July 27, 2018

Nigeria Strategy Report
H2 2018

Domestic Economy and Policy Environment

Currency: The Battle for Naira Stability

Executive Summary

In our H1 18 Nigeria Strategy Report, we projected a blow in FX outflows that will impulse the CBN to step up its intervention across FX markets. Our projection was based on the confluence of policy normalization in developed markets, flight to safety across EMs, lower domestic interest rate environment, and political risk in the domestic clime. True to our prognosis, average monthly FX outflows rose 15.4% over H1 2018 to $3.6 billion (forecast; $3.3 billion), which prompted an accelerated pace of intervention by the CBN. For context, CBN sales expanded at the IEW[1] and interbank markets over H1 18 – IEW (+122% to $1.96 billion), BDC (+83% to $2.89 billion) and Interbank sales (+56% to $11.4 billion) to drive overall intervention to $16.3 billion (+66.5%). Consequently, the NAFEX[2] and BDC rates remained relatively stable over H1 18, closing the period at ₦360.5/$1 and ₦362.3/$1 accordingly.

Coalescing our adjusted CBN outflows and inflows, we estimate monthly average reserve drawdown of $310 million (average accretion of $1.3 billion in H1 18) which summed up to $1.9 billion over H2 18 (vs. $8.0 billion accretion in H1 18) – notwithstanding Eurobond issuance – which should dwarf any significant accretion in the foreign reserve to $45.7 billion. Consequently, we expect the apex bank to put its full ammunition to use to keep the Naira at current bands, which would maintain stability in the short term to keep the interbank at ₦361/$ for the rest of 2018. Further down, the distortion of the free interplay of demand and supply at the IEW with the lag expected from CBN intervention – amidst pressure at other windows as in May 18 – would drive short term volatility in rates and an eventual adjustment to our fundamental driven purchasing power parity estimate of between ₦391.17/$ to ₦402.48/$ (7-10% down-leg from current NAFEX rate of ₦361.00/$ at the end of June 2018).

In this report, we look at the major themes that dominated the foreign exchange market in H1 2018 as well as our outlook for pull and drag of foreign exchange flows for the rest of the year

[1] Investors and Exporters' Window

[2] Nigerian Autonomous Foreign Exchange Market

CBN fires up as Hot Money lose steam

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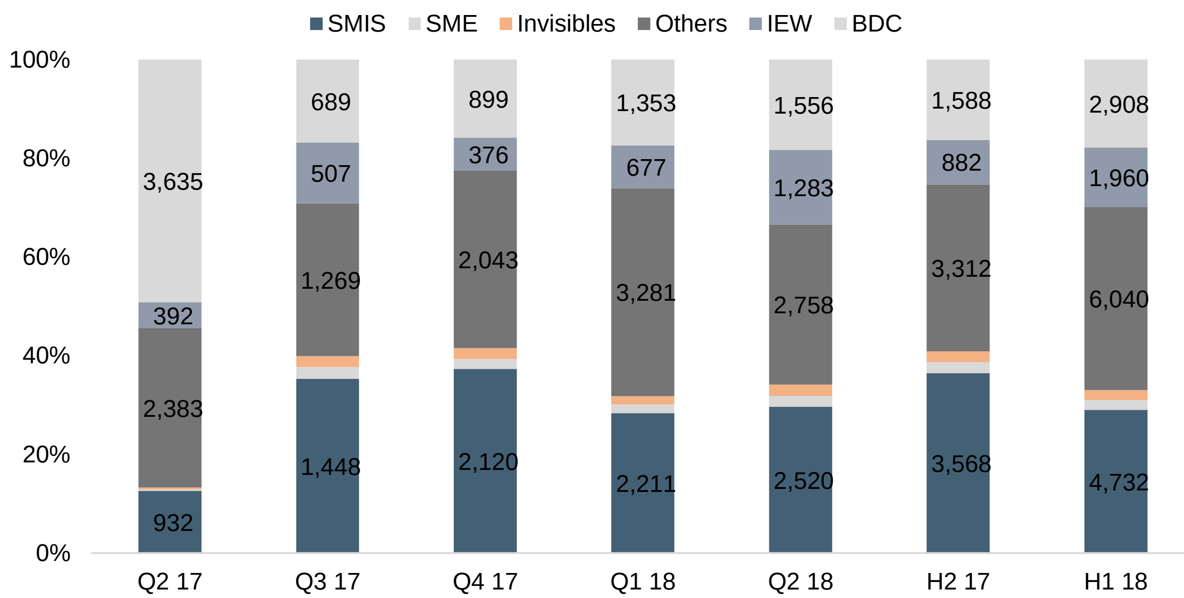
Figure 1: CBN intervention across FX markets ($'Million)



