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Thoughts from Renaissance Capital Africa

On Nigeria's path to stability, what comes first? Rate Hikes and/or True FX liberalisation

Renaissance Capital Africa recently concluded a set of investor engagements (accompanied by foreign portfolio and direct investors) with key economic actors in Nigeria. Our visit highlighted the issues raised below and further enabled us to present our thoughts as shown below.

Nigeria was heading for default as we entered 2023. It was not imminent (more of a 2024/2025 risk was our concern), but policy makers were digging a bigger and wider hole for Nigeria which would eventually prove impossible to get out of, without a debt restructuring. A 50% overvalued currency created a current account deficit that meant dollars were leaving the country, FX shortages mean too few inflows on the capital account, and the higher fuel subsidy was on course to create a budget deficit of 7.5% of GDP. IMF figures suggested 100% of federal government revenues were being spent on interest payments.

Nigeria chose to stop digging a fiscal hole in the May 2023 elections. Each of the three candidates promised reform. The team around the winner, newly elected President Tinubu, delivered it. They allowed the currency to find a new level that we think is around 7% cheap to its long-term average rate. The price of petrol more than trebled – to now nearly NGN600 a litre – and a 7.5% VAT rate was imposed on diesel sales too (since suspended for 6 months to cushion the social impact of increased global prices). These reforms were enough to bring the budget deficit back to 5% of GDP in 2023, according to the latest IMF forecast.

These were radical moves and went beyond market expectations. The team might well have assumed it was enough to push the current account into surplus, to attract in foreign currency, so helping push down inflation in 2024 and provide the private sector boost to drive higher GDP growth.

Unfortunately, the hole in which Nigeria currently finds itself is deep, and rising US treasury yields means global capital has been flowing back to the US safe haven and driving the US dollar stronger.

Meetings in Abuja two weeks ago suggest there are two choices left for Nigeria. We believe the third choice – keep borrowing, keep printing money and pretend everything will be okay – is fortunately not on the agenda. These choices are broadly – 1) intensify the free-market reforms and 2) attempt to find a middle way.

The free-market choice has the beauty of simplicity. The CBN has now dropped the ban on US dollar sales for 43 banned categories of goods, in line with this premise. The authorities are expected to encourage the banks to trade the Naira at whatever rate matches supply and demand. Together, these measures would make the BDCs redundant, so the gap between the parallel market rate (over NGN1,000 during our Abuja visit) and the official rate would close.

We suspect the official rate might sell off to NGN900-950/$, or roughly 25-30% cheap to "fair value" that is closer to NGN710-740/$. The bureau de change (BDC) rate would strengthen to join it should a steady supply of $ arise from the move.

At the same time, the CBN would hike interest rates towards 25% and ensure market interest rates double to around this level too. This would demonstrate the Bank's commitment to fighting inflation. At the same time, it would offer a near 50% return to holders of US dollars (either Nigeria or foreign), given high nominal rates and a cheap currency.

We think the NGN in early 2024 would then strengthen back to around NGN800-850/$. A 20% appreciation from the current parallel rate is not hard to imagine – we saw a strong NGN recovery in 2017 when the parallel market rate went from NGN520/$ to NGN360/$ in just a few months. This move was partly driven by active forced $ cash sales by the CBN to the BDCs.

Inflation would pick up a little further, not least because the free-market policy choice would see a further rise in the petrol price, perhaps to NGN750-800 a litre in the next 2-3 months. This would further reduce the budget deficit and mean the NNPC would have surplus US dollars to sell on the domestic market, helping deliver that currency rebound.

Inflation might still be around 20-25% in mid-2024 (expect to be heading lower) so "fair value" for the NGN would rise to NGN920/$ by September 2024. We would expect the CBN to be cutting interest rates by 3Q24 and allowing the Naira to slip back from NGN800-850/$ in line with that assumption. How the CBN might manage currency in the future is a point we will get to later.

