KPMG

Economic Snapshot H2, 2016

Nigeria

Inflation

Consumer price index (CPI) inflation trended steadily higher in H1, with the headline figure rising from 9.6% y-o-y in January to 16.5% y-o-y in June. The main drivers in this regard relate to tight forex liquidity, a weak parallel market naira and markedly higher domestic fuel prices. These factors, in addition to the central bank's decision to adopt a flexible interbank forex market – the official naira exchange rate has depreciated sharply following the implementation of the flexible regime. In July the Consumer Price Index which measures inflation increased by 17.1 per cent (year-on-year), 0.6 percentage points higher from the rate recorded in June (16.5 per cent). The pace of the increase in the headline index was however weighed upon by a slower increase in three divisions; health, transport and recreation and culture divisions. Energy and energy related prices continue to be the largest increases reflected in the Core sub-index.

Growth

According to the National Bureau of Statistics (NBS), the economy contracted by 0.4% y-o-y in 2016 Q1 after expanding by 2.1% in 2015 Q4. Economic challenges continue to prevail in 2016 H2 as the economy slips into early stages of recession due to the adverse effects of tight forex liquidity, attacks on oil installations curtailing output and delays in ramping up fiscal spending. The economy may still find itself on a firmer footing in H2 as fiscal spending is ramped up and tight forex liquidity conditions ease off to an extent. Real GDP growth is nonetheless forecast to decline to just 0.3% in 2016, down from 2.7% in 2015.

National development plan

Authorities have yet to compile a formal economic policy that outlines the country's medium term objectives as well as the strategies that will be followed to achieve these goals. That said, the passing of the 2016 fiscal budget in May did provide some insight into Nigeria's short-term objectives. The Strategic Implementation Plan (SIP) forms the basis for the preparation and implementation of the budget and outlines six major strategic intervention pillars, namely: 1) the policy environment, national security and governance, 2) economic diversification, 3) priority critical infrastructure, 4) oil & gas reforms, 5) ease of doing business, and 6) social investment.

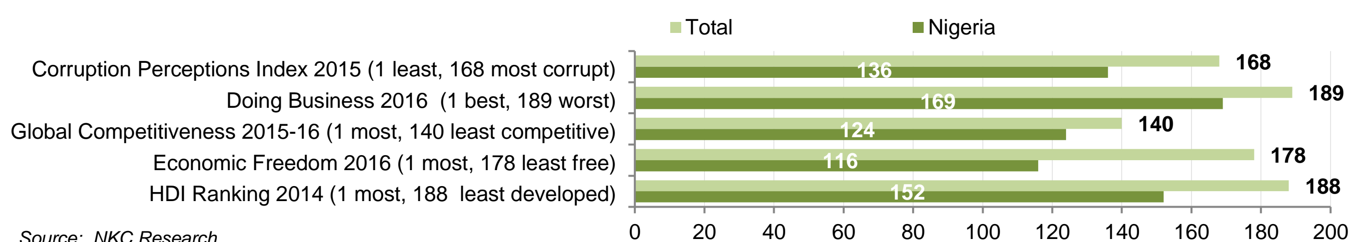
OPPORTUNITIES	STRENGTHS
Immense scope for gas production for domestic use as well as exports.	Robust real GDP growth performance in recent years. Despite the oil price shock, the medium- to long-term outlook remains relatively positive.
Africa's most populous country; biggest economy on the continent.	Nigerian oil is of a very high quality, and generally trades at a premium to Brent crude, while the cost of unearthing the oil is relatively low.
Growing middle class offers opportunities in the services sector.	The government has made progress with some key reforms in recent years.
One of the countries on the continent with the most opportunities for commercial agriculture.	Nigeria's public and external debt levels remain relatively low.

VULNERABILITIES	WHAT IS BEING DONE?
Poor infrastructure, high cost of doing business, corruption.	President Buhari's first year in office has witnessed a strong crackdown on corruption and the new administration remains committed to combating fraudulent practices.
Delays in passing the Petroleum Industry Bill (PIB) have led to lower investment in the oil sector.	Disagreements on royalty distribution and the contents and structure of the bill continue to delay the approval thereof by the Nigerian Senate. Officials have highlighted the possibility of breaking the bill into several sub-bills, to be debated and passed separately. This could simplify the passing of the least controversial sections of the bill
Security, especially in the northern states, and the prospect of terrorism remain major elements in political risk. Militant activity in the Niger Delta has also resurfaced.	While the terrorist group has been driven from major towns, Boko Haram's activities seem to have lessened and gradually being replaced by violent attacks from herdsmen. The Nigerian Army is working to investigate these cases and restore peace to affected areas
The fiscal and external positions have a high vulnerability to lower oil prices/output.	Authorities are in the process of stepping-up diversification efforts, but it will take some time before the economy becomes less dependent on oil.

