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How exchange rate (mis)management leads to illicit financial flows: a political economy analysis of feasible reform in Nigeria

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Acronyms and abbreviations

BDC	Bureau de Change
BTA	business travel allowance
CBN	Central Bank of Nigeria
FDI	foreign direct investment
FEMM Act	Foreign Exchange (Monitoring and Miscellaneous Provisions) Act
Forex market	foreign exchange market
I&E	Investors and Exporters
IFEM	Interbank Foreign Exchange Market
IFFs	illicit financial flows
MPC	Monetary Policy Committee
NAFEX	Nigerian Autonomous Foreign Exchange Rate
PTA	personal travel allowance
RDAS	Retail Dutch Auction System
SME	Small and medium enterprise
WDAS	Wholesale Dutch Auction System

Executive summary

Illicit financial flows (IFFs) remain a major issue in extractive economies such as Nigeria. Furthermore, strict capital controls and fixed exchange rates can often provide incentives for IFFs in low governance or resource-constrained economies. This paper explores the relationship between the exchange control regime and IFFs in Nigeria.

Exchange rate regimes are often a tool in the arsenal of low and middle income countries like Nigeria that are working to encourage economic growth and development. Interventionist policies such as pegged, step-locked or fixed exchange rates are commonly adopted by governments in a bid to incentivise certain sectors. However, this policy tool requires political discipline and enforcement capacity to ensure that it is effective and that it is not distorted for corrupt or illicit purposes.

The exchange rate regime in Nigeria is managed by the Central Bank of Nigeria (CBN, or 'the Bank'), which is responsible for maintaining price stability and exchange rate policy to safeguard the value of the naira. The role of the CBN and how it fulfils its functions has evolved over time in response to political and financial pressures and influence. Although the legislative framework developed in Nigeria has sought to establish independence for the Bank, it contains reporting obligations to the President and grants the powers of appointment for the Governor of the CBN to the President. Exchange rate regimes have been adopted haphazardly and they have often reinforced mechanisms for rent-seeking behaviour by the political and financial elite, leading to significant corruption and IFFs. In order to maintain a stable exchange rate, the foreign exchange market has had to be closely managed, with the number and value of transactions processed officially declining with the drop in the country's foreign exchange reserves. This has inadvertently created an unofficial or black foreign exchange market to absorb the excess demand that cannot be met in the official market.

Based on a political economy analysis of feasible reforms, this paper puts forward the following recommendations to address some of these issues:

1 The appointment process for the Governor of the CBN should be amended and aligned with the electoral cycle to further protect the true independence of the Bank.

2 Responsibility for foreign exchange policies should be placed with the Monetary Policy Committee (MPC) to encourage transparency and collaboration and to reduce the risk of political capture.

3 A single exchange rate regime should be adopted using a managed float, which could close off the leakage points in the current financial system that can be exploited for nefarious purposes.

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1. Introduction

A key objective of the foreign exchange management policy in low and middle income countries has been to limit balance of payments deficits. This can be contrasted with high-income countries, where the focus of foreign exchange management centres on achieving optimal exchange rate levels via minimum intervention by central banks and maintaining orderly trading conditions in foreign currency markets. In addition, the distributional and welfare implications of foreign exchange in import-dependent low and middle income countries like Nigeria add another layer of complexity to the exchange control regimes.

A significant percentage of Nigeria's foreign exchange is earned from oil exports. Declines in the price of oil have impacted the availability of foreign exchange and hence the exchange rate regime matters even more. In the last 40 years, periods of low oil prices have often meant that receipts both from oil and non-oil exports have remained consistently below expenditure on imports, leading to continuous pressure on the country's external reserves.

The CBN is responsible for the management of foreign reserves, the exchange policy and the supervision of the foreign exchange market. The CBN is involved in the foreign exchange market both as an intermediary of government-related foreign exchange transactions and as the implementer of foreign exchange policy. These obligations and responsibilities sit within a broad framework that includes the legal framework, institutional architecture and policy priorities of the Bank and the government. However, the scope and extent of these responsibilities have evolved over time in response to changing social, political and economic circumstances in Nigeria. These circumstances have included a high degree of corruption, political instability and insecurity, poor macroeconomic management, rent-seeking and weakened institutions, all of which make effective governance difficult (Gboyega et al., 2011; Roy, 2017; Usman, 2020).

In governance- and resource-constrained settings, stringent capital controls and fixed exchange rates may have a more direct effect on increasing corruption and IFFs. The impact of highly regulated exchange rate regimes and tight foreign currency controls on increasing IFFs in poor governance settings is twofold. Firstly, the tighter and less competitive foreign currency rules create incentives for the political elite to seek preferential access to the country's foreign exchange reserves for the purpose of extracting profits by arbitraging the foreign exchange obtained at a preferential rate (key informant interview, 2021). Secondly, citizens who do not have preferential access to the country's foreign currency reserves are left with no choice but to seek foreign exchange from other means or markets labelled as illegitimate by the strict controls. Both lead to corrupt behaviour but for very different reasons.

One area in the policy discourse that has not been significantly explored is the relationship between corruption and exchange control regimes and exchange rate systems in low and middle income countries such as Nigeria. The discourse on the extent of capital controls is normally divided into two schools of thought. One argues that loose capital controls and flexible foreign currency exchange regimes are part of the institutional mechanisms that allow global illicit flows to thrive, in the sense that illegal money becomes easier to move (Reed and Fontana, 2011). The other argues that tighter capital controls could lead to the creation of currency black markets and illegal channels for transferring funds that could be used for the purposes of tax evasion and money laundering, etc. (OECD, 2016). This debate notwithstanding, exchange rate regimes can become a key driver of corruption, including IFFs, which constrain developmental outcomes.

In this paper we highlight how the CBN is caught between legitimate developmental needs and the political considerations of the ruling coalition. Alongside the conventional aim of providing stability to the country's balance of payments, the exchange rate mechanism has often been used as industrial policy (with preferential forex (foreign exchange market) rates for sectors deemed industrially strategic or developmentally necessary). As we outline, as well as exchange rates being used as industrial policy in Nigeria, they also reflect the agendas of various political–business interests. The formulation of exchange rate policies in this way can often be linked to the nature of the prevailing business–government relationship. This has potential for corruption, including heightened IFFs, and this is because of specific political economy and business–government links in Nigeria.

We do not argue the merits or otherwise of using exchange rates as a lever to nudge economic growth. Low and middle income countries (and increasingly high income countries) have often deployed interventionist policies to nudge or propel economic growth. Policies have been used to influence the exchange rate or to use preferential exchange rates for specific imports to incentivise select sectors. While the objectives of such policies are developmental, the achievement of these outcomes do not just depend on how the incentives are designed. They also depend on the enforcement capability of the implementing agencies. Disciplining those who receive policy incentives is a function of both political capability and technical capacity. When these conditions are absent or weak, the (sometimes) unintended consequences result in the policies being distorted and captured and on them not delivering their intended developmental outcomes (Khan, 2011).

This is the reason why our analysis would be incomplete without considering the *influence that political factors play in the independence of the CBN*. These political considerations are often inextricably intertwined with the history and political economy of the country. Even if the CBN is considered to enjoy a high degree of autonomy, it is not completely insulated from political pressures. In the Nigerian context, these political pressures are somewhat insidious and have a significant bearing on the capacity of the CBN to implement policies. In particular, the financial needs of powerful groups, especially of the government and the banking sector, have shaped the policy trajectories of the CBN (Ani, 2019). Examples of policies implemented by the CBN include the Anchor Borrower Programme, which sought to address food security issues and boost large-scale agricultural production in the country by offering cash and in-kind loans to smallholder farmers, and the Cashless Policy, which levied between 2% and 5% charges on cash deposits and withdrawals at banks in six states and the Federal Capital Territory (FCT). The Cashless Policy was ultimately struck down by the Federal High Court as being unconstitutional, while the future of the Anchor Borrower Programme is currently in doubt due to the high rate of default on the loans (Onele, 2021). Powerful interest groups have strong incentives to maintain the regulatory status quo and capture reforms, even at the expense of social welfare. Any changes to the system therefore have to contend with the needs of interest groups that have so far benefited from the current system and, as such, have huge incentives to further obstruct any regulatory reform processes.

The remainder of this paper critically analyses an area of policy incoherence in the IFF debate. We explore the various definitions of IFFs and seek to map out the global scale and scope of the problem. We also address the occurrence of IFFs in Africa and Nigeria, with an emphasis on foreign exchange markets (including foreign direct investments or FDI) and the various regulatory frameworks established and administered over the years by the CBN. Finally, we put forward some policy recommendations to address legal loopholes in the foreign exchange regime.

