Naira Trending Towards 2015

Afrinvest Research

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Historical Review of the Naira – 1980 to 2013

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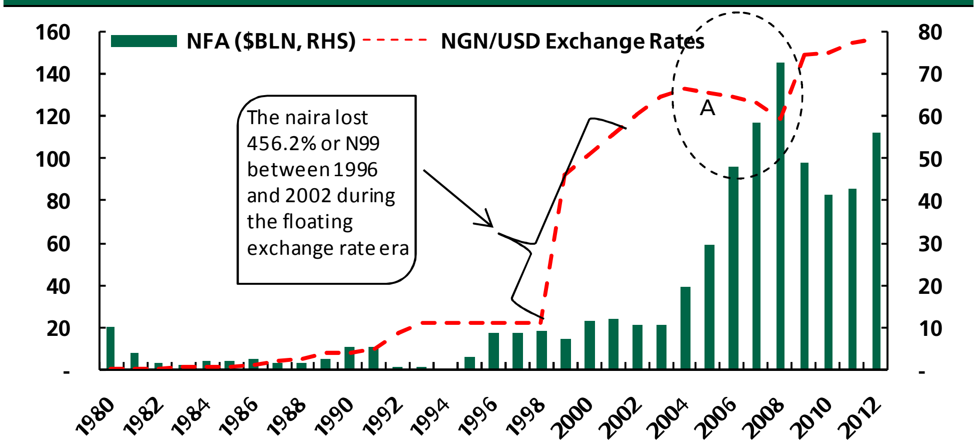
Highlights

- **Naira loses 23.0 %in a decade**
- **Contractionary monetary policy is yet to reverse the slide**
- **We expect the naira to attain N166.00/USD in the interbank market by December 2013**
- **Mild adjustment to be witnessed in Q1 2014**

The naira lost 456.2% between 1996 and 2002 as floating exchange rate regime operated

Over a 19 year period from 1980 to 2000, the naira depreciated by N101.50 (to N102.10/US$) when compared with N0.6/US$ it traded as at 1981. Not even the Structural Adjustment Programme (SAP) introduced in 1985 could have predicted this precipitous slide. The naira first hit double digits moving from N9.9/US$ in 1991 to N17.2/US$ the following year, a significant 73.7% change. Thereafter, a gradual slide ensued, attaining triple digits in year 2000. Although, the naira was considerably stable between 2000 - 2003 (below N120.0/US$), the recent adverse global capital flows amongst other factors has culminated in the current all time low of N164/US$ rate at the interbank market.

NGN/USD Trend and NFA (1980 – 2012)



Source: World Bank, Afrinvest Research

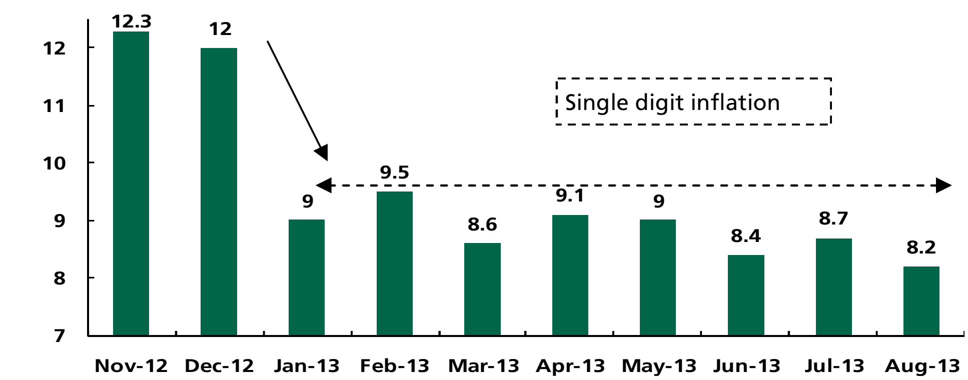
The chart above captures the trend in the naira, vis-à-vis the Net Foreign Assets (NFA) over a 32 year period. After a sharp Y-o-Y decline in the value of the naira between 1996 and 2002 (induced by the re-introduction of the floating exchange rate system), the federal government commenced the accumulation of substantial fiscal reserves between 2004 and 2008. (See point A in the chart above). Consequently, the naira appreciated by about N15.00 over the four year period until the end of the Obasanjo regime. Since 2008, however, the naira has caved due to various pressure points including the decline in oil prices, excess liquidity , capital flight, lower production volumes due to oil theft, etc.