Source: CBN, ARM Research

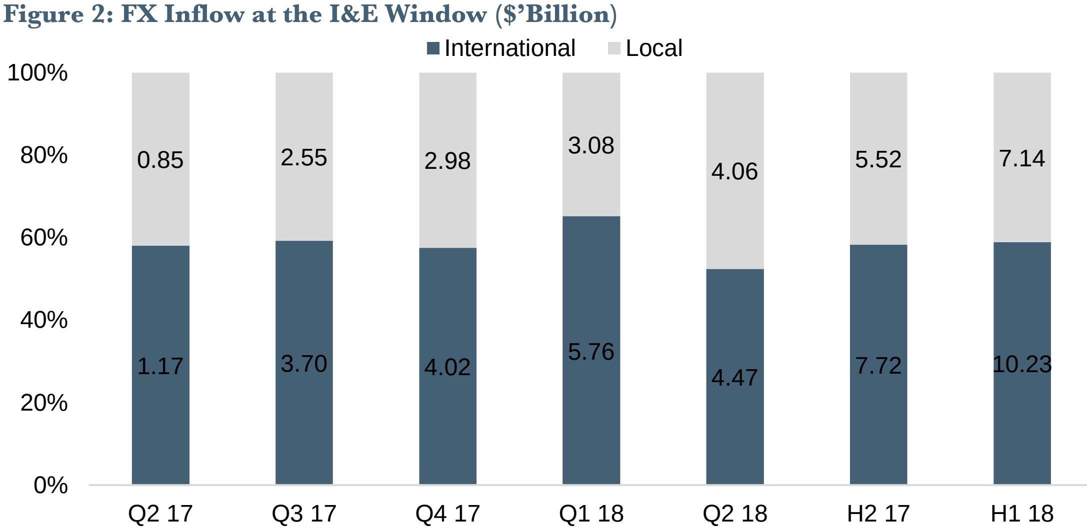
[3] Investors and Exporters' Window
[4] CBN purchased $5 billion from the IEW over H1 2018
[5] Nigerian Autonomous Foreign Exchange Market

IEW: The more you look the scarier it gets

Flows at the IEW seem well lubricated as net flows printed at $1.89 billion in the first quarter 2018 (+44% QoQ) and moderated to $1.34 billion in Q2 18, a reflection of higher outflows and lower inflows. However, excluding CBN inflows shows a bleaker picture relative to last two quarters of 2017. For context, though net flows ex-CBN sales in Q1 2018 remained strong at $1.2 billion, second quarter reflected the impending concerns as ex-CBN net flows printed at $60,000. Reflecting the protective intervention across markets, the gross reserve witnessed the first drawdown of 2018 in May ($515 million). Over Q2, monthly reserve accretion summed up to $341 million compared to $4.54 billion in Q1 18 (net of Eurobond issuance of $2.5 billion in February).

In terms of inflows, the IEW was finely greased as inflows printed at $17.4 billion in the period (H2 17: $13.2 billion). On average, monthly flows over H1 18 printed at $2.9 billion versus $2.2 billion in H2 17. Dissecting inflows to both quarters, inflows stood at $8.8 billion over Q1 18 (+6.2% QoQ), on the back of sturdy flows by FPI (+37.6% QoQ to $4.95 billion) to account for 56% of total inflows. Elsewhere, CBN inflows (+80.1% QoQ to $677 million) provided some support for local flows. Ex-CBN, local inflows would have declined 19.3% QoQ to $2.40 billion. Further down to Q2 18, CBN accelerated its intervention across FX markets, with more noticeable supply at the IEW following cut-backs in offshore funds. For context, after the 38% QoQ jump in FPI flows at the IEW over Q1 18, the IEW saw meager offshore funds with FPI flows declining 22.5% QoQ to $4.06 billion[6] to push overall offshore funds to $4.47 billion (-22.3% QoQ).

