Nigeria Viewpoint

Trip notes: in search of hot money

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EEMEA | Nigeria

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Two days in Nigeria: positive sentiment on reforms

We spent two days in Nigeria- Abuja and Lagos meeting with policymakers, multilaterals, banks, corporates, and private sector experts. The mood was positive coinciding with the positive adjustments to FX changes. Nigeria's central bank is on a promising path of making price stability the new primary objective – money supply growth is 50% and inflation is close to 30%, while the policy rate is 18.75%. A move towards orthodoxy involves tightening monetary policy using the policy rate as the main tool. That is, moving away from large negative real rates, the monetisation of fiscal deficits, and towards domestic yields that reflect market pricing and a more flexible exchange rate. On balance, we view the new government as pro-reform, and moving in a positive direction. The next big step is tightening the policy rate.

…to attract portfolio inflows

We expect the central bank to tighten interest rates aggressively in the next two meetings by 300bp in each of February and March meetings, taking the policy rate to almost 25%, which we see as the terminal rate. If year-end inflation projections of around 22-25% materialise, negative real rates would be gone and positive real rates would be more sustainable.

Timestamp: 13 February 2024 04:05PM EST

Trip feedback: The pain of reform without adequate dollar inflows

Reform-minded and leaning towards orthodoxy

Mr Bola Tinubu was sworn in as President in May 2023. Investors were enthusiastic about his immediate removal of fuel subsidies and currency adjustment in June 2023, which signalled the government's pro-reform impetus. This was a departure from the previous government of 2015-23. There was not much policy action for remainder of the year, however, which led to stagnation in the reform effort, Instead, the focus was the appointment of key economic team members. The appointments of Mr Wale Edun as coordinating minister of the economy and finance and Mr Yemi Cardoso as governor of the central bank were viewed positively. Then monetary policy committee meetings were cancelled in September, November, and January as the committee is still being assembled pending new appointments of external members. In the meantime, speeches by the Finance Minister Edun and Governor Cardoso across various platforms gave that hope work was going on in the background. Recent actions have also renewed hope among investors, including FX reforms.

Reform is painful without adequate dollar inflows. Ideally, currency devaluation should go hand-in-hand with a tightening in monetary policy. Nigeria has experienced financial repression, where domestic securities yields were effectively compressed. Gradually rates have gone higher for government securities while central bank OMOs have attracted even higher rates. But the government was not able to access much foreign funding in 2H 2023.

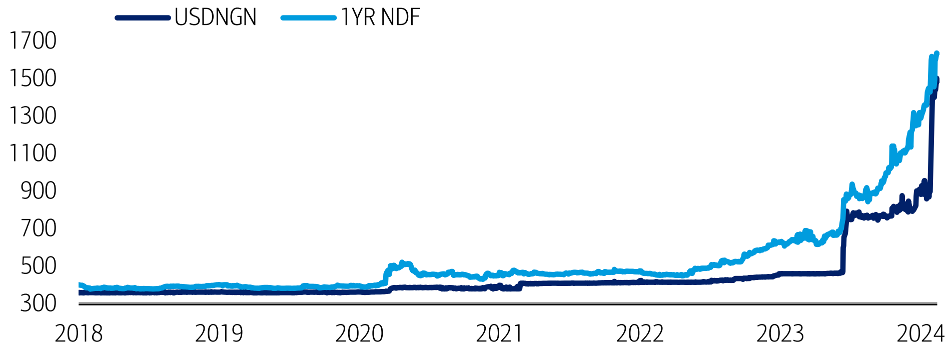
FX reforms a catalyst for foreign inflows

The most decisive and market-friendly action in 2024 is the second adjustment (devaluation) by the securities exchange, FMDQ, in calculating the NAFEM (Nigeria Autonomous Foreign Exchange Market) rate. The publishing of the calculation methodology makes the process transparent and a good signal. It uses the volume weighted average of trading transitions done in the last day as a starting point for the [next day's opening levels. This second currency adjustment narrowed the gap between parallel rates with the official market and hopefully one price is becoming the new normal.

