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RC 152321

NIGERIA

MACROECONOMIC AND BANKING SECTOR THEMES FOR 2017

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This article presents our forecasts and opinions of the broad Nigerian macroeconomic and banking sector trends that we expect would shape the economic landscape in 2017.

KEY THEMES / TRENDS FOR 2017 INCLUDE:

- Economic recovery and growth
- Insurgency and Security
- Oil production and global crude oil prices
- 2017 FG Budget
- Exchange rate policy and market liquidity

This report merely represents our views of the banking and macroeconomic landscape for 2017 and should not be relied upon for making investment decisions. Please consult qualified professionals for such investment decisions.

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Review of 2016

The French Revolution spanning 1789 and 1799 paved way for the rebirth of France into a modern democratic state. This was by no means a smooth delivery as it was characterised by high levels of political, social and economic uncertainties, such as we are witnessing today. The stunning victory of Donald Trump at the 2016 US Presidential Elections, the United Kingdom referendum "Brexit" which will effectively launch Britain's divorce proceeding from the European Union and China's increased globalization drive are instances of some political events that shaped 2016. The continued threat of radical terrorism by the Islamic State, the ambition of Kim Jong Un, the North Korean leader, to acquire nukes and the rising tension between Russia and Turkey reaching new peaks are beginning to reiterate the fragility of global security.

It would be naïve to assume that politics and economics are two distinct landscapes as, more often these days, political developments have had ripple effects on the world markets as well as investment decisions in many economies. America's election of Donald Trump, a business mogul with no previous public sector experience whose campaign was adjudged the most divisive in modern American history, as its 45th president is changing the global economic environment with US markets reacting positively in anticipation of the implementation of an expansionary fiscal policy by the US. In the same vein, Britain's decision to part ways with the European Union also impacted crude oil and stock prices around the world. These events might be indications that the West want more control of their economies and are tired of global economies and mass immigration. Amid this anti-globalization sentiment in the west, countries like Canada and a few others are still keen on embracing the world by their decision to remain open to trade, diverse cultures and people.

Though world economy has stagnated around 3% GDP growth in the last four (4) years, economic growth looks stronger in advanced economies but much weaker in emerging and developing economies. In advanced economies, economic growth has been boosted by lingering effect of recent crises, and protracted monetary policy support that was aimed at strengthening general output and employment. In emerging and developing economies on the other hand, economic growth have been slower due to the fiscal impact of declining commodity prices, poor past economic decisions, low economic productivity, rising unemployment, dearth of infrastructure, political uncertainty, etc. For good measure, there was renewed optimism in the market following the November 2016 agreement between the Organisation of Petroleum Exporting Countries (OPEC) and other non-OPEC members to cut production in a bid to shore up oil prices. As a result, crude oil prices jumped more than 2% to a high of $58.37 per barrel (pb) on the first trading day of 2017, its highest since July 2015.

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Our last publication of Macroeconomic and Banking sector themes for 2016 concluded with a quote by Albert Einstein that "in the middle of difficulty lies opportunity", to say that 2016 presented more challenges than opportunities, would be putting it mildly.

The economy officially plunged into recession after it contracted by 0.4% and 2.1% year-on-year in Q1 and Q2 respectively, and contracted further by 2.2% in the third quarter. Two factors were largely responsible for the downward trend in 2016 - reduced oil production as a result of the resurgence of Niger Delta militancy and the impact of reduced foreign exchange earnings on the economy. It is believed by analysts that delays by monetary authorities in implementing a flexible FX policy exacerbated

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the impact of weaker oil earnings on the economy.

Headline inflation maintained an upward trend for 13 consecutive months as it opened the year at 9.6% in January 2016 and sustained an upward trend throughout the year, rising to as high as 18.6% in December 2016. Oil production also dipped to 1.63 million barrels per day (mbpd) in Q3 2016 compared to 2.15 mbpd recorded in the comparative period in 2015.

With the exception of the broad effects of low oil prices and production disruptions in the delta region, the overwhelming impact of Central Bank of Nigeria (CBN) foreign exchange policies on the economy dominated the year. These policy actions were driven by the desire of the CBN to sustain the pegged value of the naira against the US dollars. Despite the announcement of a liberalization of the foreign exchange market in June, the interbank exchange rate continues to be managed. Consequently, business activities were pushed to the parallel market due to lack of supply, further widening the gap between the official and the parallel market rates. The premium between the official and parallel market rates raised concerns about the fair value of the naira, which when combined with the lack of FX liquidity resulted in a decline in FX inflows from foreign investors and other market participants through the official market. The economic recovery in 2017 will depend on how quickly and effectively these issues are addressed.