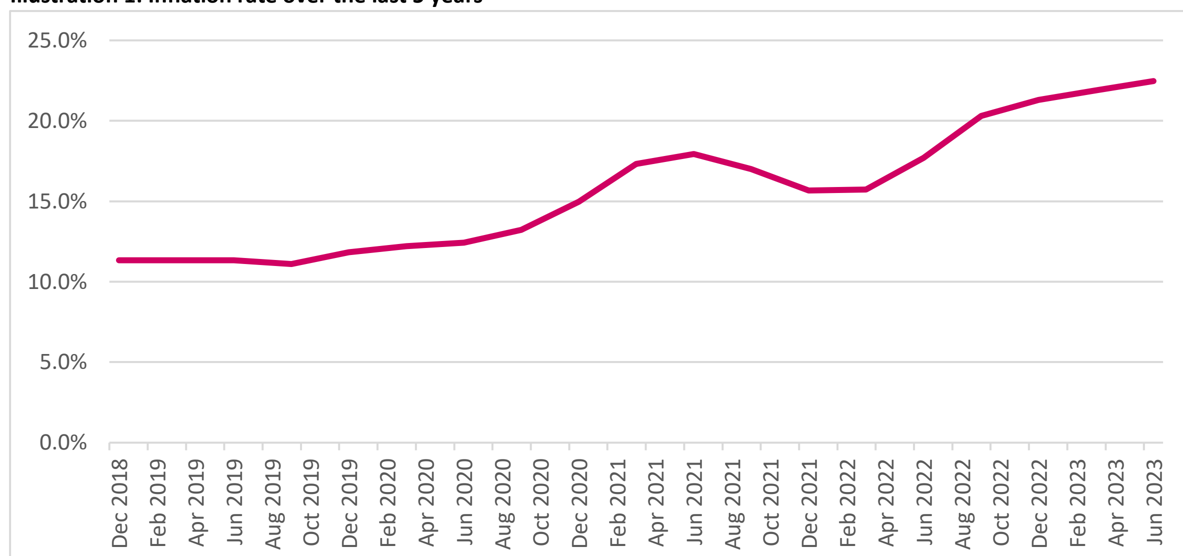
As noted above, the free-market solution offers clarity, and would send a strong signal to domestic and foreign investors that Nigeria has climbed out of the debt hole and is back on the road to growth.

Free market solutions however need political and social backing, given the social costs they impose. *The Economist* magazine in the 1840s recommended a free market solution to the Irish potato famine – let the market find the right price and corn/wheat will flow to Ireland. This bad advice meant that of the 8m Irish population of 1845, perhaps 1m died and 1m had emigrated by 1848. Fortunately, the situation is nowhere near so dire in Nigeria.

There are however limits to what a population can take, particularly after roughly 8 years of negative per capita GDP growth. Nigeria's population has risen 26% from the end of 2014 to 2023 (yes, that's an IMF guess as the 2023 census hasn't happened). Meanwhile real GDP has risen 15%, so Nigerians are roughly 10% worse off than nearly a decade ago.

Now the fuel price has more than trebled and inflation has soared to 26% (thanks to money printing). President Tinubu has offered an 83% rise in the minimum wage to the unions and withdrawn the VAT hike on diesel. We estimate this cost the government $1m a day which they don't have, which means Nigeria will have to borrow money, at rising interest rates, to compensate for this.

Illustration 1: Inflation rate over the last 5 years



To stabilise the exchange rate, there are efforts underway to borrow from Afreximbank, the World Bank and the African Development Bank. The Afreximbank borrowings may be secured against future oil sales, so 2023/24 oil revenues will effectively be sold now to try and clear the backlog of FX demand which some estimate to be as high as $10bn. External debt markets requiring more than a 10% interest rate even for five-year borrowing are seen as too expensive. Cheap borrowing from the IMF, which is usually a good option for any country (the US should try it), does not appear politically palatable.