MEGA TRENDS	
Population	181,562,056 (July 2015 est.); Age 15 - 64: 53.9%
Population growth rate (%)	2.45% (2015 est.)
Life expectancy at birth	Total population: 53.02 years; male: 52 years; female: 54.1 years (2015 est.)
HIV/AIDS	Adult prevalence rate: 3.1%; People living with HIV/AIDS: 3.5 million (2015 est.)
Adult literacy rate (age 15 and over can read and write)	Total population: 59.6%; male: 69.2%; female: 49.7% (2015 est.)
Urbanisation	Urban population: 47.8% of total population (2015); Urban population growth: 4.7% (2015)

Population below national poverty line	67.2 % (2012 est) World Bank
Unemployment rate	13.3% (2016 H2 est) NBS
Employment (% of total)	Agriculture: 39.7%; Industry: 10.8%; Services: 49.5% (2013 est.)
Labour participation rate (% of total population ages 15+)	56.2% (2014)
Business languages	English
Telephone & Internet users	Main lines in use: 187,155; Mobile cellular: 150.83 million; Internet users: 86.13 million (2015)

Sources: CIA World Factbook, World Bank, Trading Economics, ITU, UNAIDS, UNESCO, Nigeria National Bureau of Statistics & NKC Research



Source: NKC Research

Risk environment / Risk outlook

Sovereign Risk Ratings		
S&P Global Ratings	**Fitch**	**Moody's**
B+/Negative	B+/Stable	B1/Stable

S&P Global Ratings (S&P) affirmed Nigeria's long-term sovereign credit rating at "B+" on March 18, but decided to change the outlook on the rating from stable to negative. The decision was primarily justified on the basis of a more depressed crude oil price outlook. The rating agency was also critical of the central bank's management of the foreign exchange market, highlighting that the strategy of keeping the naira artificially pegged was *"creating dislocations in product and financial markets."* On the positive side, S&P highlighted that Abuja is in the process of implementing a range of reforms and transparency measures – referring to the Treasury Single Account (TSA), improvements in the energy sector and reforms related to the Nigerian National Petroleum Corporation (NNPC) – which could improve the country's medium-term prospects.

Fitch Ratings decided to downgrade Nigeria's long-term foreign currency issuer default rating (IDR) by one notch from "BB-" with a negative outlook to "B+" with a stable outlook on June 23. The agency noted that the country's external and fiscal vulnerabilities have worsened due to a sharp fall in oil revenue and that policy adjustments were too slow to mitigate the impact of low global crude oil prices. Fitch is also concerned about the escalation of militant activity in the Niger Delta which has lowered oil production, in turn *"magnifying pressures on export revenues and limiting the inflow of hard currency."*

Moody's Investors Service decided to downgrade Nigeria's long-term issuer rating from "Ba3" to "B1" on April 29. The outlook on the "B1" rating is stable. The main driver behind the downgrade decision hinges on the fact that Moody's now expects crude oil prices to remain low for longer than previously anticipated. Moody's is also concerned about how successful the state will be with the transition to a less oil-dependent Federal Government of Nigeria (FGN) budget, *"and the implications for the government's balance sheet should it not achieve its aims."* The final driver behind the decision to downgrade the rating relates to concerns around debt interest payments, as the government looks set to accumulate a substantial amount of debt, both domestically and abroad, to plug the envisaged fiscal shortfall.

