration of export value and smuggling of exports through neighboring countries. According to one interviewee:

> You see, these are policies that force Nigerians to break the law. Because for me if I source my goods using 750 naira and you are forcing me to sell at 423 naira, I will find my way to cheat because I will not declare the true value of the goods. That is the truth! ... It is either I keep my money and stop doing business, or I find a way to survive... people under-declare the value of exports (Interview 6).

The consequence of exports not being appropriately recorded through official channels is that the forex inflow will be diverted to other countries and coming to Nigeria illegally. Moreover, the government also loses revenue that would have otherwise been generated from trade. The exporters argue that the CBN policies on export proceeds are to blame for the malpractices and declining forex inflow through trade:

> …it is encouraging people to do things outside the system. Most of the traffic you see in West African ports is because of Nigeria's goods, both imports and exports. Some exporters would rather smuggle their goods out of Nigeria and export to other countries through the ports of our neighboring countries (Interview 6).

Another exporter suggests that people are finding alternative ways to survive in other African countries because they are forced by overregulation that placed restrictions on how much they could sell their products or proceeds:

> If you are looking for forex, allow exporters to bring in their money and sell it at their preferred rate. Most of the forex that is supposed to come into this country goes to other African countries. Most of the exporters

> are finding ways to survive. Because your survival comes first before loyalty to your country. They thought they had a monopoly of power, not realizing that people would find ways to survive (Interview 5).

"Settlement behind closed doors"

The rebate scheme intends to diversify Nigeria's sources of foreign exchange through the export of goods and services, thereby minimizing the exposure to volatile foreign exchange inflows, mainly from oil exports. Unfortunately, the initiative has deepened the distortions in the foreign exchange market by creating another window for exchange rate subsidy and opportunity for further malpractices. The World Bank highlighted this issue, noting that in the face of a widening parallel to I & E rate premium and persistent foreign exchange shortages, the rebate scheme created an incentive for exporters to settle transactions with third parties at the parallel rate rather than through the I & E window (World Bank, 2022). There is anecdotal evidence that the parallel rate has become the prevailing rate in the willing-buyer-willing-seller market, but transactions are still documented at the I & E rate for accounting purposes (p. 12). This evidence is empirically corroborated and supported by the following statement from an informant who requested maximum anonymity:

> ...the reason I say this is because we all know that this is Nigeria, we do not have to fool ourselves. Let us say, for example, you tell me to sell the dollar at 410 naira, and then you give me a 65-naira rebate.... but of course, that is not the case; people will trade it at the I&E market. For example, you want to buy $20,000 from me. On the I&E market, it is recorded as 410, but then we can settle behind closed doors for the difference. So, you know you will pay me the difference outside the I & E window... The bank can arrange it or you can do it yourself. Officially,

> it will be recorded as 410, but we will arrange for you to pay me the difference between 410 and 700 [naira]. If you do not, no one will sell you the dollar at 410. So, the incentive has encouraged more people to go into the export business, not because they are selling [the proceeds] at the official rate of 410. They are still selling it at the black-market rate. The 65 naira is like extra profit for them. They benefited from both sides – the rebate and the difference between the exchange rates (Anonymous).

The central bank has been celebrating that the inflow of forex has increased since the beginning of the RT-200 initiative. One might think that the CBN may not be aware that these malpractices are taking place. Nevertheless, the informant argues that the authorities know what is going on:

> They [CBN] know what is happening, just that officially, you cannot talk about it. Everybody knows it. You cannot come out and say it, but we know what it is (Anonymous).

5.2.5.3 Economic Patriotism for Banks and Inhibitive Policies: BDCs Complaints

Some of the malpractices in foreign exchange transactions, in addition to those involving export proceeds, are carried out with the connivance of commercial banks. Commercial banks are the transmission channel of CBN policies, including those related to foreign exchange. Banks have been accused of unethical or fraudulent practices in the allocation of foreign exchange to qualified individuals and companies. The criteria for the allocation of foreign exchange are not always transparent, and there are allegations of bribery in the banks before eligible beneficiaries could obtain the official exchange rate. According to one informant:

> There is one forex window called small-scale window where you [can] access dollars for small-scale industries. I am telling you most of the beneficiaries said before you can get $20,000 you must be prepared to give up to 500,000 naira or even 1,000,000 naira. Even the personal travel allowance that [the CBN] said the banks should be giving to people, before you [could] get the $4,000, you [must] give probably 300,000 naira (Anonymous).

Dissatisfaction with the banks' handling of forex allocation also comes from their closest competitors, the Bureau De Change (BDC) operators. This is perhaps due to the seemingly faltering relationship between the CBN and the BDCs, especially in the wake of the suspension of weekly forex allocation to the latter in 2021 (see Chapter Four). The BDCs accused the CBN governor, Godwin Emiefele, of pursuing "economic patriotism" in favor of the banks because he was the managing director of a commercial bank before his appointment as central bank governor. This frustration is conveyed in the following interview transcript:

> Since the Central Bank Governor announced the suspension of foreign exchange sales to BDCs, we have written several letters of courtesy visit and proposals. For more than a year, we have not received any response.... Honestly, there is self-interest, [and] no sincerity of leadership. The man comes from the banking industry and the banking industry in Nigeria is lazy. They all depend on the economic patronage of the Central Bank. They take the money in their vaults to buy dollars from the central bank to come and hoard and start creating scarcity in the market (Interview 7).

In addition to 'favoritism,' the BDCs also lamented that despite transferring the responsibility of forex allocation solely to banks, the black-market premium (margin between official and parallel exchange rate) continues to widen:

> What we see now is favoritism. When you are running a state managed economic policy, there will be an economic patriotism…look at since the withdrawal of the sale of forex to BDCs, it is now sold to the banks so that the exchange rate will come down, but what do we have today? A margin of more than 260 naira! (Interview 7)

Since the BDCs no longer benefit directly from the CBN's allocation of foreign exchange, they tend to emphasize the advocacy of a market-driven exchange rate that promotes competition and eliminates the tendency to create winners and losers. The real beneficiaries of the multiple exchange rate are somewhat obscured, as manufacturers groan and parents also complain about the difficulty in accessing forex to send to their children studying abroad. It is argued that a market-driven exchange rate will introduce competition into the system by breaking the monopoly of the banks as the only source of subsidized foreign exchange (interview 7).

BDCs also complain about inhibiting policies that hamper their operations (interview 7). First, BDCs cannot receive electronic transfers from other countries because foreign exchange transactions in Nigeria are predominantly cash-based. Second, the licensing fee was prohibitive before the CBN suspended the issuance of new licenses. The fee was raised from 10 million to 35 million naira by Governor Emiefele as a measure to reduce the already large and growing number of BDCs. This has helped to reduce the number of licensed BDCs from 2,400 to 1,400. Unfortunately, the same governor who argued that there were too many BDCs and succeeded in reducing the number to about 1,400, later licensed an additional 3,000. Third, there are complex documentation requirements for small transactions, such as selling foreign currency for personal travel expenses. This tends to give the unlicensed BDCs a competitive advantage, as they do not require any documentation to conduct foreign exchange transactions. The fourth inhibiting policy is that the CBN has made membership of the Association of Bureau de Change Operators of Nigeria (ABCON) voluntary. According to the interviewee, Governor Emiefele did this to deliberately shield some powerful individuals from regulation, control, and discipline by ABCON:

> …when he [Governor Emiefele] came, our self-regulatory status was removed, and it was made voluntary so that we would not have the power to control these big guys in the presidency or the National Assembly and the state governors. There was a committee chairman in the National Assembly, when we started automating our processes, we charged our members only 100,000 naira because automation is expensive. This man had over ten (10) BDCs and he reported us to the Director of Trade and Exchange at the CBN that ABCON has come up with this payment for automation and he is not ready to pay. I swear to God Almighty. And that is why they are not making it compulsory to join the system (Interview 7).

5.2.5.4 All Fingers Pointing to The Governor of CBN

All the interest groups that participated in this study have directly or indirectly expressed dissatisfaction with the leadership of Governor Emiefele and the exchange rate policies implemented under his leadership. Although individuals and groups will naturally want their preferred policies to be implemented, the central bank has faced considerable difficulties in managing the exchange rate due to dwindling foreign exchange inflows resulting from external shocks. While this may justify some of the management strategies adopted by the CBN, it should not be an excuse for pursuing a system that creates opportunities for rent-seeking and corruption.

The dissatisfaction of various interest groups with Mr. Emiefele's leadership of the CBN and his policies includes prioritizing the banking industry, where he comes from (Interview 5, Interview 7), and direct involvement in partisan politics (Interview 1, Interview 2). While it is difficult to concede or completely dismiss the notion that the governor's priority for banks is mainly due to his affiliation with the industry, his foray into politics is an open secret. The CBN Governor's involvement in politics is prima facie evidence that political considerations will strongly influence what he does as the head of the apex bank. Some of the reactions of the respondents to the CBN Governor's presidential ambition are captured in the following transcripts:

> The CBN governor tried to campaign for president. How? Where does that happen in any country? It does not happen anywhere. CBN should be apolitical (Interview 1).
>
> ... in which country would you see a central bank governor even giving the impression of contesting for a political office. Even the rumor of that should have been vehemently dispelled (Interview 2).

5.3 Interest Groups and Exchange Rate Policy in Indonesia

As I have done for the case of Nigeria, tracing the influences of interest groups begins with identifying groups' preferences based on how they are affected by the exchange rate in general and what level of the exchange rate is their preferred option. This is followed by identifying the interaction of the groups with policymakers to determine their influence.

5.3.1 Group's Policy Preferences

In theory, the export sector should prefer a depreciated currency to support its international competitiveness, at least if its operations require little or no foreign currency-denominated inputs. Like commodity exporters in Nigeria, palm oil exporters in Indonesia do not seem to benefit from a weak currency. However, farmers do, to some extent. A weak rupiah should benefit the Indonesian palm oil industry because local content in the production process is almost 100 percent, except for fertilizer (interview 11). However, farmers seem to benefit more than exporters, and the latter prefer a stable rupiah to a depreciating one. This view is expressed by a key official of the Indonesian Palm Oil Association in the following statement:

> …what we want to see [as] exporters or the industry is more like a stable exchange rate not necessarily a weak one. But sometimes, the farmers would like to see the exchange rate weak because it is better for them. I still remember for example, in 1998-1999 when the value of the rupiah depreciated significantly, the farmers said that it is better to have even much weaker rupiah (Interview 11).

One of the reasons why exporters prefer stability to depreciation is that they are exposed to higher dollar-denominated debt liabilities if the currency becomes volatile and depreciates. Many of the exporters borrow from foreign financial institutions, and a weak local currency means that the loan repayment amount will increase. Another reason is related to the adjustment of domestic prices of fresh palm fruit bunches (FFB) according to changes in the price of crude palm oil (CPO) in the international market (interview 8). When there is an increase in the international price of CPO, it is passed on to the price of FFB, of which smallholders produce about 40 percent. The remainder comes from state-owned enterprises and private companies. The downside for exporters is that a depreciating rupiah erodes the profit to be made from price margins. What exporters are most likely to demand from Bank Indonesia is at least a stable rupiah, if not an overvalued one. Whether they succeed will depend on their interaction with BI and their ability to influence exchange rate policy.

5.3.2 Access to Decision Makers

Bank Indonesia's autonomy makes it less likely that stakeholders inside and outside the government can directly influence its policy decisions. However, the bank regularly consults with relevant government agencies and the private sector. For example, BI invites the Indonesian Palm Oil Association every three months to discuss the development of the palm oil sector. The meeting provides an opportunity for industry players to inform BI about developments in the industry, but it is not certain that this influences the central bank's policy choices. (Interview 8).

5.3.3 Attempt to Influence Policies

Interest groups' attempt to influence Bank Indonesia's policies is mostly through media advocacy. When the groups have demands or want to express dissatisfaction with a central bank policy, they often do not communicate formally, but rather resort to media advocacy. Evidence of this is provided in the following interview transcript:

> When we have something to say about central bank policy, we do not do it in a formal, official way. We do it, for example through the media, through the statements we make... [Currently] I think the central bank would like to implement the policy that export earnings must stay in the Indonesian financial system for more than six months. Right now, the regulation is that export earnings must be placed in domestic financial institution, but there is no restriction in terms of [when to repatriate]. For example, export earnings in Indonesia can be repatriated [the] following day... The exporters do not agree. But we do not officially respond to the central bank. [However] we make statements in the media that this is not good. (Interview 8).

If implemented, this will be like what exporters face in Nigeria, where export earnings are subject to some kind of restriction. However, it is different from the Nigerian situation because Indonesia has a single market-determined exchange rate. Indonesian exporters are only required to deposit their proceeds for a certain period before repatriating them overseas. The reason why exporters do not agree with this policy is that it violates the free movement of capital in and out of Indonesia. Second, the return on saving dollars in Indonesia is lower than in other neighboring countries such as Singapore (Interview 8).

My interviewee in Indonesia suggests that there is little room for interest groups to influence the policy direction of the central bank because of BI's independence. However, this refers to direct influence through lobbying, for example. Alternative channels of influence, such as media campaigns and policy advocacy, cannot be completely ruled out. However, during this study, I could not find any evidence that the BI's policies reflect the demands of interest groups.

5.4 International Policing of Exchange Rate Policies

Adherence to regional and international agreements can tie the hands of national governments to adopt certain policies or change existing ones. In the arena of the international monetary system, the International Monetary Fund (IMF) plays the role of an 'international financial police/firefighter' or sometimes a 'financial therapist'. The World Bank is a closely related institution that does not have an explicit mandate to maintain stability in the international monetary system. However, it could indirectly force national governments to pursue structural and monetary reforms consistent with the IMF's mandate. The two institutions are collectively referred to as the Bretton Woods institutions. Nigeria and Indonesia have had a long relationship with these institutions since the 1960s. Both countries underwent IMF financial therapy when the health of their economies deteriorated in the 1980s and 1990s.

Nigeria has been a member of the two Bretton Woods institutions since 1961. After the Structural Adjustment Program (SAP) of the 1980s, the attitude of Nigerian policymakers, academics, interest groups, and the public toward the institutions has been somewhat antagonistic and suspicious. Regardless of the merits of policy advice and technical assistance programs, any presence or action by the Bretton Woods institutions in Nigeria is seen as having ulterior motives. This sentiment is understandable given the unpleasant memories of the SAP among Nigerians. There is a general belief that the economic reforms prescribed by the Bretton Woods institutions in the late 1980s were the root cause of the deterioration in the living conditions of Nigerians. A major component of the reform was the liberalization of the exchange rate, which led to the devaluation of the naira against foreign currencies.

The International Financial Institutions – IMF and World Bank (hereafter, IFIs) are the main sources of potential international influence on the exchange rate policies of both Nigeria and Indonesia. The IFIs try to influence the direction of economic policies in their member countries through various channels (See, Stichelmans 2016). Since we are dealing with the issue of exchange rate, the discussion will largely focus on the IMF, which has the mandate to ensure the stability of the international monetary system.

The IMF has at least three channels through which it can advise and persuade policymakers or seek to influence economic policy decisions directly. The first channel is technical assistance, which aims to promote human and institutional capacity building. Second, the IMF conducts annual surveillance to assess countries' economic policies and make recommendations. This is done under the auspices of Article IV of the IMF's Articles of Agreement, which mandates the Fund to consult with member countries on economic conditions and policies. The annual exercise allows the Fund to identify the strengths and weaknesses of policies and to advise countries on desirable policy options. A detailed consultation report, which includes the views of member countries' local authorities and the IMF's recommendations, is prepared by the IMF's staff. The third channel of IMF influence on countries is financial assistance. These are primarily the Fund's lending programs through which it influences policy reforms in recipient countries. It is also the function of the IMF that has arguably generated controversies and criticisms for bringing little benefits to developing countries, if not detrimental outcomes due to the conditionalities attached.