2. Framing corruption and IFFs

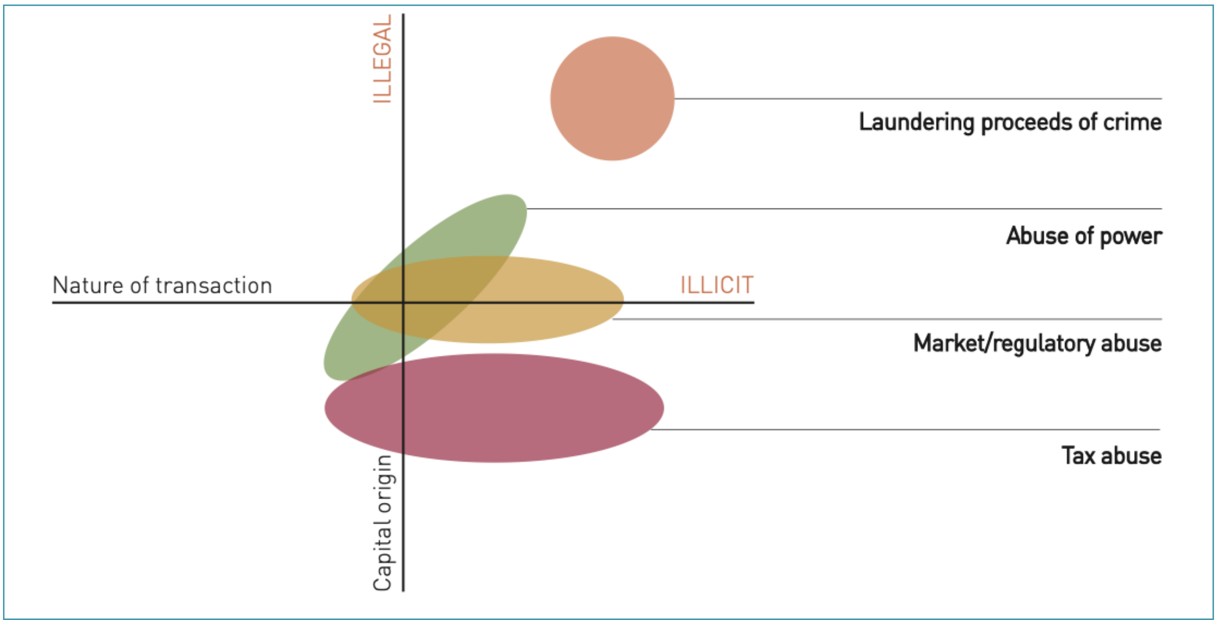
2.1. Defining IFFs

Generally speaking, IFFs describe many different types of financial flows. Consequently, analysis of IFFs is complex, layered and often necessarily multi-jurisdictional. The complexity of the issue is magnified by the fact that it often touches on aspects of fiscal policy and taxation, trade and balance of payments, financial-sector stability and inclusion, banking and exchange controls and exchange rate regimes, and many aspects of the judicial system including anti-money laundering and countering of terrorist financing. Such flows also have a significant impact on the domestic political economy of developing economies and are therefore increasingly studied for their distributional consequences.

The wide range of possible participants in conduct that may give rise to IFFs – including individuals, government or corporations, or a combination of all three – adds further complexity. Conduct giving rise to IFFs can vary greatly, ranging from tax evasion or customs fraud by individuals, to money laundering (including by public officials), the laundering of funds through political corruption, transactions involving cross-border crime, or the violation of exchange regulations. It can also include conduct by multinational and other corporate entities to maximise profits and minimise tax burdens, such as through transfer pricing, trade mis-invoicing and profit shifting.

The literature has both broad and narrow definitions of IFFs. The narrow formulations refer to cross-border financial flows involving funds that are illegally earned, transferred or utilised (Global Financial Integrity 2017)Under such a narrow definition, there is a requirement of illegality in at least one point in the transaction for the flow to be characterised as an IFF. The World Bank formulation of IFFs, for instance, refers to 'cross-border movement of capital associated with illegal activity or … money that is illegally earned, transferred or used' (World Bank, 2017). Similarly, as Figure 1 shows, the High-Level Panel on Illicit Financial Flows from Africa's (2021) definition of IFFs refers to funds transferred between enterprises or countries that have illegal origins or for an illegal purpose, or financial transfers linked to illicit activity.

Figure 1. Origins of illicit financial flows



Source: High-Level Panel on Illicit Financial Flows from Africa (2021: 23).

The broader formulation includes not only actions taken for the purpose of circumventing the law, but also actions that are taken without an underlying economic justification for the purpose of circumventing the spirit of the law. An even broader formulation would characterise any financial flow as an IFF that has a negative impact on an economy, once all its direct and indirect effects in the context of the specific political economy of the society are taken into account (Blankenburg and Khan, 2012).

The strictly legalistic definition allows for an element of objectivity. However, one critical aspect that is overlooked in such a definition is whether the flows, if stopped, would improve developmental outcomes in the country. In other words, are the illicit flows actually damaging for development?

The often-familiar response to norm-setting by the adoption of definition is the reliance on laws and other formal rules because of their relative precision to delineate conduct. Research from the Anti-Corruption Evidence (SOAS-ACE) consortium posits that a reliance on the law and formal rules in the form of a legal definition of IFFs (a definition that delineates the use and transfer of funds) is problematic in at least two important regards (Khan et al., 2019).

Firstly, in many jurisdictions, the law lacks legitimacy and consistent meaning, and so formal rules tell us little about social norms and behaviours. In this formulation, a legal regime in a state that is dominated by narrow interests can expropriate resources in illegitimate ways and transfer them out of the country via legal means. This can include government expropriation of property owned by the opposition or their supporters via regulatory policies or laws, for instance. A reliance on the formal rules in this context would not classify such movements of funds as IFFs, but the conduct would nonetheless be problematic. In other words, this is an example of actions that may be legal without being legitimate. If we want to capture these socially damaging flows as IFFs, a strictly legal definition would generate many false negatives.

Secondly, reliance on laws and formal rules could also give rise to false positives. Many firms in low- and middle-income countries do not have adequate capacity to adhere to the often-complex formal rules and mechanisms governing cross-border financial transactions. In some cases, regulations can be so complicated – for instance, with tight and unreasonable capital controls – that smaller traders inadvertently contravene the rules. In such cases it is possible that some cross-border flows break complex and unnecessary laws inadvertently and are not necessarily the damaging ones we want to target. In some extreme cases of false positives, a fear of government expropriation or state capture could result in the illegal (by the standards of that country) transfer of funds by entrepreneurs and businesses. The policy solution here is obviously not to criminalise such entrepreneurs but to ensure the threat of expropriation is removed. Ignoring these differences in political economy across countries and focusing only on the enforcement of laws could therefore have unintended consequence of easing and entrenching the control and/or economic capture of authoritarian or populist governments. It is therefore critical to differentiate between illegitimate and illegal flows while defining IFFs.

A further discussion includes characterising IFFs as a distinct form of corruption (Khan et al., 2019). Although whichever definition is used, the cross-border movement of funds generated by corruption will always be classified as IFFs. Classifying IFFs as a separate form of corruption will only lead to 'double counting', however, when the funds involved in IFFs are generated by other forms of corruption. Hence, while we investigate corruption linked to exchange rate mechanisms in this paper, when our research has pointed to the possibility of the exchange rate mechanism giving rise to IFFs, we have indicated this as well.

2.2. Designing feasible and effective reform to tackle IFFs

One critical issue to consider while designing policy reform for an organisation that has responsibility for overseeing the monetary system, and that also has significant political influence, is the issue of 'enforcing rules on the enforcer'. Anti-corruption policies have to be both *feasible and effective* (which forms the basis of the SOAS-ACE framework). A strategy that is feasible to implement must also have high impact (i.e., positive outcomes), and a strategy that is potentially very impactful also has to be feasible in terms of implementation. Feasibility and impact therefore have to go together to achieve results.

Effective implementation can sometimes be achieved if there are strong self-interested incentives on the part of relevant stakeholders to engage in horizontal peer monitoring. If the peer monitoring and pressure is sufficiently strong, this can constrain players (including enforcers) to 'play by the rules'. When these incentives and abilities on the part of peers is absent, a second approach is to redesign policy in completely new ways so that once again a configuration of interests and capabilities emerges such that the enforcement of anti-corruption regulations is possible by peer monitoring by actors from within the sector. We have argued that these strategies are necessary in low and middle income countries because relying entirely on the enforcement of anti-corruption strategies by an external agency ignores the problem of 'enforcing rules on the enforcer' in contexts where the rule of law is weak (Khan et al., 2019). The challenge for our framework, which is usually applied at the sectoral or sub-sectoral level (e.g., electricity, skills training, extractives, absenteeism in primary health care) is that identifying such strategies is likely to be challenging for a central bank in a low and middle income country.

Conventional policy reform for economic agencies like central banks tends to focus on technical issues, for instance whether to rationalise multiple exchange rates or apply a peg to the exchange rate. However, implementation depends on the interests and capabilities of affected parties and how they use their influence to achieve outcomes favourable to themselves – and on how competing interests can check these activities. Policy reform suggestions like strengthening enforcement of regulations are often not *feasible,* because key government agencies like the central bank in many low and middle income countries are likely to be influenced by powerful constituencies and stronger enforcement might not be in their interests. Nor is it *effective* to identify additional interventions because many such interventions may not by allowed constitutionally.

The fundamental premise of the SOAS-ACE framework – which is to find effective opportunities for self-interested rule enforcement by stakeholders – applies even here in the context of the CBN. Therefore, despite challenging parameters, we have looked for feasible policy responses that take into account a configuration of interests and capabilities that may make some reform plausible. The CBN is an internationally respected central bank as it is responsible for running one of the most sophisticated economies in the developing world. As such, our recommendations leverage the value of reputation for critical stakeholders, because this can be a powerful countervailing coalition that limits narrower interests. This is especially true since reputational effects have direct links to a country's ability to raise funds in a competitive international financial market.

