Macroeconomic Commentary | Nigeria

Balance of Payment Report

DECEMBER 2024

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Current Account Surplus: A Sustainable Trend?

Nigeria's current account stood at a surplus of USD5.14bn as of Q2:2024, representing a 416.17% YoY increase from USD996.28mn in Q2:2023 and 52.19% QoQ from USD3.38bn in Q1:2024, as reported by the Central Bank of Nigeria (CBN). This massive growth is largely attributable to the surplus goods balance which expanded by 1108.83% YoY and 60.25% QoQ to USD5.30bn in Q2:2024. This is a result of higher net exports of oil and gas and non-oil and electricity items.

An analysis of Nigeria's trade statistics reveals that petroleum oils and crude exports account for the largest portion of the country's total exports (c. 75%) making the country susceptible to shocks in the oil market.

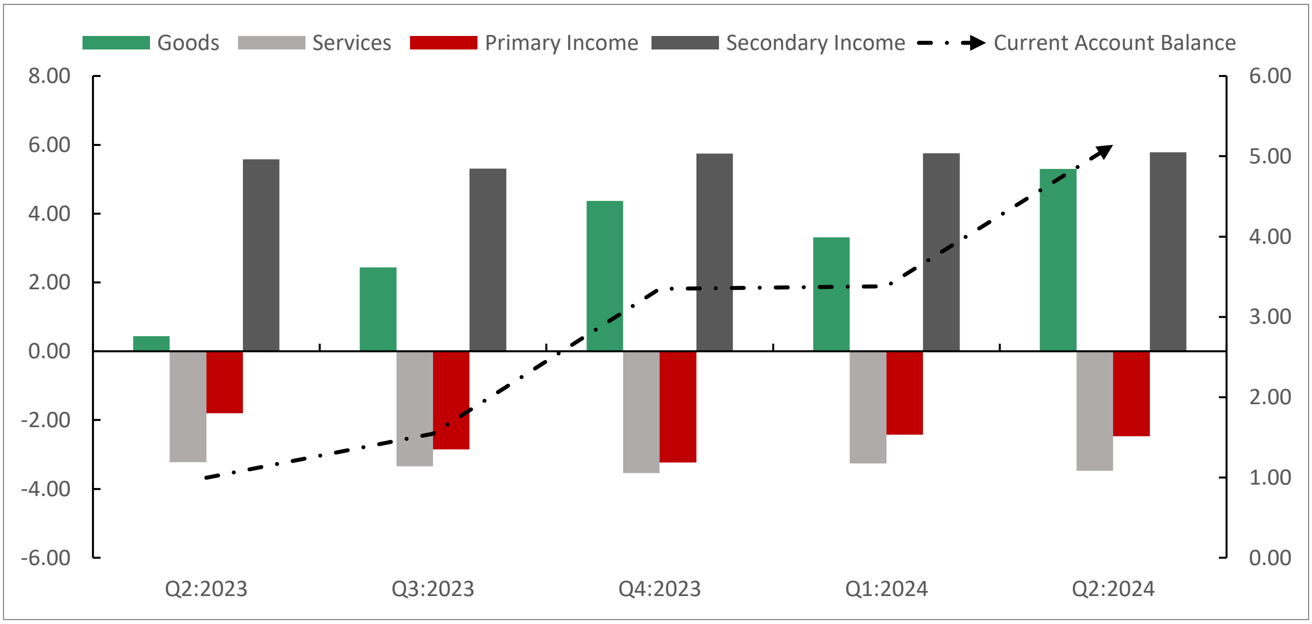
Crude oil production volumes averaged 1.41 million barrels per day (mbpd) in Q2:2024 (vs 1.22mbpd in Q2:2023 and 1.57mbpd in Q1:2024). This 15.57% YoY increase reflects a lower base effect from Q2:2023 (considering Q2:2022's 1.43mbpd) and does not represent a significant improvement in the country's crude oil production.

Oil prices during the review period were slightly favorable increasing by 8.44% YoY and 1.44% QoQ to USD86.92 per barrel in Q2:2024. Thus, with the lacklustre performance of crude oil production and a moderate increase in oil prices, this buttresses our view that the 201.76% YoY increase in export value in Q2:2024 can be mostly anchored on the Naira devaluation.

The current account surplus was also supported by an increase in secondary income (mostly remittances inflows) which expanded by 3.65% YoY to USD5.78bn. We view the CBN's measures (*which include the granting of new licenses and access to Naira liquidity for IMTO's, and the implementation of the willing buyer-wiling seller model*) directed at improving diaspora remittances to encourage foreign exchange (FX) inflows into the country as a major catalyst for this. The improvement of economic conditions in diaspora countries also contributed to higher remittance inflows recorded. We, however, note that these remittance inflows are yet to recover to pre-pandemic levels.

