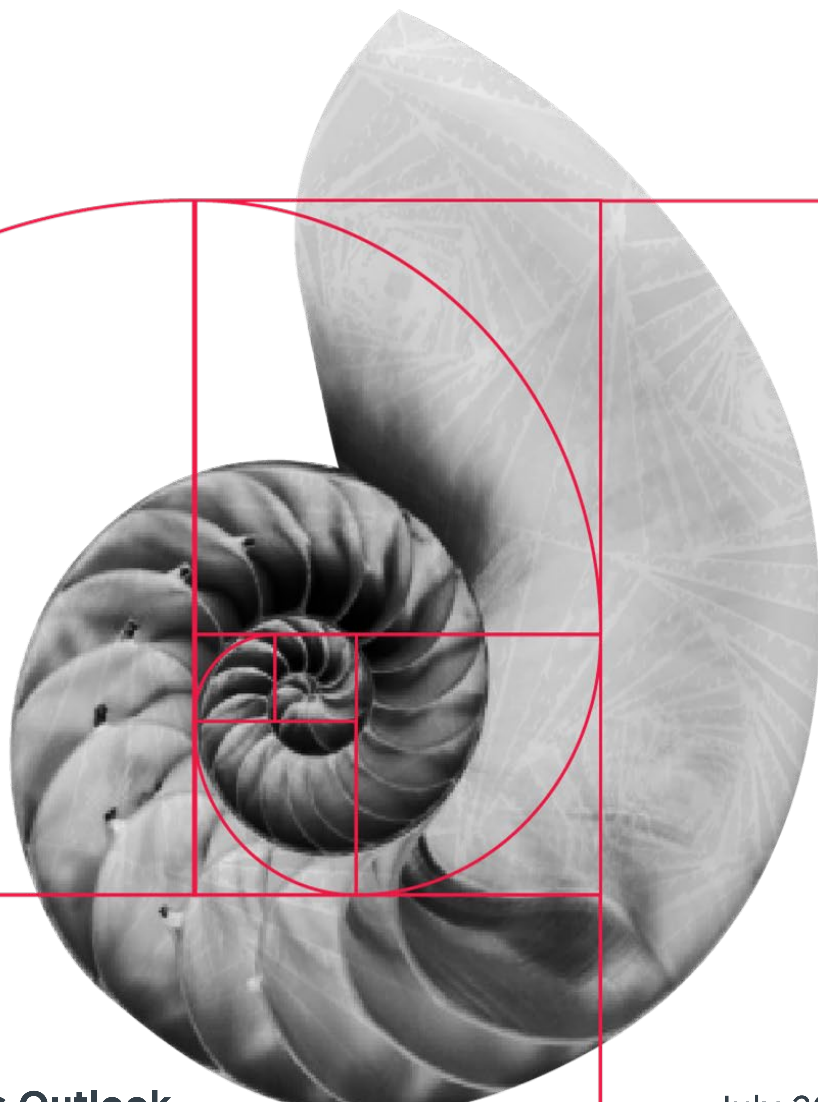
Veering from the Watershed Point.



H2-23 Macroeconomic Outlook
Domestic Economy

July 2023

Executive Summary.

Domestic economic activities were in a lull in Q1-23, primarily driven by the impact of the CBN's naira redesign drive amid existing challenges, such as increased production costs exacerbated by high energy prices and elevated borrowing costs. However, the transition phase ushered in by the general elections brought about cautious optimism on medium-term economic prospects, especially as the new administration set the ground running with long-awaited reforms. Notably, President Tinubu signed a new Electricity Act, authorising states, companies, and individuals to generate, transmit and distribute electricity, thus repealing the Electric Power Sector Reform Act (EPSRA) of 2005. Following the PMS scarcity associated with the President's announcement in his inaugural address, the NNPCL announced new PMS prices from 31 May, effectively removing PMS subsidies. Simultaneously, the CBN announced the abolishment of its multiple FX windows on 14 June, collapsing all the official FX segments into the Investors & Exporters Window (IEW).

We expect the policy reforms from PMS subsidy and FX liberalisation to be painful for households and businesses in the short term based on an anticipated squeeze in consumer wallets and increased production costs. Besides, looking at the GDP by output approach, we estimate the domestic economy to grow by 2.92% y/y in 2023FY relative to the 3.10% y/y growth recorded in 2022FY, supported by the oil sector returning to growth and the telecommunications and finance sub-sectors supporting the non-oil sector's growth.

While the lingering factors stoking domestic prices remain intact, the recent fuel and FX reforms constitute new triggers to push prices upwards in H2-23. Notably, PMS prices have adjusted upwards by *c.* 175.0%, with further increases in sight as FX liberalisation induced the exchange rate to trade between NGN660.00 – NGN750.00/USD. Consequently, consumers have no respite in sight as increased price pressures are expected to squeeze consumer wallets further, potentially reducing consumption. Overall, we project the headline inflation to average 25.11% y/y over 2023FY (2022FY: 18.77% y/y) and 29.23% y/y by year-end (December 2022: 21.34% y/y) based on our base case.

On the currency, while we view the CBN's FX liberalisation as positive in boosting foreign investor's confidence, we think they may adopt a wait-and-see approach, for now, looking for signals on the CBN's plans for clearing the FX backlogs and boosting FX supply to support the market in the near term. Besides, we suspect that due to the previous lessons learnt from the damaging currency controls of the prior administration, investors will be on the lookout for signs that there are no counter policies to prevent them from leaving at any point in the near term before returning to the market in their droves.

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Given that the end of rate hikes by systemic global central banks is in sight amid sticky domestic inflation, we think the MPC will tread cautiously at subsequent policy meetings. Thus, we suspect the dilemma will remain whether to keep hiking policy rates less aggressively or keep the policy parameters constant. However, at this stage, continuous increases in the MPR at a time when supply-side factors are the dominant upside risk to near-term price pressures will undermine economic growth. On a balance of factors, while our baseline view is for the MPC to adopt a HOLD stance at subsequent meetings over H2-23, we do not rule out a 25bps – 50bps hike at the July policy meeting.

Government reforms and policies are expected to reap benefits in the medium-to-long term if they are maintained. However, we see limited upsides for oil revenue in the short term, and the public debt profile is likely to balloon in 2023FY on the impact of naira depreciation on external debt outstanding. Nonetheless, while we expect revenue to increase in 2023FY relative to 2022FY levels, we anticipate a corresponding increase in aggregate expenditure. Accordingly, we expect the fiscal deficit to remain high, to be funded majorly from domestic sources and CBN's Ways & Means advances, as we do not expect the government to access the Eurobond market given the elevated global interest rates.

Contents.

Growth.

Q1-23 GDP: Cash Shortages Ease Domestic Growth Momentum

Although the Nigerian economy maintained its positive growth trajectory in Q1-23, the growth momentum slowed compared to the prior quarter, settling lower at 2.31% y/y (Q4-22: 3.52% y/y). We attribute the slow growth primarily to the adverse effect of the cash scarcity on the informal sector, which was induced by the CBN's naira redesign drive. Indeed, data from the World Bank in 2018 revealed that the informal sector contributes 48.2% to Nigeria's GDP. Away from the cash crunch, the growth in Q1-23 was pressured by the impact of the election uncertainties and lingering increases in production costs. Consequently, the breakdown provided showed that the Non-oil sector grew slower by 2.77% y/y (Q4-22: +4.44% y/y), while the Oil sector contracted moderately by 4.21% y/y (Q4-22: -13.38% y/y).

Figure 1: Nigeria's real GDP growth

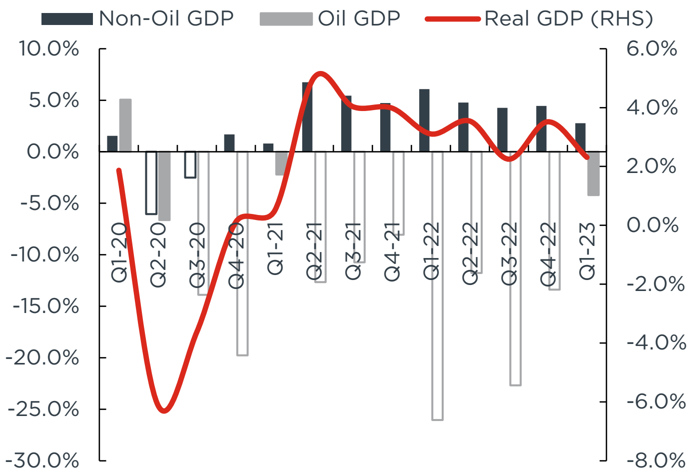
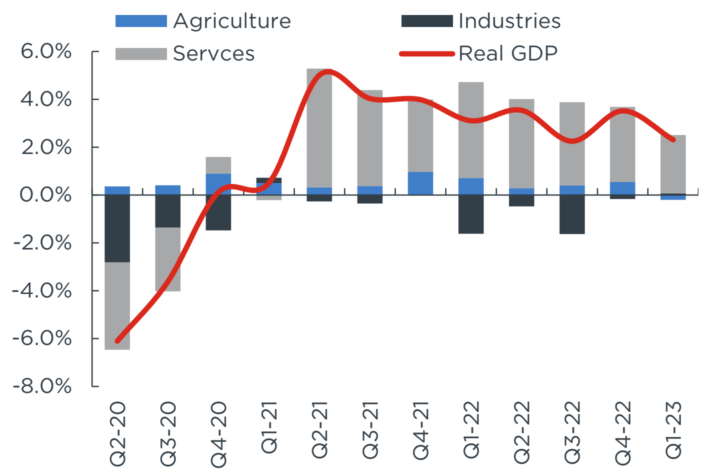


Figure 2: Contribution to real GDP growth



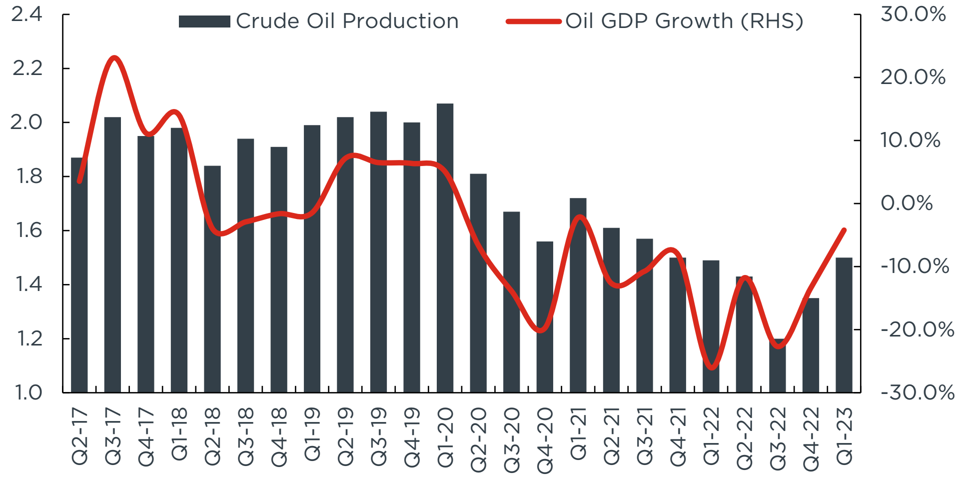
Source: NBS, Cordros Research

Oil Sector Still in the Woods Despite Higher Crude Oil Production

The growth of the Oil sector remained negative in Q1-23, although we note that the decline (-4.21% y/y) was an improvement from the -13.38% y/y contraction recorded in Q4-22. In line with our expectations, the moderate contraction was bolstered by higher crude oil production, which settled at 1.51mb/d in the review period (Q4-22: 1.34mb/d | Q1-22: 1.49mb/d). Remarkably, Nigeria's crude oil production has maintained a steady uptrend since reaching its lowest level in September 2022 (1.14mb/d). The improved oil production is largely supported by the positive impact of the government's recent efforts to curb crude oil theft and vandalism in the upstream segment of the oil sector. Our analysis of the data from the Nigerian Upstream Regulatory Commission (NUPRC) showed that crude oil production increased across the Escravos (+24.4% y/y), Odudu (+44.8% y/y), and

Bonga (+23.1% y/y) production terminals, while it declined modestly at the Forcados (-1.9% y/y) terminal.

Figure 3: Crude production vs oil GDP growth

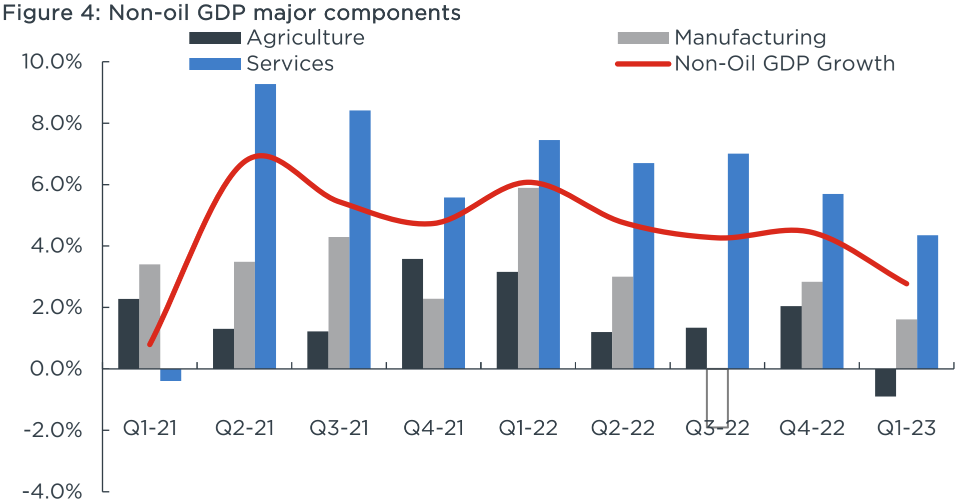


Source: NNPC, NBS, Cordros Research

CBN Naira Redesign Initiative Weighed on Non-Oil Sector

The non-oil sector grew slower by 2.77% y/y relative to 4.44% y/y in Q4-22 – the lowest print since Q1-21 (+0.79% y/y) –, largely driven by the (i) cash crunch experienced in Q1-23, and (ii) lingering increase in production costs worsened by exchange rate pressures and elevated borrowing costs amid high domestic inflation. Although the main drivers of the Non-oil sector's growth were the ICT (+10.32% y/y vs Q4-22: +10.35% y/y) and finance & insurance (+21.37% y/y vs Q4-22: +11.61%y/y) sectors, we highlight that the slower growth in trade (+1.31% y/y vs Q4-22: +4.54% y/y), and manufacturing (1.61% y/y vs Q4-22: +2.83% y/y) combined with a decline in Agriculture (-0.90% y/y vs Q4-22: +2.05% y/y) GDP dragged the Non-oil sector overall performance in Q1-23.

Figure 4: Non-oil GDP major components

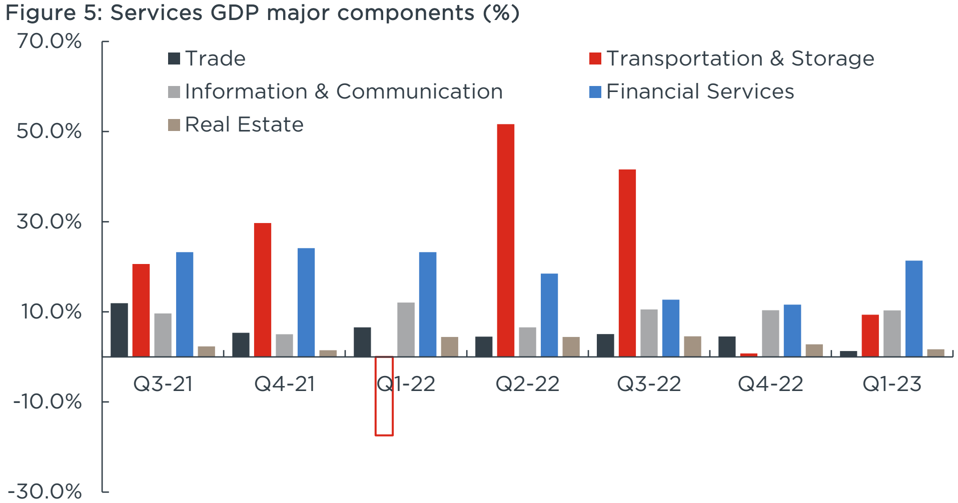


Source: NBS, Cordros Research

Financial Services & ICT Sectors Support the Services GDP Growth

Despite the base-effects induced slowdown in the Services sector (+4.35% y/y vs Q4-22: +5.69% y/y), the sector remains the main broad driver of the economy. The preceding is underpinned by sustained growth in the financial & insurance and ICT sectors amid slow growth in the trade subsector. Notably, the financial & insurance subsector grew significantly by 21.4% y/y (vs +11.6% y/y in Q4-22) against the backdrop of the increased e-banking transactions consummated in the review period due to the CBN's currency redesign drive. In the same vein, the ICT sector maintained its sturdy growth in Q1-23, supported by the twin impact of increased subscribers and higher data traffic influenced by the increased adoption of electronic payments in the review period. For instance, MTN Nigeria's (*c.*40.5% market share as of March 2023) subscriber base grew to its highest level (76.70 million subscribers) since the commencement of operations in 2001 and recorded 50.3% y/y growth in data traffic in Q1-23. On the flip side, the slow growth recorded in the trade sector (+1.31% y/y) was driven by the informal sector's inability to access adequate cash to drive sales in the period.

