Economy Alert:

Naira Floats in New Foreign Exchange Policy

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Exchange rate to be market driven

The Central Bank of Nigeria (CBN) published the guidelines re-introducing the flexible exchange rate market. This in our view is positive for the economy and markets because it should provide a liquid market for price discovery as the exchange rate will be market determined rather than managed. However, while this could relieve some of the challenges around foreign exchange availability, market concern is likely to shift to exchange rate stability.

Capital inflows key to currency stability

Considering the economic structure in terms of revenues and exports would change very little in the near term, it is probably safe to assume foreign exchange supply will continue to be a challenge and this concern has been exacerbated by the downside risks to oil production. Thus, the market and probably the authorities, are betting that this market structure provides sufficient clarity to trigger an influx in Foreign Direct Investments (FDI) and Foreign Portfolio Inflows (FPI). The challenge with this assumption is that there is a huge amount of flows currently trapped, which would need to be released whilst investors test the liquidity and credibility of this market structure. Thus, the ability of the CBN to reassure and restore confidence in the market through its interventions will be key to the resurgence of capital inflows.

Market structure to improve FX liquidity

On the structure of the market, the CBN stands as a liquidity provider, intervening in the interbank market through the authorised dealers and in some cases, selling to end-users through the Secondary Market Intervention Sales (SMIS) mechanism. On the bright side, this relieves the CBN from being the key provider of foreign exchange liquidity, reducing the attrition in foreign reserves whilst providing authorised sellers a platform to sell in a transparent market and at a competitive rate. In addition, the Foreign Currency Trading Position Limit of banks has been reviewed to +0.5%/-10% of Shareholders' Funds (SHF) effectively allowing banks go long the USD, only up to a maximum of 0.5% of SHF to prevent the speculative build up of USD positions, and short the USD up to a maximum of 10% to provide liquidity to clients.

Use of interbank funds

The CBN was quite unequivocal about the use of interbank funds stating that sales to Bureau de Changes (BDCs) will be a clear violation of the guidelines; in addition, the 41 items not "eligible for Forex" remain inadmissible in the interbank market. This is no respite for manufacturers with imports included on the list. However, proceeds of Foreign Investment Flows and International Money Transfers are admissible at the interbank rate.

Possible risks to new exchange rate structure

The key risk to this flexible exchange rate structure is in the implementation. We recall that the foreign exchange market structure was somewhat similar to this before the rDAS/wDAS window was closed in February 2015. Situations that create sharp divergence in rates amongst the different markets as well as scenarios that force successive interventions in the interbank market by the CBN could result in policy reversal or additional measures to restrain demand.

Stage set for further depreciation. Tighter monetary policy expected

Based on our outlook as stated in our "economic scenarios for 2015 and 2016, the exchange rate should be around NGN/USD 280 whilst the 6-month forward on the NGN/USD is priced at 325. This suggests that inevitably, the exchange could depreciate from the official rate of NGN/USD 197 when the market opens for trading on Monday. On the bright side, this adjustment will definitely compensate the government for revenues in Naira terms, providing some buffer, albeit marginal. However, depending on how quickly the currency weakens, we could see inflation ratchet higher than the 15.6%y/y recorded in May to around c.18%y/y as a peak within the next 6 months. This suggests monetary tightening will continue to be a consideration for the Monetary Policy Committee (MPC) with potentially higher rates before year-end.

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