



REDENOMINATION OF NAIRA

INTRODUCTION:

Redenomination, the latest contending policy issue in Nigerian economy today, refers to reduction in the par value of a currency, usually by a factor of ten. In other words, redenomination is the process where a new unit of a currency replaces the old unit with a certain ration. For instance, Ghana in July this year decided to implement redenomination policy by replacing the old 10, 000 cedi with a new 1 Ghana cedi, i.e., four zeros were removed from the old currency to arrive at the new one.

When implemented, redenomination usually results in the birth of an entirely new currency, with a new symbol. In the case of Ghana, for instance, the currency changed from Cedi (¢) to Ghana Cedi (GH¢).

The contending issues revolving around the redenomination policy are:

- What is the rationale for implementing such policy or under what condition is such policy required in a country?
- What would happen to the external value of the domestic currency after such policy is implemented?
- What would be the impact of such policy on the Nigerian markets, especially the capital market?
- What are the benefits of such policy on the economy as whole?

RATIONALE FOR REDENOMINATION:

Redenomination, sometimes referred to as currency reform, often serves as the last resort for monetary authorities of hyper-inflationary economies, where domestic currencies have lost significant value locally and internationally, to regain public confidence in the domestic economy and the economic policies implemented therein. For instance, Angola re-denominated its currency in 1995 when inflation rate was 2672 per cent, while Brazil re-denominated its currency in 1994 when inflation rate was 2076 per cent.

Currency redenomination also can be a means by which governments attempt to reassert monetary sovereignty. If citizens lose confidence in the national currency, they may begin to use foreign currencies, particularly those with greater prestige. This may be a psychological and an economic blow to the government. With widespread foreign currency substitution (or, more extremely, full dollarization), the central bank no longer controls the money supply, rendering it unable to provide lender of last resort functions. Consequently, economic policy is influenced not only by international capital markets, but also by foreign central banks. Currency redenomination, then, is a means by which governments can attempt to reverse this currency substituting behaviour. If citizens are confident that the new local currency will hold its value, they may be willing to shift from using foreign currencies, such as euros and dollars, to using the new domestic currency.

While the act of dividing a currency's value by a factor of ten is somewhat symbolic, it can also help to convince citizens of a currency's worth. As a result, redenomination often occurs after economic crises, as governments attempt to convince citizens and markets that hyperinflation is a thing of the past. In some cases, the timing is correct, in that redenomination caps off

high levels of inflation. In other cases, governments are not able to curtail inflation immediately after redenomination, and they may make multiple efforts at currency reform. Argentina and Brazil during the 1980s and early 1990s exemplify this pattern.

Many nations with high levels of inflation also have relatively low-value local currencies, making large denomination currencies necessary for basic transactions in the economy. While it is high or hyperinflation that often causes this situation, the presence of large-denomination notes may be the most obvious sign to citizens of a potential need for redenomination.

BENEFITS FROM REDENOMINATION:

It is important to say no economic theory postulates that a country that redenominates its currency would reap certain economic gains. Redenomination of currency is a symbolic reform without guaranteed benefits. It only helps to create impressions that past inflations have been eliminated. So, it does not necessarily imply that future inflation will be low. Thus, it is possible for a country to report worse inflationary trends after redenomination.

However, there are probable gains that could accrue after redenomination in an economy. Besides the administrative and personal convenience that would result from the use of lower units of currency to execute high-value transactions, implementation of redenomination policy might signal renewed commitment of the monetary authorities to effectively manage general price level. It is this “signaling effect” that makes the general public to have expectation of low inflation in the future.

Since today’s interest rate is set in line with the expected inflation rate, the “signaling effect” might then cause a decline in general interest rate in the economy. In addition, the expectation of lower inflation would likely strengthen the domestic currency in the Foreign Exchange Market.

However, if the post-redenomination inflation turns out to be significantly higher than the expected inflation, the policy might spark off economic reactions that could worsen the state of the whole economy. Thus, for there to be real benefits from redenomination, the post-redenomination inflation must be within expectations. This therefore implies that the monetary

authorities must be actively committed to stabilizing the economy after implementing redenomination policy.

