

Economic Report | Monetary Policy

MPC Preview: Policy trade-off still favours no change

Economic Snapshot

August 2017 Inflation Data/Indices

	MoM	YoY	Prev YoY
Headline	1.0%	16.0%	16.1%
Food	1.1%	20.3%	20.3%
All Items Less Farm	0.9%	12.3%	12.2%
Imported food	1.3%	14.4%	14.1%
Energy	0.4%	10.7%	11.6%

Currency Markets

	Latest	Daily Chg	YTD
USDNGN	359.9	-0.2%	14.1%
EURNGN	430.49	-0.1%	29.8%
GBPNGN	484.7	-0.4%	25.6%
JPYNGN	322.0	-0.31%	18.4%

Monetary Aggregates – July 2017

	(₦'bn)	MoM	YoY
M2	22,200	2.4%	-1.5%
CPS	22,172	0.8%	-1.1%
NCG	4,987	12.7%	66.0%
NFA	8,743	3.3%	15.6%
NDC	27,160	2.9%	6.8%

External Position

	Latest	QoQ	YoY
Trade Balance (\$'mn)	84.76	-9.6%	N/A
External Reserves (\$'mn)	31,883	5.5%	28.0%
Foreign Debt (\$'mn)	13,808	21.1%	23.3%

Growth Data – Q2 2017

	(₦'bn)	%of total	YoY
Real GDP	16,307	100%	0.5%
Agriculture	3,745	23.0%	3.4%
Oil	1,449	8.9%	1.6%
Services	5,974	36.6%	-0.5%
Wholesale and Trade	2,787	17.1%	-1.6%
Manufacturing	1,529	9.4%	0.6%

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- As the MPC commences a two-day policy meeting today, we expect majority of its members to vote to keep monetary policy unchanged. This decision will be aided by the body's zero tolerance for price and exchange rate volatility which has subsisted in the last few months.
- Despite improved economic fundamentals, we expect the MPC to remain cautiously optimistic and not to put a shade on the modest stability seen in the FX market thus far. For context, our view is premised on MPC's surmise on the strong relationship between recent FX market gains and Nigeria's slowly recovering economy.
- In addition, sustained pressure on MoM food inflation is likely to drive a retention of current hawkish policy stance—with recent floods set to impact Q4 inflation numbers. In any case, with average inflation still over 16% YTD, subsisting negative real return on investment should provide further support to the apex bank.
- Farther out, given the fragile pace of real GDP growth, subsisting CA surplus position and expected downtrend in inflation, we expect the MPC to switch to an accommodative monetary policy stance in H1 2018.
- We think the CBN will continue to scale back on OMO issuances to drive a downtrend in the yield curve till our H1 2018 call plays out.

Core of MPC still favour no change

At its last meeting in July, the MPC elected to leave its monetary stance unchanged by keeping MPR at 14%, with the asymmetric

corridor at +200 and -500 basis points around the MPR, CRR at 22.5%, and liquidity ratio at 30%. While two external members voted for a rate cut, on the premise of supporting growth and reducing FG borrowing cost, majority of the members (internal members) still favored a hold on policy stance. Justifying the vote to maintain status quo, the CBN harped on the need to protect growth against the risk of upsetting exchange rate and price stability. Though the committee held a fairly optimistic medium-term outlook on the economy, a clamour for caution dominated sentiment with majority of the members stressing the need to safeguard the relatively nascent stability in the FX market via an optimal interest rate parity necessary to attract sufficient inflows to the economy.

Domestic fundamentals send mixed signals

Real GDP expanded in the second quarter of 2017 (+0.55% YoY) following five consecutive quarters of economic contraction due to a recovery of crude production from 2016 battered levels. More so, resilience in agriculture kept the non-oil GDP in the positive territory. That said, non-oil GDP growth still disappointed as the Q2 17 reading (0.4% YoY) signalled a slowdown from Q1 17 levels (+0.72% YoY) following contractions in Services and Trade. The pattern in non-oil, owing to a slack in ICT (12% of GDP) and impact of credit tightening on Trade (17% of GDP), suggests that the pace of economic recovery is likely to remain soft over the rest of 2017 and even going into 2018.

Despite recent moderation in inflation in August, our latest market research points to renewed retail price pressures across some commodity names. In addition to this, we expect the extension of flooding into September to limit pass-through from impact of improving food supply following the commencement of the main harvest in the South (MoM: September 2017E: 1.0%; historical average: 0.68%). Largely reflecting this, our food inflation expectation for October through December is slightly ahead of trend levels (+3bps higher than the average over the three years leading to 2016 at 0.81% MoM) with Nigerian Metrological Agency having also highlighted potential impact of shorter length of growing season in many parts of the country. Consequently, we now look for average food inflation of 19.75% YoY over 2017 and 20.23% by December. In view of this, headline inflation should average 16.7% YoY over the rest of 2017. On balance, though the weak growth outlook provides argument for monetary policy accommodation, we believe the CBN, as in prior meetings, is likely to focus on the largely sticky inflation picture and its price stability mandate in arriving at a decision.

That said, recent cessation of the one-year OMO paper and gradual reduction in clearing rates at OMO auctions suggest the CBN is edging closer to an inflection point policy wise, if one goes by historical patterns. For evidence, we note the recent action by the CBN in money markets, where the apex bank allowed liquidity build up into massive demand at the primary market which eventually resulted in rates decline at the primary market auction (PMA). In addition, since the CBN ceased issuance of the one-year bills at its OMO auctions, Treasury bill yields have maintained a downtrend with longer term rates dropping faster than that of shorter-term instruments. Specifically, at last week's PMA, the stop rate on the one-year paper dropped by 152bps (compared to prior auction) to close at 17.0%. The attendant impact of this has cascaded into a downtrend in secondary market rates on Treasury bills and bonds. We believe the change in CBN stance reflects one of two things: an attempt to reduce the real return on rates to capture the impact of declining inflation or given the failed bond auction in August, the apex bank is now sensitive of the impact of its OMO issuances on government borrowings. Given limited evidence of coordination between the fiscal and monetary blocs of Nigeria's economic management team, we lean towards the former as the justification for CBN's reluctance at mopping up system liquidity. In the interim, we therefore expect the CBN to assume a less aggressive stance at its OMO windows to continue to drive rates lower.

However, in terms of symbolism via the MPR, we do not think the CBN is at an end to the tightening cycle as policy rates remain negative in real terms. In the light of the clamour for caution at the last MPC, and our views regarding downward sticky inflation in Q4 17, we expect the MPC to leave its policy rate unchanged at this meeting.

Farther out, we see a confluence of rising maturities in the first half of 2018 which the CBN would struggle to grapple with as creating scope for yields to slide. Furthermore, we see continuing CA surplus picture and further room for inflation to trend lower as widening the monetary policy space for an accommodative posture in H1 2018.

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