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2016 at a glance

JAN

- CBN discontinued sale of FX to Bureau de Change (BDCs) to stem sharp practises.
- CBN resumed sale of PTA/BTA to customers through banks.
- CBN discontinued daily dollar auctions to banks in a bid to stem reserves attrition.
- CBN replaced CoT with a Negotiable Current Account Maintenance fee of N1/mille.
- Introduction of FG's Stamp Duty charges of N50 per deposit of ≥1,000.

FEB

- Headline inflation rose to 11.4% from 9.6% in Jan. 2016.
- 45% increase in electricity tariff took effect on Feb. 1st, 2016.
- Forcados terminal, was attacked by the Niger Delta Avengers (NDA).
- Banks encouraged to allocate 50% of its CBN intervention funds to fresh LCs.

MAR

- Banks commenced publishing details of FX sales to customers.
- The CBN permitted banks to resume receipt of FX cash deposits from customers.
- The MPC increased MPR by 100 bps to 12% and CRR by 250 bps to 22.5%

APR

- Lingering fuel scarcity affected businesses, thus hindered economic activities in the country.
- Headline inflation maintained its upward run at 13.7% from 12.8% in March 2016.
- The federal government (FGN) announced a possible currency swap deal between Nigeria and China.

MAY

- Headline inflation soared to 15.6% from 13.7% reported in April 2016.
- Price of Petrol was increased by 67% from N87 to N145 per litre.
- Real GDP for Q1 2016 contracted by 0.36% being the 1st contraction since Jun 2004.
- CBN announced a review of the foreign exchange policy and a possible floating of the naira.

JUNE

- The FX Interbank market was reopened with new FX policies and market guidelines.
- The adoption of floating exchange rate saw the naira devalued by 43%.
- CBN launched the 1st Naira-settled over-the-counter (OTC) FX Futures on FMDQ OTC Securities market.
- CBN sold $4.05bn ($582.87mm spot and $3.47bn forwards)

JULY

- FGN begins the disbursement of N50billion budget support facility to states.
- Inflation increased to 17.1% from 16.5% reported in June 2016.
- CBN released circular directing international money transfer operators to sell FX to BDC
- MPC increased MPR by 200 bps from 12% to 14%.

AUG

- CBN reviews dollar sales by banks to BDCs at $50,000 from $30,000 per BDC per week.
- CBN directs banks to sell 60% of all FX to raw materials, plant & machinery.
- CBN reinstates nine (9) banks banned from FX market for failure to remit NNPC funds.
- Nigerian economy officially in a recession as Real GDP for Q2 2016 contracted by 2.06%.

SEPT

- FGN signs contracts valued at $5.1bn for the construction and modernization of rail lines.
- Inflation rises to 17.9% in September 2016 from 17.6% in August 2016.

OCT

- CBN signs agreement with Travelex to sell $15,000 per week to over 3,000 BDCs.
- CBN Suspends 19 Banks from FX Sale to BDCs.
- FGN approves plans to concession railway rehabilitation to General Electric (GE).
- Inflation comes in high at 18.3% relative to 17.9% recorded in Sept. 2016.

NOV

- DSS and EFCC raid BDCs over alleged FX infractions, mandated them to sell at N400/$1.
- Nigerian economy contracts by 2.24% year-on-year in Q3 2016.
- OPEC agrees output cut with some non-OPEC members for first time in 15yrs.
- Inflation rises to 18.5% from 18.3% in Oct. 2016.

DEC

- President Buhari presents the 2017 Budget to the joint session of the National Assembly.
- Inflation increased slightly to close the year at 18.6% in Dec. 2016 compared to 18.5% reported in Nov. 2016.
- The Nigerian Military takes over Sambisa forest, ransacks Boko haram and claims victory.