At the same time, the CBN removed various limits such as the +-2.5% cap spread on interbank foreign exchange transactions. It also removed the cap on FX retail transactions for items such as medical and education fees. However, for banks it placed a limit on net open positions of FX at 20% short and 0% long of shareholder funds. It is normal for banks to keep more FX in a country where inflation is rising, and the currency is weakening. The latest change resulted in some banks selling some of their dollar holdings on the open market. FX liquidity improved temporarily in the FMDQ turnover numbers.

Post the FX reforms of the past few weeks, we have seen some extreme moves in the market in general. Spot moved higher before the latest auction and peaked at around NGN1,500 given the $ supply with the expectation to buy bills in the auctions slowly. It is now trending lower, at around NGN1,450. The effective rate in the 12M is around 23.5%, and the discount yield is around 18%. The NDF market, such as 1Y NDF ASW (bills vs implied yields), is back into positive territory for the first time in many years.

Exhibit 1: Massive moves post FX reforms
USD/NGN and 1YR NDF



Source: Bloomberg

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Exhibit 2: NGN Forecasts
Naira floated in June 2023

	Q1 24	Q2 24	Q3 24	Q43 24	Q1 25
USD-NGN	1520	1530	1540	1550	1500

Source: BofA Global Research

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Naira outlook: we see stabilisation from here

In our view, a flexible USDNGN + tight monetary policy including market-reflective yields in domestic securities could unlock FPIs in the near term. In that scenario, the naira could appreciate in nominal terms. We think it's currently undervalued. However, if monetary policy is not tightened enough the naira could continue to be weakening without a real turning point and diverge further from the parallel rate. Our baseline is stabilisation from here. During the week of FX reforms FX turnover increased close to $1.8 billion per week compared to close to $500 million per week. This suggests to us that higher FX turnover could result in a more stable currency.

Official FX backlogs now lower

The new government inherited about $7 billion in official FX backlogs in mid-2023. It appointed auditor Deloitte to verify the authenticity of the backlogs. The audit found that $2.4 billion was not valid. The government has since paid back about $2.5 billion, leaving an official backlog of around $2.3 billion. The settlement of $2.5 billion was covered by a loan extended by Afreximbank to NNPC, the state oil company. There could be other backlogs that are not officially recorded by the authorities, which explains why USDNGN has not stabilised or found a turning point.

Other reforms could attract stable capital over time

Broader reforms take time to attract long-term capital. Nigeria remains an oil-driven story, accounting for at least 90% of exports, half of fiscal revenues and nearly 10% of GDP. Oil production is 25% down from pre-pandemic levels, while IOCs are divesting from onshore oil fields due to production losses. However, local oil companies are investing in onshore fields, and they are better at managing pipeline vandalism and oil theft. Production could increase to 165mbpd of combined crude and condensates this year from 1.2mbpd in September 2022. Plus.

Exhibit 3: Oil and gas monthly exports (USD millions)

Monthly dollar export receipts from oil have been declining largely due to lower oil production and, to some extent, international prices

Source: Haver

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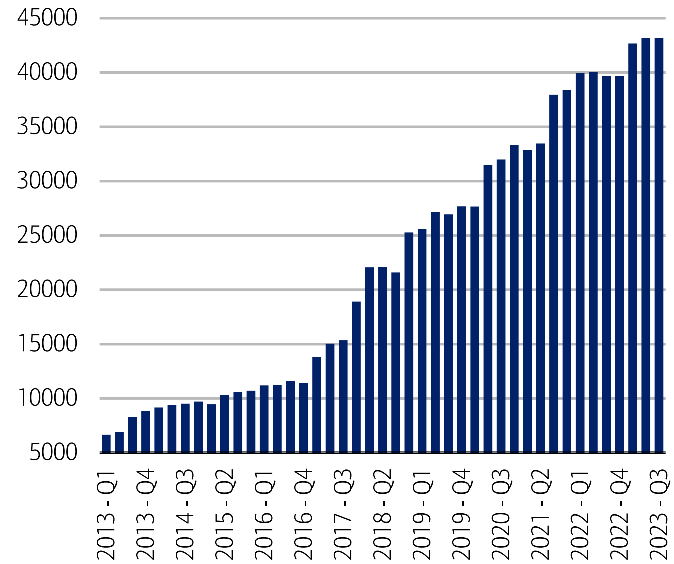
Exhibit 4: Public external debt historical trend (USD millions)

