NEW THINKING. NEW OPPORTUNITIES.

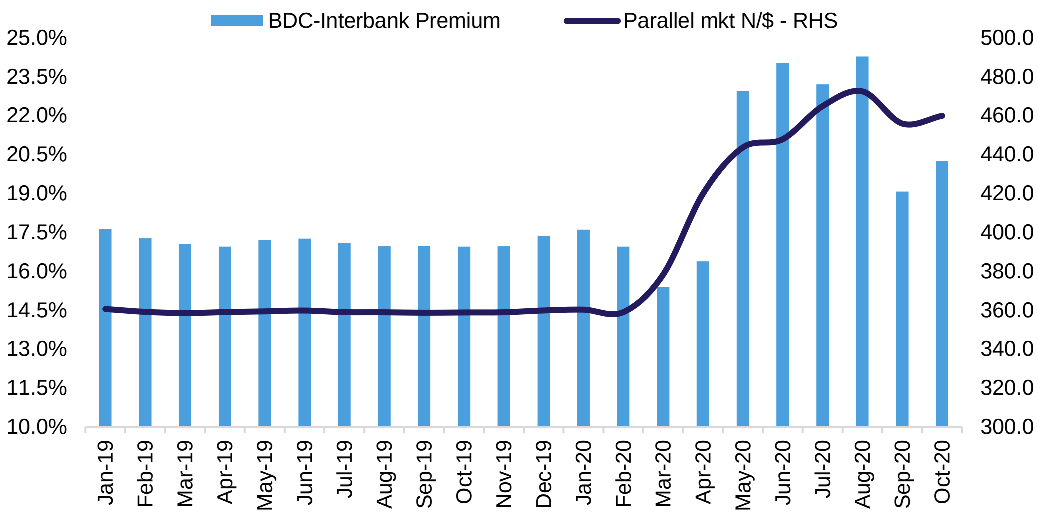
November 10, 2020 — Economic Research

Monthly Economic Insights

Dollar Rationing to Persist on Meagre Inflows and Rising Outflows

The CBN intervention across segments of the FX market improved in the month of October, with total intervention sales rising 25% MoM to $1.9 billion from $1.5 billion in September, albeit below the average of $2.0 billion over Q1 2020 when inflows moderated the level of interventions. CBN sales to the SMEs, Invisibles and SMIS (retail and wholesale) segments totalled $540 million compared to $400 million in September. Non-auction sales increased to $535 million compared to $407 million in September. Notwithstanding the higher sales, the gross external reserves depleted marginally to adjusted level of $35.54 billion from $35.59 billion in September following modestly higher crude oil prices over Q3 relative to Q2. Even with the higher sales in the month of October, the BDC-Interbank premium still widened to 20.2% (from 19% at the end of September) with the parallel market exchange rate depreciating to N459.9/$ (average for October from N455.9/$ in September).

Figure 1: BDC-Interbank Premium and Parallel Market Rate



Source: CBN, Aboki FX, NOVA Research

The CBN remained a net supplier at the IEW to the tune of $259 million following increase in outflows by 22% to $896 million. While local FX supplies (exporters, individuals and non-bank financial institutions) provided some support (increasing 18% MoM to $484 million), the paucity of foreign inflows persists (at just $122 million in October). The foreign and local (ex-CBN FX supply combined only accounted for 68%of the total outflows during the month, with the market recording a net deficit of $289 million, which necessitated the CBN net supply of $259 million.

The Month's Key Points

Other Readings

Persisting Food Pressure Pushes Headline Inflation to 13.71% YoY, October 15

Monthly Economic Insights – October 2020, October 7

Monthly Oil Market Update – October 2020, October 9

Low Liquidity Expected to Dampen Impact of Lower Rates, September 23

MPC Preview: Balancing FX Stability and Moderating Economic Contraction, September 21