We have used primary and secondary research methods to review existing literature on IFFs and foreign exchange rate regimes in low and middle income countries. We also conducted semi-structured interviews with participants in the foreign exchange market in Nigeria, all of whom chose to remain anonymous. This includes representatives of corporate entities in various industries, members of the financial sector and legal professionals. Finally, we have obtained insights into the operations of the Bureau de Change (BDC) market from the first-hand knowledge of a former BDC operator.

3. Regulating foreign exchange markets

Foreign exchange markets in low and middle income countries are often a ripe source of and avenue for IFFs out of the country. These markets are typically funded by inflows of FDI, remittances and foreign currency earnings from the export of natural resources, commodities or goods. Many of these flows are susceptible to round-tripping or trade mis-pricing by market participants in a bid to take advantage of special protections or preferential treatment offered to some parties or categories of financial flows[1].

Nigeria's foreign exchange reserve is derived mainly from the proceeds of crude oil production and sales, with the Federal government being a major stakeholder in the sale of crude oil and a key foreign exchange recipient. As a result of the close connection between the extractive industries (particularly the oil and gas industry) and foreign exchange reserves in Nigeria, the foreign exchange market is susceptible to being a key avenue for IFFs. The CBN plays a pivotal role in the management and supervision of this market and is responsible for managing foreign earnings by the government as well as private actors. The CBN regulates foreign exchange earned by private actors by requiring that petroleum products export-derived foreign exchange earnings be surrendered and sold to financial institutions and, ultimately, to the CBN (CBN, 2015).

The rich literature on rent-seeking highlights the dangers associated with the monopoly power enjoyed by governments to enact regulations and policies and to exercise discretion in the interpretation and implementation of such regulations and policies (Bhagwati, 1982; Shleifer and Vishny, 1993; Khwaja and Mian, 2011; Schwab and Werker, 2018).

In Nigeria, the government – represented by elected members, the CBN and private-sector participants – is part of a foreign exchange ecosystem that is bound by complex social, political and financial relations. The patterns of influence within this interconnected foreign exchange system are intricate, and the interactions take place in the context of embedded social networks, political conflicts and vested interests. These have an impact on institutional performance. The interests of the various participants in the ecosystem can sometimes be misaligned with private-sector users who are focused on their individual or sector economic goals and the government on macro-level policy or geo-political concerns. Although a part of the government, the CBN acts as a mediator between these two camps, but it is often influenced by political interests rather than market or efficiency concerns.

The CBN is the main government agency responsible for the management of capital controls. The imposition of capital controls is generally regarded as an aspect of a state's power to manage its currency. Capital controls are often used to either support the value of the

1 Round-tripping is the practice of buying and selling the same assets (in this case foreign currency) in order to take advantage of market price variations to make a profit

currency or to prevent capital flight that may lead to balance-of-payment issues. The actions that constitute capital controls are varied and typically include any actions taken to regulate the inflow and outflow of capital, including limitations on the amount of money that citizens and companies can exchange or transfer out of the jurisdiction. Restrictions such as these, which make it more difficult to move assets legitimately, inadvertently encourage the use of illegal methods and may create incentives for circumventing the rules for purposes that might otherwise be regarded as legitimate.

Capital controls may trigger specific types of IFFs because citizens who have obtained their income legally may, in seeking to transfer their income abroad, be forced to break specific exchange rules. These flows then become IFFs even if the foreign exchange regulations themselves reflect narrow or particularistic interests and do not serve any social purpose, or even if they are well-intentioned but poorly thought through. In poor governance settings, tight exchange controls and fixed, uncompetitive exchange rates, along with dwindling foreign exchange reserves, may serve to increase IFFs for these reasons. With fewer capital controls, however, unauthorised fund flows may be more likely to be illicit (for instance, using funds involved in other criminal activities), even if the currency transactions to take the money out of the country are in themselves legal. This is one reason why definitional issues of illegal and illegitimate or illicit matter, because they force us to be clear about which dimension of a complex problem we want to focus on, while keeping in mind possible interconnections.

In section 4, we review the institutional architecture within which the CBN operates. We highlight the importance of autonomy from government interference and clarity of objectives for the CBN in the management of foreign exchange as a necessary precondition to stem the flows of IFFs in Nigeria. We note, however, that absolute independence for the CBN is not realistic, desirable or even necessary, as the CBN remains a part of government and connected to political decision-makers. It is also practically difficult to achieve absolute independence, particularly in low and middle income countries where government intervention or correction of the market may be necessary for developmental or political reasons, and also because legal or constitutional guarantees of independence may be difficult to enforce in practice.

Two governance issues appear to arise from the CBN’s responsibility for foreign exchange market management. The first issue is the scope of the CBN’s responsibility for the management of the foreign exchange market and the degree of independence granted to it to pursue this mandate. The second is the extent of the opportunities available for individuals and businesses to influence the CBN to their advantage in either the formation or implementation of laws and policies through the illicit provision of non-transparent benefits.

In section 5, we review the procedural operation of the foreign exchange market in Nigeria. Given that the procedural processes serve as touchpoints at which the movement of IFFs may occur, we consider areas where risks are highest and evaluate opportunities in processes and procedures for the minimisation of risk. Experience from the implementation of anti-corruption interventions caution us about the need for pragmatism in the design of interventions. These interventions must consider the institutional context within which they will be implemented, particularly the capacity and interest of the government institutions that will be affected, and the impact on the incentives for the current beneficiaries. In this context, a well-functioning regulatory institution is likely to hamper IFFs. Conversely, a regulatory institution insufficiently independent of political authorities, coupled with strong incentives for beneficiaries of IFFs to destroy regulations or institutions that constrain their ability to engage in IFFs, will fail to effectively prevent the prevalence of IFFs.

3.1. IFFs in Nigeria

IFFs in Nigeria arise primarily from corruption in government, illegal exploitation of natural resources and trade mis-invoicing. There is a close relationship between IFFs and corruption in Nigeria. Corruption in various forms (political corruption and collusion with private-sector interests) is often the source of funds that are illegally transferred, resulting in IFFs (Meyer and Mullard, 2019). The existence of petroleum mineral resources creates opportunities for corruption, bribery and embezzlement. Several corruption cases have come to light in relation to Nigeria's oil and gas sector – one example is the Malabu oil case in which several multinational enterprises and public officials were implicated in a scheme to defraud the government and the Nigerian public of over US$1 billion via bribery, money laundering and the setting up of anonymous corporate entities.

There is a high incidence of illegal exploitation of natural resources outside licensing and regulatory limits in Nigeria. This includes oil bunkering and siphoning and underground mining for which no revenue declaration is made. In 2013, it was estimated that up to 100,000 barrels of crude oil was stolen per day from pipelines in the Niger Delta region of Nigeria. Between 2010 and 2014, the Nigeria National Petroleum Corporation recorded a loss of almost 1.2 million metric tons of petroleum products as a result of pipeline vandalism and illegal oil bunkering (Nigerian National (ML/TF) Risk Assessment Forum, 2016). In addition to illegal oil bunkering, there have also been reports of undeclared mining or extraction of other natural resources found in Nigeria such as gold. As a result of the prevalence of this issue, the House of Representatives began investigations in 2018 into allegations that between 2013 and 2018 illegal mining and exportation of gold had led to losses in revenue of over US$50 billion (Nwabughiogu 2018)

Nigeria is also susceptible to trade mis-invoicing, which occurs through the under-invoicing of imports (leading to lower value added tax (VAT) and customs duties collection), under-invoicing of exports (reducing the royalties and corporate income tax payable), and over-invoicing of imports (reducing the corporate income tax due). Research by Global Financial Integrity found that, in 2015, over US$8 billion flowed out illicitly from Nigeria. (Global Financial Integrity 2019) Analysis of trade mispricing in Nigeria also put lost government revenue at over US$2 billion, of which almost US$900 million can be attributed to import mis-invoicing (including uncollected VAT, customs duties and corporate income tax) with another US$1.3 billion attributable to lost royalty and corporate payments from exports mis-invoicing (Table 1). The vast majority of exports mis-invoicing is in respect to petroleum products, while about 20% of revenue lost due to the under-invoicing of imports relates to the importation of vehicles, iron, electrical equipment, aluminium products and ceramics (Global Financial Integrity, 2018).

Table 1. Trade mis-invoicing and potential revenue losses in Nigeria (2014 data):

	US$, Millions	% Collections
Import Value Analysed	**22,525**	–
Import Under-Invoicing	**2,400**	–
VAT %, lost revenue	10D	2%*
Customs duty %, lost revenue	365	10%**
Import Over-Invoicing	**1,860**	-
Company income tax %, lost revenue	415	5%
Export Value Analysed	**82,023**	–
Export Under-Invoicing	**5,885**	–
Company income tax %, lost revenue	1,312	17%
Royalties lost revenue	9	–
Export Over-Invoicing	**5,559**	–
Potential Revenue Losses	2,201	4%^

* All VAT (import & other), ** Import & excise duties, ^ All Revenue

Source: Global Financial Integrity (2018).

