

Nigeria Strategy Report

H1 2020

Domestic Economy and Markets

Currency: How long can the CBN keep up?

Executive Summary

Across the various windows, the naira remained stable over H2 2019. Particularly, the BDC and parallel rates held steady at ₦359/\$1 and ₦360.5/\$1 respectively, while the NAFEX rate depreciated slightly by 1% to ₦364.2/\$1. Once again, the apex bank continued to manage stability of the naira despite significant pressures faced over H2 19. For clarity, events in the FX space took a turn around over the second half as foreign inflows slowed together with exodus of foreign flows over same period. In turn, CBN became a net seller at the IEW, net selling \$4.7 billion over H2 2019 compared to a net purchase of \$6.0 billion in H1 2019. Overall, the FX reserve was depleted by \$6.5 billion over H2 19 compared to an accretion of \$2.2 billion over the first half.

Despite calls for a devaluation in the naira, the CBN has continued to hold tightly unto the naira. We think as pressure continues to mount on the CBN, the apex bank might have to give in. However, we do not see that happening in 2020. Over H1 2020, we expect further depletion in the reserve to the tune of \$4.1 billion and another \$2.9 billion over the second half to close 2020 at \$31 billion. Particularly, while we expect a moderation in outflows over H1 20, we anticipate a faster moderation in inflows on the back of lower oil price and depressed FPI inflows. Irrespective, we think the CBN will continue to manage the naira at current level of ₦360 – 365/\$ given the position of our FX reserve projection. For emphasis, the apex bank has hinted it will maintain the naira at current level as long as the FX reserve remains above \$30 billion. That said, our estimates exclude a possible Eurobond issuance or/and multilateral financing over the year. We think the FG could raise as much as \$3 billion from the international market, which should further shore up the reserves.

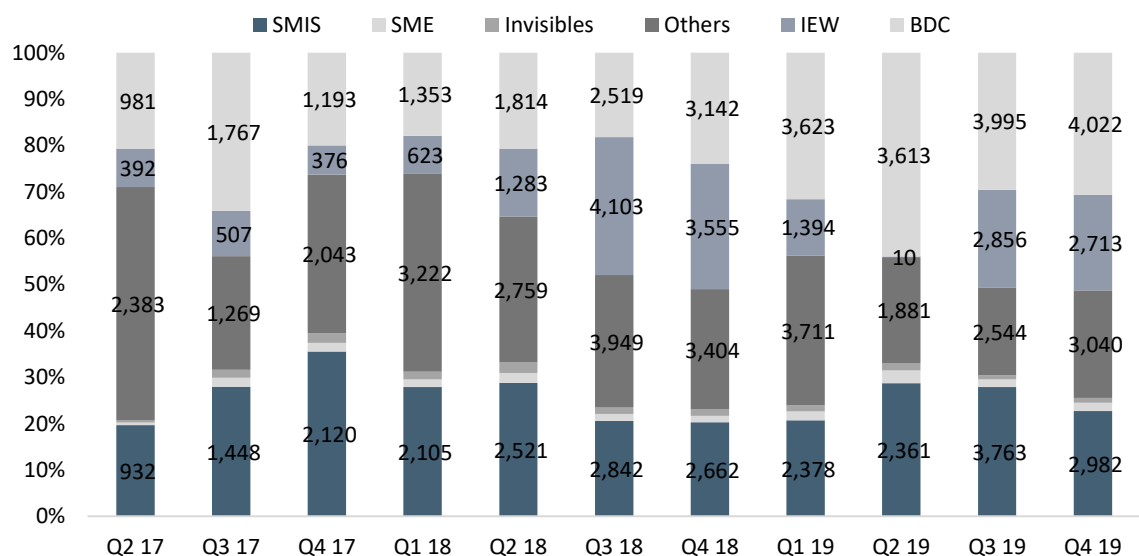
In this report, we look at the major themes that dominated the foreign exchange market in H2 2019 as well as our outlook for pull and drag of foreign exchange flows over 2020.

Confluence of higher outflows and weak inflows dampen FX reserve

Across the various windows, the naira remained stable over H2 2019. Particularly, the BDC and parallel rates held steady at ₦359/\$1 and ₦360.5/\$1 respectively, while the NAFEX rate depreciated slightly by 1% to ₦364.2/\$1.

