NKC AFRICAN ECONOMICS

THE OUTLOOK FOR THE NAIRA

Jan 2015

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BACKGROUND

Pressure mounts on naira

The Nigerian naira traded mostly sideways within a range of N158/$ - N166/$ during the 2014 Q1 - Q3 period. That said, the local unit traded above the upper limit of the official trading band for the majority of this period. The naira's fortunes deteriorated markedly during 2014 Q4, mainly on account of the sharp drop in global crude oil prices and the associated decline in foreign exchange receipts. In response to all this pressure, the central bank decided to devalue the official naira exchange rate in November 2014, from a mid-point of N155/$ to N168/$ (i.e. by 8.4%), while the corridor was adjusted from ±3% to ±5%. That meant that the new trading band was set at N159.6/$ - N176.4/$. The naira remained under pressure after the devaluation and ultimately ended the year at N182.9/$, roughly 14.4% y-o-y weaker.

Order-based foreign exchange system

The naira remained under immense pressure at the start of 2015 as a result of markedly lower crude oil prices. Then, on February 18, the Central Bank of Nigeria (CBN) announced that its bi-weekly foreign exchange auctions had been suspended. The Retail Dutch Auction System (rDAS) foreign exchange window was closed and the CBN instructed traders to channel all forex demand through the interbank market. The CBN also announced that the interbank foreign exchange market would be order-based going forward – banks are only allowed to purchase forex if in possession of an order from a corporate customer. The CBN has continued to intervene in the foreign exchange market, selling US dollars directly in the interbank market at a rate of around N198/$.

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The naira has remained remarkably stable since the introduction of the order-based foreign exchange system – this is not surprising given the tight forex liquidity conditions the exchange rate arrangement entails. However, apart from a brief period following the successful presidential elections, demand for foreign exchange remained elevated which kept Nigeria's foreign reserves under pressure. At the end of June 2015, central bank governor, Godwin Emefiele, listed up to 40 items that would henceforth not be eligible for the purpose of purchasing foreign exchange on the interbank market. These items comprise food-related products, clothes and cement, amongst others. Importers of these products were then forced to turn to the parallel market to gain access to foreign exchange. In turn, this resulted in a wider gap between the official and parallel market exchange rates. The CBN then further tightened its grip on the foreign exchange market in August 2015. The monetary regulator decided to ban forex deposits at commercial banks, a move we interpret as an attempt to curb transactions in the parallel market. The CBN also announced that traders will have to settle forex orders 48 hours in advance – this rule was subsequently amended to 24 hours.

CBN reaffirms commitment to peg

Subsequent developments only reaffirmed the CBN's commitment to maintain the naira exchange rate at its current level. The monetary regulator throttled forex supply even further in November, when it was announced that foreign exchange will only be sold to bureau de change outlets once a week, whereas previously these sales were facilitated twice a week. The central bank also instructed that bureaux de change outlets provide customers' bank verification numbers in order to purchase forex. The new regulations again resulted in a wider gap between the official and parallel market exchange rates. Also, at the Monetary Policy Committee (MPC) meeting held on November 24, the CBN decided to ease policy by lowering the Monetary Policy Rate (MPR) by 200 bps while also adopting an asymmetric corridor around the policy rate (+200 bps / -700 bps). The Cash Reserve Requirement (CRR) was also lowered further from 25% to 20%. Lower interest rates and an increase in domestic currency liquidity are certainly not in line with a policy aimed at defending the exchange rate, and possibly signalled that the CBN intended to maintain the order-based foreign exchange system for longer than originally anticipated.

RECENT DEVELOPMENTS

During his budget presentation on December 22, President Muhammadu Buhari highlighted the adverse impact of forex restrictions on the domestic business environment. This represented the first acknowledgement by authorities that the CBN's current stance on the naira exchange rate holds adverse consequences for economic growth. Pressure has mounted on authorities to devalue the naira over the past month, with International Monetary Fund (IMF) Managing Director Christine Lagarde also calling for a liberalisation of the forex market during a visit to Nigeria early in January.