Nigeria has been both a victim and a beneficiary of the IMF's technical assistance/policy advice and credit facility. Like other developing countries, the IMF's structural adjustment program of the 1980s has yielded few benefits and appears to have exacerbated some of Nigeria's challenges. However, the country has benefited from the Fund's lending facilities and technical assistance, culminating in institutional reforms and capacity building (see, CBN 2021).

The World Bank also uses loan conditionality and research to influence the economic policies of its member countries. The bank's development loans are offered to countries with accompanying conditions that require prior actions to be taken before approval. The bank also seeks to justify its lending conditions and related policy advice through its research activities in development economics and related fields.

Having highlighted the persuasive and coercive channels through which the IFIs are expected to influence the economic policy direction of countries, we now attempt to trace the evidence for the existence of these influences on the exchange rate policies of Nigeria and Indonesia. The main sources of this evidence are the IMF's Article IV consultation reports on the two countries, specifically those between 2001 and 2022. These reports highlight the policies recommended to the countries, as well as the authorities' views and responses to the recommendations. I have tried to extract from the reports only the exchange rate policy recommendations and whether the central banks implement the preferred policy options of the IMF.

5.4.1 IMF to Nigeria: Allow Exchange Rate Flexibility in a Unified System

The IMF's mandate to safeguard international monetary relations suggests a strong interest in exchange rate-related issues. The Fund has advised Nigerian policymakers to dismantle multiple exchange rate practices and adopt a more market-based approach to foreign exchange transactions. This and other related recommendations have appeared in virtually every IMF report (especially Article IV consultations) on Nigeria between 2001 and 2022. In some instances, the CBN may have complied with these recommendations, as reflected in certain reforms in the foreign exchange market. In other cases, the CBN remained reluctant to implement the policy recommendations or chose to make gradual efforts in that direction. The recommendation to adopt a fully market-determined exchange rate has been the IMF's most consistent policy advice to Nigeria. This recommendation has persisted despite various policy changes and intermittent reversals by the CBN.

When the CBN introduced the Interbank Foreign Exchange Market (IFEM) in 1999 (see Section 4.3.1), the IMF noted that interbank transfers of foreign exchange purchased from the CBN were prohibited twice within two years in early 2000 and 2001 (IMF 2001, 22). According to the IMF staff, "this action, together with administrative measures restricting access to the IFEM, led to the segmentation of the interbank market with two different exchange rates ... and recommended that: (a) merge the IFEM and the open interbank market, thereby eliminating the practice of multiple currencies; (b) reduce the spread between the IFEM and the parallel market." The implementation of these recommendations requires the removal of the restriction on the transferability of foreign exchange obtained from official sources between banks. It also implies the narrowing of the gap between the official and parallel exchange rates, which ultimately leads to the devaluation of the currency.

In the policy change that followed the IFEM, where the CBN reintroduced the DAS (see Section 4.3.1), the IMF commended the move as effective in stemming the decline in international reserves and maintaining market stability. The adoption of the DAS was preceded by mini-devaluations of the naira, which resulted from the high demand for foreign exchange generated by the expansionary fiscal policy and the deterioration of the external balance (IMF 2003, 13). While the devaluation of the naira during this period was in line with the IMF's preference, as it helped to narrow the gap between the official and parallel exchange rates, the Fund noted that further reforms were needed to achieve a unified foreign exchange market:

> Additional reforms are warranted to unify the foreign exchange market, as the market remains segmented and administrative procedures and documentation highly burdensome. The aim should be to allow the interbank foreign exchange market to play the role of allocating foreign exchange in the system on a continuous-time basis (IMF 2003, 13).

Despite the need for further reforms, both the CBN and the IMF have acknowledged the improvement in the foreign exchange market following the introduction of the DAS. As discussed in Section 4.3.1, the DAS, which was conducted on a retail basis, that is, RDAS, was transformed into the Wholesale Dutch Auction System (WDAS). This policy change may represent one of the Fund's influences on policy decisions, as evidenced by the following statement in the 2002 IMF Article IV Consultation Staff Report:

> The [Nigerian authorities] agreed with the staff that once sufficient experience had been gained, the CBN should consider moving to the next stage and fostering the development of a wholesale auction, which greatly enhances the effectiveness of the interbank market for foreign exchange (IMF 2003, 28).

The WDAS was suspended and replaced by the RDAS in 2013, before the latter was finally abolished in 2015 (Section 4.3.1). Evidence in the 2016 Article IV Consultation Report suggests that this action was also motivated by the IMF recommendation. The IMF recommended in 2014 that the CBN should introduce greater exchange rate flexibility and unify exchange rates by eliminating the gap between the RDAS and the IFEM, rather than through administrative measures. In the 2016 report, the status of implementation of the 2014 recommendations shows that the CBN has partially responded by closing the RDAS window:

> The RDAS window was closed in February 2015, and exchange rate for the central bank intervention devalued by 17 percent. However, since that time the interbank rate has effectively been fixed (IMF 2016, 43).

Although the closure of the RDAS window and its replacement by the IFEM helped to address some challenges, the IMF noted that the gap between the IFEM and BDC rates widened due to foreign exchange (forex) shortages and administrative measures introduced by the CBN. Concerning the administrative measures, the CBN argues that the forex controls provided an opportunity to deal with dwindling reserves due to falling oil prices (IMF 2016, 16). The administrative controls in question are those associated with foreign exchange restrictions on some categories of imports and the continued multiple currency regime (see Section 4.6). IMF staff have explicitly stated that they do not support the multiple exchange rate and exchange restrictions and will not recommend their approval in the absence of a clear timetable for policy change.

In 2016, the CBN announced a de jure flexible exchange rate system which aims to operate as a market-based system where the CBN intervenes periodically as the need arises. According to the IMF:

> With the CBN announcing the reintroduction of a flexible exchange market in Nigeria... and the new policy actions in the foreign exchange market announced in February 2017, the MCP [multiple currency practices] and one of the exchange restrictions identified during the 2016 Article IV consultation have been removed. However, the market remains tightly regulated, and transactions occur at a multiplicity of exchange rates[30] (IMF 2017, 3).

Multiple exchange rates and restrictions have persisted despite consistent pressure from the IMF to remove them. However, the IMF also acknowledges the CBN's commitment to promoting exchange rate unification and its intention to remove foreign

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[30] The multiple rates comprise:
(a) Official exchange rate = 305/US$
(b) Interbank market = 315/US$
(c) International money transfer companies = 375/US$
(d) Parallel market = 400-500/US$

exchange restrictions as economic conditions improve. The IMF recognizes that the new foreign exchange measures, including the introduction of the I & E window and the CBN's sustained intervention in the foreign exchange market, have helped to minimize the parallel market premium (IMF 2018, 47). The CBN seems to favor a gradual convergence of the multiple exchange rates, while the IMF continues to stress the urgency to pursue a unified exchange rate system. However, in the 2018–2021 Article IV consultation reports, the IMF staff commended the ongoing convergence of exchange rate windows. Still, it highlighted the need for greater exchange rate flexibility at a unified rate.

By 2021, the phrasing of IMF's recommendation has shifted to a "multi-step approach to exchange rate unification and flexibility" from "moving towards a unified exchange rate as soon as possible." This indicates that progress is being made in the policy transition, which the IMF noted and offers a stepwise approach in that direction. The multi-step recommendation involves immediate, near-term, and medium-term steps (IMF 2021, 18). The immediate step is to allow 'greater adjustment' (devaluation)[31], eliminate parallel market premiums, and decrease the participation of CBN in the I&E exchange rate market. However, the CBN differed with the IMF on the need for additional exchange rate adjustment, emphasizing that "allowing further depreciation would add to rising inflation" (19). By the judgement of the IMF as admitted in the 2021 report:

> The CBN made considerable adjustments since 2020Q1 to foster greater exchange rate unification and flexibility in line with the market fundamentals. Accordingly, the official rate was adjusted by 19 percent in March and 5 percent

[31] The repeated use of 'greater flexibility/adjustment' in IMF's recommendations suggests that there have already been adjustments, but more is needed.

> in July, facilitating the unification of rates in the investors and exporters (I&E) window, Bureau de Change (BDC), and retail and wholesale windows … Going forward, the CBN commits to allowing the I&E rate to adjust in tandem with the interbank rate. The authorities will also continue liberalizing the foreign exchange market to eliminate exchange rate misalignments. They are determined to confine interventions to smooth disorderly FX market conditions. They view other complementary measures as warranted to reinforce exchange rate adjustments and mitigate excessive depreciation, adverse inflation, and welfare consequences (IMF 2021, 90).

With the various measures enumerated by the IMF in the above statement, the CBN has achieved great feat in pursuing exchange rate unification and flexibility. Other reforms in the foreign exchange market have been carried out in line with the economic conditions and some of the recommendations of the IMF. One of the notable achievements, which the IMF said was in line with its advice, is the abolition of the official exchange rate and the adoption of the NAFEX rate:

> The discontinuation of the official exchange rate in May 2021 goes in the direction of the staff's previous recommendations, although it does not yet fully unify exchange rates. To this end, the institutional removal of multiple FX windows at the CBN and allowing all FX transactions to occur in the I&E market are important (IMF 2022, 16).

The I&E rate is heavily managed by the CBN, which means that the full exchange rate unification desired by the IMF has yet to be realized. The CBN considers the exchange rate to be unified, with the I&E rate serving as the reference rate in the economy. The CBN has argued that its foreign exchange management policy is a deliberate attempt to curb excessive demand for frivolous imports to protect local industries.

5.4.2 IMF's Diminishing Influence in Indonesia after the Asian Financial Crisis

The prominent engagement that has shaped the current relationship between the IMF and Indonesia is the Fund's program in the aftermath of the Asian financial crisis (AFC). There is already a lot of literature on Indonesia's financial turmoil during the crises and its subsequent economic and political reforms, including the IMF's role as a 'financial crisis firefighter.' I do not intend to repeat the story here. The focus of this section is to trace, as I did in the case of Nigeria, the evidence of the IMF's continued influence on Bank Indonesia's exchange rate policy choices after the AFC. I do so with the aim of assessing whether IMF recommendations largely drive Bank Indonesia's exchange rate policy.

Indonesia has had a cordial relationship with the IMF since the early days of Suharto's New Order in the mid-1960s. This relationship was fostered by Suharto's economic team, which became very influential in economic policymaking. The technocrats, however, maintained their independence in policymaking while dealing with the Bretton Woods institutions, sometimes ignoring the IMF's advice in the 1980s (Martinez-Diaz 2006). The IMF's renewed and deeper engagement with Indonesia occurred during the AFC in the late 1990s. What began as an exchange rate shock in 1997 soon became a banking crisis and a full-blown financial crisis that engulfed Southeast Asian economies, with Indonesia being the hardest hit. As a last resort for Indonesia to get out of the crisis, the IMF stepped in to help, of course, with the usual requirements to implement structural and institutional reforms.

The need to rebuild the economy and restore market confidence provided the impetus for improving monetary and exchange rate policy, among other reforms. Before the AFC, the exchange rate regime was heavily managed by Bank Indonesia (BI), perhaps because the BI reported to the central government's Monetary Board, which includes the BI governor, the finance minister, and other cabinet members. This exchange rate regime is believed to have contributed to the depth of the financial crisis (Basri 2018). Growing pressure on international reserves due to large capital outflows necessitated the floating of the exchange rate in August 1997. This led to a sharp depreciation of the rupiah and a consequent rise in inflation. In 1998, BI introduced a soft inflation targeting regime with a monetary target as part of measures to address this challenge and in accordance with the financial agreement with the IMF (Basri 2018, 34). BI was also granted independence in 1999 to pursue its objectives, which strengthened the central bank's credibility, boosted confidence in the economy, and contributed to price and exchange rate stability.

Since the AFC, Indonesia has continued to maintain an exchange rate regime that is free of restrictions in accordance with IMF Article VIII. Accordingly, the practice of multiple currencies in the form of foreign exchange subsidies for food imports was abolished in December 1998 (IMF 2003a). With the transition to a fully market-determined exchange rate system, the IMF's policy advice also shifted. Subsequent advice emphasized preserving the system and limiting intervention in the foreign exchange market to contain excessive currency volatility. The IMF supported this approach but encouraged BI to be prepared to intervene in response to both depreciation and appreciation while taking advantage of the latter to accumulate foreign reserves (IMF 2004). In 2006, the IMF advised BI to consider this symmetrical but limited intervention, and the 2007 Article IV Consultation Report indicated that BI had responded somewhat to the Fund's advice:

> BI's interventions in the foreign exchange market have been limited over the past year... Direct intervention has focused on limiting short-run volatility, although

> with pressure generally in one direction, the intervention has also been somewhat asymmetric (IMF 2007, 32).

The direction of pressure referred to in the above statement is that of depreciation of the rupiah. In other words, the intervention is aimed at stopping the depreciation of the currency. One of the measures taken by BI to limit the pressure on the rupiah – which was welcomed by the IMF – is the "recycling of official foreign exchange receipts to provide liquidity to the foreign exchange market (IMF 2008, 14)". This is simply selling foreign exchange receipts from oil sales to prevent currency depreciation. This has also been the dominant approach of the Central Bank of Nigeria (see Chapter 4). The difference is who the foreign exchange is sold to. In Indonesia, it is sold to the forex market through the banks for resale to all customers. In Nigeria, however, it is sold to the forex market at a fixed rate to designated individuals, companies, and official transactions.[32] It is noteworthy that BI, too, used to channel a significant proportion of its forex intervention to state-owned enterprises (SOEs).[33] This was highlighted by IMF staff in the 2013 Article IV consultation:

> Some FX sales by BI also appeared to be directed toward fulfilling the large and lumpy FX needs of state-owned enterprises, including Pertamina (oil and gas) and *Perusahann Listrik Negara* (electricity), rather than spreading intervention more broadly throughout the interbank market (IMF 2013, 14).

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[32] This is where beneficiaries are selected, setting in motion the complex interplay of forces striving to gain preferential access to the favorable official rate.

[33] The difference with Nigeria in this regard is that there is no fixed exchange rate coexisting with a parallel rate which give rise to large black-market premium.

The IMF, thus, recommended that BI should continue to reduce the forex sales to SOEs and, instead, encourage them to meet their forex needs at the interbank market. Additionally, the Fund advise the Indonesian authorities to proceed with the plan to improve the financial risk management of the SOEs, including that aimed at mitigating the effects of exchange rate volatility through hedging (IMF 2013, 14).[34] The IMF stated in the 2014 report that BI acted in response to this recommendation:

> Foreign exchange sales have been scaled back to SOEs. New regulations were introduced by BI in September 2014 to encourage prudent hedging by SOEs of their FX exposures, followed by regulations effective 2015 on corporate private external borrowing (IMF 2015, 53).

It is imprecise whether BI introduced the new regulation on hedging mainly to implement the IMF recommendation. Since BI is already planning to strengthen the risk management practices of SOEs, as mentioned above, the new regulation may have coincided with, rather than been a response to, the IMF's advice. The evidence of IMF influence here is weak at best. The Fund's exchange rate policy recommendations for Indonesia generally appear to have diminished from 2014 onwards. What continues to appear in Article IV consultation reports on exchange rate policy between 2015 and 2022 is largely an admonition to BI to remain committed to exchange rate flexibility. This implies allowing the exchange rate to move freely in response to market forces, with foreign exchange intervention limited to preventing disorderly market conditions.

[34] Hedging with forex is a strategy used to protect one's position in a currency pair from an adverse move (investopedia.com).

