

Nigeria Strategy Report

H2 2020

Domestic Economy and Markets

Nigeria Currency: Calm before a storm?

Executive Summary

Once again, events over H1 2020 revealed the apex bank's vulnerability to external shocks. With FPI inflows and oil receipts jointly accounting for c.50% of CBN's FX inflows, the twin shock of covid-19 pandemic and lower oil price posed a threat to the FX reserves. While we expected the CBN to give in to mounting pressures on the reserve, we didn't envisage that happening this year. Nonetheless, the tide turned following the unexpected outbreak of covid-19 pandemic, resulting in a slump in oil price and inflows (both oil and non-oil). With limited string to its bow, the CBN was forced to adjust the tightly held official rate from ₦306/\$1 to ₦360/\$1. In addition, rates at the IEW were revised higher to a maximum of ₦380/\$1 from an average of ₦360/\$1. Similarly, average rate at the parallel market depreciated by 19.8% YTD to ₦455/\$1. However, the reserves only depleted by \$2.4 billion¹ over H1 20 reflecting \$3.4 billion and \$278 million inflows from IMF and AfDB respectively. Meanwhile average import cover expanded to 9.2x compared to 7.9x in H2 2019 largely reflecting the faster decline in imports.

Going into the rest of the year, despite CBN's administrative controls, we expect further depletion in the FX reserves on the back of lower inflows. While the \$3.4 billion IMF loan facility will provide a temporary relief, the CBN would be counting on disbursement of facilities from AfDB and World Bank. Overall, we forecast a depletion of \$7.8 billion over H2 20 with the FX reserve closing the year at \$28.8 billion. That said, our estimate excludes expected inflow from World Bank (\$1.5 billion) and AfDB (\$222 million). Including these inflows to our model will take the reserves to circa \$32 billion by year end. Given our expected level of reserve relative to CBN's proclaimed comfort level of \$30 billion, we see limited downside in FX rates over the rest of the year. Downside risk to our forecast are: (i) A second wave of the virus, resulting into economies closing longer than expected (ii) crude oil price going lower than anticipated (\$27.5/bbl).

In this report, we focus on developments in the FX space over H1 20 and delineate our outlook for the reserves and naira over the rest of the year.

¹ Ex the multilateral inflows, the reserve would have been depleted by \$6.1 billion.

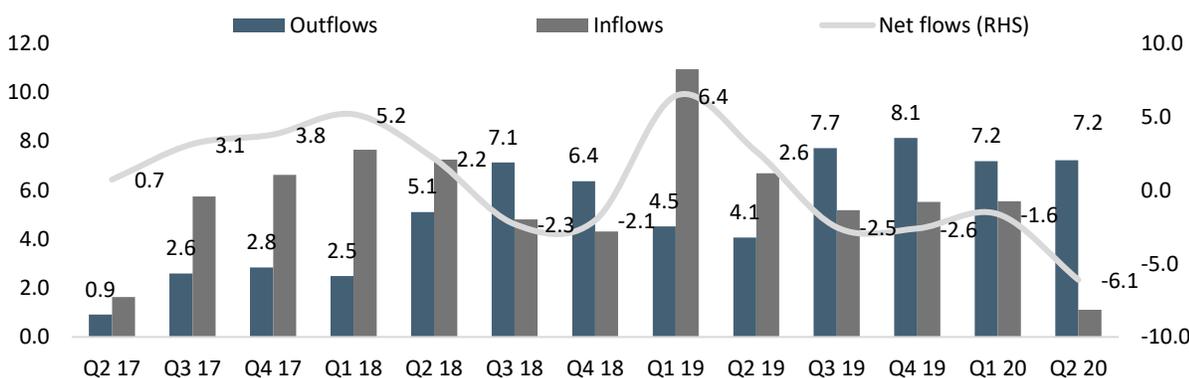
CBN bows to pressure...