Figure 5: Services GDP major components (%)



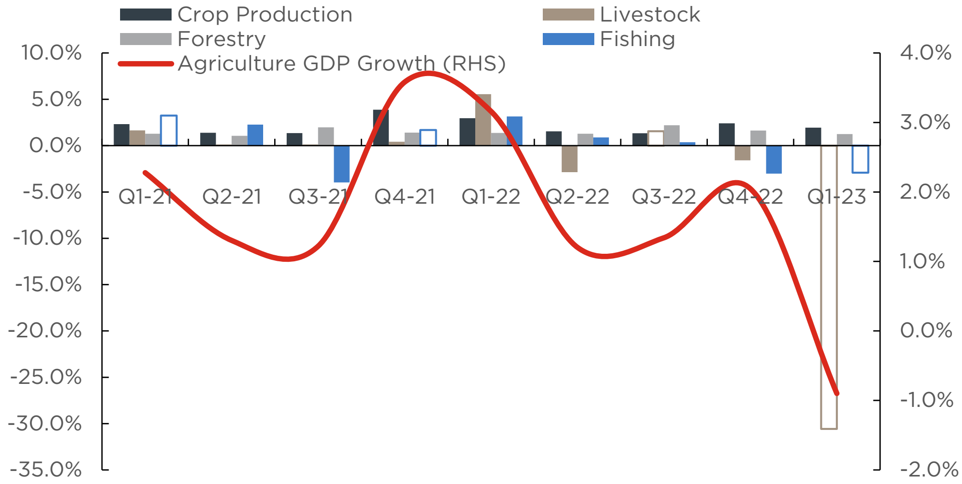
Source: NBS, Cordros Research

Agricultural Sector Recorded its First Contraction on Record

Given the dominance of the informal sector in the agriculture sector (91.9% of the GDP as of 2015), it was not surprising that the sector recorded its first decline since at least 1987 (annual GDP: -3.2% y/y). Precisely, the Agriculture sector contracted by 0.90% y/y in Q1-23 (Q4-22: +2.05% y/y), reflective of the underwhelming demand and disruptions to supply conditions brought about by the CBN's naira redesign initiative. Aside from the aforementioned, we note that the following challenges - (i) below-average cultivation activities, worsened by the persistent conflicts in the food-producing region, and (ii) higher input prices – exerted pressure on the sector's performance in the review period. Subsequently, across the sub-sectors, we highlight that crop production (+1.93%

y/y vs Q4-22: +2.41% y/y) and forestry (+1.24% y/y vs Q4-22: +1.63% y/y) grew, albeit slower during the review period. On the other hand, the livestock (-30.57% y/y vs Q4-22: -1.59% y/y) sub-sector recorded its most significant decline since the NBS started keeping the current data series, while fishing (-2.92% y/y vs Q4-22: -3.02% y/y) experienced a moderate decline.

Figure 6: Agriculture GDP growth breakdown

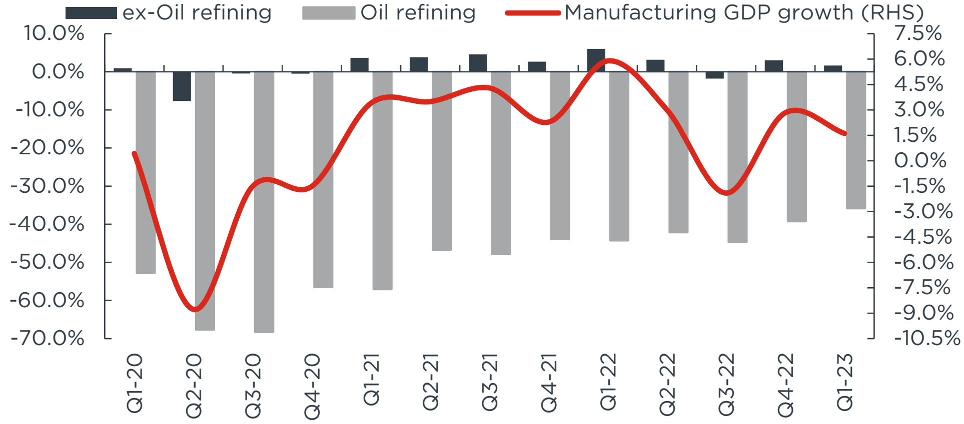


Source: NBS, Cordros Research

Production Costs & Cash Scarcity Drag Manufacturing Sector Growth

The manufacturing sector was not immune to the impact of the stifled domestic spending induced by the cash shortages, as the sector's growth eased to +1.61% y/y in Q1-23 relative to +2.83% y/y in Q4-22. In addition, we highlight that (i) elevated production costs, (ii) depressed consumer demand worsened by heightened inflationary pressures, (iii) currency pressures, and (iv) electioneering activities contributed to the sector's slim growth. Accordingly, growth moderated across the cement (+1.58% y/y vs Q4-22: +3.89% y/y) and food & beverages (+3.90% y/y vs Q4-22: +4.94% y/y) subsectors, while it declined further in the textile & footwear (-3.68% y/y vs Q4-22: -1.17% y/y) subsector. Elsewhere, oil refining maintained its downward trend (-35.84% y/y vs Q4-22: -44.70% y/y) for the 17th consecutive quarter, reflecting the weak capacity of modular refineries and as the main refineries remained non-operational due to poor maintenance.

Figure 7: Manufacturing GDP breakdown



Source: NBS, Cordros Research

Outlook: Both the Oil & Non-Oil Sectors to Support GDP in 2023FY

Given that economic activities have normalised after the negative impact of cash scarcity in Q1-23, we revise our 2023 full-year estimate higher to 2.92% y/y (previously: +2.77% y/y). Our forecast is also hinged on the sustained improvement in crude oil production and the absence of major shocks to the domestic economy amid the relatively positive sentiments surrounding the present administration. Notwithstanding, we believe the following underlying factors will undermine the economy's growth in 2023FY relative to 2022FY: (i) high production costs exacerbated by elevated borrowing costs, (ii) an increase in taxes in line with 2023 Fiscal Policy Measures (FPM), (iii) depressed demand supported by the highly inflationary environment, and (iv) initial impact of currency pressures given the FX market's liberalisation. Notably, we expect the Agriculture, trade, real estate and manufacturing sectors to bear the brunt of these impacts. **Overall, we expect the economic growth to settle at 2.92% y/y in 2023FY (2022FY: +3.10% y/y).**

Figure 8: GDP growth projection

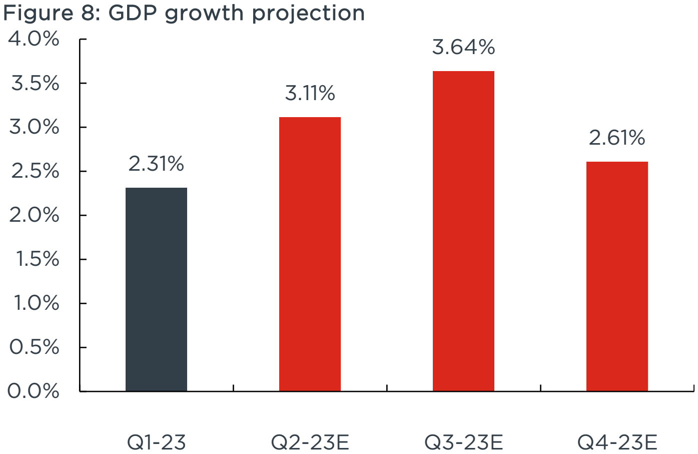
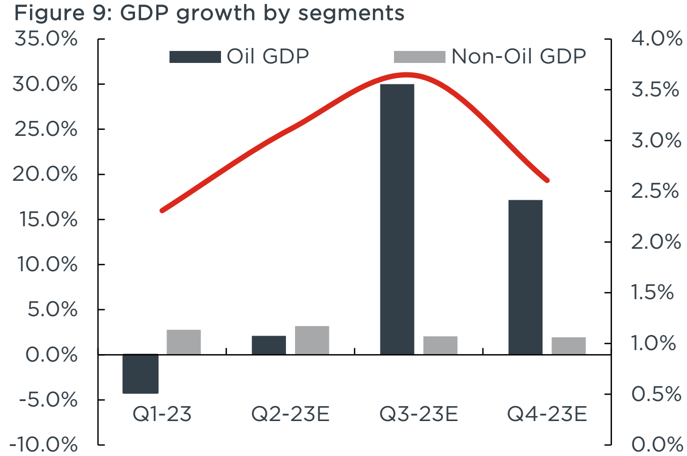


Figure 9: GDP growth by segments



Source: NBS, Cordros Research estimates

Positive Outlook in the Oil Sector as Crude Oil Production Improves

Although oil production declined in April 2023 (-18.0% m/m) due to strike-induced shutdowns at a few oil terminals, we still expect crude oil production (including condensates) to average 1.53mb/d, higher than the 2022FY production volume (1.37 mb/d), especially as NNPCL has intervened to resolve the disputes. The Nigerian government's relentless efforts to eradicate oil theft and major pipeline vandalism support our expectation for higher crude oil production. Besides, the Federal Government recently signed the Nigeria Upstream Petroleum Measurement Regulations, 2023, and six others into law to tackle inaccurate measurements. We also believe that the reopening of major oil terminals that were shut down for most of 2022, will support higher crude oil production. That said, we estimate that the production level for 2023FY will be significantly below pre-pandemic levels (c.2.10mb/d) and Nigeria's current OPEC crude oil production quota (1.74mb/d), highlighting other factors limiting crude oil production, including, (i) lagging impact of ageing infrastructure, (ii) limited investment inflows, and (iii) International Oil Companies (IOCs) divestments away to cleaner energy amid a challenging operating environment. Indeed, given the continued reduction in Nigeria's actual crude oil production, the country's 2024 oil production quota was reduced to 1.38mb/d at the last OPEC+ meeting held on 04 June 2023. **Overall, we expect the Oil sector growth to return to positive territory in the short-to-medium term, with a growth estimate of 10.72% y/y in 2023FY (2022FY: -19.22% y/y).**

Figure 10: Crude oil benchmark prices (USD/bbl.)

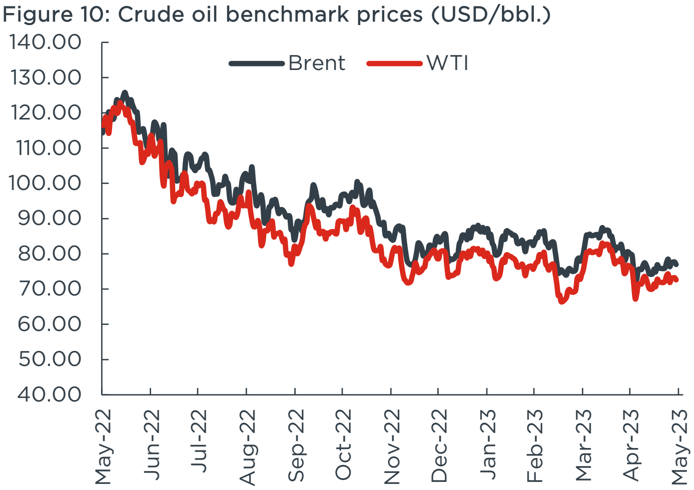
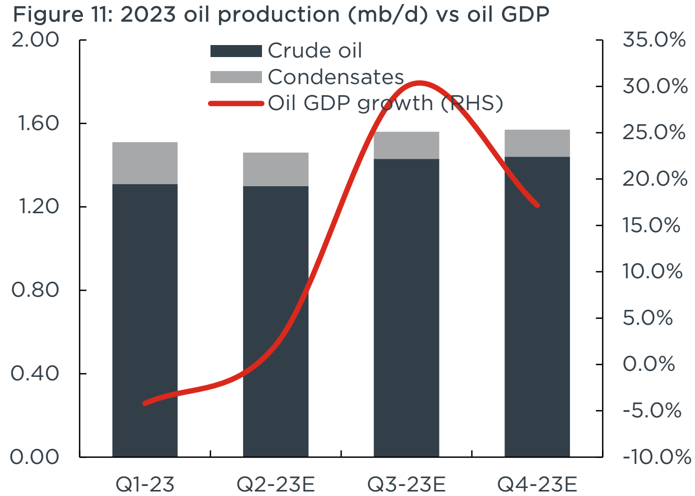


Figure 11: 2023 oil production (mb/d) vs oil GDP

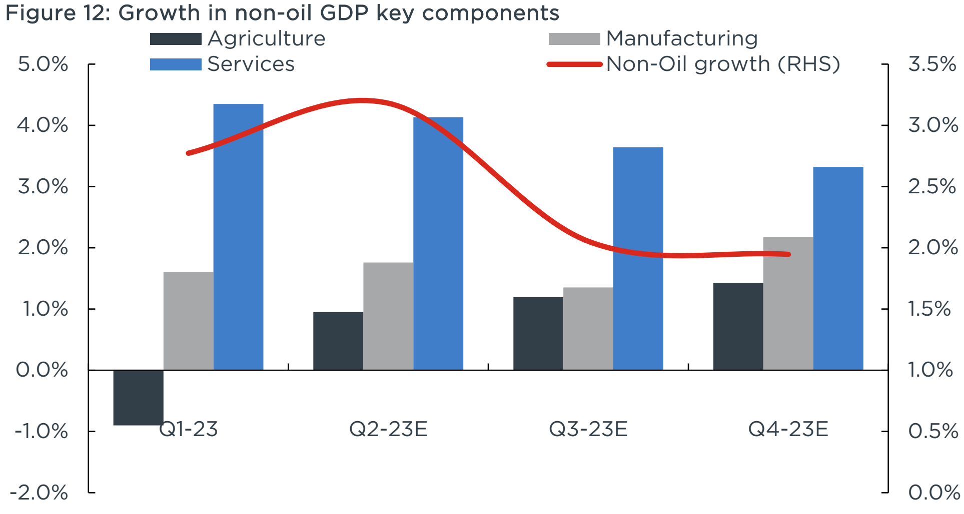


Source: Bloomberg, NBS, Cordros Research estimates

Non-Oil Sector's Growth to Ease

Barring any significant shocks in the economy, our outlook on the non-oil sector for H2-23 is focused on the recovery in the informal sector from the cash shortages experienced in Q1-23. In line with historical trends, we expect the Services sector to continue to support the overall non-oil sector's growth, primarily supported by the immense contribution from the telecommunications and financial services subsectors. Simultaneously, we expect the manufacturing and Agriculture sectors to be hampered by elevated production costs and unfavourable climate conditions. **Therefore, on a balance of factors, we expect non-oil GDP to grow by 2.45% y/y in 2023FY (2022FY: +4.84% y/y).**