From the foregoing analysis, the differences in exchange rate policy between Nigeria and Indonesia (dirigiste versus market-based systems) defines the IMF's recommendation. It can be argued that the AFC forced Indonesia to adopt a market-based exchange rate regime. Moreover, the fear of repeating a similar traumatic experience may have provided the incentive for the Indonesians to maintain the system, along with greater independence for the BI. The evidence presented above illustrates the gradual improvement of Indonesia's exchange rate policy after the AFC. There seems to be little or no room for IMF advice on policy options, given that the system is generally appropriate.

A pertinent question is: Would Indonesia have adopted a market-based exchange rate system if it had not experienced a major crisis and sought IMF assistance? The IMF program during the AFC arguably provided an opportunity for Indonesian technocrats to implement necessary reforms that were resisted by powerful groups (Martinez-Diaz, 2006). The Fund "saw the program as an opportunity to help the reformist team push through desirable reforms, and the team saw the program as providing leverage to do so" (IMF 2003a, 72). It is noteworthy that at the height of the mounting pressure on the rupiah, the currency was floated before the IMF program was negotiated. Thus, the floating of the currency was not forced by the IMF per se, but the maintenance of the system was. In addition, the IMF program required enacting laws for central bank independence and took a coercive stance against amendments that would jeopardize the central bank law (Martinez-Diaz, 2006). The IMF's coercive instrument created the enabling environment for successfully implementing the nascent floating exchange rate regime introduced at the beginning of the AFC.

5.5 Exchange Rate Management and Political Pressures: Central Bankers' Perspectives

Central bankers' beliefs about the economy determine their policy preferences and how they respond to the preferences of other stakeholders. Central bankers do not necessarily have uniform views about the economy and how and when to use policy instruments. Differences in their perceptions of optimal policy, both within and across central banks, can be explained by academic background and other characteristics. However, there is a tendency for views to converge on specific issues and policy options.

The most common belief among central bankers is the importance of their independence and insulation from political influence in policymaking. The importance of independence stems from contrasting policy preferences between the central bank and politicians (Goodman 1991). For example, politicians may be relatively less concerned than central bankers about the inflationary risk of a policy action, especially in the desperate attempt to win public support during election cycles. These differences in risk aversion can lead to conflicts between central banks and politicians over adopting exchange rate policies that prioritize price and currency stability. The resolution of this type of conflict depends in part on the degree to which the central bank is responsive to the demands of politicians and domestic interest groups (Goodman 1991). A more independent central bank with autonomous technocrats can invoke their discretionary powers to implement policies that differ from those preferred by stakeholders. This decision-making process is conducted behind closed doors, and even when policy pronouncements are made through speeches or policy documents, it is difficult to decipher what factors played a role in influencing the decisions.

The focus of this section is to analyze central bankers' views on whether they are influenced by domestic and international political pressures and what they believe is the best strategy for managing the exchange rate. I surveyed central bankers in Nigeria and Indonesia to elicit their beliefs about exchange rate management and perceptions of political influence on their operations, particularly in exchange rate policymaking.

One approach to tracking these beliefs is to code and analyze central bankers' public statements and actions. However, I followed the strategy used by Schulz (2017), which emphasizes the use of a standardized questionnaire to ask central bankers directly. I kept the questions as short as possible and phrased them in a way that was not too sensitive to elicit a low response. Blinder et al. (2017, 3) argues that central bankers "are a tight-lipped group who know how to keep secrets, and one cannot ask them sensitive questions, no matter what guarantees of confidentiality are given." Therefore, I limit the questions to those that the central bankers are comfortable answering.

5.5.1 Characteristics of Nigerian Central Bankers

Central bankers are arguably among the most difficult populations to survey. They seem to have strict information disclosure rules and may be reluctant to respond to surveys or to participate in research in general. Through personal contacts, I collected responses from fifty-two (52) respondents who work at the headquarters of the Central Bank of Nigeria (CBN). Table 5.1 shows the demographics of the respondents. The number of males is 35, representing 67.3 percent of the total respondents. The number of female respondents is 17(32.7 percent), which can be considered significant given the dominance of men in most public institutions.

Table 5.1 Demographic information of respondents

Nigeria		%
Gender	Male	67.3
	Female	32.7
Highest academic qualification	PhD	7.7
	Masters	69.2
	Bachelors	21.2
	Other	1.9
Academic discipline	Economics	26.9
	Business & Accounting	32.7
	Other social sciences	15.4
	Others	25
Years of working experience at the Central bank	Less than 10 years	36.5
	10-20 years	59.6
	More than 20 years	3.8
Indonesia		
Gender	Male	100
	Female	0
Highest academic qualification	PhD	60
	Masters	40
Academic discipline	Economics	60
	Business & Accounting	20
	Financial Mathematics	20
Years of working experience at the Central bank	Less than 10 years	25
	10-20 years	25
	More than 20 years	50

Source: Author

The CBN has a pool of academically qualified staff based on the sample of this study. Almost 70 percent of the respondents have a Master's degree, 7.7 percent have a

Ph.D., and about 23.1 percent have a Bachelor's degree and other qualifications. These qualifications were obtained in various fields, but the majority are in business administration and accounting, economics, and other social sciences, as shown in Table 5.1.

The educational composition of the central bankers in terms of educational attainment and fields of study suggests that policymaking competence is not necessarily lacking in the CBN. In addition to education, about 60 percent of the respondents have over a decade of working experience at the central bank. Academic discipline and work experience could have important implications for the work of central bankers in terms of their policy preferences for exchange rate management and response to political pressures.

5.5.2 Views on Exchange Rate Management

This section of the survey seeks to determine whether the CBN's official position on exchange rate management reflects the general views of the staff. If most of the staff express opinions that are contrary to the institutional view of the central bank, we can infer that policy decisions are likely to follow a top-bottom approach. It will also imply the possible influence of other stakeholders on the top management of the central bank.

Table 5.2 Nigerian Central Bankers' views on exchange rate management:

Questions	N	Mode	Agree %	Neutral %	Disagree %
The CBN has autonomy to formulate and implement monetary and exchange rate policies.	52	5	98.1	1.9	0
The input of Central bank staff is used in the decision-making process of Monetary Policy Committee and the governing board.	52	5	78.9	15.4	5.7

The utility of staff recommendation on policy decisions depends on the leadership style of Central bank's top management.	52	4	78.9	17.3	3.8
The official exchange rate has been effective in stabilizing the naira and controlling inflation.	52	3	23.1	48.1	28.8
The parallel market exchange rate has impact on inflation.	52	5	88.5	5.8	5.8
Unification of the exchange rates will cause hyperinflation in Nigeria.	52	2	30.8	25	44.2

Source: Author

I begin by asking central bankers how autonomous they think the CBN is in implementing exchange rate policy and whether they are involved in the decision-making process. None of the respondents doubt the autonomous status of the CBN in formulating and implementing monetary and exchange rate policies (Table 5.2). However, there are some differences of opinion on whether the policy decisions of the Monetary Policy Committee and the Governing Council reflect the staff's recommendations. It is important to establish at the outset of the analysis that the staff is involved in the policymaking process before eliciting their perspectives and preferences. Nearly 80 percent of respondents believe that the CBN's Monetary Policy Committee and Governing Board use staff input in decision-making (Table 5.2). At the same time, most respondents agree that the extent to which staff recommendations are used in policy decisions depends on the leadership of the central bank at any given time. Only a few (17.3 percent) are unsure whether this is the case (Table 5.2).

I now turn to the issue of exchange rate regimes and the normative statements about the operation of Nigeria's foreign exchange system. The first two questions concern the exchange rate regime considered appropriate for Nigeria (Figure 5.1) and the rationale for maintaining multiple exchange rate regimes (Figure 5.2). For simplicity, exchange rate regimes are generally classified into three broad categories based on the degree of fixity or flexibility of a country's exchange rate arrangement: fixed, intermediate, and flexible/floating. This can be confusing because of the variety of regimes that can be associated with each of the three categories.

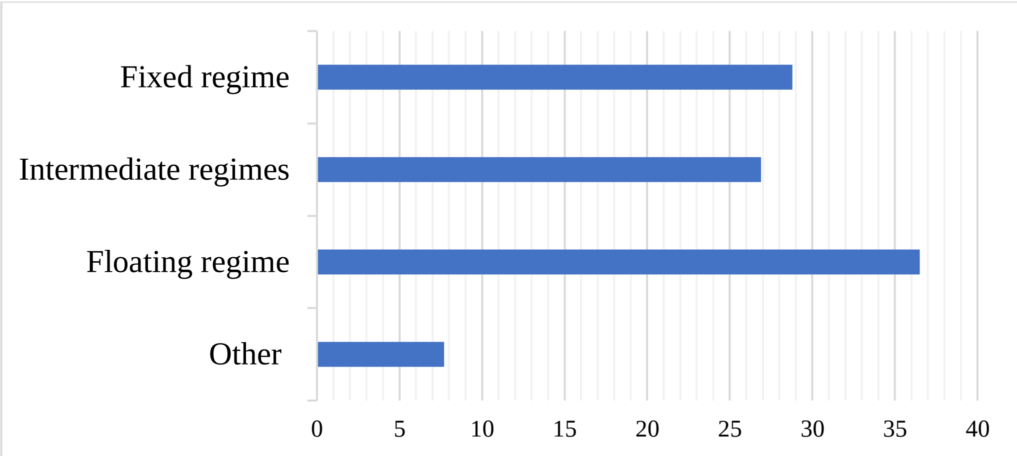

Figure 5.1 Exchange rate regime
Source: Author

The distribution of responses to the exchange rate regime options in my survey illustrates the difficulty of classifying exchange rate regimes. One of the reasons for this is the de jure and de facto dichotomy of exchange rate regimes implemented by countries. I therefore focus on the respondents' preferences for a fixed or flexible exchange rate regime with respect to Nigeria. The floating regime, which implies greater exchange rate flexibility, has the highest support (36.5 percent) as the appropriate option for Nigeria. Those in favor of either a fixed regime (28.8 percent) or an intermediate regime (26.9) are quite large. There is simply no consensus within the central bank as to which regime is more appropriate for Nigeria.

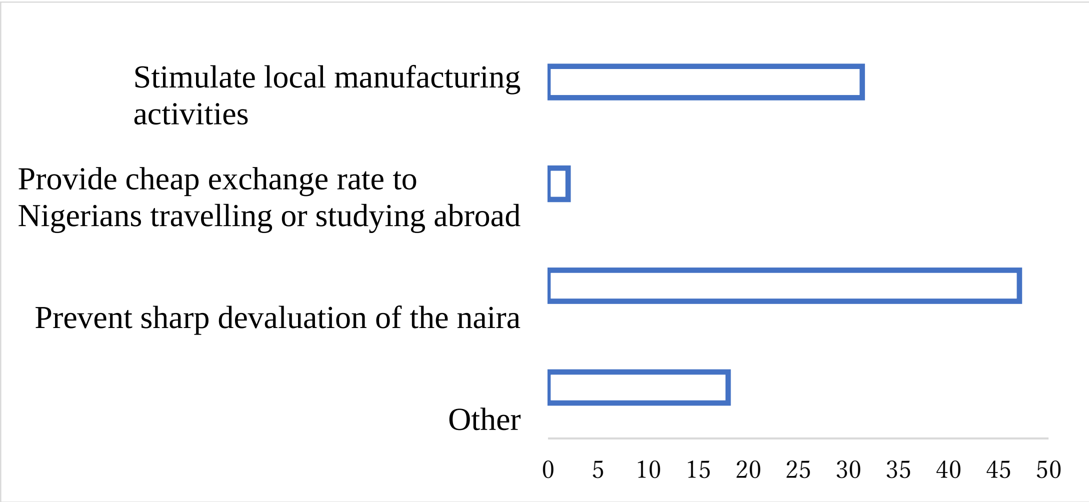

Figure 5.2 Rationale for multiple exchange rate system

Source: Author

The most controversial aspect of Nigeria's exchange rate policy, which is frowned upon by the IMF and others, is the multiple exchange rate regime. The CBN has made considerable progress in the process of abolishing the system. Two prominent and closely related justifications have been advanced by the CBN for maintaining the system for such a long period: The inflationary risk associated with the abolition of the system due to currency depreciation and the need to stimulate local production by providing foreign exchange at the official rate for the importation of critical raw materials. These are the explicit reasons. The need to finance certain government transactions with foreign exchange is also part of the rationale for the official exchange rate. A key staff member of the Trade and Exchange Department confirmed in an interview that "the military also benefits from the official rate for the purchase of military hardware to combat insecurity in the country" (Interview 9). According to my anecdotes, government officials also receive their estacode allowances at the official rate when traveling abroad for both official and personal reasons.

In addition, the official exchange rate is used for personal and business travel allowances of non-government officials. Therefore, I included a question on whether the purpose of multiple exchange rates is to provide a cheap exchange rate for Nigerians traveling abroad for business or education. Except for perhaps one respondent, no other respondent believes that this is one of the purposes (Figure 5.2). A significant proportion of the respondents (31.4 percent) believe the purpose is to stimulate domestic production of goods and services. The majority (47.1 percent) agrees with the main reason for maintaining the official exchange rate – to prevent a sharp currency depreciation that could trigger an inflationary spike. But has the official exchange rate been effective in stabilizing the naira and controlling inflation? Central bankers' responses to this question have been mixed. Interestingly, most of them are not sure about the effectiveness of the official exchange rate in fighting inflation. A significant portion of the respondents (28.8 percent) strongly disagree. Those who agree are in the minority (23.2 percent).

The CBN has often emphasized that "Nigeria's stable exchange rate" has contributed to price stability (see IMF 2021, 19). The exchange rate stability alluded to here is the administratively managed exchange rate. Because the CBN does not recognize the parallel rate, arguing that it represents a small part of the foreign exchange market.[35] This suggests that the CBN believes that the parallel rate has an insignificant impact on inflation. However, this position is at odds with the observed reality, given that a

[35] See, https://www.youtube.com/watch?v=d6Ga6Xbt1F4; https://twitter.com/i/status/1331293820953227267

significant amount of foreign exchange transactions is settled in the parallel market. Therefore, the prices of imported items tend to reflect the parallel rate.[36]

Contrary to the CBN's official opposition, an overwhelming majority of CBN staff in my sample (88.5 percent) agree that the parallel market exchange rate impacts inflation (see Table 5.2). Although the magnitude of this impact should be determined by empirical work, prima facie evidence suggests it is significant. On the question of whether the unification of exchange rates will lead to hyperinflation, central bankers' opinions are mixed. The responses indicate more disagreement than agreement. However, the proportion of those expressing uncertainty (25 percent) is significant (Table 5.2).

5.5.3 Political Insulation or Stimulation?

The independence of the central bank ideally means that it is insulated from political interference. The politics of exchange rate policy in Nigeria remain complex and challenging because of the need to balance competing interests and maintain economic stability. This section of the survey (Table 5.3) asks central bankers about the potential influence of politics in the CBN's exchange rate policymaking process. The central bank will, of course, argue that its policies result from pragmatic decisions that are not politically motivated. However, a significant number of CBN staff (63.5 percent), representing the majority in my sample, admit that political pressures motivate changes in exchange rate policy (Table 5.3).

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[36] For more on this, refer to the analysis of Pinto (1987, 2016); and Gray (2021) highlighted in Chapter one.

