

January 20, 2021



Nigeria Strategy Report

H1 2021

Domestic Economy and Markets

Balance of Payment: Deficit set to print higher

Executive Summary

Nigeria's current account deficit is expected to record a new high in FY2020 following the significant deterioration in export earnings largely driven by the covid-19 pandemic. As at H120, the current account balance recorded a total deficit of \$8.9 billion, which is worse than the \$7.4 billion deficit posted in the comparable period in 2019. Asides being the deepest contraction in the current account balance since H115 (-\$7.7billion), Q220 deficits of \$3.2 billion marks the sixth consecutive quarterly deficits we have seen; the longest since Q415.

Export earnings are set to improve in 2021 relative to 2020 levels as global economy rebounds. We project total export earnings in 2021 to print at \$51.9 billion, 33% higher than 2020 levels. Our forecast is premised on our expectations of higher Brent oil prices (\$52.47 in 2021 vs \$43.92 in 2020) which has recently crossed the \$50/barrel mark on the back of the covid-19 vaccine success rate. Also, we think that the expected recovery in the global economy should translate into increased crude oil demand especially in H221, which should give the OPEC+ more legroom to ease on production cut. Thus, we estimate oil export to grow by 31% YoY to \$43.3 billion as improved oil production (1.90mbpd vs 1.81mbpd) combined with higher prices support earnings. Similarly, we envisaged an improvement in non-oil export as non-oil GDP numbers improve. This should be supported by both the monetary and fiscal initiatives embarked upon by the government to accelerate the recovery of the economy from a recession. However, we estimate FY21E current account deficit to increase by 5% YoY to \$22.1 billion. Despite the expected recovery in export, we expect the improvement in trade deficit to be neutered by the services and income leg. Our view is premised on CBN's expansionary policies which should support improvement in business activities and domestic demand as the impact of covid-19 fades.

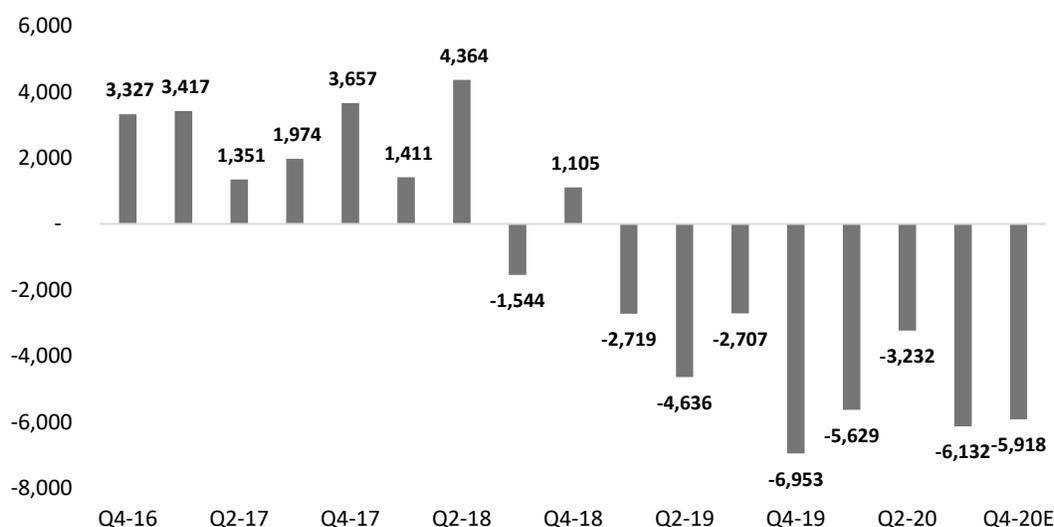
In this report, we focus on developments in the Domestic environment, highlighting our views on Nigeria's current and financial accounts position.

