

Monetary Policy: *When will the ‘Dove’ coo?*

Key Macro Indicators

Currency	This Week	Prior Week
External Reserve (\$'bn)	47.75	47.79
USD/NGN (₦/\$)		
NAFEX	360.85	361.05
Parallel	363	362
Economic Snapshot	Latest (%)	Prior
Inflation YoY (March)		
Headline	12.48	13.34
Core	10.92	11.18
Food	14.8	16.08
GDP (%) - YoY	Q1 18	Q4 17
Real GDP	1.9	2.1
Oil	14.8	11.2
Agriculture	3.0	4.2
Manufacturing	3.4	0.1
Services	0.5	-0.8
Capital Importation (\$'mn) - Q4 17	Q1 18	Q4 17
Foreign Portfolio Investment - Equities	701.61	989.2
Bonds	335.88	309.5
Treasury Bills	3,527.6	2,178.
Foreign Direct Investment	246.6	378.4

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Summary

Notwithstanding the downtrend in inflation which is expected to close the year at 9.9%, the budding apprehension about the impending liquidity in the system and lower capital flows with a growing possibility of capital flight—which poses a risk to the committee’s unspoken goal of building the reserve and achieving a sustained stability of FX, will leave the committee with a cautious stance of leaving policy parameters unchanged all through 2018

- This week’s Monetary Policy Committee (MPC) meeting produced our expected retention of the policy rate at 14% alongside all other policy parameters (**See Report - *MPC Preview: Rate cut delayed, not derailed***). However, the policy guidance on interest rate moves, in my view, was modestly ‘hawkish’, despite the haunting moderation in the headline inflation, accretion in the external reserve and the relative stability of the currency. In fact, the decision to leave policy rate unchanged was not entirely unanimous this time, as one member voted for an increase in the policy rate to 14.5%. In passing, we await the full minutes of the meeting, to know which member is more hawkish than the pack, so we don’t miss the body language of a runner for the central bank governor.

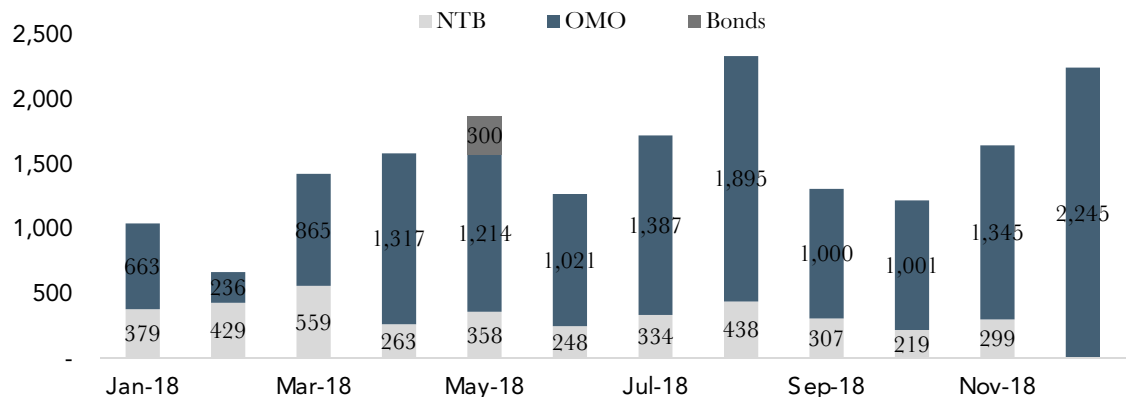
What has changed?

- Rhetoric of the accompanying communique and statement from Governor Emefiele in the post-meeting interview kept resonating the word, **Liquidity!** Basically, the committee is now progressively voicing concern about the impact of impending liquidity in the second half of 2018 on exchange rate and price stability. The MPC alluded to the forecast of high liquidity injection in the second half of 2018, upward pressure on prices, driven largely by substantial expansionary fiscal policy, which will arise from the late passage of the 2018 appropriation bill, outstanding balance from the 2017 budget and the pre-election expenditures. Furthermore, the MPC recognized the liquidity impact of rising FAAC distribution, following increase in crude oil prices.