Once again, events over H1 2020 revealed the apex bank’s vulnerability to external shocks. With FPI inflows and oil receipts jointly accounting for c.50% of CBN’s FX inflows, the twin shock of covid-19 pandemic and lower oil price posed a threat to the FX reserves. While we expected the CBN to give in as pressure continue to mount, we didn’t envisage that happening this year. Nonetheless, the tide turned following the unexpected outbreak of covid-19 pandemic, resulting in a slump in oil price and inflows (both oil and non-oil). With limited string to its bow, the CBN was forced to adjust the tightly held official rate from ₦306/\$1 to ₦360/\$1. In addition, rates at the IEW were revised higher to a maximum of ₦380/\$1 from an average of ₦360/\$1. Similarly, average rate at the parallel market depreciated by 19.8% YTD to ₦455/\$1. However, the reserves only depleted by \$2.4 billion over H1 20 reflecting \$3.4 billion and \$278 million inflows from IMF and AfDB respectively. Meanwhile, average import cover expanded to 9.2x compared to 7.9x in H2 2019 largely reflecting the faster decline in imports.

... as external pressures threaten CBN’s reserve

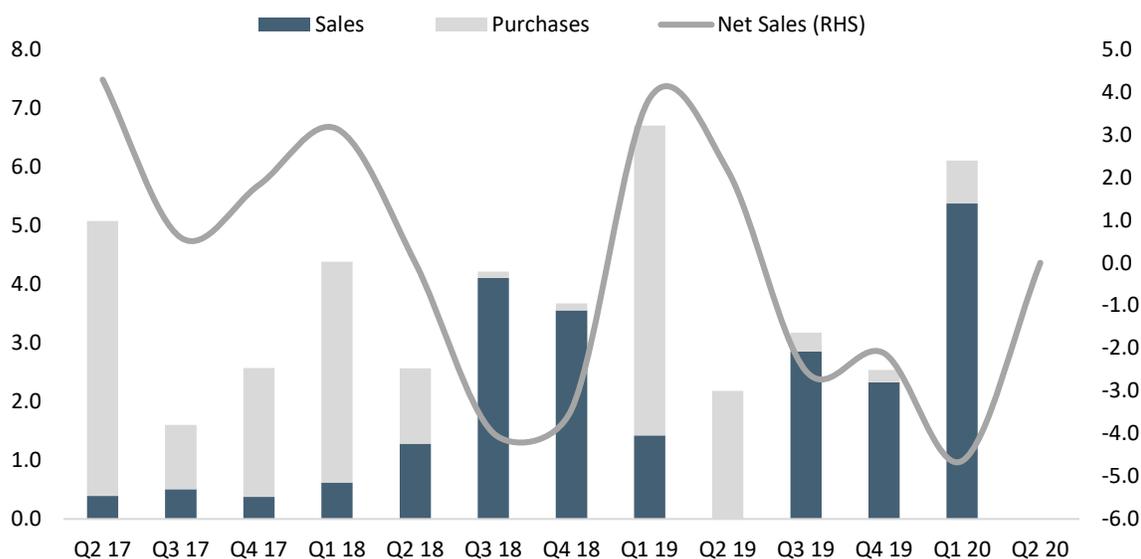
Despite flows at the IEW starting the year on a good note, the trend was short-lived. For clarity, balance of flows printed at a net inflow of \$561 million in January 2020 – after six consecutive months of net outflow. This was driven by increased FPI inflows as well as a moderation in outflows. In fact, the CBN for the first time in seven months became a net buyer at the window. However, the subsequent month challenged CBN’s stance against an imminent naira doom. Remarkably, the death toll from the covid-19 pandemic rose rapidly resulting into lockdowns and reduced economic activities across the World. Furthermore, oil prices were significantly lower owing to reduced demand from little to no economic activity and a price war between two big oil cartels – Russia and Saudi Arabia. The effect of these resulted in further slump in FPI inflows and higher repatriation of flows. In turn, total inflows (ex CBN) declined by 37.7% over H1 2020 to \$6.7 billion.