Infrastructure	Diversity of the Economy	Banking Sector	Continuity of Economic Policy	GDP Growth	Key Balances	Foreign Investment	Socio-economic Development	Forex Reserves
Very weak	Oil dominates exports	Improving, but low oil price poses risk	Reform progress has been slow and mixed	Declined sharply due to oil price shock	Twin deficits	Declined on tight forex liquidity	Low	Under pressure

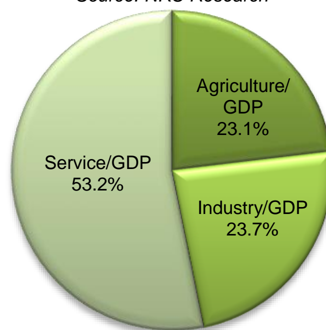
Stock Market	Listed Companies	Liquidity	Market Cap	Dominant Sector	Daily Trading Volume
Nigeria Stock Exchange (NSE)	175 (June 2016)	Very liquid in African context	$35.95bn (Equities, June 2016)	Finance, consumer goods & industrial goods	429 million shares (2016 Q2)
Capital Market	**Development**	**Liquidity**	**Maturity Range**	**Municipal Bonds**	**Corporate Bonds**
Yes	Advanced in African context	Very liquid in African context	91-day to 20-year	Yes	Yes

Macro-economic overview

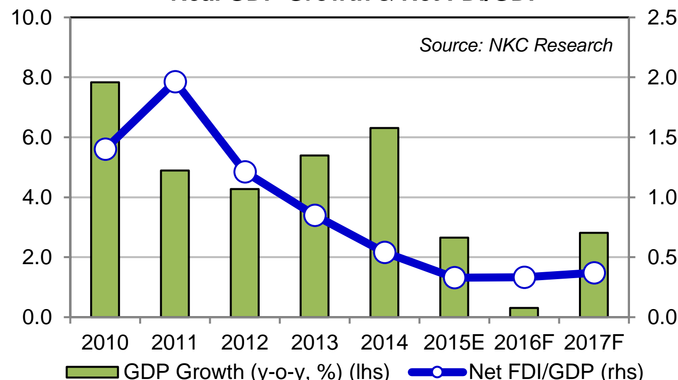
As Africa's largest economy and oil exporter, Nigeria has been hit hard by the global slump in crude prices. It is facing its worst economic crisis in decades as there has been increased pressure on government and foreign exchange earnings. Nigeria will endure an economic contraction in 2016 as external and domestic challenges, exacerbated by a series of controversial monetary and fiscal policy developments, have led to a fall in manufacturing activity, declining oil production, a delayed implementation of an expansionary budget and reduced inflows of investment. However, despite some limited improvement ahead, any positive growth over the next two quarters will not be sufficient to offset the poor H1.

The outlook for 2017 is brighter, as the long-delayed expansionary budget will come to be implemented, oil prices will rise and oil production will return to growth. Furthermore, a more flexible exchange rate regime will encourage some foreign direct investment to return. However, growth will still be far below that enjoyed over the 10 years prior to the oil price-slump in H214, when the average annual expansion rate was 7.4%.

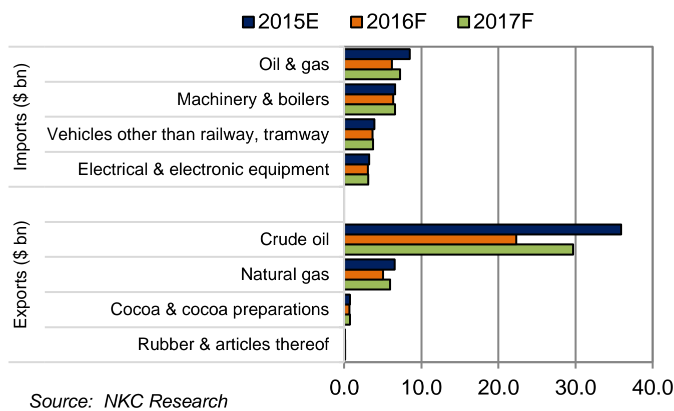
There are a number of factors which have undermined Nigeria's manufacturing sector in recent quarters. One of the most damaging has been the controversial naira peg and related capital controls. The government had maintained the exchange rate at an overvalued level of NGN197-199/USD for 16 months (between February 2015 and June 2016), leading to a severe shortfall of US dollars, as oil exports - a key source of foreign exchange - fell. Meanwhile, foreign investors were loath to put money into Nigeria and risk a subsequent loss in value when the inevitable currency devaluation took place. An inability to source dollars meant that businesses were unable to pay suppliers, stifling production. A further blow for the sector has come from intermittent electricity outages over the course of H1, which have been exacerbated over the past several months by attacks on gas infrastructure by the Niger Delta Avengers (NDA), a terrorist group seeking secession for the Niger Delta region from Nigeria. We forecast real GDP growth will decline to just 0.3% this year, before rebounding to 2.8% next year. We must highlight though that the risks to our growth outlook remain balanced to the downside. The Nigerian economy could well contract on an annual basis if developments pertaining to fiscal spending, the exchange rate and security risks do not transpire as we currently predict.



