

Economic Report | Currency
Goodbye naira peg, Hello floating naira
Economic Snapshot

May 2016 Inflation Data/Indices			
	MoM	YoY	Prev YoY
Headline	2.8%	15.6%	13.7%
Food	2.6%	14.8%	13.2%
All Items Less Farm	2.7%	15.1%	13.4%
Imported food	3.1%	18.6%	16.3%
Energy	3.5%	25.9%	23.7%
Currency Markets			
	Latest	Daily Chg	YTD
USDNGN	198.50	0.28%	0.40%
EURNGN	223.81	-0.19%	-3.30%
GBPNGN	281.97	-0.39%	3.97%
JPYNGN	187.24	0.20%	-12.9%
Monetary Aggregates - May 2016			
	(₦'bn)	MoM	YoY
M2	20,722	-0.03%	7.96%
CPS	19,049	-1.70%	2.13%
NCG	3,803	-3.32%	48.6%
NFA	5,207	3.19%	-4.98%
NDC	22,852	-1.97%	7.74%
External Position			
	Latest	QoQ	YoY
Trade Balance (\$'mn)	-467	-49%	N/A
External Reserves (\$'mn)	26,450	-5.1%	-9.1%
Foreign Debt (\$'mn)	10,718	0.9%	10.4%
Growth Data - Q1 2016			
	(₦'bn)	%of total	YoY
Real GDP	15,988	100%	-0.4%
Agriculture	3,275	20.5%	3.1%
Oil	1,646	10.3%	-1.9%
Services	5,918	37.0%	0.2%
Wholesale and Trade	2,909	18.2%	2.0%
Manufacturing	1,578	9.9%	-8.1%

Wale Okunrinboye

adewale.okunrinboye@arm.com.ng
CBN delivers on flexible naira promise

Yesterday, the Central Bank of Nigeria (CBN) provided clarity on the flexible naira policy adopted at the May 2016 MPC meeting with release of guidelines on the new market architecture. In the new currency regime, the USDNGN would trade fully floating under a single structure in the autonomous/interbank with no guidance on naira range. Other key highlights of the new system as announced are as follows:

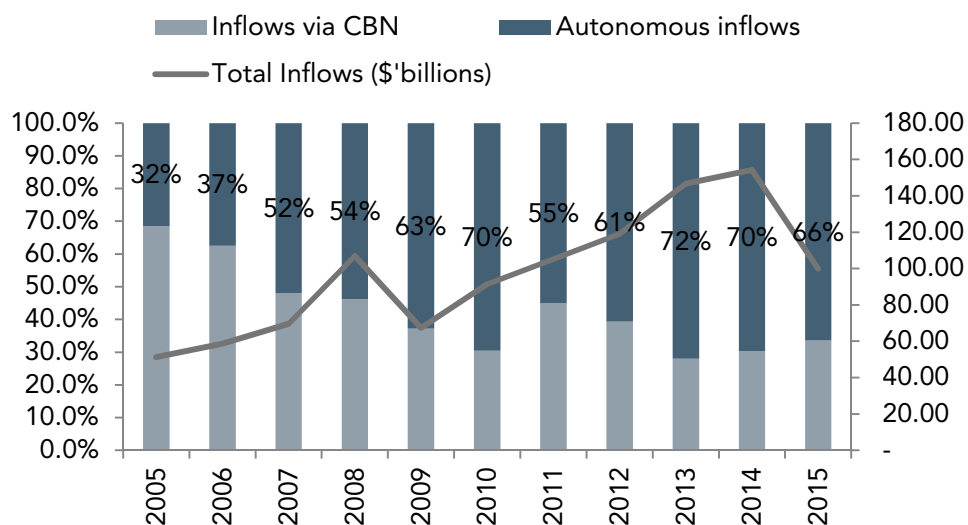
- Market participants (described as authorized dealers, authorized buyers, oil companies, exporters, end-users etc.) shall trade in the single market via the FMDQ Thomson-Reuters order matching system.
- Authorized dealers shall display 2-way quotes in transactions with other authorized dealers but may display one-way quotes in transactions with other market participants.
- Maximum bid-offer spreads shall be determined by FMDQ via its market organization activities with FMDA.
- CBN will introduce FX primary dealers (FXPD) to act as a sort of 'market-maker' for large trade sizes with the CBN in addition to the development of long tenored forward/futures market for the naira.