The NGN/USD rate is arguably the strongest monetary policy tool the CBN has employed in the past 3 years. The proactive initiatives and policies designed by the apex regulator has maintained (to a certain degree) a stable naira. This achievement has delivered some benefits within the last 12 months, as seen particularly in the successive decline in the inflation rate (12.0% August 2012 - 8.2% August 2013).

Pressure Points on the Naira

Inflation rate declined to single digits in 2013, from 12.0% in August 2012 to 8.2% as at August 2013).

INFLATION (Nov. 2012 - August 2013)



Source: NBS, Afrinvest Research

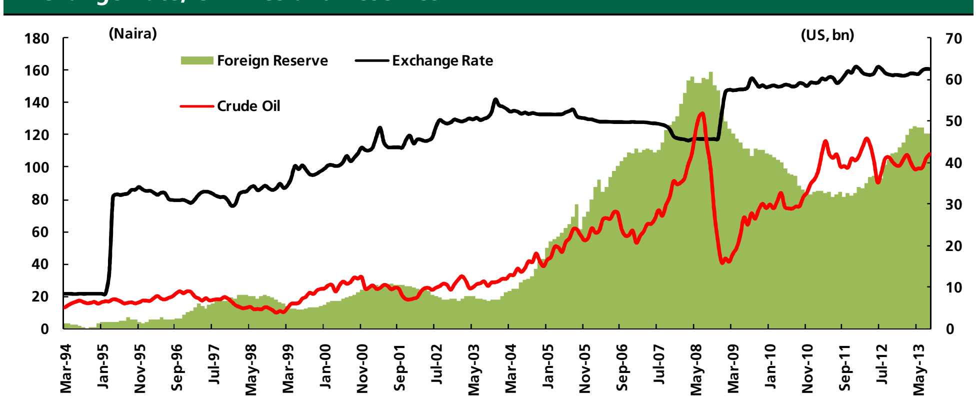
The CBN has continued to checkmate liquidity needs in the economy through various monetary measures, i.e. the Wholesale Dutch Auction System (WDAS), Open Market Operation (OMO), the Monetary Policy rate (MPR), Net Open Position (NOP) and most recently the Cash Reserve Ratio (CRR), targeted at reducing the pressure on the naira. However, the naira has recently come under severe pressure from internal and external factors. We present below a summary of those factors:

Government revenues have continued to face significant pressure due to the decline in oil production (Q1 2013 2.29mbpd Vs Q2 2013 2.11mbpd), caused by the combined effect of oil theft and pipeline shutdowns due to the burgeoning illegal trade.

Fiscal Pressure and the Naira

The flow of revenue determines the viability of the 2013 budget assumptions. The budgetary scope of the government in 2013 is essentially based on the following assumptions i.e. a N160/US$ Naira exchange rate, an oil production of 2.53mbpd, benchmark oil price of $79.00 and a projected Gross Domestic Product (GDP) growth rate of 6.5%. However, government revenues have continued to face significant pressure due to the decline in oil production (Q1 2013 2.29mbpd Vs Q2 2013 2.11mbpd), caused by the combined effect of oil theft and pipeline shutdowns due to the burgeoning illegal trade. This situation has dampened the country's foreign exchange reserves as the CBN continues to use this as a tool in the regulation of the

Exchange Rate, Oil Price and Reserves



Source: Bloomberg, CBN, Afrinvest Research

The monetary authority has consistently maintained a tight grip on the macroeconomic environment in the last 13 quarters as evidenced by its restrictive policy statements