Figure 12: Growth in non-oil GDP key components



Source: NBS, Cordros Research estimates

Services Sector to Maintain Solid Growth Path, Albeit Slowly

We expect the ICT subsector to maintain its growth trend over 2023FY, buoyed by solid voice and data traffic growth across telecommunications companies. Most recently, telco's Payments Service Banks (PSBs) have gained traction, given the increasing need for digital banking platforms. For context, MTNN's PSB (MOMO) active wallet rose to 3.2 million in Q1-23 (Q4-22: 2.0 million). Additionally, we believe the sustained rollout and adoption of 4G and 5G networks will support the telecommunication subsector's growth in the short-to-medium term. Nonetheless, we see a potential risk of higher taxes in the telecommunication sector in line with the 2023 Fiscal Policy Measures (FPM). Notably, the government has imposed a 5.0% excise duty on mobile telephone services (GSM), fixed telephone and internet services, both post-paid and prepaid. Elsewhere, we expect improved private spending on capital projects to generate a positive spillover effect in the real estate subsector, particularly as the initial election uncertainties have faded. At the same time, we believe the smoothening out of cash shortages should buoy the trade sector's performance. Also, we believe low consumer disposable income, high cost of building materials, and low public spending on capital projects pose downside risks to the real estate, cement and construction subsectors. **Overall, we now expect the Services GDP to grow by 3.83% y/y (vs +6.66% y/y in 2022FY) amid the high statistical base effects from the prior year.**

Figure 13: ICT and Services GDP growth

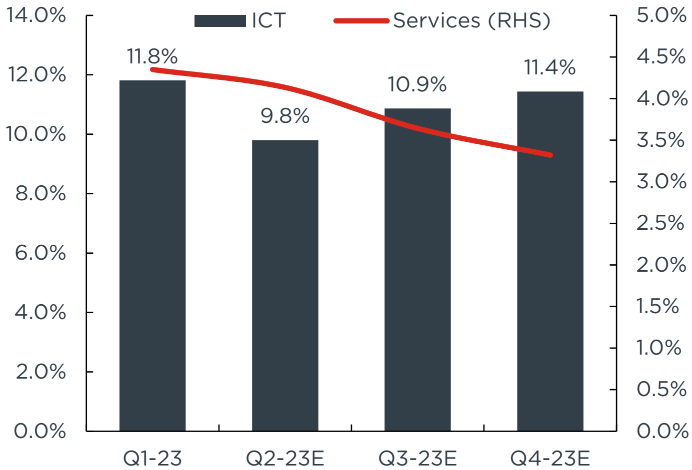
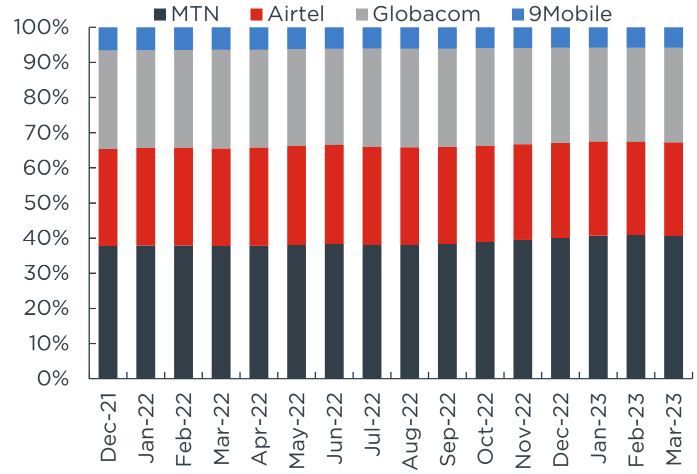


Figure 14: Telecoms market share (par subscribers)



Source: NCC, NBS, Cordros Research estimates

Higher Taxes Mounts Fresh Pressures on Manufacturing Sector Growth

Despite the easing of the cash scarcity witnessed in Q1-23, we still expect the manufacturing sector to remain under pressure over the rest of 2023. Aside from the already existing factors - (i) high input costs, (ii) cumulative increase in interest rates leading to elevated borrowing costs, and (iii) lingering FX liquidity constraints – we believe the higher taxes in line with the 2023 FPM will mount further pressures on the sector's output. Notably, key taxes in the 2023 FPM that will impact the manufacturing sectors include (i) the introduction of a 10.0% green tax on Single Use of Plastics (SUPs) and (ii) an additional excise tax on alcoholic beverages, tobacco, wines, and spirits. **Overall, we expect the manufacturing sector to grow slower by 1.73% y/y in 2023FY, relative to the 2.45% growth in 2022FY.**

Figure 15: Manufacturing GDP growth

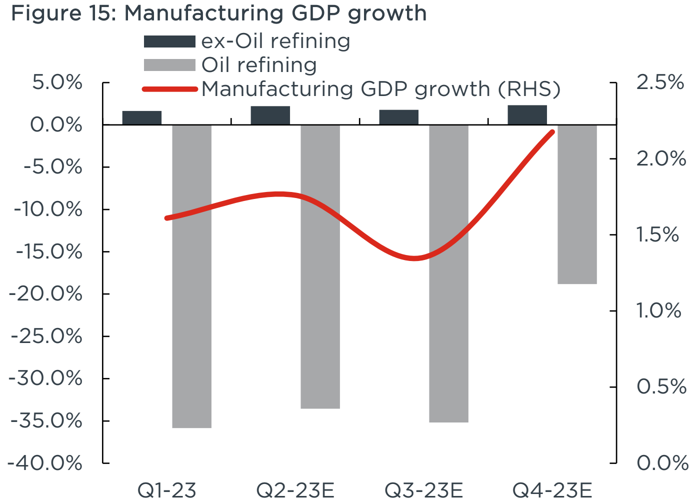
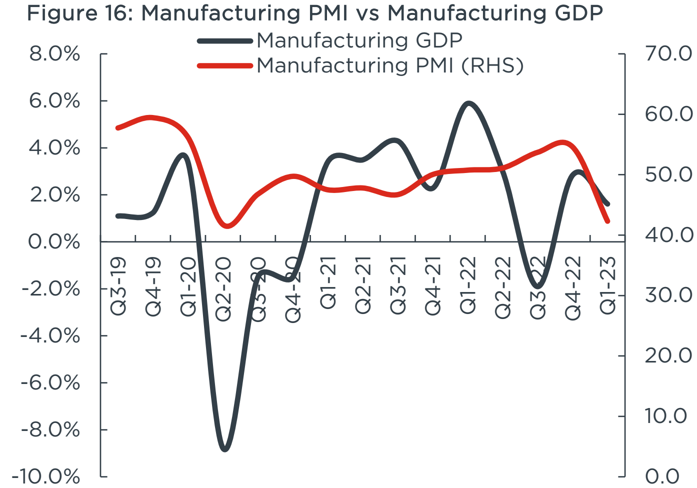


Figure 16: Manufacturing PMI vs Manufacturing GDP

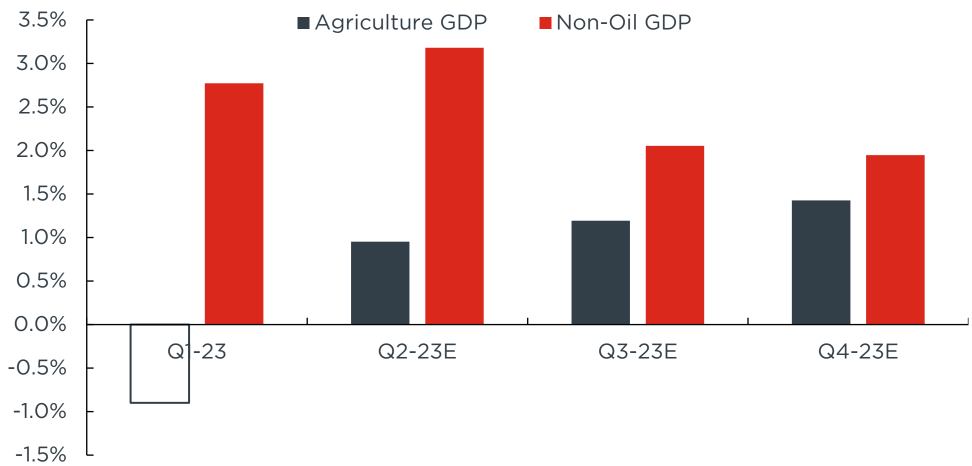


Source: NBS, CBN, Cordros Research estimates

Low Agriculture Output Expected in 2023FY

Relative to historical averages (2017-2022: 2.35%), we envisage Agricultural GDP to remain sub-optimal in 2023FY driven by challenges which include (i) lower food supply buoyed by below-historical average cultivation activities, (ii) persisting conflict in food-producing areas, (iii) higher input prices worsened by increased fertiliser prices, (iv) unfavourable weather conditions, and (v) depressed demand in line with the highly inflationary environment. Based on our estimates, we believe that the decline experienced in Q1-23 and the underlying challenges in the sector will drag the overall performance of the Agricultural sector in 2023FY. **All told, we estimate a slower growth of 0.79% y/y in the Agriculture Sector relative to the 2022FY level (+1.88% y/y).**

Figure 17: Agriculture and non-oil GDP growth



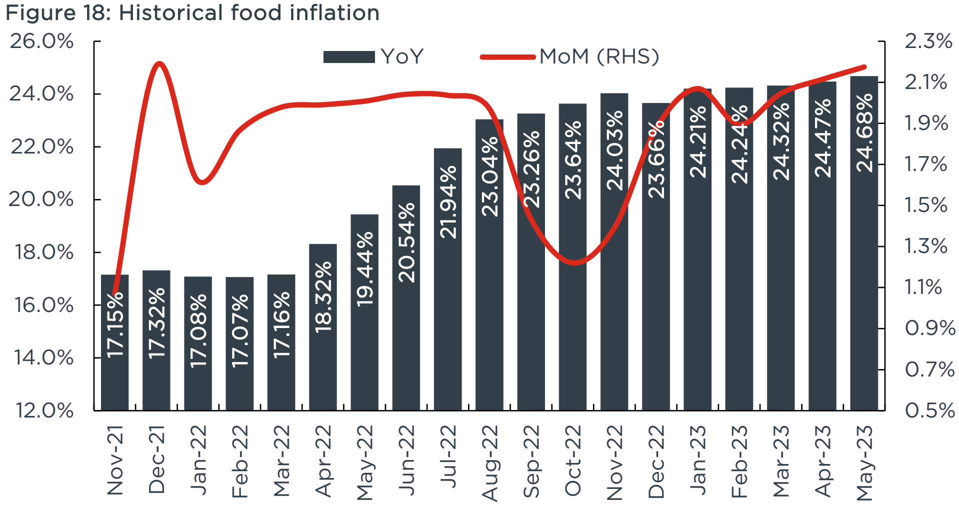
Source: NBS, Cordros Research estimates

Inflation.

High Food & Transport Costs Exert Upward Pressures on Prices

In our 2023FY outlook report, we highlighted that domestic prices would remain elevated through 2023FY, given the combined effects of (i) soaring energy costs, (ii) persistent local currency pressures, (iii) electricity tariff hikes, and (iv) flood incidents on food prices. In line with our expectations, headline inflation accelerated through the first five months of 2023 (+107bps vs 5M-22: +209bps) with significant pressures across the food (+107bps vs 5M-22: +213bps) and the non-food (+157bps vs 5M-22: +102bps) baskets. Notably, food inflation increased to a 17-year high, settling at 24.82% y/y as of May, due to several factors, including (i) lingering passthrough impact of increased transport costs triggered by the intermittent PMS scarcity, (ii) festive-induced higher demand associated with Ramadan and Easter celebrations, (iii) below-average harvest season in 2022 induced by flooding incidents, and (iv) underwhelming cultivation activities due to persistent conflicts in the northern region and high input prices. Accordingly, prices increased across the Processed Food (+120bps), Imported Food (+38bps), and Farm Produce (+62bps) sub-baskets in 5M-23.

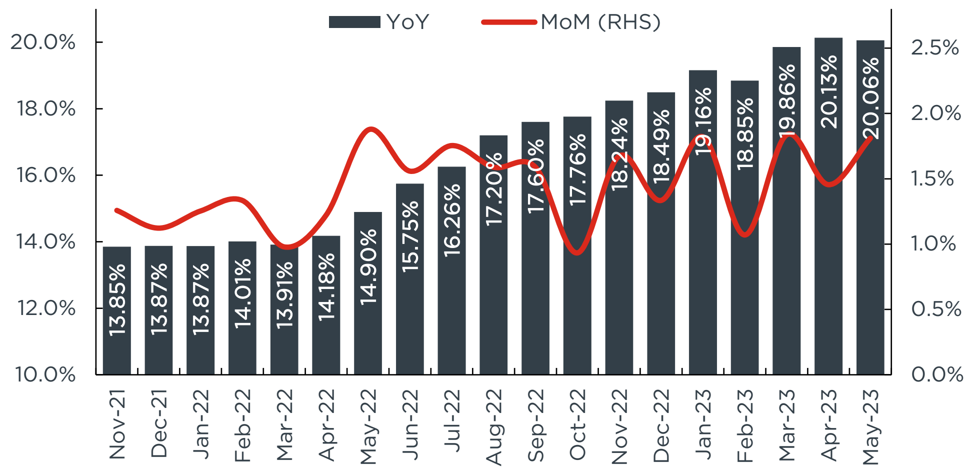
Figure 18: Historical food inflation



Source: NBS, Cordros Research

The volatility in the core basket in 5M-23 was majorly driven by the significant pressures across the Transportation (+371bps vs 5M-22: +134bps), Education (+264bps vs 5M-22: +207bps), and Utilities (+80bps vs 5M-22: +277bps) sub baskets. Notably, given the strong correlation (0.78) between the price of PMS and the cost of transportation, we are not surprised that Transportation prices (23.87% y/y as of May 2023) trended towards the highest level since the NBS started keeping the current data series. Likewise, the Utility sub-basket (+18.31% y/y as of May 2023) rose to its highest level since March 2017 (+18.85% y/y), reflecting the surge in the prices of cooking gas (+22.1% y/y to NGN928.45/KG) and diesel (+28.69% y/y to NGN842.25/litre) in the review period. Aside from the erstwhile mentioned, we believe the electioneering spending and lingering FX challenges contributed to the pressures in the core basket in 5M-23.

Figure 19: Historical core inflation



Source: NBS, Cordros Research

Headline Inflation to Remain Upward in 2023FY

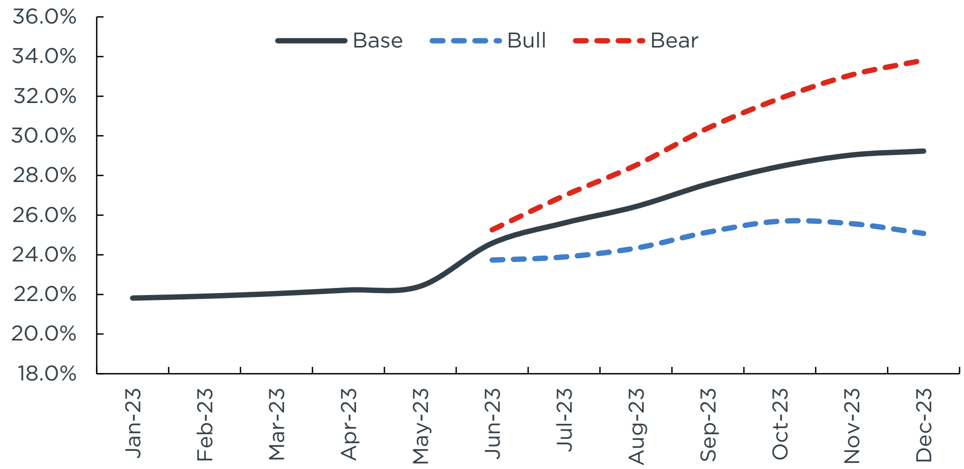
We expect the headline inflation to remain elevated till the end of 2023FY, driven by a combination of the following existing factors: food shortages, high energy costs, and currency pressures amid the recent abolishment of multiple FX windows. Aside from these factors, we believe that the new taxes and excise duties, in line with the 2023 Fiscal Policy Measures (FPM) and 2022 Finance Act, will mount fresh pressures on domestic prices over the projection period. Finally, the 174.6% average increase in PMS prices since 31 May, in line with current market realities, is also expected to pose a new risk that could stoke upward price pressures over H2-23.

Casting our spotlight on the components of headline inflation, we expect food prices to remain high over H2-23. Our forecast is hinged on the following factors: (i) below-average cultivation activities, (ii) passthrough effects of high transport costs on food prices, (iii) extreme weather conditions, and (iv) lingering insecurities in the food-producing regions. In addition, we highlight that fears surrounding Russia pulling out of the Black Sea Grain Deal pose a significant upside risk to global food prices, potentially exerting upward pressure on the imported food sub-basket.