THE CASE OF NIGERIA:

In view of the foregoing, the proposal of the Central Bank of Nigeria, the monetary authority in Nigeria, to re-denominate the domestic currency, Naira, by dividing the existing Naira by 100, may not be economically justified. This is premised on the fact that present inflation rate in the economy is within a single-digit value (6-9 per cent), which qualifies Nigerian economy as a moderately stable economy. Also, public confidence in the Nigerian economy is quite high as evidenced by growth in domestic and foreign investments in the country. More so, foreign currencies are not being used for domestic transactions in the economy, thus there is still much confidence in Naira as it were.

However, taking into consideration the other targets of the Central Bank of Nigeria, such as the re-positioning of Naira as a “reference currency” for transactions across the West African sub region and the making of Nigeria a financial hub for investors across the whole of Africa, among others, the

redenomination of Naira could be of high significance to the Nigerian economy. In this regard, redenomination will allow the Naira to be directly and easily linked and monitored with the US dollar and hence increase external confidence in the Naira. To sustain the confidence in Naira and hence the Nigerian economy, the CBN must ensure that inflation is strictly controlled. More so, with the full deregulation of exchange rate that would likely characterize post redenomination era, low level of inflation is essential to sustaining Naira value relative to foreign currencies. Thus, it is expected that inflation rate will be the utmost target variable for the monetary authority during the post-redenomination era. In other words, redenomination is expected to result in a shift from monetary targeting to inflation rate targeting, a major policy framework with its own pros and cons.

IMPLICATIONS ON THE NIGERIAN CAPITAL MARKET:

Premised on the signal of renewed commitment of the monetary authorities to effectively manage general price level and the probable increase in external confidence in the nation's economy that redenomination of Naira might cause, the Nigerian capital market is expected to experience a boost.

The signal of more effective management of general price level makes investors to anticipate lower and stable inflation. Thus, the general level of interest rate is expected to fall. Such fall in interest rate will in turn boost investment in the Nigerian capital market.

Also, the probable rise in external confidence in the Nigerian economy will attract more foreign direct investment into the country, with a positive impact on the capital market. However, significant fall in interest rate might have a negative impact on inflow of foreign investments into the economy.

However, upside risk to interest rate is high in the post-redenomination era, especially in the long run. Where the CBN envisaged that inflation rate will rise above the target rate, it might decide to raise interest rate as a policy measure to keep inflation rate within target, as the CBN would probably be more committed to maintaining inflation rate than maintaining interest rate in the post-redenomination era. Consequently, this might impact negatively on domestic investment in the country.

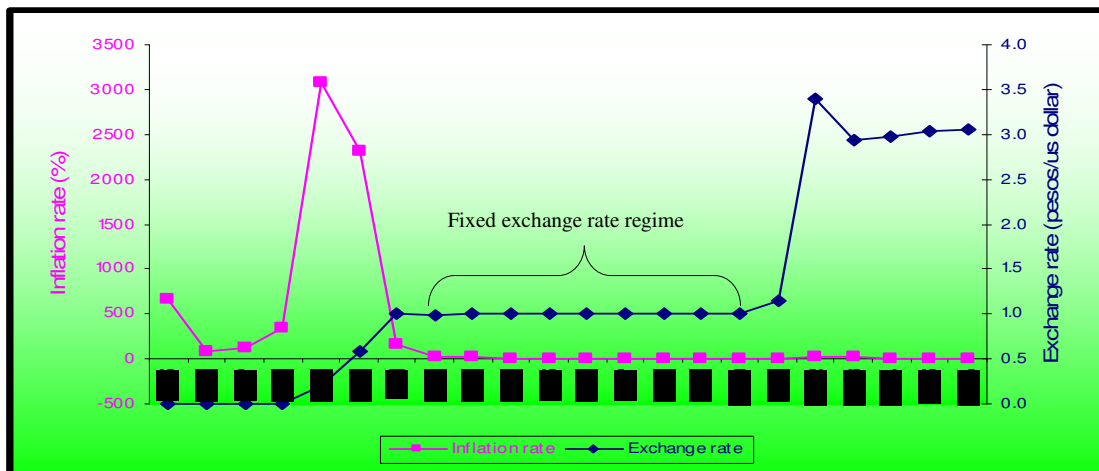
Thus, while its impact on capital market looks positive in the short run, the currency reform has uncertain implications for the Nigerian capital market in the long run. It is all about what happens to the economy as a whole. If the economy grows we should expect growth in the capital market, and vice versa.