NOVA Economic Outlook H2 2020 – A

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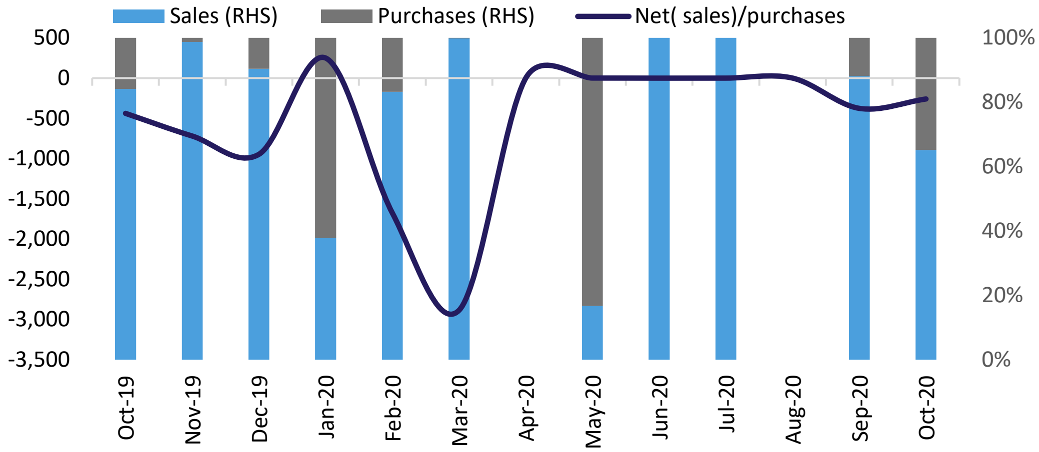
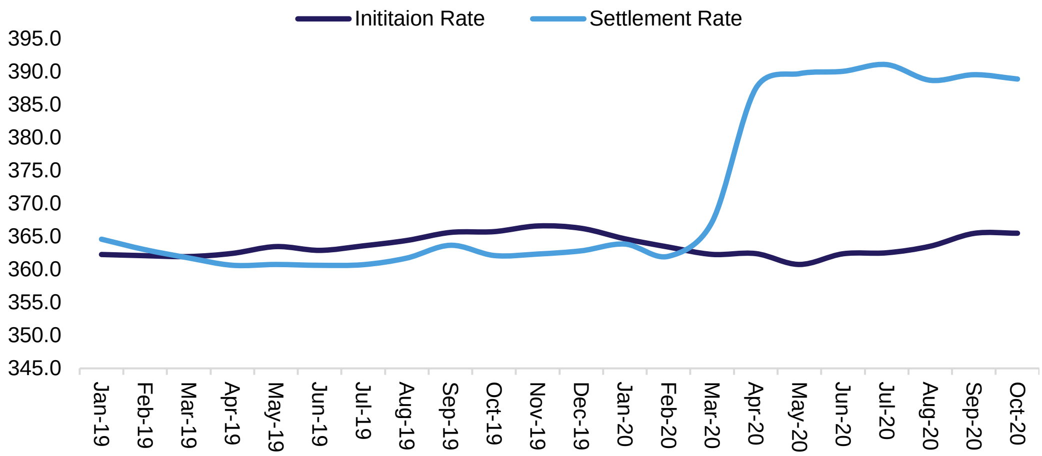
Figure 2: CBN Activity at the IEW



Source: CBN, FMDQ, NOVA Research

OTC FX futures market activity slowed in the month of October, with total value traded reducing to $246.52 million compared to $393.58 million in September. Futures contract worth $1.48 billion matured on October 28. Compared to the rate at initiation of N365.5/$, the NAFEX rate on the settlement date averaged N388.9/$ with a total counterparty settlement gain/loss of N34.7 billion.