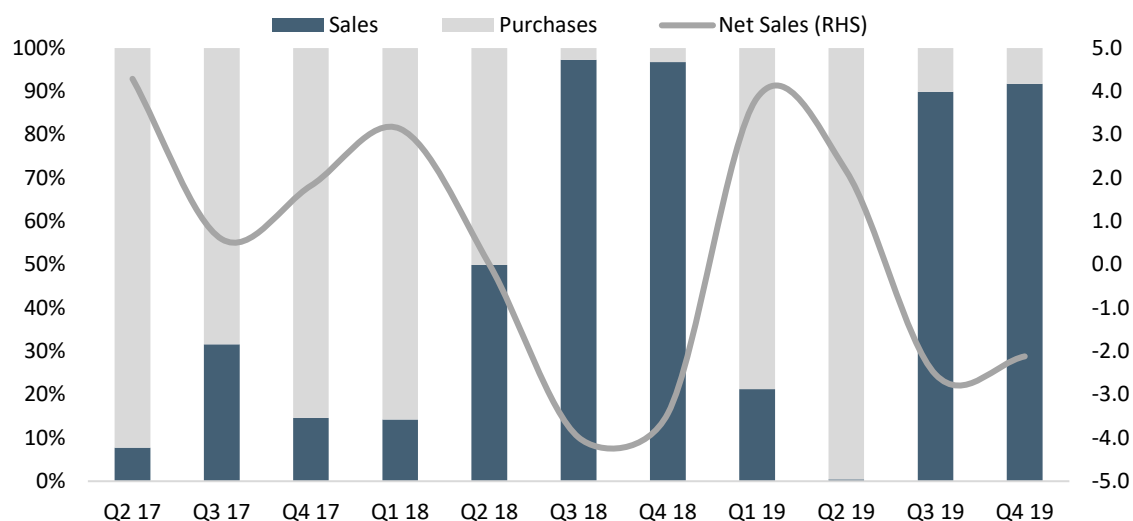
Once again, the apex bank continued to manage stability in the naira despite significant pressures faced over H2 19. Events in the FX space took a turn around over the second half as foreign inflows slowed together with exodus of flows over same period. In turn, CBN became a net seller at the IEW, net selling \$4.7 billion over H2 2019 compared to a net purchase of \$6.0 billion in H1 2019. To buttress, outflows through the CBN rose rapidly on the back of higher FX demand for imports and higher FPI repatriation over the review period. For imports, we think improved FX stability began to reflect on total imports. On the latter, higher repatriation mirrored increased risk across emerging markets. Consequently, CBN stepped up its interventions across the various segments to the tune of \$21.5 billion (19%) over H2 19.

Figure 1: CBN intervention across FX markets (\$'Million)

