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MARKET COMMENTARY

Ashmore

Nigeria: After the Election

By Jan Dehn

Barring any last minute surprises, Nigerians will go to the polls on Saturday 28 March to elect a new president. While the choice of president matters to Nigeria's outlook, the greater significance of the election is that the government will finally find room to get on with a much needed adjustment to last year's decline in oil prices. We expect this adjustment to occur whoever wins.

Nigeria's place among Emerging Markets oil producers

Oil producers in Emerging Markets (EM) are a diverse bunch, but they broadly fall into three categories. Saudi Arabia epitomises one extreme, having used the oil boom of the past decade to reduce its debt stock from more than 100% of GDP to just 2% of GDP. This means that it can soften the blow of lower oil prices with fiscal spending without incurring any major fiscal or wider economic stress. At the other extreme is Venezuela, an example of a country which has not only spent all its oil revenues, but has also borrowed against expected future income and overstimulated its economy with over-easy monetary and fiscal policies. Venezuela is now facing a serious adjustment challenge. Nigeria falls somewhere between these two extremes. It has managed to spend almost every Dollar it has earned from oil, but it has resisted the temptation to borrow or to overstimulate the economy. Nigeria's external debt is only 3.4% of GDP and the total public sector debt stock is only about 20% of GDP.

Nigeria's conventional adjustment problem

Nigeria's problem is therefore a relatively conventional adjustment problem, which can be solved with the usual medicine of external and domestic adjustment. When oil prices declined in 2014, Nigeria's central bank responded by weakening the currency and hiking rates, but as we pointed out in a recent piece[1] there is also need for fiscal adjustment. This adjustment has not taken place. Basically, the election got in the way – preventing both a sufficient devaluation and making it impossible to make the required fiscal adjustment. Pressures on the currency began to mount and, rather than addressing the fundamental cause of the problem, Nigeria's central bank engaged in numerous changes in the regulations surrounding FX trading with the result that FX liquidity dropped sharply. The impact of these delaying tactics will undoubtedly be to make the eventual adjustment larger. On the other hand, Nigeria's problem remains a relatively simple macroeconomic adjustment challenge rather than an unsurmountable structural challenge such as excessive debt or an overly intrusive state.

The election

Barring any last minute surprises, Nigerians will go to the polls on Saturday 28 March. Opposition candidate Muhammadu Buhari of the All Progressives Congress is leading in the polls against incumbent President Goodluck Jonathan of the People's Democratic Party.

Buhari is a controversial leader. He ran Nigeria from 1983 to 1985 as part of a junta that took power through a coup. He therefore has an authoritarian reputation, although he has since attempted to win power legitimately in three previous elections. On the other hand, Buhari's time in government services (in the military, as governor for North-Eastern State, as Federal Commissioner for Petroleum and Natural Resources, as Head of the Petroleum Fund and as Head of State) has been characterised by pursuit of better governance and aggressive reforms and adjustment.

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The post-election challenge

Regardless of who wins on 28 March, Nigeria is heading for further macroeconomic adjustment. We believe that the Nigerian Naira (NGN) needs to weaken another 10-15% and fiscal adjustment is sorely needed to reflect the smaller resource envelope (lower oil prices).

This places the 2015 Budget in first place on the agenda of the next government. Adjusting to lower oil prices is not just an economic and fiscal challenge, it is also a major political challenge. The Nigerian constitution gives Nigeria's 36 states rights to a share of Nigeria's oil revenues. Traditionally, the Federal Government has used the funds in the Excess Crude Account (ECA) to 'buy' political support from key states. This system is unlikely to change, but at the moment the ECA is running very low (about USD 2bn). For this reason, it matters a great deal that the election outcome produces a clear winner – strong political capital vested in the president means that less money has to be paid to the states in exchange for political support.

The role of the central bank

The monetary policy committee of the Central Bank of Nigeria (CBN) has maintained a neutral role in the run-up to the election. It has sold reserves to keep the NGN flat at around 200 to the USD, while interest rates have been maintained at 13%. With FX implied yields closer to 30% and liquidity in the FX markets very low, it is clear that Nigeria needs both higher rates and a weaker NGN. It is crucial to get the election out of the way to pave the way for the CBN to obtain space to do what is necessary, particularly on the FX side.

[1] The quintessential Nigerian distribution problem, weekly research 1 December 2014.

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A rationed FX market

Most FX trading is now happening via central bank auctions. Local corporate demand for USD exceeds the available supply. The CBN has changed the rules governing FX trading more than a dozen times in less than a year. For these reasons, Nigerian local currency markets have become tougher to trade due to the de facto rationing of FX. Liquidity is very low.

If this situation does not change the risk is that Nigeria's domestic bond market will be excluded from the main EM local currency government debt benchmark index (JP Morgan's GBI EM GD index). JP Morgan has already issued a warning to this end on the grounds that the bank feels that investors are struggling to replicate the index.

If Nigeria was to drop out of the GBI EM GD index a large section of the investor base – including passive buyers – would also disappear, resulting in even lower market liquidity. Active managers' positions would become off-benchmark bets rather over or underweights relative to the index, requiring greater conviction. Net net, the demand for Nigerian assets would fall and the government would face higher yields and an even weaker currency.

Our view

The economy requires further adjustment, which will likely occur via additional weakening of the NGN. This makes local assets unattractive at current yields (14%-16% yield across the local curve). However, we expect that the government will allow the currency to adjust once the election is out of the way at which point local securities become attractive. As for sovereign credit, Nigeria's sovereign blended spread is now just shy of 500bps. Given Nigeria's low debt burden, external debt may become interesting provided that the government commits to adjustment after the election.

Risks

What are the risks to this outlook? Oil prices always matter to Nigeria. Beyond oil prices, there is a risk that the election is irregular, resulting in an upsurge in political noise. Also, if the government fails to recognise the need for adjustment the macroeconomic challenges will only grow larger. On the other hand, we tend to assign less weight to Boko Haram and other security related problems. Boko Haram is a major problem in parts of Nigeria, but it is not a problem that has typically impacted the valuations of securities held by foreign investors, local banks and pension funds.

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