

August 2, 2018



Nigeria Strategy Report

H2 2018

Domestic Economy and Policy Environment

Monetary Policy: A classic catch-22, where will the balance tilt?

Executive Summary

In our H1 18 Nigeria Strategy Report, we projected that over the first half of 2018, the CBN will opt for a sustained moderation in the marginal clearing rate at its OMO auctions as well as lower OMO issuances as the way of signaling lower rates while keeping the appearance of policy tightening via holding the monetary policy rate (MPR). Farther out (H2 18), wherein we projected a downtrend in inflation and positive real rate, we expected that the monetary authority will cut the MPR to close the year at 12%. In line with expectation, marginal clearing rate at the OMO auction moderated by 228bps over the first half of 2018 to 12.75% even as net OMO issuance declined to ₦597 billion (H2 17: ₦1.54 trillion). However, our views farther out in the year of a cut in the MPR was revised in May 2018 where we had noted that the monetary authority's budding apprehension about the impending liquidity in the system and lower capital flows with a growing possibility of capital flight, will leave the committee with a cautious stance of leaving policy parameters unchanged all through 2018.

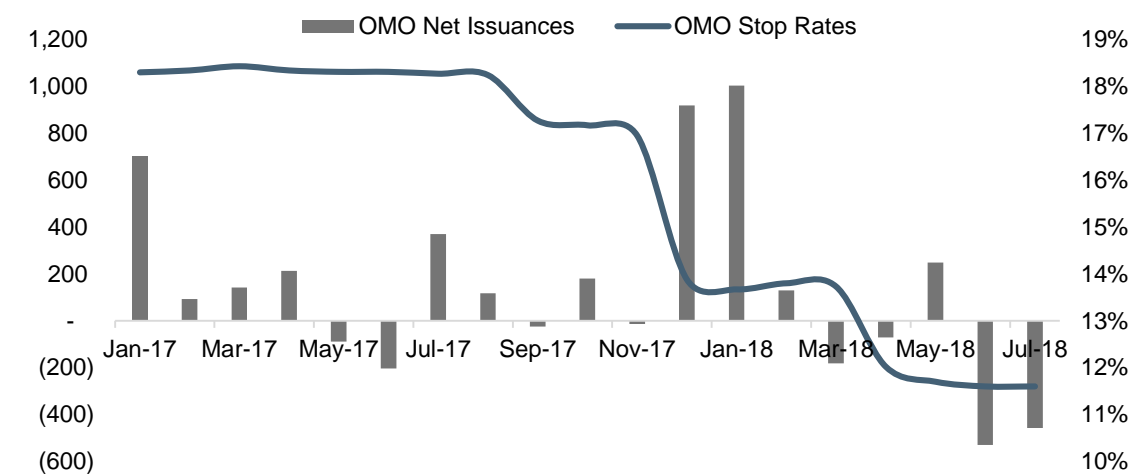
Over the rest of 2018, while the near-term expectation of a downtrend in inflation and stability in exchange rate should drive monetary easing and an eventual cut in interest rate, we think the risk in the medium term to inflation and exchange rate, will continue to dominate the tone of the monetary authorities and thus guides towards keeping interest rate unchanged. In that case, we do not envisage further downtrend in OMO stop rates, as we believe the MPC will hedge its bet in favor of sustaining current monetary and exchange rate stability than take a sharp leap into the unknown with potential negative outcome. Presently, the apex bank has expressed concern on capital flight and inflationary pressure. In fact, at its monetary committee meeting in July, 3 members now vote for a rate hike of 25-50bps.

This report focuses on trends and policies in Nigeria's monetary economy and our outlook for policies towards the rest of the year.