We understand the temptation to seek more foreign borrowing. The external debt to export ratio in Nigeria remains low by African standards. If combined with a formalisation of parallel market flows, this might be enough to secure the currency around NGN800/$ over the next few months. The risk is that Nigeria cannot quite borrow enough, cannot quite clear that backlog, and that the country ends up with more debt, with less export revenues next year (as they would already be mortgaged to the new loans) and still with some FX shortages, so still no new capital inflows. **Nonetheless, we see a 60% chance that this is the policy mix we should expect.**

Whatever happens, a rise in the CBN and market interest rates looks likely. Today, one-year yields at 10% compared to inflation at 25.8% leaves a 16-percentage point gap, which is the largest of the 27 African countries we follow. Investors in one year-Naira are destined to lose money if inflation stays at this level. The CBN needs to suck up the Naira liquidity, even though the DMO (Debt Management Office) appreciates the low market rates, if there is to be any chance of US dollar investors voluntarily choosing to convert into Naira.

In either scenario then, we expect Nigerian interest rates to rise to around 20-25%, and the Naira to be around NGN920/$ by September 2024, on the assumption that inflation runs at around 25% over the coming year. We no longer fear a scenario where the Naira is in freefall in late 2024/25 leading to potential default.

For us, the big question is what we might see from the CBN in terms of currency policy going forward.

The least helpful policy in our view is the one that has been in existence since the 1980s. The currency remains stable while the oil price is high, and then belatedly, after the inevitable oil price collapse, there is a sudden and huge move in the currency. In the mid-1980s, this was from NGN1/$ to NGN4/$ in just 2-3 years. In the 1990s it was from NGN22 to NGN85, and we all remember more recent big moves. The devaluations push up inflation and destabilise the economy.

Angola used to have a similar policy, but with a change of president came a change of monetary policy too. Now Angola lets its currency strengthen when the oil price rises, and lets the currency weaken when the oil price falls. For the Budget Minister this must be glorious. To show how this works, if we think in Naira terms, and use an oil price of $100 and a NGN1,000/$ rate, then each barrel of oil is worth NGN100,000 (of which perhaps half goes to Nigeria).

If the oil price falls to $50 and the Naira rate does not move, then government revenues collapse by half. The government has to borrow to fill the gap, adding to its debt, and might choose to borrow from the CBN, adding to inflation. This is what has happened in recent years.

In the event the oil price falls to $50 and the NGN halves in value to NGN2,000/$, then budget revenues stay the same. Debt does not have to rise and nor does borrowing. Inflation will of course pick up, as a one-off reaction.

Then if the oil price rebounds to $100, the NGN can recover to NGN1,000 and again budget revenues stay the same. The budget has predictability. Businesses dependent on government contracts can be sure they will get paid so can plan ahead and invest. Everyone can follow the oil price and make an informed guess as to the direction of the policy.

Illustration 2: The NGN is now 7% undervalued to its 26-year history average of NGN716/$