In addition, the apex bank can intervene in the markets via 2WQ with FXPDs as a market participant with no guidance on bid-offer spread range as in the past. The CBN noted that interbank funds cannot be sold to BDC operators and that the proscription of access to imports on 41 items list remains in place.

Exit CBN, enter autonomous flows

Given our long-held views about the need for the CBN to end the arbitrary determination of USD/NGN in favour of a system of price discovery via market forces, yesterday's decision to completely abandon the idea of a naira peg, as against taking an easier route via devaluation can be viewed as a positive. Under a fully floating system, the influence of the larger autonomous inflows, relative to dollar inflows via the CBN, should be more evident in USD/NGN determination. Since 2007, autonomous dollar inflows now account for more than half of total dollar inflows into the Nigerian economy, exceeding CBN dollar inflows.

Figure 1: USD Inflows to Nigerian economy



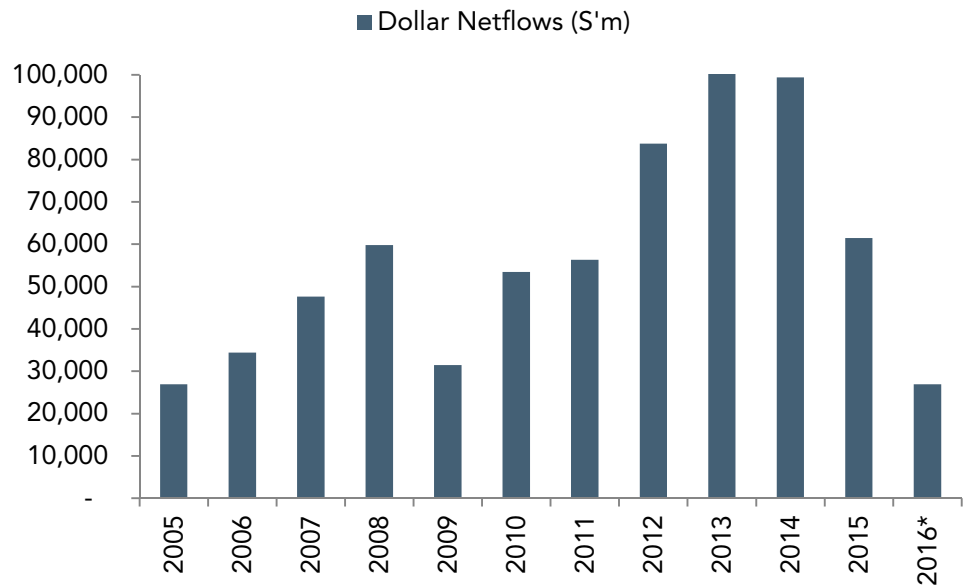
Source: CBN, ARM Research

However, as we noted in prior reports¹ CBN's dictatorial hold on the clearing naira rate meant that the regime shift in the dollar supply side had no influence on currency market dynamics. Thus, going forward, the key positive from CBN's

¹ [USD/NGN: Calm in between storms](#) and [Endgame in sight for Naira skirmishes](#)

shift, is that autonomous flows would now exert greater influence on NGN determination. On this wise, CBN data showing that Nigeria is a net positive dollar flow country implies that improved dollar supply from this source should be readily available to meet current dollar shortages. For evidence, available data over January and February 2016 show that at \$7.2billion, autonomous flows are 3x inflows into CBN reserves.