Foreign Direct Investment (FDI) to Nigeria fell 27 percent from $4.7 billion recorded in 2014 to an estimated $3.4 billion in 2015. This is partly ascribed to the adverse effects of lower crude oil prices on the economy in general; however, we believe the CBN's stance on the naira – and the tight forex liquidity conditions associated therewith – also served to keep investors on the sidelines last year, mainly due to concerns in relation to the ability (or the lack thereof) to repatriate profits. The CBN estimates that net FDI rebounded from $0.2bn in Q4 2015 to $0.6bn in Q1 2016. This figure is on the optimistic side in our view, and we expect net FDI would have trended lower in H1. The outlook for the remainder of the year is mixed. On the one hand, the monetary regulator's decision to loosen its grip on the naira exchange rate may see tight forex liquidity conditions ease off to an extent, which may incentivise an increase in foreign investment. On the other hand, the rise in security threats in the Delta will deter investment in the oil sector, or even worse, contribute to an increase in disinvestment. Lower oil output will also prevent the economy from benefitting from the rebound in crude oil prices in Q2. In general, we predict net FDI flows will decline slightly to $1.4bn this year.



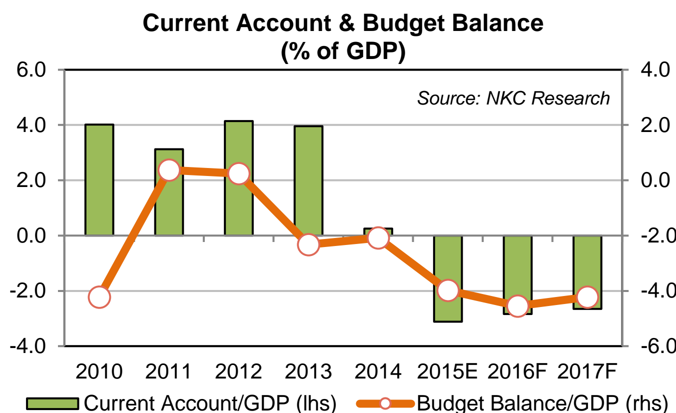
The dependence on a single commodity to generate foreign exchange earnings, in addition to limited scope to ramp up production, makes Nigeria especially vulnerable to oil production and price shocks. It thus comes as no surprise that Nigeria's exports declined by 44% to $45.9bn in 2015 due to the sharp fall in crude oil prices. Imports also fell by 15% to $52.3bn last year, ascribed to a lower fuel import bill and tight forex liquidity conditions. The trade balance plunging into negative territory contributed to a current account deficit equal to 3.1% of GDP in 2015.



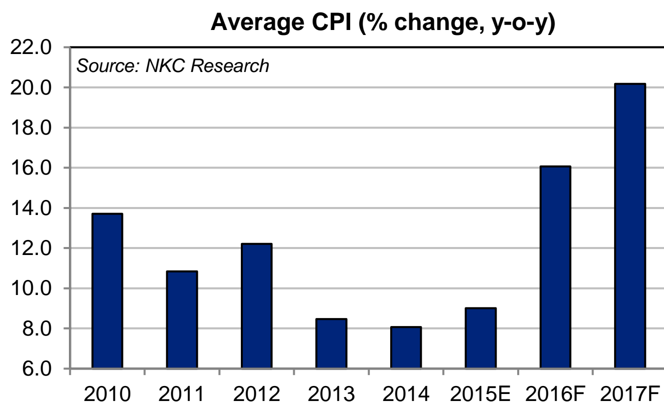
Main Imports: % share of total	2015E	2016F	2017F
Oil & gas	16.23	14.81	15.48
Machinery & boilers	12.65	15.27	14.05
Vehicles other than railway, tramway	7.47	8.83	8.01
Electrical & electronic equipment	6.17	7.31	6.68
Main Exports: % share of total	**2015E**	**2016F**	**2017F**
Crude oil	78.26	76.41	75.84
Natural gas	14.24	17.28	15.22
Cocoa & cocoa preparations	1.59	2.34	1.81
Rubber & articles thereof	0.21	0.38	0.29