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Outlook for 2017: The year of economic recovery and growth

With Africa's largest economy entrenched in its worst economic crisis in almost three (3) decades as a result of lower oil prices, which shrank government earnings and caused a shortage of foreign exchange in the import-dependent Nigerian economy, the agreement between OPEC and some non-OPEC members to reduce their output by almost 1.2 mbpd which saw crude oil prices rally to $58.37 pb on January 3rd, 2017 ignites hope for a successful implementation of its 2017 Budget and an early exit from economic recession.

There are concerns however that the economic recovery of the country is dependent on the commitment of members to the OPEC production cut deal and the resolution of militancy activities in the delta region. For the purpose of this publication, we consider two (2) scenarios:

First Scenario: Oil prices remain circa US$57 pb levels and the successful resolution of the militancy attack on oil facilities in the delta region (best case).

Second Scenario: Oil prices crash below US$40 pb and the attacks on oil facilities continues following the inability of government to resolve issues with the militants (worst case).

Other themes of macroeconomic importance for 2017 include:

ECONOMY AND 2017 BUDGET OF RECOVERY AND GROWTH

The 2017 budget of N7.29 trillion titled "Budget of Recovery and Growth" is 20.1% higher than the 2016 budget of N6.07 trillion and predicted on key macroeconomic assumptions of oil production output of 2.2 mbpd, oil price of US$42.5 pb (reviewed upwards to US$44.5 pb by the National Assembly), exchange rate of N305/US$1, inflation rate of 12.92% and GDP growth rate of 2.5%. The budget earmarked N2.24 trillion for capital expenditure, which represents 30.7% of Total Budget, and N2.9 trillion for salaries and pensions. Debt servicing increased from N1.48 trillion in 2016 to N1.66 trillion in 2017 reiterating the federal government's intention to borrow more. With a projected revenue of N4.94 trillion, the projected fiscal deficit stood at N2.36 trillion (2.18% of GDP) compared to N2.22 trillion (2.16% of GDP) in 2016. The federal government plans to meet this fiscal deficit through domestic borrowings of N1.25 trillion and external debts of N1.07 trillion. The highest capital allocation of N529 billion - which represents 23.6% of total capital spending budget - is earmarked for the Ministry of Power, Works and Housing.

On the upside, following the increase of oil prices from US$42.5 pb to above US$50 pb, we see an improvement in government foreign exchange earnings, and a stimulation of economic activities well enough to positively impact all economic indicators including inflation, unemployment, GDP, exchange and interest rates, capital inflows etc. This will result in a successful implementation of the 2017 budget. In line with the latest 2017 economic projection by the IMF and Fitch of an expected GDP growth of 0.6% and 2.6% respectively, we are optimistic that the economy will recover and grow above 1% if the conditions of the best case are successfully met.

On the otherhand if the country is faced with the realities of the second scenario, all economic indices might stay depressed and cause recession to linger further into the year as revenue generation prospects of the country would remain uncertain and as such, the actual performance of the 2017 budget might be less than desired.

BUSINESS AND REGULATORY ENVIRONMENT

The condition of the business environment in 2016 showed the resilience and ingenuity of Nigerians at adapting to tougher macro-economic realities. Despite the economic challenges, the business community found a way to stimulate economic activities albeit at a rather slow pace relative to the previous year. It is however believed that the non-implementation of full terms of the CBN flexible exchange rate policy, brought about a multiplicity of exchange rates with tough consequences for all sectors of the economy rather than foster effective price discovery.

Compared to 2015, the regulatory environment witnessed less regulatory fines and sanctions. In view of the heightened regulatory oversight, we expect corporates to conduct their businesses within the ambit of law whilst displaying the highest level of professionalism and compliance to regulatory provisions.

Should our first scenario play out, we expect to see an improvement in foreign exchange earnings with attendant impact on foreign exchange supply, business activities, and economic wellbeing. On the flipside, any further deterioration could lead to a worsening of the foreign exchange environment, a depression of business activities and protracted economic contraction.

EXCHANGE POLICY

In Nigeria today, we have a highly fragmented FX market with over six (6) sub-market rates mainly as a result of the foreign exchange policy in the country. Considering that a credible FX market is an important factor in building a thriving economy, we expect a full implementation of the terms of the flexible exchange rate policy, which will aid effective price discovery and eliminate multiplicity of rates. The combination of such policy(ies) with an improvement in foreign exchange earnings will ultimately lead to a moderation of inflation, and narrowing of the gap between the official and parallel rates.