	Current FX rate vs $	FX rate implied by long-term average REER	FX rate if REER falls to previous lows	Date of REER low	Long-term average divided by current rate	IMF 2023 C/A (% GDP)	IMF 2024 C/A (% GDP)	deviations away from historic average	Dec-23 forecast	One-year local currency yields	Latest CPI (% YoY)	CPI (date)	Real interest rates, %
Ethiopia	55.7	93.0	137	Jan-04	1.67	-2	-2	2		na	28.2	Aug-23	na
C.A. Republic	622	763	1,027	Dec-99	1.23	-9	-8	1	650	na	2.4	Jun-23	na
Eq. Guinea	622	728	1,209	Oct-00	1.17	-3	-3	0	650	7.1	10.8	May-23	-3.7
Mozambique	63.9	73.6	108	Sep-16	1.15	-16	-39	1		18.2	4.6	Sep-23	13.6
Zambia	21.6	23.3	39.4	Dec-00	1.08	4	7	0		15.1	12.0	Sep-23	3.1
Botswana	13.7	14.5	18.0	Sep-98	1.06	1	1	0		na	1.2	Aug-23	na
Uganda	3,754	3,940	4,930	Aug-11	1.05	-7	-8	0		12.6	2.7	Sep-23	
Cameroon	622	649	760	Oct-00	1.04	-3	-2	0	650	4.6	7.3	Dec-22	-2.7
Tanzania	2,507	2,607	3,328	Aug-06	1.04	-5	-4	0		8.6	3.3	Sep-23	5.3
Chad	622	639	821	May-00	1.03	0	-3	0	650	7.2	12.5	Apr-23	-5.2
Congo (Rep)	622	633	800	Apr-97	1.02	4	2	0	650	6.9	5.1	Jul-23	1.7
Gabon	622	625	701	Sep-00	1.01	-1	-2	0	650	na	4.6	May-23	na
Rwanda	1,221	1,228	1,641	Jan-04	1.01	-13	-11	0		9.9	18.4	Sep-23	-8.5
Mauritius	45.0	45.0	55.4	Dec-06	1.00	-6	-4	0		3.6	5.3	Sep-23	-1.7
Senegal	621	621	685	Nov-00	1.00	-15	-8	0	650	6.7	3.8	Sep-23	2.9
Ivory Coast	621	617	730	Jul-97	0.99	-5	-4	0	650	6.9	4.6	Jul-23	2.3
Algeria	137	136	162	Jan-21	0.99	3	1	0		na	11.1	Aug-23	na
Morocco	10.2	10.1	10.7	May-12	0.99	-3	-3	0		3.3	5.0	Aug-23	-1.7
Kenya	150	144	368	Aug-97	0.96	-5	-5	0	151	15.2	6.8	Sep-23	8.4
DR Congo	2,469	2,308	3,147	Jan-10	0.94	-6	-5	0		na	29.3	Jul-23	na
Namibia	19.0	17.7	53.4	Jan-97	0.93	-7	-6	0		8.6	5.4	Sep-23	3.3
Nigeria	768	716	1,211	May-97	0.93	1	1	0	830	10.0	25.8	Aug-23	-15.8
Angola	833	763	3,042	Sep-99	0.92	3	4	0		12.2	13.5	Aug-23	-1.4
Egypt	30.9	27.8	43.7	Jan-04	0.90	-2	-2	0	37.0	26.0	38.0	Sep-23	-12.0
Tunisia	3.17	2.70	3.73	Feb-19	0.85	-6	-5	-1		9.7	9.0	Sep-23	0.7
Ghana	11.8	9.66	15.7	Nov-22	0.82	-2	-3	-1		33.0	38.1	Sep-23	-5.1
South Africa	19.0	14.8	20.5	Dec-01	0.78	-3	-3	-1		9.4	4.8	Aug-23	4.6

Note: Auction yields except Angola, Egypt, Nigeria, Uganda, South Africa

However – this is not a perfect policy. It is good for the budget, but the oil price is volatile and the swings in the currency will be hard for sectors like manufacturing. Sometimes your goods will be expensive (when the oil price is high and the currency is strong) and sometimes cheap, relative to the rest of the world.

An alternative is the daily devaluation policy of Rwanda. Here, you take a currency that is roughly fairly valued, like the NGN is today, and you ensure that the currency weakens roughly in line with inflation, so it never again becomes overvalued or undervalued. You pre-announce a monthly devaluation of say 1% a month, or 0.05% a day, so businesses can plan ahead.

How do you manage the volatile oil price (a problem Rwanda does not have)? You store the high export earnings as CBN reserves and at the NSIA, Nigeria's sovereign wealth fund, whilst times are good, and withdraw it when times are bad, a little like Nigeria did in the run-up to the global financial crisis when reserves were over $60bn. You trust the politicians will not blow the revenues in attempt to win elections. Here we however find the flaw in that system.

A variation in the Rwanda policy would be to allow fairly wide (10-15%) currency bands on either side of a central rate which would be devalued every month. This was a policy that Poland, Hungary, and others followed in the late 1990s and early 2000s, and it worked. Central banks still had room to vary interest rates, the market had a significant role in setting the currency rate, and when the currency hit the strong end of the bands, FX reserves would rise, and the opposite would happen at the other end.