The CBN estimates that merchandise exports declined by 41% y-o-y in 2016 Q1. The sharp drop in exports is mainly ascribed to the fact that crude oil prices declined to multi-year lows in Q1. That said, a drop in oil production also played a part, with output down by roughly 5.8% q-o-q in Q1, according to the Organisation of the Petroleum Exporting Countries (OPEC). Turning to imports, the central bank's figures again point to a 41% y-o-y fall in Q1, most likely ascribed to forex shortages and a lower fuel import bill – in actual fact, the CBN estimates that oil & gas imports declined by roughly 55% y-o-y in Q1.

We forecast exports will decline to $31.6bn in 2016. While global crude oil prices have rebounded from the Q1 lows, Nigeria will unfortunately not benefit immensely from this development, ascribed to an escalation in militant attacks to oil installations in the Delta region. Imports are projected to fall to $40bn this year – the decline in crude oil prices will again drag the fuel import bill lower, while forex liquidity will remain fairly tight despite the adoption of a flexible interbank forex market. Besides dragging imports lower, US dollar scarcities will also contribute to a narrower shortfall on the combined services, income and current transfer accounts – the CBN's preliminary figures actually suggest that the combined invisible accounts recorded a small surplus in Q1. We predict that a smaller shortfall on the invisible accounts will more than offset the wider trade deficit, translating into a narrower current account deficit equal to 2.8% of GDP in 2016. Nigeria's external balances will however remain under pressure until 2019 when we expect the rebound in crude oil prices to start gaining more traction.



Nigeria's fiscal revenue projections for 2016 are based on a $38/bbl. oil price, production of 2.2 million bpd and an exchange rate of N197/$.
Despite the slump in production, authorities' projections now seem to be on the conservative side. Oil revenues may well be slightly higher than budgeted in local currency terms, mainly due to the adoption of a more flexible interbank forex market and the associated expectation of a significantly weaker naira exchange rate. That said, the majority of revenue is projected to stem from non-oil sources, and it is here where we believe authorities' projections may be overly optimistic. The poor performance of the economy in general, with a technical recession now more than likely by Q2, means tax revenues may fall well short of target.. The Government has also opted to pursue mostly soft measures to increase non-oil fiscal revenues. In other words, rather than increasing tax rates directly, the government will attempt to improve revenue administration. We see these types of measures as having a larger risk of falling short of target. We project the fiscal deficit will widen from 4% of GDP in 2015 to 4.5% of GDP in 2016.



Inflation continued on a steep upwards trajectory and rose to 17.1 percent in July up from 16.5 percent in June with tight forex liquidity and higher administered costs as the key drivers. Forex liquidity conditions have remained extremely tight despite the central bank's move to introduce a flexible interbank foreign exchange rate regime, as the latter has thus far failed to lure increased forex inflows. Investors remain concerned about weak GDP growth and elevated security risk in the Niger Delta. In response to mounting inflationary pressure, the CBN decided to raise the benchmark interest rate by 200 bps to 14% following the Monetary Policy Committee (MPC) meeting concluded on July 26. While the central bank remains concerned about GDP growth, the MPC highlighted that high inflation erodes purchasing power while negative real returns discourage increased foreign investment. Liquidity conditions were not tightened as the apex bank opted to keep the cash reserve requirement (CRR) at 22.5% while the liquidity ratio was maintained at 30%. Excess naira liquidity will however continue to undermine the normalisation of benchmark asset prices.

We expect price pressures will continue to mount in H2. While the implementation of the flexible exchange rate regime should ease tight forex liquidity conditions to some extent, this looks set to be a gradual process. As such, US dollar scarcities and a weak parallel market exchange rate will continue to add upward pressure on the domestic price level moving forward. While the central bank remains concerned about growth, we expect the CBN to adopt a more conventional stance in H2 by raising interest rates and tightening liquidity. Apart from curbing inflation, a tighter monetary policy stance should also encourage a much needed increase in foreign investment inflows to revitalise the interbank forex market and help ease tight US dollar liquidity conditions.

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