Our outlook on core inflation is centred around persistent high fuel costs, FX challenges and higher electricity tariffs as the FGN continues to implement increases in electricity costs. In proper context, prices are expected to increase over H2-23, as the adjustment to gasoline prices in line with market realities has seen PMS prices average NGN526.70/litre (previously: NGN191.84/litre). Moreover, lingering currency pressures amid the liberalisation of the FX market are also expected to negatively impact the core inflation sub-basket. Given that the official market is currently in its price discovery phase, we highlight that the naira is trading between NGN680.00/USD – NGN780.00/USD at the official FX market. Besides, given the currency depreciation and high inflation, electricity tariffs may increase in line with the Multi-Year Tariff Order (MYTO). Thus, we factor a 15.0% increase in electricity tariff in our base case scenario. Furthermore, we expect the effects of increased taxes in line with the 2023 Finance Act and the newly amended Fiscal Policy Measures (FPM) to stir up pressure on the core basket.

Tying all together, we expect headline inflation to settle at an average of 25.11% y/y over 2023FY (2022FY: 18.77% y/y) and 29.23% y/y by year-end (December 2022: 21.34% y/y) based on our base case.

Figure 20: Headline inflation (y/y) scenarios



Source: NBS, Cordros Research estimates

Bull case: In this scenario, we assume that market dynamics influence PMS prices to settle between NGN430.00/litre – NGN480.00/litre and electricity prices to remain at current levels. Besides that, our optimistic case assumes the local currency trades between NGN600.00/USD – NGN650.00/USD. Based on the preceding, we expect the headline CPI to average 23.65% y/y over 2023FY and settle at 25.08% y/y by year-end.

Bear case: If we assume (i) PMS sells above NGN550.00/litre, (ii) electricity prices increase above 20.0%, and (iii) currency depreciation above NGN750.00/USD, amid existing factors impacting consumer prices, we expect the headline inflation to average 26.69% y/y over 2023FY and a year-end print of 33.81% y/y.

Balance of Payments.

External Position Improves on Higher Trade Balance

Nigeria's external account returned to a surplus position in Q4-22, as the trade balance surplus grew amidst lower services and income payments. Notably, the Current Account (CA) balance settled at a USD2.35 billion surplus in the review period, relative to a USD2.06 billion deficit in Q3-22. The surplus was primarily driven by an increased trade surplus, a decline in service payments, and a lower income account deficit during the quarter. Precisely, compared to a USD42.04 million deficit in Q3-22, the trade balance returned to a surplus position in Q4-22, settling at USD2.80 billion on account of higher exports (+2.9% q/q) relative to the decline in imports (-17.1% q/q). While the higher exports reflect an increase in crude oil production (+11.7% q/q), we note that imports were lower on account of the (i) persistent FX liquidity challenges and (ii) lower import demand exacerbated by the lingering currency depreciation. Elsewhere, the surplus in the current transfers declined by 9.4% q/q to USD4.95 billion, as lower government remittances outweighed the increases in workers' remittances.

Figure 21: Trade balance (USD billion)

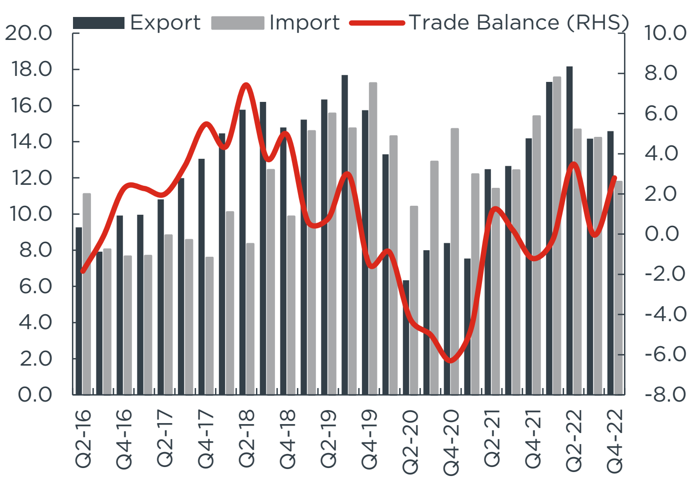
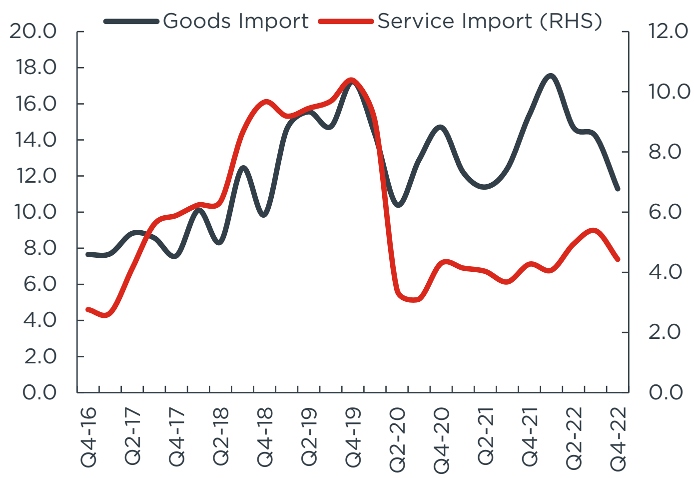


Figure 22: Goods vs Services imports (USD billion)



Source: CBN, Cordros Research

On the other hand, the services account deficit moderated by 22.7% q/q to USD3.13 billion, likely induced by the intermittent disruptions to flight operations, high travel costs, and FX liquidity constraints. Likewise, we note that the primary income balance by 34.0% q/q to USD2.26 billion, primarily in line with lower repatriation of investment income by foreign investors as FX liquidity issues persisted in the review period. **Overall, the Q4-22 data puts the total CA surplus for 2022FY at USD1.02 billion (or 0.2% of GDP) relative to a USD3.25 billion CA deficit (or -0.8% of GDP) in 2021FY.**

Figure 23: Goods, Service, Income, Current transfer (USD billion)

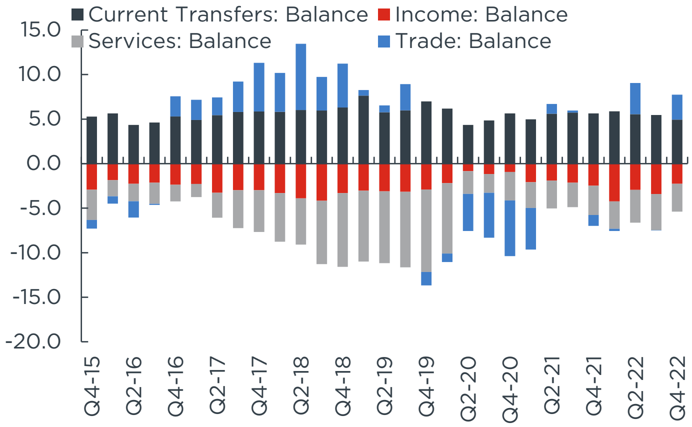
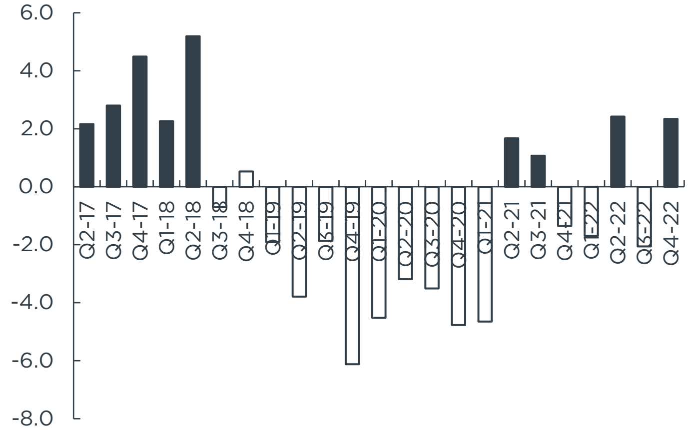


Figure 24: Current Account (USD billion)

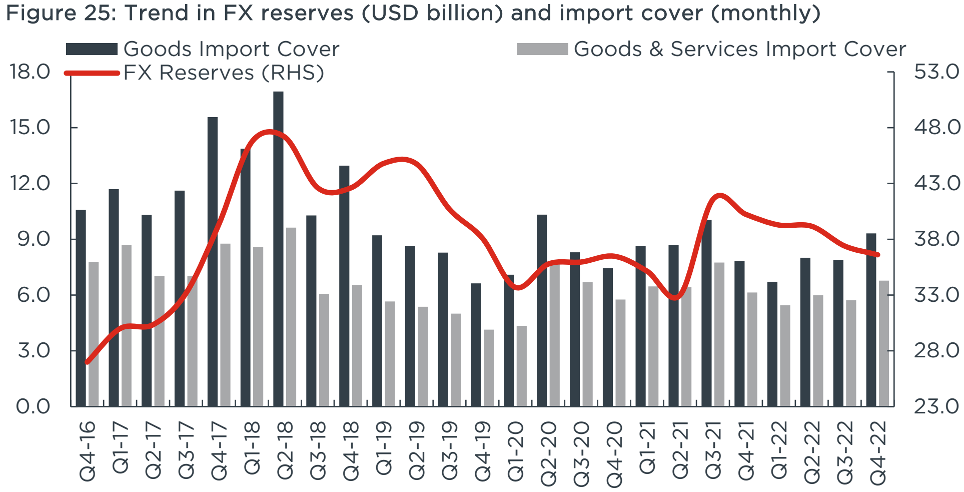


Source: CBN, Cordros Research

Despite the CA surplus, the gross FX reserves declined by 2.1% q/q or USD786.15 billion to USD36.61 billion in Q4-22 (Q3-22: USD37.39 billion). We understand that the depletion aligns with the CBN's intervention at the Investors and Exporters Window (IEW), public sector direct payments, third-party Ministries, Departments & Agencies (MDA) transfers, and Joint Venture cash call payments.

Year-to-date, the gross FX reserves declined by 7.7% or USD2.86 billion to USD34.22 billion as of 26 June, enough to cover approximately six months of goods and services imports. The preceding extends the broader decline trend, which started in August 2022 amid continued interventions by the CBN to support the local currency, albeit slowly. Notwithstanding, we note that the recent trend in gross FX reserves has been weighed by the trifecta impact of (i) subdued oil production relative to pre-pandemic levels, (ii) lingering drop in crude oil prices, and (iii) tight global financing conditions.

Figure 25: Trend in FX reserves (USD billion) and import cover (monthly)



Source: CBN, Cordros Research estimates

CA Surplus to Increase on Account of FX Market Liberalisation

For 2023FY, we projected a CA surplus of USD3.04 billion, as we expect total exports to increase above the 2022 level, while imports are likely to remain constrained by the lingering effects of currency depreciation. Precisely, we forecast crude oil production (including condensates) to rise by 13.4% y/y to 1.55mb/d in 2023FY (2022FY: 1.37mb/d), given the government's recent efforts at tackling crude oil theft and vandalism. Notably, oil and gas exports accounted for c.88.9% of total exports in 2022FY. Asides from that, we expect the liberalisation of the FX market and the associated currency depreciation to spur the growth of non-oil exports in H2-23. Accordingly, our model suggests a 5.1% increase in total exports to USD67.49 billion in 2023FY (2022FY: USD64.23 billion).

Figure 26: Oil vs non-oil exports contribution (%)

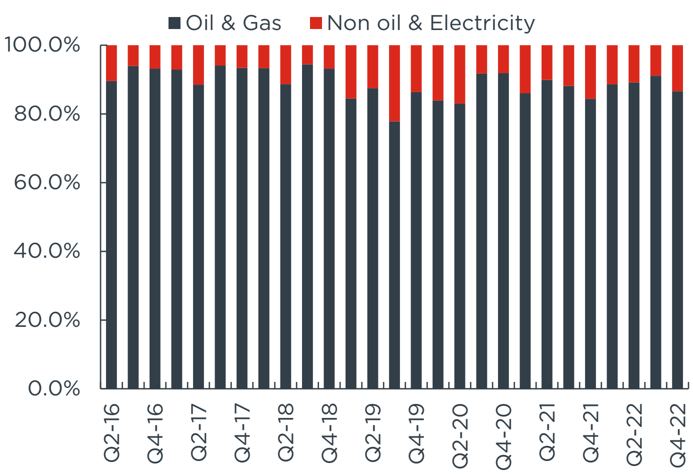
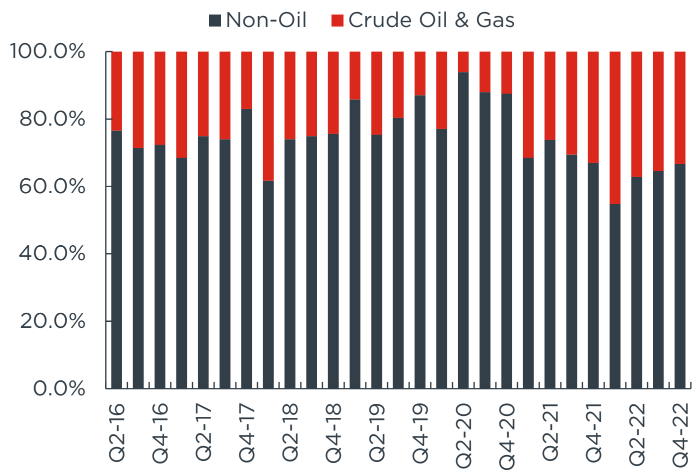


Figure 27: Oil vs non-oil imports contribution

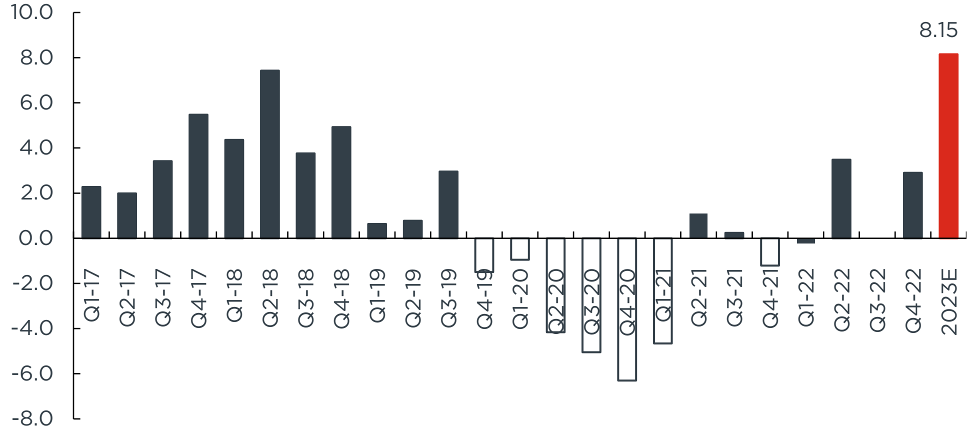


Source: CBN, Cordros Research Estimates

We expect aggregate imports to rise slowly, relative to the prior year, reflective of the moderation in demand exacerbated by (i) lingering currency pressures, (ii) challenges accessing FX, and (iii) elevated inflationary pressures. Besides, we suspect the intermittent PMS scarcity witnessed in Q1-23 will likely have compressed oil & gas imports, partly weighting down 2023FY total imports. Consequently, we forecast a 1.9% y/y increase in imports in 2023FY (2022FY: +13.2% y/y).

Overall, given our estimate of faster growth in exports (+5.1% y/y) compared to imports (+1.9% y/y), we expect the 2023FY trade surplus to settle higher at USD8.15 billion (2022FY: USD6.00 billion).