Illustration 3: Rwanda, Angola, and Nigeria's currencies over time

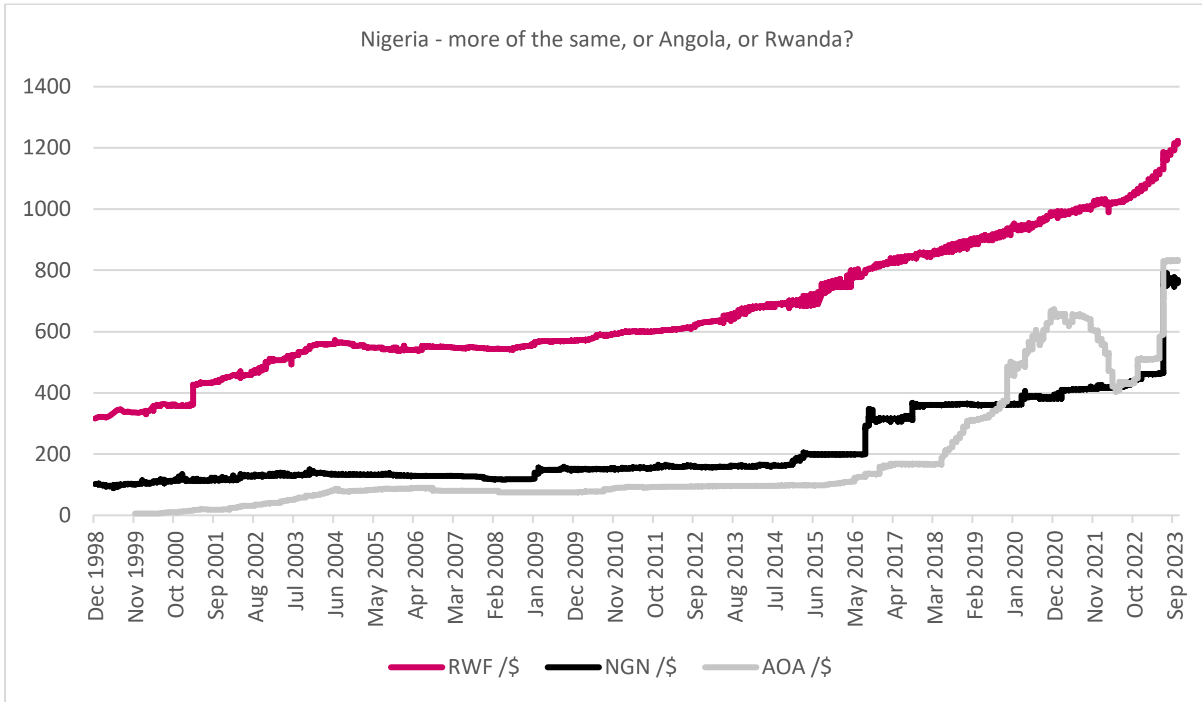
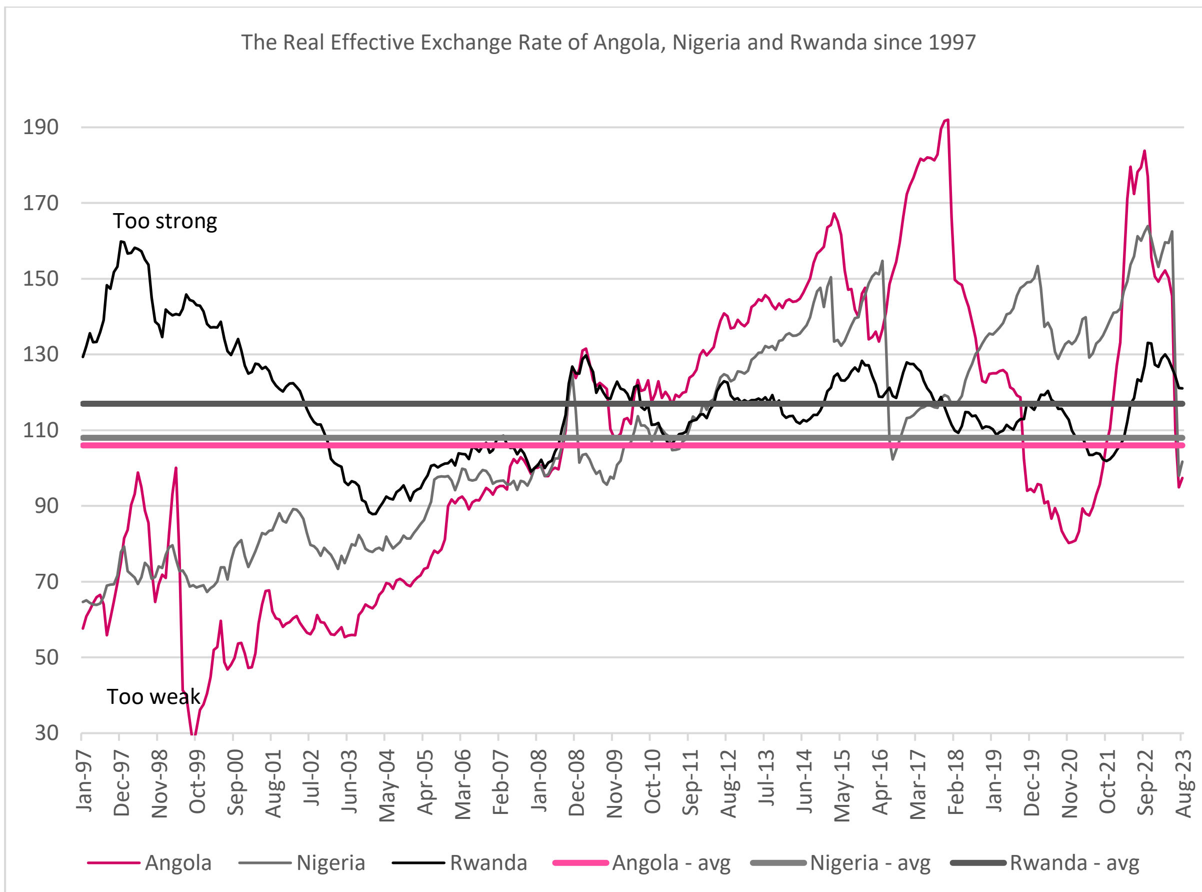