Current account deficit continues to deteriorate

Nigeria’s current account deficit is expected to record a new high in FY2020 following the significant deterioration in export earnings largely driven by the covid-19 pandemic. As at H120, the current account balance recorded a total deficit of \$8.9 billion, which is worse than the \$7.4 billion deficit posted in the comparable period in 2019. Asides being the deepest contraction in the current account balance since H115 (-\$7.7billion), Q220 deficits of \$3.2 billion marks the sixth consecutive quarterly deficits we have seen; the longest since Q415.

Bearing in mind the events that unfolded over the course of the year, we expect the current account deficit to print at \$20.9 billion (FY 19: \$17.0 billion). Relative to H1 20, we expect to see higher deficits over the second half at \$12.0 billion. The expectation for a continuing deterioration in the deficit position over the remaining half of 2020 reflects the surge in total imports in Q320 as indicated in the recently released foreign trade report by the National Bureau of Statistics (NBS), amidst declining exports. To give more context, total import, as pointed out in the foreign trade report, grew by 38% YoY to ₦5.4trillion dwarfing the total export value of ₦3.0trillion in the same period which declined by 43% YoY. The decline in export was driven by the subdued performance in both the Oil and Non-oil export which declined by 35% YoY and 63% YoY respectively. To this end, we expect the balance of trade position to worsen in Q320 and do not envisage a material change in this trend throughout the rest of the year. The worsening trade balance coupled with an expected increase in service and income deficits through H220 should more than offset the expected gradual increase in current transfers.

Figure 1: Current Account Balance (\$'million)



Source: CBN, ARM Research

H120 deficit magnified on covid-19 impact

Dwelling more on what played out in H120 so far, we highlight that the bulk of the pressure emanated from the deterioration in the balance of trade position and a decline in current account transfer. Compared to H119 where there was a trade surplus of \$1.4 billion, we witnessed a downturn as trade deficits magnified to \$5.1 billion. This was due to slower pace of contraction in total import relative to what was seen in total export. Imports declined by 18% YoY to \$24.8billion following the 32% YoY and 14% YoY moderation in oil and non-oil import respectively to \$4.0billion and \$20.8billion. The outbreak of the covid-19 virus and subsequent lockdown measures embarked upon by nations across the globe to curtail the spread dwindled activity level globally especially in the second quarter of the year. On a QoQ basis, total import fell by 32% to \$10.1billion in Q220 largely driven by the significant moderation in oil import and 11% QoQ decline in non-oil import.

On the other hand, exports plummeted at a faster pace relative to imports, down by 37% YoY to \$19.7billion in H120. The slide in exports was due to the 39% YoY contraction in oil exports to \$16.5billion which accounted for 83% of total exports over the period (H219:86%). A look at what played out on the crude oil price front largely explains why we saw that much of a decline in oil export numbers. Average crude oil prices over H120 fell by 36% YoY to \$42.10/barrel as global demand for crude oil nosedived on the back of the pandemic induced impact on economic activities. Similarly, average crude oil production also reduced slightly by 3% to 1.94mbpd further adding to the downward pressures on oil export earnings. In the same vein, Non-oil exports also shrank by 26% YoY to \$3.3billion. Data from the NBS shows that the decline was more pronounced on raw material, solid minerals and energy goods export. We believe the devaluation in the Naira and lack of access to raw materials may have led to a deterioration in GDP numbers in H120 to an average of -2.12% (vs +2.11% in H119) which further sheds more light on the decline seen in non-oil exports over the period.