At the same time, external debt stock has been rising



Source: Haver

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Structural issues at the heart of FX shortages

At the heart of FX shortages In Nigeria are lower oil export receipts and rising external debt. Pre-pandemic, Nigeria relied on large oil export receipts, access to Eurobond markets, and foreign portfolio inflows. FDI has never been big. The loss of oil production has been a big negative for FX inflows. International markets closed, while FPIs exited central bank bills in 2018 and 2019. A good share of remittances became less formal. Things promise to be different from 2024 onwards, as long as foreign portfolio inflows come through and international debt markets open up. The Ivory Coast, Benin and Kenya have recently been successful in the Eurobond market. The World Bank could extend $1.5 billion to Nigeria linked to policy adjustments, such as the removal of fuel subsidies, and tight and more conventional monetary policy.

Monetary policy outlook: promising change

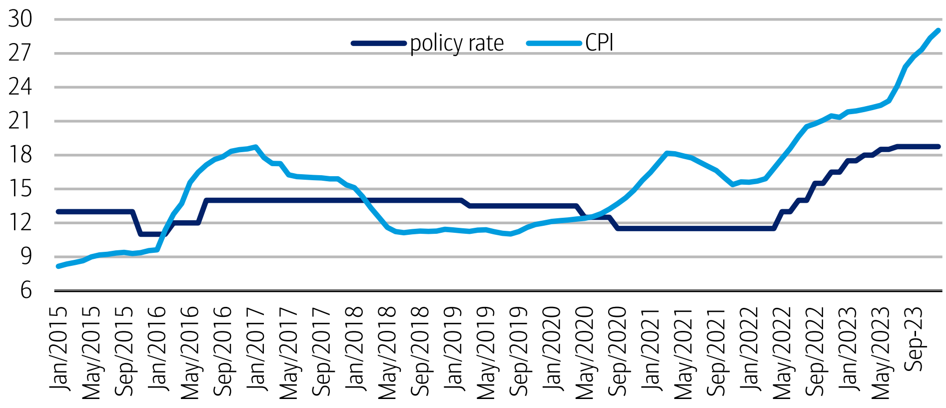
Monetary policy in Nigeria has been generally loose and characterised by financial repression. Inflation close to 30%, money supply growth close to 50%, negative real rates and low domestic yields do not reflect a good central bank. Other instruments have been used across the years to influence domestic liquidity conditions – standing deposit facility rate, cash reserve requirements ratio, along with monetary policy rate. the central bank is promising change. To refocus on inflation targeting objective. In order to do this, they would like to use interest rate as the main tool of monetary policy. In short returning to orthodoxy.

Aggressive hikes to normalise monetary policy

Inflation has yet to peak, while recent devaluation could keep upside pressures strong. However, market participants and policymakers believe second devaluation is not likely to cause substantial upside pressures to inflation as pricing was already operating on parallel rates. We do agree – somewhat. We see peak inflation around 33% in 2Q 24 with the benefit of base effects and 25% by year end, weaker than the government assumption of 21.4%. To get to a neutral level, we think the central bank would need to hike to 25%, by a total of 625bp at the next two meetings: likely 300-400bps at the first and the balance at the March meeting. That would show a strong commitment to tight monetary policy and keep real rates closer to neutral, and likely positive in late 2024 and into 2025. That would the unlock FPIs, in our view. Markets would be disappointed by a 100-200bp hike.