On the other hand, the services balance and the primary income balance stayed in deficit, at USD3.47bn and USD2.47bn, respectively, compared to USD3.22bn and USD1.80bn in Q2:2023 due to higher payments for travel and other business services as well as interest payments on short-term and other investments.

Chart 1: Nigeria's Current Account (USD'bn)



Source: CBN, Meristem Research

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Current Account Maintains a Positive Trend: A Sustainable Turn?

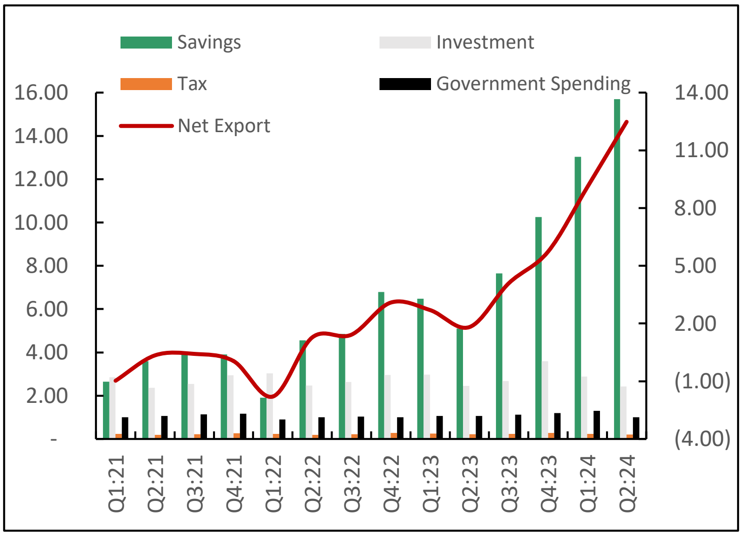
Table 1: Inflation Differential Between US and Nigeria (%)

	Inflation (US)	Inflation (Nigeria)	Inflation Differential
2019	2.30%	11.98%	9.68%
2020	1.40%	15.75%	14.35%
2021	7.00%	15.63%	8.63%
2022	6.50%	21.34%	14.84%
2023	3.40%	28.92%	25.52%
Nov-2024	2.70%	34.60%	31.90%

Source: NBS, US Bureau of Labour Statistics, Meristem Research

The impact of expansionary fiscal policies and contractionary monetary policy – *depicted by the relationship between government taxes & spending and private savings & investment spending: (X-M)=(S-I)+(T-G)*, also explains the source of Nigeria's current account surplus. The chart below depicts that most of the surplus (deficit) is closely anchored on increased(decreased) savings and low (higher) investment spending, which can be attributed to the increase in the monetary policy rate in 2024 (27.50% vs 18.75% in December 2023). This further raises a concern about the future surplus/deficit balance of the current account balance when the monetary policy Committee begins its rate-cut cycle as projected in H2:2025.

Chart 2: Economic Breakdown of the Current Account (NGN'trn) Q1:2021-Q2:2024



Source: NBS, Meristem Research

Given that the current account balance has a long-term impact on the exchange rate in the country (provided it is persistent and sustainable), we do not view the current structure of the current account as competitive. Thus, this is not likely to impact NGN/USD exchange rate dynamics positively. Also, with the USD's special status as a reserve currency, its importance in global trade, the expected changes to oil production volumes following President Trump's return and the likely reduction in oil prices due to an increase in production in the US, we expect a further strengthening of the USD in 2025. It thus becomes very important for production volumes to increase significantly in Nigeria beyond current levels for the current account balance to have a sustainable impact on the exchange rate in the country. Economic conditions in diaspora countries also have an impact on remittance inflows into the country. Thus, our mild expectation for global growth also poses a threat to current account balance in 2025.

This then begs the question, is the current currency crisis likely to persist? We analyse the Purchasing Power Parity (PPP) relationship which assesses the impact of inflation deferential to determine if a currency valuation is aligned. Based on the fundamentals of Nigeria's current account data and the inflation differential between Nigeria and the US, we conclude that the exchange rate (NGN1,672.69/USD as of 30th November 2024) is currently overvalued. Trade conditions and policy fiscal policy direction need to improve significantly to turn the tide of persistence and sustainability of the current account. This includes an increase in oil production, diversification of FX export revenue sources beyond crude oil exports and local sourcing of oil for domestic refining to reduce imports. The PPP model, however, has its limitations as it assumes that there are no barriers to trade, no transportation costs and price differences of non-tradable inputs. Our expectations for a marginal uptick in crude oil production, despite lower oil prices for 2025, will provide some respite for the current account balance and could likely slow down the pace of expected devaluation in 2025.