Figure 1: Structure of flows at the IEW vs. Balance (RHS) in \$’Billion



Source: FMDQ, ARM Research

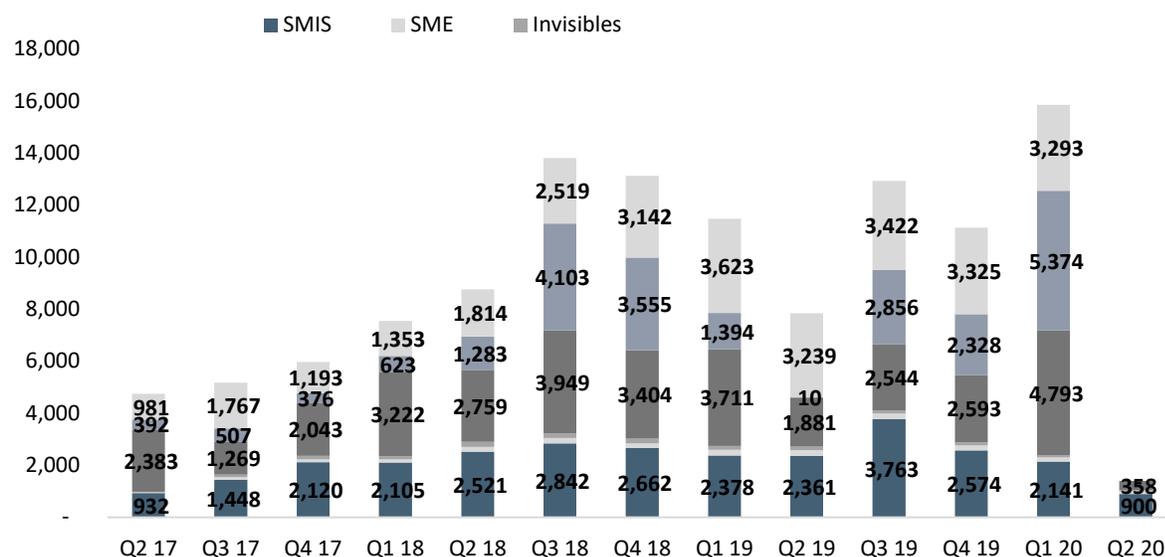
Figure 2: CBN activity at the IEW (\$'billion) vs. Balance (\$'billion)



Source: FMDQ, ARM Research

Consequently, the CBN took to administrative control in order to limit the pressure on its reserve. This helped reduce total outflows by 31.9% over H1 2020 to \$10.2 billion. Specifically, FX sales to BDCs was suspended, due to the border closure and travel restrictions across the world which was expected to reduce FX demand. Since April, the apex bank halted sales at the IEW, forcing most foreign investors to roll over investments despite lower rates. For context, despite FI maturity of \$6.5 billion with estimated FPI holdings of \$3.2 billion between April and June, the IEW only recorded total outflows of \$987 million during same period with CBN recording no sale at the window. Prior to this, the CBN net sold \$4.6 billion at the IEW in Q1 20 reflecting lower inflows (\$5.5 billion) compared to outflows (\$9.2 billion) over same period. In addition, rates for different users at the IEW were adjusted upwards from prevailing rates of ₦360/\$1 – ₦365/\$1. Consequently, applicable FX rates from International Money Transfer Operators (IMTOs) to Banks was adjusted to ₦376/\$1, Banks to CBN (₦377/\$1), CBN to BDCs (₦378/\$1) and maximum of ₦380/\$1 from BDCs to end-users.

Figure 3: CBN intervention across FX markets (\$'Million)



Source: FMDQ, ARM Research

In the heat of the moment, the FG got approval of a \$3.4 billion loan facility which was eventually disbursed in April. This has helped prop up the reserve to \$36.3 billion from a 30-month low of \$33.7 billion in March. Perhaps a coincidence; towards the end of April, CBN announced resumption of FX sales to SMES and school fees payment shortly after getting approval of the \$3.4 billion IMF loan. Nonetheless, the apex bank linked the resumption to gradual easing of the Covid-19 lockdown both globally and domestically. Meanwhile, sales to the BDC segment remained on hold pending resumption of international flights. Aside the IMF facility, the FG awaits approval of a \$1.5 billion and \$212 million² from World Bank and AfDB respectively.

A unified or managed rate?