Table 5.3 Political considerations in Nigeria's exchange rate policy

Questions	N	Mode	Agree %	Neutral %	Disagree %
Political pressure motivates exchange rate policy change.	52	4	63.5	17.3	19.2
The CBN considers appropriate timing when implementing exchange rate policies.	52	4	71.1	23.1	5.8
Currency devaluation can be implemented at any time deemed necessary, irrespective of a pre-election year.	52	4	69.2	15.4	15.4
The socialist or capitalist ideology of a Nigerian President and ruling political party influences the exchange rate policy adopted in Nigeria.	52	4	53.8	25	21.1
Politically powerful elite influence the choice of exchange rate policy in Nigeria.	52	3	34.6	26.9	38.5

Source: Author

One indication of partisan considerations in policy decisions is the postponement of the implementation of a politically sensitive policy, such as currency devaluation, until after elections. This may be true regardless of the political ideology of the country's executive authorities. But those with socialist leanings, for example, will most likely oppose currency devaluation under any circumstances. Clear evidence of this is provided by my interviewee at the CBN and other evidence in relation to Nigeria's President Muhammadu Buhari. The former president is known for his strong socialist stance on economic policy since his tenure as a military head of state in the 1980s. In the following transcript, the CBN staffer I interviewed specifically refers to an instance when a currency adjustment was made when the president was indisposed:

> Of course, in terms of policy, the CBN has to follow the line of thinking of the government. For example, I think there was a time in 2016 when the CBN was able to adjust the exchange rate downwards [that is,

> currency devaluation] while President Buhari was away. It may not have been done because of his influence on the policy. (Interview 9).

This evidence reflects the weak autonomy of the CBN given the influence of the executive authorities, especially the President of Nigeria. President Buhari, who consistently opposes any policy change that could lead to a devaluation of the naira, could ultimately prevent any attempt by the apex bank in that direction, even if the realities prove it is the right way to go. Savage (2017) noted that when the CBN removed the peg on the naira exchange rate in 2016 (as alluded to in the interview transcript above) but later reversed the decision, "CBN Governor Emiefele may have acquiesced to Buhari's desire for a strong naira" (para. 3).[37]

I asked respondents about the implementation of currency devaluation before the election season and the influence of presidential ideology on exchange rate policy in Nigeria. A striking majority (69.2 percent) believe that the election cycle has no impact on the devaluation decision, while more than half of them (53.8 percent) also agree that a president's ideology matters (Table 5.3). At first glance, this seems contradictory. However, the responses to the latter may assume that a more market-oriented president is less likely to interfere with the central bank's decision to adjust the currency when necessary. This is consistent with the analysis in the previous two paragraphs. It is important to note, however, that the goal of retaining political office is important to a politician seeking re-election. The tendency to tolerate policies such as currency devaluation that could ruin the politician's chances may be low, regardless of ideology.

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[37] https://www.euromoney.com/article/b150qqtzdz52p5/nigerias-unfree-float-leaves-questions-hanging

Table 5.4 Interest Groups Engagement with CBN

Questions	N	Mode	Agree %	Neutral %	Disagree %
Interest groups are involved in exchange rate policymaking.	52	2	31.4	33.3	35.3
The advocacy of Interest groups provide input for policymaking.	52	3	40.4	44.2	15.4
The exchange rate preferences of interest groups are considered in exchange rate policymaking.	52	3	15.4	50	34.6
Exchange rate policies often reflect the outcome of consultation with interest groups.	52	3	26.9	48.1	25
Interest groups' pressure determine exchange rate policy decisions.	52	3	17.3	44.2	38.4

Source: Author

Regarding the involvement of interest groups and their influence on exchange rate policy, most respondents are neutral on almost all questions (Table 5.4). On the one hand, this suggests that interest groups are not very involved and have little influence on policy direction. On the other hand, it may imply that central bankers recognize the political power of certain groups – such as MAN – to influence exchange rate policy. However, they are not sure whether the final policy decisions of the Board of Governors and the Monetary Policy Committee consider the demands of interest groups. Exactly half of the respondents (50 percent) are not sure whether the exchange rate preferences of interest groups are considered in exchange rate policymaking (Table 5.4).

5.5.4 The Coercion and Persuasion of International Institutions

Through the channels highlighted in Section 5.4, international financial institutions can influence countries' exchange rate policies. I asked central bankers directly whether this was the case in Nigeria, and about 60 percent of them agreed. The recommendations and conditionalities of these institutions are often criticized for being too harsh on developing countries and for prescribing one-size-fits-all policies without considering local conditions. In some circumstances, however, the recommendations may be appropriate, which may be why 30.6 percent of my respondents agree, while 46.2 percent remain neutral.

Another direct question on a policy change by the CBN in line with the IMF's recommendation is the abolition of the official exchange rate window and the adoption of the I&E rate as the only recognized foreign exchange market. In 2020, The World Bank requires Nigeria to implement some reforms (including the currency) before it approves a loan. According to Reuters (2020), "The World Bank needs Nigeria to step up reforms of its currency, the naira, before it can approve a $1.5 billion loan, its country director said."[38] Neither the World Bank nor the Nigerian authorities explicitly state whether it was in fulfillment of this condition that the CBN adopted the I&E exchange rate in 2021. I found a wide range of opinions among respondents, with identical responses among those who agree and those who disagree (32.6 percent). Although those who are not sure dominate, the responses to the question generally suggest that it is difficult for staff to conclude that the IFIs necessitated the policy change (Table 5.5).

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[38] https://www.reuters.com/article/nigeria-worldbank-idINJ8N2GY03J/

The IFIs may have succeeded in persuading or forcing the central bank to pursue some reforms, but not all their recommendations are implemented, as my interviewee at the CBN noted when I asked about the influence of the IFIs:

> The fact that the recommendation of the international financial institutions is not implemented suggest that they have little or no influence on Nigeria's exchange rate policy [. . .] People think the IFIs do not mean well for the country. But we are hurting ourselves. If anything, a foreign country should be interested in a stronger naira because it makes imports from other countries cheaper and our exports expensive.

Table 5.5 Coercion and Persuasion of International Institutions

Questions	N	Mode	Agree %	Neutral %	Disagree %
International financial institutions (IMF and World bank) influence exchange rate policy decisions in Nigeria.	52	4	59.6	21.2	19.2
The recommendations of World bank and IMF on Nigeria's exchange rate policies are appropriate.	52	3	30.6	46.2	23.1
Adoption of I & E exchange rate by the Central bank was necessitated by the International financial institutions.	52	3	32.6	38.5	32.6
Regional coordination of exchange rate policies is necessary for currency stability within West Africa. *[39]	52	4	67.3	21.2	7.7
ECOWAS Exchange Rate Mechanism influences Nigeria's exchange rate policies.	52	3	30.8	40.4	28.8

Source: Author

[39] *Two respondents added the phrase: "when there is a consensus"

5.6 The Exchange Rate Views of Indonesian Central Bankers

My survey of Bank Indonesia employees has received a disappointingly low response. Despite the many channels through which I tried to reach the respondents via acquaintances and personal contacts, my efforts were in vain. Only five BI employees completed the questionnaire (see Table 5.1). However, this challenge was partly resolved by an in-depth semi-structured interview with a key Bank Indonesia official, which somewhat complements the lack of multiple perspectives. In addition, not all staff may have the knowledge and experience to respond appropriately to the questions. Given their academic qualifications and professional experience, the five respondents to the questionnaire are well-placed to provide a representative perspective on BI's exchange rate policy. Three hold Ph.D. degrees in economics, financial mathematics, and business and accounting, respectively. The other two have Master's degrees in economics. Two Ph.D. holders have more than two decades of working experience at the central bank, one of whom is a deputy director. This means that their answers would be very useful as they can give a good account of the politics of exchange rate policy in Indonesia during the main period that this study focuses on – 2000 to 2022. Comparatively, only two of the 52 respondents at the Central Bank of Nigeria have more than 20 years of equivalent work experience.

5.6.1 Exchange Rate Management: Indonesia

Bank Indonesia appears to be one of the most independent central banks in post-AFC Asia. The lessons of the crisis and the commitment to prevent a recurrence make it necessary for Indonesia to pursue key institutional reforms such as BI's autonomy. Bank Indonesia is the only institution in Indonesia that is independent of the central government and cannot be controlled by the president (Interview 10). Like their Nigerian counterparts, Indonesian central bankers are fully committed to BI's policy autonomy and the usefulness of staff input in the decision-making process (Table 5.6).

Regarding the appropriate exchange rate regime for Indonesia and similar countries, the respondents share the views of the Nigerian central bankers, who favor the floating exchange rate regime. Based on the experience of the AFC, Indonesia recognizes that the fixed exchange rate regime may not be appropriate, not least because it requires large foreign reserves to support the regime (Interview 10). The market should determine the exchange rate, while the central bank intervenes to ensure the currency's stability when there is a tendency for depreciation (Interview 10).

Table 5.6 Indonesian Central Bankers' Views on Exchange Rate Management

Questions	N	Agree %	Neutral %	Disagree %
Bank Indonesia enjoys complete autonomy in formulating and executing monetary and exchange rate policies.	5	5	0	0
The decision-making process of the Monetary Policy Committee and the governing board incorporates input from Bank Indonesia staff.	5	5	0	0
The value of staff recommendations in policy decisions is influenced by the leadership style of the central bank's top management.	5	5	0	0
A multiple exchange rate system is necessary for promoting priority activities and safeguarding the economy against inflationary pressures in developing countries.	5	3	1	1
A unified, market-responsive exchange rate system poses a risk of hyperinflation in developing economies.	5	2	2	1

Source: Author

Indonesia does not have the kind of multiple exchange rate system that Nigeria has. But I asked Indonesian central bankers whether they thought the system was necessary to promote priority activities and contain inflationary pressures in developing countries. Surprisingly, only one of the respondents disagreed (table 5.6). It is likely that they did not unanimously disagree because they believe that the theoretical role of the multiple exchange rate system should be beneficial for developing countries. Unfortunately, this is often not the case, as discussed in Chapter four (see Section 4.5).

5.6.2 Exchange Rate Politics in Indonesia

The distributional impact of currency depreciation or appreciation on different actors makes it a politically sensitive issue, especially in the context of elections. Currency depreciation could have a greater impact on the popularity of a government seeking re-election. Post-election postponement of an unpopular policy such as currency devaluation is one of the manifestations of political considerations in exchange rate policy. In the case of Nigeria, we have seen how the president's stance against devaluation constrains the central bank from pursuing such a policy even when economic conditions make it necessary. In Indonesia, central bankers believe that their policies are not influenced by elections or a politically influential elite (Table 5.7).[40] My Interviewee at BI emphasize the high degree of independence of the monetary authority in pursuing its mandate:

> We are so independent that no government authority can interfere with the central bank's decision to set monetary policy... We set the policy rate independently of any election year. We have elections in 2024, the situation is getting heated. But we are independent, we do not look at other situations. As you see now, the Board of Governors is raising the interest rate because of inflation (Interview 10).

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[40] The latter is somewhat almost non-existent in Indonesia since the opportunity for rent seeking is eliminated, unlike the Nigerian situation.

The survey respondents also agree that political pressure arising from elections or other stakeholders do not influence the policy decisions of BI (Table 5.7).

Table 5.7 Exchange Rate Politics in Indonesia

Questions	N	Agree %	Neutral %	Disagree %
Bank Indonesia can take decisions on the exchange rate at any time deemed appropriate, regardless of political considerations or election cycles.	5	4	0	1
Ideology of the President and the ruling political party may play a role in shaping exchange rate policy decisions at Bank Indonesia.	5	2	0	3
The politically influential elite in Indonesia may have some influence on exchange rate policy decisions made by Bank Indonesia.	5	0	0	5
Political pressure from various stakeholders can sometimes influence exchange rate policy decisions in Indonesia.	5	0	1	4
Interest groups can provide valuable input to Bank Indonesia's exchange rate policy decisions.	5	1	1	3
Interest groups in Indonesia do lobby for exchange rate policies that benefit their interests.	5	1	2	2
The preferences of interest groups for a strong or weak currency may be taken into consideration by Bank Indonesia in its exchange rate policymaking process.	5	1	1	3
Bank Indonesia's exchange rate decisions are often aligned with the preferences of interest groups.	5	0	1	4
Interest groups can sometimes indirectly exert pressure through advocacy that influences exchange rate policy decisions in Indonesia.	5	0	1	4

Source: Author

Regarding interest groups, I asked respondents similar questions in different ways to try to uncover the role of groups in getting their preferred policies implemented by the BI. The preferred policy in question might be with respect to the central bank's decision to intervene in the foreign exchange market in the direction of currency appreciation or depreciation. There seems to be little, if any, impression on the part of central bankers that interest groups influence the policy direction of BI (Table 5.7). This does not mean that the BI conducts its policy in complete isolation from the private sector. Interest groups are sometimes invited by the central bank to gather market information before the regular meeting of the monetary policy department. The BI staff I interviewed explain this interaction in the following transcript:

> Our monetary policy department has five divisions. In the macro area, we have many subdivisions. One of them focuses on private sector surveillance. Their job is to get all the information on certain issues... We invite [the private sector] to express their views, but not on a regular basis. We collect material from them, note down important points and present it to the head of the department, who then presents it to the Board of Governors and they decide (Interview 10).

5.6.3 International Institutions and Bank Indonesia

In Section 5.5, we have seen how Indonesia turned to the IMF when the AFC wreaked havoc on the Indonesian economy. During this period, the IMF exerted its influence on the country's economic policy decisions. I asked Indonesian central bankers whether the international financial institutions are maintaining their influence on Indonesia's policy decisions post-crisis. The respondents did not unanimously disagree, as some of them were not sure whether such influence persists and whether Bank Indonesia considers the recommendations of the IMF in its decision-making process (Table 5.8).

Table 5.8 International Financial Institutions and Bank Indonesia

Questions	N	Agree %	Neutral %	Disagree %
International financial institutions (IMF and World Bank) have some influence on exchange rate policy decisions in Indonesia since the Asian Financial Crisis.	5	1	2	2
The recommendations of the IMF on Indonesia's monetary and exchange rate policies are often considered by Bank Indonesia in its decision-making process.	5	0	3	2

Source: Author

The negative image of the IMF in developing countries is virtually the same. The reason, of course, is largely related to the fact that the Fund's policy prescriptions often impose an unbearable burden on a country that is in desperate need of financial assistance. Policymakers believe they have a better understanding of the domestic economy and are in a better position to determine what policies are appropriate. A similar sentiment was expressed by my interviewee at BI:

> [We] do not want any foreign institution to control the Indonesian economy. Sometimes, internally, in Bank Indonesia, we hate them! Because they know nothing. They do not know the situation of the domestic economy, but they want to determine the regulations based on their countries. When the IMF [program was requested], we just wanted them to give us some help, temporary help. After that they should leave. We know our problem. But now there is not even a little intervention from the foreign institutions (Interview 10).

In the absence of the conditions that would allow international financial institutions (IFIs) to have an impact, there seems to be no intervention on their part. As I metaphorically mentioned earlier, the role of the IMF is sometimes that of a firefighter.

In such situation, as exemplified by Indonesia, they are not expected to remain on the scene after the financial disaster has been resolved.

5.7 Overbearing Power of Political Elite on Nigeria's Exchange Rate Policy

Evidence from interviewees and other sources points to the influence of Nigeria's president(s) and members of parliament on the CBN. While presidential interference may be well-intentioned, it can have unintended negative consequences. An example is the case highlighted by commodity exporters when President Obasanjo intervened to resolve the stakeholders' disagreement with the CBN on the issue of repatriation of export proceeds (see, Section 5.2.3). This is a positive intervention, but it may set a precedent that compromises the institutional independence of the CBN. President Buhari's desire for a strong naira may also be to avert the adverse effects of a weak currency on domestic prices. However, defending the value of the currency requires sufficient foreign reserves. Unfortunately, by the time President Buhari took office in 2015, the price of crude oil had collapsed from a peak of $109 per barrel in 2012 to an average of $40 per barrel (see Figure 4.4 in Chapter 4). This significant decline in petrodollar inflows affected the country's ability to maintain the same overvalued level of the naira exchange rate against the US dollar. A nominal devaluation becomes necessary, but the president is adamant about maintaining the status quo, which ultimately proved to exacerbate the challenges by widening the gap between the official and parallel rates, providing ample arbitrage opportunities.