Estimating the quantum of liquidity

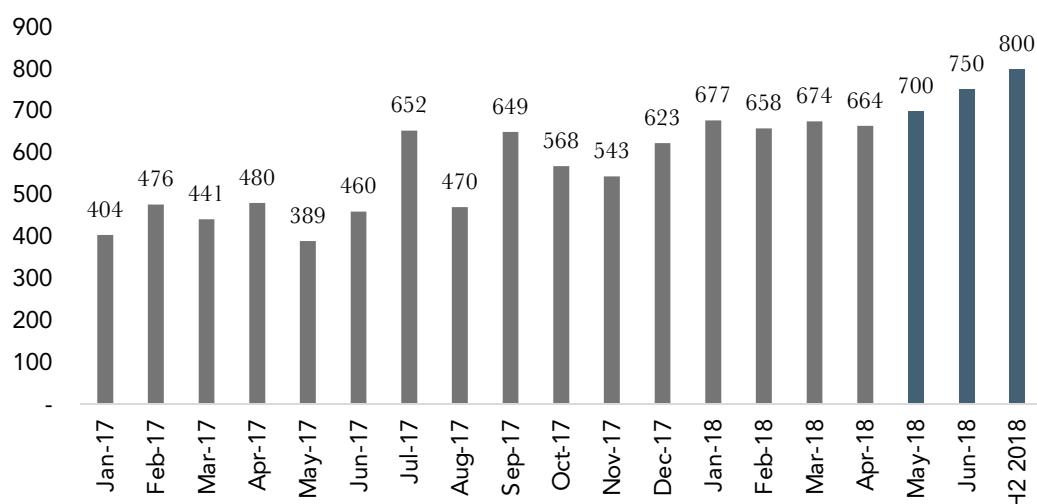
- Over the second half of 2018, the CBN will have to grapple with an elevated maturity profile, which resounds our view at the start of the year (**See Note: Fixed Income: The unstoppable force of liquidity**). More so, following rising crude oil prices and peak production levels, FAAC inflows have risen from an average of ₦500 billion in 2017 to ~₦650 billion recently, and is likely to cross ₦700 billion mark in H2 2018, when the impact of >\$75/bbl. crude oil starts to play out. What's more, given the coming election and late passage of the 2018 budget, there is a tendency to implement the budget swiftly, before the election, especially on the capex leg, which will further stoke the expected liquidity pressure.

Figure 1: 2018 Maturity Profile - OMO, NTB, and Bonds (₦' billion)



Source: FMDQ, ARM Research

Figure 2: FAAC distribution – historical and forecast (₦ billion)