Figure 28: Trade balance (historical and forecast; USD billion)

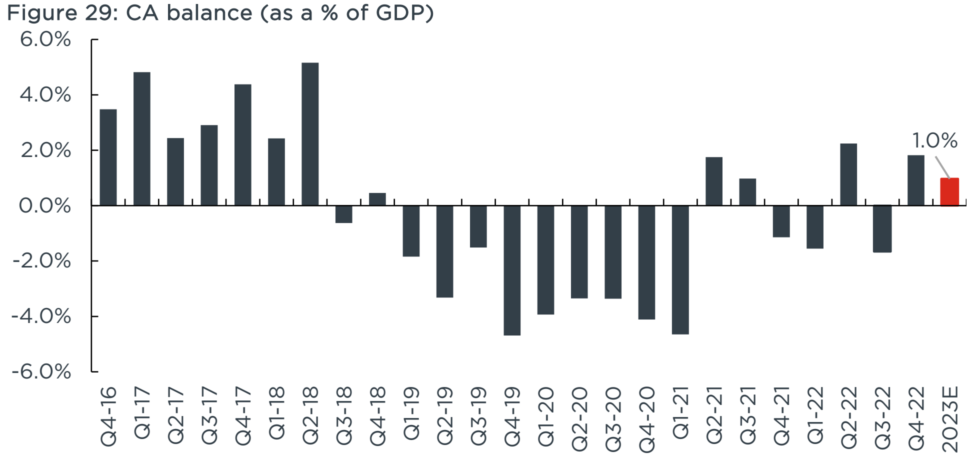


Source: CBN, Cordros Research estimates

In line with our 2023FY outlook, we maintain our expectation of increased global mobility, leading to a rise in service-based transactions. However, FX challenges and intermittent suspension of flights by international carriers would ensure the service account deficit remains significantly below pre-pandemic levels. Accordingly, we expect the services account (net) to increase by 28.3% y/y to USD17.91 billion in 2023FY (2022FY: USD13.96 billion) – 47.0% below pre-pandemic levels (c. USD33.76 billion). Conversely, our model suggests the deficit in the primary income balance will reduce by 13.6% y/y, given the high base effects from the prior year and positive sentiments regarding a relatively pro-market government compared to the previous administration. Concurrently, we expect the surplus in the secondary income balance to increase by 9.5% y/y, in line with the rise in emigration rates and the absence of significant global economic shocks.

On a balance of factors, we now look for the CA surplus to settle higher at USD3.04 billion in 2023FY (2022FY: USD1.02 billion), translating to 1.0% of GDP (nominal) at an effective exchange rate of NGN700.00/USD.

Figure 29: CA balance (as a % of GDP)



Source: CBN, Cordros Research estimates

Capital Importation: Foreign Inflows Remain Underwhelming

Capital importation into Nigeria remains frail as confidence has been eroded, and significant and sustained macroeconomic reforms will be needed to renew foreigners' interests in the country after the pandemic-induced mass exodus in 2020FY. According to the National Bureau of Statistics (NBS), capital importation declined by 51.5% y/y to USD1.06 billion in Q4-22 (Q4-21: USD2.19 billion | Q3-22: USD1.16 billion) – the lowest level since Q2-21 (USD875.62 million). We believe the persistent fall in capital importation reflects foreign investors' lacklustre interest in the country given (i) the weak macro narrative, (ii) an unclear foreign exchange framework, (iii) elevated global interest rates, and (iv) heightened global uncertainties. Accordingly, the breakdown provided showed that there was a broad-based decline across portfolio investments (-55.6% y/y to USD285.26 million), foreign direct investments (-76.5% y/y to USD84.23 million), and other investments (-41.7% q/q to USD691.23 million). On an annual basis, capital importation declined for the third consecutive year, dipping by 20.5% to USD5.33 billion in 2022FY (2021FY: USD6.70 billion) – the lowest annual print since 2016FY (USD5.12 billion).

Asides from a new government being a breather for the country in the short term as sentiments are likely to improve, we think the recent policy pronouncements by the new administration are positive in improving foreign inflows over the medium term. The NNPCL removed the PMS subsidy on 31 May, while the CBN abolished its multiple FX windows on 14 June, collapsing all its various rates into the Investors and Exporters Window (IEW). Aside from that, the President also signified the end of current capital control measures as he assured foreign investors that they would be able to repatriate their profits and dividends easily. Overall, while these actions are positive in boosting foreign investor's confidence, we think they will adopt a wait-and-see approach, for now, looking for signals on the CBN's plans to start clearing the FX backlogs and boosting FX supply to support the market in the near term. Thus, if local FX liquidity improves and investors can easily repatriate their capital, we expect foreign capital inflows to increase over the short-to-medium term.

Figure 30: Capital importation (USD billion)

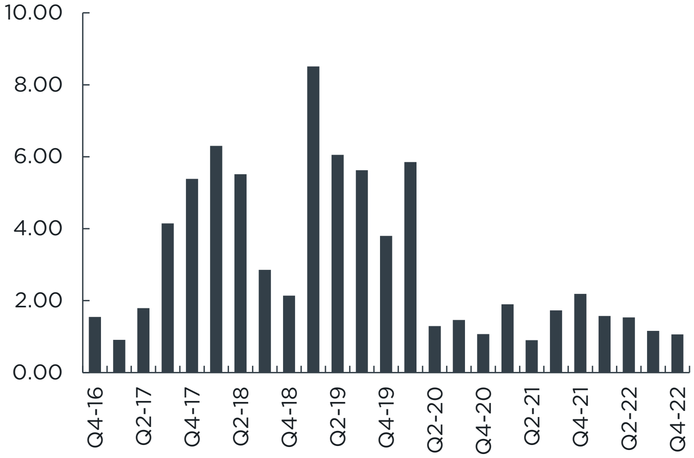
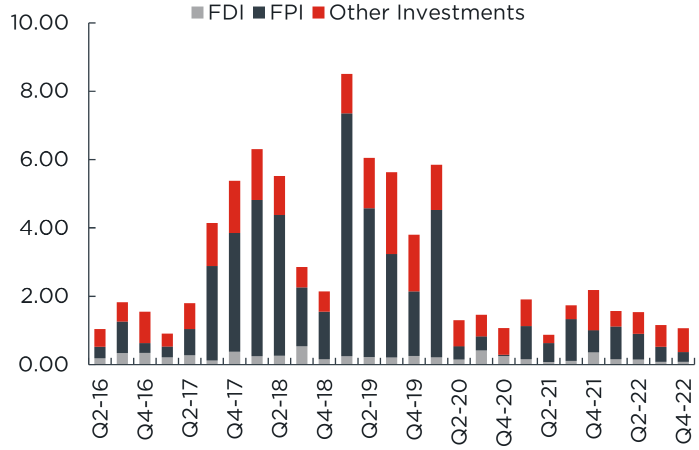


Figure 31: Capital importation composition (USD billion)



Source: NBS, CBN, Cordros Research

Figure 32: FPI contribution to total inflows (%)

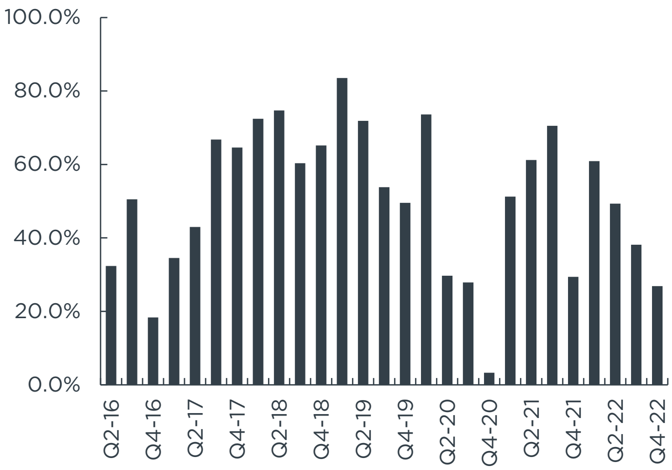
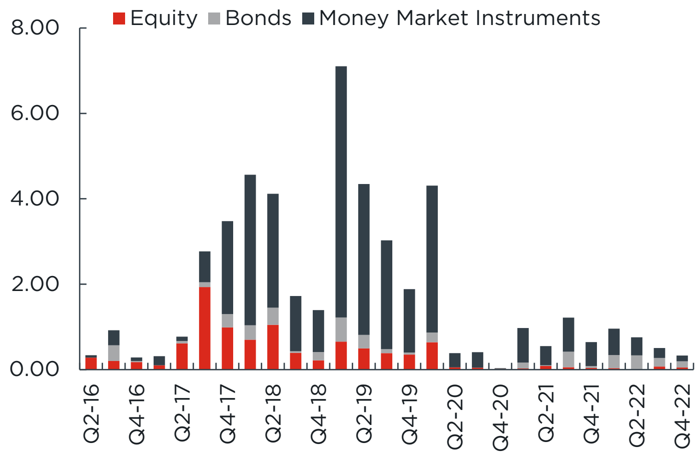


Figure 33: FPI composition (USD billion)



Source: NBS, CBN, Cordros Research

Currency.

Will the "Benjamins" Find Their Way Back to the FX Market?

The naira remains on the back foot against the US dollar as FX demand continues to outstrip supply. The demand for the greenback remains high as market players continue to source for FX to fulfil and clear their outstanding obligations, just as the CBN's FX interventions remain frail. At the same time, offshore players remain on the sidelines amidst existing challenges, including FX illiquidity, lack of flexibility in the exchange rate framework, high global interest rates, and an overvalued local currency. However, the CBN abolished its multiple FX windows, collapsing all its various rates into the Investors and Exporters Window (IEW) on 14 June. In line with the preceding, the naira depreciated significantly by 39.5% year-to-date (as of 27 June) to NGN763.00/USD at the Investors and Exporters Window (IEW). Simultaneously, the exchange rate pressures also manifested in the gross FX reserves depletion of 7.7% to USD34.22 billion year-to-date, as FX inflows remain limited while the CBN used the reserves to finance external obligations and support the FX market. On the FX inflows, crude oil exports remain low, capital importation continues to dry up, and the country cannot access the Eurobond market, given unfavourable external conditions.

Elsewhere, In May, the total inflows into the Investors & Exporters Window (IEW) increased by 46.8% m/m to USD1.14 billion (April: USD775.70 million). Although foreign inflows settled higher to USD207.10 million (April: USD96.20 million), they remain underwhelming relative to pre-pandemic levels (2019FY monthly average: USD1.56 billion), primarily because of the exisiting FX constraints and limited macro reforms. Simultaneously, inflows from local sources increased by 37.1% m/m to USD931.50 million, primarily driven by higher inflows from Exporters (+42.7% m/m to USD437.80 million | 47.0% of local inflows) and Non-bank corporates (+30.3% m/m to USD440.00 million | 47.2% of local inflows).

Figure 34: FX Reserves & Official Exchange Rate (NGN/USD)

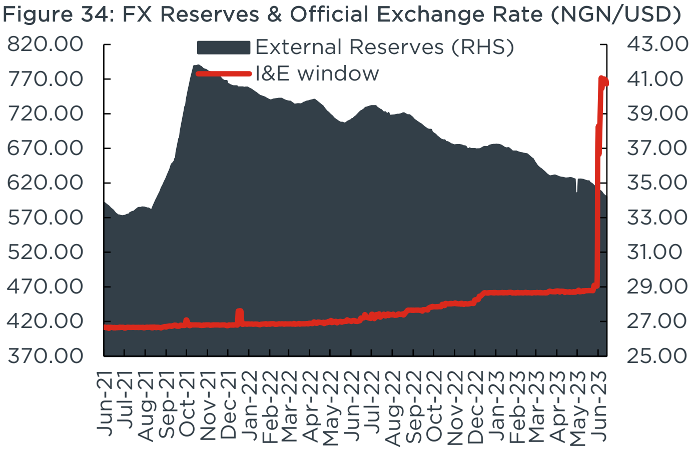
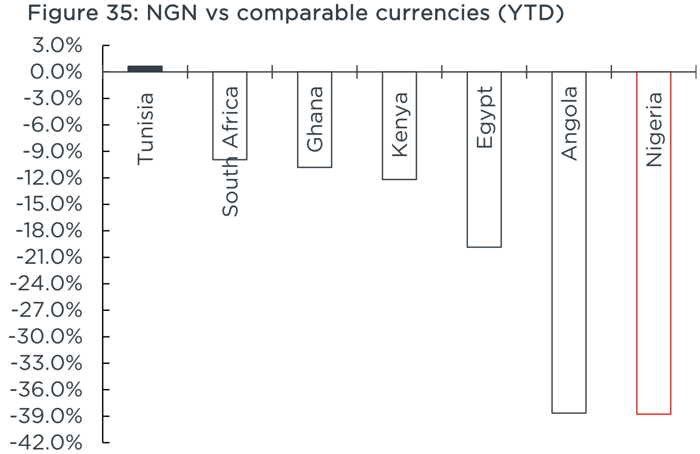


Figure 35: NGN vs comparable currencies (YTD)



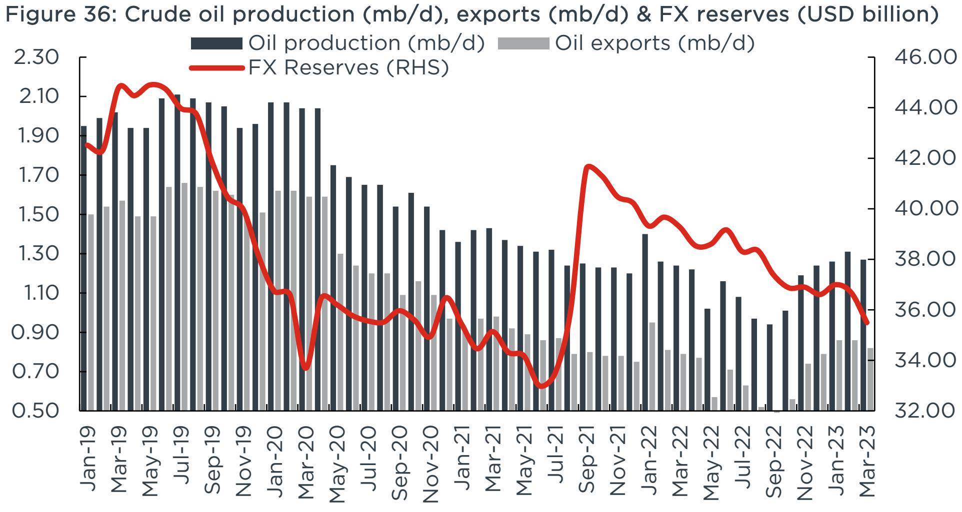
Source: CBN, FMDQ, Cordros Research

The Impact of Dangote Refinery on FX Savings May Be Limited

On the expected impact of Dangote Refinery on the local currency, we think the FX savings will be limited in the short term. On the one hand, we expect the significant savings to be in terms of freight cost, which we estimate at NGN20.07/litre (or 6.0% of the expected open market price), amounting to NGN659.30 billion (or USD1.43 billion) per annum based on 90 million litres consumption per day. **On the other hand, our analysis of CBN's data during pre-COVID levels shows that Nigeria needs to ramp up crude oil exports to a range of 1.50mb/d – 1.70mb/d to maintain a decent level of FX reserves which can be used to support the local currency.** The preceding means that crude oil production (excluding condensates) will need to increase from the current 1.27mb/d to between 1.95mb/d – 2.15mb/d after adding the approximate 450kb/d under the Direct Sales Direct Purchases (DSDP) contract. Consequently, we think the central turning point is if Nigeria produces enough crude oil equal to or higher than its OPEC production quota, of which the extra barrels can be exported for hard currencies.

Thus, given that our crude oil production (excluding condensates) expectation for 2023FY (1.37mb/d) is 21.3% below Nigeria's current OPEC production quota (1.74mb/d) and taking into account the FX savings from logistics costs, we do not see a meaningful impact of the Dangote Refinery on FX savings or the naira in the near term.