The pressure on the naira exchange rate intensified further when Brent crude oil prices dipped below the $30/bbl level on January 12, prompting the central bank to halt all forex sales to bureau de change outlets. This decision, motivated on the basis that these institutions were involved in currency speculation, resulted in the parallel market exchange rate depreciating to roughly N300/$. The CBN also decided to reverse an earlier decision and allow forex deposits at commercial banks to shore up the amount of dollars in the banking system. Governor Godwin Emefiele was then summoned to appear before the Senate on Tuesday, January 19, to explain why the parallel exchange rate depreciated by such a significant margin. However, the Senate reported afterwards that authorities were satisfied with the CBN's stance on the naira, and Senate President Bukola Saraki reported that the CBN would continue to support *"a downward interest rate regime and policies that would diversify the economy."*

BASELINE ASSESSMENT

The current exchange rate regime shields the naira and Abuja's level of foreign reserves against external shocks and current account pressures. The order-based system essentially allows the CBN to throttle forex supply when it deems it appropriate to do so. Thus, the CBN can in theory decide to retain its current stance on the naira, irrespective of external developments and oil price movements. That said, the 'cost' of maintaining a stable currency will increase in line with external pressures intensifying. A drop in crude oil prices will translate into a decline in foreign exchange receipts. In turn, the CBN will have access to fewer US dollars to supply to the market, and forex liquidity will tighten. This holds adverse consequences for the domestic business environment, as firms that require foreign goods – be it manufacturing materials, machinery or intermediate goods – will no longer be able to acquire dollars from the official market to pay for imports. In some cases, these firms will turn to the parallel market, where the cost of forex is significantly higher, which will adversely impact operational cost and could ultimately filter through to higher inflation.

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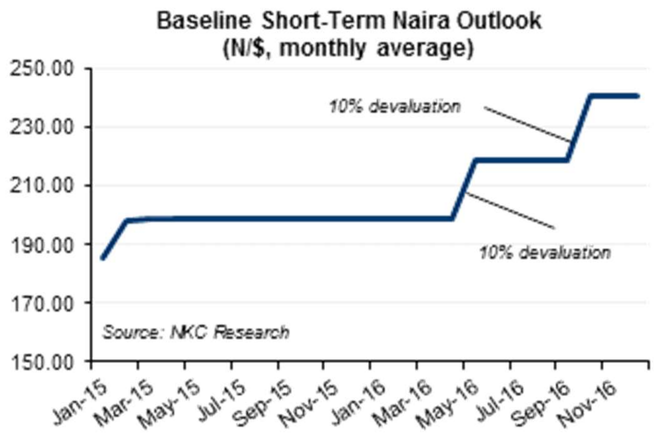
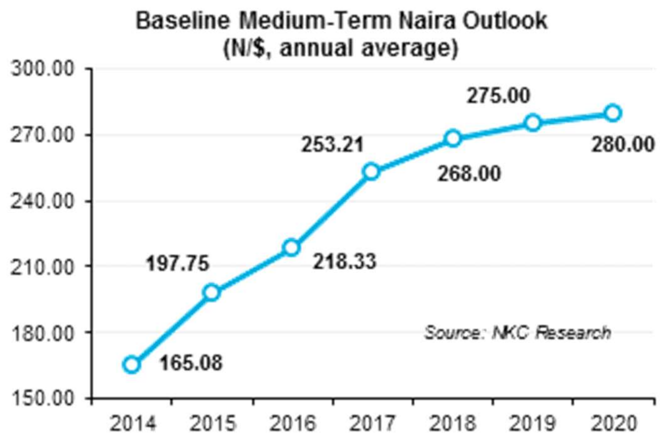
Tight forex liquidity also deters foreign direct investment (FDI), as foreigners are weary of investing in a country where it is difficult to repatriate profits. Portfolio investors are also likely to remain on the sidelines out of fear of a naira devaluation. This was in fact already the case last year, with Nigeria recording net portfolio outflows of $74m during the 2015 Q1 - Q3 period, compared with net portfolio inflows to the value of $3.5bn during the same period a year earlier. There is also a concern about the impact of a dollar shortage on the ability of private sector firms to meet external debt obligations. In general, the adverse effects of tight forex liquidity conditions will increasingly start to filter through to the real side of the economy, potentially leading to slower GDP growth and increased unemployment.

Our current baseline scenario predicts a 10% devaluation in 2016 Q2, followed by another 10% devaluation early in Q4. While pressure has mounted on authorities to devalue the currency in recent weeks, we believe the current rhetoric is still leaning towards safeguarding the average Nigerian against markedly higher inflation. The recent comments made by Senate President Saraki certainly support this view. Furthermore, we believe the current monetary policy stance – characterised by excess liquidity and lower interest rates – is not in line with a central bank which intends to liberalise the foreign exchange market. In actual fact, we will consider moves by the apex bank to mop-up excess liquidity or to raise interest rates as a leading indicator towards an eventual devaluation.

