

Nigeria Strategy Report

H1 2020

Domestic Economy and Policy Environment

Monetary Policy: CBN caressing both FPIs and Economic Growth

Executive Summary

Over H2 2019, the monetary authority maintained its drive to spur economic growth while keeping FX stability at the fore front of its activities. To start with, following a rate cut in March 2019, the monetary authority kept its benchmark rates unchanged all through the second half, reflecting the need to balance the trend between growth and inflation. Meanwhile, in a bid to support FX inflows, stop rates at the OMO auctions (CBN's preferred monetary policy tool) were hiked in August and has remained at almost the same level since then. In a separate move, non-bank locals (individuals and corporates) were barred from participating in CBN's auctions in October. Elsewhere, upon seeing the gains realized from its initial directive of a minimum loan to funding requirement of 60% for DMBs, the CBN revised it higher to 65% effective from Dec 31st, 2019.

Looking ahead, anticipated maturities is expected to come in at ₦15.6 trillion over 2020 split into ₦13.0 trillion OMO bills and ₦2.6 trillion of T-Bills. More worrisome is the fact that about ₦3.6 trillion of OMO maturities would certainly hit the system due to exclusion of non-bank locals from participating in OMO auctions. Though the apex bank might have expressed more fondness to supporting growth in the real sector in recent time, we can't ignore its major concern - maintaining FX stability. Hence, we believe FX stability will continue to be a major focus area for the CBN in 2020. It is therefore pertinent to adjudge what CBN's reserve position would be over 2020. We see the FX reserve ending H1 2020 lower at \$34 billion against the backdrop of slow inflows and continued intervention to meet FX demands. Hence, we think the CBN has enough ammunition to continue its growth drive in the interim. In our view, we think as long as FPI are satisfied, the CBN will give less thought to the impeding liquidity – stemming from the exclusion of non-banks in OMO auctions. Nonetheless, we believe the CBN would continue to enforce its loan to funding requirement in a bid to manage liquidity, while maintaining its regular OMO auctions. On the former, excess liquidity in the system is given out as loans. In addition, any shortfall is duly charged to the DMBs as CRR, thus reducing liquidity as well.

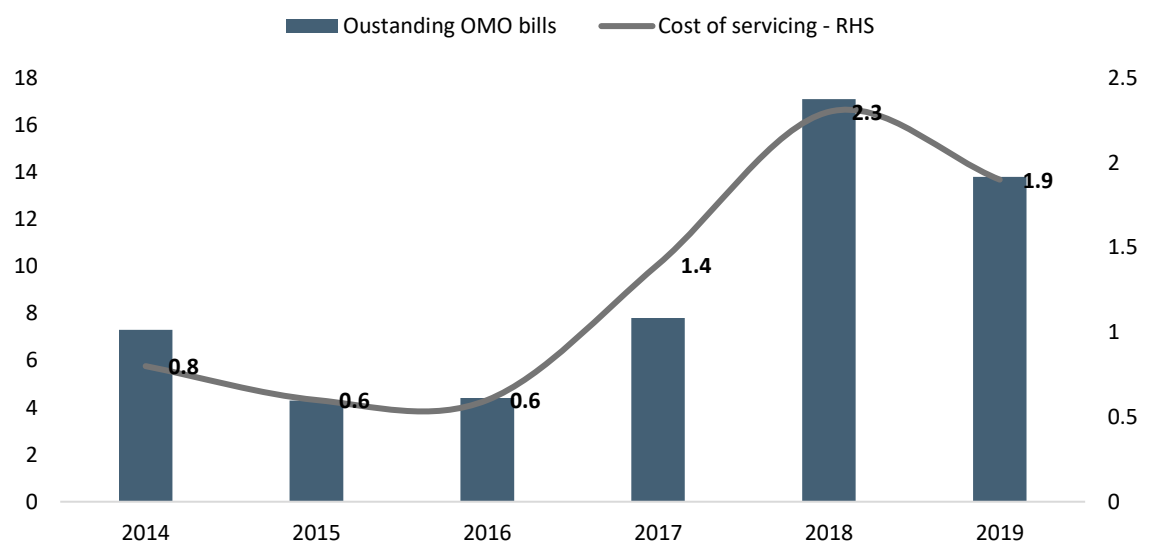
In this report, we look at the major themes that dominated monetary policies in Nigeria over H2 2019 and delineate our outlook for CBN's monetary stance over 2020.