Figure 36: Crude oil production (mb/d), exports (mb/d) & FX reserves (USD billion)



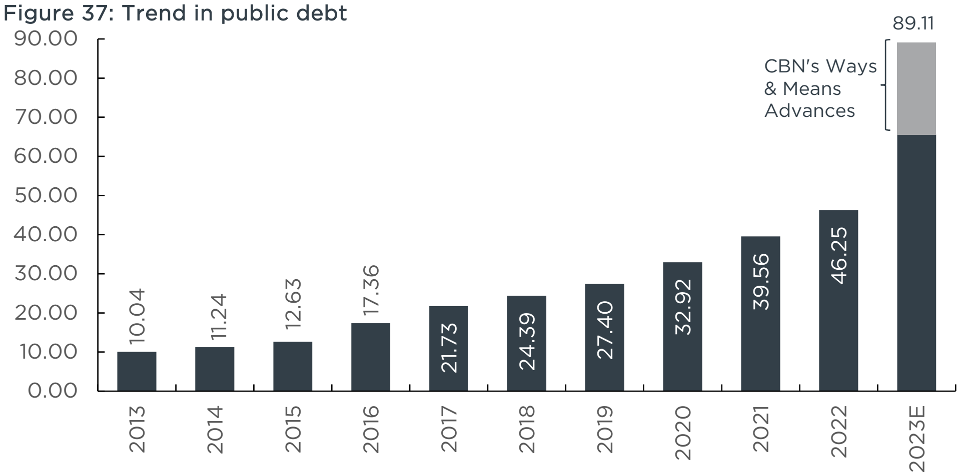
Source: CBN, Cordros Research

CBN Abolishes its Multiple FX Windows, Collapsing them into the IEW

As noted earlier, the CBN abolished its multiple FX windows, collapsing all its various rates into the Investors and Exporters Window (IEW) on 14 June. Accordingly, the CBN re-introduced the "willing buyer, willing seller" model at the IEW, with the operations guided by the extant circular on establishing the window, dated 21 April 2017. In line with this, we now expect a more market-determined exchange rate, boosting stakeholders' confidence and increasing FX inflows, as there will no longer be an incentive to channel FX through the unofficial markets to take advantage of arbitrage opportunities. Besides, we expect the associated FX unification to support government revenue in the medium term, given that dollar-based income will now be converted using a higher exchange rate. The domestic capital market is also expected to benefit from the FX liberalisation as naira asset valuation becomes attractive for foreign investors, increasing foreign portfolio inflows. FX inflows from diaspora remittances and exports are also likely to increase as there will no longer be a preference for diverting FX flows to the unofficial FX market, consequently boosting FX liquidity.

Conversely, we expect foreign debt service cost to increase in naira terms, just as the external debt is likely to induce a higher public debt profile relative to pre-FX liberalisation. On our estimates, the FX liberalisation would lead to an NGN11.32 trillion increase in total public debt even without contracting new debt in the current year. Thus, for 2023FY, public debt is likely to hit NGN89.11 trillion (or 42.4% of GDP) assuming (i) NGN720.00/USD exchange rate on external debt outstanding, (ii) the government borrows NGN1.76 trillion it expects from multilateral/bilateral sources, and (iii) CBN's Ways & Means is eventually added to the debt stock. Elsewhere, we expect import costs to rise, negatively impacting domestic prices. Consequently, increased cost pressures will likely limit near-term growth as consumption expenditure and business investments are negatively impacted.

Figure 37: Trend in public debt

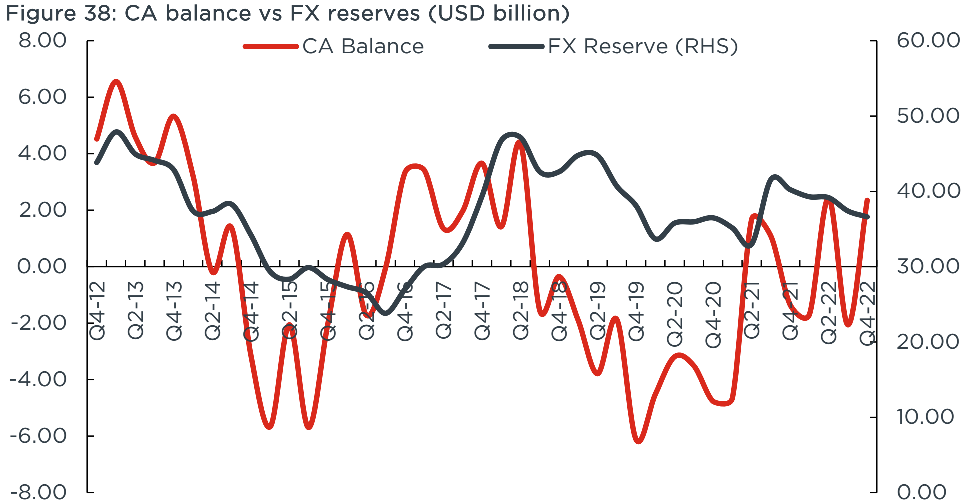


Source: CBN, Budget Office, Cordros Research estimates

That said, we note that the external position (measured by the CA balance) positively correlates with the FX reserves. Thus, given our expectations of a slightly favourable CA balance relative to 2022FY, we expect inflows to the gross

FX reserves to remain tempered relative to pre-pandemic levels. The preceding is likely to impede the CBN's ability to sufficiently increase its FX sales to the IEW, more so that the country is not expected to access the Eurobond market in the current year as global conditions remain unfavourable. Nonetheless, we expect foreign investors' sentiments to improve, albeit below pre-pandemic levels, in line with the liberalisation of the FX market. However, they may not return in their droves if they do not see convincing actions from the CBN on clearing the FX backlog and supporting the market to reduce volatility in the short term.

Figure 38: CA balance vs FX reserves (USD billion)



Source: CBN, Cordros Research

Covering All Bases

On the CBN's liquidity position, we estimate average monthly oil inflows of USD775.01 million over H2-23. The preceding is based on our crude oil average price estimate (USD80.66/bbl.) and expectations on average crude oil exports (0.90mb/d), after accounting for production (1.44mb/d) estimates, excluding condensates. Furthermore, we project average monthly non-oil inflows to increase by 27.9% y/y, given the favourable base effects from the prior year and the impact of FX liberalisation on non-oil inflows, to USD1.89 billion in H2-23. **Thus, we expect the average monthly inflows into the CBN's coffers to settle at USD2.66 billion in H2-23 (H2-22: USD2.25 billion).**

On our expectations for the CBN's FX outflows, we assume that the CBN's halt of FX sales to the BDCs will remain intact. At the same time, we expect the CBN's FX allocation to commercial banks to increase slightly for onward sales to the retail segment as FX demand pressures remain intact. At the same time, we assume that CBN's inflows to the IEW will increase compared to 2022FY levels, given our view that the CBN may increase its FX supply in the window to support the market in the early days of the FX liberalisation and reduce FX volatility.

Overall, we expect the CBN's average monthly cash outflow to increase by 8.9% y/y to USD2.91 billion in H2-23 (H2-22: USD2.68 billion).

On balance, our estimated monthly average net cash flow translates to a reserve depletion of USD1.50 billion over H2-23 (vs depletion of USD2.56 billion in H2-22). Consequently, we expect the reserves to settle at USD33.01 billion at the end of 2023, translating to import cover (goods) of about five months.

Figure 39: Crude oil production, exports & FX reserves

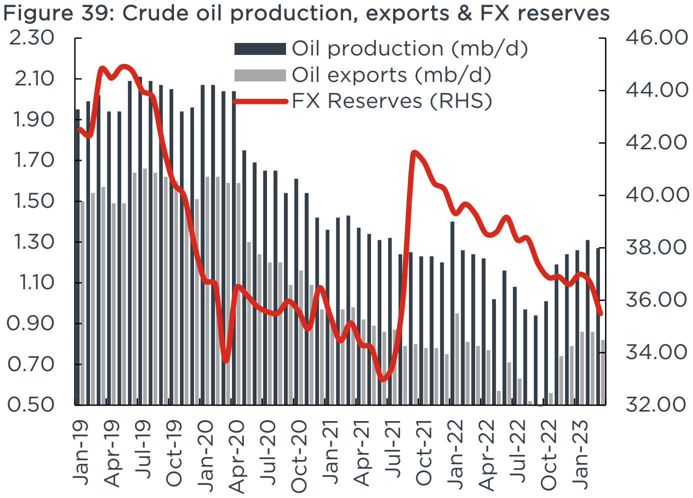
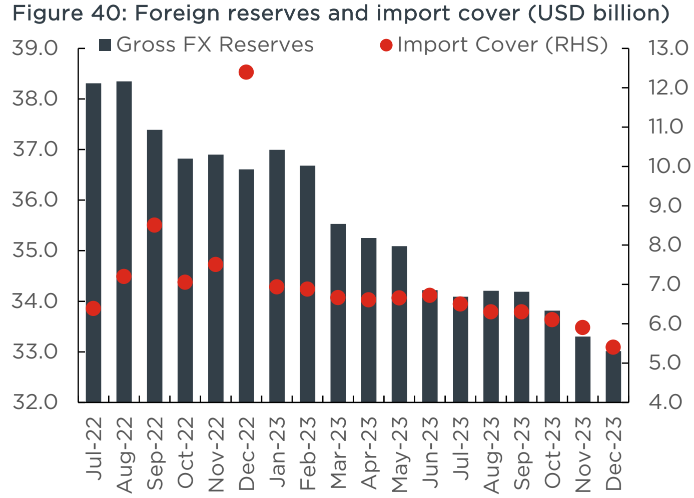


Figure 40: Foreign reserves and import cover (USD billion)



Source: CBN, Cordros Research

That said, it is essential to reiterate the CBN's actions of abolishing its multiple FX windows, which, combined with the PMS subsidy removal, are favourable for the economy over the medium term. We view these two reforms as vital and low-hanging fruits that should have been implemented years ago for the economy not to be in the present fiscal and monetary mess. However, we highlight that there are still some restrictions on eligible transactions in the IEW. One such is that the CBN maintained that the 43 items banned from accessing FX at the IEW remain intact, potentially undermining the path towards exchange rate unification. Nonetheless, given the commitment of the current CBN's leadership to improve its reputation and focus squarely on monetary policy, we will not be surprised to see positive changes in this regard over the medium term.

Overall, while the CBN's FX liberalisation is positive in boosting foreign investor's confidence, we think they may adopt a wait-and-see approach, for now, looking for signals on the CBN's plans to start clearing the FX backlogs and boosting FX supply to support the market in the near term. Besides, we suspect that due to the previous lessons learnt from the damaging currency controls of the prior administration, investors will be on the lookout for signs that there are no counter policies to prevent them from leaving at any point in the near term before returning to the market in their droves.

Monetary Policy.

MPC Appears to Have Reached its Peak of Monetary Tightening

The Monetary Policy Committee (MPC) of the Central Bank of Nigeria (CBN) started the year by maintaining its aggressive monetary policy tightening, increasing the Monetary Policy Rate (MPR) by 100bps at the January policy meeting. However, by the March meeting, the Committee's tone changed as the risk of overtightening became salient in policy discussions, just as we envisaged in our 2023 full-year outlook. During the meeting, the Committee acknowledged that a moderate tightening approach would be the most suitable option to decelerate inflation without hurting output. Elsewhere, given the cases of bank failures in the United States and Switzerland, the MPC highlighted that it examined the impact of further policy rate hikes on the stability of the banking system. In its assessment, the Committee was convinced that further rate hikes would not adversely impact the Nigerian banking system's stability. Finally, at the May policy meeting, the MPC raised the MPR further by 50bps to 18.5%, citing the need to (i) consolidate the gains made so far, (ii) support the efforts towards moderating demand-pull inflation, (iii) narrow the negative real interest rate gap, and (iv) boost the MPC's credibility following the earlier forward guidance to continue to tighten when confronted with unabating price pressures.

Figure 41: MPR & Inflation

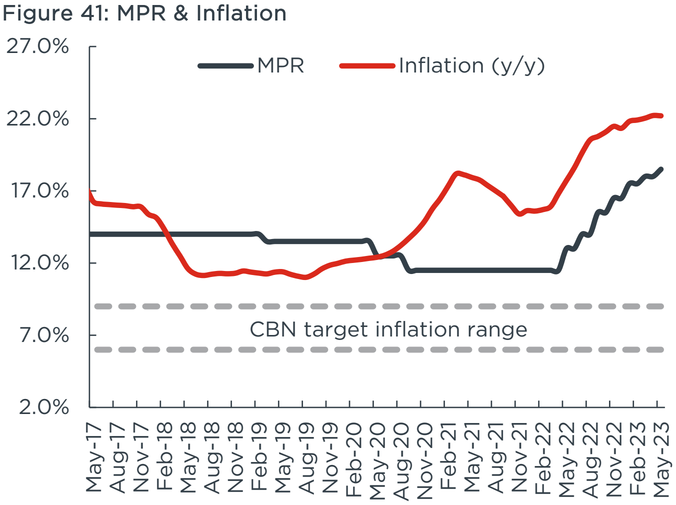
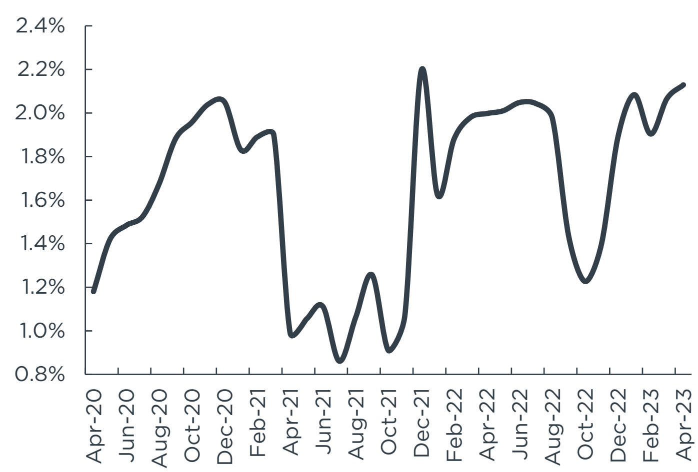


Figure 42: Food inflation (m/m)



Source: NBS, Cordros Research

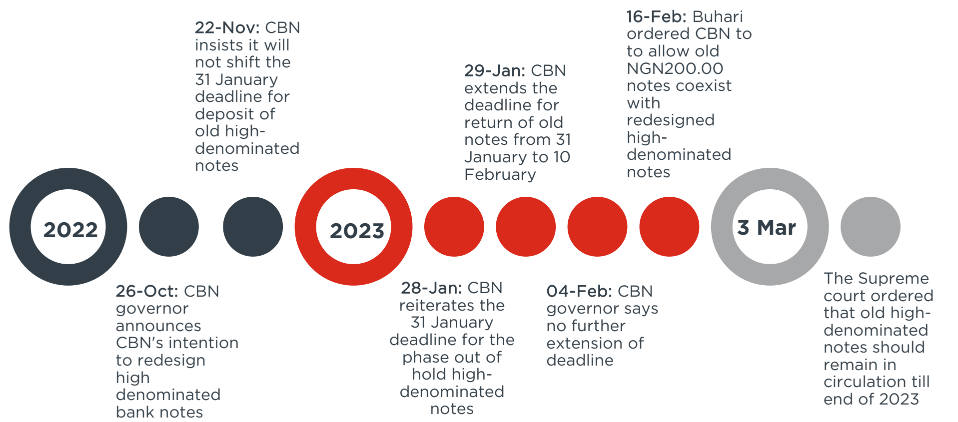
Naira Redesign Conundrum Highlights Policy Inconsistencies in Nigeria

When the CBN Governor announced the plans to redesign high-denominated naira notes and phase-out old notes on 26 October 2022, he highlighted some rationales, one of which included the need to rein in the currency outside the banking system into the banking system, making monetary policy more efficacious. However, this rationale was already flawed in the first place, more so that the tight deadline introduced further significant hardship for the citizens.

Notably, Currency Outside Banks (COB) as a percentage of Currency in Circulation (CIC) ranged between 78.4% and 92.4%, averaging 84.5% between 1960 and 2022. In our view, the preceding should not be a source of concern whatsoever because cash is printed not to sit in the bank's vaults but to exchange hands (for people to use in transactions). Moreover, COB averaged 6.0% as a percentage of Money Supply (M2) between September 2019 and December 2022, further reflecting that the COB is also not a source of concern for inflation and monetary policy as it is insignificant.

Based on the foregoing and given that the informal sector (48.2% of GDP as of 2018) constitutes a significant portion of the domestic economy, activities witnessed a considerable cash crunch in Q1-23 as old high-denomination bank notes were withdrawn from the system with substantial undersupply of new banknotes. The untold hardship seen during the period highlighted how the naira redesign was flawed right from the announcement, more so that the deadline for bank notes phase-out was tight. Accordingly, we were unsurprised by the policy flip-flops (figure 43) witnessed during the period.