CBN relaxes liquidity strain with bouts of caution

In our H1 18 Nigeria Strategy Report, we projected that over the first half of 2018, the CBN will opt for a sustained moderation in the marginal clearing rate at its OMO¹ auctions as well as lower OMO issuances as a way of signaling lower rates while keeping the appearance of policy tightening via holding the monetary policy rate (MPR). Farther out (H2 18), wherein we projected a downtrend in inflation and positive real rate, we expected that the monetary authority will cut the MPR to close the year at 12% (**See report: Monetary Policy: Dialing back on monetary tightening**). In line with expectation, marginal clearing rate at the OMO auction moderated by 228bps over the first half of 2018 to 12.75% even as net OMO issuance declined to ₦597 billion (H2 17: ₦1.54 trillion). This sits well with our views that stability in USDNGN, downtrend in inflation, and elevated liquidity levels would prompt CBN to reduce its pace of liquidity mop up and steer a cut in OMO rates. However, our views farther out in the year of a cut in the MPR was revised in May 2018 (**See report: Monetary Policy: When will the ‘Dove’ coo?**) where we had noted that the monetary authority’s budding apprehension about the impending liquidity in the system and lower capital inflows 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. In fact, the decision to leave policy rate unchanged was not entirely unanimous, as one member voted for an increase in the policy rate to 14.5% in May’s monetary policy committee (MPC) meeting.

Figure 1: OMO stop rates and net-Issuances (Jan 2017 – July 2018) - ₦billion



Source: CBN, FMDQ, ARM Research

¹ Open Market Operation

After two consecutive months of aggressive liquidity mop-ups, which saw OMO sales touch its highest level in January (₦1 trillion), the apex bank slowed down the pace of its sterilization in February with net OMO sales of ₦129 billion. Particularly, the CBN refrained from mopping up excess liquidity for one week which cascaded into liquidity surfeit in the system. The month of March was no exception as CBN net repaid ₦182.4 billion—its highest net repayment in nine months. Moreover, CBN's increasing tolerance for naira liquidity was evident in its frequency of liquidity mop as it only sold OMO bills on five working days in March—a move last seen in November 2016. Same in April, CBN failed to roll over its maturing OMO bills by net repaying ₦70.8 billion (vs net repayment of ₦182.4 billion in March). CBN sold OMO bills just three times in April and cut OMO rates by 165bps and 235bps to 10.95% and 12.05% for the 90 Day and 250 Day paper respectively. This sits well with our views earlier in the year that stability in USDNGN, downtrend in inflation, and elevated liquidity levels would prompt CBN to reduce its pace of liquidity mop up and steer a cut in OMO rates.

CBN makes a U-turn in May

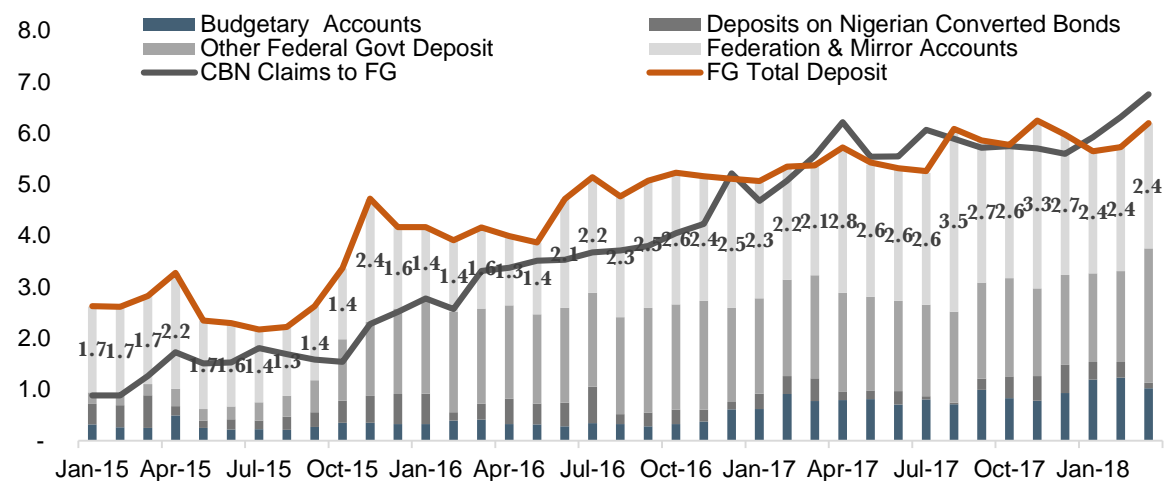
After the decline in OMO rates of 255bps Year-to-April to 12 %, CBN raised OMO rates by 15bps to 12.15% in May as the bank net-issued ₦742 billion worth of OMO bills after two consecutive months of net repayments (March: ₦182 billion, April: ₦70.8 billion). To our minds, the CBN is slightly drifting from its earlier posture to now taking a proactive stance to wade off likely liquidity threats to currency. For clarity, at the May MPC meeting, the focal point of discussion was liquidity and its attendant impact on currency and price stability. This is not surprising as the bloated liquidity profile over the rest of the year – emanating from elevated maturity profile (OMO: ₦9.9 trillion, NTB: ₦2 trillion), higher FAAC inflows (~+27% YoY) and late passage of the 2018 budget could usher in a replay of 2016 where speculation on USDNGN drove wider spread between the interbank and parallel market rates. However, in the month of June, CBN's body language was one that signaled dovishness. For context, CBN net repaid ₦435 billion (vs net issuance of ₦742 billion in May) worth of OMO bills while leaving OMO rates inert as in May.