Over 60% of imports into Nigeria comprise items such as machinery, vehicles, electrical equipment, rubber, iron and steel, and imports originate predominantly from European and Asian countries. The value of these imports into Nigeria has grown exponentially over the last 20 years to over US$35 billion as of 2016. Reported exports have also grown and have reached over US$45 billion (according to the CBN). Trade to and from Nigeria is highly concentrated, with over 60% of trade by Nigeria occurring with only 10 countries, namely: China, the United States (US), the United Kingdom (UK), Belgium, India, Germany, France, Netherlands, Brazil and Japan (Global Financial Integrity, 2018). China and the US are the largest source of imports into Nigeria and as such account for the largest proportion of lost potential revenue.

Recently, the CBN has sought to address the occurrence of trade mis-invoicing by moving import and export operations to an electronic system. Under this system traders are required to submit electronic invoices that are authenticated by Authorized Dealers on the Nigeria Single Window portal – Trade Monitoring System (CBN, 2022). Invoices registered at prices outside a 2.5% range of benchmarked global prices for the item imported or exported will be automatically rejected.

4. Institutional architecture of the CBN

The framework, objectives and power of the CBN has evolved over the years. In the face of an unstable currency, changing fiscal and monetary policy goals, a growing economy and populace, the job of the Bank has often been difficult and thankless. It has also been further constrained by political pressures from successive governments. However, the CBN remains the one institution in Nigeria with adequate data on transactions that researchers and civil society can use (Harvey et al., 2020).

4.1. Objectives of the CBN

In its early post-independence years, the policy thrust of the CBN mirrored the core objectives set out in the 1958 CBN Act and focused on funding government financing needs and providing financial support for a nascent banking sector. This initial focus was in line with most post-independence monetary frameworks across the globe, which have been described as geared towards the (cheap) financing of government activities, the provision of subsidised credit to favoured sectors, and the active pursuit of an exchange rate target (more often reflecting the interests of powerful urban consumers at the expense of producers) (Honohan and O'Connell, 2008). Since its early days, the CBN has seen an evolution in its responsibilities and policy priorities with the main policy thrust now revolving around its role as an agent of monetary policy, the maintenance of external reserves and the provision of 'lender of last resort' support to the government.

The CBN Act of 2007 institutionalised the objective of price-stability by expressly mandating the Bank to pursue monetary policy and price stability (Federal Republic of Nigeria, 2007). Maintaining the value of the naira is therefore clearly articulated as a policy objective of the Bank in the CBN Act. The CBN is also responsible for managing the country's foreign reserves by virtue of Section 2 (c) of the CBN Act of 2007. The Act directs the CBN to endeavour to maintain external reserves at levels considered by the Bank to be appropriate for the economy and the monetary system of Nigeria. The level of authority and freedom to pursue policies in this regard – such as designing appropriate exchange rate regimes or determining and adjusting exchange rate targets (i.e., the true scope of the CBN's powers) – envisaged by the drafters of this provision is unclear.

At a higher level of abstraction, there is the familiar discontinuity between the narrower economic objectives of a free market and the politically motivated objectives often pursued by elected politicians. In Nigeria, this is playing out in the context of the CBN extending its remit beyond monetary policy to superintend fiscal issues usually within the ambit of the Ministry of Finance. According to a key informant, this incursion into the fiscal space commenced under the leadership of the previous CBN Governor (key informant interview, 2021). In order to address the funding shortfall required to provide financing for infrastructure in the power sector, the CBN created a fund for the banks to lend to borrowers in the power and infrastructure sectors. The remit of the fund was subsequently expanded to support funding for the agriculture sector. This incursion into the fiscal space by the CBN has been significantly expanded by the current Governor of the Bank with the creation of multiple funds and anchor borrower schemes. The move of the CBN into the fiscal policy arena was further enabled by the failure of President Buhari to appoint a Minister of Finance expeditiously at the start of his presidency, which created a vacuum that was ultimately filled by the CBN.

As stated above, the objectives of the CBN include both maintaining price stability and the exchange rate policy to safeguard the value of the naira. As with all legislative enactments, objectives specified in the law may contain several elements that are inconsistent with policy objectives, thereby creating the potential for conflict. The close linkages between monetary policy and the exchange rate (for instance expansionary monetary policy can increase domestic money supply leading to lower interest rates, which in turn lead to capital outflows and depreciatory pressures on the currency) mean that public policy interests in each area cannot be treated separately. In addition, the CBN Act defines the governance arrangements for managing the exchange rate less clearly than the arrangements for making monetary policy decisions. At a more practical level, these objectives may have multiple dimensions that include policy setting, rulemaking, and oversight, with some of the dimensions further vested in institutions outside the CBN such as the banks.

Maintaining monetary and price stability is closely related to the micro-financial stability in the payments and banking systems (Goodhart, 2000). A key determinant of the objective of the CBN to maintain monetary and price stability therefore relates to the role of the Bank in the supervision of the banking sector. Similarly, the objective of maintaining the value of the currency is also intertwined with the regulation of the banking system. The promulgation of the CBN Decree No. 24 of 1991 and the Banking and Other Financial Institutions Decree (BOFID) No. 25 of 1991 (Federal Republic of Nigeria, 1991a; 1991b) pivoted the focus of the CBN and conferred upon it significant powers in the areas of banking supervision and the promotion of safety measures and soundness of the financial system. The subsequent amendments to the 1991 Act in 1993, 1997, 1998 and 1999 maintained and buttressed the CBN focus on banking supervision. A key informant interviewed for this study advocated a divestment of the functions within the CBN, though they cautioned that this would not resolve concerns around the independence of the CBN as the level of independence enjoyed by the Bank is highly influenced by the occupant of the position of Governor of the CBN and the President (key informant interview, 2021).

For many low and middle income countries that lack robust legal systems, have inadequate accounting standards and suffer a dearth of sophisticated financial instruments to hedge financial risks, there is a clear need for significant focus on banking supervision as these shortcomings make them particularly vulnerable to financial instability. In the Nigerian context, there is an additional risk as the licensing of banks is a very political process with close linkages between the banks and the political elite who hold majority shares in the banks (Balogun, 2011). These linkages open up the CBN to interference in the conduct of its regulatory functions with possible spill over effects into its monetary and exchange rate objectives.

4.2. CBN independence

The nature of the relationship between the CBN and the government has evolved over time in response to changes in the state of the economy and the goals of the government. It is useful to study the CBN's trajectory as this has an important bearing on the Bank's strategy to manage exchange rates. It's 'function creep' has been the result of both developmental needs typical of a low and middle income country as well as the political agendas of different ruling coalitions over the years. Various CBN Governors have enjoyed more or less independence from over-reach from the presidency depending on the temperaments of the occupants of both offices, as well as the economic state of the country, global pressures and the robustness of the country's foreign reserves.

The heterodox literature on the independence of central banks acknowledges the need for their involvement in the process of structural transformation and supporting employment growth, and has been critical of the agenda of central bank independence. This has been seen to be linked more to international financial institutions (IFI) and western-led models of inflation control and price stability (Mkandiwire, 1997). In recent times many African central banks have implemented policies that reflect the development narrative and political agendas of incumbent governments. The National Bank of Rwanda's policies, for instance, focus on facilitating the transformation of Kigali into a financial centre, in keeping with the agenda of the Rwandan Patriotic Front (Behuria, 2020). Similarly, the Bank of Zambia, while considered effective in terms of maintaining its autonomy, was nonetheless subject to significant political interference during the tenure of the Patriotic Front in 2011 (Cheelo and Hinfelaar, 2020). In this sense the CBN is no different to many central banks in Africa. As such, its independence, regardless of legislative provisions, is directly impacted by the agendas of political and business interests as well as the state of the relationship between the government and business.

Statutory provisions have granted the CBN the mandate to preserve price stability and have guaranteed its autonomy from government to make sure that short-term political considerations do not interfere with its ability to achieve this objective. Some of the broad measurements in the legislative framework that may be used to assess the degree of autonomy and independence of the CBN include the degree of insulation from political pressure through security of tenure and appointment; the degree of control the government exerts over policy decisions; the statutory provisions detailing the objectives of the Bank; and the provisions relating to lending limits to the government. While the CBN is expected to work closely with the government, it is also expected to retain its independence in pursuing policy and regulatory goals. A key informant with inside knowledge of the operations of the CBN noted that the President exerts a significant degree of control over the CBN and cited the President's reluctance to devalue the naira as a driving force that has trumped all the fiscal and monetary arguments to the contrary (key informant interview, 2021).

The institutional framework within which the CBN pursues its objectives is relevant to the evaluation of its independence. The CBN Act 2007 established a governance structure with an independent Board as the highest decision-making body with responsibility for policy formulation and administration of the Bank and the obligation to provide periodic reports to both the Executive and Legislative arms of the government (Federal Republic of Nigeria, 2007). The Board is chaired by the Governor of the CBN with the other members comprising the Deputy Governors of the Bank as well as non-executive members appointed by the Federal Government of Nigeria. The CBN Governor is a political appointee of the President, subject to ratification by the Senate. The Governor, Deputy Governors and Directors of the Bank are appointed in the first instance for five years and reappointed for another term not exceeding five years. The Monetary Policy Committee (MPC) is the highest policy-making committee of the CBN. The MPC is chaired by the Governor of the CBN and includes, as members, all four Deputy Governors, two representatives of the CBN Board, three members appointed by the President and two members appointed by the Governor. The Committee meets bi-monthly for monetary policy decisions through majority voting and communicates its decisions to the public by publishing communiqués.