Liquidity Dynamics of the Naira

The monetary authority has maintained a tight grip on the macroeconomic environment over the past 13 quarters as evidenced by its restrictive policy statements. These policies have however helped stabilize the value of the naira, spurring huge flows of Foreign Portfolio Investment (FPI). Compared to the foreign exchange losses other emerging markets (Indian rupee [-18.5%], Indonesian rupiah [-15.4%], Brazilian real [-13.7%], South African rand [-9.9%]) have faced since May against the dollar, the naira has lost only 3.4% within the same period. This outperformance certainly reflects the heavily managed nature of the exchange rate framework in Nigeria. However, we highlight below some pressure liquidity induced points on the naira in recent times:

- **Capital Market Trade Flows:** The flow of trades in the capital market has the propensity to deliver an immediate effect on the direction of the naira (in comparison to the balance of trade which has a lag effect on the naira). The relative stability of the naira in Q12013 has been influenced considerably by the influx of foreign funds in search of competitive yields. However global events have the propensity to spark a pullout at a higher velocity, destabilizing the exchange rate. It is in this respite that the recent announcement of a proposed reduction in the bond buying program in the United States sparked massive outflows from emerging markets (MSCI Emerging Market Index [EMI] declined 3.0% within this period [May 2013]). This news has spurred a huge depreciation in emerging market currencies with larger exposures to U.S. FPI. The naira has not been immune from this dynamics as foreign investors have pulled out of the domestic economy driving the naira southwards. The naira recently hit an all time low of N164.09/US$, 3.6% decline from May 22, 2013. However, a breath of calm might be by the corner as Fed is set to continue its QE for the rest of 2013.

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- **Domestic Economic Activity:** The Domestic economic activity as measured by GDP grew 6.18% in Q2 2013, lower than the 6.99% and the 6.56% posted in Q4 2012 and Q1 2013 respectively. This has been principally attributed to the persistent decline in the contribution of the oil sector to the domestic economy. The oil sector, which contributes the largest portion of the country's foreign exchange earnings and largest contribution to the country's current account has been under significant threat from illegal bunkering and vandalism. This key income source of the government has been constantly declining representing a drag in the accumulation of the foreign reserve account. The federal government continues to rely on oil receipts for FAAC allocations, thus limiting transfers to the Excess Crude Account (ECA) and the Sovereign Wealth Fund (SWF). The continued decline in oil receipts continues to pose a threat to government revenues, limiting the fire power to regulate the naira.

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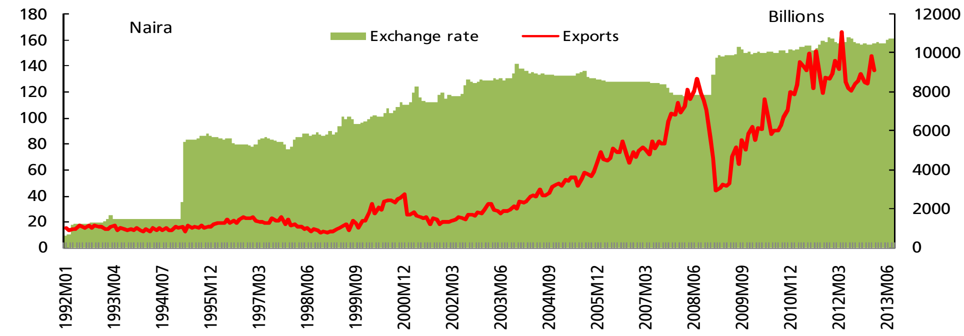
Total Export Vs Naira Vs Oil production



Source: World Bank, Afrinvest Research

- **The Naira and Inelastic Lending Rates:** Domestic lending rates (prime and maximum) has historically ranged between 17.0% - 25.0% in the last three years despite improvements in the general health of the economy. Excessively high interest rate depresses economic activity and dampens growth, which in turn weakens the buffer the real sector offers to the naira. In our opinion, the long term strength of the naira can only be sustained with a redesign of policies that can drive the lending rates down to an affordable range.