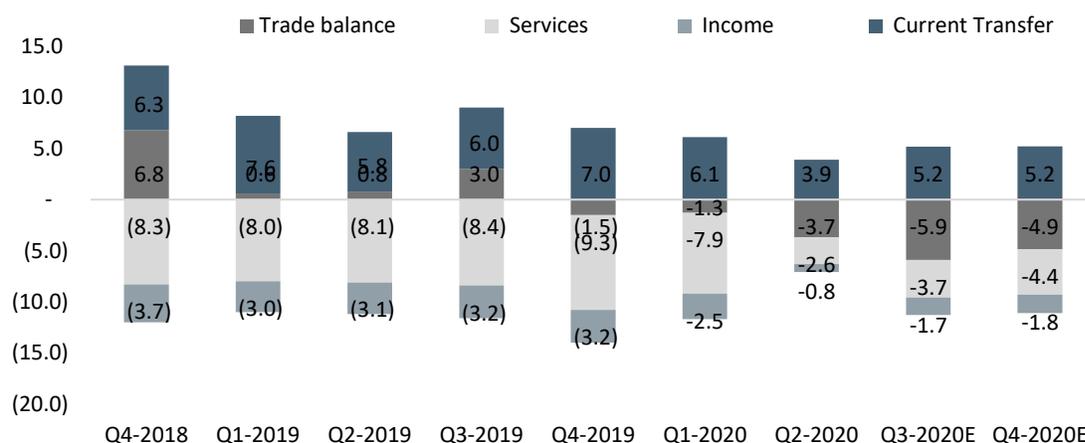
Placing further pressure on the current account is the 25% YoY decline in current transfer surplus to \$10.0billion largely due to reduced worker remittances which reflects the impact of job and income losses caused by the virus particularly in Q220. We recall that unemployment numbers in advanced economies soared to record highs during this period following the stay-at-home order and halt in economic activities. Over the past 10 years, worker remittances as a percentage of current account surplus averaged 94%, which gives a picture of the importance it plays in the nation's balance of payment position. Worker

remittances in Q220 stand-alone according to CBN data reduced by \$2.5billion, 42% lower on a YoY basis, just to give more clarity as to how much it impacted on Q220 numbers.

On a positive note, service and income deficit both declined by 35% YoY and 45% YoY to \$10.5billion and \$3.4billion respectively largely due to somewhat muted activities. The decision of the CBN to halt sales of FX at the tail end of March 2020 through to August 2020 as well as downbeat corporate performance as lockdown measures persisted likely reduced the income deficit numbers over the period. Also, reduced business and personal travel expenses (-68% YoY to \$3.5 billion) which include payment for health and education related expenses and lower demand for expatriate services moderated services deficit YoY over the review period.

Touching on foreign reserves performance, the escalated current account deficit balance on the back of lower export revenues and relatively elevated import, combined with receding FPI flows following increased risk aversion in the global capital market led to 20% YoY reduction in FX reserves to \$36.2 billion as at the end of H120.

Figure 2: Trade balance (\$'million)



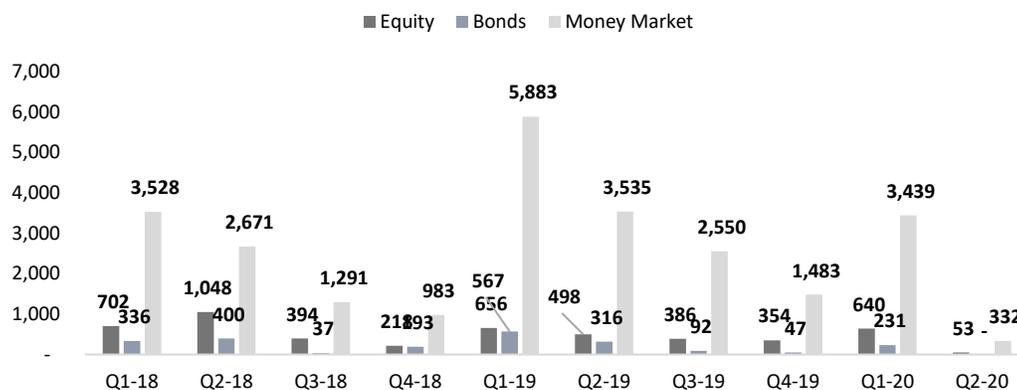
Source: CBN, ARM Research

Investors continue to exercise caution on investing

Capital importation into Nigeria plummeted by 51% to \$7.2 billion in H120 mainly driven by the 59% YoY decline in Foreign Portfolio Investments to \$4.7 billion, as investor’s sentiments across money market (-60% YoY to \$3.8 billion), bonds (-74% YoY to \$231 million) and equity (-40% YoY to \$693 million) declined. We note that FPI inflow has historically contributed the most to the capital being imported into the country (68% in 2019 and 66% in H120). However, the increased risk aversion of foreign investors following the outbreak of the pandemic and its consequential impact on the global economy led to heightened interest in safe haven assets despite increasing accommodative stance of major central banks in the world.