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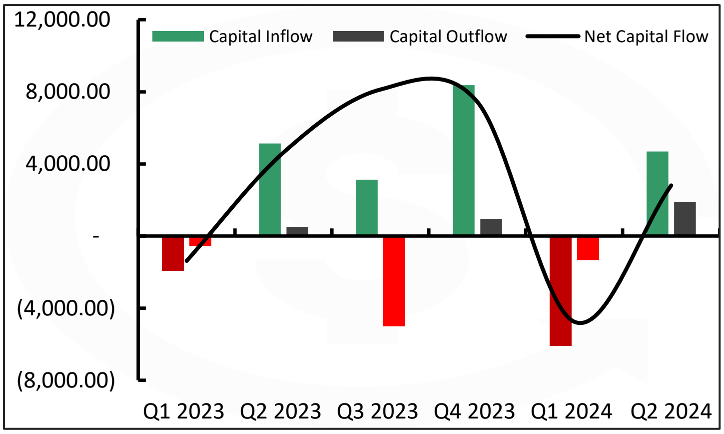
Capital Inflow Dynamics: Can Nigeria Sustain Its Investment Momentum?

The other half of the balance of payment (Capital &Financial account) gives a picture of capital mobility and its impact on the short-term exchange rate. Data from CBN reveals that Nigeria recorded a capital and financial account surplus of USD2.81bn in Q2:2024, although lower than the USD4.64bn surplus recorded in Q2:2023 (-39.44% YoY). The YoY decline is primarily attributed to reduced investment inflows into the economy, which fell by 8.67% YoY, coupled with a sharp 273.99% YoY increase in investment outflows.

Specifically, contractions in foreign direct investments (FDIs) and other investments (-21.77% YoY and (-111.57% YoY), respectively, offset a +117.16% YoY growth in foreign portfolio investments (FPIs), reflecting foreign investors response to attractive domestic rates while remaining wary of Nigeria's weak macroeconomic fundamentals as they shunned FDI.

Chart 3: Net Capital Inflow by Component (USD'mn)



Source: CBN, Meristem Research

Higher FDI inflows and short-term loans occurred in Q2:2023, driven by heightened investor confidence following the inauguration of a new administration.

On a quarter-on-quarter basis, however, Nigeria's net investment flow of USD2.81bn in Q2:2024 represents a remarkable 159.05% improvement from the USD4.76bn deficit recorded in Q1:2024 as Naira-denominated assets were more attractive to foreign portfolio investments FPI's. This uptick was spurred by monetary policy measures, including a cumulative 600bps hike in the monetary policy rate in Q1:2024, which created a high-interest-rate environment.

A series of monetary policy actions had been carried on in Q1:2024 that extended into Q2:2024, as the CBN aimed to attract investors, enhance FX supply, stabilize the Naira and reduce inflationary pressures in the long run. For context, FPI inflows surged by 215.39% QoQ, primarily due to increased subscriptions to short-term debt securities (c. 76% of these inflows were directed towards CBN-issued short-term securities)

Additionally, increased issuance in the fixed income market by the government, driven by borrowing requirements to finance the 2024 budget deficit and repayment of Ways and Means, also contributed significantly as government-issued short-term securities accounted for about 23% of the inflows into the debt market during Q2:2024.

Improved investment capital inflows in Q2:2024 led to accretion in the country's external reserves position (+7.65% QoQ) and positively impacted Nigeria's exchange rate market. During the period, the exchange rate market witnessed 7.57% volatility, with the Naira depreciating sharply from NGN895.23/USD at the start of the year to a low of NGN1665.50/USD in the official market. However, the surge in capital inflows in H1:2024 boosted FX liquidity, resulting in a decline in volatility to 4.10% and an appreciation of the Naira to as high as NGN1,072/USD in April 2024.