Figure 3: OTC FX Futures Contracts

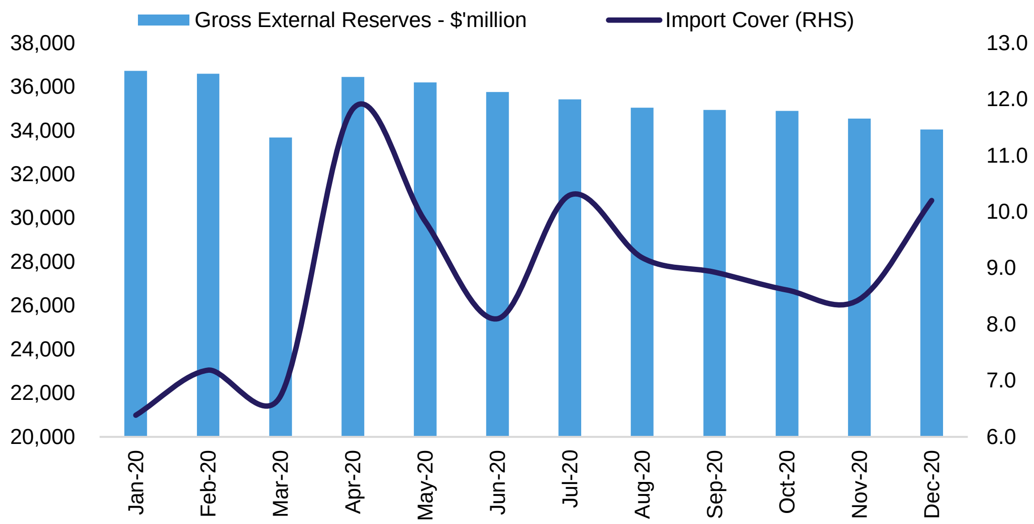


Source: FMDQ, NOVA Research

With foreign portfolio inflows expected to remain meagre for the rest of the year, amidst still below $50/barrel crude oil price, we expect the CBN to continue to manage its dollar supply. Particularly, we expect the FX supply for FPI repatriation to remain lower than the required demand with such funds continually dominating demand at primary market fixed income auctions. Coupled with our modelled FX sales to BDCs of $790 million over the next 2 months and sales across other segments, we expect the gross foreign exchange reserve to close the year at $34.06 billion on our base scenario and $35.05 billion on our best-case scenario, Adjusting the reserve position for expected foreign borrowing of $2.11 billion, could result in a corresponding increase in both our base and best-case scenarios. With further moderation in interest rate and rising inflation, our modelled interest rate-inflation differential increased in favour of the U.S, expanding the

Naira overvaluation. Overlaying the widening inflation-interest rates differential on our purchasing power parity model, the fundamental value of naira lies between N414.7/$ and N431.6/$ (7% – 10.5% overvaluation from current NAFEX rate of N386/$). Notwithstanding our fundamental assessment of the optimum exchanger rate, we believe an outright floating of the exchange rate with intermittent intervention to avoid unnecessary speculative attacks will have more meaningful impact.

Figure 4: Forecast Gross External Reserves and Import Cover (Base Case)