Figure 2: FX Inflow at the I&E Window ($'Billion)



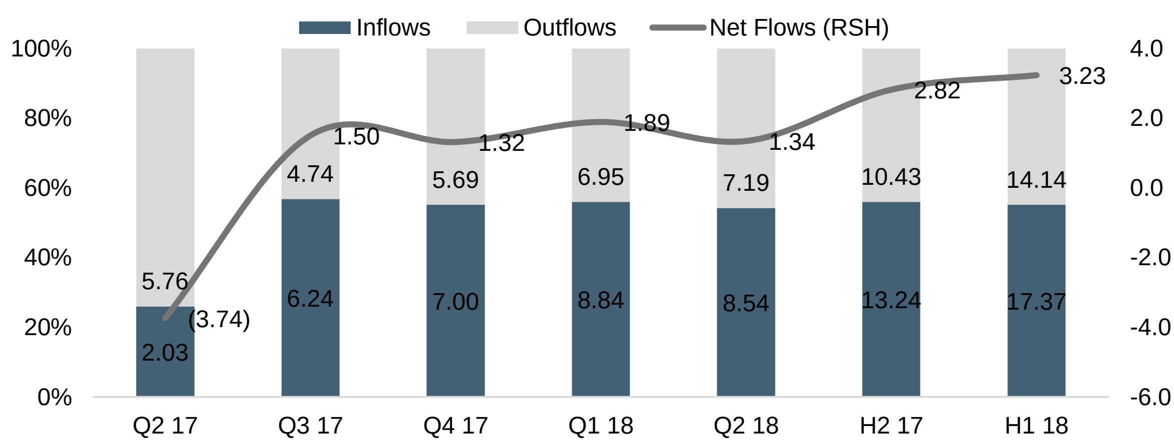
Source: FMDQ, ARM Research

[6] to account for 48% of total inflows vs. 56% in Q1 18

In terms of demand, the IEW recorded more rapid purchases over H1 18 with purchases of $14.14 billion far exceeding $10.43 billion recorded in H2 17. Going by breakdown, dollar demand printed at $6.95 billion and $7.19 billion in Q1 and Q2 2018 respectively. Parsing through the numbers reveals that while CBN dollar purchases at the IEW largely dominated demand in the first quarter, portfolio outflows was more evident in the second quarter.

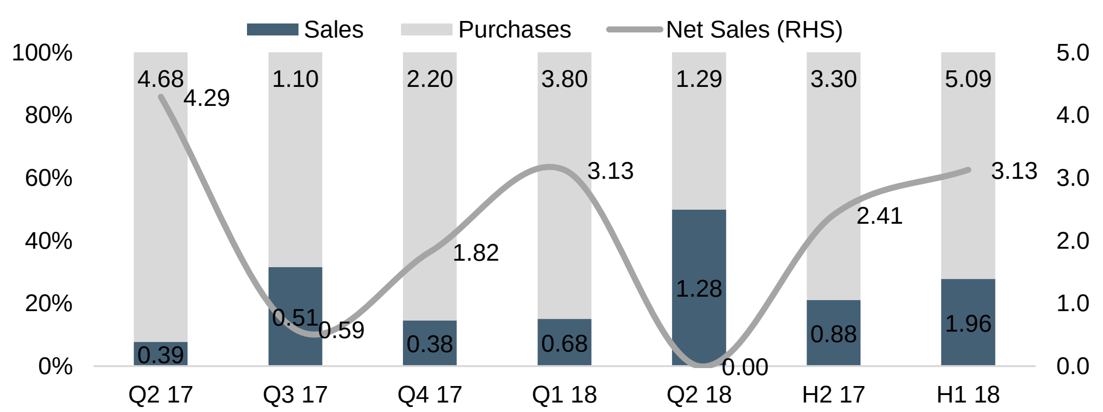
For context, in the first quarter, in a bid to leverage on robust net inflows and ensure stability, the apex bank mopped up $3.8 billion at the window, constituting 55% of total demand in the period. However, over Q2 18, with the drying FPI flows and by extension offshore funds, the CBN purchases at the window moderated 66.2% QoQ to $1.29 billion[7], as capital repatriation by foreign investors (estimated at $5.91 billion in Q2 18 and $9.1 billion over H1 18) overtook the CBN at the market.