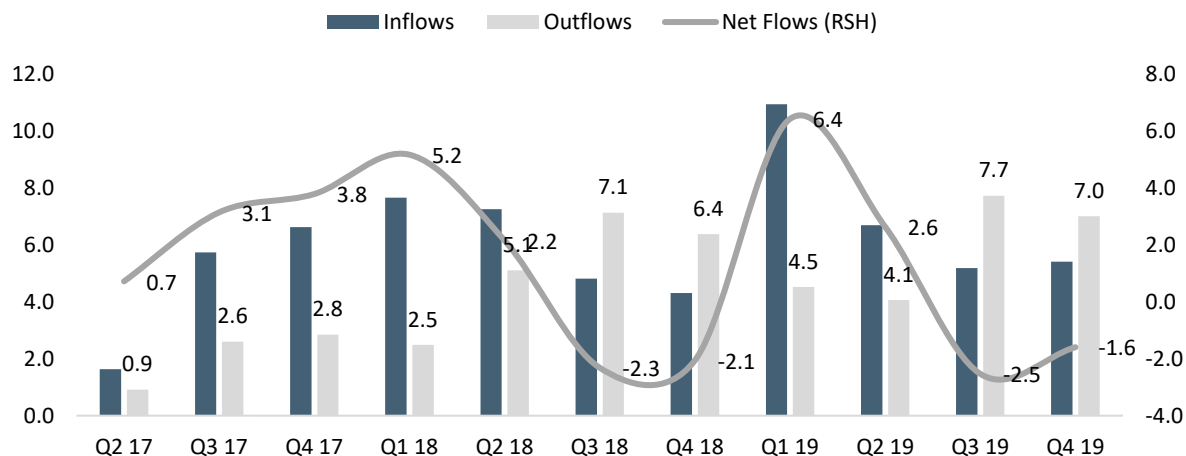


Source: FMDQ, ARM Research

On the other hand, it was a dearth of inflows across the FX space. At the IEW, despite modest increase in local inflows (Exporters, Individuals and non-bank financial institutions), foreign inflows slowed significantly resulting in a 39.8% decline in inflows (\$10.6 billion) to the IEW with Q4 recording the lowest inflow in the year. In our view, we believe the more depressed flow over the last quarter mirrored uncertainties surrounding CBN's policies, particularly exclusion of non-banks locals from participating in OMO auctions. Overall, the FX reserve was depleted by \$6.5 billion over H2 19 compared to an accretion of \$2.2 billion over the first half.

Figure 2: CBN activity at the IEW (\$'billion) vs. Balance (\$'billion)

Source: FMDQ, ARM Research

Figure 3: Structure of flows at the IEW vs. Balance (RHS) in \$'Billion

Source: FMDQ, ARM Research

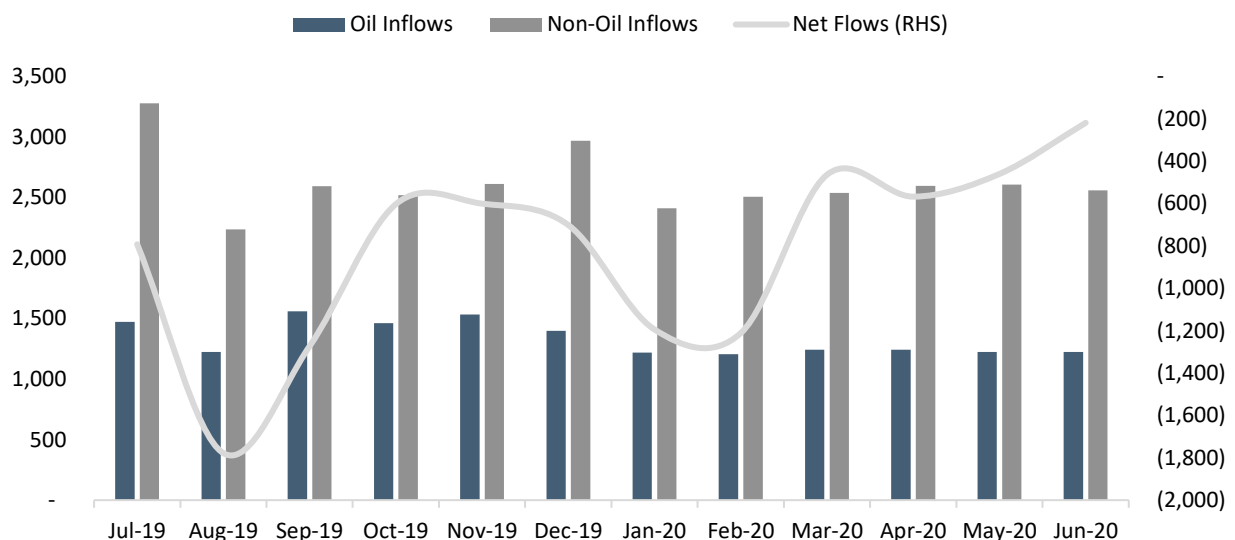
How long can the CBN keep up?

Despite calls for a devaluation in the naira, the CBN has continued to hold tightly unto the naira. We think as pressure continues to mount on the CBN, the apex bank might have to give in. However, we do not see that happening in 2020. Over H1 2020, we expect further depletion in the reserve to the tune of \$4.1 billion and another \$2.9 billion over the second half to close 2020 at \$31 billion. Particularly, while we expect a moderation in outflows over H1 20, we anticipate a faster moderation in inflows on the back of lower oil price and depressed FPI inflows. Irrespective, we think the CBN will manage the naira at current level of ₦360 – 365/1\$ given the position of our FX reserve projection.

For emphasis, the apex bank has hinted it will maintain the naira level at current level as long as the FX reserve remains above \$30 billion.

