

January 21, 2021



Nigeria Strategy Report

H1 2021

Domestic Economy and Markets

Currency: An FX Crisis?

Executive Summary

Whilst the Central Bank of Nigeria (CBN) tried to stabilize currency rates in H2:2020, the Naira depreciated across various FX windows, as the parallel market rate fell by 23.61% to ₦445/\$1. In the I&E FX window, the Naira depreciated by 12.46% to close at ₦410.25/\$1, driven by demand pressures from both manufacturers and investors. The CBN also made further adjustment to the official rate as it was adjusted from ₦306/\$1 to ₦360/\$1 in March, then moved to ₦379/\$1 in August. As the twin shocks of the COVID-19 pandemic and low oil prices hit the Nigerian economy, the CBN's ability to intervene and hold the Naira stable was impaired. In the year, limited inflows were reflected on external reserves as it depleted by \$3.22 billion (-8.35%) in 2020 (depleted by 2.24% in H2:2020) to settle at ₦35.37 billion. The reserves only fell by \$811.36 million in the second half of 2020 reflecting the \$3.4 billion and \$1.5 billion inflows from the IMF and World Bank in the year.

As the pressure mounts on Nigeria's FX position following the global pandemic and low oil prices, the reserves are expected to still be supported by swaps and external financing in the form of loans in H1:2021. That said, we estimate gross revenue to close at \$32.41 billion in the first half of the year and close at \$28.79 billion by the year's end. We point out the CBN's option to issue instruments (i.e., Eurobonds) at the debt market to support the reserves. This does not factor into our forecast for FX reserves.

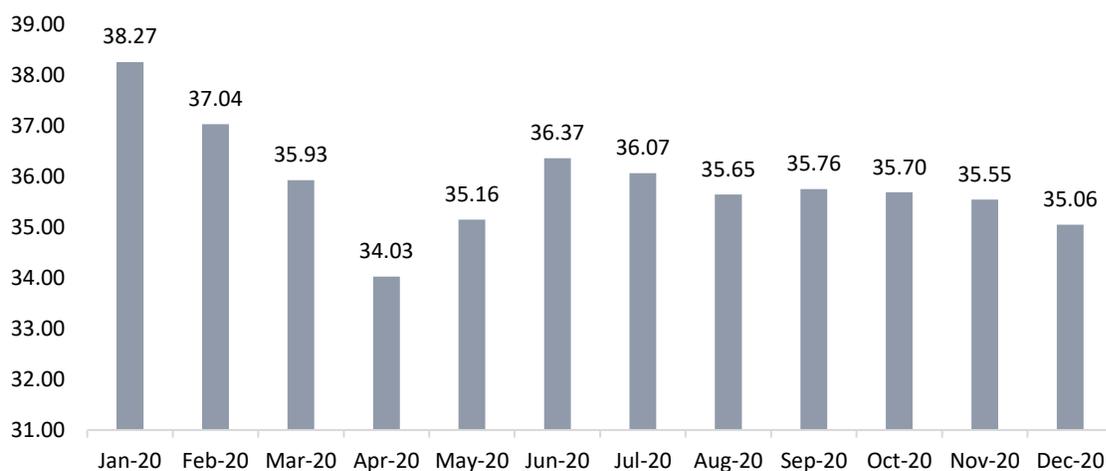
From the exchange rate perspective, although the pressure on net flows is expected to linger in 2021, we expect that its cushioned with expectations of improved oil receipts in the year. We recall that prior to the blow from COVID-19 and low oil prices, the CBN was insistent on sustaining the naira, pegging the red line for FX reserves at \$30 billion. With reserves currently above \$35 billion, oil prices looking up, and hopes for a positive impact of the COVID-19 vaccine strengthen, we envisage that the CBN will manage the naira within ₦379 – ₦410/\$1 in 2021.

In this report, we look at the major themes that dominated the foreign exchange market in H2 2020 as well as our outlook for pull and drag on foreign exchange flows over 2021.

An FX Crisis?