The relationship between the Federal Government of Nigeria and the CBN has undergone a great deal of change since independence and is now significantly different to what it was when the first CBN Act was enacted in 1958. In principle, there is a clear division of responsibilities and accountabilities between the CBN on the one hand, and the government and the Minister of Finance on the other hand. However, these formal institutional arrangements for the independence of the CBN may not necessarily reflect the true nature of the relationship with the government in practice. At inception, there was a clear policy thrust in the 1958 Act to guarantee independence and prevent interference from government. The 1968 amendment of the CBN Act diluted this policy thrust by requiring that the CBN keep the Minister of Finance informed on monetary and banking policies pursued or intended to be pursued and mandating that disagreements between the two parties be resolved by a binding directive from the Federal Executive Council. The promulgation of the CBN Decree No. 24 of 1991 transferred the reporting requirements of the CBN from the Ministry of Finance to the President. The provisions required that the CBN keep the President informed on monetary and banking policies pursued by the Bank and stated that the President may provide binding directions on the monetary and banking policies to be pursued by the Bank.

A key feature of independence turns on the obligation to lend to the government. There is consensus that monetary policy autonomy may be compromised by the obligation to lend to the government or to provide implicit or explicit subsidies through the preferential pricing of government debt. The reliance on natural resources as the source of public finance in Nigeria in an era of volatile oil export revenues has led to significant budget deficits at all levels of government. The CBN Act 1991 broadened the powers of the Bank as far as the maintenance of monetary stability and reduced the size of advances that the CBN may grant to the Federal Government in relation to the annual budget from 25% to 12.5%. Although the CBN's ability to lend to the government was limited in percentage size, since 1991 the size of the annual budget of the Federal Government has increased significantly.[2] As such, the size of the advances from the CBN to the government in pure monetary terms has increased and the effectiveness of the CBN laws limiting government access to central bank

2 Nigeria's budget increased over the last two decades with most new annual budgets exceeding that of the preceding year.

credit remains questionable in reality. The monetary framework is still dominated by a focus on cheap financing of government expenditure, and it is widely acknowledged that the efforts by the CBN to limit its financing of the government have not been successful.

The independence of the CBN in performing its function is also very much influenced by the source of public finance in Nigeria. The reliance of the Nigerian economy on oil revenues coupled with the volatility in oil prices are significant sources of instability in the Nigerian economy. The absence of taxes as a key source of government revenue ensures that the government is less likely to bargain with citizens over what goods and services it prioritises in exchange for tax payments. Secondly, the standard tool for insulating the economy from volatility is achieved through the sterilisation of oil revenues. The 1999 Nigerian Constitution, however, mandates the immediate disbursement of oil revenue to all tiers of government, which makes sterilisation impossible and robs the CBN of what would have been a key tool in its arsenal.

5. Management of the foreign exchange market in Nigeria

5.1. Legal framework for the foreign exchange market

The CBN was given statutory responsibility for monitoring and supervising the foreign exchange market through Sections 1 and 8 of the Foreign Exchange (Monitoring and Miscellaneous Provisions) Act ('FEMM Act') (Federal Republic of Nigeria, 1995. The CBN was also given the power to issue guidelines and circulars to banks and financial institutions under its supervision to regulate the procedures for transactions within the market as well the general operation of the market, while the CBN Act and the Bank and Other Financial Institutions Act permitted foreign currency from a wide range of sources to be sold in the market (Federal Republic of Nigeria, 1991a, 1991b). The FEMM Act was enacted in 1995, setting out the parameters for the liberalisation of the foreign exchange market as well as establishing the autonomous foreign exchange market for the conduct of transactions eligible for the sale and purchase of foreign exchange.

The FEMM Act, together with the Foreign Exchange Manual (Central Bank of Nigeria 2018) published by the CBN and periodic guidelines and circulars issued by the CBN, principally govern the inflow and outflow of foreign capital in Nigeria. Any person carrying out a transaction in the market permitted under the CBN Act is generally not obligated or required to disclose the source of the foreign currency they are seeking to sell. In addition, any foreign currency purchased in the autonomous market may be repatriated from the country without any requirement for further approval except for sums in excess of US$5,000 (now US$10,000 under revised guidelines) which is being exported via a port of entry, such as an airport.

5.2. Scope of the powers to regulate the foreign exchange market

The specific powers to regulate the foreign exchange market are provided in both the FEMM and CBN Act. In Sections 7(2) and 8(1) of the FEMM Act, the CBN is given what appears to be broad powers not only to regulate transactions in the Autonomous Market, but to supervise and monitor the operation of the market to ensure the efficient performance of the Autonomous Market. Section 20(5) of the CBN Act also empowers the CBN to prescribe the circumstances under which other currencies may be used as a medium of exchange in Nigeria. These broad powers give the CBN the flexibility to adapt to changing circumstances without the need to negotiate the entire legislative process. Also important is the ability to provide additional clarification, particularly in the context of situations that were not contemplated when the legislation was drafted. Finally, it circumvents the problems associated with embedding complex policy structures and choices in legislation.

Our research suggests the scope of the powers granted to the CBN focuses more on the implementation of policies rather than the creation of policy. Support for this interpretation is provided by the sections of the FEMM Act that establish policy and rulemaking functions. The general power to issue directives is granted to the Minister of Finance. Section 8(2) of the FEMM Act empowers the Minister of Finance to issue such directives not inconsistent with the Act as may seem appropriate for the efficient operation of the Autonomous Market. In addition, while Section 1(2) of the FEMM Act empowers the CBN to issue guidelines to regulate the procedures for transactions in the Autonomous Market and for such other matters as may be deemed appropriate for the effective operation of the Autonomous Market, these powers may only be exercised with the approval of the Minister of Finance. This arrangement has the potential for conflict, with policies embedded in the rules being contradictory or inconsistent with the legally prescribed objectives and a lack of certainty associated with the ease by which the policies may be reversed by political appointees.

5.3. The current operation of the Forex market: the Nigerian Autonomous Foreign Exchange Market (NAFEX)

The various iterations of the forex market in Nigeria (including the current operation) have been at best dysfunctional, and at worst have reinforced mechanisms to support the extraction of rents by the politically powerful with access to the attractive official exchange rate. This system has given rise to a significant degree of internal corruption, while also providing the means for IFFs out of the country. Ultimately, it has undermined the efforts of the government to stem the flow of IFFs.

The exchange rate policy adopted by the Federal Government of Nigeria through the CBN has oscillated between a fixed and flexible exchange and sometimes a combination of both. From 1960 to 1986, the CBN implemented a fixed exchange rate regime. In 1987, the government adopted a flexible exchange rate system which continued until 1994 when the official exchange rate was again fixed. Commencing in 1995, the government implemented a policy of ‘guided deregulation’, which saw the adoption of a flexible dual exchange mechanism. By 1999 the CBN’s objective was to establish a market-based interest and exchange rate system and it merged the dual exchange rate mechanism. However, the value of the naira fell steeply. Since then, both a controlled official rate and an unofficial rate has existed in the country with the unofficial, ‘parallel’ or ‘black-market’ premium increasing steadily.

The current iteration of the foreign exchange market in Nigeria is the result of several revisions made to the market in 2016. These were driven by the consequences of the sharp decline in oil prices in the preceding two years.[3] The external reserves fell from US$34.24

3 The CBN released three sets of guidelines, namely: (1) Revised Guidelines for the Operation of the Nigerian Inter-bank Foreign Exchange Market; (Central Bank of Nigeria 2016)((2) Guidelines for Primary Dealership in Foreign Exchange Products (Central Bank of Nigeria 2016);and (3) How the CBN Naira-settled OTC FX Futures Market will work (Central Bank of Nigeria 2016)

billion at the end of December 2014 to US$28.28 billion at the end of December 2015 (Premium Times, 2015). Table 2 outlines the different exchange rates over the last two decades.

Table 2. The different exchange rate regimes used in Nigeria (2002 onwards)

Year	Exchange rate regime
2002–2014	• Retail Dutch Auction System (RDAS) • Wholesale Dutch Auction System (WDAS) • Interbank Foreign Exchange Market (IFEM)
2015–2016	• IFEM
2016	• IFEM with the following interventions by the CBN: – Retail Special Secondary Market Intervention Sales (for raw materials, agriculture, machineries, airlines and petroleum products) – Invisibles Window (business and personal travel allowance, school fees, accommodation and medical expenses) – Small and Medium Enterprises (SME) Window (small-scale importation valued at US$20,000 and below) – Investors and Exporters (I&E)
2017	• Fixed CBN Official Rate • IFEM • NAFEX Fixing Market (I&E Window)

Sourec: CBN (n.d.).

With the reserves at historical lows, the CBN responded with a raft of regulations to protect foreign reserves. The CBN abolished the dual market comprising the CBN window and the interbank market by closing the RDAS and WDAS and established a single market for foreign exchange in its place (CBN, 2015). This closed the loophole where foreign exchange could be purchased at a subsidised rate. The entities permitted to participate in the market include authorised dealers, oil companies, oil service companies, exporters, end-users and any other entity that the CBN may designate from time to time. The CBN tightly managed the interbank rate and maintained a peg within a band against the US dollar. This was a significant policy shift for the Bank, which had, since 2004, maintained a flexible exchange rate through a crawling peg against the US dollar.

