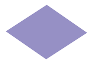
Rhombus Advisors LLC
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Omotunde A.J. Mahoney
+1-973 509 5300

NIGERIA RESEARCH NOTE

The May 2016 MPC decision - reading the tea-leaves

*Tuesday's MPC Communiqué contained no fewer than eight approving references to (exchange-rate) **"flexibility"** and four allusions to the need for a new **"framework"** (for the FX market).*

*No wonder[1] the statement has inspired such **breathless headlines** as, "In Retreat for Buhari, Nigeria Prepares to Let Naira Weaken."[2] However, a close examination of the text leaves **a number of unanswered questions regarding the evolving exchange-rate regime and the implications for the Naira**.*

1) The statement begins by acknowledging that the **economy is in the grip of stagnation the stagflation**, a condition that the Committee is keen to portray as 'exogenous', viz.:

"Many of the prevailing conditions in the economy during the review period were outside the direct control of monetary policy."

Instead, responsibility is laid firmly at the door of:

- **the prolonged budget impasse** which had *"denied the economy the timely intervention of complementary fiscal policy"*[3]; and,
- **the shortage of foreign exchange** which had, *"provided some basis for price increases in an economy characterized by high import dependence."*

2) Turning to the "issues" surrounding the foreign-exchange market, the Committee claims to have traced these, after thorough research, to *"the low foreign exchange earnings of the economy."*

It is certainly true that all commodity exporters have experienced a brutal terms-of-trade shock from the collapse in prices since mid-2014. However, in the specific context of Nigeria, **what has transformed this generic shock into a full-blown crisis is clearly the decision to hold the Naira at N197=USD**[4], thereby preventing the exchange-rate from performing its natural role as a shock-absorber.

3) When the Committee presents its **strategic response to the crisis** in the foreign-exchange market[5], **the contradictions are even more striking**. The MPC sets the stage by disingenuously *"recalling"* having

[1] Especially given the obduracy with which the competent authorities have until now dismissed all calls to adjust the Naira's unsustainable peg.

[2] Bloomberg, May 24, 2016 – 10:05 AM. An even more hyperbolic example: *"CBN throws Naira into open market, nullifies N197/$ exchange rate"* – The Vanguard, May 25, 2016.

[3] Even though one of the Committee's external members had explicitly warned, as far back as Nov. 2015, that, *"Manufacturing activity continues to shrink in consequence, at least in part, of the continuing application of measures to conserve reserves.[…] It is a source of regret that monetary policy measures aimed at conserving forex demand may be responsible for job destruction rather than support and enhance job creation."*
See discussion in Rhombus research note, "*Insights into November's MPC deliberations*".

[4] Over the 23 months in question which have seen a 57.4% decline in the price of Brent crude, the Naira has been allowed to depreciate by a mere 17.6%. Its USD parity was last adjusted in Feb. 2015.

[5] Where the USD commands a rate of N350 on the (largely retail) parallel market and N285 on the (wholesale) "wire funds" rate that formed the basis for the recent adjustment in the administered price of premium motor spirit (i.e. gasoline) from N87 to N145 per litre. Ignoring these anomalies, however, the statement subsequently notes that, *"The market continues to demonstrate confidence in the Bank's ability to deliver a credible foreign exchange market."*

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signaled the imperative of reforming the foreign exchange market at its two previous meetings[6]. It then reports - not entirely persuasively – that, *"The Bank had made very significant and satisfactory progress with the reforms framework."*

4) The Committee next pauses to issue what amounts to **a significant caveat** that we consider more than warranted :

"A dynamic foreign exchange management framework that guarantees flexibility ***could not replace the imperative for the economy to increase its stock of foreign exchange*** *through enhanced export earnings* (emphasis added).*"*

5) These preliminaries dispensed with, the Committee now unveils its pièce de resistance that we propose to deconstruct in two installments, each comprised of two sentences. The first segment reads:

"The foreign exchange market framework now ready, (emphasis added) *the MPC voted unanimously to adopt greater flexibility in exchange rate policy to restore the automatic adjustment properties of the exchange rate. Consequently, all 9 members voted to hold and introduce greater flexibility in managing the foreign exchange rate."* [7]

There are three major problems with this pronouncement:

- the authoritative predicate[8] with which the first sentence opens **flies in the face of the relatively nuanced assertion discussed in Para. 3**, above.
- the automatic adjustment property alluded to is **contingent upon the exchange-rate being allowed to float - an eventuality that is clearly not envisaged** here.
- the inclusion of the redundant second sentence is **tantamount to 'protesting too much'**.