Whilst the Central Bank of Nigeria (CBN) tried to stabilize currency rates in H2:2020, the Naira depreciated across various FX windows, as the parallel market rate fell by 23.61% to ₦445/\$1. In the I&E FX window, the Naira depreciated by 12.46% to close at ₦410.25/\$1, driven by demand pressures from both manufacturers and investors. As the twin shocks of the COVID-19 pandemic and low oil prices hit the Nigerian economy, the CBN’s ability to intervene and hold the Naira stable was impaired. In the year, limited inflows were reflected on external reserves as it depleted by \$3.22 billion (-8.35%) in 2020 (depleted by 2.24% in H2:2020) to settle at ₦35.37 billion. The reserves only fell by \$811.36 million in the second half of 2020 reflecting the \$3.4 billion and \$1.5 billion inflows from the IMF and World Bank in the year.

Figure 1: Gross Foreign reserves in 2020 in \$’billion



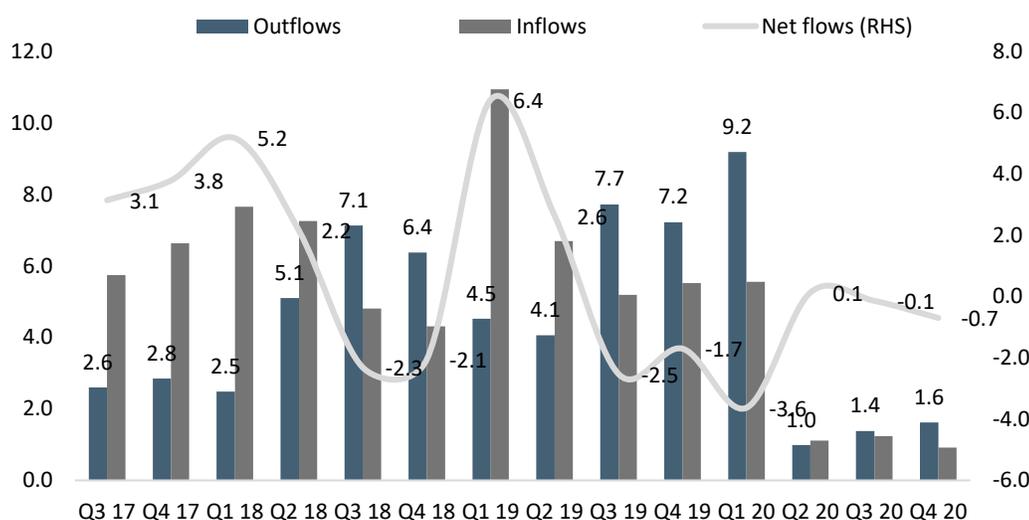
Source: CBN, ARM Research

FPI Inflows Drop Significantly

At the IEW, the CBN remained a net seller at the window through H2:2020, save for July - average net outflow settled at \$169.72 million (vs. H1:2020 at \$583.78 million). This was reflective of lower FPI inflows, despite lower average outflow compared with H1. Average monthly FPI inflow slowed in H2:2020 significantly to \$24.88 million compared to H1:2020 (\$584.08 million). The slowdown in inflows is off the back of the challenges pertaining to capital repatriation in Nigeria, as well as contraction in yield following the apex bank’s restrictions on OMO bills – The CBN cut stop rates in the second half of 2020 to as low as 4.86% on 82-DAY OMO instruments in its bid to manage liquidity management costs. In addition, global oil prices remained subdued as there were fears of a second wave of the COVID-19 pandemic.

Fresh lockdowns imposed exacerbated the impact of the ease in supply cuts by OPEC+ (cuts eased from 9.7MMbpd to 7.7MMbpd in H2:2020), as Brent crude averaged \$44.29pb in the second half of 2020. These factors further contributed to the decline in FPI inflows in H2:2020. Average FDI in H2:2020 also fell by \$16 million to close at \$29.90 million when compared to H1:2020. Generally, inflows were impeded as foreign investors evaded Nigerian assets with unattractive rates in the money market, uncertainty around FX availability upon exit, and a relatively risky business environment. For further context, total exports as at Q3:2020 was 43.41% less than in Q3:2019 according to the NBS. Ultimately, average total inflows (ex CBN) fell by 67.69% in H2:2020 to close at \$2.15 billion when compared to H1:2020's \$6.66 billion.