In addition to the influence of the president, members of parliament also tend to play a role in maintaining the status quo – an overvalued official exchange rate. They benefit from the system by receiving the official foreign exchange through several Bureau de Change (BDCs). Evidence of this comes from my interview with a key player in

Nigeria's foreign exchange market, who revealed that some powerful individuals, including members of parliament, have dozens of BDC licenses through which they obtain the official exchange rate (Section 5.2.5.3).[41] The CBN governor Emefiele was accused of using BDC licenses as a "souvenir" for elites. Roy et al (2022,36) also found that powerful political interests have been able to extract illicit profits because of the foreign exchange mechanism instituted by the CBN.

5.8 Conclusion

This chapter analyzed the causal link between stakeholder preferences and policy outcomes. In Nigeria, interest groups have limited influence, which depends on the central bank governor and economic conditions. In Indonesia, interest groups have less influence on Bank Indonesia, perhaps due to the independence of the central bank or because the exchange rate system does not provide rent-seeking opportunities as it does in Nigeria. The powerful groups in Indonesia prefer exchange rate stability to devaluation or overvaluation. The evidence shows that Nigeria pursued some reforms along the lines recommended by the IMF but resisted changing the dirigiste exchange rate system. In contrast, the coercion of the IMF program helped to fully implement and maintain the liberalized system in Indonesia and ensured greater autonomy for the central bank. Therefore, Indonesian central bankers can exercise their discretion in policy decisions, but their Nigerian counterparts are not as politically insulated. The evidence presented in this chapter points to the overbearing influence of Nigeria's political elite, who use their position to maintain a dirigiste exchange rate regime.

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[41] See, also, this newspaper report https://saharareporters.com/2021/06/17/exposed-nigerias-central-bank-governor-emefiele-bribes-silences-national-assembly-members

Chapter Six: Domestic and International Political Economy of Exchange Rate Policies: Implication for Development in Nigeria and Indonesia

6.1 Introduction

The exchange rate has economic and political implications. It is relevant for economic development not only as a tool of industrial policy but also because of its role in the performance of globally integrated economies, thus highlighting the importance of exchange rate policy choice. This chapter evaluates some of the consequences that dirigiste and market-based exchange rate systems can have on economic performance, as illustrated by Nigeria and Indonesia. The chapter first discussed the distributive politics and international dimension of exchange rate policy choices in the context of the two countries. The international political economy of the two countries' policies extends beyond the issue of regional monetary cooperation to encompass the evolving geopolitical dynamics that are driving policy changes. A brief analysis of the geopolitics of currency and its implications for developing countries, particularly Nigeria and Indonesia, is also provided.

6.2 Domestic Politics of Exchange Rate Policy

Exchange rate policy has political implications, given the different effects it has on diverse groups within and across countries. Domestic producers, exporters, consumers, and even the government all have their preferences on the exchange rate, suggesting the need for a trade-off in policy decisions. Typically, the preferences are associated with the framework for exchanging the national currency with foreign ones (exchange rate regime) and the units or amount at which the currency is exchanged (exchange rate level/value). In systems where the market forces largely determine the value of the currency, as in

Indonesia, there is less distortion and more transparency, which engender market confidence. However, Nigeria's exchange rate management is a system where the beneficiaries of the scarce (overvalued) official exchange rate are selected in a non-transparent manner. The overvalued official rate is akin to a tax on exporters and a subsidy for importers. But as the scarcity of forex persists, the rationing becomes more stringent, and only the most privileged individuals can obtain the official rate, which will most likely be resold at the expensive parallel rate. The black-market premium widens significantly between 2016 and 2022 in Nigeria (see Chapter 4).

One of the central hypotheses presented in the political economy of exchange rate literature is that the preferences of powerful interest groups determine the choice of exchange rate policy (see Chapter 2). The expectation is that internationally oriented sectors are likely to favor devaluation and stability of the exchange rate, while importers and other non-tradable sectors prefer overvaluation and flexibility. In the two cases under study, there is rarely any competition between groups pushing for devaluation or overvaluation – almost everyone is not in support of the former. Moreover, even though "business interest in influencing monetary policies and electoral outcomes has grown in many Asian countries because of their growing dependence on exports, Indonesia seems to be the major exception, showing a more balanced approach to exchange rates than simply favoring the exporters" (Wang 2014, 245). I found no clear evidence that Indonesia's exchange rate policy within the study period favored exporters with a rupiah devaluation. Even some of the exporters prefer stability to depreciation of the rupiah.

In Nigeria, what matters for exporters is to have the freedom to sell their export proceeds at the prevailing market price, not the officially fixed price.[42] Importers of raw materials and finished goods are interested in obtaining the subsidized official exchange rate. Money changers also want to receive forex allocation from the central bank to resell in the open market. There exist other powerful beneficiaries of the official exchange rate (based on my interviews with CBN staff), which are not fully explored in this study. These include the Nigerian military and importers of critical items such as petroleum products.

Additionally, urban consumers in Nigeria have a greater demand for a strong currency because it provides higher purchasing power that satisfies their taste for foreign goods and services, including payment for educational and health tourism abroad. The CBN has dedicated some exchange rate windows to supply the subsidized foreign currency for those purposes. This is a major incentive for politicians to maintain an artificially high value of the naira. It also implies that the primary constituency of successive governments in Nigeria when formulating public policies and delivering public goods is the urban centers. With too few forex resources to satisfy the huge demands mentioned above, selecting winners of the forex subsidy becomes challenging. In the final analysis, most Nigerians would have to grapple with the consequences of the exchange rate dirigisme since access to the official rate becomes increasingly difficult for those engaged in productive activities. Rent seekers and those willing to offer bribes tend to obtain the official rate, which they can sell at the attractive parallel rate. This

[42] In addition, commodity exporters in both Nigeria and Indonesia are opposed to devaluation as illustrated by the findings of this study.

misapplication of the subsidy is perhaps the basis on which many argue (including manufacturers who supposedly benefit) that the official rate should be abolished.

Another political explanation for the choice of exchange rate policy has to do with the imperative of maintaining political office. Politicians can use the exchange rate to win constituents' support when seeking (re)election, though this is determined by the extent of central bank autonomy in policymaking. In many countries, the exchange rate policy is conducted by 'independent' monetary authorities. In some cases, such independence is superficial, as in Nigeria, while in others, like Indonesia, the central bank enjoys a significant degree of political insulation. My interviewee at Bank Indonesia alluded to this independence by citing the example of some policy changes initiated at the bank without necessarily considering the electoral disadvantage such action may cause the incumbent president or the ruling political party. However, as suggested by one of my interviewees, who was a chairman of the Bank Indonesia Supervisory Board, central bank independence depends on the willingness of the political authorities, especially the president.

The AFC had instilled the necessary discipline in Indonesia to dissuade political interference in the operations of the central bank, including exchange rate policymaking. It would have been unlikely for Bank Indonesia to possess a significantly higher level of autonomy than its Nigerian counterpart without the necessity presented by the AFC and the IMF program that followed. As pointed out by the Financial Times, "Bank Indonesia won its independence after the Asian financial crisis with the 1999 central bank law, which was vetted by the IMF and designed to protect it from political interference. The law precludes it from providing credit to the government and from buying state debt except in the secondary market."[43]

Before the democratic transition in 1999, the central banks of Nigeria and Indonesia were controlled by cabinet members throughout the military regimes. Since the political system of neopatrimonialism characterizes the two countries, there has always been room for patronage and conferment of benefits to the president's cronies. However, the difference is that Indonesia's Suharto tends to support rural areas, while almost all the military leaders in Nigeria prioritize urban centers. For instance, it is only the urban populace that requires forex to travel abroad for vacation or pay medical and educational bills in foreign institutions.

It is noteworthy that recently, the independence of Bank Indonesia has also been challenged by Indonesian politicians, especially in 2020 during the Covid-19 pandemic.[44] There was a proposal by the members of the Indonesian parliament to change the laws governing Bank Indonesia. The proposed reforms include; "allowing cabinet ministers to vote at Bank Indonesia's monthly monetary meetings to set interest rates, setting up a monetary council to oversee the central bank whose members would include the finance minister and another cabinet minister with an economics-related portfolio, expanding Bank Indonesia's mandate to include jobs and economic growth, and allowing the central bank to finance government deficits."[45] If these reforms are implemented, Bank

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[43] https://www.ft.com/content/cbb8d3de-f394-4291-8899-6302579c62f7

[44] See, for instance; https://www.centralbanking.com/central-banks/governance/7698686/lawmakers-propose-reducing-bank-indonesias-independence; https://asia.nikkei.com/Economy/Indonesia-s-central-bank-independence-comes-under-fresh-attack; https://www.eastasiaforum.org/2020/10/19/can-bank-indonesia-protect-its-independence/ ; https://www.afr.com/world/asia/indonesia-moves-against-central-bank-independence-20200901-p55rft

[45] https://www.ft.com/content/cbb8d3de-f394-4291-8899-6302579c62f7

Indonesia would effectively acquire the status of its former self and that of Nigeria's central bank – less independent, highly politicized, and a weak institution.

6.2 Regional Cooperation and Coordination of Exchange Rate Policies

Regional cooperation and coordination of exchange rate policies is the collaborative efforts among countries within a specific geographic region to manage and align their exchange rate policies in pursuit of common goals. The central goals are the exchange rate, macroeconomic stability, and, ultimately, a monetary union. The different political economies of countries can affect the prospects of this collaborative arrangement. Countries have different economic conditions, priorities, and levels of economic development, which can complicate the process of reaching a consensus on policy alignment. Additionally, sovereignty concerns and differing policy goals can sometimes hinder the implementation of coordinated strategies.

Nigeria and Indonesia are actively involved and perhaps the most influential countries in their regional economic blocks – the Economic Community of West African States (ECOWAS) and the Association of Southeast Asian Nations (ASEAN). The raison d'etre of economic integration like the ECOWAS and ASEAN is to, among other objectives, eliminate trade barriers and promote economic growth and development of member countries. The evolution of the agreements could lead to the establishment of a monetary union, which entails the use of a common currency. For instance, ECOWAS sought to create a monetary zone with a common currency by establishing the Monetary Cooperation Programme (EMCP) in 1987. In a bid to achieve the objectives of the program, member countries were required to pursue economic policy reforms geared towards macroeconomic convergence among them. The reforms comprise the realignment of exchange rates and the adoption of a market-based exchange rate policy, the removal of exchange control regimes, and the minimizing of fiscal deficits and their financing through the rationalization of government expenditure and tax reform (Ebi 2003, 146). Had these reforms been embarked upon as proposed, they may have significantly influenced the choice of exchange rate policies in Nigeria and other member states.

It is believed that policy coordination is beneficial for the countries' trade relations and economic stability. In my survey of Nigerian central bankers' opinions about the necessity of regional coordination of exchange rate policies for currency stability within West Africa, for instance, the majority (67.3 percent) agreed that it is paramount (see, Table 5.5, Chapter five). However, neither the short nor the medium-term objectives of the EMCP have been fully attained (Ebi 2003, 146). Additionally, "the well-functioning of a monetary union is not limited to macroeconomic convergence of its member countries alone, but it demands the convergence in policy preferences, or at least agreement on the policy objectives and therefore on the weighting of targets and choice of instruments of economic policy" (Ekpo and Udoh 2014, 66).

In the case of ASEAN, the strong interest in a common currency was triggered by the 1997-98 Asian financial crisis. The crisis underscored the adverse contagion among countries in the region, which raises the need for cooperation on crucial policy issues. ASEAN members realize the urgency to take precautionary actions against the reoccurrence of similar or more severe crises. One of the policy options involves the promotion of a more stable and durable exchange rate arrangement in the region in which a common currency was considered a potential long-term objective for strengthening Asian regional cooperation (Ebi 2003, 151). The AFC, thus, provided the impetus for serious consideration of financial and monetary cooperation among East Asian economies generally. In 1997, Japan even floated the idea of establishing an Asian Monetary Fund. However, it was not successful because of the strong opposition from the United States and the lack of cooperation by countries within the region (Wang 2014, 247).

Commitment to regional initiatives by countries may be fostered or impeded by domestic politics. Saputro (2017, 206) noted that "the change in domestic politics had influenced Indonesian financial authorities' responses to regional initiatives. Indonesian democratic administrations started to perceive regional cooperation as an alternative forum to recover and sustain the domestic economy in the wake of the Asian financial crisis." In the post-AFC period, the ASEAN and the broader East Asian region experienced increasing integration and economic interdependence, highlighting the importance of policy coordination. While exchange rates play a pivotal role in connecting interdependent economies, demanding earnest attention in policy coordination efforts, it is noteworthy that exchange rate policy within the Asian region has remained among the least coordinated aspects (Kawai and Takagi 2012, 264). Bank Indonesia and other central banks within the region sometimes engage in bilateral swap agreement, which is not policy coordination of exchange rate per se but a sort of financial cooperation (interview 10).

6.3 Geopolitics and the Future of Currency Policy

Like the choice of exchange rate policies, the decisions surrounding regional financial and monetary collaboration are not solely determined by economic circumstances. They are influenced by international politics (Wang 2014, 248), as in the case of the proposed Asian Monetary Fund mentioned above, which would have rivaled the IMF. Resistance and the search for an alternative to the IMF as a representative of Western control among developing and emerging countries is gaining momentum, as is China's evolving stance toward regional/international cooperation. China has been pursuing a strategic agenda to increase its influence in global institutions. For example, it has established a contingency mechanism for renminbi liquidity through the Bank for International Settlements (BIS). Similarly, the renminbi has joined the US dollar, yen, euro, and pound sterling as one of the currencies that underpin the International Monetary Fund's special drawing rights (SDRs). Moreover, the BRICS countries (Brazil, Russia, India, China, and South Africa) are seeking ways to challenge the hegemony of the US dollar. This includes exploring the possibility of creating a joint reserve currency to circumvent the dollar and other major Western currencies. This initiative also serves as an alternative to the SDR.[46]

There are ongoing efforts to promote the use of local currencies to settle international transactions among countries in addition to the quest for a viable rival to the US dollar's reserve currency status. The success of this undertaking will likely influence how Nigeria, Indonesia, and other countries manage their exchange rates and how they interact with the international financial system. The debate is now raging about the potential of a new (BRICS) currency countering the dollar's dominance. Many developing countries find the proposed initiative appealing because of their economic vulnerabilities to the US dollar or, politically speaking, the dissatisfaction with the 'weaponization' of the dollar in terms of economic sanctions against sovereign nations by the United States.

Some have argued that there are currently no definite contenders to supplant the US dollar as the primary currency, and crafting a worldwide currency seems improbable

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[46] https://www.project-syndicate.org/onpoint/will-multipolarity-follow-global-dollar-hegemony-by-carla-norrlof-2023-07

due to existing geopolitical tensions. Nevertheless, the strengthening of capital markets and heightened trade between significant emerging economies are elevating the status of their currencies. Additionally, the implementation of joint protective measures against the impacts of US dollar fluctuations and efforts to establish an alternate payment system indicate a shift towards a more diverse currency landscape.[47] This shift is, however, facing some obstacles which are not necessarily insurmountable but are worthy of careful consideration.