Figure 2 : Net Dollar flows through the Nigerian economy



Source: CBN, ARM Research *Jan-Feb annualised

Admittedly, the time and dollar reserves wasted by apex bank and fiscal authorities before capitulation to allowing fundamentals force are costly in hindsight but perhaps a bit of better late than the late. Farther out, we think the lack of commitment to an arbitrary rate allows the CBN flexibility to intelligently use foreign reserves to intervene during periods of market volatility unjustified by fundamentals and also to capture gains in periods of increased portfolio inflows.

Another derivative gain of the shift to market-driven system is the move to develop mechanisms for managing the risk associated with the increased currency volatility associated with the flexible regime. Going forward, economic agents should increase demand for hedging instruments by to handle FX uncertainty which should ensure the establishment of a currency

forwards/futures markets as in developed markets. This framework is a ready solution for the demand front-loading problems associated with the current managed float.

Potentially, the longest-lasting impact from this regime change is on the structure of economic production. A more adjustable rate provides a greater incentive to grow competitive non-oil exports on the one hand and reduce elastic components of import demand. From a policy perspective, Nigeria's economic managers can now develop policies which target sectors with potential to boost trade balance. Overall, taking together with hike in electricity tariff in February and recent adjustment to domestic PMS prices, the shift to a flexible exchange rate will likely completely erase prior insinuations of a socialist/populist orientation to the current administration.

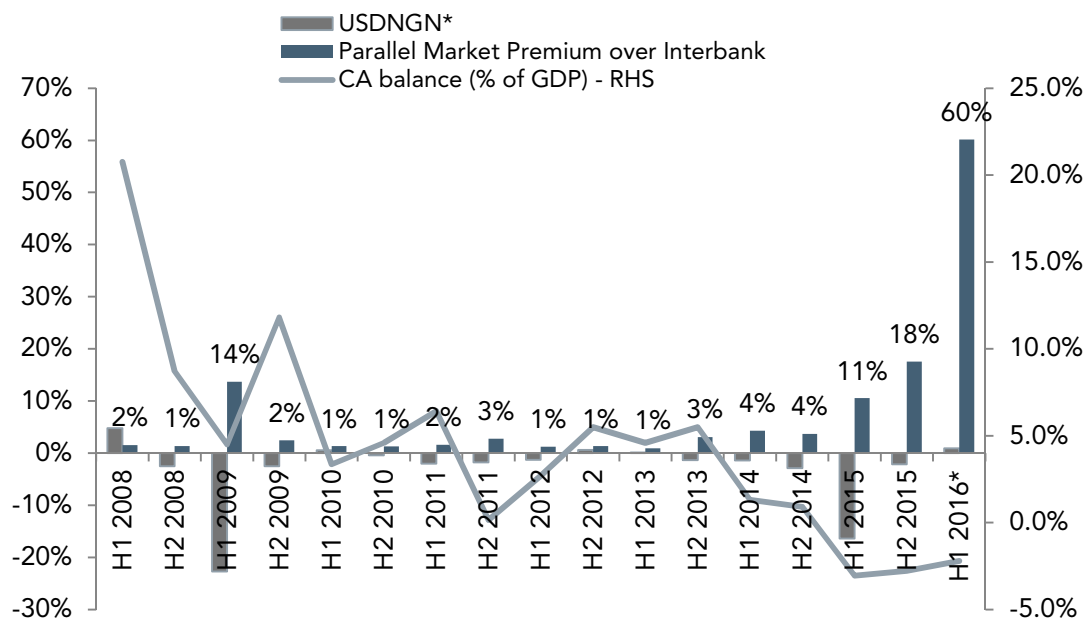
Fundamental concerns underpin downside in USDNGN

Beyond the positive vibes from the FX regime change the key question remains where the USDNGN will trade under the new system. Under a market system, naira trajectory should reflect demand and supply forces which in this case should mirror movement in underlying fundamentals in the current account. Over the near term, influence of autonomous flows are unlikely to be sufficient to plug current account deficit (2015: -2.8% of GDP) and demand overhang in the interbank market, which are currently reflected in the rise in mean parallel market spread over interbank USDNGN to multi-year highs. Updating our framework of calibrating current account balances and parallel market premiums to our exchange rate forecasts, we see scope for a wider down-leg in exchange rate from the 25-30% in our prior forecasts to a 40-45% under the new system.