Figure 2: Structure of flows at the IEW vs. Balance (RHS) in \$'Billion

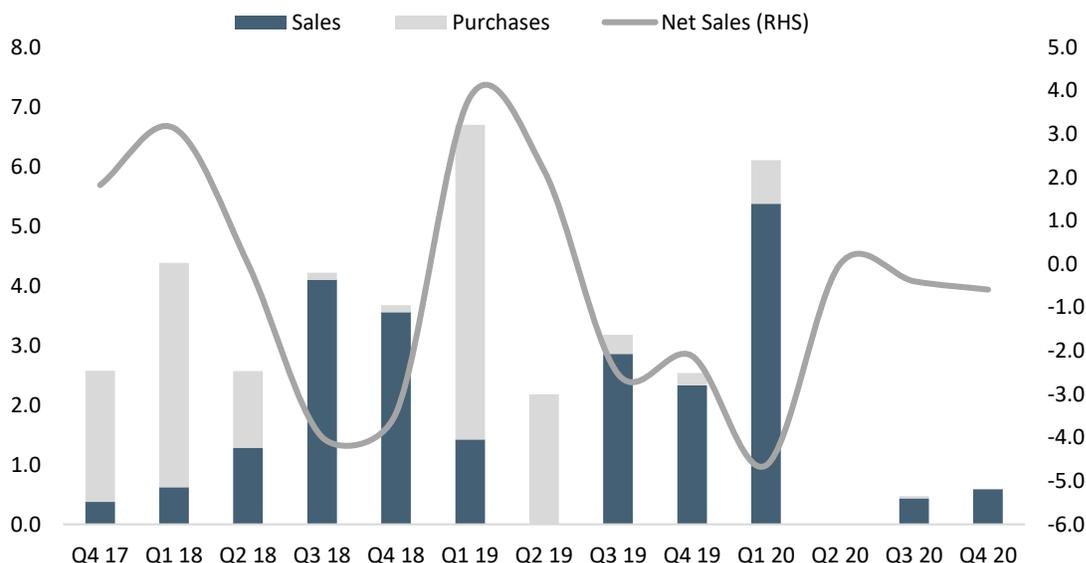


Source: FMDQ, ARM Research

Total outflows in the second half dropped by 70.48% to close at \$3 billion when compared to H1:2020's \$10.17 billion. The lower sales of FX at the IEW reflects the CBN's attempts at managing its dollar supply as well as overall decline in the level of participation by foreign investors in the Nigerian markets. The CBN initially implemented a partial suspension in sales of FX to BDCs and IEW in April. This resulted in a sharp 90.40% decline in outflows in April to \$334.80 million from March's \$3.48 billion, as foreign investors were forced to roll-over investments. Subsequently, FX sales remained restrained as average outflows came in at \$600.26 billion in H2:2020. The land border closure and the lower trading activities between countries due to the COVID-19 pandemic made a further case to limit FX supply from the CBN. The apex bank returned to selling FX at the IEW in September, and this was reflected in rise in average outflows for Q3:2020 to \$810.68 when compared to Q2:2020's

\$328.86 million when the FX sales were initially suspended. The pressure of the dollar scarcity was felt at the parallel market as Naira at the window depreciated by 23.61% in 2020 to close at ₦445 /\$.

Figure 3: CBN activity at the IEW (\$'billion) vs. Balance (\$'billion)