With crude oil prices trending near $30/bbl, we believe pressure will continue to mount on authorities as the adverse effects of tight forex liquidity on the domestic business environment becomes increasingly apparent and the private sector becomes more vocal, ultimately resulting in a devaluation by Q2. Our baseline assessment sees further devaluations of the naira exchange rate over the medium term, but the magnitude thereof will gradually decline as crude oil prices trend higher and diversification efforts start to reap some benefits.





In summary, our baseline scenario is based on the following assumptions:

- Brent crude oil price will average $39.4/bbl in 2016, rising gradually over the medium-term;
- The CBN will prefer a gradual adjustment of the naira exchange rate to smooth the impact on inflation;
- Forex liquidity will remain fairly tight despite the devaluation, but forex demand will decline slightly; and
- A devaluation will not result in a significant increase in foreign investment inflows, as the currency will remain overvalued – foreign investment will increase more steadily from 2017 onwards as the naira moves closer to a market-clearance level in addition to the impact of more favourable economic policies.

SCENARIO ANALYSIS

Our baseline assessment currently represents the most likely outcome in our view. That said, the probability of the CBN opting to adjust the naira at a different point in time or by a more significant margin remains high, mostly due to the large number of factors, political considerations included, that have a bearing on the decision. Different devaluation scenarios are briefly explored below. We will firstly consider more aggressive scenarios characterised by a devaluation earlier than predicted under the baseline assessment, followed by passive scenarios where the central bank prefers to delay a devaluation until 2016 H2.

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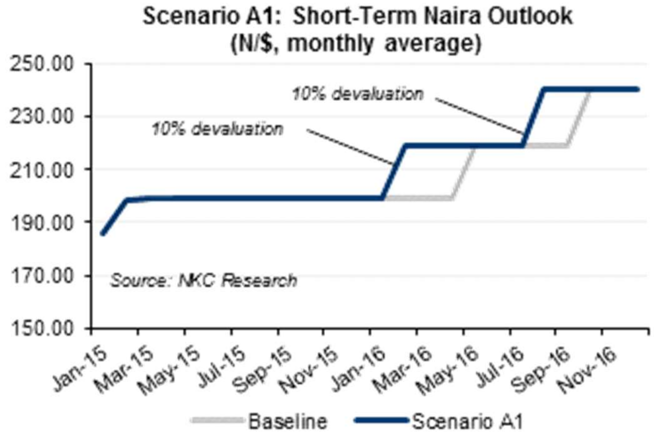
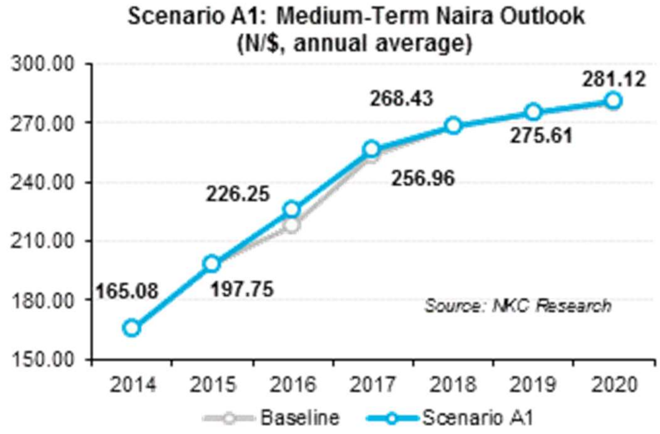
Aggressive scenarios: Naira devalued earlier than baseline

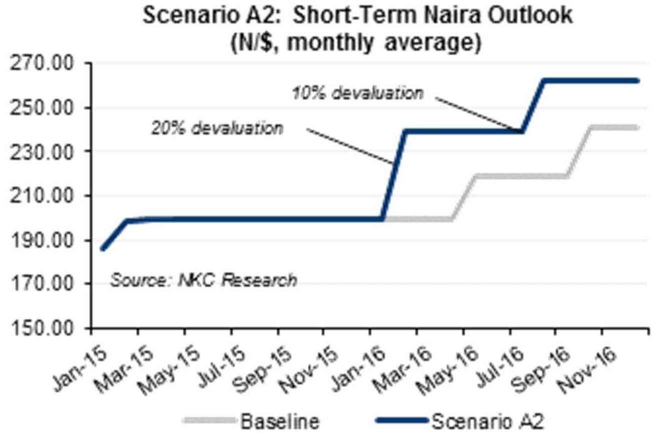
There remains a real possibility that the CBN may opt to devalue the naira in Q1. **Despite the fact that authorities have recently reaffirmed their commitment to naira stability, the apex bank will likely not make any announcements to the contrary prior to the actual devaluation to prevent traders from positioning themselves for speculative purposes.** We still believe the CBN will change its monetary policy stance prior to a devaluation in response to the expectation of higher future inflation. Excess domestic currency liquidity is also not supportive of defending the exchange rate. Below we list the main triggers that make an earlier devaluation more likely.