Figure 43: Abridged Timeline of Announcements Relating to the Naira Redesign Drive



Source: CBN, News Media, Cordros Research

Despite the (i) purported rationale of the naira redesign drive and (ii) cumulative interest rate hikes, inflationary pressures remain elevated, underscoring the supply-side factors stoking inflationary pressures. Precisely, headline inflation maintained a steady uptrend in 5M-23 primarily on account of several structural/supply side factors, including the (i) lagging impact of the low underwhelming harvest season in the prior year, (ii) below-average farm cultivation, (iii) higher transport costs, (iv) lingering currency pressures, and (v) electioneering activities. Accordingly, fiscal authorities need to complement the actions of monetary authorities to tame inflationary pressures and not monetary authorities trying to perform double functions, which, most times, leads to unintended consequences.

MPC to Switch to a "Hold" Stance in the Second Half of the Year

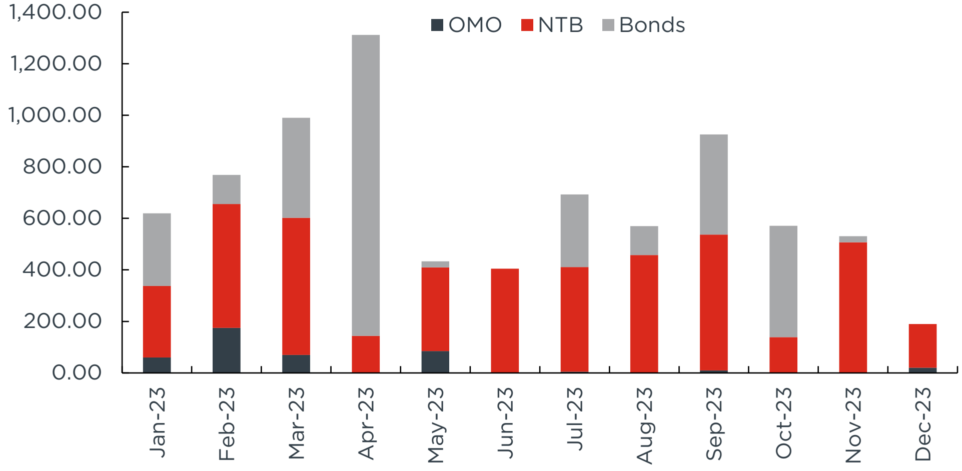
The trajectory of economic growth, inflation rate, and global interest rates for the remainder of the year influence our perspective on the Monetary Policy Rate (MPR). On growth, we highlight that the domestic economy has been less affected by the global slowdown. That said, after the self-inflicted slowdown witnessed in Q1-23, we expect domestic economic activities to normalise over the rest of the year, barring unexpected economic shocks. Overall, real GDP is likely to slow in 2023FY compared to 2022FY, as explained in the GDP section of our outlook. The preceding could pose a source of concern to the MPC at subsequent meetings, albeit they are likely to take solace from the economic growth not turning negative.

On the other hand, the risks to consumer prices remain tilted to the upside, including (i) higher fuel prices given the PMS subsidy removal, (ii) higher taxes, (iii) lingering exchange rate pressures amid FX liberalisation, (iv) likelihood of adjustments in electricity prices, and (v) existing food supply challenges. Indeed, our inflation analysis suggests that the headline inflation is projected to average 25.11% in 2023FY and settle at 29.23% by year-end under our base case scenario. The preceding implies that consumer prices are likely to remain sticky over H2-23, confirming that more supply-side factors outside the purview of monetary policy are fanning inflationary pressures rather than demand-pull inflation.

On the external front, the forward guidance by the systemic global central banks suggests we may be nearing the peak of monetary policy tightening. Notably, the FOMC kept its key policy rate steady at 5.00% - 5.25% in its June policy meeting, albeit with a hawkish tone. At the same time, we suspect that the ECB will tilt towards a further 25bps increase apiece in the key interest rates at its July policy meeting, after which it is likely to consider halting further interest rate increases. Elsewhere, since the June meeting of the BOE, we understand that gilt yields have risen materially, particularly at shorter maturities, now suggesting a path for Bank Rate that averages 5.50%. Thus, we think the odds favour the possibility of another rate hike at the August policy meeting after which a HOLD stance is likely to be considered at subsequent meetings. Overall, we believe a pause in interest rate increases will likely dominate H2-23.

On a balance of factors, given that the end of rate hikes by systemic global central banks is in sight amid sticky domestic inflation, we think the MPC will tread cautiously at subsequent policy meetings. Thus, we suspect the dilemma will remain whether to keep hiking policy rates less aggressively or keep the policy parameters constant. However, at this stage, continuous increases in the MPR at a time when supply-side factors are the dominant upside risk to near-term price pressures will undermine economic growth. **On a balance of factors, while our baseline view is for the MPC to adopt a HOLD stance at subsequent meetings** over H2-23, we do not rule out a 25bps – 50bps hike at the July policy meeting.

Figure 44: Maturity profile (NGN billion)



Source: FMDQ, CBN, Cordros Research

Fiscal Policy.

Teetering on the Precipice of Self-Inflicted Debt Concerns

Nigeria's fiscal position remained dire in 2022, similar to the past few years, given continuous revenue underperformance amid higher expenditure outturns. Despite the FGN's retained revenue (excluding GOEs[1]) increasing in 11M-22 (NGN5.86 trillion vs 2021FY: NGN4.79 trillion) relative to the prior year, we highlight that grants & donor funding (NGN974.49 billion) primarily drove the increase. Thus, although the FGN's retained revenue underperformed the prorated budget (NGN7.55 trillion) by 22.3%, if we excluded the inflows from grants, the revenue underperformance would have increased to 35.3% relative to the prorated budget. Nonetheless, non-oil revenue was higher than the prorated budget by 0.9%, while oil revenue significantly underperformed the prorated budget by 70.8%. Notably, at NGN586.71 billion as of 11M-22, oil revenue is on course to be at its lowest level on record, even lower than NGN697.80 billion recorded in 2016 when the oil price crash caused a significant decline in the government's oil revenue. The preceding is not surprising, given that crude oil production fell to a record low, averaging 1.14mb/d (excluding condensates), given the plethora of factors mentioned in the GDP section of this report. If we include GOE's retained revenue, we note that the aggregate revenue settled at NGN6.50 trillion – 28.9% below the prorated budget.

At the same time, the FGN's expenditure (excluding GOEs and project-tied loans) settled at NGN12.28 trillion in 11M-22 – 12.3% lower than the prorated budget (NGN15.27 trillion). The breakdown provided showed that the underperformance was principally driven by significantly low capital expenditure in the review period. Specifically, we highlight that the capital expenditure was 57.0% below the prorated budget. However, recurrent expenditure increased by 0.8% relative to the prorated budget, with debt servicing settling at NGN5.24 trillion (+43.7% vs prorated budget: NGN3.65 trillion). The aggregate expenditure (including GOEs and project-tied loans) settled at NGN12.87 trillion in 11M-22, representing a 22.6% underperformance compared to the prorated budget (NGN16.63 trillion).

Given the revenue and expenditure underperformance, the fiscal deficit settled at NGN6.37 trillion in 11M-22 (prorated budget: NGN8.17 trillion). Annualising the number, we estimate the fiscal deficit settled at NGN6.95 trillion – 7.6% higher than the FGN's aggregate expenditure (excluding GOEs and project-tied loans) in 2017FY. The fiscal deficit was financed through domestic borrowing (including the CBN) of NGN5.86 trillion and NGN510.21 billion as foreign borrowing.

[1] Government Owned Enterprises

Figure 45: Crude oil production (mb/d) vs oil price (USD/bbl.)

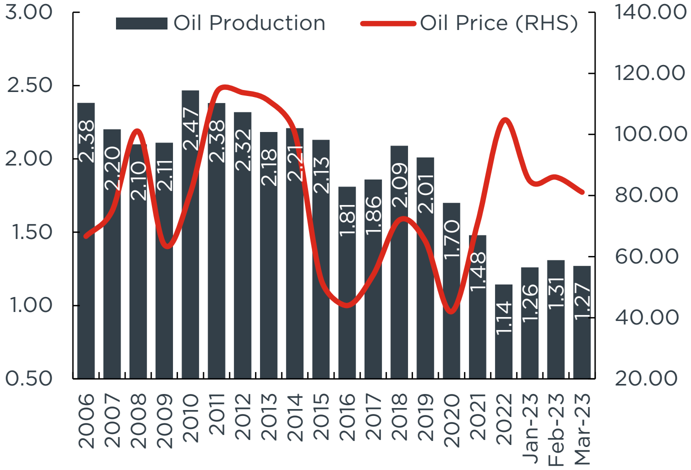
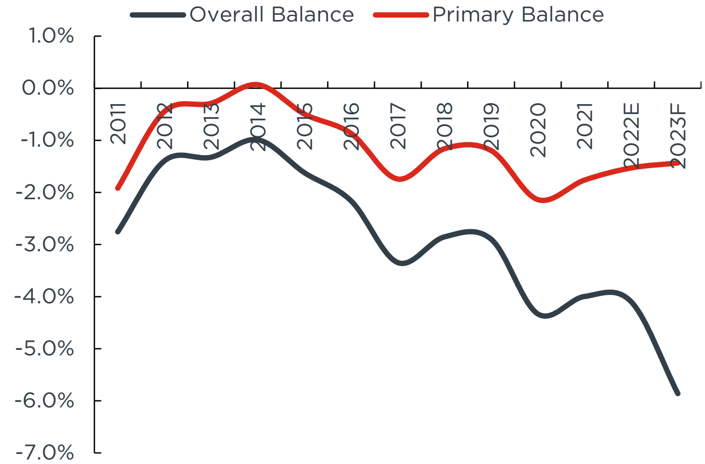


Figure 46: Trend in the budget deficit (% of GDP)



Source: CBN, Budget Office, Cordros Research estimates

Faster Growth in Expenditure to Offset Higher Revenue in 2023FY

Although we expect the government's revenue to be higher in 2023FY compared to 2022FY, we believe the revenue would underperform the budget given the ambitious targets of the FGN. Our prognosis for increased revenue is hinged on implementing the 2023 Finance Act and Fiscal Policy Measures (FPM) amid the continued consolidation of economic growth amid strong corporate performances. However, we expect the increased expenditure over the year to outweigh the improvement in revenue, leading to a wider fiscal deficit above the budgetary estimates.

For context, as indicated in Figure 50, Nigeria could not take advantage of increased oil prices in 2022. We suspect the situation has been precarious so far in 2023, given the moderation in oil prices amidst the underwhelming crude oil production. Accordingly, we imagine oil revenue remains frail, significantly trailing the budgeted oil revenue for the period. Elsewhere, we believe that the non-oil revenue maintained its increase relative to the prior year because of the combined impacts of (i) resilient domestic economic activities and (ii) tax provisions of the 2023 Finance Act and FPM. Indeed, we understand that Companies' Income Tax (CIT), Oil and Gas Royalties, and Value Added Tax (VAT) contributed significantly to the revenue shared by the three tiers of government in 4M-23. According to the Federation Accounts Allocation Committee (FAAC), the amount disbursed to the three government tiers increased by 14.4% y/y, averaging NGN770.86 billion monthly in 4M-23 (4M-22: NGN673.73 billion). Consequently, we suspect that the non-oil revenue drove higher aggregate income in 4M-23. However, the impact of underwhelming oil revenue suggests that the aggregate revenue was below the prorated budget in the review period, just as we have seen in the past three years.

On the other hand, we envisage that aggregate expenditure increased more than expected in 5M-23, albeit below the budget, given increased borrowing during the review period amid the high PMS subsidy costs. Notably, the 2023 budget shows that the government expects to borrow NGN7.04 trillion from the domestic market – 99.2% higher than the 2022FY domestic borrowing plan. As of 5M-23, we highlight that the total borrowing in the domestic debt market in 5M-23 stood at NGN3.39 trillion (or 48.2% of planned domestic borrowing). Simultaneously, we also suspect that the FGN maintained its usage of the CBN's Ways & Means advances, albeit moderately, despite the securitisation done with the CBN. Based on the preceding, we imagine that growth in expenditure must be running ahead of the increase in revenue, leading to a widening fiscal deficit.

Figure 47: Trend in FAAC disbursement (NGN billion)

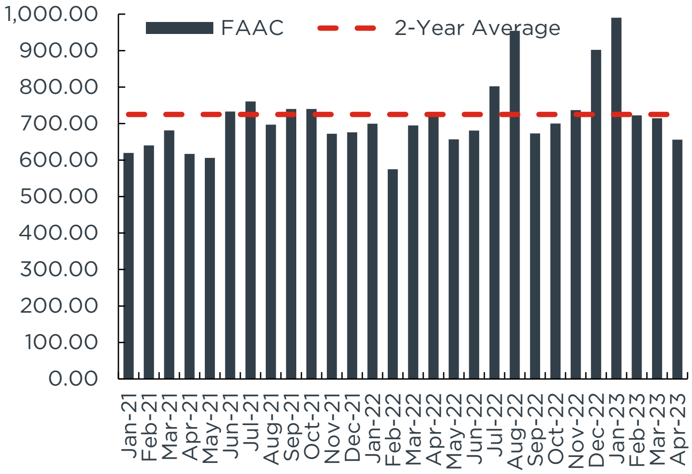
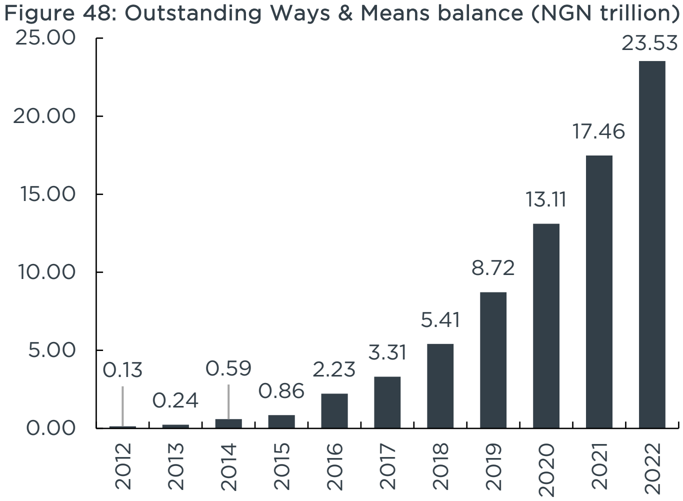


Figure 48: Outstanding Ways & Means balance (NGN trillion)



Source: NNPC, CBN, Cordros Research

FGN 2023 Budget: Fiscal Deficit to Widen More than Expected

FGN sustained its expansionary fiscal policy thrust in 2023 with a historic budgetary estimate of NGN16.32 trillion. However, the National Assembly approved a budget of [1]NGN17.64 trillion (+15.5% y/y), split across recurrent non-debt (NGN6.55 trillion), debt service (NGN6.56 trillion), and CAPEX (NGN3.37 trillion). Meanwhile, projected retained revenue is set at NGN8.07 trillion, excluding GOEs revenue (net operating surplus). If we include the GOEs' finances, the government expects the 2023FY budget deficit to rise to NGN11.34 trillion (or 5.03% of GDP) – almost equal to the 2021 aggregate expenditure (NGN12.07 trillion) excluding GOEs and project-tied loans. Overall, the FGN expects the deficit to be financed by domestic borrowing (NGN7.04 trillion), foreign debt (NGN1.76 trillion), project-tied loans (NGN1.77 trillion) and privatisation proceeds (NGN206.18 billion). The remaining balance (NGN553.46 billion) will be financed by additional revenue from spectrum fees and maritime sector tax.