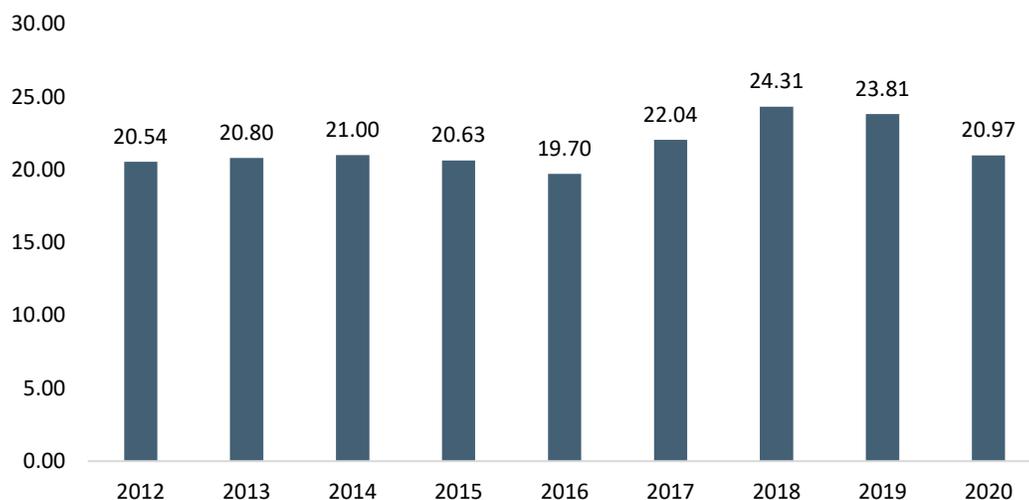
Source: FMDQ, ARM Research

Nearer to Exchange Rate Unification

The CBN made further adjustment to the Naira in H2:2020. As pressure mounted on to devalue the currency, we saw the official rate adjusted from ₦306/\$1 to ₦360/\$1 in March. In August, the CBN moved the rate to ₦379/\$1. Further contributing to the devaluation was CBN’s goal to unify the exchange rates, in line with the World Bank’s request. For clarity, the World bank stated that a unification of the Naira exchange rates is a reform Nigeria should fulfil to acquire much needed loan support from the organization. The move to unify the exchange rates is expected to spur positive investor sentiment towards Nigerian assets, as it should spell more confidence in conversion rates upon exit. In addition, it should boost transparency and limit arbitrage in the market.

In November 2020, the CBN introduced a policy allowing diaspora remittances to be received by beneficiaries in Dollars. Nigerians will now be able to receive money through International Monetary Transfer Operators (IMTO) in foreign currency. This should help in closing the gap between the official rate and parallel market rate as the increased liquidity of FX in the system should lessen the demand for dollars at the parallel market. The World Bank estimates total remittances to Nigeria in 2020 to be \$20.97 billion – the highest in sub-Saharan Africa.

Figure 4: Nigerian Remittances since 2012 (\$'billion)



