Time to Adjust the Exchange Rate:

The MPC needs to adopt an exchange rate management strategy that will boost investors' confidence.

The Monetary Policy Committee (MPC) needs to adopt an exchange rate management strategy that will boost investors' confidence in the Nigerian economy. A currency adjustment that reflects the decline in the crude oil price will boost investors' confidence in the economy and would lead to capital inflows. The MPC of the Central Bank of Nigeria (CBN) will hold its first meeting for the year 2016 between January 25 and January 26, 2016. At the end of its November 2015 meeting, the MPC lowered the Monetary Policy Rate (MPR) and the Cash Reserve Requirement (CRR) to 11% and 20% respectively. The MPC however maintained the Liquidity Ratio (LR) at 30%.

The FOMC may announce a rate increase on January 27, 2016.

The International Monetary Fund (IMF) revised its global economic outlook for 2016 and 2017 lower than the projection in its October 2015 Edition of World Economic Outlook (WEO). The revised global outlook was contained in the IMF WEO, UPDATE released on January 19, 2016. While it expects a modest and uneven recovery to continue in the advanced economies, it notes that the picture in many of the emerging and developing countries is challenging. The major downside risks that the IMF sees are: the slowdown in China, the current low commodity prices and the gradual monetary tightening in the United State (U.S). The Federal Open Market Committee (FOMC) of the Federal Reserve System (The Fed) may increase its Federal Fund Rate by another 25 basis points when it meets between January 26, 2016 and January 27, 2016. This will further increase the yields in the U.S and reduce the flow of capital to the emerging and developing markets.

The IMF estimates that the Nigerian economy, measured by the Real Gross Domestic Product (GDP) grew by 3% in 2015 and is projected to grow by 4.1% in 2016. The GDP growth is lower than the average historical growth rate of 5.31% recorded between 2011 and 2014. The CBN maintained that the need to reflate the economy necessitated its recent monetary policy easing. **However, the current exchange rate policy may not attract the needed investments into infrastructure developments, which are required to make the economy competitive.**

The inflation rate closed the year 2015 at 9.55% the highest figure in 36 months.

The inflation rate closed the year 2015 at 9.55% the highest figure in 36 months. The increase was fueled by an increase in the price of imported foods and in fuel price in the country. The short-term outlook of inflation rate would be influenced by the increase in electricity tariff, the impact of a depreciation of the Naira on the pump price and the decline in global commodity prices. The real yields on most of the fixed income securities are negative at the moment. **Our inflation rate forecast shows that the average inflation rate will remain in single digit in the year 2016.**

The short-term outlook for oil price remains bearish.

The short-term outlook for oil price remains bearish on growing global supply and weak demand, and the appreciation in the value of the U.S Dollar. The price of Bonny Light crude oil declined by 37.46% between the last MPC meeting and January 18, 2016. The low oil price has negative impacts on the external reserve, fiscal and current account positions of the Federal Government of Nigeria (FGN).

The Bonny Light price closed at US$44.56/b on November 24, 2015 and closed at US$27.87/b on January 18, 2016. **An adjustment in the exchange rate may increase the Naira revenue of the government and attract capital from other sources.**

A devaluation may stem the decline in the external reserves in the short-term.

The 30-day moving average external reserves declined by 5.48% from US$30.13bn at the last MPC meeting to US$28.48bn as at January 18, 2016. This reflects the declining oil exports as a result of the drop in oil price, drop in capital inflow and the CBN's strategy to support the Naira. **We expect the external reserves to continue to drop in the short-term under the current declining oil price and exchange rate management strategy of the CBN. The policies to grow non-oil exports may take time to achieve the objective. A devaluation may stem the decline in the external reserves in the short-term.**

There is an unsustainable and unhealthy disparity between the exchange rate at the official market and that of the parallel market. The value of the Naira depreciated by 24.69% to US$/N300.50 on January 19, 2016 from US$/N241.00 as at November 24, 2015. However, it remained stable at the official market at US$/N197. It is too early to observe the impact of the recent CBN policy to allow foreign currency cash deposits with Nigerian banks**. This policy is intended to increase the supply side of the foreign exchange in the banking system.**

Banks are cautious about lending at the moment.

Despite the efforts of the CBN to stimulate lending to the real sector, our findings show that banks are cautious about lending at the moment. The major issues relate to the weak demand in the country, low oil price, lack of clear economic policy direction. The daily average inter-bank liquidity in the last one month is about N870bn. Banks currently invest substantial amount of money in safe government instruments despite the low yields. The CBN resumed its liquidity mop-up activities recently to reduce the liquidity in the system. The average 30-day NIBOR (Nigerian Interbank Offered Rate) between September 2015 MPC meeting and November 2015 meeting is 13.21%, while it is 8.69% between November 2015 and January 19, 2016. We however note that the FGN budget deficit of over N2.2trn and the rising interest service to revenue of over 35% will drive up interest rates and yields.

An adjustment in the exchange rate is desirable.

Considering the outlook of oil price, its impact on external reserves and the current low investors' confidence in Nigeria, an adjustment in the exchange rate is desirable. We expect an adjustment in the value of the Naira to a region of US$/N230-US$N240. We maintain a hold decision on CRR, MPR and LR.

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