Illustration 4: Rwanda's currency is the least volatile in recent years, in terms of real currency appreciation or depreciation



There are of course other options, such as inflation targeting. We think that is hard in a country where half of inflation is driven by food (and the weather – and not even former governor was powerful enough to control the weather) and a further 10-20% of the CPI basket is driven by global oil prices.

The authorities have some complicated decisions to take.

Our overall view is that the broad thrust of policy is reformist. We were delighted to meet MOFI, the Nigerian federal government's asset manager, which is making an accurate registry for all Nigeria's many assets. We were pleased to hear more about the NNPC's moves to become more market orientated, with a probable listing on the stock exchange in the coming year or two. The NSIA continues to grow the sovereign wealth fund. The DMO manages the debt in a very professional manner as always. Nigeria's public bodies have talented people in place, who given the right macro framework, will help move the country in the direction we need to see; and RenCap Africa will be doing all it can to assist in that move.

Illustration 5: Key macro indicators, largely from the IMF's recent World economic outlook

Figure 73: Nigeria key economic indicators													
Ratings (M/S&P/F) Caa1/B-/B-	EODB Rank 2020('19): 131 (146) - Weak					Corruption Rank: 154 (149) - Weak							
Year	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**2023E**	**2024E**
Activity													
Real GDP (% YoY)	4.3	5.4	6.3	2.7	-1.6	0.8	1.9	2.2	-1.8	3.6	3.3	2.9	3.1
Investment (% GDP)	15	15	16	15	15	15	20	25	27	27	20	20	20
Unemployment rate year-end (%)	11	10	8	9	13	17	23	na	na	na	na	na	na
Nominal GDP (lcl bn)	72,600	81,010	90,137	95,178	102,575	114,899	129,087	145,639	154,252	176,076	202,365	244,683	295,837
Nominal GDP ($bn)	461	515	568	492	405	376	422	448	429	441	477	390	395
Population (mn)	167	172	176	181	186	191	196	201	206	211	217	222	228
GDP per capita ($)	2,756	2,998	3,223	2,719	2,176	1,969	2,153	2,230	2,083	2,088	2,202	1,755	1,734
Bank credit to private sector (lcl, bn)	7,673	9,343	11,986	12,448	14,984	14,767	13,227	16,250	18,714	23,932	na	na	na
Lending/GDP (%)	11	12	13	13	15	13	10	11	12	14	na	na	na
Gross domestic saving (% of GDP)	19	19	16	12	17	19	22	22	24	26	21	21	20
Prices													
CPI (average % YoY)	12.2	8.5	8.0	9.0	15.7	16.5	12.1	11.4	13.2	17.0	18.8	25.1	23.0