Figure 3: Participants activity at the IEW vs. Balance (RHS) in $'billion



Source: FMDQ, ARM Research

Figure 4: CBN activity at the IEW ($'billion) vs. Balance ($'billion)



Source: FMDQ, ARM Research

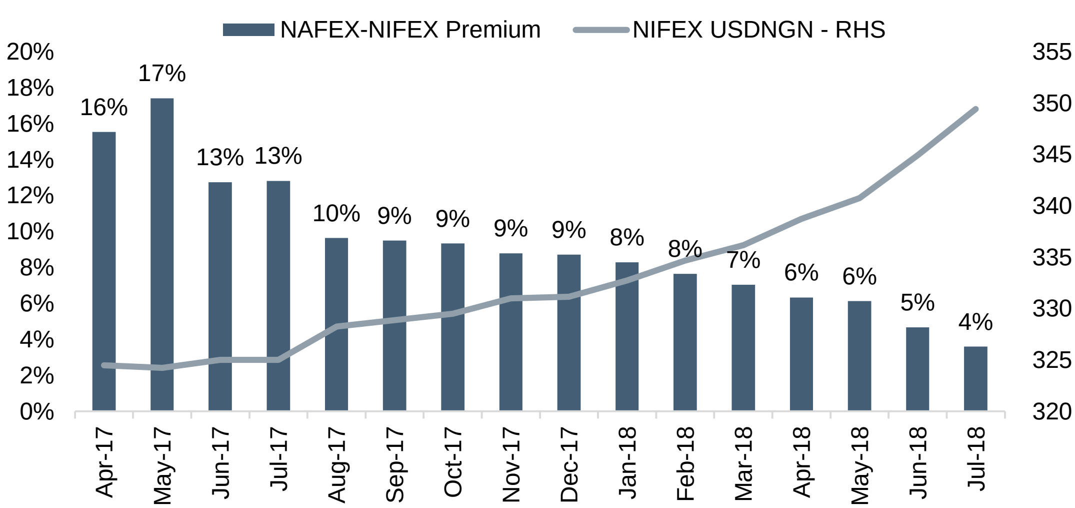
[7] Constituting just 18% of total purchases of $7.19 billion

NIFEX tiptoes to the convergence point

Prior to the introduction of the NAFEX, the NIFEX had been a long-standing reference rate for Spot FX operations in the official window, largely focused on providing liquidity for Secondary Market Intervention Sales, and dominated by the CBN and DMBs, with banks only transacting excess of funds accessed[8] from CBN and not own sourced dollars. However, with the success of the NAFEX – which now stands as the new reference rate and ultimately the interbank – the need for a convergence is more evident. However, given the signal an abrupt move of the NIFEX fixing to the NAFEX could relate, the FMDQ and CBN have adopted a more strategic convergence with a cut back in supply of dollars at the NIFEX and cessation of its fixing on the FMDQ platform with bank sources suggesting a complete cancellation of the fixing to authorized dealers by the end of the year.

Certainly, with the rates gradually converging, we are likely to achieve a 'one market' rate by the end of the year without necessarily announcing a shift in the exchange rate at the NIFEX. However, while the thought would have been a possible move of the CBN official rate (IFEM) of ₦305/$ to reflect the real purchasing power parity of ₦342.17/$, the political will of such move is currently lacking as the impact could translate to higher energy prices[9] with consequent impact on inflation.