This appreciation was albeit short-lived due to the predominantly short-term nature of the inflows and speculative activities. Also, foreign investors sought to maximize carry trade opportunities during the brief recovery in April as the appreciation of the Naira offered additional gains from the exchange rate differential, significantly boosting the USD value of their Naira-denominated returns. (see Tables below for estimated gain)

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Table 2: Carry Trade Estimate Excluding Currency Appreciation

1-Year NTB Yield	1-Year US Treasury Yield	Interest Rate Differential	Carry Trade (exc. FX)
21.53%	5.07%	16.46%	16.46%

Table 3: Carry Trade Estimate Including Currency Appreciation

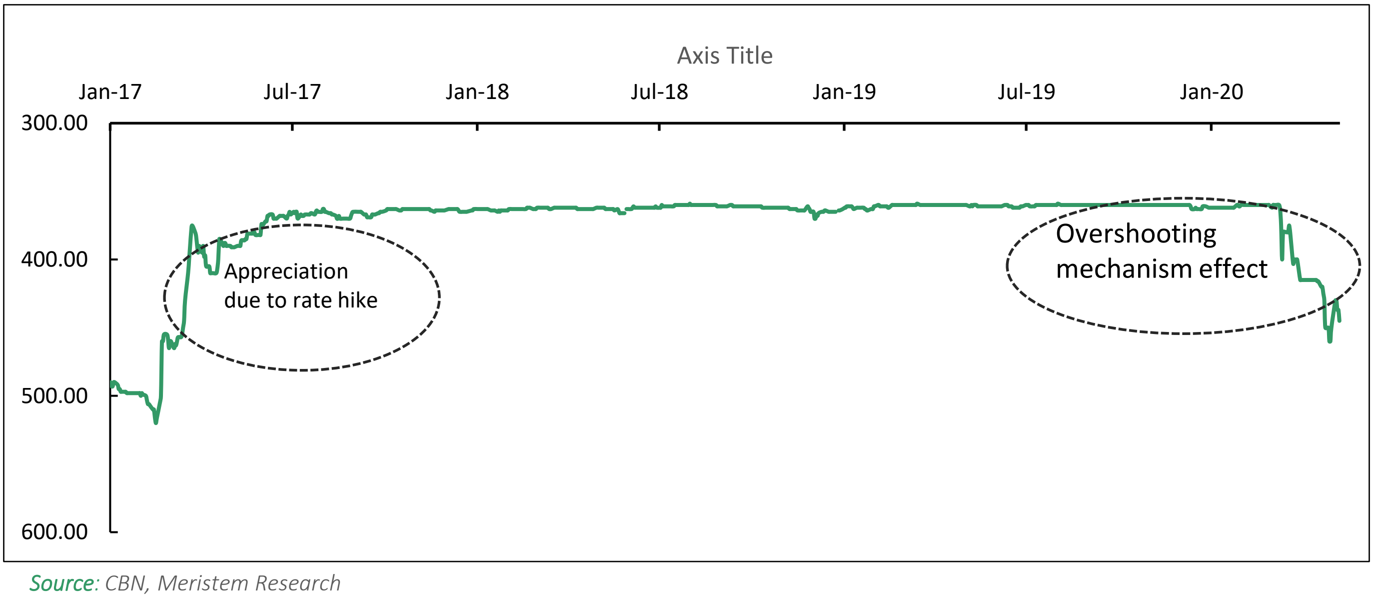
Avg. Exchange Rate FEB-2024	Avg. Exchange Rate APR-2024	Exchange Rate Differential	Carry trade (inc. FX)
1523.69	1240.82	22.80%	39.26%

We recall a similar occurrence in 2017, where elevated interest rates and the establishment of the I&E Window, spurred by earlier monetary policies, attracted significant investment inflows and led to substantial Naira appreciation. Remarkably, investment inflows into the economy surged by 1799.06% YoY (+64.39% QoQ) in Q2:2017, largely driven by foreign portfolio investments (+542.95% YoY) and other investments (+319.75% YoY), primarily borrowings. There was also significant accretion to the external reserves (+1.15% QoQ in Q2:2017 and +9.29% QoQ in Q3:2017), reduced exchange rate volatility (from 1.53% in Q1:2017 to 0.83% in Q2:2017 and 0.34% in Q3:2017), and Naira appreciated by 6.27% in Q2:2017. As the chart below projects, this appreciation at the official window was sustained for about 3 years as the government and monetary authority used a fixed exchange rate system. Interventions were frequently conducted in the FX market to keep the rate between NGN360-NGN410/USD. Cracks, however, began to show due to pandemic-induced capital flight and the build-up of FX backlogs.

This aligns with the law of overshooting mechanism which implies that a rise in the monetary policy rate causes a short-term appreciation of the exchange rate, followed by a depreciation beyond the initial level, it came as no surprise that the exchange rate depreciated at a faster pace as the MPR reduced and pandemic-induced capital flight occurred.