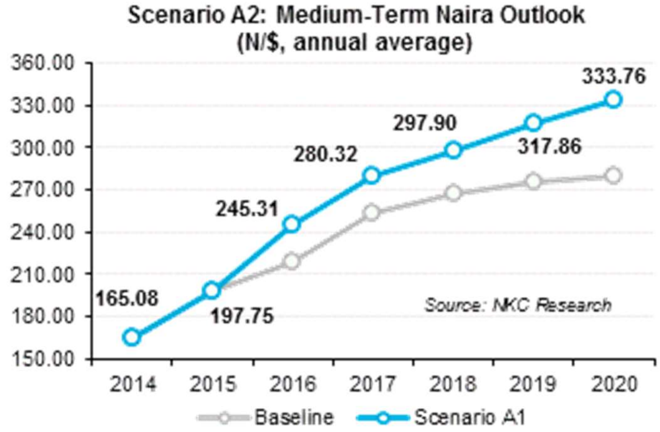
Triggers:
- Higher interest rates early in Q1;
- Excess liquidity being mopped up (higher overnight interest rates);
- Accelerated decline in foreign reserves;
- Severe disruption to oil production; and/or
- Brent crude oil price dropping to $20/bbl.





Our first aggressive scenario (A1) predicts a 10% naira devaluation in Q1 followed by another 10% devaluation in Q3. As is evident from the figures above, aside from the timing, there is very little difference between this scenario and our baseline assessment, with the average naira exchange rate only marginally weaker compared with the baseline assessment over the medium term.





Our second aggressive scenario (A2) predicts a 20% devaluation in Q1 followed by 10% devaluation in Q3. This time there is a more noticeable difference when compared to the baseline case. It must also be noted that tight forex liquidity conditions will ease to a greater extent if the CBN devalues the naira by a more significant margin, and this may incentivise increased foreign investment inflows. That said, this scenario (A2) still represents the less likely outcome in

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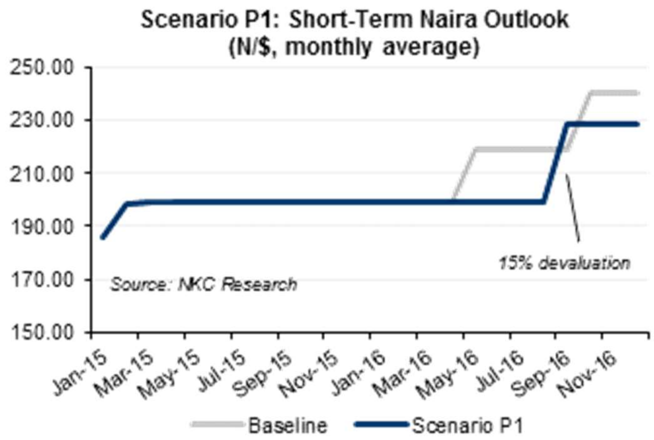
our view. Authorities remain very concerned about the impact of a weaker naira on domestic inflation and the cost of living. **As such, we believe the CBN will rather opt for a 10% devaluation.**

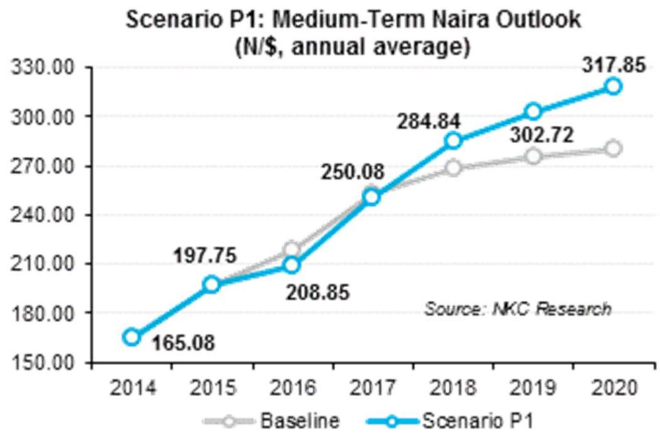
Passive scenarios: Naira devalued later than baseline

The passive scenarios are characterised by the CBN opting to delay a devaluation until 2016 H2. Recent developments – referring to Governor Emefiele defending the current stance on the naira before the Senate, and the latter being satisfied with his defence – have arguably increased the probability that the CBN will hold off on a naira adjustment. More concrete signs that would tend to support a delayed devaluation include the triggers outlined below.