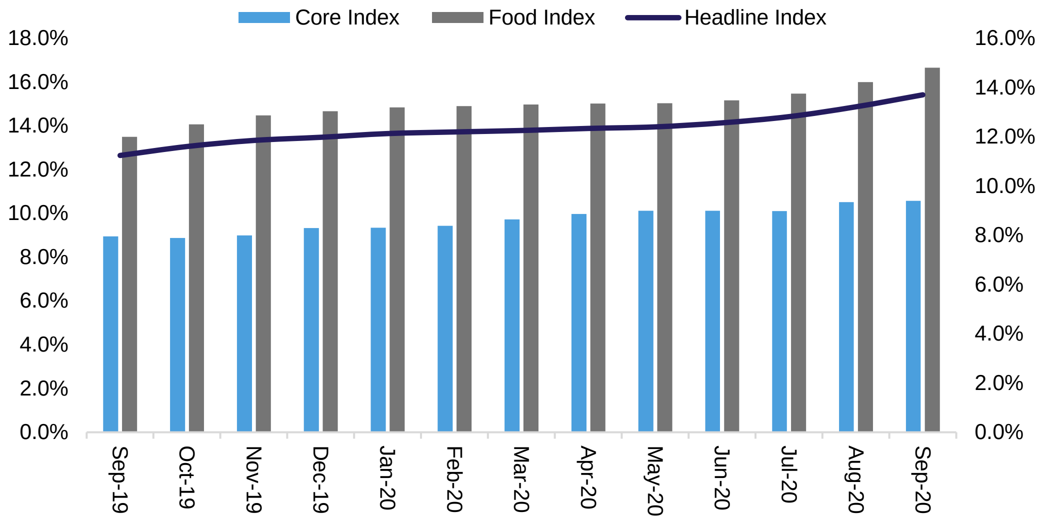


Source: CBN, NOVA Research Estimates

Implementation of Higher Electricity Tariff to Elevate End Year CPI Figures

After exceeding 1% in April, month-on-month inflation has maintained a constant jump to reach 1.48% MoM in September. The increase has been largely dominated by decline in market supplies of farm produce, rising cost of transportation and FX pass-through to manufactured products. According to FEWSNET, the shortage of farm produce is largely a result of exacerbated flooding in localized areas of the Northeast and atypically high staple food prices during the extended lean season from April/May through the end of September. For transportation cost, the increase in prices of diesel and PMS (following rising crude oil prices) contributed to the upsurge in the prices, with a further transmission to higher prices of transported food items.

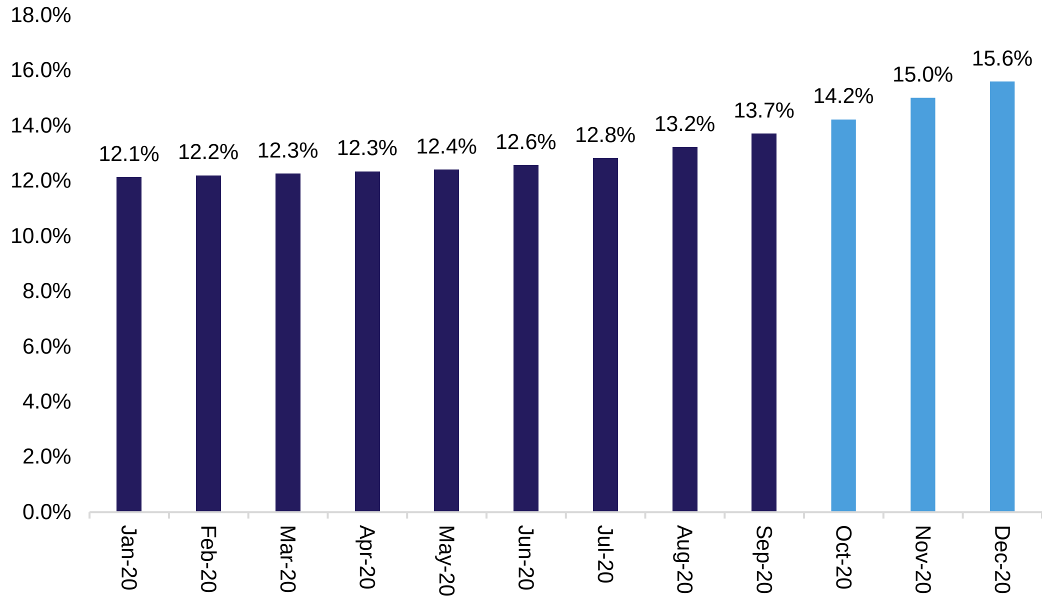
Figure 5: YoY Trend in Headline, Core and Food Inflation Trend



Source: NBS, NOVA Research

With the persisting higher prices of livestock (up 20% to 30% relative to the pre-COVID-19 period across most markets), staple foods (increased 65% to 120% between January and May), rising PMS price (+8.3% MoM in September) and FX pass-through to manufactured products, we expect inflation in the month of October to deliver same trend as in September. For the month of October, we expect the consumer price index to expand by 1.53% MoM, with headline YoY expanding to 14.22%. Beyond October, the now implemented upward adjustment in electricity prices effective November and rising PMS/diesel prices due to increasing global crude oil prices will add more pressure to inflationary trend over the next two months. On electricity tariff, we expect the impact to reverberate across industrial and consumer prices, with the major shock area being the core index which incorporates Housing Water, Electricity, Gas and Other Fuel (HWEGF). The combined impact of increases in electricity tariff, rising diesel/PMS prices and lower than average harvest season will define new levels for inflation in the next two months. Adjusting our model for the above-mentioned pressures, we arrived at a base average inflation rate of 13.2% in 2020, compared to average of 11.4% in 2019.

Figure 6: Actual and Forecast 2020 Inflation Trend



Source: NBS, NOVA Research Estimates