Furthermore, the rising uncertainty around the FX market at the time especially with regards to liquidity also adversely affected FPI inflow into the country. Similarly, the massive decline in the attractiveness of CBN’s OMO bills (Average of 10.31% in H120 vs 13.05% in H119) bearing in mind the soaring inflationary numbers which averaged 12.98% in 2020 also negatively impacted on FPI inflow into the country.

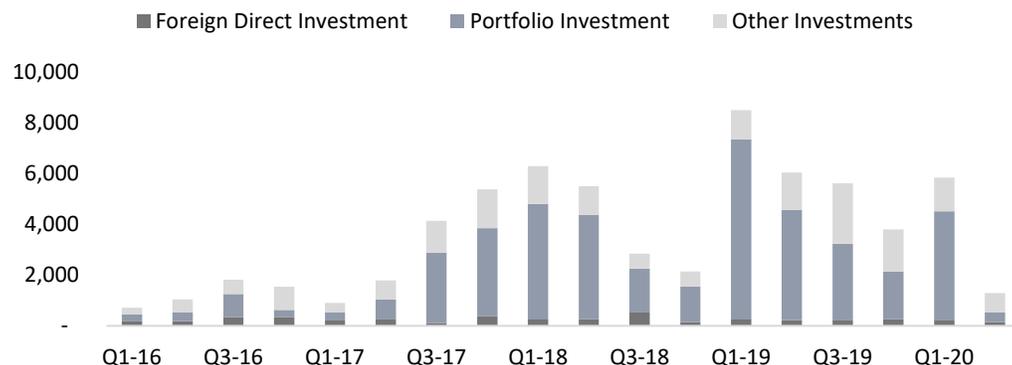
Figure 3: Portfolio Flows Breakdown (\$'million)



Source: CBN, ARM Research

Similarly, FDI inflow declined by 23% YoY to \$362 million as investors unwillingness towards taking long term real investment position in Nigeria persists. Historically, this portion of foreign capital inflow remained underperforming as uncertainty in the political environment, insecurity, infrastructural deficiency and policy summersault continues to weigh more on the minds of investors. Adding to it was the negative impact of the pandemic which placed commodity dependent nations in an uncomfortable position further aggravating the need for investors to stay cautious in this regard. Finally, lower trade credit and other claims led to a decline in other investment inflow on a YoY basis .

Figure 4: Capital Importation Breakdown (\$'million)



Source: CBN, ARM Research

While we are yet to see H220 numbers, we believe flows are going to remain depressed throughout the rest of the year. Our views are premised on the continued illiquidity in the FX market even as the nation's export earnings remain subdued. Although Brent crude oil prices crossed the \$50/barrel mark in recent times, the country's commitment to OPEC production cut agreement will limit crude oil sales thus putting pressure on overall crude oil earnings.

Again, the currency repatriation challenge experienced by investors over the course of the year doused foreign portfolio investment flows thereby putting downward pressure on the FX reserves. However, we note the recent \$1.5bn loan facility from the World Bank moderated the expected pressure on the nation's FX reserves which closed at \$35.36 billion at the end of FY20.