The CBN also reserved the right to participate in the market as required through direct or dynamic secondary market intervention mechanisms such as the sale of forex to authorised dealers on a wholesale basis or to end-users through authorised dealers on a retail basis. Retail intervention by the CBN is carried out on a bi-weekly basis with retail customers placing bids with the CBN via their banks at rates that they feel will win them the auction. According to a key informant who participates in these auctions, most customers typically only get allocated 15%–20% of their bid amount (key informant interview, 2021). For the services and SME space, the CBN allocates funds to banks every week at their own predetermined ratio and permits banks to take minimal spread or earnings on what they buy and then sell onward at (no more than two naira on the dollar) on that. Transactions in the services sector include personal travel allowance (PTA) for tourism purposes, business travel allowance (BTA) for business travel, medical expenses and tuition fees. The SME market is focused on SMEs with a staff base of between 2 and 2,000 employees and a share capital of 200,000 naira to 500,000,000 naira.

In place of the previous dual windows, the CBN introduced a special I&E foreign exchange window in 2017. Foreign investors were permitted to convert capital brought into Nigeria for investment into naira at a market rate agreed by the other parties in the transactions. The FEMM Act, in principle, permits the free repatriation of capital but the reality is somewhat different because of the scarcity of foreign exchange (key informant interview, 2021). This scarcity is driven by the fact that earnings from oil exports continue to decrease due to declining oil prices and exported crude quantities (thanks to incidents of insecurity, illicit oil bunkering and lower global demand), while the demand for foreign exchange (to pay for imported products, business and personal needs such as medical expenses, tuition, etc.) continues to grow.

In sum, by 2017, there were three official foreign currency markets in operation. First, the official CBN window through which the CBN, at its discretion, could sell foreign exchange to authorised dealers or end users via a multiple book-building process. Second, the IFEM in which commercial banks sell foreign currency to other commercial banks (interbank rates) and to large commercial customers. Third, the NAFEX, an investors and exporters window in which portfolio investors, importers and exporters, authorised dealers and other parties with foreign currency to exchange can sell/buy to/from other commercial banks and to big commercial customers. Table 3 summarises the rates as published by the CBN in 2017.

Table 3. Three official currency markets in 2017

		2017	
Month	**January**	**October**	**November**
DAS (US$)			
IFEM (US$)	305.20	305.62	305.90
BDC (US$)	493.29	362.21	362.41
UK Sterling	378.32	40325	404.45
EURO	324.37	359.34	359.07
CFAFr	0.49	0.55	0.54

Notes: DAS = Dutch Auction System; CFAFr = . Communaute Financiere Africaine Franc (Niger)
Source: CBN (2017).

This multiplicity of markets was a result of the government's desire for a more stable exchange rate. The move by Nigeria to a more de facto fixed regime can be seen in other sub-Saharan African extractive countries such as Angola and Zambia. Whilst it had a controlled rate regime (with a trading band), Angola had two currency markets – the official market and the black market, which, due to a lack of supply of foreign currency in the official market, operated at more than double the official exchange rate (Silva, 2016). However, in 2019, Angola liberalised its exchange rate regime, removing the tight trading band previously imposed and allowing parties to freely transact and agree on the applicable exchange rate for transactions (Strohecker and Mohammed, 2019).

In 2021, the CBN abandoned the prior practice of fixing the rates and neither set a band nor pegged a rate for transactions in the window. For exporters, the new policy permitted them to sell export proceeds in the market at a rate determined by market forces rather than a CBN prescribed rate (Ohuocha, 2017). This window operates under the 'willing buyer willing seller' principle and the exporters either sell directly to third parties or to the Bank which allocates the funds at a rate that they are able to sell at.

Additional policies to conserve foreign reserves include the mandate that banks had to allocate at least 60% of all their foreign exchange sales to the manufacturing sector, prohibiting the pricing of domestic transactions in foreign currency, and prohibiting access to the interbank market for the importation of 41 specified items. Other efforts include the 'dollar for cash deal', where the CBN committed to pay 5 naira on every US dollar received offshore in a bid to improve liquidity to the market (key informant interview, 2021).

5.4. BDCs and IFFs in Nigeria

BDCs have been a key fixture in the exchange rate management system in Nigeria since the late 1980s. They were first licensed by the CBN to serve as retail foreign exchange dealers and act as brokers in the interbank market and were permitted to purchase foreign exchange from the CBN via bank cheques issued by their banks twice a week. These BDCs then sell on their purchases to the general public for the BTA and PTA as well as other unreported transactions. However, the importance of BDCs in the system was heightened in the 2000s when scarcity of US dollars and a fixed exchange rate led to burgeoning black-market trading at up to four times the official exchange rate (88 naira to US$1 on the black market as opposed to 22 naira to US$1 on the official market) (Fawenhimi, 2015).

The CBN had traditionally taken a lighter touch regulatory approach towards BDCs than its approach with banks and other financial institutions, for instance. The BDCs were required to provide weekly and monthly reports to the CBN containing details of the persons to whom the foreign currencies were sold to. However, according to a key informant who was a BDC operator, there was very little compliance by BDCs with the documentation requirements of the CBN. The operator noted that, even though the BDC operators routinely exceeded the foreign exchange transaction limits to individuals, they would render the reports to the CBN without any consequences. The lack of compliance requirement by the BDCs and the absence of regulatory sanctions was also exploited by formal banking institutions, who, wary of their own stringent reporting requirements, would sell foreign exchange to the BDCs to circumvent their own reporting requirements (key informant interview, 2021). In particular, banks colluded with BDCs to sell some of the foreign currency they had been allocated at an official rate to the BDCs who had a higher demand for foreign currency than they were provided by the CBN (capped at US$20,000 per week). Sales of this nature occur at a higher exchange rate than they are permitted to sell to their customers, thereby providing arbitrage opportunities for banks.

An anonymous source explained that once the opportunities for arbitrage expanded in the subsequent decade due to increasing demand and declining supply, various political actors (including sitting members of the legislative, senior civil servants at the CBN and other government agencies) sought to take advantage of the arbitrage opportunities. They began to provide the capital start-up costs as silent owners of BDCs run and managed by others. BDCs therefore became a means for the politically powerful to funnel illicit funds out of the country and launder money within the country. The involvement of various political entities and civil servants in the establishment of BDCs ensured that the CBN for several years turned a blind eye to their operation and failed to exercise adequate regulatory and compliance oversight (key informant interview, 2021).

The relationship between BDCs and the politically powerful in Nigeria is therefore closely linked. Firstly, a significant proportion of the large sums needed as initial and regulatory capital for the operation of BDCs is sourced from those who have identified BDCs as an effective avenue to hide and launder illicit funds. Some of these political actors and traditional rulers have even gone as far as using proxies to register BDCs and in fact are the ultimate beneficial owners of a large number of BDCs. Secondly, the political elite often use the BDCs as conduits to acquire properties in offshore jurisdictions (key informant interview, 2021).

In 2021, however, the CBN banned the sale of foreign exchange to BDCs with the CBN Governor noting that the Bank was ‘awash’ with complaints. These concerned the operations of BDCs that were facilitating corruption in the country, promoters obtaining licences to run multiple BDCs, and international organisations and embassies sourcing their forex needs on the black market rather than in the official market (Elebeke, 2021). A report published in 2020 mentions how the CBN was grappling with monitoring over 4,000 BDCs even at that time (Harvey et al., 2020).

5.5. How the multiple exchange rates are (mis)used in practice

The framework for the management of Nigeria’s foreign exchange rate is set out in Section 16 of the CBN Act 2007, which states that ‘the Naira exchange rate would be determined, from time to time, by a suitable mechanism devised by the CBN for that purpose’. This responsibility, in practice, is often determined by an interplay of factors that go beyond statutory provisions. This includes the degree of CBN independence, the agenda of the political party in place and the choice of exchange rate regime.

From the inception of the NAFEX in 2016, the CBN has operated a system of multiple exchange rates. This is not unique to Nigeria, with many countries – particularly low and middle income economies – often applying separate, fixed exchange rates to different types of transactions. In this system, different exchange rates apply to different types of transactions, with the CBN setting an official preferential rate for eligible current account transactions and a less preferential rate for capital account transactions. These rates include the official exchange rate from the CBN (mainly applicable to petroleum imports and government expenditures), an interbank rate (at which banks lend to each other), another used by international money transfer companies, a religious pilgrimage rate, an I&E Window rate and a black-market rate. The rationale for the CBN maintaining multiple exchange rates is clear and motivated by direct practical considerations. Given the severe balance-of-payments problems (see below) associated with declining foreign reserves, the alternative to a devaluation is to place limits on the range of transactions that are eligible for foreign exchange to conserve foreign exchange resources. However, several studies have questioned the effectiveness of multiple exchange rates, arguing that the insulating effects become ineffective and hide structural fiscal problems that will resurface over time (Wang, 2014). Figure 2 shows the evolution of the current account balance maintained by the CBN.

Figure 2. The Nigerian current account balance

Source: World Bank (n.d..)