Two decades ago, Cohen (2003) noted that the barriers to displacing the US dollar as the dominant global currency are associated with the requirements for competitive success of the new currency and the inherent inertia in monetary behavior. Three attributes shape the choice of currency in the global market place according to Cohen. First is the confidence in the future value of the currency that is predicated on political stability in the country of origin. The second attribute has to do with the openness and development of the financial market of the country. Third, the currency must have a transactional network determined and enhanced by the size of the country's economy and its degree of integration into world markets (6). Even if the challenger currency fulfills these attributes, there is the inertia of switching to a new currency because of the cost and uncertainties involved. One example among other similar inertias is when the pound sterling remained a dominant currency for about half a century after British ceased to be an economic power (7). Around 1920, key factors shifted the preference towards the dollar over the pound. The United States had surpassed the United Kingdom in economic

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[47] https://www.credit-suisse.com/about-us-news/en/articles/media-releases/the-future-of-the-monetary-system-202301.tag*article-topic--media-release---research.html

size as early as 1872 and established a central bank in 1913, whereas Britain had weakened its position as a major international creditor due to borrowing during World War I. However, inertia delayed the overturning of the old order. (Frankel 2023, 6)

In a recent scholarly contribution, Weiss (2022) assesses how geopolitics affect the role of the US dollar as a reserve currency. The study examined the extent to which US allies hold reserves in the US dollar and what implication a geopolitical stratification of the world would have on the reserve status of the US dollar. Regarding the holding of US dollar reserves by allies of the US, the study finds that about 50 to 60 percent of US assets held by foreign governments over the last decade belong to nations with strong US relations. When nations with any military cooperation with the US are counted as allies, almost 75 percent of US assets held by foreign governments are held by allies. These countries remain crucial reserve holders, though US dollar reserves are no longer exclusive to allies dependent on US military aid as in the past.

Regarding the short- and long-term impact of a geopolitically stratified world, there seems to be a limited threat to the US dollar's reserve currency status. This is because the US dollar's reserve currency status is supported by close allies (with less likelihood of incurring sanctions) and by other countries that have economic incentives to hold US dollar assets. Weiss (2022) acknowledges that these incentives may likely change in the coming years. He examines a scenario where developing and emerging economies stop using the US dollar for trade invoicing and instead adopt the Chinese RMB. Weiss concluded that while a shift from the US dollar in trade invoicing among emerging economies could result in a considerable reduction of US dollar reserves, the

US dollar would still constitute the largest portion of foreign exchange reserve assets (3). Carla Norrlof (2023)[48], also argues that:

> It is unlikely that unipolarity will fade at all any time soon – or even in the medium term. That will remain the case even in a more fragmented global economy where security partnerships determine economic relations and sanctions against Russia contribute to a realignment of some global currency holdings. The pandemic and recent geopolitical developments do not justify confident bets on the dollar's demise. The greenback's centrality is mainly determined by economic factors and an incumbency advantage reinforced by network effects.

The network effects or network eternality is one of the advantages of a single international currency. Frankel (2023, 7) pointed out that the global monetary system can be seen as a balance between the benefits of having a single currency due to network effects and the drawbacks, which involve the potential for the country issuing that currency to misuse its dominant position, prompting other nations to seek alternatives. Historically, the misuse of this dominant position referred to actions like devaluing the currency through excessive budget deficits, money supply growth, current account deficits, and inflation. When determining international currency shares through econometric analysis, factors like a currency's ability to maintain its value, a country's size, and the openness and liquidity of its financial markets are considered. More recently, the excessive use of this dominant currency position has acquired a second meaning, as

[48] https://www.project-syndicate.org/onpoint/will-multipolarity-follow-global-dollar-hegemony-by-carla-norrlof-2023-07

it has become increasingly apparent that frequent American implementation of sanctions can lead some countries to reduce their reliance on the dollar.

The future of the US dollar's position and the viability or prospects of emerging alternatives are unfolding events. We may not be able to predict with precision what the outcomes would be. However, the changes that are taking place in the global political economy could significantly shape the future of the international financial system. The use of local currencies to settle transactions is gaining momentum as many bilateral and multilateral cooperation is being pursued to facilitate such arrangement. For example, Indonesia has recently "formed a National Task Force to expand the use of local currency transactions (LCT) in Indonesia with partner countries, involving the participation of Bank Indonesia and other government ministries and agencies. The National LCT Task Force was created in accordance with a Memorandum of Understanding (MoU) concerning cooperation and coordination to increase the use of local currency transactions in Indonesia with partner countries, as witnessed by the President of the Republic of Indonesia, Joko Widodo on September 5, 2023 on the sidelines of the ASEAN Summit 2023 in Jakarta (Bank Indonesia 2023).[49] The LCT National Task Force aims to enhance the stability of the rupiah's exchange rate and bolster the resilience of the domestic financial market. The introduction of local currency transactions is anticipated to have a positive impact on export-import operations, investments, and cross-border payment transactions.[50]

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[49] https://www.bi.go.id/en/publikasi/ruang-media/news-release/Pages/sp_2524523.aspx#:~:text=Indonesia%20has%20formed%20a%20National,Investment%2C%20Ministry%20of%20Finance%2C%20Ministry

[50] https://heaptalk.com/govact/to-boost-rupiah-stability-indonesia-unveils-local-currency-transactions-task-force/

African countries are also beginning to consider currency swaps as a solution to address the significant obstacles caused by their dependence on the US dollar that is impeding trade among them. For instance, the Central Bank of Nigeria and the National Bank of Ethiopia have recently entered into an agreement where they exchanged the earnings of two companies – Dangote Cement in Ethiopia and Ethiopian Airlines in Nigeria. Between these two countries, there is a substantial amount of US dollars being held because of a scarcity of hard currency, which has prevented businesses operating across borders from accessing their funds.[51] This currency arrangement involves exchanging the revenues of Ethiopian Airlines in Nigeria and the profits of Dangote Cement in Ethiopia, amounting to $100 million, as both companies encountered difficulties repatriating their profits due to foreign exchange shortages in both countries.[52]

The Pan-African Payment and Settlement System (PAPSS), launched by the African Export-Import (Afrexim) Bank under the auspices of the AfCFTA in 2022, is a continental-scale platform created to facilitate the swift processing, clearing, and settling of payments within Africa. PAPSS's primary objective is to empower individuals, businesses, and governments to conduct instantaneous cross-border transactions using over 40 different African currencies, thus diminishing the reliance on US dollars and other foreign currencies. This initiative aims to streamline cross-border trade, which can be especially problematic for small and medium-sized enterprises (SMEs) when obtaining foreign currencies.[53]

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[51] https://trendsnafrica.com/nigerian-and-ethiopian-central-banks-swap-100m-of-blocked-funds/
[52] https://www.thereporterethiopia.com/35363/
[53] https://african.business/2022/08/finance-services/pan-african-payment-and-settlement-system-drives-africas-banking-integration

6.4 Consequences of Exchange Rate Policies on Economic Development

The conceivable channels through which the exchange rate affects development include inflation (macroeconomic stability), trade, and investment. In what follows, I discuss these channels in the context of Nigeria and Indonesia, emphasizing the adverse effects of Nigeria's exchange rate system.

6.4.1 Inflation and exchange rate policy

The exchange rate is the most important price in an economy because it can affect other prices, especially for imported goods and services. The ostensible logic of Nigeria's exchange rate regime is to prevent the depreciation of the currency, which could trigger a sudden and sharp rise in inflation. Conversely, segmenting the foreign exchange market with multiple rates has resulted in a sustained naira depreciation. The main reason is the growing demand for foreign exchange relative to the dwindling supply. Even transactions eligible for the official exchange rate could not be fulfilled due to the shortage of foreign exchange. As a result, the gap between the official and parallel rates continues to widen, as we saw in Chapter Four. Since most of the demand for foreign exchange is met in the parallel market, the increase in inflationary pressures due to currency depreciation reflects the parallel market rate, not the scarce official rate. The argument here is that the official exchange rate has not been effective in taming inflation, and this is the view of CBN staff, as discussed in chapter five.

Indeed, many factors drive inflation, and the relative impact of the exchange rate can be better measured quantitatively, for example, through regression analysis. [54] However, it is plausible to argue that the parallel market has a greater impact on inflation because manufacturers and other importers cannot get 100 percent of their foreign exchange needs at the official rate. They must source for 40 percent or more from the parallel market. Second, speculators and rent-seekers would want to profit by ensuring the parallel rate rises. Moreover, when people in Nigeria talk about the depreciation of the naira against the US dollar, they are referring to the parallel market because the official rate is fixed. This means businesses would make their plans and projections and set prices based on the parallel rate. In chapter five, I also discussed the plight of exporters when their suppliers (farmers) price commodities according to the international price of the commodity based on the prevailing exchange rate of the naira.

In short, the exchange control regime restricts access to the official rate for certain transactions, and the multiplicity of exchange rates tends to exacerbate inflationary pressures in Nigeria. As foreign exchange shortages persist, the restriction becomes more severe, and most people resort to the expensive parallel market, which is then passed on to domestic prices. Compared to Indonesia, which operates a managed floating exchange rate regime, Nigeria's inflation continues to rise despite the inflexibility of the exchange rate. Figure 6.1 shows the persistence of inflation in Nigeria, especially since 2015, when oil prices fell significantly, while Indonesia's inflation appears to be declining and remains in single digits.

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[54] A major limitation of this exercise is the lack of historical data for the actual black market exchange rate, not the 'BDC rates' reported by the CBN which is not always reflective of the real market transaction.

A negative consequence of inflation is that it erodes the purchasing power of money, which reduces people's real income and welfare. Thus, inflation creates macroeconomic instability and uncertainty in the economy. When prices change unpredictably, economic agents face difficulties in planning, budgeting, savings, and investing. This can adversely affect confidence, expectations, and incentives for economic activity in productive sectors.

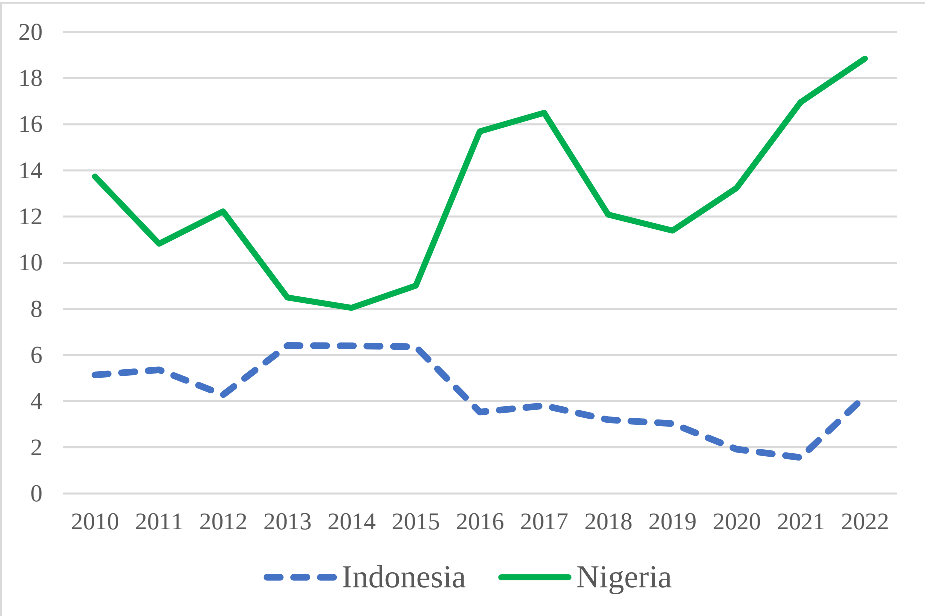

Figure 6.1 Inflation (CPI annual %)
Source: Author based on World Bank data

6.4.2. Trade and Investment

Trade, which involves the export and import of goods and services, can be affected by exchange rates and many other factors. Exports tend to affect economic development by increasing production, income, employment, and competitiveness. Exports can also stimulate innovation, technology transfer, and learning by doing, which can help a country diversify its economy and earn foreign exchange.

In the current state of the global economy, the use of the exchange rate as a development strategy in the context of promoting manufactured goods exports by developing countries may not necessarily be viable. In other words, a deliberate policy of exchange rate undervaluation, which has stimulated the export sector of many Asian economies, may be difficult to replicate in Nigeria and other developing countries. The export-led growth strategy was originally adopted by Germany and Japan in the 1950s and 1960s. It was then adopted by other East and Southeast Asian economies between the 1970s and 1990s, and by China in the 2000s (Johnston 2021; Palley 2012). There are signs that it may not be effective in the present, given the weak demand in developed countries and the difficulty for all emerging economies (which have a significant share of the global economy) to become net exporters.

Haddad and Pancaro (2010) note that while this strategy has been used successfully by Asian economies in the past, the global economic outlook is not as strong due to the low demand for developing countries' exports on the international market. At best, exchange rate undervaluation can boost exports of low-income countries in the short run. In the long run, this policy can have negative consequences. One of these negative effects occurs because an undervalued exchange rate is as good as a subsidy to exporters of tradable goods and a tax on consumers whose purchasing power has been reduced. Another consequence of maintaining the undervaluation policy for a long period is that "it may be difficult to exit from a policy of sustained undervaluation once it becomes necessary to do so. Governments may be pressured by influential lobbies that derive rents from the status quo" (Haddad and Pancaro 2010, 4).

An alternative strategy suggested for developing countries such as Nigeria and Indonesia is to de-emphasize export-led growth and focus instead on strengthening the demand side of the domestic economy. In this view, the new approach to development should focus on stimulating domestic demand and balancing imports and exports (Palley 2012; Johnston, 2021). In a similar line of argument, Nevin (2021) notes that there are so many barriers to exporting manufactured goods,[55] and it should not be the priority for Nigeria. Instead, Nigeria should choose a development path that is appropriate for the country, based on the realities of how the modern world works. Because the development path will not be the same as that of Asian countries. The focus should be on exporting Nigerian brands while keeping the brains at home. This means leveraging Nigeria's comparative advantage in high value-added services (which are already being exported) without Nigerians necessarily leaving the country. These include financial services, business outsourcing, coding, and the entertainment industry (movies, skits, and music) (Nevin 2021). In general, "Africa's growth industry may leapfrog from agriculture to the competitive IT industry sector" (Mine 2022, 96).

This line of thinking about an alternative growth strategy is plausible given the obvious obstacles faced by latecomers in trying to develop their economies. Much of the discussion on the relationship between the exchange rate and export-led growth has focused primarily on manufactured goods, and of course manufacturing is the cornerstone of industrialization. However, the exchange rate is still relevant for the export of raw materials, which is the bulk of Nigeria's and other developing countries' exports. Even the IT industry mentioned above requires a reliable exchange rate policy that guarantees the availability of stable foreign exchange earnings for exporters of IT services. It is also

55 For example; "Where is Nigeria going to export to? Which country will it displace in the market?" (Nevin, 2021)

important from the perspective of competitiveness in regional markets such as the ECOWAS and the African Continental Free Trade Agreement (AfCFTA).[56]

An exchange rate policy is expected to support and favor the export sector. However, as I discussed in chapter five, Nigeria's exchange rate regime is at odds with the preferences of commodity exporters. The requirement to remit export proceeds at an official rate that differs significantly from the parallel rate is a heavy export tax that exporters find intolerable. Currency undervaluation is supposed to be an export subsidy and a tax on imports. But in Nigeria's case, the opposite is true. This requirement motivates under-reporting or smuggling of exports to avoid administrative scrutiny, resulting in reduced government revenue and low foreign exchange inflows through official channels. To encourage the repatriation of export earnings, the CBN introduced the rebate scheme discussed in chapter five, which has not yielded positive results, if not created greater distortions. This contrasts with the strategy used by Indonesia to achieve the same goal of encouraging exporters. In Indonesia, exporters are offered tax incentives on condition that they allow their proceeds to remain in financial institutions for a certain period. This is in addition to the fact that the exchange rate system is not like Nigeria's, with dual rates that diverge widely.