Thus, one of the major difference between the length time of the appreciation witnessed in 2017 and 2024 is the adoption of a willing-buyer, willing-seller exchange rate system in 2024 where market realities play a major role in determining FX rate and the monetary authority reduced the level of interventions in the market.

Chart 4: Foreign Exchange (FX) Rate 2017-2020 (USD/NGN)



Source: CBN, Meristem Research

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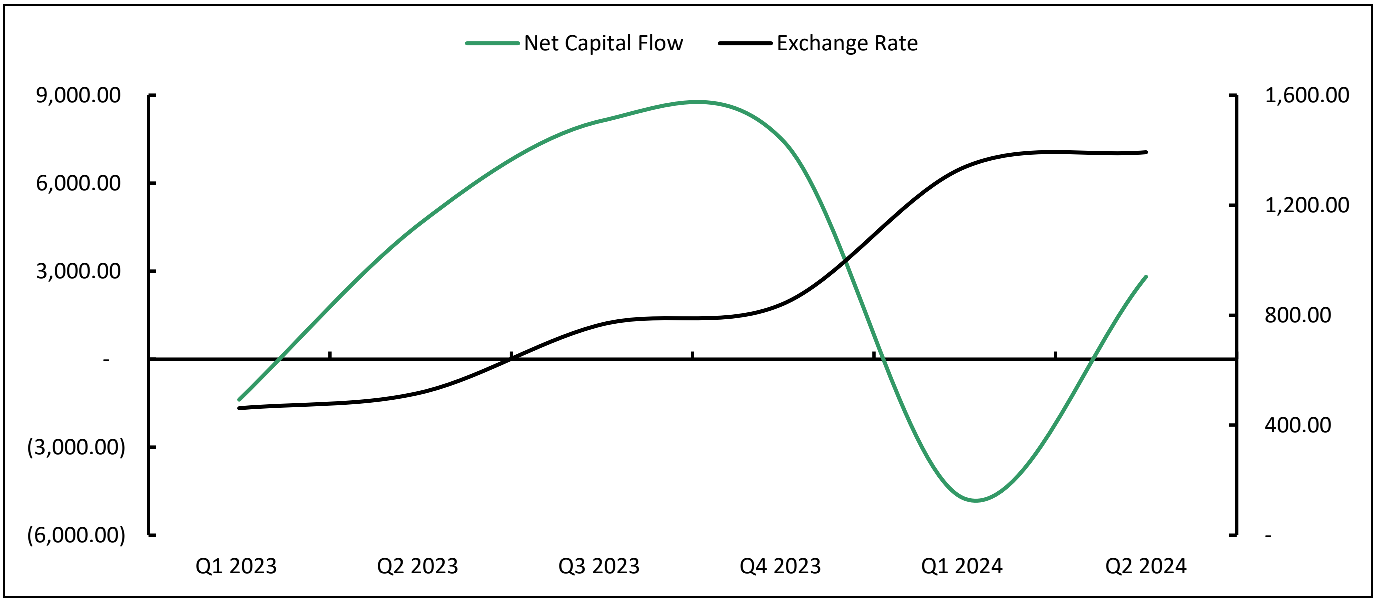
Outlook: Stability on the Horizon Amidst Lingering Risks

Looking ahead, the possibility of inflationary pressures stocking mildly across advanced economies, driven by expansionary fiscal policies and slower rate cuts expected in 2025 by monetary authorities, could disrupt the ongoing disinflation trend in the medium term. This scenario suggests that interest rates in these economies may not decline as much as anticipated, posing a downside risk to Nigeria's attractiveness as an investment destination. This risk is further compounded by persistent economic policy uncertainties and worsening macroeconomic conditions, which could deter substantial long-term capital inflows. Moreover, while emerging and frontier markets may expect elevated investment inflows in the near to medium term, driven by attractive yields, Naira depreciation presents a significant downside risk to foreign capital sustained depreciation may erode the gains from the high-yield environment, thereby reducing foreign investors' overall return on investment.

Nonetheless, the introduction of the Bloomberg B-Match platform (which provides real-time data and automates trade matching) is expected to enhance FX market efficiency. By improving transparency in intra-day transactions, the platform could help reduce speculation activities in the market, narrow bid-ask spreads, and strengthen the CBN's regulatory oversight in the FX market. Furthermore, the country's growing reserves position, USD750m inflow from the World Bank, recent foray into the Eurobond market, and the domestic dollar bond raised in 2024 could enhance the CBN's ability to supply liquidity to the FX market, supporting a relatively stable outlook for the Naira.

Chart 5: Net Capital Flow (USD'mn) and Average Exchange Rate (NGN/USD)



Source: CBN, Meristem Research

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