In the first week of July, the CBN further increased the Retail Secondary Market Invention auction (SMIS) rate to ₦380.5/\$1 (previously: ₦360/\$1). It’s worthy to note that over 70% of transactions at the auctions were occurring at over ₦380/\$1 prior to the adjustment. Hence, we believe the adjustment reflected CBN’s need to unify its various exchange rates. To buttress, the World Bank has been hampering on the need to unify the various exchange rates and adopt a more flexible exchange rate regime; which is one of the conditions for disbursement of a \$1.5 billion loan facility. In our view, we see the possibility of an upward adjustment to the CBN official rate in line with the World bank’s condition of unifying rates. However, in the longer term, with the managed float still in place, we believe the exchange rate disparity will persist.

² Out of the \$500 million request, \$288 million has been approved

Calm before a storm?

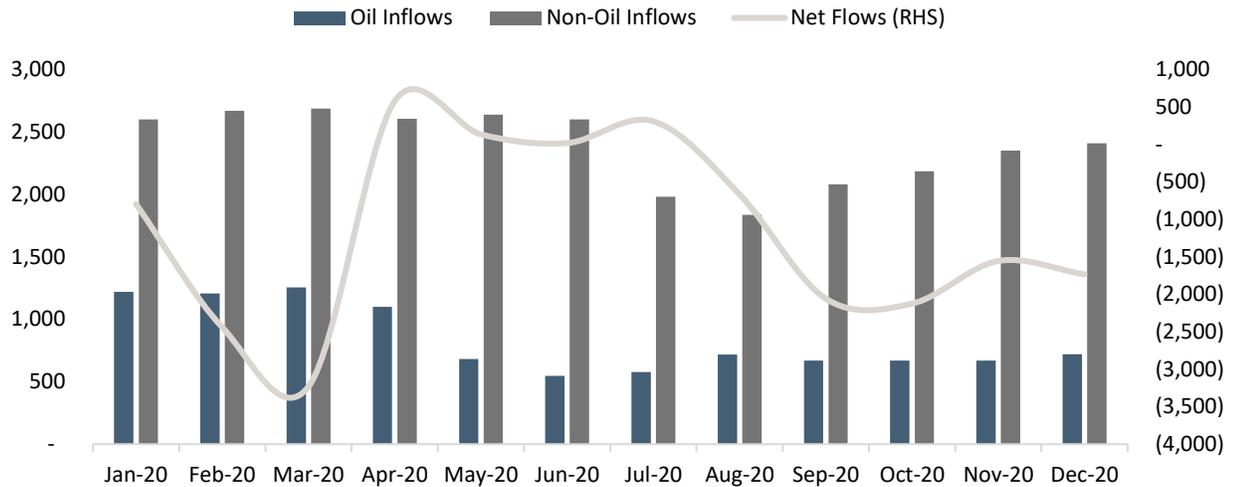
In framing our outlook for the rest of the year, we focus on key drivers of flows into CBN coffers. Despite CBN's administrative controls, we expect further depletion in the FX reserves on the back of lower inflows. While the \$3.4 billion IMF loan facility will provide a temporary relief, the CBN would be counting on disbursement of facilities from AfDB and World Bank.

On inflows, we anticipate lower oil inflows and non-inflows over the rest of the year. For oil inflows, while we expect a pickup in oil demand and oil price, we still expect average oil price to print lower (-4.8% to \$40/barrel) in H2 20 relative to H1 20. Furthermore, we see scope for lower oil production as Nigeria increases compliance to the OPEC+ production cut. We estimate oil production to average 1.7mbpd over H2 20 compared to 1.98mbpd³ in H1 20. Overlaying this with our oil price estimate, we project a 33% decline in oil inflow to \$4.0 billion. For non-oil inflow, we think FPI flows will remain depressed over the rest of the year. For clarity, we expect foreign investors to favor less risky markets on the back of concerns of a second wave of the covid-19 pandemic and its impact on economies. Furthermore, we think CBN's present rationing of dollar casts a doubt on emergence of new flows. We expect the foregoing to translate into lower FX purchases by the CBN with total non-oil inflow estimated at \$12.8 billion in H1 20 (vs. \$15.8 billion in H2 2019).