Further delays can only create further fragmentation and escalate FX scarcity, with attendant consequences for the economy.

INFLATION

Having risen consistently through 2016, we expect inflation rate to moderate somewhat during 2017. With productions costs driven primarily by exchange rate concerns, we expect that an improvement in foreign exchange availability and stability, coupled with base effects will cause a further moderation in inflation. A continued illiquidity of foreign exchange will however result in increased inflationary pressures on the economy. We believe that the present inflationary pressure is not entirely a monetary phenomenon and the use of monetary policy tools alone might be ineffective. Consequently, we expect the government to commence the implementation of fiscal policies that will not only augment the monetary policies in place, but also spur productivity and encourage local production.

INTEREST RATES

Fixed income yields have risen significantly over the last year as CBN tightened the monetary policy environment in its drive to maintain price stability and encourage much needed foreign currency portfolio investment flows. In the absence of significant foreign currency flows, there have been calls for an easing in the monetary environment, especially with the decline in economic activities and rise in fiscal deficits and government debt servicing costs. While it is believed that the tight monetary policy environment is required, in view of rising inflation and devaluation pressures, it is not unlikely that the CBN may bow to pressure to ease by half year. Under our scenario 1 considerations, an increase in foreign currency receipts accruing to the government, with attendant accretion to reserves and improved exchange rate stability, will cushion fiscal deficit, ease FX illiquidity challenges and spur economic activities. This would result in a gradual decline in yields as investment shifts towards real sector economic agents.

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Conversely, the downside risk of a worsening foreign currency revenue base could negate any gains from an ease in monetary policy. In addition, challenges created by FX illiquidity, FX market fragmentation and cost-pull inflation would further hurt economic activities and investor confidence, leading to higher yields.

NATIONAL AND SUB-NATIONAL BORROWINGS

The timeline of FG's intervention to states revealed that N1.4 trillion has been granted to state governments as Salary Bail-out, debt restructuring and conditional support facilities between June 2015 and June 2016 following the inability of most states to pay its staffs salaries. These states need to improve the Internally Generated Revenue (IGR) to minimize dependence on the centre.

The federal government,on the otherhand, have concluded plans for the issuance of $1 Billion Eurobond before the end of the first quarter of 2017 and are also finalizing proceedings to re-present the 2016-2018 Borrowing plans to the National Assembly. These further underpins the government's determination to develop infrastructure in the country in a bid to stem capital flight and FX demand. We expect the government to articulate a clear implementation strategy for the proposed borrowings and re-present it to the National Assembly for approval as the economy is in dire need of improved infrastructure.

INSURGENCY AND OIL OUTPUT

Despite the commendable rescue of 21 of the over 200 school girls abducted in Chibok by Boko Haram and the reported victory of the Nigerian Army over the Boko Haram insurgency, the socio-political environment remains fragile with the resurgence of Biafran agitators, sporadic killings by suspected Fulani herdsmen, pockets of kidnappings and the increased attacks on crude oil production facilities by the Niger Delta Avengers (NDA) and other militants in the delta region.

Scenario 1 will witness an increase in capital inflow as the availability of FX in the economy will revamp economic activities and reawaken investors' confidence. The government will also be able to meet its projected oil production level of 2.2 mbpd (or more), take advantage of the increase in oil prices to boost the country's economic standing and shore up reserves. On the other hand, scenario 2 might be occasioned by incessant vandalization of oil producing facilities by the militants and further relegate the economy to continued negative growth. We expect the federal government to conclude negotiations with the militants and calm the restiveness in the region.

We also expect the National Assembly to live up to the expectations of Nigerians by prioritizing the smooth passage of the Petroleum Industry Bill (PIB). The bill, which will provide legal and regulatory framework for the oil industry, is the singular reason why the huge investment potentials in the refining, deregulation, deal financing etc. of the industry are yet to be harnessed and maximized.