Export earnings set to improve in 2021

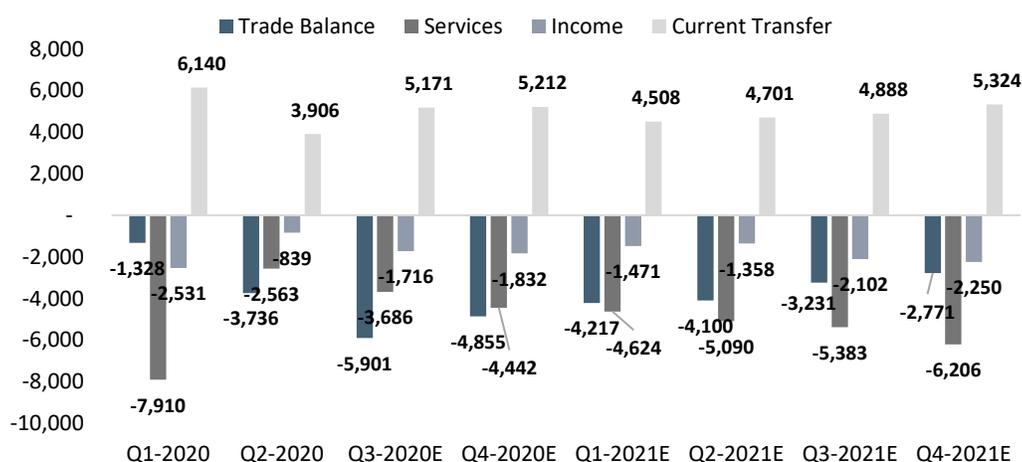
Export earnings are set to improve in 2021 relative to 2020 levels as global economy rebounds. We project total export earnings in 2021 to print at \$51.9 billion, 33% higher than 2020 levels. Our forecast is premised on our expectations of higher Brent oil prices (\$52.47 in 2021 vs \$43.92 in 2020) which has recently crossed the \$50/barrel mark on the back of the covid-19 vaccine success rate. Also, we think that the expected recovery in the global economy should translate into increased crude oil demand especially in H221, which should give the OPEC+ more legroom to ease on production cut. Thus, we estimate oil export to grow by 31% YoY to \$43.3 billion as improved oil production (1.90mbpd vs 1.81mbpd) combined with higher prices support earnings. Similarly, we envisaged an improvement in non-oil export as non-oil GDP numbers improve. This should be supported by both the monetary and fiscal initiatives embarked upon by the government to accelerate the recovery of the economy from a recession. We estimate non-oil export to grow by 46% YoY to \$8.7 billion, supported by a low base (FY20: 5.9 billion), while on the import leg, we project a 14% YoY and 19% YoY improvement in oil and non-oil import to \$10.2 billion and \$54.8 billion, respectively. While the deficit in the trade balance may remain elevated, we expect the improvement in export earnings, as highlighted above, to support an 18% YoY moderation to \$13.0 billion in FY21E.

Current account deficit to remain elevated

However, we estimate FY21E current account deficit to increase by 5% YoY to \$22.1 billion. Despite the expected recovery in export, we expect the improvement in trade deficit to be neutered by the services and income leg. Our view is premised on CBN's expansionary policies which should support improvement in business activities and domestic demand as the impact of covid-19 fades. As such, this should drive increased spending on traveling and transport expenses, education and health expenses as well as imported professional and technical services.

This said, we estimate service deficits to increase by 15% YoY to \$21.3 billion. Similarly, improved corporate performances should likely lead to higher dividend income for investors which may lead to increases in foreign repatriation, thus, explaining our expectations for a 4% YoY increase in income deficit to \$7.2 billion. However, job and income losses as well as devaluation of the Naira may weigh on worker remittances, thus, leading to a moderation in current transfer over the FY21E period. We project inflow from remittances to decline by 5% YoY to \$19.4 billion.