We highlight below some of the ways in which this exchange rate mechanism leads to corruption.

i) Political connections can be used to obtain preferential rates

A key informant described a specific instance where an individual was able to access foreign exchange at a rate that was 25% below the official exchange rate from the CBN. The allocative choices by the CBN of the scarce foreign exchange resources are often influenced by parties for their own benefit. In a context where enforcement is limited, the multiple rates mean that the government is operating a single exchange rate with a 'tax' for those without influence and whose transactions therefore fall outside of the eligible regime, alongside an effective 'subsidy' for those with influence who are able to get their transactions into the preferential regime. Citizens who do not have this preferential access but need to send funds outside the country for legitimate reasons will have incentives to use the parallel market (discussed in the next section). This is one reason why the distinction made earlier between flows that are illegitimate and flows that are illegal becomes important.

ii) Specific business–government links can be used to influence eligibility criteria for exchange rates

Other studies question whether the motivations articulated in government policies for multiple exchange rates are in fact pretexts for the real motive of benefiting certain political constituencies and passing a cost on to other segments (Alesina and Tabellini, 1989). A key informant referred to instances where the CBN policy on eligible transactions for foreign exchange have been influenced by the political elite, such as the imposition of restrictions on access to foreign exchange for sugar if you did not own a sugar refinery. The same entity established a farm to grow sugar and the CBN revised the policy once again to this entity's benefit and restricted foreign currency for the importation of raw or refined sugar. Similar restrictions were put in place for cement and some agricultural products.

iii) Rent-seeking via arbitrage

The existence of multiple exchange rates leaves open several avenues for arbitrage. For instance, banks with close CBN ties can make profits by arbitraging between the markets. A key informant described a recent transaction where a Nigerian company bought goods worth US$4 million at the preferential CBN rate. The prepared invoice valued the goods at US$5 million and the excess was sold in the black market at the higher rate. In the example above, the interviewee referenced the fact that because such large transactions need to be approved by the CBN, provisions are made to 'incentivise' the staff at the CBN responsible for the transaction. The exchange rate differential also has a significant effect on investments with the applicable rate at the point of exit having a significant impact on the returns on investment unless a preferential rate can be secured (key informant interview, 2021).

iv) Potential for mis-invoicing and creation of IFFs

There are other problems associated with a regime of multiple exchange rates. In situations where there is a discrepancy between the rates, it is often difficult to prevent leakages of transactions from one market to the other. Specifically, exporters in Nigeria, although required to surrender their export proceeds to the CBN at the official rate, often disguise the receipts and prefer to sell them in the parallel market, with IFFs making up an estimated 3.5% of reported trading amounts. The true value of exports can be hidden by mispricing the invoices and undervaluing exported goods, thereby creating IFFs. This practice has spillover effects into the economy. Exporters who do not declare their export receipts also conceal these earnings from tax authorities. Table 4 shows how serious the problem is, with Nigeria making the list of African countries with the largest illicit flows.

Table 4. African countries with the largest IFFs, 1980–2018 (by highest total IFFs)

Country	IFFs (mllllons of US$)	IFFs (% of total trade)
South Africa	441,481	15.5
Democratic Republic of the Congo	165,649	20.4
Ethiopia	84,316	33.5
Nigeria	67,058	3.4
Republic of the Congo	55,083	23.8
Angola	45,133	4.4
Sudan	38,666	15.1
Botswana	31.486	16.1
Zambia	27,500	11.8
Cameroon	26,599	14.9

Source: Signé et al. (2020).

Regardless of the motivation, the choice of eligible transactions and allocation criteria invariably has distortionary effects. The multiple rates confer a fiscal benefit on the CBN and serve as an implicit tax. The official rate is overvalued and requires exporters to surrender their export proceeds at the overvalued rate. In addition, foreign exchange is made available to preferred importers at a favourable rate. The importers with access to foreign exchange enjoy a subsidy, while exporters pay an implicit tax.

5.6. Parallel foreign exchange market

The CBN has at various times restricted the sale of foreign currencies. The parallel market (also known as the unofficial or black market) developed in Nigeria as demand for foreign currency began to outstrip supply by the government and/or the CBN, driving up the price of foreign currencies and providing an opportunity for holders of foreign currency to sell their funds at higher than the official rate. As shown in Table 5, just as with the official exchange rate (IFEM), the parallel market rate (BDC) has risen rapidly in Nigeria.

Table 5. Official and parallel market rates

Year	IFEM (US$)	BDC (US$)
2012	158.76	160.86
2013	159.27	162.46
2014	164.88	171.45
2015	195.52	222.78
2016	253.49	372.86
2017	305.79	395.42
2018	306.08	361.81
2019	306.92	359.53
2020	358.81	433.70
2021*	381.00	477.82

Note: * 2021 data only published until April 2021.
Source: CBN (2017).

Parallel markets for foreign exchange almost always develop in response to policies that either restrict the sale of foreign currency or policies that fix prices at a level at variance with the market value of the currency (OECD, 2016). These markets are typically well developed where a country suffers periodic balance-of-payment deficits on account of either depleted foreign reserves or insufficient borrowing capacity.

The parallel market in Nigeria is operated by private individuals such as Hausa traders, who sit outside hotels and provide exchange services to visitors without the need for documentation or for disclosure requirements. This is the market where legitimate individuals and businesses who are unable to purchase foreign currency at the official rates source foreign currencies. An illustration by one informant is as follows: a company is importing goods into Nigeria and has an invoice of US$100 million to settle but is only sold US$40 million in the official market by the CBN. Such a company is left with two choices – cease operating or find other avenues to plug the shortfall. The only solution available to that company, if it intends to carry on operating, is to buy funds outside of the official market. This transaction, which is for a legitimate economic purpose and should ordinarily be conducted through the official market, is now forced to move to the parallel or black market as the holder of the foreign currency is not willing to sell on the official market.

Even where transactions are conducted in the official market, the mechanisms by which they are conducted also have a distortionary effect on financial flows. Another informant described a mechanism now commonly seen in the market wherein foreign exchange sellers get a rate determination from their banks typically at or close to the official rate. Sellers go on to find counterparties willing to buy at the parallel market rate. Both parties then transact in the official market at the official rate but conduct a hidden parallel transaction where the premium amount (described as the difference between the official rate and the parallel market rate) is transferred to the seller by the buyer to complete the transaction. Such transactions effectively reflect the shortage of foreign currency at the official rate. This mechanism creates the false impression that transactions are being conducted in the official market at the stated CBN rate, thereby obscuring the existence of separate IFFs (key informant interview, 2021).

Participants in the parallel market are not defined, especially as there is no legal recognition accorded to the operators. Any person who has foreign currency to sell or buy may participate in the market. However, although no legal recognition is given to the market, over time operators in the market have informally organised themselves into groups to: 1) monitor the rates from the IFEM and BDCs; 2) decide on the rates in their (parallel) market; and 3) pass on information about government regulation that may indirectly affect them.

The demand for and supply of foreign currency determine the rate of exchange in this market. There is no official quoted market for parallel market transactions and the only way to observe the rates is based on individual transactions as negotiated per transaction. The parallel premium (i.e., the difference between the official rate and the parallel market rate) will depend on a variety of factors that cut across the scarcity of foreign currency, the range of transactions subject to exchange controls, the level of monitoring and enforcement, and the penalty structure. In addition, there are several fund providers operating in the market who can affect rates for profit by limiting the liquidity of the market (key informant interview, 2021). The existence of the parallel premium also affects the inflow of foreign exchange. Individuals abroad who repatriate funds into the country also choose, for the most part, to make their repatriations in the parallel market rather than the official market because they can get more naira for their foreign currency in the parallel market (key informant interview, 2021).

Although the parallel market is believed to reflect true market conditions, the CBN does not acknowledge its existence in designing policies. The existence of the parallel market is tolerated on account of the realisation that the existence of high demand with a corresponding rationing in the official market will inevitably create a secondary market (Gray, 2020). However, given the restrictions limiting the transfer of deposited cash imposed by the CBN, foreign currency obtained from the parallel market can, for the most part, only be exported physically (Olisah, 2020).

6. Policy recommendations

The trajectory of the efforts to combat IFFs resembles in many respects that of the efforts to combat corruption in Nigeria, and indeed elsewhere. As with corruption, the process of defining the parameters and measuring the effects of IFFs is rooted in a complex intellectual and political history with seemingly little consensus. This is to be expected on an issue for which getting normative agreement is difficult. Unfortunately, the lack of consensus on definition and identification spills over into efforts to measure the effectiveness of interventions to stem the occurrence of IFFs. Unlike the anti-corruption debate, however, which focuses on the absence of capacity within low and middle income countries to counter corruption, the IFF debate is broader and includes interests in high-income economies, which is predominantly the destination of illicit funds.

Getting the tenor of the debate right is important in order to avoid repeating the mistakes made during anti-corruption campaigns. The implicit assumption in many low and middle income countries has been that the dominant anti-corruption campaign, in many ways, has been driven by an agenda set by and designed to meet the political demands of industrialised countries. The focus on IFFs and the increase in efforts to recover and return stolen assets to low and middle income countries has helped shift assumptions about the asymmetric distribution of costs and benefits. This rebalancing has cast the issue of corruption and the recovery of stolen assets as a global problem detrimental to both high-income and low and middle income countries alike. Broadening the concern has helped to reshape the conversation around the specific distribution of costs and benefits with many low and middle income countries taking an active role in setting the IFF agenda. Given that efforts to curb IFFs must be transnational to be effective, a transparent and inclusive process will reduce opposition to the efforts and will better the chances that all necessary parties will participate in attempts to stem IFFs.