EXTERNAL RESERVES AND CAPITAL FLOWS

The Nigerian external reserves grew by US$3.6 billion (15%) from US$23.8 billion on the 19th Oct. 2016 to US$27.4 billion on the 19th January, 2017. On a year-on-year basis, reserves shrunk by US$0.8 billion (2.8%) as reserves stood at US$28.2 billion in January 2016. According to NBS's report, capital inflows into the country increased from US$1.04 billion in Q2 2016 to US$1.82 billion in Q3 2016 which represented a 75% increase in Foreign Direct Investment (FDI), Foreign Portfolio Investment (FPI) and other investments between Q2 and Q3 2016. On a year-on-year basis however, total capital into the country declined by 46.9% from US$9.6 billion in 2015 to US$5.1 billion in 2016. This validates the exit concerns of foreign portfolio investors which is premised on repatriation risk.
The quarter on quarter (Q-o-Q) increase in capital inflows is a positive development that will result in further improvement if first scenario plays out as the much needed FX will ease the pressure on the naira and Investor confidence will continue to gain momentum. However, the second scenario will further dampened investor confidence and lead to further depletion of the reserves.
The resilience of the Nigerian banking sector was tested

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The Banking Industry

this past year as institutions were impacted by economic headwinds, including increasing regulation and FX restrictions, acute FX scarcity arising from reduced oil receipts, worsening asset quality and muted loan growth. With the economy on its way to recording its first annual contraction in over 20 years, the industry is best placed to facilitate economic recovery and growth.

SYSTEM ILLIQUIDITY

The combined effect of dampening appetite for risk assets creation, weaker asset quality, naira depreciation, FX scarcity and epileptic economic activities is further constraining earnings. With the first scenario successfully achieved, the system liquidity will improve and banks will witness better asset performance as customers will be able to meet the repayment of maturing loan obligations which raise earnings. Conversely, scenario 2 will see system illiquidity situation linger further into the year and asset quality deterioration will impact the industry.

ASSET QUALITY

The industry has been plagued by declining asset quality in the wake of the decline in crude oil prices, devaluation of the naira and FX scarcity, with ratio of non-performing loans rising to 11.7% from 5.3% in Dec 2015[3]. especially challenged exposures to general commerce, manufacturing, oil & gas and power sectors.

With the oil and gas loans accounting for about 30% of total industry exposure, an improvement in oil sector receipts as detailed in scenario 1 will provide relief for banks, enhance repayment of obligations and improve asset performance. The downside, however, of continued challenges to production and evacuation of crude oil from the delta region will lead to further deterioration of asset quality and repayment defaults as reduced earnings weakens the ability of players to meet their scheduled repayment to banks.It is not unlikely that the CBN would extend more NPL forbearance for exposures to the most hit sectors of the recession including oil and gas, power, general commerce, manufacturing etc.

CAPITALIZATION

With banks reeling under the pressure of naira devaluation and earnings challenges, capital adequacy buffers might have been eroded below minimum regulatory requirement level. In view of the full compliance to Basel II in the computation of capital adequacy ratio (CAR), and the possibility of further asset quality deterioration ocassioned by loan loss provisioning implications, it is not unlikely that banks might have to raise additional capital to stay within the 15% minimum capital requirement of the CBN. There may then be considerations for a reduction in this requirement or forbearance as the current market conditions are unsuitable for a capital raise.

CONCLUSION

Despite the beating the Nigerian economy has taken in the last 24 months, one thing is still clear; the fundamentals of the economy, which includes the market size, population, enterprise competency of Nigerians, demographic, natural resources etc., are still very strong. In our opinion, the harmonization and implementation of the right policies (both fiscal and monetary), that will optimize these fundamentals into stimulating economic activities and maximizing productivity, appear to be the missing link.

Below are some issues that the government must address to return the country on the path of economic recovery and prosperity this year:

- Genuine liberalization of the foreign exchange market with the intention of achieving a single exchange rate should be topmost on the minds of monetary authorities.
- Credibility of the foreign exchange policy is key to attracting investors. Hence, policies must be transparent, unambiguous and fully implemented.
- The federal government must put its best foot

forward in finding a lasting solution to the militancy concerns in the Niger Delta.

- The true deregulation of the downstream oil and gas sector will only be achieved when the Petroleum Industry Bill (PIB) has been passed into law. Significant investment in local refining can only come to fruition after the signing of the PIB into law.
- The government, as a matter of urgency, needs to prepare an economic blueprint detailing milestones and roadmaps with unambiguous key performance indicators (KPI) regarding the attainment of economic prosperity.
- Policy credibility will attract desired investment and in turn bring about sustainable and inclusive economic growth.