Central Bank restarts funding to the FG

In contrast to H2 17 where the CBN financing to the FG increased slightly by ₦52 billion over the period, CBN financing to the FG expanded sizably over the period by ₦1.2 trillion in the first quarter of 2018 to ₦6.8 trillion. The expansion in funding was on the back of jumps in overdrafts (15.4% to ₦3.8 trillion) and claims on federation and mirror accounts

which added ₦790 billion over the period. However, CBN holdings of FG treasury bills moderated by 30% over the period to ₦307 billion. To add, unlike prior quarter wherein FG deposit with the CBN far exceeded CBN's claims to FG, the balance seems to have reversed to a net claim on the FG to the tune of ~₦536 billion, as FG deposit grew by just 3.3% over the quarter while CBN claims on FG expanded by 21% over the same period. Coming at a period of significant improvement in fiscal revenue, the increased CBN exposure to the fiscal side comes at a surprise, which in our view suggest the growing worry about system liquidity, concerns on price and exchange rate stability, which informs a slightly hawkish posture by the monetary authority.

Figure 2: Component of FG's Deposit to CBN vs CBN's Claims to FG (₦'billion)



Source: CBN, ARM Research

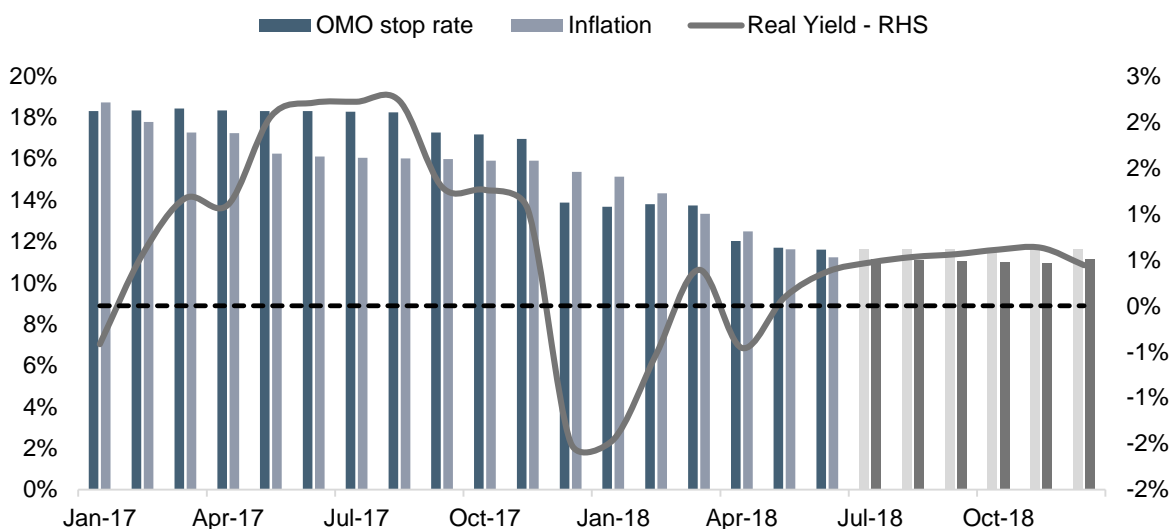
Has interest rate touched the bottom?