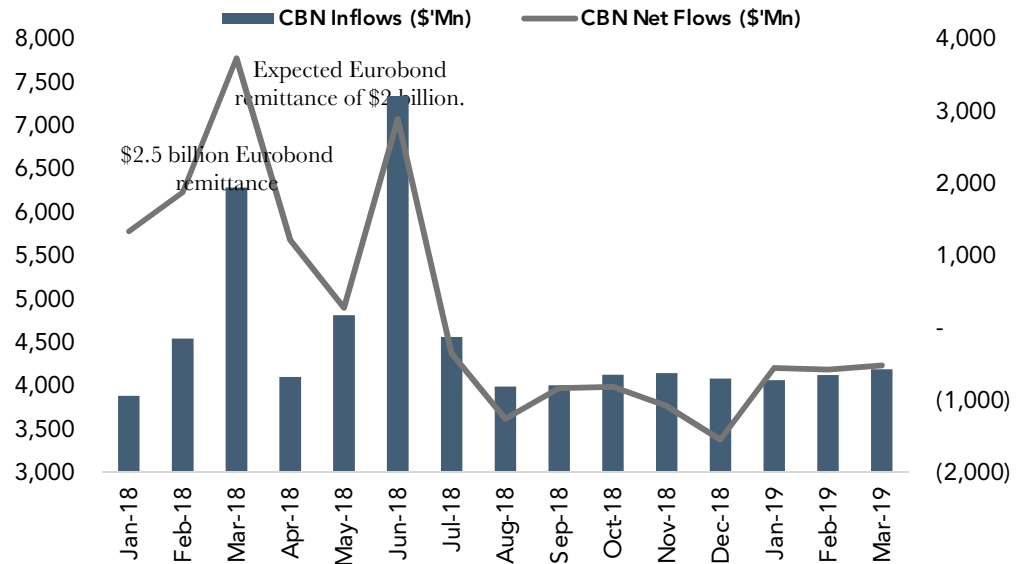
Source: NBS, ARM Research

Exchange Rate & FX Reserve...the veiled worry

- It is an unspoken fact that the key goal of the CBN is to maintain stability in the FX market, and thus, possible capital reversal and reduction in portfolio inflows is a cause for concern for the monetary authority. Surprisingly, after rising to a high of \$47.9 billion on the 10th of May 2018, recent data from the CBN revealed a gradual drawdown in the reserve. For context, between 10th and 21st of May, the reserve has been drawn-down by \$112 million to \$47.6 billion (-0.55% MtD). The drawdown in the reserve is largely connected with the increased sales by the apex bank at the IEW. Going by available data from IEW, the CBN increased its sales at the window to \$92.9 million so far in May, from \$65.3 million for the whole of April, in a bid to cover the sudden slump in inflows at the window. As at the time of writing, offshore inflow at the IEW had declined 86% MoM to \$254, reflecting 87% MoM decline in FPI flows to \$227 million. Thus, for the first time in 10 months, the IEW recorded a net-demand of \$1.1 billion from a net-supply of \$303 million same period in April.
- Going forward, we have estimated a case wherein foreign investors exit their maturing local fixed income instruments, which we estimate at \$9 billion (30% of \$37 billion - ₦11 trillion). This implies an average monthly capital flight of \$697 million which added to our revised mean CBN intervention across other segments of \$4.3 billion brings average monthly outflows from the apex bank to \$4.9 billion.

On our expected CBN inflows, we have adjusted our crude oil price projection to average \$70 per barrel for the rest of the year and factored in the \$2 billion Eurobond by the fiscal authority for the year, which raised our average monthly CBN inflow to \$4.6 billion. Accordingly, we estimate mean monthly reserve drawdown of \$340 million with an end year balance of \$44 billion.

Figure 3: Capital reversal likely to put some pressure on CBN flows



Source: CBN, ARM Research

Maintain Status Quo - the plausible direction

The options available to the MPC to curb the liquidity concerns, are;

- Raise the MPR by 100bps to 15%
 - Change the corridor around the MPR from +200/-500bps to +/-200bps.
 - Raise the CRR from 22.5% to 25-30%
 - Maintain status quo.
- In trying to ascertain the direction the MPC will take, we analyze the impact of the possible options available to the committee. Firstly, while raising rates would ensure the mop-up of excess liquidity, its impact on depressed consumption, increase in borrowing cost and the possible repricing of risk assets by the banks negates the case for a raise in interest rate. Also, while changing the standard deposit facility (SDF) rate from MPR minus 500bps, which is 9% to 12% (MPR minus 200bps), will curb excess liquidity with the banks, the CBN's use of OMO has largely distorted the workings of the SDF and SLF as rate anchors and thus weakens the influence of the

corridor around the MPR. More so, the CBN decision, initiated in 2014, to limit the maximum amount of funds on which it pays the SDF rate to ₦7 billion per bank in a day limits the influence of the SDF. Elsewhere, while raising the cash reserve ratio (CRR) to 25% - 30% from current levels of 22.5% will rein in on excess liquidity, the impact on bank's lending to the real sector, which the MPC is looking to improve, disavows this option. ***Consequently, we are of the view that the MPC may maintain status quo through H2 2018 on concerns of liquidity and increase its quantum of mop-ups via OMO from the end of Q3 2018.*** In our view, the CBN now measures its performance with the external reserve level, which it hopes to take to \$50 billion psychological mark before the end of the current tenure. More so, the CBN seems to have completely relegated its secondary role of economic growth and rather plays the role through its direct intervention funds/programmes. Overall, despite the downtrend in inflation which is expected to close the year at 9.9%, the budding apprehension about the impending liquidity in the system and lower capital flows with a growing possibility of capital flight—which poses a risk to the committee's unspoken goal of building the reserve and achieving a sustained stability of FX, will leave the committee with a cautious stance of leaving policy parameters unchanged all through 2018.

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