CPI (year-end, % YoY)	12.0	8.0	8.0	9.6	18.5	15.4	11.4	12.0	15.8	15.6	21.3	30.6	15.4
Fiscal balance (% of GDP)													
Consolidated government balance	0	-3	-2	-4	-5	-5	-4	-5	-6	-6	-6	-5	-5
Primary government balance	1	-2	-1	-3	-3	-4	-3	-3	-3	-4	-3	-3	-2
Total public debt (% of GDP)	18	18	18	20	23	25	28	29	34	37	40	39	41
External indicators													
Exports ($bn)	115	91	103	50	33	44	61	63	36	47	63	na	na
Imports ($bn)	51	56	58	45	36	31	43	55	36	52	54	na	na
Trade balance ($bn)	64	35	45	6	-2	13	18	7	0	-5	9	na	na
Trade balance (% of GDP)	14	7	8	1	-1	4	4	2	0	-1	2	na	na
Current account balance ($bn)	17	19	1	-15	5	14	7	-14	-16	-3	1	3	2
Current account balance (% of GDP)	4	4	0	-3	1	4	2	-3	-4	-1	0	1	1
Net FDI ($bn)	6	4	3	2	3	2	0	2	1	1	#N/A	na	na
Net FDI (% of GDP)	1	1	1	0	1	1	0	0	0	0	na	na	na
C/A balance plus FDI (% of GDP)	5	5	1	-3	2	4	2	-3	-4	0	na	na	na
Exports (% YoY, value)	-1	-21	14	-51	-34	34	36	3	-43	32	34	na	na
Imports (% YoY, value)	-9	10	4	-23	-21	-12	38	28	-35	45	3	na	na
FX reserves (ex gold, US$bn)	46	45	37	28	27	40	43	38	37	na	na	na	na
Import cover (months of imports)	11	10	8	8	9	15	12	8	12	na	na	na	na
External Debt													
Gross external debt YE ($bn)	21	24	29	32	36	46	54	60	71	76	na	na	na
Gross external debt YE (% of GDP)	5	5	5	7	9	12	13	13	16	17	na	na	na
Gross external debt YE (% of exports)	19	27	28	65	107	103	90	96	198	162	na	na	na
Short-term external debt YE ($bn)	12	0	0	0	10	20	23	29	0	na	na	na	na
Short-term external debt YE (% of GDP)	3	0	0	0	2	5	6	6	0	na	na	na	na
Short-term external debt YE (% of export	11	0	0	0	30	45	38	46	0	na	na	na	na
Short-term external debt to reserves (%)	27	0	0	0	36	51	54	75	0	na	na	na	na
Total debt service ($bn)	1	0	5	2	2	4	5	5	6	13	na	na	na
Total debt service (% of GDP)	0	0	1	0	1	1	1	1	1	3	na	na	na
Total debt service (% of exports)	1	1	4	3	7	8	9	8	16	28	na	na	na
Total debt service to reserves (%)	3	1	12	6	9	9	13	13	15	na	na	na	na
Currency and monetary policy												*IMF forecasts*	
Key policy rate (% YE)	12.00	12.00	13.00	11.00	14.00	14.00	14.00	13.50	11.50	11.50	16.50	na	na
Broad money growth (%YoY)	16	1	21	6	18	2	12	6	31	17	na	na	na
Exchange rate (€) annual average	203	209	211	215	281	345	362	364	410	472	447	#N/A	#N/A
Exchange rate ($) annual average	157	157	159	193	253	306	306	325	359	399	424	627	749
Credit rating history												Latest	
Moody's	Ba3	Ba3	Ba3	Ba3	B1	B2	B2	B2	B2	B2	B3	Caa1	na
Standard & Poor's	BB-	BB-	BB-	B+	B	B	B	B	B-	B-	B-	B-	na
Fitch	BB-	BB-	BB-	BB-	B+	B+	B+	B+	B	B	B-	B-	na

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