Eurobond: A drop in the ocean?

The government recently issued $1.0bn Eurobond, in addition to the $500.0m previously issued. Several banks (GTBank, FBNH, Access Bank and Fidelity Bank) have also issued Eurobonds ranging between $300.0m – $500.0m within the last two years. This poses an interesting question: does this avenue constitutes a viable forex supply window to the Nigerian foreign exchange space? We see these inflows simply as “one off” events.

The Federal government remains the largest forex earner. In addition, the government's dollar positions constitutes the largest portion of the assets on CBN’s balance sheet. The CBN supplies about US$600.0m weekly to authorized dealers through the WDAS. This amounts to approximately $2.0bn per month and $24.0bn in a year (Compared to $2.0bn from Eurobond issuances in 2013). However, despite the expected Eurobond issuances in the near term (DMO’s Diaspora bond and other DMBs issuances), we do not see any significant upside effect on the naira as demand is poised to continue to far outweigh supply.

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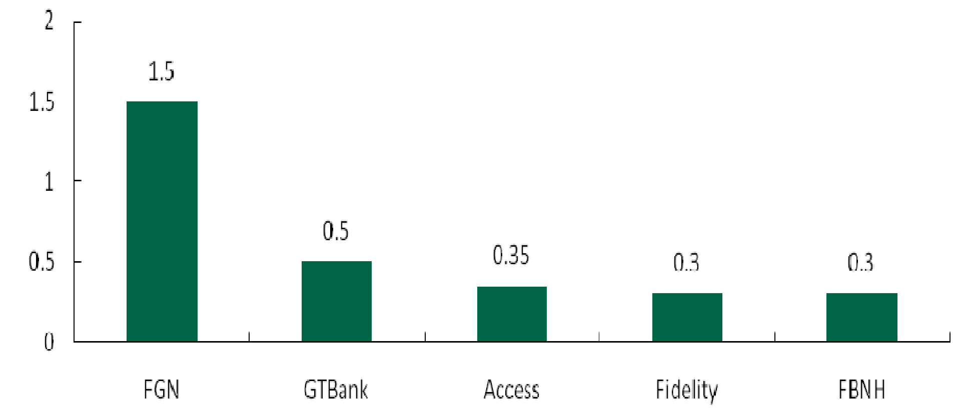
Eurobond issuances ($bn)



Source: DMO, Afrinvest Research

Funds Flow: FDI and FPI

Approximately $2.0bn in form of FDI is expected to be injected in the economy through the power sector privatization exercise.

The inflow of foreign capital into the economy should constitute a buffer for the naira. Approximately $2.0bn in form of FDI is expected to be injected in the economy through the power sector privatization exercise. While this is expected to place more dollars in the coffers of the CBN, we also do not foresee significant near term upside effect on the naira.

There is a positive correlation between net FPI inflows in the Nigerian capital market and the value of the naira. Given the current volatile global financial system and the potential crystallization of Quantitative Easing (QE) in the US in the mid-long term. The Naira is poised to remain at the mercies of adverse capital flows should the relative calm that surrounds QE eases.

Oil receipts account for 96.8% of the country's total exports. This predisposes the economy to external shocks.

Counter Cyclical Fiscal Strategy

The incorporation of a long term diversified strategy in fiscal policy is required to deliver the cushioning support for shocks in various segments of the economy. Performance analysis of various sectors as shown in the country's GDP highlights the increasing need to diversify revenue sources. The current over reliance on oil receipts (oil receipts account for 96.8% of the country's total exports) by the government poses a huge threat to the stability of the economy.

The persistent pressure on the naira could have been minimized if a counter cyclical fiscal policy is developed, as the CBN cannot continue to defend the naira with foreign reserves. To reduce this pressure, an inward looking policy (tax incentives, infrastructure development and production subsidy) should be emphasized to reduce the dependence on imported goods. Asides from oil receipts, the development of the Agricultural sector will in the short term reduce the foreign exchange burden of food imports and over the long term enhance foreign receipts if its comparative advantage in the sector is efficiently deployed.

