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ECONOMIC COMMENTARY

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The FX Intervention Policy & Foreign Reserves

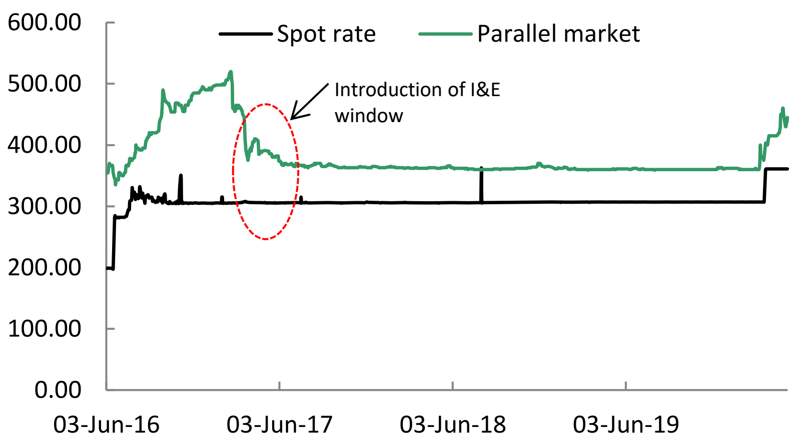
Introduction

The Nigerian foreign exchange market has gone through series of reforms from the introduction of the Second-tier Foreign Exchange Market (SFEM) in 1986 to the introduction of the autonomous foreign exchange market in 1995 and the Interbank foreign exchange market in 1999. However, sustained liquidity pressures have seen to the existence of a thriving parallel market with significant premiums to the official rate.

Following the 2016 economic recession when a slump in average monthly FX inflows and capital flow reversals (*following the US interest rate hike*) saw the Naira exchange at NGN525 to the Dollar in January 2017, the CBN created the Investors & Exporters (I&E) FX window. The I&E FX window was established to boost FX liquidity and ensure timely settlement of eligible FCY transactions. According to the CBN, the major suppliers of FX to this window are portfolio investors, exporters and authorized dealers.

Since its establishment, the I&E window has processed over USD60bn in transactions and afforded the CBN the much-needed dollar liquidity to sustain its market intervention policy - thus helping stabilize the naira. Through its continued intervention, the CBN has managed to artificially maintain the stability of the exchange rate.

Chart 1: Parallel market and Spot rates



Source: FMDQ, Meristem Research

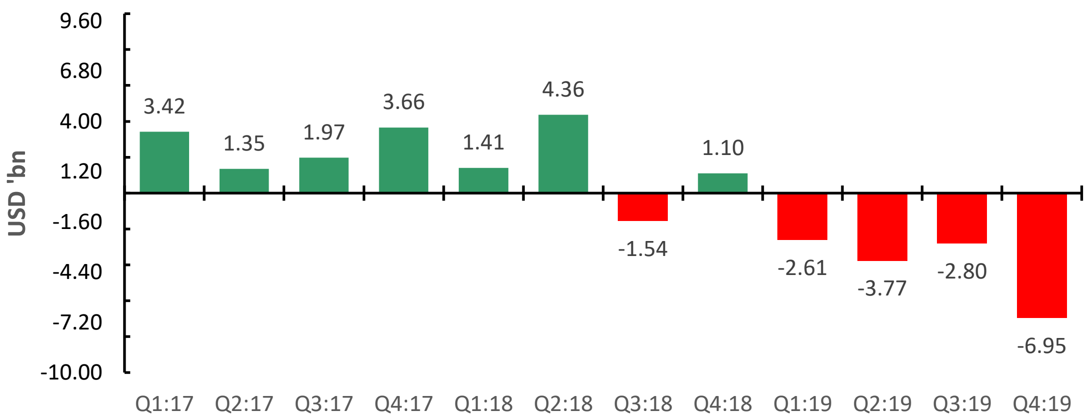
Prior to April 2017, the Central Bank's intervention in the FX market was primarily through the Inter-bank market and the Secondary Market Intervention Sales (SMIS- Wholesale and Retail). The introduction of the I&E window had the attendant effect of narrowing the parallel market premium and eased the liquidity squeeze in the FX market as the Naira appreciated in the parallel market by 2895bps to NGN380.00/USD in May 2017 (vs. NGN490.00/USD in December 2016).

So far, the year 2020 has been filled with a flurry of unprecedented and unforeseen events. Nothing could have prepared Governments and Central Banks for the far-reaching impact of the COVID-19 on the global economy. Since the announcement of the index case in Wuhan, China, in December 2019, the number of confirmed cases worldwide has surged past five million. Given the infectious nature of the virus and in a bid to curtail the spread, Governments across the world imposed several lockdown measures, prohibiting movements of persons and essentially grounding economic activities to a halt. This has had devastating effects on global supply chains, especially the global oil market- Nigeria's main source of FX accretion.

FX Liquidity: A slack valve in the face of structural issues

The persisting current account deficit has rallied attention from fiscal and monetary authorities on appropriate measures to buoy the worsening imbalance. **Attempts at capital control saw to the restriction of FX sales to some dairy products producers and more recently, the CBN raised the FX rate for import duty payment to NGN361.00 to a dollar from NGN326.00 to a dollar for importers of non-essential items.** The over-dependence on imports saw Nigeria's current account deficit deepen by 157% from Q3:2019 to reach USD6.95bn – the largest deficit on record.