Exhibit 5: Inflation and monetary policy outlook

Near-term aggressive tightening could restore the 2018-19 positive real rates scenarios by year end 2024 and into 1Q25



Source: Haver, BofA Global Research

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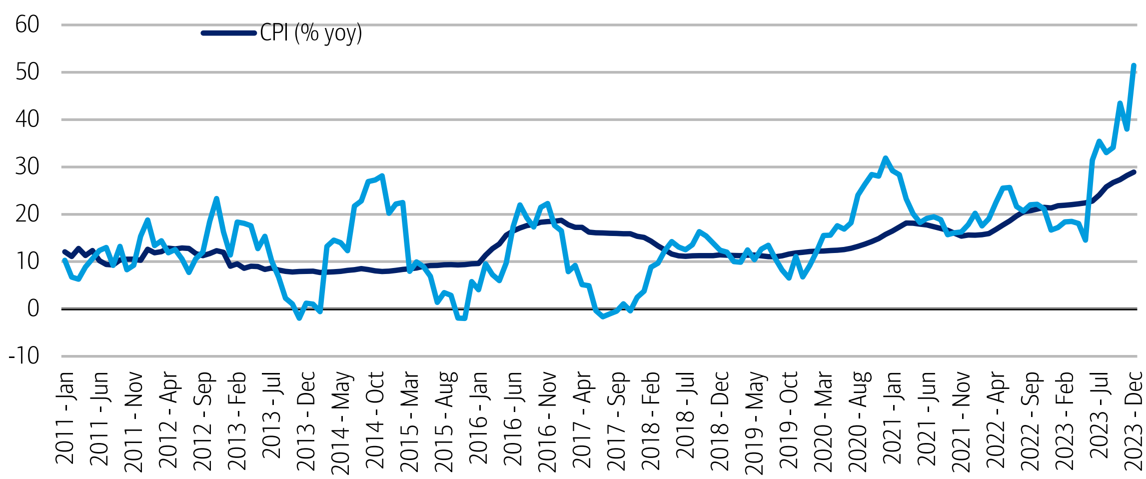
Exhibit 6: Inflation and money supply growth (M3)

Growth in money supply is outstripping inflation, suggesting looser monetary policy or that the inflation basket may need revising



Source: Haver

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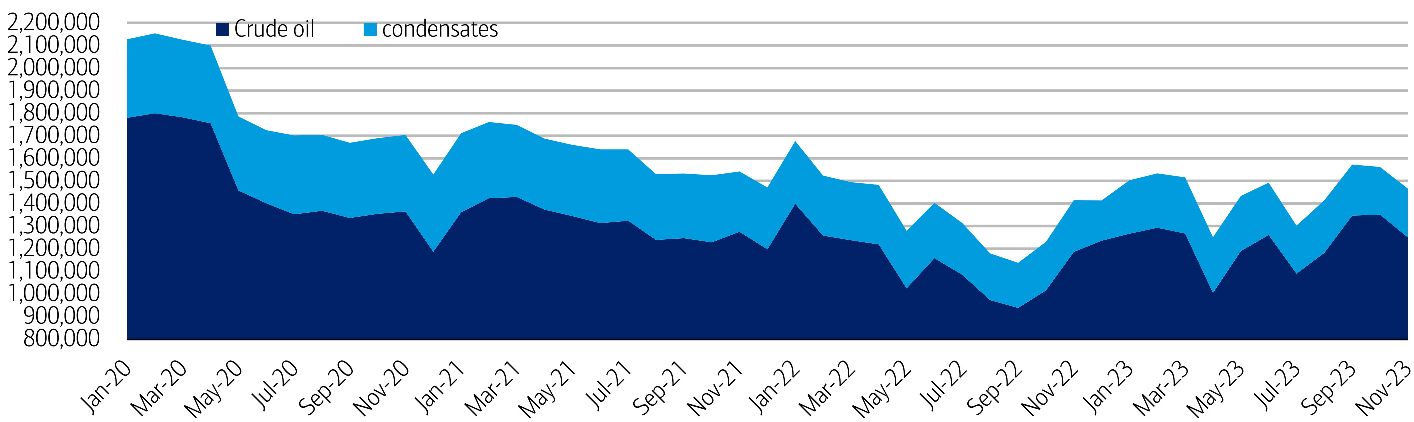
Exhibit 7: Oil production trends (barrels per day)

Since dipping in September 2022, oil production has been gradually rising



Source: Nigeria Upstream Petroleum Sector

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Can oil production increase? Possibly to 1.65mbpd

Yes, on a reduction of oil losses (theft/pipeline vandalism) rather than big investment in new oil fields. High frequency data from government officials show that December and January output is likely to reach 1.6m bpd. Can crude get to 1.5mbpd? We doubt it. But 1.4mbpd is likely, from the peak after the recent peak of 1.35mbpd reached in Oct/Nov 2023. If that materialises, total oil production could be around 1.65mbpd at best. But this would still be a positive addition to FX inflows.