As Nigeria's foreign-exchange challenges intensified, coupled with other factors, exports of goods and services continued to decline, especially after 2010 (see Figure 6.2). On the other hand, Indonesia's exports of goods and services have been growing steadily. This does not mean that the exchange rate is the main driver of Indonesia's exports, but

[56] Although perpetual reliance on commodity exports has its disadvantage, which derive from their low value relative to value-added goods and services, and the exposure to market volatility.

it plays a supporting role. Evidence on the impact of the rupiah's value on Indonesia's export growth is mixed (see chapter four). However, the stability of the exchange rate and the absence of strict controls, as in the case of Nigeria, can contribute to export growth and the repatriation of export earning

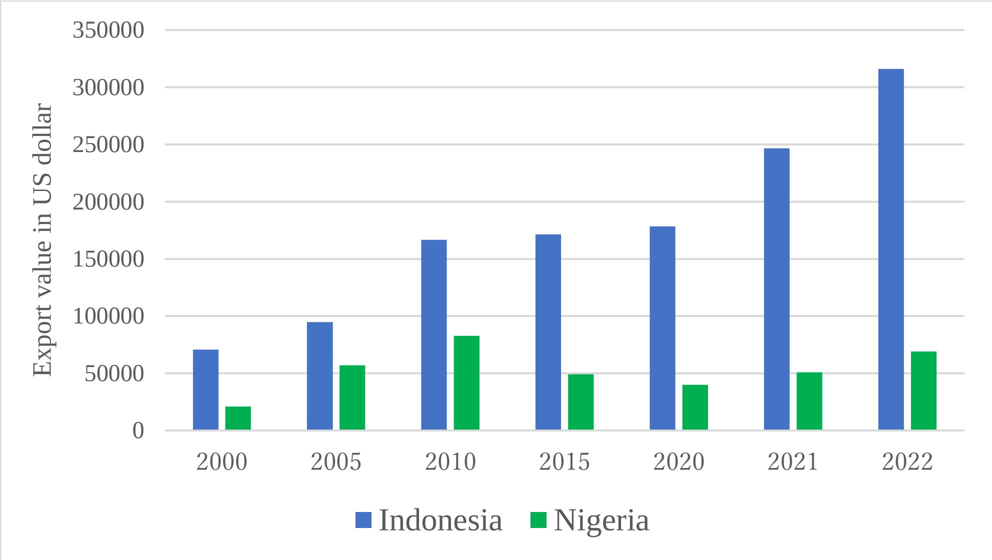

Figure 6.2 Exports of Goods and Services
Source: Author based on World Bank data

The consequences of Nigeria's exchange rate regime are not only detrimental to exports, but also hinder the inflow of foreign capital through direct and portfolio investments. Nigeria has attracted less FDI compared to Indonesia and other emerging markets. Figure 6.3 illustrates how Indonesia managed to attract FDI inflows after the Asian financial crisis. The figure shows that Indonesia's FDI inflows were negative from the year 2000 due to the devastating impact of the AFC, which caused huge capital flight from the country. With successful reforms and economic stability, FDI inflows resumed and grew strongly.

Investment in the tradable sectors is one of the main channels through which a stable and competitive real exchange rate policy can support economic development. Arguably, the market-based exchange rate system in Indonesia tends to inspire greater investor confidence than the complex system in Nigeria. Among other structural factors that make investment risky, the persistent shortage of foreign exchange is cited as a major impediment to FDI in Nigeria.[57] The scarcity is exacerbated by the existence of an overvalued official exchange rate that is difficult to access and the continuous depreciation of the naira at the flexible black-market rate.

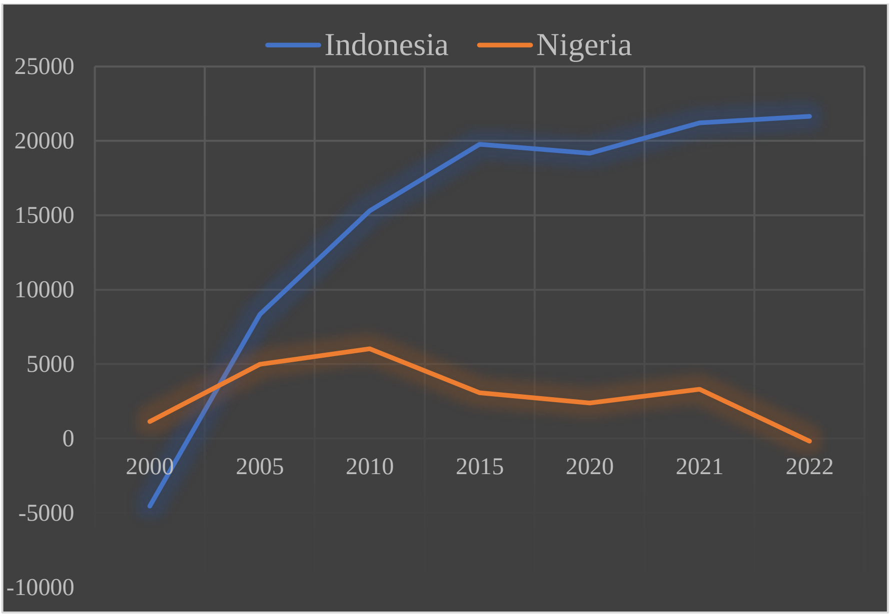

Figure 6.3 Foreign Direct Investment (FDI) Inflows
Source: Author based on World Bank data

[57] See, for instance, https://guardian.ng/business-services/sec-blames-lingering-fx-crisis-on-rising-foreign-investment-outflows/; https://african.business/2022/06/finance-services/why-is-nigerias-capital-importation-so-low ; https://businessday.ng/business-economy/article/massive-fdi-slump-spotlights-how-badly-nigeria-is-being-run/

The causal link between FDI inflows and the availability of foreign exchange is somewhat bidirectional. Low FDI inflows mean less foreign exchange in the economy, and the persistent shortage also discourages FDI and other domestic investment. The negative impact of foreign exchange challenges on FDI is also manifested in the inability of airlines to repatriate their earnings from countries. According to the International Air Transportation Association (IATA), Nigeria tops the list with the highest amount of blocked airline funds in 2022.[58] The top five countries account for 68.0 percent of all blocked funds. These include: Nigeria ($812.2 million), Bangladesh ($214.1 million), Algeria ($196.3 million), Pakistan ($188.2 million), and Lebanon ($141.2 million).

6.5 Conclusion

Decisions on exchange rate policy are supposedly made after considering local and international factors. The political economy of the exchange rate considers both domestic and international aspects of exchange rate policy. At the national level, domestic politics can pressure policy decisions from individuals and groups. The country's participation in a regional or international monetary regime may also influence the policy choice to align with the policies of other countries. Nigeria and Indonesia are involved in their regional trade arrangements, which entails cooperation on economic policies. However, the exchange rate policies of the two countries tend to reflect national priorities and objectives rather than being influenced by commitments to regional policy coordination and cooperation. This is changing due to regional initiatives in Africa and Asia, as well as the

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[58] https://airlines.iata.org/2023/06/04/iata-continues-tackle-blocked-funds
https://www.iata.org/en/pressroom/2022-releases/2022-12-07-03/

evolving developments in the international monetary system driven by the BRICS countries and China, which entails a reduction in the hegemony of the US dollar in international monetary relations. The adverse consequences of Nigeria's exchange rate system have manifested in macroeconomic instability and poor trade and investment performance. The system is detrimental to exports and impedes foreign direct/portfolio investment inflows. Indonesia's market-based exchange rate system tends to provide a more conducive macroeconomic environment that supports investment.

Chapter Seven: Conclusion

7.1 Summary of Findings and Conclusion

What are the persistent exchange rate challenges and their implication in Nigeria? Why and how did Indonesia succeed in fostering exchange rate flexibility and stability? Do policymakers in Nigeria and Indonesia implement exchange rate policies based on domestic and international political pressure or their independent discretion? How do exchange rate policies affect the economic performance of Nigeria and Indonesia? The preceding chapters of this dissertation have examined these questions using a combination of primary and secondary data analysis. The research investigated whether the exchange rate policies in Nigeria and Indonesia reflect domestic and international political pressures or policymakers' discretion. The goal was to gain insight into why Nigeria's exchange rate challenges persisted. This chapter summarizes the results of the study and draws conclusions. It also makes recommendations for policy and further research.

The first objective of the study sought to understand how the central banks of Nigeria and Indonesia use policy instruments to manage the flow and availability of foreign exchange in the foreign exchange market. The aim is to understand the similarities and differences in exchange rate management and its implications in Nigeria and Indonesia. The analysis in Chapter 4 traced some historical aspects of exchange rate policy to gain a better insight into how the different systems in the two countries emerged. While the two countries shared common institutions, political systems, and economic structures, their exchange rate policies diverged. In terms of institutional and policy similarities, the central banks of Nigeria and Indonesia have gained independence in the pursuit of their mandates since the democratic transitions in the early 2000s. However, Bank Indonesia appears to have greater independence than the Central Bank of Nigeria based on the findings of this study. I found evidence of the direct influence of Nigerian presidents on exchange rate policy decisions (section 5.2.4; 5.5.3). Interestingly, both Nigeria and Indonesia have a presidential system of government with similar political institutions (section 1.5.1).

The two countries also share similar vulnerabilities to volatility in international commodity prices, which affect exchange rate management. However, Indonesia's economy is relatively diversified, with more manufactured goods in the country's exports than Nigeria. This suggests the existence of multiple channels for the accumulation of foreign exchange reserves in Indonesia, although commodity exports remain important. On the other hand, Nigeria's reserves typically correspond to the rise and fall of crude oil prices. Both countries use reserves to intervene in the foreign exchange market. Therefore, the size and sources of reserves are important for both countries. However, there are differences in the nature and purpose of the intervention.

Bank Indonesia mainly sells foreign exchange to banks when excessive volatility or low inflows threaten the rupiah's value. Such intervention does not necessarily involve the allocation of foreign exchange for different purposes at different rates. In contrast, the Central Bank of Nigeria allocates foreign exchange to multiple windows at different rates. Until 2021, foreign exchange was also sold to the Bureau de Change. Although the multiple rates have been largely eliminated, the Investors and Exporters (I & E) rate, the only forex market officially recognized by the CBN, continues to coexist with the parallel market rate. In short, forex intervention in Indonesia is aimed at stabilizing the currency in the face of currency volatility, while in Nigeria it is aimed at maintaining the official exchange rate. The official exchange rate is then rationed to prioritized transactions and individuals. Given the additional pressure on limited foreign exchange resources and the increased risk of reserve depletion, the CBN engages in stricter demand management. This involves restricting the transactions eligible for the scarce official foreign exchange and requiring exporters to surrender their proceeds at the official rate. Bank Indonesia also sometimes engages in foreign exchange supply and demand management to stabilize the rupiah. However, the difference with Nigeria is that Bank Indonesia coordinates with the government to offer a tax incentive to exporters who convert and deposit their proceeds in rupiah. This is the supply side. On the demand side, the cap on spot forex transactions is sometimes adjusted downward for forex demand that has no documentation to prove a link to the real economy.

What political and economic factors influence these exchange rate policy choices in Nigeria and Indonesia? The second objective of this study attempts to address this question by unraveling the interaction between central banks and key stakeholders in exchange rate policy to examine who influences policy. Stakeholders include business interest groups, political elites, international financial institutions, and central bank officials.

I. Interest Groups Influence

The political economy of exchange rate literature predicts that interest groups influence decision-makers to implement policies consistent with the groups' preferences. The need to determine the extent to which preferences of interest groups and other stakeholders translate to policy decisions prompted the use of the process tracing method. I examined the intervening causal mechanism from preferences to outcomes. Beyond the theoretical configuration of interest groups' preferences for fixed or flexible exchange rate regimes and devalued or overvalued currency, the case of Nigeria reveals further nuances of interest groups' preferences.

- The results show that, regardless of the business orientation of interest groups in Nigeria, there appear to be few, if any, beneficiaries of a devalued naira. And since the overvalued exchange rate is the one controlled and rationed by the central bank, the lobby for exchange rate policy may be focused on efforts to obtain forex at the official exchange rate. This is the preferred choice of local manufacturers, importers, and those engaged in currency trading – the Bureau de Change (section 5.2.1).
- Exporters, on the other hand, prefer to have control over their export proceeds in terms of the rate at which they can sell the dollar proceeds. In other words, the exporters prefer not to sell their proceeds at the official rate because of the substantial black-market premium in Nigeria. In the absence of such a requirement in Indonesia, the exporters of palm products, for example, prefer stability to currency depreciation (section 5.3.1). A weak rupiah should ideally benefit Indonesia's palm oil industry because the production process involves almost 100 percent local content. However, most of the exporters borrow from foreign financial institutions, and a weak local currency increases the amount of loan repayments. This is somewhat consistent with the exporter's dilemma highlighted in some studies (see section 2.3.5.1). Another factor influencing the choice of Indonesian exporters is like Nigeria's situation, where local commodity suppliers adjust their prices according to changes in international prices. Commodity exporters in both countries share the view that currency depreciation is more beneficial to farmers. This deeper dimension of preferences is not adequately

captured in the political economy literature discussed in chapter two.

- Regarding access to policymakers and attempts to influence exchange rate policy, the central banks of Nigeria and Indonesia engage interest groups representing relevant sectors of the economy. This study shows that the accessibility of interest groups to the CBN varies over time and under the tenure of different governors (section 5.2.2). There is also a convergence of interests among different groups, for example, in the clamor for exchange rate unification. Such advocates include the local manufacturers, whom the CBN claims to support with the official exchange rate. The CBN did not respond to interest groups' demand for exchange rate unification. However, the influence of manufacturers is manifested in other aspects of exchange rate policy as the study revealed (section 5.2.4). In Indonesia, there is little room for interest groups to influence the central bank's policy direction, at least not through direct lobbying. Alternative channels of influence through media campaigns cannot be ruled out. However, this study did not find evidence that Bank Indonesia's policies reflect the demands of interest groups (section 5.3.3).

II. <u>Role of Political Elite</u>

Politicians have a lot at stake in exchange rate policy because it can affect their popularity. In Nigeria, in addition to the electoral advantage of an overvalued naira, the exchange rate policy confers special benefits to politicians. Some politically connected individuals receive the official exchange rate from the central bank to pay for their international transactions or to resell the forex on the parallel market to make huge profits from the black-market premium. One of the pieces of evidence for this comes from my interview with a key player in Nigeria's foreign exchange market, who revealed that some powerful individuals, including members of the parliament, have dozens of Bureau de Change licenses through which they obtain the official exchange rate (section 5.2.5.3).[59] Roy et al. (2022,36) also found that powerful political interests have been able to extract illicit profits because of the foreign exchange mechanism instituted by the CBN. These beneficiaries are incentivized to maintain the status quo and prevent a market-based system. I also found that President Muhammadu Buhari's preference for a strong naira is a major obstacle to policy changes between 2015 and 2022, when the exchange rate challenges intensified (Section 5.5.3; 5.7). The president's preference may have been driven by an ideological stance on the economic role of the state and a fear of the political backlash that could result from currency devaluation.

In Indonesia, every democratically elected president has shown commitment to upholding the institutional autonomy of Bank Indonesia when executing monetary and exchange rate policies. The lessons of the Asian financial crisis may have influenced this commitment. Nonetheless, there is a current movement among certain Indonesian politicians to introduce reforms that could potentially alter the independent status of the central bank. Comparatively, the level of political influence on exchange rate policy in Nigeria outweighs that in Indonesia.