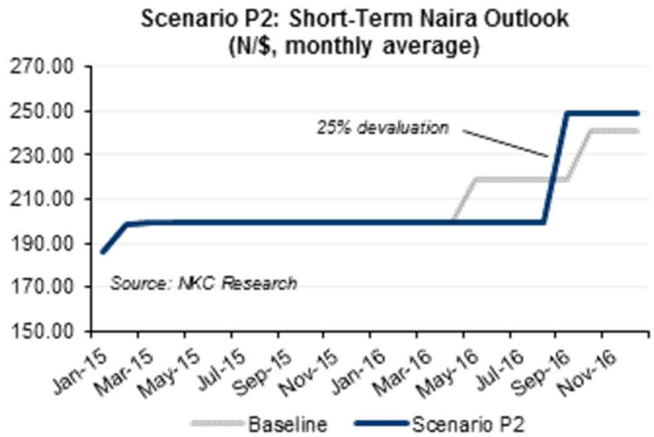
Triggers:

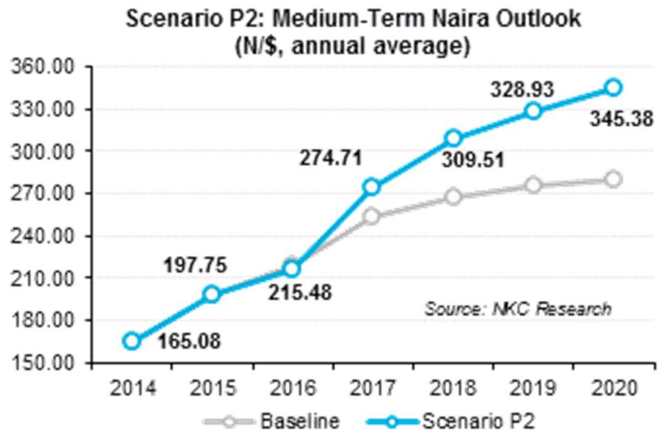
- Further monetary policy easing;
- Economic indicators remaining fairly robust despite tight forex;
- Stabilisation in foreign reserves; and
- Brent crude oil price trending higher to $40/bbl.





Our first passive scenario (P1) is characterised by a 15% devaluation in Q3. The reason for the adjustment being larger in magnitude than compared to the other scenarios relates to the fact that the naira will likely become increasingly overvalued the longer a devaluation is postponed. Despite the more significant adjustment, the annual average value of the naira in 2016 will remain stronger under this scenario compared to the baseline. That said, the outlook for the unit is worse over the medium term.





Our second passive scenario (P2) entails an even larger adjustment in the region of 25% in Q3. Again, the difference between this scenario and the baseline, in terms of the naira's annual average value in 2016, is negligible. However, the currency's fortunes deteriorate rapidly over the medium term. Regardless, this scenario, characterised by

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a larger adjustment in the value of the naira, again represents the less likely outcome in our view. **We tend to think that, even if the decision is postponed to H2, the CBN would rather opt for a smaller adjustment to minimise the impact on inflation.**

CONCLUDING REMARKS

Given the information currently at hand, we predict the naira will be devalued at some stage during Q2. That said, it must be highlighted that the situation remains very uncertain, and an adjustment in the value of the local currency may well occur earlier or even later than predicted under our baseline assessment. Recent developments, referring to Governor Emefiele's defence of the CBN's current stance on the naira before Senate, have arguably made the latter more likely in our view. In general, if the local unit is indeed devalued, we believe the monetary regulator will prefer a smaller naira adjustment. However, the magnitude of the devaluation will increase the longer it is postponed, mainly because the naira will become increasingly overvalued moving forward.

There is one scenario not outlined above, one which sees the CBN stick to its current stance and maintain the naira peg for the duration of 2016. This is theoretically possible, as the central bank could just continue to throttle forex supply. Developments that would signal that Abuja is leaning towards this scenario are fairly similar to the triggers listed under the passive scenarios outlined previously in this report. However, the cost of doing so will continue to rise as the adverse effects of tight forex liquidity on the real side of the economy intensify. Authorities may attempt to counter these adverse effects by implementing policies aimed at making the economy less reliant on oil proceeds. However, diversification efforts will not yield significant results in the short term.

SOURCES OF INFORMATION

Bloomberg
Central Bank of Nigeria
Reuters
Nigeria National Bureau of Statistics

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