Notwithstanding the importance of international efforts, the vast majority of the changes needed to tackle IFFs will have to occur at the national level, often in complex political environments. A sensible approach to reform in the presence of complex political economy concerns is to identify channels in the rules and institutions that are amenable to technical solutions. We subscribe to the view that incremental policy changes can be more effective than a political 'big bang' approach. Decades of experience with unsuccessful attempts to tackle corruption remind us that implementing reform in political institutions is complex, but that progress can be made where the reforms incorporate practices already in existence. For instance, in order to implement land reforms, Peru implemented laws that granted property rights to squatters who relied on customary methods of demonstrating possession to establish their rights (De Soto, 1989).

The changes that we propose below take into account the interdependence between foreign exchange management and IFFs on the one hand, and the close links between monetary policy and foreign exchange policy on the other. As a result, there is a strong case for developing new formal institutional arrangements that can mediate between these interdependencies. The recommendations we make require changes on two fronts. Firstly, we propose enhancing the independence of the CBN and ensuring that the opportunities for exercising undue influence are minimised in the policies and procedures for the management of the foreign exchange market. Secondly, we recommend curtailing the autonomy of the CBN Governor by establishing a foreign exchange policy framework with processes and procedures that allow decisions to be made in a structured and credible manner, insulated from individual decision-making and the avenues for influence.

The proposed changes acknowledge the nuance between the notion of independence and autonomy. In this view, the notion of independence focuses on the CBN's management of the foreign exchange regime free from outside influence. The notion of autonomy concerns the discretion of the CBN to deploy instruments to manage the foreign exchange regime within the set objectives. Our recommendation is to increase the independence of the CBN with respect to foreign exchange management and strengthen the rules of restraint around decision-making within the CBN on foreign exchange policy in order to create checks and balances on the authority of the CBN. The expected outcome of this combined action would be the dismantling of the multiple exchange rates and the current allocative framework for the distribution of foreign exchange.

The statutory framework already defines the roles and responsibilities of the CBN, sets out objectives, delineates the degree of independence and establishes the accountability framework. However, the recommendations proposed do not require an amendment to the CBN Act at this point, as this would not be feasible nor necessary without proper consultation. Instead, we propose the pursuit and formulation of a political consensus grounded in broad agreement and leveraging on the value of maintaining the CBN's international reputation as a professional and responsible central bank. There are instances in which such broad agreement has provided the basis for practices which later become enshrined in legislation. The statutory establishment of the MPC in the CBN Act in 2007 was presaged by the non-statutory establishment of a monetary policy committee in 2004.

Proposal 1 – Align the appointment of the Governor of the CBN to the electoral cycle on a fixed term, irrespective of when appointment is made

The statutory process for the appointment of the CBN Governor and the grounds and procedure by which the Governor may be dismissed affect the independence of this position. The CBN Act splits the responsibility for the appointment of the CBN Governor between the President and the Senate through an 'advice and consent' process. In this process, the President nominates the candidate and, with the advice and consent of the Senate, appoints the Governor. This process is designed to lend legitimacy to and engender public trust in the holder of the office. Much of the advice and consent given by the Senate in respect of governorship appointments occurs at committee level but the process often concludes with hearings, investigations and a floor debate.

The CBN Act sets the office of the Governor a term limit of five years with the option for reappointment for another five-year term. However, this term limit is not a guarantee of appointment as the Governor may be removed by the President at any time for any reason or no stated reason. Similar to the appointment process, the removal of the Governor is subject to advice and consent from the Senate with a required two-thirds Senate vote for successful dismissal. The statutory established term therefore does not prevent the possibility of the removal of the Governor but may serve to inhibit removal as it sets a normal expected tenure of the Governor.

The above provisions do not make any stipulations with respect to timing the appointment to either coincide or overlap with election cycles. The current Governor of the Bank, for instance, was appointed prior to the election and inauguration of President Buhari but was reappointed by the President after his re-election victory. Having only served one year of his five-year term when Buhari's administration took office, the Governor may be likely to feel allegiance or commitment to the President in order to retain his position. We propose the introduction of a fixed term for the Governor with beginning and end dates tied to the election cycle, irrespective of whether the posts are filled or when appointments are made.

Calibrating the length of term for the CBN Governor relative to the political cycle will mean that the Governor only owes allegiance to the President in their last year of office and will strengthen the independence of the Governor from the successive President. There is precedence for timing the appointment of the Governor relative to the electoral cycle. For example, the term of the Governor of the Bank of Mexico starts in January of the fourth year in office of Mexico's President.

We acknowledge that this safeguard would be lost in the instances where Nigeria's President is elected for a second term. But this could be mitigated by limiting or prohibiting the reappointment of the CBN Governor. Two central banks (the European Central Bank and the Bank of Spain) have explicit prohibitions on the reappointment of their governor. The rationale is that a prohibition serves to strengthen the autonomy of a governor by ensuring that the political participants empowered to reappoint the incumbent are not able to use the threat of non-renewal to influence central bank policy. In addition, the changes will need to eliminate the avenues for holdover provisions. Holdover provisions may affect the dynamics of the advice and consent process and permit the President of Nigeria to appoint the CBN Governor in an acting capacity. Other appointments to key government positions have permitted extended periods during which an appointee serves in a holdover capacity.

Proposal 2 – Expand the remit of the MPC to include foreign exchange policy management

The MPC is responsible for formulating monetary and credit policy for the Nigerian financial system. The MPC was established under Section 12 of the CBN Act 2007. The Committee is made up of the CBN Governor as Chair, four Deputy Governors, two members of the Board of Directors of the Bank, and five external members (three members appointed by the President and two members appointed by the Governor). The MPC meets regularly based on a pre-announced calendar of meetings. The outcomes of the regular meetings are communicated to the public through a policy communiqué. The composition of the MPC and its broad mandate is largely in line with how similar committees in leading central banks are constituted and mandated.

The CBN has already taken significant strides towards transparency and credibility with monetary policy. Our proposal seeks to build on the success of the MPC in monetary policy and extend the gains to the foreign exchange policy decision-making process by creating a more broad-based public consensus on foreign exchange policy. We recommend that the scope of the MPC is expanded beyond the current remit of formulating monetary policy to include exchange rate policy.

The monetary policy framework and the choice of foreign exchange regime are related and decisions on the exchange regime have effects in the monetary policy arena. The potential for inconsistency between these two aspects of macroeconomic policy is well known but the MPC has no formal authority to make decisions on foreign exchange policy. Responsibility for monetary policy has been placed with a committee, but the Governor maintains responsibility for foreign exchange policy. Given the interaction between exchange rate and monetary policy, giving responsibility for monetary policy to the MPC without the corresponding responsibility for foreign exchange rate management encroaches on the accountability for monetary policy.

We suggest that, because of the close linkages between monetary policy and the foreign exchange regime, foreign exchange policy decisions should be subject to a similar specialised and consultative governance process. The rationale is that committees are more likely to make better monetary policy decisions and outperform individual decisions due to their consultative and collaborative nature (Blinder, 2004). Firstly, the decisions of the committee are more likely to reflect the pooled views of the members, which are less likely to be extreme positions or be dominated by the views of any one individual. Secondly, decisions by a committee are more likely to be transparent. Thirdly, decision-making on the exchange rate regime by a committee serves to reduce the avenues for undue influence either from the vested interests of the political elite, politicians or businesses. We also know that the MPC as currently constituted already displays some level of independence. A study analysing the voting patterns of the MPC notes that, although the 'internal' members have similar voting patterns, the majority of external members appear to lend dissenting voices (Ekor et al., 2014). The committee can therefore serve as an independent arbiter and decision-maker on foreign exchange policy.

Proposal 3 – Consolidate the various exchange rate regimes into one single rate

The most important requirement is to move away from using multiple exchange rates to respond to foreign exchange shortages. The CBN could use market interventions to influence a single exchange rate, and an independent Governor and MPC could develop capacity and prestige in being able to do this. This has value for Nigeria in international transactions, and a number of powerful constituencies (including exporters and importers who fall outside preferred categories) are potentially powerful constituencies who would support such a policy. The procedural changes suggested earlier can empower monetary policy managers to develop the type of managed float that other low and middle income countries have used with some success. This includes convertibility on the current account and some convertibility on the capital account. This will not address all types of IFFs, but our analysis shows that a significant element of IFFs in Nigeria relate to problems created by a narrow set of interests who have successfully managed to keep bringing different variants of multiple exchange rates back to the policy mix.

7. Conclusion

This paper argues that the tight currency controls enforced by the CBN in Nigeria has created opportunities for increased corruption and IFFs. Powerful political interests have been able to extract illicit profits as a result of the foreign exchange mechanism instituted by the CBN. As such, it is necessary that institutional and policy changes be made to ensure a more effective regulatory framework. This includes protecting the independence of the CBN from political overreach by the executive and closing the avenues for arbitrage or leakage in the foreign exchange system by adopting a single rate regime and introducing some convertibility for the currency.

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