6) The decision continues: *"The Bank would however, retain a small window for funding critical transactions.* ***Details of operation of the market would be released by the Bank at an appropriate time.*** (emphasis added)*"*

Here, the devil is in the details, specifically:

- How 'small' a foreign-exchange window is the Central Bank expected to operate and, most critically, **what criteria will determine which transactions, are deemed "critical"** and therefore eligible for the preferential exchange rate?[9]

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[6] In fact, although the March communiqué did indeed report that, *"A comprehensive reform of the foreign exchange market … is currently being undertaken"*, none of the personal statements submitted by individual Members provided any evidence of their involvement in the exercise ostensibly underway. Nor had there been any subsequent mention in the intervening eight weeks.

[7] This wording appears, appropriately enough, in the opening paragraph of the section entitled *The Committee's decisions*. More succinct variations appear in the concluding passages of the *External developments* section, and the *Committee's considerations*, respectively.

[8] *Stricto sensu*, an ablative absolute which is by definition categorical.

[9] I.e. the obvious flaw with multiple exchange rates, as demonstrated by the catastrophic dénouement of Venezuela's experiment.

- The open-ended time-frame strongly suggests that there are still **several conceptual and operational details to be finalized**, a proposition that is buttressed by the concluding sentence in the statement's section on *External sector developments*.[10]

7) For investors, there are **three significant points**[11] to take away from the latest MPC decision:

⇨ The MPC has now explicitly acknowledged that the **existing regime FX provides an inadequate framework for mediating supply and demand**[12].

⇨ The central bank is **apparently preparing to formalize the emerging two-tier FX regime** – the goal being to boost the supply of hard currency.

⇨ However, with real interest rates deep in negative territory, the new dispensation will leave portfolio investors unimpressed, so **the anticipated FX inflows are simply unlikely materialize**.

In other words, even before one takes into account the crippling attacks on Nigeria's oil and gas infrastructure has sustained over the last three months[13], it is clear that **there is no end in sight to the ongoing Naira crisis**[14].

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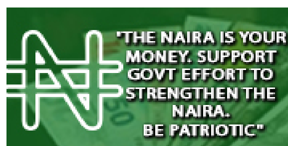
[10] Viz., *"The Management of the Bank has been given the mandate to work out the modalities for achieving the desired flexibility that is in the overall interest of the Nigerian economy and when the implementation of the new framework would begin."* Given the level of disarray in the foreign-exchange market, it is inconceivable that the competent – if anonymous - authority would have delayed rolling out the new arrangement, were it in fact ready for implementation. *A propos*, it is remarkable to see the Committee acknowledging in such explict terms the open secret that substantive control over exchange-rate policy matters has been assumed by the presidency - in apparent disregard of the provisions of Section 16 of the Central Bank of Nigeria Act (2007).

[11] We regard as no more than a punt the Committee's decisions to retain unchanged the policy rate and associated corridor; the reserves ratio and the liquidity ratio.

[12] Although a welcome development, this Damascene conversion has come exactly two weeks after the NNPC stopped using the official exchange rate of N197 in its fuel pricing formula, as discussed under Footnote 5, above. As will be recalled, that development occurred on the same day as VP Osinbajo declared at an investor conference in Lagos that, *"We believe there must be some substantial re-evaluation of the foreign exchange policy especially wth a view to increasing forex supply."*

[13] Daily oil production has been cut to a little more than half the 2.2 million bb on which the 2016 budget is premised, while electricity output has dropped to barely 1,000 mWh (as a result of the shortage of the natural gas feedstock on which Nigeria's thermal-generation plants depend).

[14] These bearish prospects lend an almost tragic poignancy to the following exhortation that has begun appearing in the form of a banner ad. - clearly sponsored by the authorities - in Nigeria's major dailies.



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