On inflows, we anticipate lower oil price to weigh on oil-inflows. Particularly, we see oil price moderating 5% YoY to \$61/bbl over 2020 (H1 20F: \$61, H2 19: \$63), as we expect supply from the US and the other non-OPEC producers to outweigh the increased cuts from OPEC and the support lent from improved demand growth. Overlaying this with our crude oil production forecast of 2.07mbpd, we estimate total oil inflow at \$7.3 billion (-14.9%). For non-oil inflow, given the recent paucity of flows seen in the IEW, we think flows will remain depressed over H1 2020. For clarity, we think foreign investors will remain cautious barring policies that could trigger growth and confidence in the naira. We expect the foregoing to translate into lower FX purchases by the CBN with total non-oil inflow estimated at \$15.2 billion (vs. \$16.2 billion in H2 2019).

Figure 4: CBN oil and non-oil inflows and forecast (\$'Billion)



Source: CBN, ARM Research

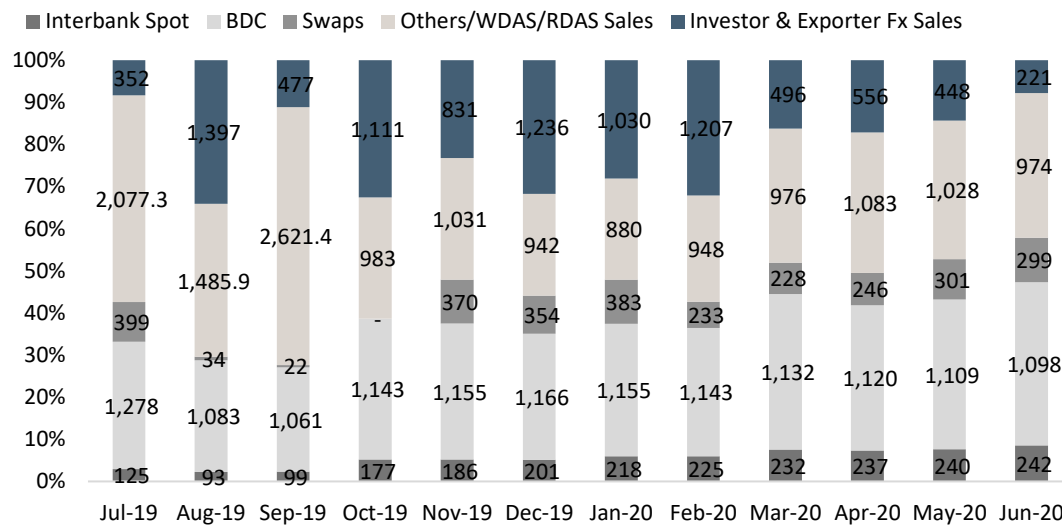
Lower FPI repatriation to limit outflows

As mentioned earlier, we see prospect for a moderation in total outflows through the CBN. On one hand, while we expect higher FX demand for imports, we believe lower FPI repatriation in H1 2020 will drive total outflow lower. To be clear, given CBN's recent posture, it's evident the apex bank would continue to caress FPI in order to manage its FX reserve. As a matter of fact, while rates have fallen over 665 bps¹ in the T-Bills market, the CBN has kept OMO rates circa 13% to keep FPIs. We think this should give a level of comfort to the FPIs, at least for the next one year.

¹ H2 2019

Coalescing our modeled FPI repatriation and expected dollar demand for imports over H2 19, we see a slight moderation in CBN's intervention² to \$21.1 billion (-1.9% lower compared to H2 19), largely reflecting our expected lower repatriation.

Figure 5: CBN sales and forecast across FX markets (\$'Billion)



Source: FMDQ, ARM Research

Overall, we expect gross reserves to end the first half at \$34.1 billion and go lower to \$31.3 billion by year end. That said, our estimates exclude a possible Eurobond issuance or/and multilateral financing over the year. We think the FG could raise as much as \$3 billion from the international market, which should further shore up the reserves. In our view, we believe CBN's FX reserve over H1 20 offers enough room to keep the naira at current levels. However, going into the last quarter of the year, we expect pressure to mount on the CBN as the reserve advances close to its comfort level of \$30 billion. We therefore expect the CBN to do what it can to support dollar liquidity such as raising OMO rate to keep FPI and/or restricting FX demand for specific imports.

² at the interbank forward & spot and sales at the IEW

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