IOCs divestments are positive for local oil firms

Local oil companies are buying stakes from IOCs in onshore fields. The IOCs are selling for various reasons. First, is the security issue with onshore fields/pipeline vandalism. Second, they are not pumping in new capital and are going greener. Deep offshore makes more sense for them and they can reinvest the funds in offshore. On the other hand, locals are putting new money into onshore and scaling up production of these oil fields. They have better relations with host communities, which reduces the security risk. Increasing local ownership in a resource sector is a political and economic positive in low-income countries whose resource ownership has been dominated by international companies.

What about the impact of the Dangote refinery?

Dangote is likely to be a positive over the next 12 months. Full capacity is up to 650k bpd. However, refining petroleum products is yet to commence. Domestic demand for petrol is around 300 thousand barrels per day, which Dangote can fully supply and still contribute to exports.

Regulatory concerns with the Petroleum Investment Act

Local players do not seem to have many concerns about the PIA, apart from the delays in approving deals/transactions. The fiscal regime for has been improved in the new PIA. NNPC used to delay paying cash calls to IOCs, which seem to have been reduced if not settled.

Fuel subsidy is back - likely at a cost of $7-10 billion

The government was bold enough to remove the fuel subsidy at the end of May 2023 and declared the liberalisation of the petroleum sector. The petroleum price was increased by 300% at the time but has relatively been flat since. The second adjustment of the exchange rate at the end of January from around NGN900 per USD to NGN1,450 has not been followed by another increase in local petroleum prices. Our on-the-ground consultations suggest that petroleum prices are unlikely to be raised in the near term because of the risk of social protests. The government is keen to avoid protests related to high fuel prices or more generally high cost of living.

To get to the fuel subsidy costs we look at historical data on petrol consumption. This varies. With full subsidies, consumption in a year could reach up to 70 million litres. For instance, the authorities' data show that petrol consumption averaged 64.14m litres in 1Q 2022 and 66.8m litres in 3Q 22. About 15.6m litres is said to be smuggled to neighbouring countries. When the subsidy was removed, consumption fell to 50m litres per day. So, we use average daily consumption of 50-70m litres to calculate the cost of the fuel subsidy. We arrive at a price NGN240 per litre before removal and an increase to NGN620 in June 2023. Converting to USD, domestic petrol prices rose to about 80 cents per litre post the subsidy removal. We don't expect any near-term changes, which could keep prices around 40 cents per litre. So, government would now be subsidising by about 40 cents per litre consumed. In a year petrol imports equal 18.25-25.55 billion litres. This means the cost of subsidies is likely $7.3$10.2 billion.

NNPC remains the only importer of petroleum in the country and subtracts the costs before remitting to Treasury oil-related fiscal revenues. The government does not pay directly but loses revenue when the NNPC deducts its costs and transmits less revenue.

One positive development is we will be able to better calculate NNPC revenues as it has started to bank with the CBN.

Fiscal is focused on raising revenues by admin measures.

The government has set an ambitious revenue growth target of 18% from about 9%. All efforts are focused on improving administrative measures, modernising compliance, and information technology. The government is not keen on raising tax rates or aligning with other ECOWAS members, a long-standing IMF recommendation. NNPC revenues through the CBN might be a positive for transparency, though. The government needs to be prepared for higher borrowing costs stemming from tighter monetary policy.

The IMF is due to publish an Article 4 report in the coming weeks. The last published report was in February 2024. An IMF mission is likely this month along with the publication. We think the IMF is likely to be a lot more constructive about the new government's direction of travel compared with the policy inaction that was detailed in the February 2023 report.

Succession risk is a headwind

President Tinubu is pro-reform and supports and trusts his economic team. However, he Tinubu is 72 years and has health issues. Without President Tinubu it is difficult to envisage reform being sustained. The economic team is pro-reform but could be changed should another leader take over.

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