Though the CBN hinted at likely clearing the current interbank dollar demand overhang², with the governor noting that Nigeria has sufficient reserves to meet unmet LCs, uncertainty over the resolution of this item could stoke heightened near-term volatility when the naira starts trading next week Monday. Farther

out, NGN trajectory should more closely match trends balance of payment where current account outlook is crucial. Given recent recovery in oil prices and conciliatory talks between the FGN and Niger Delta militants (that should allow repairs on oil pipelines), we see scope for improvement in CA balances by the latter part of 2016.

Figure 3: Current Account balance, naira performance and parallel market premium



Source: CBN, ARM Research *Q1 2016

Mixed bag for capital markets but index inclusions hold promise

For the equities market, the change in FX market architecture drives mixed fortunes across various sectors, in our view, with prospects of a naira depreciation implying negative connotations for corporates with huge dollar liabilities. Scanning through our coverage names we find the FMCGs to be the most exposed while banks should reports gains from FX trading. In addition, the proscription of FX access to for palm oil imports should continue to provide a shot in the arm for palm oil producers. For the broad market, the removal of FX curbs removes risk to index exclusion by MSCI (who yesterday set a September 2016 date for a definitive announcement on Nigeria's status) which should prove positive for overall market sentiment. Indeed, market participants appear to be

taken an optimistic view with the NSEASI extending its intraday gain of +1.7% before announcement—market open to close yesterday 3.17% higher similar to the one day bounce (+3.78%) the day after the May MPC in which flexibility was formally announced.

For fixed income markets, the existence of a single forex market removes the incentive to take speculative positions (to exploit mispricing as obtainable under the old forex market) on the currency which could see such funds flow into the FI market. To our mind, this understanding together with current economic exigencies reduces the need for any precautionary monetary tightening to stem initial volatility when the flexible market goes into operation. That said, the apex bank could raise interest rates in a quest to keep real yields positive following sustained spikes in inflation. Similar to equities, prospect of index inclusions (with J.P Morgan specifying a minimum one year period for re-adding Nigeria to its EMGBI) holds prospect for yield downtrend farther out.

All rights reserved. Unauthorised use, reproduction, distribution or disclosure of this document is strictly prohibited.

This material has been issued by Asset & Resource Management Company Limited (“ARM”), a Company regulated by the Nigerian Securities and Exchange Commission. The analyst(s) primarily responsible for preparing this research report, in whole or in part, certifies that with respect to each security or issuer covered; all of the views expressed accurately reflect his/her personal views about the subject securities and issuers and no part of his/her compensation was, is, or will be, directly or indirectly, related to the inclusion of specific recommendations or views in the report.

This research report is based on information from sources that ARM and its analysts believe to be reliable. Neither ARM nor any of its research analysts, nor any member of the ARM Group, gives any representation or warranty, express or implied, or undertaking of any kind or assumes responsibility or liability of any kind with respect to the accuracy or completeness of the information set out in this report or any third party’s use (or the results of such use) of such information. This report is provided solely for informational purposes and is not to be construed as providing advice, recommendations, or endorsements of any kind whatsoever. The investments and strategies discussed here may not be suitable for all investors; counsel of investment advisor should be obtained with regard to such investments and or strategies. This research report is not a replacement for advice from an accountant, lawyer, personal finance advisor or other category of investment advisor. The investments discussed in this report may oscillate in price or value. Opinions and information provided are made as of the date of the report issue and are subject to change without notice. This research report is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Reference herein to any specific security or financial instrument does not necessarily constitute or imply its endorsement or recommendation by ARM, its directors, officers, employees or designated agents. Members of ARM may act as broker, advisor or lender, or make a market in any investments or issuers referenced in this report. Further information on any of the securities discussed herein may be obtained upon request to ARM. By accepting this document, you agree to be bound by the foregoing limitations.