Source: World Bank, ARM Research

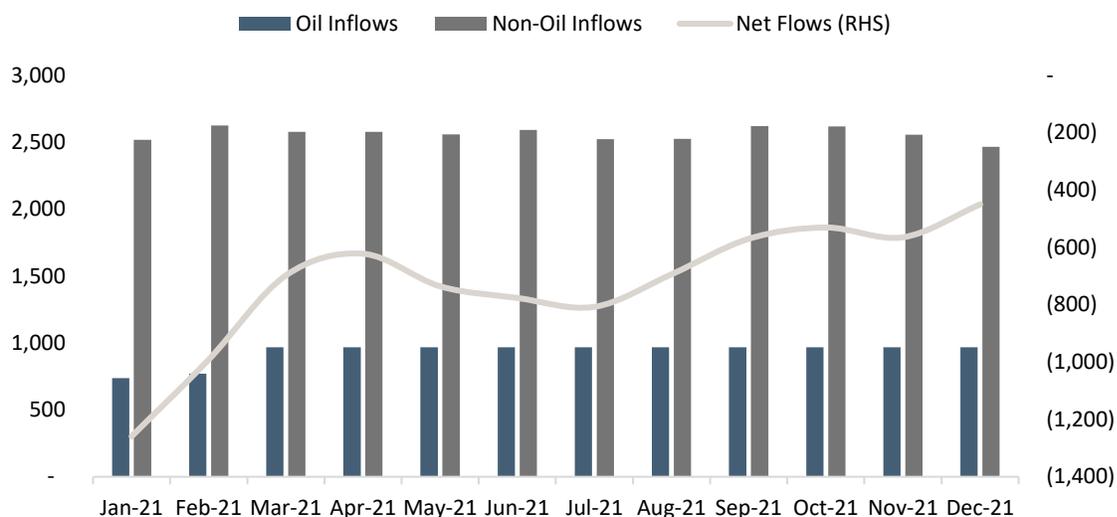
Determining Factors in 2021

For oil inflows, we expect that global crude oil market would fare better in H1:2021 than in H2:2020, especially considering OPEC’s sustained commitment to curb supply. Despite the ease in cuts agreed by the cartel for early 2021, Saudi Arabia’s pledge to unilaterally limit output by an extra 1MMbpd is a positive step towards rebalancing the oil market and returning oil prices to pre-pandemic levels. Developments pertaining to the COVID-19 vaccine is also expected to continue in bolster positivity in the oil market. In our outlook for 2021, we set our base case forecast for Brent crude in 2021 at \$52.47. Supporting this, with our higher output levels projected for Nigeria (1.80MMbpd in H1:2021 vs 1.69MMbpd in H2:2020), we estimate total oil inflow for 2021 at \$5.38 billion in H1:2021 and \$11.19 billion for the whole year 2021.

For non-oil inflow we expect that the FPI flows would remain dampened going into H1:2021. The economic situation in Nigeria poses it as a risky market, especially considering the rising negative real rates of return and economic outlook (IMF projects Nigeria’s economy to grow by only 1.7% in 2021 – the 3rd lowest in Sub-Saharan Africa after Republic of Congo and Zambia). This is expected to lead investors to consider other markets which show signs of notable recovery in 2021, with Nigeria relatively less favored. The lower yields also back our expectation for lower FX Swaps in H1:2021, as we project that transactions will remain dampened with banks less satisfied by money market rates. We also believe that the CBN would not be so quick to raise interest rates in H1:2020 despite its potential to turn investor

heads, as the apex bank maintains its pro-growth stance in trying to revive the economy. We thereby forecast total non-oil inflow at \$15.45 billion in H1:2021 and \$30.75 billion for the whole year 2021.

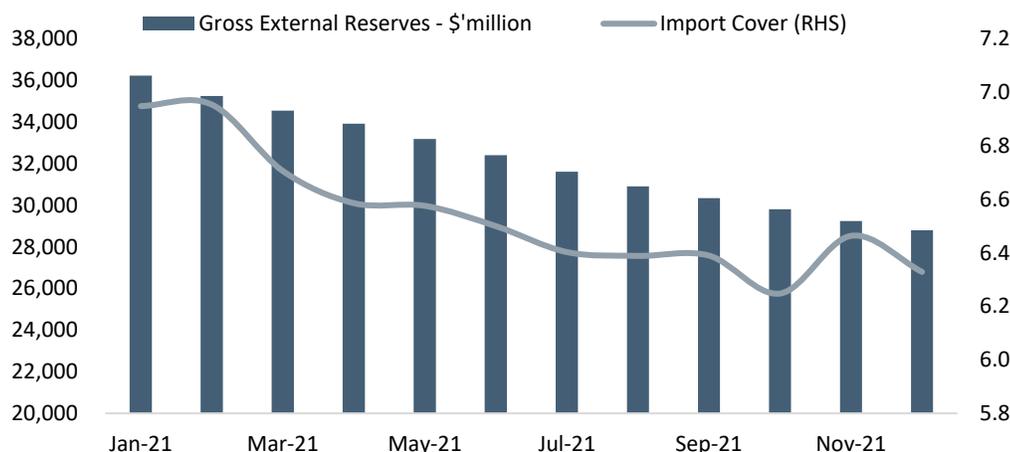
Figure 5: CBN oil and Non-oil inflows and forecast (\$'Billion)



Source: CBN, ARM Research

We expect visible and invisible imports to accelerate in 2021 as there is a pick-up in economic activity. This should spell increased outflows as demand for FX for imports and travel purposes amidst the ease in lockdown restrictions. For FPI's, whilst the CBN have imposed measures to restrict outflow, the apex bank's body language to maintain accommodative interest rates spells more pressure to allow foreign investors leave. Another year of limiting FX sales further would worsen perception of repatriations risk of funds, making the economy even less attractive to foreign investors. On the back of these, we project a total of \$28.15 billion in total outflows in H1:2021 and \$55.16 billion in the year.

Figure 6: FX Reserve forecast vs Import Cover



Source: CBN, ARM Research

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