Figure 5: Current Account Forecast (\$'million)



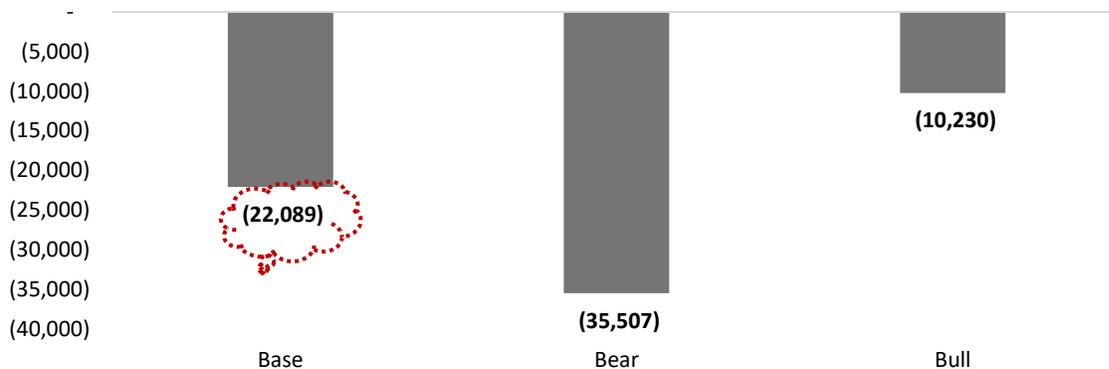
Source: ARM Research

On a scenario basis, we think key upsides to our estimates include stricter FX restriction for importation which could impact largely on components in the service segment. Should this play out, we estimate service deficits to print at \$19.3 billion (vs \$21.3 billion in our base case scenario). Furthermore, we could see far lesser negative number in the balance of trade position should crude oil prices recover faster than expected (\$60.84/b vs \$52.47/b in our base case estimate). This combined with our bullish crude oil production estimate of (2.02mbpd vs 1.90mbpd) could lead to a balance of trade surplus of \$0.06 billion (vs our base case estimates of a deficit of \$13.0 billion).

On the flip side, continued deterioration in crude oil prices amidst recovery in import as the global economy normalizes may drive the current account deficit higher than our base estimates. We highlight the uncertainty the new strain of covid-19 may have on the global economy especially with regards to new lockdown measures which could further depress global activities .

Should this crystallize, we forecast crude oil price and production to average \$42.34/barrel and 1.67mbpd in 2021 vs our base case estimates of \$52.47/barrel and 1.90mbpd. This translates to a balance of trade deficit of \$26.2 billion, which when combined with pressures on the service and income leg of the balance of payment account may translate into an overall deficit of \$35.5 billion (vs \$22.1 billion for our base case estimate).

Figure 6: Base, Bull and Bear Cases (\$'million)



Source: ARM Research

Capital flows to remain subdued in 2021

Capital flows into Nigeria is set to improve from 2020 levels in 2021. The gradual and sustained recovery in crude oil prices could reflect strengthening global demand, which also gives room for upscaling crude oil production over the course of the year. This could potentially increase the nation’s foreign exchange earnings and further improve the ability of CBN to achieve stability in the Naira in the FX market, thus, boding well for foreign investor sentiments.

However, the volume of inflow may likely remain below the 2019 levels as factors such as FX uncertainty, still fragile global growth and heightened uncertainty as to what may play out globally in light of the swiftly spreading new strain of the covid-19 virus, which may turn off FPIs investor interest away from risky assets especially in frontier and emerging markets, persists.

In 2020, the CBN came up with a policy that inhibited FPIs from repatriating funds from the Nigerian market. While the decision was made owing to the crash in FX earnings, FPI investors may require more than just a recovery in crude oil prices and increased supply of crude oil to convincingly invest in the Nigerian economy. We suspect the decision may have raised investors uncertainty about the Nigerian market with the new strain of covid-19 further solidifying reasons to stay clear, as its potential impact on the oil space remains unclear.

Furthermore, the reduction in rates on fixed income securities and expectations that it could remain so for longer also supports our view of a lower capital inflow in 2021 relative to 2019 levels.

We also expect other types of capital inflow to remain subdued. On FDI, we posit that foreign investors may continue to remain unwilling to take on long term investment position in the country. We had earlier highlighted reason for this ranging from insecurity to policy conflicts all of which increases the riskiness of such investments.

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