Chart 2: Nigeria's Current Account Balance from Q1:2017 to Q4:2019

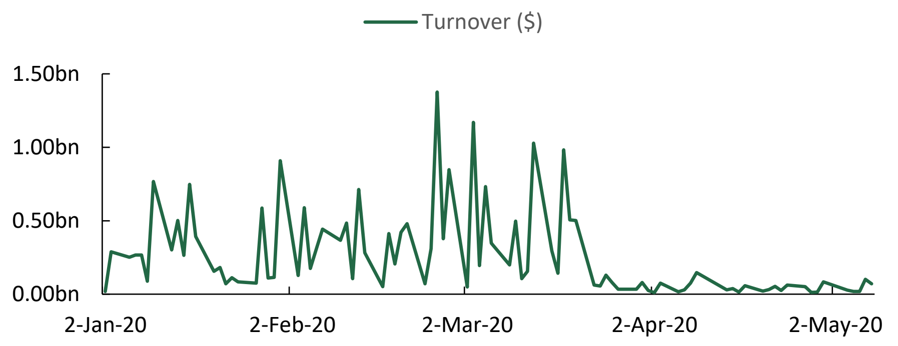


Source: NBS, Meristem Research

Against the backdrop of a decline In FX accretion to the reserves and the subsequent dip in reserves position, the CBN technically adjusted the official rate across the FX windows in March 2020, to reflect current market realities. The Interbank rate was adjusted to NGN360/USD, while the I&E FX rate was adjusted to NGN380/USD.

The slowdown in FPI dollar inflow resulted in a slump in daily turnover in the I&E FX window from Q1:2020 average of USD345mn to USD44.50mn between April and 8th May 2020.

Chart 3: I&E Window Turnover

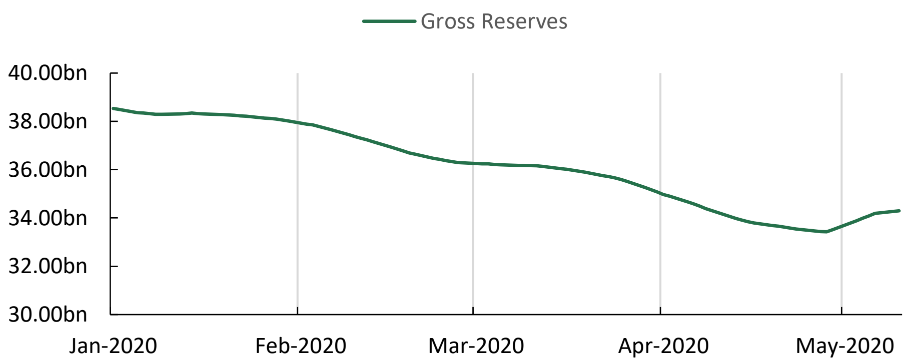


Source: FMDQ, Meristem Research

External Reserves: A victim of FX interventions and low oil prices

Shocks to global crude oil prices have cast significant strain on accretion to external reserves and the ability of the CBN to keep supporting the Naira in the face of mounting liquidity pressures. Nigeria's external reserves recorded a 10.40% decline from $43.08bn as at the beginning of 2019 to $38.60bn at the end of December 2019 following the trade spat between the US and China which led to a slowdown in global economic activities and fall in global crude oil prices. More recently, the Corona Virus out-break resulting in lockdowns has strained businesses and supply chain globally. Thus, oil prices have taken a beating- a cause for concern about Nigeria's external reserve balances and the sustainability of supporting the Naira. At the end of the first-quarter of 2020, the external reserves had shed USD3.37billion, pegging at USD35.16bn from USD38.59bn in Dec 2019. The reserves recorded a further decline in April to USD33.52bn as the situation in the global oil market worsened and oil prices plummeted to record-lows.

Chart 4: Gross Reserves



Source: CBN, Meristem Research

Following the approval and disbursement of the USD3.4bn loan from the IMF, and the gradual recovery in accretion to FX reserves (to the tune of USD1.14bn so far in May), the reserves position improved to USD35.77bn in May.

Finding a Balance

Taking cues from the 2016 recession, a potent combination of capital flight (*as foreign investors repatriated their funds to safety)* and declining oil revenue accretion to the reserves, hampered the Apex bank's ability to continue defending the Naira. Four years forward and the situation is being replayed. So far, the intervention policy of the CBN has been an artificial fix to support the Naira - one that has been living on borrowed time.

To address the severe impact of the COVID-19 on the Nigeria economy, the International Monetary Fund approved a USD3.4bn emergency loan request by the Federal Government. The approval and disbursement of the funds was accompanied by some recommendations, one of which is the convergence of foreign exchange rate across all windows to the I&E FX rate.

Considering the gross imbalance of Nigeria's export to imports (*Nigeria is a net importer*), the cessation of the CBN's periodic intervention in the foreign exchange market would translate to a repricing of the currency. By implication, the value of the Naira would be determined by the market forces of demand and supply.

Herein lies the long-standing dilemma: *Ceasing FX interventions to shore up the reserves or digging into the reserves to intervene periodically in the FX markets*. We acknowledge the commitment of the CBN's Governor in maintaining a Managed Floating Exchange Rate Regime as stated during the renewal of his five-year term in December 2019. However, the long-term sustainability of the intervention policy is doubtful in the face of a depleting Foreign Exchange Reserve.

We opine that as long as the structural issues in the real sector persists, the export basket remains undiversified and the economy remains grossly import dependent, the long-run stability of the Nation's foreign reserves is unobtainable.

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