Countercyclical fiscal policies are key to subduing the "oil curse" of periodic instability and slow development.

Having reviewed the economics of other oil dependent countries (Middle East and North Africa) we believe that countercyclical fiscal policies are key to subduing the "oil curse" of periodic instability and slow development. The effective management of the National Sovereign Investment Authority (NSIA) could in the future reduce the correlation of government expenditure with crude oil prices and output. The Nigerian government should work towards a longer term commitment to benchmark oil prices, as against the current yearly debates and bargaining that surrounds budget preparation. In addition, emphasis should be geared towards the diversification of the foreign receipts base of the economy.

Adopting Longer Term Forecasts

Afrinvest Research recommends the adoption of an approach of longer term forecasting for key monetary policy indicators (especially interest rate and exchange rate) as exemplified by the US Federal Reserve. Such forecasts should seek to cover the expected policy direction over a minimum of three years.

Growth in the aggregate savings provides a pool of investible funds that can be channeled to the real sector

The MPS Argument

Increasing the marginal propensity to save (MPS) amongst the populace will help accelerate the rate of investment in the economy. This can be achieved through reduced income tax and cheap loans. Incentives can be provided for individuals who utilize their savings for investment in the form of capital allowances. This would boost domestic production and further reduce imports pressure on the naira.

Domestic lending rates have remained high (above 20%) given the current risk pricing and the CBN's restrictive monetary policies

Driving the real economy and curtailing borrowing cost

The importance of real sector growth to the development of the economy has been emphasized in various Afrinvest Research publications. The Nigerian government is clearly intensifying effort in this direction as evidenced by quantifiable progress in the development of agriculture and focus on fixing the debilitating infrastructural deficits in the power sector. We are hopeful that the successful privatization of this sector will deliver an inclusive growth trajectory for the entire economy as experienced in the telecommunications sector.

On the other hand, the opportunity cost of attracting and retaining foreign portfolio investments in the country by keeping interest rate high needs to be reexamined. Domestic lending rates have remained high (above 20%) given the current risk pricing and the CBN's restrictive monetary policies. We suggest more policies that will stimulate lending in order to stimulate economic growth.

Our Medium Term Outlook for the Naira

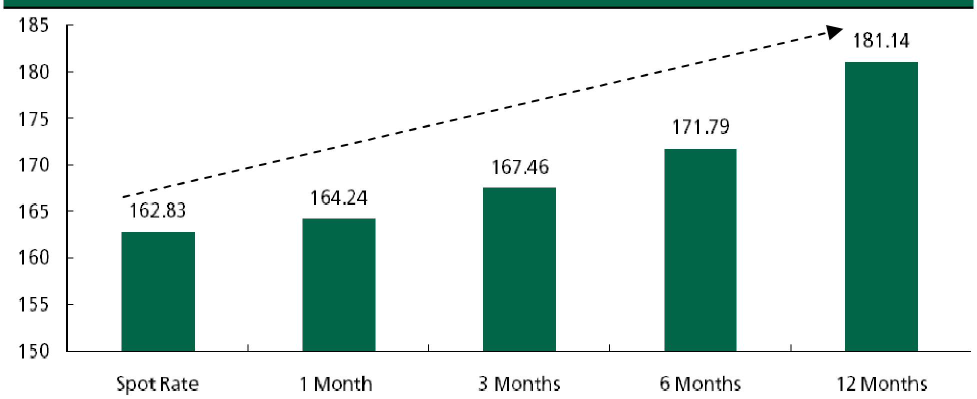
We expect the naira to peak in the neighborhood of N166.00/USD at the interbank market by December 2013.