CBN caressing both FPIs and Economic Growth

Over H2 2019, the monetary authority maintained its drive to spur economic growth while keeping FX stability at the fore front of its activities. To start with, following a rate cut in March 2019, the monetary authority kept its benchmark rates unchanged all through the second half, reflecting the need to balance the trend in economic growth and inflation. However, in our view, we see the MPR as a symbolic tool given its ineffective transmission to other major rates. Meanwhile, in a bid to support FX inflows, stop rates at the OMO auctions (CBN's preferred monetary policy tool) were hiked in August and has remained at almost the same level since then.

In a separate move, non-bank locals (individuals and corporates) were barred from participating in CBN's auctions in October. We think the rationale behind the exclusion of non-banks locals from participating in CBN's auctions is to reduce the cost of financing these maturing bills, which is far higher than the yield on its interest earning assets. For context, outstanding bills have increased from just ₦4.3 trillion in 2015 to record level of ₦17.0 trillion in 2018. Similarly, the cost of financing these bills have risen rapidly as the CBN have hiked the OMO rates at specific periods just to keep FPIs. We estimate an annual average cost of ₦1.9 trillion over the past three years in servicing the maturing OMO bills.

Figure 1: Outstanding CBN OMO bills and Cost of servicing (₦trillion)



Source: CBN, ARM Research

The direct impact of this has seen excess funds in the system chase other riskless investment options such as T-bills and fixed deposits with banks. Due to the relatively smaller markets of these instruments, rates have crashed significantly. In turn, T-Bills secondary rates declined significantly

by 742bps to 4.7% over H2 19 mirroring increased demand from free liquidity created at the OMO window. Similarly, average prime lending rate moderated by 83 bps to 15.27%.

In addition, we think the CBN has successfully disintegrated the transmission between the OMO rates and T-Bills rate and thus, bifurcated the fixed income market. While keeping OMO rates elevated for FPIs, the CBN has indirectly forced domestic rates lower even below headline inflation, to support growth.

Elsewhere, upon seeing the gains realized from its initial direction, the CBN revised the minimum loan to funding ratio for DMB's from 60% to 65% effective from December 31st, 2019. In addition, the apex bank instructed banks to prevent customers with outstanding loans and recipients of intervention funds from investing in T-Bills or OMOs.

In our view, we believe the revised loan to funding requirement was against the backdrop of gains recorded after the initial directive. For emphasis, total net credit to the private sector by DMBs increased by ₦1.2 trillion over H2 2019 (H1 2019: ₦22.7 billion).

CBN's policies annul the maturity effect

At the early part of the second half, supported by lower maturities and moderating inflation, the CBN cut the one-year OMO stop rate by 64 bps MoM to 11.84% in July. However, the month of August ushered a different outcome as the CBN was embattled with a fast pace of FPI outflow (+68% MoM to \$3.2 billion) following a widespread risk that triggered across emerging markets. Eventually, the CBN was forced to raise OMO rate twice to limit the rate of foreign investors repatriation. Over the latter part of the year (Q4 19) where we expected higher maturities, to dictate higher stop rates, the CBN recorded significant demand at its October auctions (2.5x) with the apex bank having enough bargaining power. Consequently, OMO rates were left almost unchanged over October, declining from 13.5% in September to 13.3% in October. Subsequently, OMO rates has trended at circa 13.3% reflecting elevated demand at the auctions. In addition, the trend in stop rate seem to conform with CBN's stance on reducing its cost of liquidity management.

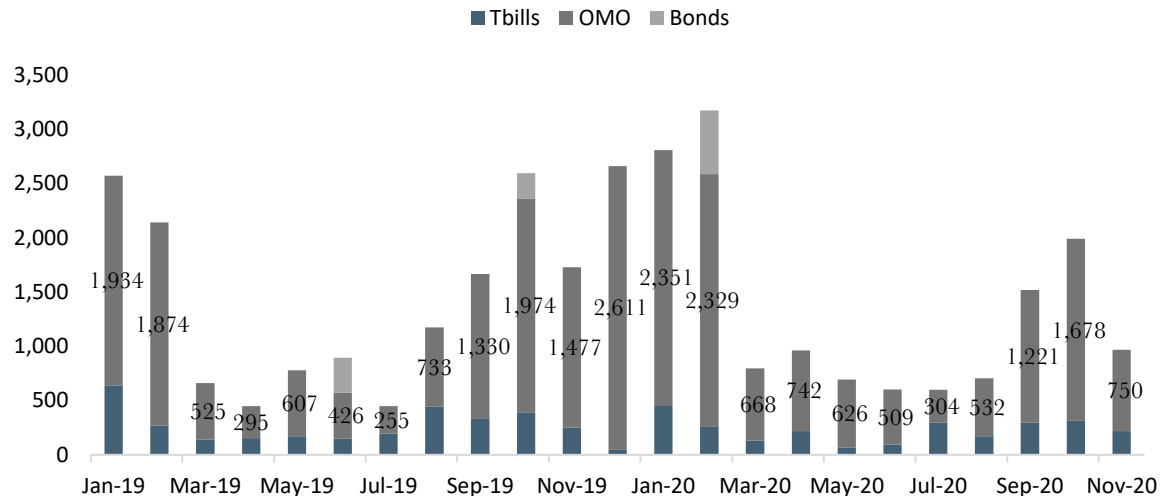
An impending liquidity... what happens?