III. Assessing the Influence of International Financial Institutions

The Bretton Woods institutions often use their instruments of persuasion or coercion to force national governments to pursue structural and institutional reforms. Indonesia

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[59] See, also, this newspaper report https://saharareporters.com/2021/06/17/exposed-nigerias-central-bank-governor-emefiele-bribes-silences-national-assembly-members

represents a classic case of IMF influence in action when the country was hit by the Asian Financial Crisis (AFC) between 1997 and 1998. Indonesia floated the rupiah in 1997 and moved to a market-based exchange rate system. With this policy shift, the IMF's subsequent advice to Indonesia emphasized the system's sustainability and limited intervention in the foreign exchange market to contain excessive currency volatility. In general, the Fund's exchange rate policy recommendations for Indonesia seem to have diminished since 2014. What continues to appear in the Article IV consultation reports between 2015 and 2022 on exchange rate policy is largely an admonition to BI to maintain exchange rate flexibility. It can be argued that the AFC forced Indonesia to adopt a market-based exchange rate regime. Moreover, the fear of a repeat of similar traumatic experiences coupled with the IMF program has incentivized Indonesians to sustain the system, along with greater independence for Bank Indonesia. There appears to be little or no room for the IMF's persistent advice on policy options, given that the system has generally been appropriate over the past decade (Section 5.4.2).

The IMF stabilization program during the AFC arguably gave Indonesian technocrats the opportunity to implement necessary reforms that were initially opposed by powerful groups (Martinez-Diaz 2006). Thus, the floating of the rupiah during the crisis was not forced by the IMF per se, but retaining the system was. The IMF program necessitated the strengthening of central bank independence, and the Fund took a coercive stance against changes that would jeopardize the central bank law (Martinez-Diaz 2006). I argue that the IMF's coercive instrument created an enabling environment for the successful implementation of the nascent floating exchange regime introduced at the beginning of the AFC.

Nigeria did not share Indonesia's experience of a severe economic crisis that would provide the impetus for a similar IMF intervention. But since the early 2000s, the Fund has been advising Nigerian policymakers to abandon multiple exchange rates and adopt a more market-based approach to foreign exchange transactions. This is the IMF's most enduring policy advice to Nigeria. In some cases, the CBN may have followed some of the Fund's recommendations, as evidenced by certain reforms in the foreign exchange market. In other cases, the CBN remains reluctant to implement the recommended policy(s) or chooses to make incremental efforts towards implementation, such as the move to a market-based exchange rate regime.

IV. <u>Central Bankers, Exchange Rate Management, and Political Pressure</u>

The choice of an exchange rate policy could reflect the preferences of external stakeholders or the discretion of central bankers. This discretion stems from the independent status of the central banks. Although my results show that Indonesia's central bank is more independent, central bankers in both countries believe they are sufficiently autonomous. They also share similar views on the appropriateness of floating exchange rates in their countries.

In Nigeria, the results show a divergence of views between the official position of the central bank and the staff on some aspects of exchange rate management (section 5.5.2). For instance, the CBN often emphasizes that the official exchange rate has contributed to price stability and that the parallel market exchange rate has an insignificant impact on inflation. In contrast, most of the CBN staff in my sample do not agree that the official exchange rate effectively controls inflation. Also, most of them agree that the parallel market exchange rate impacts inflation. Additionally, the staff do not believe in the notion that unification of exchange rates will lead to hyperinflation, as is often argued by the CBN and other analysts.

What explains the contrast between the staff's perspective and the CBN's institutional position on exchange rate management? I find a possible reason in this study. An experienced staff of the CBN revealed to me in an Interview that "policymaking at the CBN used to be bottom-up, but unfortunately, it is now top-bottom. The top management decides the policy and those at the bottom are required to defend and implement the policy as it is (Interview 9)." This is where political considerations come into play. The higher echelons of the Bank may share the views of the staff on pragmatic policies, but they may be constrained by politicians, as in the evidence presented in this study on the role of the Nigerian president in policy decisions. Consistent with this evidence, a significant number of the CBN staff also acknowledged that political pressures motivate changes in exchange rate policy in Nigeria. This contrasts with Indonesia where the central bankers believe that political pressure due to elections or from other stakeholders does not influence the policy decisions of BI (section 5.6.2).

Regarding the influence of interest groups, there seems to be little, if any, impression among the central bankers that interest groups influence the policy direction of BI. On the other hand, their Nigerian counterparts tend to be neutral on whether the final policy decisions of the Board of Governors and Monetary Policy Committee consider the demands of interest groups. They simply remain ambivalent because they may have recognized the political clout of powerful groups like the Manufacturers Association of Nigeria (MAN), but are not sure how much they influence the policy.

Finally, the question of coercion and persuasion of the Bretton Woods institutions. Indonesian central bankers did not unanimously disagree whether the International financial institutions sustained their influence on Indonesia's policy decisions post-crisis. The findings, however, indicate that given the continuous improvement of the exchange rate system, the rationale for IMF's recommendation and influence simply disappears in Indonesia. In Nigeria, most of the central bankers believe that International financial institutions influence Nigeria's exchange rate policy decisions. As revealed in this study, some of the exchange rate reforms by the CBN may have corresponded to, or necessitated by IMF's demands, but the Central Bank resisted the elimination of exchange control.

In conclusion, this dissertation examined the extent to which the exchange rate policies in Nigeria and Indonesia reflect domestic political pressures, conditionalities of International Financial Institutions, commitment to regional monetary cooperation, or policymakers' discretion. Some influential interest groups like the Manufacturing Association and Bureau de Change operators have had some influence on Nigeria's exchange rate policy. However, this influence is determined by the central bank governor and perhaps the prevailing economic condition at a given time, including the level of international reserves available to support forex interventions. On the other hand, interest groups in Indonesia have no direct influence on exchange rate policy. The influence of the IMF on Indonesia's exchange rate policy was evident during the AFC, when the Fund's conditions required reforms, including the maintenance of a floating exchange rate regime along with central bank independence. The IMF was unable to persuade Nigeria to abandon its multiple exchange rate system, in part because it did not experience similar economic crises faced by Indonesia. The exchange rate policies of the two countries also tend to reflect national priorities and objectives rather than being influenced by commitments to regional policy coordination and cooperation.

Based on the analysis in this dissertation, I argue that Nigeria's persistent exchange rate challenges, particularly in the past decade, which is associated with the failure to adopt a liberalized exchange rate system, cannot be attributed to either pressure from interest groups and international actors or the poor judgment of central bankers. Instead, the main obstacles hindering a policy shift when the exchange rate challenges escalated, especially from 2014 onwards, are twofold. First, the dominant influence of Nigerian President Muhammadu Buhari (2015-2023), who favors exchange control and an overvalued currency. Second, the influential elite, including members of parliament, who benefit from the system. These two factors have played a significant role in impeding the adoption of a liberalized exchange rate system in Nigeria, despite the economic conditions indicating the need for a policy shift due to declining reserves and low investment.

The persistence of Nigeria's exchange rate dirigisme has had a negative impact on exports of goods and services, inflows of foreign direct investment, and macroeconomic stability. A combination of these factors makes economic diversification difficult, if not impossible, which then translates into lower economic performance, thereby dampening the prospects for economic development.

7.2 The Way Forward

One of the key findings of this research is the effect of the weak independence of Nigeria's Central Bank, as reflected in the interference of the country's president(s) and other actors in important policy decisions. In addition to influencing the change or maintenance of policies, the frequent dismissal of governors of the central bank (which I did not discuss) demonstrates an explicit indication of the weak independence of the Bank. In 2014, President Goodluck Jonathan sacked Sanusi Lamido Sunusi, while President Bola Tinubu suspended Godwin Emiefele in 2023. Both scenarios were politically motivated, though I do not intend to delve into the political imbroglio that characterizes the two cases. The key takeaway is that the removal of a CBN governor by a Nigerian president, regardless of their intentions, indicates the absence of institutional independence, which undermines the confidence of both foreign and domestic private sector stakeholders. However, institutional independence may grant excessive discretionary powers that are susceptible to abuse by the governor and management of the central bank. This is the dilemma of central bank independence in Nigeria. Nonetheless, the central bank must be insulated from political interference. Roy et al. (2022, 33) also suggested that the independence of the CBN should be strengthened to ensure that undue influence in foreign exchange management is minimized and noted the need to curtail the autonomy of the CBN Governor. However, I differ slightly with Roy et al. (2022) on how to achieve this. They recommended the introduction of a fixed tenure for the governor, with the start and end dates tied to the electoral cycle, and extending the responsibilities of the Monetary Policy Committee (MPC) to include exchange rate management.

What I would recommend is the empowerment of the sub-national governments as federating units to become veto players in the affairs of the CBN to counterbalance the excessive power of the President and the Federal Government in influencing the decisions of the Bank that permeate the entire country. The Nigerian constitution already provides for consensus among state governments on matters of the federation, such as revenue mobilization and allocation, and other national economic policies. Some key decisions regarding the central bank should also be subject to a similar political consensus. This can be a mechanism of domestic restraint. Therefore, the power to appoint the CBN governor should be exercised not only by the president and the National Assembly, but also by the 36 state governors. In this way, the governor will not feel that he/she is the president's appointee and is likely to have the courage to reject requests that are inimical to the national economic interest. In addition, the appointment of deputy governors should depart from the existing practice of appointing individuals from outside the Bank, often from the commercial banking sector. Deputy Governors should be selected from among the directors of the CBN because they have extensive experience in the conduct of monetary and exchange rate policy.

If domestic solutions to curb excessive political interference in the CBN's functions are very difficult to implement, a source of external restraint may be the country's commitment to a regional or international currency arrangement or, in extreme cases, IMF intervention. A harsh IMF program may be inevitable as a last resort if there is no domestic consensus to pursue pragmatic policies in the face of deteriorating economic conditions.

The second recommendation for ameliorating Nigeria's foreign exchange challenges has to do with the Bureau de Change (BDC). The CBN should strengthen its monitoring and supervision of BDCs and enforce stiff penalties on foreign exchange trading by unlicensed operators. The parallel foreign exchange market in Nigeria thrives in part because of complex documentation at commercial banks, lack of sufficient foreign exchange to meet the huge demand, and corruption. The documentation process can be easily addressed using technology, but stimulating the supply of foreign exchange requires several measures to increase economic productivity and manage frivolous demand. There are already numerous proposals on how the country can encourage foreign exchange inflows by addressing structural issues that hinder economic productivity. My argument throughout this research is that in addition to economic aspects such as boosting exports of services and agricultural products, increasing crude oil production, and eliminating refined fuel imports by building/rehabilitating local refineries, political obstacles to effective foreign exchange management must be addressed. The political obstacles are reflected not only in the maintenance of harmful policies, but also in the opportunity they provide for rent-seeking and corruption.

Corruption has become a systemic scourge in Nigeria and is one of the major contributors to the exchange rate challenges. Roy et al (2022, 36) argued that the tight foreign exchange controls enforced by the CBN in Nigeria have created opportunities for increased corruption and illicit financial flows. Public funds misappropriated in naira are often converted into US dollars and other foreign currencies through the parallel market, leading to further depreciation of the naira. This is prevalent among public officials, as observed in the case of legislators by the former Chairman of Nigeria's Independent Electoral Commission (INEC), Professor Attahiru Jega, who publicly revealed that some members of the National Assembly are notorious for demanding bribes from the heads of government departments and agencies under the guise of oversight functions.[60] These bribes are often paid in hard currency, creating additional demand for foreign exchange and devaluing the naira. Frankly, Nigeria's elites have not shown a real commitment to controlling corruption, which is a major factor exacerbating Nigeria's exchange rate problems.

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[60] https://www.premiumtimesng.com/news/headlines/270056-just-innational-assembly-members-notorious-for-bribe-seeking-jega.htmlb

7.3 Future Studies

The independence of a central bank is widely recognized as a catalyst for instilling confidence in monetary and exchange rate policies. As shown in this research, Bank Indonesia achieved its political insulation due to the financial crisis and the subsequent IMF program. After two decades of enjoying great autonomy, there are attempts by some Indonesian politicians to reverse this status by amending BI's laws. A promising avenue for further research is to explore how central bank independence can be promoted sustainably in developing countries like Nigeria and Indonesia. Future research endeavors could also empirically investigate how corruption and rent-seeking exacerbates Nigeria's exchange rate challenges, employing the same process tracing method used in this dissertation. Finally, it is crucial to undertake a comprehensive analysis of the implications of regional and international monetary initiatives, such as those facilitated by AfCFTA, ASEAN, and BRICS, and their potential impact on shaping the currency policies of not only Nigeria and Indonesia but also other developing economies.

Postscript

The analysis in this study was conducted before recent events in Nigeria that have impacted exchange rate management. The governor of the Central Bank of Nigeria, Godwin Emiefele, was suspended on June 9, 2023, by the newly inaugurated president, Bola Ahmed Tinubu, who was sworn into office on May 29, 2023. On June 14, 2023, the CBN made changes to Nigeria's foreign exchange market, including abolishing market segmentation with multiple rates, and ending export rebates and related schemes.[61] These changes support my argument that the CBN is heavily influenced by the president and that former President Buhari hindered the liberalization of the foreign exchange market. However, there is skepticism about the sustainability of the new policy due to political and economic reasons, and concerns about expertise in managing the new system. The Economic Intelligence Unit predicted that Nigeria may revert to tighter exchange controls to stem the decline of the naira's value and noted that the CBN lacks experience in conducting monetary policy under a floating exchange rate regime.[62] Although the official and parallel market rates almost converged after the attempted liberalization of the exchange rate system, the gap between parallel and the I & E (official) rates reemerged. The CBN has indicated that it will intervene to stabilize the market and slow down the depreciation of the naira, but this requires sufficient external reserves. However, the CBN's financial report for the first time in about seven years in August 2023 revealed that the net reserves were less than the initial figures indicated. This may lower confidence in the naira by both Nigeria's residents and foreign investors. It implies a significant challenge in managing Nigeria's exchange rate unless the government increases oil output and adopts alternative measures to generate more foreign exchange.

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[61] See CBN circular https://www.cbn.gov.ng/Out/2023/CCD/Operational%20Changes%20to%20FX%20Market.pdf

[62] See, https://leadership.ng/economist-intelligence-unit-expect-nigerias-return-to-cbn-controlled-exchange-rate/

Appendix

List of Interviewees[63]

Code	Gender	Affiliation	Date	Duration (minutes)	location
Interview 1	Male	Nigerian Association of Chambers of Commerce Industry Mining and Agriculture (NACCIMA)	27/09/22	40	Abuja
Interview 2	Male	NACCIMA	4/10/22	51	Phone
Interview 3	Male	National Sesame Seed Association of Nigeria (NSSAN)	4/10/22	44	Phone
Interview 4	Males (3) Female (1)	Manufacturers Association of Nigeria (MAN)	7/10/22	50	Zoom
Interview 5	Male	Cocoa Association of Nigeria (CAN)	01/10/22	31	Phone
Interview 6	Male	Major exporter of Ginger	28/09/22	52	Phone
Interview 7	Male	Association of Bureau de Change Operators of Nigeria (ABCON)	14/10/22	60	Phone
Interview 8	Male	Central Bank of Nigeria (CBN)	29/09/22	30	Abuja
Interview 9	Male	Central Bank of Nigeria (CBN)	01/10/22	35	Phone
Interview 10	Male	Bank Indonesia (BI)	2/1/23	70	Zoom
Interview 11	Male	Indonesian Palm Oil Association	20/01/23	32	Zoom

[63] The position of the interviewees in their respective affiliations is not included in the table, to preserve their anonymity. The central bankers have at least twenty years of working experience to enable them give insightful information on exchange rate policy. The interest group interviewees are leaders and key executives of their respective business associations who can share valuable information about their policy preferences and interaction with policymakers.

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