Figure 5: Historical NAFEX-NIFEX premium and NIFEX rate



Source: FMDQ, ARM Research

[8] After settling SMIS demands

[9] PMS import exchange rate of ₦305/$

The confluence of the pulls and drags

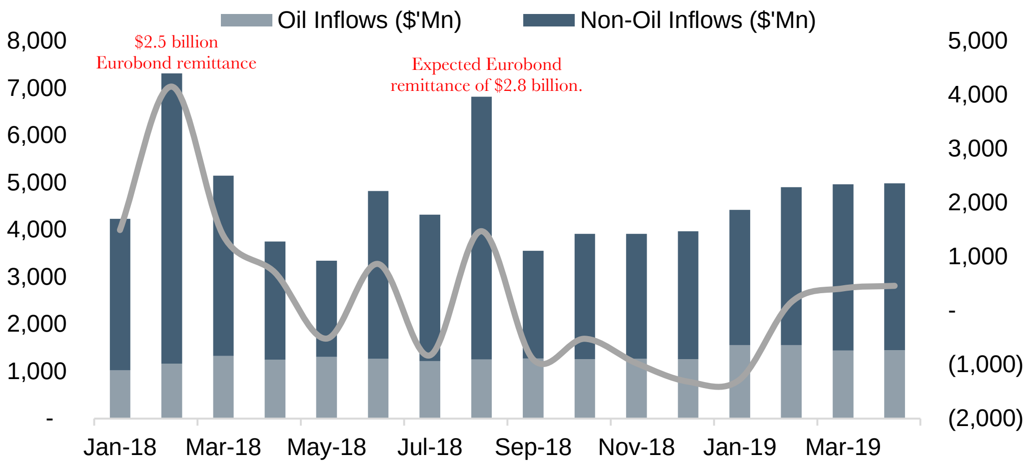
In our H1 18 Nigeria Strategy Report, we noted that the confluence of policy normalisation in developed markets, flight to safety across EMs, lower domestic interest rate environment, and political risk in the domestic clime would shudder FX outflows in Nigeria with the impact subduing any significant growth in the financial account. However, while noting the neutering impact of our forecast current account balance of $3.1 billion over H1 18 and reconciling net reserve for opened swap positions and CBN portion of the reserve[10], we estimated that import cover should remain above 10 months by the end of H1 18. True to our views, adjusting the reserve position at the end of June of $47.8 billion settled the import cover at 11.4 months. In framing our outlook for movement in the foreign reserve and impact on the NGN over H2 2018, we examined the fundamental levels through balance of payment (BOP) data and focused on the drag and pull of flows to the CBN.

On the BOP, we reconciled our implied goods trade surplus of $16 billion (+21.9% YoY) with income net debit position of $10.5 billion, net current transfer of $25.7 billion and $16 billion service deficit, which necessitated current account surplus estimate of $14.5 billion. On the financial account, with the impact of the gradual unwinding of QE in developed economies and depressed yield in the fixed income market already reflecting in flows at the IEW, we expect a decline in offshore funds over H2 18 to $7.4 billion. However, given the cheery flows over H1 18 ($11.5 billion), we estimate overall consolidation over 2018 to $18.9 billion (54.7% YoY).

On CBN inflow, adjusting our model to reflect the upbeat forecast on crude oil production and prices of 2mbpd (with crude export of circa 1.5mbpd) and $70/bbl. respectively, we forecast average monthly crude oil inflow of $1.5 billion over H2 18 with overall flow for the year estimated at $16.2 billion (+56% YoY). On non-oil inflows, given that the sturdy inflows at the IEW provided an easy reservoir for the apex bank to shore up the reserve over H2 17 (average of 33.5% of total non-oil flows) and by extension H1 18 (average of 41.6% of total non-oil flows), our expectation of slower flows at the IEW over the rest of the year speaks to a decline in non-oil inflows over the period to $12.9 billion (-39.2% compared to H1 18 of 421.3 billion), despite expected issuance of $2.8 billion Eurobond. Overall, over H2 18, we expect 23.7% decline in average monthly CBN inflows to $3.6 billion, with sum of inflow for the period contracting to $21.8 billion (vs. $28.6 billion in H1 18 and $26.3 billion in H2 17).

[10] 73% of total reserves

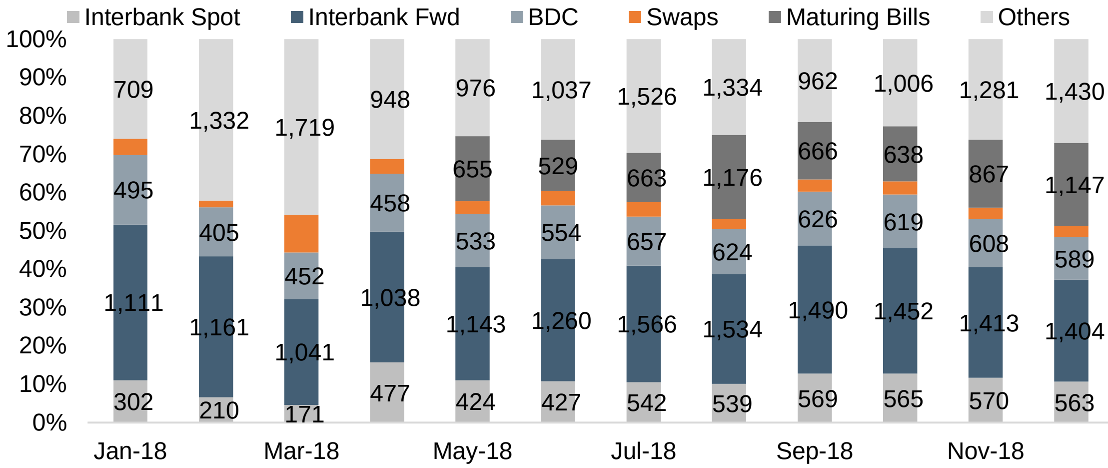
Figure 6: CBN oil and non-oil inflows and forecast ($'Billion)