CBN's Intervention vs The Invisible Hands

Given recent developments in the naira exchange rate space in the past year, we are of the view that the naira will slide further in the near term towards N166.00/USD in the interbank market by December 2013. A key contributor to this downward trend remains seasonally waning oil receipts due to the lingering oil theft. This may be compounded by the yuletide as seasonal higher domestic demand fuels imports. In addition, foreign investors might exit positions to close their books for the year as well. While we expect mild stability come first quarter of 2014 supported by FPI inflows, we are somewhat cautious due to the anticipation of a new CBN governor next June and upcoming elections in 2015. An important caveat to our outlook is the outcome of the remaining two MPC meetings of the CBN for 2013, scheduled to hold by 23rd - 24th September, and in 18th - 19th November. The CBN might see reasons to alter the present N155±3% to N157±3% band should the existing pressure intensify.

Current forward contracts aligns with our view that the naira will slide further in the near term to trade above N180/USD within 12 months.

Naira Forward Contract Rates



Source: Bloomberg, Afrinvest Research

Yuletide: 90 days of pressure

Considering the periodic boom of activities during the fourth quarter of the year, it is valid to expect more demand for the dollar by importers in Q4, as importers fund their imports for the yuletide. The naira has historically depreciated by an average of 1.0% during the last quarter of the year as evidenced in the graph below.

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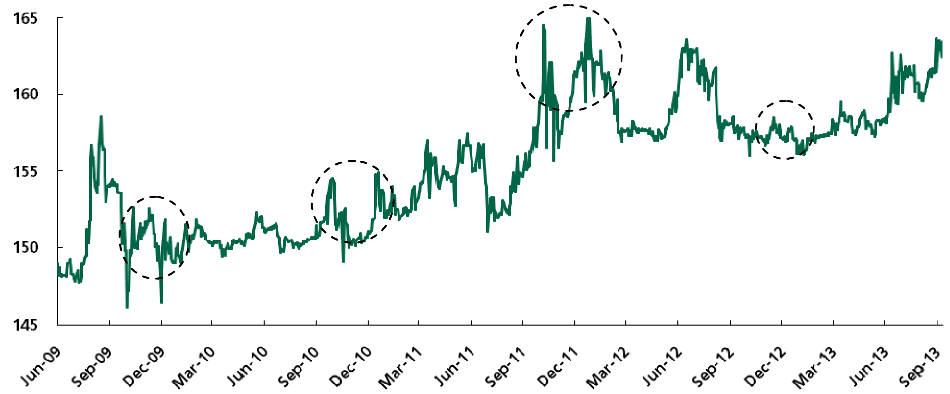
NGN/USD Spot rate (2009 – 2013) - The Yuletide Effect



Source: Bloomberg Afrinvest Research

Reducing Exposure to Oil Price Volatility

As outlined earlier, Nigeria's dependence on crude oil (currently 70.0% of total forex earnings) makes economic growth susceptible to oil price shocks. A decline in crude oil price therefore leads to a corresponding decline in oil receipts; which forestalls the accumulation of external reserves, creating a negative signaling effect that leads to capital flight, thus depreciating the naira. More recently, this vicious cycle has been further compounded by crude oil theft which has kept output below 2million bpd since July 2013. Given that crude oil price is exogenously determined, more attention should be paid to output. Therefore, issues surrounding the oil and gas industry (particularly the PIB) should receive accelerated attention of the policy makers.

Afrinvest Research has been able to establish a strong positive correlation between the Exchange Rate and Crude Oil Price in Nigeria. Based on our model, when oil price declines by US$1.00 per barrel, the naira depreciates by about 10 cents. Assuming oil price reduces to US$100.00 per barrel from the current US$117.80 price as at 4/9/2013, we should expect the naira to depreciate by N11.53 to N173.33/US$.

With the discovery of the Shale oil, crude oil prices is projected to moderate in coming years. In addition, the threat by the US to reduce oil imports constitute a downside risk on crude receipts of OPEC members. Consequently, the CBN must establish a "real" and "sustainable" value for the naira as the opportunity cost of "substantial" support for the naira increases.

The US Fed recently announced the continuation of Quantitative Easing for the rest of 2013. We expect this to ease the current pressure on the naira as capital flight eases in the short term. However, adverse capital flows, increasing imports and volatile oil prices pose the highest threat to the naira as it trends towards 2015.

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