[1] 2023 approved budget including GOEs and project-tied loans amount to NGN21.83 trillion

Table 1: Breakdown of 2022 approved budget (NGN trillion)

Fiscal items	2023 (Approved)	2022 (revised)
Assumptions		
Oil production volume (mb/d)	1.69	1.60
Benchmark oil price (USD/bbl.)	75.00	73.00
Average exchange rate (USD/NGN)	435.57	410.15
Revenue		
FGN retained revenue	8.07	8.24
Oil & related revenue	2.23	2.19
Non-oil tax revenue	2.43	2.13
Other revenue	3.41	3.92
Expenditure		
Gross FGN expenditure (ex-GOEs)	17.64	15.27
Statutory transfers	0.967	0.818
Debt service	6.56	3.98
Sinking fund	0.248	0.293
Recurrent (non-debt) exp.	6.55	5.69
Aggregate capital expenditure (ex-transfers)	3.37	4.43
Fiscal deficit (ex-GOEs & project-tied loans)	**9.56**	**7.03**

Source: Budget Office, Cordros Research

Overambitious Budget Supports Widening of the Fiscal Deficit

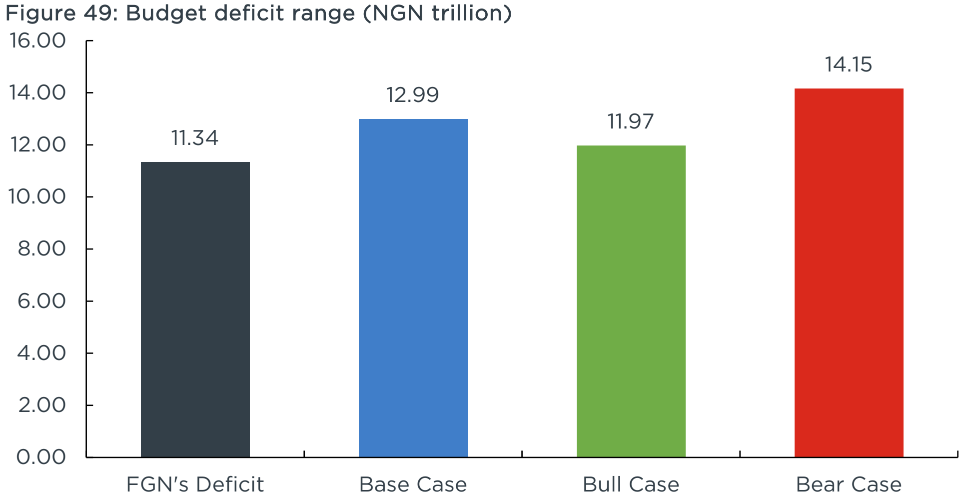
While the government maintained its crude oil production expectation of 1.69mb/d, it revised the oil price benchmark to USD75.00/bbl. (previously: USD70.00/bbl.). For us, we expect crude oil production to increase by 11.9% y/y to 1.53mb/d in 2023FY (2022FY: 1.37 mb/d), given our expectation of an improvement in crude oil production in line with the government's clamp down on illegal pipelines. However, constraints such as IOCs divestments and the lingering lagging impact of infrastructure decay would ensure that crude oil production remains sub-optimal. At the same time, we expect the crude oil price to be ahead of the FGN's estimate, but this would not be enough to salvage the oil revenue's underperformance amid a huge PMS under-recovery burden in H1-23. On balance and in line with the recent development in the FX space, where the official exchange rate depreciated by an average of 36.0%, we have raised our oil revenue estimates. Specifically, we now expect oil revenue to settle at NGN1.48 trillion (previously: NGN1.25 trillion) – 33.8% below the FGN's assumption of NGN2.23 trillion but 130.5% higher than 2022FY actual oil revenue (NGN640.05 billion).

Elsewhere, we are optimistic that the non-oil revenue will surpass the government's estimate (NGN2.43 trillion) by 6.7% y/y on account of the (i) strong non-oil revenue performance in the past two years and (ii) accounting for a positive impact of the 2023 Finance Act and Fiscal Policy Measures (FPM).

Therefore, we project the non-oil tax revenue will settle at NGN2.60 trillion. Meanwhile, we expect the other revenue lines to grossly underperform the budget due to the ambitious targets, especially independent revenue (NGN2.62 trillion). The preceding is also in line with gross historical underperformance (2009 to 2021 average performance ratio: 59.3% | 11M-22: 55.0%), given the weak operational efficiencies in most state-owned enterprises (SOEs), which undermines revenue-generating capacity. **Overall, we project FGN's total retained revenue to settle at NGN6.28 trillion in 2023FY (vs 11M-22: NGN5.86 trillion). Assuming 80.0% GOEs' revenue performance, the aggregate revenue would be NGN8.22 trillion (vs 11M-22: NGN6.50 trillion).**

Assuming a budget implementation rate of 95.0% (4-year average implementation rate: 94.7% | 2011: 95.9%; 2015: 94.1%; 2019: 93.1%), our scenario analysis indicates that the fiscal deficit (including GOEs' and project-tied loans) could range between NGN11.97 trillion and NGN14.15 trillion. Therefore, our baseline expectation is that the fiscal deficit will print NGN12.99 trillion in 2023FY compared to NGN7.99 trillion in 2022FY.

Figure 49: Budget deficit range (NGN trillion)



Source: Budget Office, Cordros Research estimates

FGN to Rely Heavily on the Domestic Debt Market to Plug the Deficit

Like in previous years, the FGN's ability to mobilise debt is crucial to achieving a meaningful budget implementation rate. On foreign borrowing, we highlight that the FGN expects to borrow NGN1.76 trillion in the foreign capital market in 2023. However, given the elevated interest rates and regional contagion, we do not expect the government to access the Eurobond market more so that global uncertainties will likely persist in the year. Elsewhere, we are conservative with other financing sources as we assume the government will meet its target from privatisation proceeds (NGN206.18 billion) and multilateral/bilateral project-tied loans (NGN1.77 trillion).

Consequently, the preceding leads to a funding gap of NGN11.02 trillion when juxtaposed with our baseline fiscal deficit (NGN12.99 trillion). Given that this gap will be too much to be covered by the domestic capital market, we will not be surprised if FGN maintains the use of the CBN's Ways & Means advances. Indeed, on 27 May 2023, the two legislative houses approved the increase of Ways & Means to 15.0% of the previous year's revenue (previously: 5.0%). On domestic borrowing, the government has raised NGN3.13 trillion as of 6M-23, representing 44.5% of its total domestic borrowing plan (NGN7.04 trillion) for the year.

Figure 50: Debt Service to Revenue Ratio

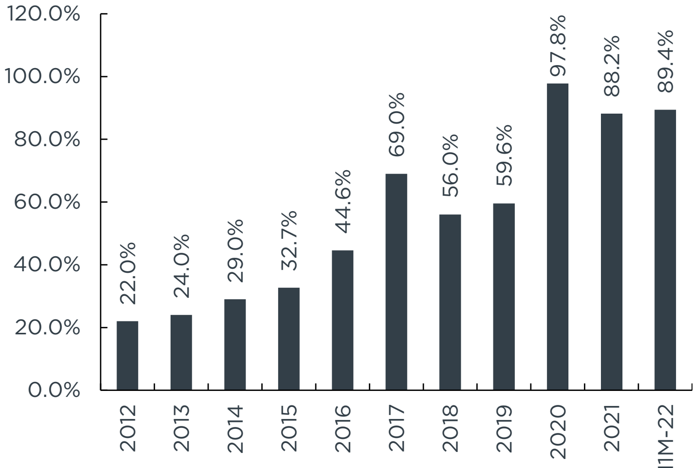
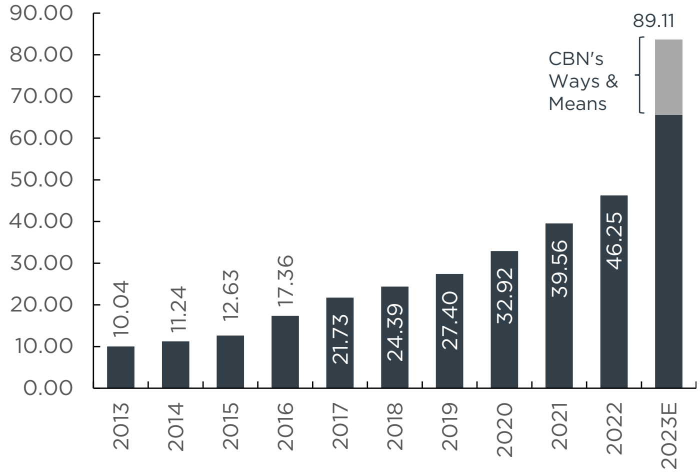


Figure 51: Trend in Public Debt (NGN trillion)



Source: Budget Office, CBN, Cordros Research Analysis

Appendix. *Nigeria - Key Economic Forecasts.*

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023FY
Activity													
Real GDP (% YoY)	5.3	4.2	5.5	6.2	2.8	(1.6)	0.8	1.9	2.3	(1.9)	3.4	3.1	2.9
Private consumption (% YoY)	(3.1)	0.3	21.2	0.6	1.5	(5.7)	(0.4)	4.6	(1.1)	(1.7)	25.7	(4.1)	(2.3)
Government consumption (% YoY)	4.6	(2.0)	(10.3)	(7.0)	(11.9)	(15.1)	(12.4)	39.9	8.8	61.6	(34.0)	(9.9)	4.4
Oil production (million b/d year-end)	2.4	2.0	2.2	2.2	2.1	1.6	1.9	1.9	2.0	1.8	1.6	1.4	1.5
Nominal GDP (NGN billion)	62,980	71,714	80,093	89,044	94,145	101,489	113,712	127,737	144,210	152,324	173,528	199,336	219,270
Nominal GDP (USD billion)	410	459	515	569	495	405	376	398	448	402	423	468	313
Real GDP (NGN billion)	57,511	59,930	63,219	67,153	69,024	67,931	68,491	69,800	71,388	70,014	72,394	74,639	76,816
Population (million)	165	170	176	181	187	193	199	205	211	218	223	229	235
GDP per capita (USD)	2,490	2,700	2,931	3,134	2,641	2,093	1,886	1,941	2,121	1,846	1,895	2,042	1,332
Gross national saving (% of GDP)	10.2	11.0	11.9	12.7	12.4	13.7	12.6	12.4	12.5	14.3	14.6	13.4	14.3
Stock of bank credit to the economy (NGN billion)	7,313	8,150	10,006	12,889	13,086	16,117	15,741	15,134	17,188	20,373	24,378	29,446	32,979
Stock of bank credit to the economy (% of GDP)	11.6	11.4	12.5	14.5	13.9	15.9	13.8	12.1	11.1	13.4	14.0	14.8	15.0
Loan to deposit ratio (%)	44.8	42.3	38.0	64.2	69.6	80.0	78.2	64.3	59.9	65.0	65.0	65.0	65.0
Fiscal balance (% of GDP)													
Federal government balance	(2.8)	(1.4)	(1.3)	(1.0)	(1.6)	(2.2)	(3.3)	(2.9)	(2.9)	(4.3)	(4.1)	(4.5)	(5.8)
Total public debt	17.6	17.7	18.6	17.5	20.3	23.4	25.3	28.4	19.9	21.6	22.8	23.2	42.4
Capital Expenditure	1.5	1.0	1.1	0.7	0.6	0.2	1.3	1.3	0.8	1.1	1.7	2.2	1.0
Debt Indicators													
Gross external debt (USD billion)	5.7	6.5	8.8	9.7	10.7	11.4	18.9	25.3	27.7	33.4	38.4	41.7	44.1
Gross external debt (% of GDP)	1.1	1.0	1.7	1.8	2.3	3.4	5.1	6.1	6.2	8.3	9.1	8.9	14.1
Gross external debt (% of exports)	5.7	6.7	9.0	11.7	23.3	32.9	41.3	41.3	42.6	92.8	81.9	64.9	65.4
Total debt service (USD billion)	3.4	4.3	5.3	5.9	5.5	5.6	6.0	7.1	8.0	8.9	10.4	12.0	14.7
Total debt service (% of GDP)	0.8	0.9	1.0	1.0	1.1	1.4	1.6	1.8	1.8	2.2	2.5	2.6	4.7
Total debt service (% of exports)	3.4	4.4	5.4	7.2	12.0	16.2	13.0	11.5	12.3	24.8	22.1	18.7	21.8
External Balance													
Exports (NGN billion)	19,036	22,446	14,245	16,304	9,593	8,527	13,598	18,532	19,192	12,523	18,908	26,797	29,664
Exports (USD billion)	99.9	97.0	97.8	82.6	45.9	34.7	45.8	61.2	65.0	35.9	46.9	64.2	67.5
Imports (NGN billion)	10,033	5,625	7,016	7,374	6,698	8,818	9,563	13,165	16,960	12,701	20,844	25,591	28,482
Imports (USD billion)	65.2	35.7	44.6	46.5	34.7	34.8	31.3	43.0	62.1	52.4	51.4	58.2	59.3
Trade balance (NGN billion)	9,003	16,821	7,229	8,930	2,895	(290)	4,036	5,367	2,232	(178)	(1,936)	1,206	1,182
Trade balance (% of GDP)	14.3	23.5	9.0	10.0	3.1	(0.3)	3.5	4.2	1.5	(0.1)	(1.1)	0.6	0.5
Current account balance (USD billion)	12.7	18.9	20.1	1.3	(15.4)	2.7	10.4	3.9	(16.7)	(17.0)	(1.9)	1.0	3.0
Current account balance (% of GDP)	3.1	4.1	3.9	0.2	(3.1)	0.7	2.8	1.0	(3.7)	(4.2)	(0.4)	0.2	1.0
Exports (% YoY, NGN value)	46.3	17.9	(36.5)	14.5	(41.2)	(11.1)	59.5	36.3	3.6	(34.8)	51.0	41.7	10.7
Imports (% YoY, NGN value)	50.9	(43.9)	24.7	5.1	(9.2)	31.6	8.5	37.7	28.8	(25.1)	64.1	22.8	11.3
Foreign exchange reserves (ex. gold, USD billion)	32.6	43.8	42.8	34.2	28.3	27.0	39.4	42.6	38.1	36.5	40.2	36.6	33.9
Foreign exchange reserves adequacy (average months of import cover)	6.1	8.6	10.0	7.4	7.0	9.1	12.0	13.8	7.9	7.7	7.8	9.3	5.6
Prices													
CPI (average % YoY)	10.9	12.2	8.5	8.0	9.0	15.6	16.5	12.1	11.4	13.2	17.0	18.8	25.1
CPI (year-end % YoY)	10.3	12.0	8.0	8.0	9.6	18.5	15.4	11.4	12.0	15.8	15.6	21.3	29.2
Interest & Exchange Rates													
Monetary policy rate (MPR), % year-end	12.0	12.0	12.0	13.0	11.0	14.0	14.0	14.0	13.5	11.5	11.5	16.5	19.0
Broad money supply (NGN billion)	13,303	15,481	15,681	18,886	20,030	23,592	24,141	27,069	28,783	37,829	43,818	51,747	55,007
Broad money supply (% YoY)	15.4	16.4	1.3	20.4	6.1	17.8	2.3	12.1	6.3	31.4	15.8	18.1	6.3
Credit to the private sector (NGN billion)	14,184	15,152	16,191	18,126	18,721	22,326	22,243	23,536	26,695	29,890	35,195	41,802	45,982
Credit to the private sector (% of GDP)	22.5	21.1	20.2	20.4	19.9	22.0	19.6	18.4	18.5	19.6	20.3	21.0	21.0
3-month interest rate (T-bill year-end %)	14.1	11.7	10.9	10.8	5.7	21.0	14.0	11.3	5.2	0.4	5.0	4.4	UR
5Y yield (% year-end)	11.2	12.0	13.3	15.3	11.0	11.4	14.0	15.2	10.3	6.3	12.3	12.9	UR
Official exchange rate, (NGN/USD) year-end	156.7	155.8	155.7	168.0	197.0	305.0	306.0	307.0	307.0	380.0	435.0	461.5	750.0
Official exchange rate (NGN/USD) annual average	153.9	157.5	157.3	158.6	193.3	253.5	305.8	306.1	306.9	358.8	410.4	428.3	622.6
BDC exchange rate (NGN/USD) annual average	159.3	160.9	162.4	171.5	222.7	372.9	395.4	361.5	359.5	435.3	515.8	646.0	NA
BDC exchange rate (NGN/USD) year end	165.0	159.0	172.0	191.5	267.0	490.0	363.0	361.0	362.0	475.0	565.0	736.0	NA
I & E exchange rate (NGN/USD) annual average							365.6	362.1	361.9	381.5	435.0	428.3	622.6
I & E exchange rate (NGN/USD) year end							360.3	364.0	364.5	394.7	410.4	461.5	750.0

Source: World Bank, CBN, NBS, Budget Office, DMO, FMDQ, Bloomberg, Cordros Research estimates

Disclosures.

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