APPENDIX I

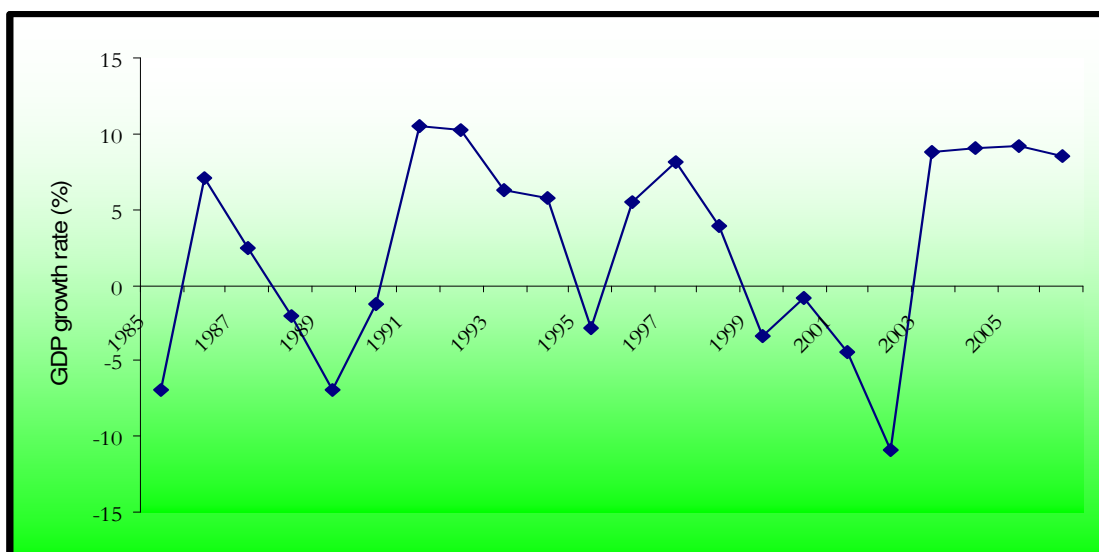
ARGENTINA EXPERIENCE:

Prior to 1992, Argentina's five-year average annual inflation rate was 1207.9 per cent, with the highest of 3079.5 per cent reported in 1989, while five-year average exchange rate was 3,564 australes to 1 US\$. Although the country witnessed decline in inflation rate to 171.7 per cent in 1991, the country's currency further depreciated relative to US\$ with 10,028 australes exchanging for 1 US\$. Consequently, the country re-denominated its currency in January 1992 by re-introducing *peso* to replace the *austral* at the rate of 1 peso = 10,000 australes, and then pegged its international exchange rate at 1 peso = 1 US\$.

TRENDS IN INFLATION AND EXCHANGE RATES IN ARGENTINA



TRENDS IN GDP GROWTH RATE OF ARGENTINA



After the redenomination, inflation subsided significantly with sharp and continuous decline in the inflation rate from 171.7 per cent in 1991 to 0.9 per cent in 1998, while exchange rate remained fixed by the Central Bank at 1 peso = 1 US\$ till 2001. However, the fixed exchange rate made imports

cheap, producing a constant flight of dollars away from the country and a progressive loss of Argentina's industrial infrastructure, which led to an increase in unemployment. The situation, worsened by the country's huge foreign debt obligations, culminated into a recession with the country experiencing a 4 per cent decline in GDP in 1999. Eventually, the country abandoned the exchange rate peg at the end of 2001. Thereafter, exchange rate rose significantly from 1 peso/US\$ to 3.4 peso/US\$ in 2002, translating to 240 per cent depreciation in the international value of peso within one year. Consequently, inflation rate climbed significantly from negative level to 25.9 per cent in 2002. However, after this time, average annual inflation rate has been 9.6 per cent, while international exchange rate hovers around three pesos/US\$. Ever since, the Argentine economy has been on the recovery path.

From the foregoing, it is observed that Argentina slumped into recession in 1999, approximately seven years after its last redenomination. While redenomination could not be said to be the primary cause of the recession, other complementary policies such as those highlighted below could be used to explain the recession.

- After redenomination, the Argentine Central Bank pegged the exchange rate at 1 peso/US\$, which implied that peso was relatively overvalued. This consequently made imports cheaper and then led to the collapse of local industries, with the ultimate outcome being widespread unemployment.
- Also complementary to the redenomination was the policy which gave depositors the option to withdraw their deposits at banks in US Dollar. This policy consequently allowed widespread circulation of US dollar in the Argentine Economy and then facilitated the flight of US dollars to foreign countries.