Source: CBN, ARM Research

On outflows, although we had estimated a drawdown in reserve from electioneering concerns – which we believed would strangle flows into the economy with current funds taking a safe flight, the quantum of outflows was largely underplayed. That is, our focus had been on flight to safety of maturing money market instruments with the exemption of OMO. Recasting our outlook for capital flights going into the year, we have extended our estimate to capture maturing OMO. Going by available data, total global outstanding of treasury bills and OMO stood at ₦13.3 trillion ($36.9 billion) as at July 18. Going by historical average, wherein offshore funds constituted 36% of total global outstanding, we estimate offshore funds of ₦4.78 trillion ($13.28 billion) with a total maturity of $5.2 billion over 2018. Accordingly, assuming a case wherein foreign investors exit 50% of their maturing local fixed income instruments estimated at $2.58 billion over 2018, this implies average monthly capital flight of $860 million. Overlaying that on our stance that the apex bank would step up its dollar sales across markets (average monthly sales of $3.0 billion), we estimate CBN average overall monthly outflows of $3.9 billion.

Figure 7: CBN sales and forecast across FX markets ($'Billion)

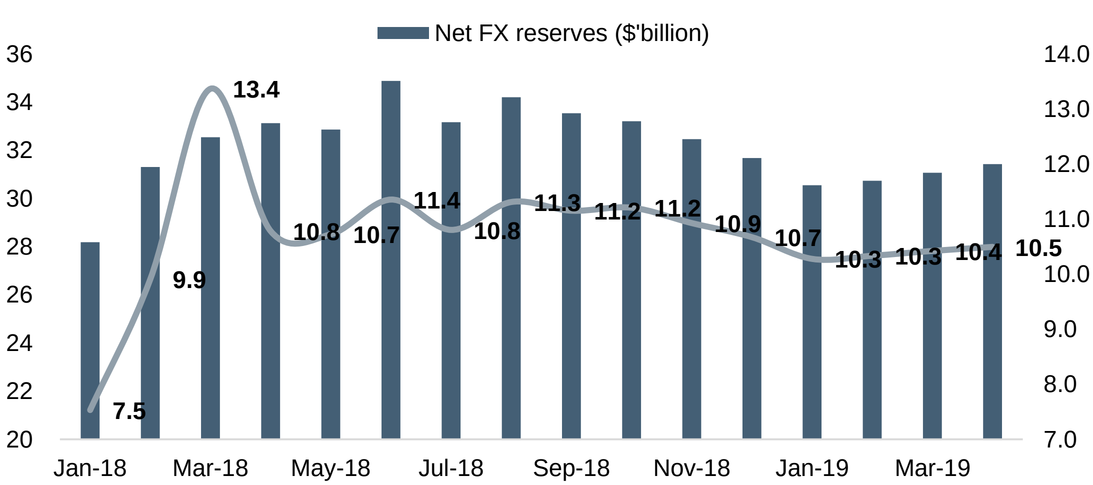


Source: CBN, ARM Research

The Battle for Naira Stability

Coalescing the above adjustment, we estimate monthly average reserve drawdown of $310 million (average accretion of $1.3 billion in H1 18) which summed up to $1.9 billion over H2 18 (vs. $8.0 billion accretion in H1 18) – notwithstanding Eurobond issuance – which should pressure a drawdown in the foreign reserve to $45.7 billion. Consequently, we expect the apex bank to put its full ammunition to use to keep the Naira at current bands, which would maintain stability in the short term to keep the interbank at ₦361/$ for the rest of 2018. Further down, the distortion of the free interplay of demand and supply at the IEW with the lag expected from CBN intervention – amidst pressure at other windows as in May 18 – would drive short term volatility in rates and an eventual adjustment to our fundamental driven purchasing power parity estimate of between ₦391.17/$ to ₦402.48/$ (7-10% down-leg from current NAFEX rate of ₦361.00/$ at the end of June 2018).

Figure 8: Forecast net FX reserves and import cover



Source: CBN, ARM Research

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