Looking ahead, anticipated maturities is expected to come in at ₦15.6 trillion over 2020 split into ₦13.0 trillion¹ OMO bills and ₦2.6 trillion of treasury papers. More worrisome is the fact that about ₦3.6 trillion of OMO maturities would certainly hit the system due to exclusion of non-bank locals from participating in OMO auctions. Though the apex bank

¹ Based on 27% holdings of non-banks (locals) as at August 2019

might have expressed more fondness to supporting growth in the real sector in recent time, we can't ignore its major concern - maintaining FX stability.

Figure 2: Maturity Profile (₦billion)



Source: FMDQ, ARM Research

As mentioned earlier, while average T-Bills rates nose-dived to single digits, the apex bank has kept OMO rates at c.13% levels just to keep the foreign portfolio inflows. In turn, the flows have continued to provide support to the FX reserves. Hence, we believe FX stability will continue to be a major focus area for the CBN in 2020. It is therefore pertinent to adjudge what CBN's reserve position would be over 2020.

For us, we see the FX reserve ending H1 2020 lower at \$34 billion against the backdrop of slow inflows and continued CBN intervention to meet the FX demand (FPI repatriation, increased services deficit and imports). This excludes a possible Eurobond issuance in H1 2019. Hence, with FX reserve above \$30 billion, we believe the CBN has sufficient ammunition to support the naira at different FX windows. For context, after being a net buyer (\$6.0 billion) at the IEW for six consecutive months, the CBN has been non-hesitant in aggressively supplying (\$4.7 billion) same window since July 2019.

Having highlighted the above, we think the CBN has enough ammunition to continue its growth drive in the interim (over H1 2020). In our view, we think as long as FPI are satisfied, the CBN would not give much of a thought to the impending liquidity from the exclusion on non-banks in OMO auctions. As a matter of fact, while liquidity from PFAs cannot chase dollar, liquidity from other non-banks (ex PFAs) is just about ₦1 trillion, which should not be a concern. Nonetheless, as a means of managing the impending liquidity, we believe the CBN would continue to enforce its

loan to funding requirement while maintaining its regular OMO auctions. On the former, excess liquidity in the system are given out as loans. In addition, any shortfall is duly charged to the DMBs as CRR, thus reducing liquidity as well. We also see possibility of a review in the loan to funding requirement upwards to 70%.

Irrespective, we see limited upside for OMO rates over H1 2020 as this would nullify CBN's drive on trimming its cost of financial system liquidity management. More importantly, we believe CBN's FX reserve position over H1 2020 should give it enough bargaining power to keep OMO rate at current level over H1 2020. However, beyond H1 2020, should FPI flows and oil price remain depressed, we could see more profounding pressure on the CBN as the FX reserve draw close to its \$30 billion comfort level. As a result, we do not rule out a possibility of higher OMO rate just to keep FPIs. That said, due to the ineffective transmission of the MPR, we do not anticipate a change in the MPR over H1 2020.

While some banks are currently taking placements from non-banks and placing same funds in the OMO market, we do not think this can be sustained. Our justification is because most banks would have a limit on its OMO investment hinged on the need to comply with CBN's loan to funding requirement.

That said, we highlight events that could likely occur in the coming months: (i) Non-banks placing excess funds with DMBs money market, who in turn place same funds at CBN OMO auctions (ii) Given that the CBN has been funding the FG for some months now, the FG could as well increase their treasury bills issuance which would also mop up liquidity. However, we note both actions could negate CBN's initial drive on improving credit to the real sector.

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