On outflows, while we expect a gradual pick up in the economy over H2 20 and by extension visible and invisible imports, we think constraints placed on repatriation of FPI flows will curtail total outflows from the FX reserves. Elsewhere, we also foresee a reduction in the frequency or amount of BDC sales in the coming months as a means to curb outflows from the FX reserved. Thus, we project a 10.3% decline in outflows over H2 2020 (\$24.7 billion).

³ Estimated using OPEC figures

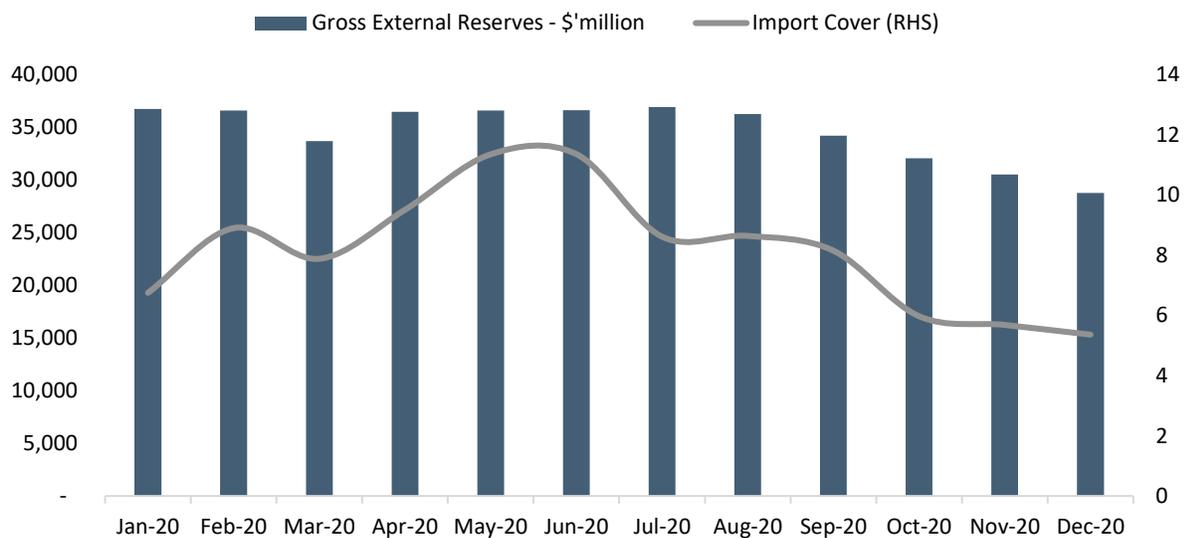
Figure 4: CBN oil and non-oil inflows and forecast (\$'Billion)



Source: CBN, ARM Research

Overall, we forecast a depletion of \$7.8 billion over H2 20 with the FX reserve closing the year at \$28.8 billion. That said, our estimate excludes expected inflow from World Bank (\$1.5 billion) and AfDB (\$222 million). Including these inflows to our model will take the reserves to circa \$32 billion by year end. Given our expected level of reserve relative to CBN’s proclaimed comfort level of \$30 billion, we see limited downside in FX rates over the rest of the year. Downside risk to our forecast are: (i) A second wave of the virus, resulting into economies closing longer than expected (ii) crude oil price going lower than anticipated (\$27.5/bbl).

Figure 5: FX Reserve forecast vs Import Cover



Source: CBN, ARM Research

Beyond 2020, we envisage more pressure on Nigeria's FX position and the CBN's fate is likely to continue relying on external financing in the form of multilateral loans. Firstly, the earliest possible time for the availability of the highly anticipated vaccine globally, according to consensus expectations is Q1 2021. Thus, we anticipate a slow pick up of global economic activities which also translates to a slower recovery in global oil prices to the peaks of \$60 - \$70/bbl levels observed in January. Furthermore, with CBN's recent posture of winding down OMO obligations, cutting the OMO rates⁴ together with foreign investors' increased repatriations risk perception, we see limited inflows even till H1 2021. It is worth stating that, in addition to the lower flows, we could see further squeeze on the reserves stemming from; (i) recovery in visible and invisible imports (ii) maturity of investments which were earlier rolled over in H1 20.

⁴ This is done to reduce cost of managing liquidity, and it is a trend we noticed after inflows of the multilateral loans began in June

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