In framing our outlook on interest rate for the rest of the year, we look at the trajectory of inflation, exchange rate, and economic growth for the next 12 months, considering a proactive stance by the monetary authorities. On currency, based on our estimated inflows and outflows, we expect the CBN to put its full ammunition to use in keeping the Naira at current bands, which would maintain stability in the short term and keep the interbank at ₦361/\$ for the rest of 2018. However, further down in 2019, we think the distortion of the free interplay of demand and supply at the IEW with the lag expected from CBN intervention would drive short term volatility in rates and pose risk to exchange rate stability. On Inflation, our analysis suggests that while base effects although minimal would drive lower CPI, structural bottlenecks from elevated transportation costs should limit scale of moderation in inflation. Summing up developments across both core and food inflation sub-components, we project mean headline inflation to hover around 12.04% YoY over 2018 (2017: 16.55%). Nevertheless, farther out into 2019 after the elections, with higher crude oil prices, we expect the clamor for PMS hikes and even higher electricity tariff to get louder which, if

implemented, would pressure consumer prices both in the core and food basket and keep the headline reading on an upward trajectory.

Consequently, while the near-term expectation of a downtrend in inflation and stability in exchange rate should drive monetary easing and an eventual cut in interest rate, we think the risk in the medium term to inflation and exchange rate, will continue to dominate the tone of the monetary authorities and thus guides towards keeping interest rate unchanged. In that case, we do not envisage further downtrend in OMO stop rates, as we believe the MPC will hedge its bet in favor of sustaining current monetary and exchange rate stability than taking a sharp leap into the unknown with potential negative outcome. Overall, notwithstanding the downtrend in inflation, the budding apprehension about 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 sustained FX stability—will leave the committee with a cautious stance of leaving policy parameters unchanged all through 2018.

Figure 3: Trend in OMO stop rate vs. Inflation



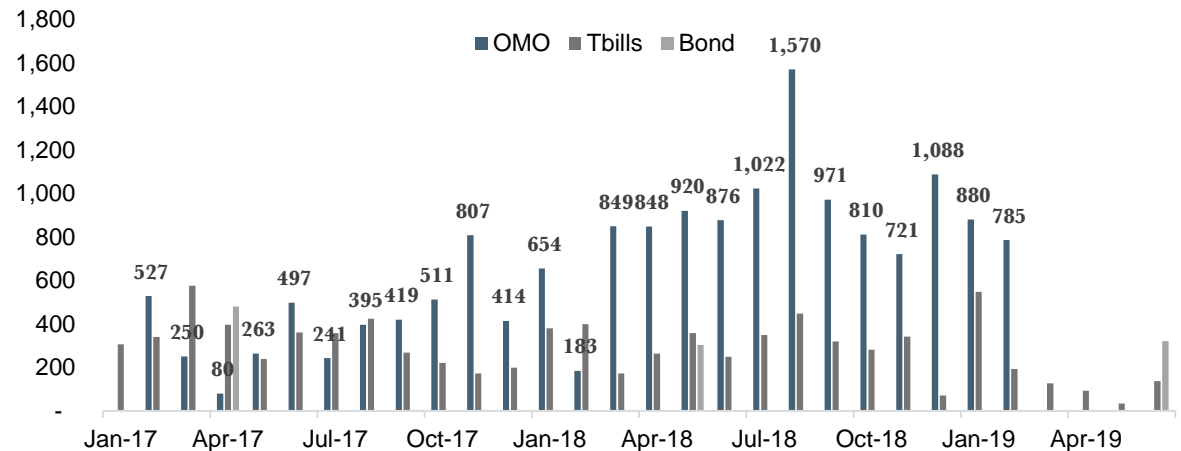
Source: NBS, FMDQ, ARM Research

How will the apex bank manage impending liquidity?

The monetary policy looks set to grapple with elevated system liquidity from maturing bills and bonds. Specifically, with a total of ₦5.1 trillion from maturing OMO bills, and ₦1.5 trillion maturing Treasury bills, the question in our minds is if the apex bank will be comfortable with the elevated liquidity levels or focus on sterilizing this liquidity via higher OMO issuances. In framing our outlook, while we think the fiscal authorities will net-issue in subsequent treasury bill auction, after using up the remain balance of ₦138 billion from

Eurobond for refinancing maturing bills, we think the net issuance will be sizably lower in the range of ~ ₦100 – ₦200 billion. Consequently, the CBN will potentially have to grapple with a liquidity profile in the region of ₦5.1 trillion as well as FAAC inflows over the period. Thus, with CBN's growing concern of exchange rate and price stability, we are of the view that the apex bank will at the tiniest roll-over maturing OMO bills to curb the huge liquidity injection.

Figure 4: Maturity profile (OMO, Bills and Bonds) monthly to June 2019 (₦'billion)



Source: FMDQ, ARM Research

A classic catch-22, where will the balance tilt?

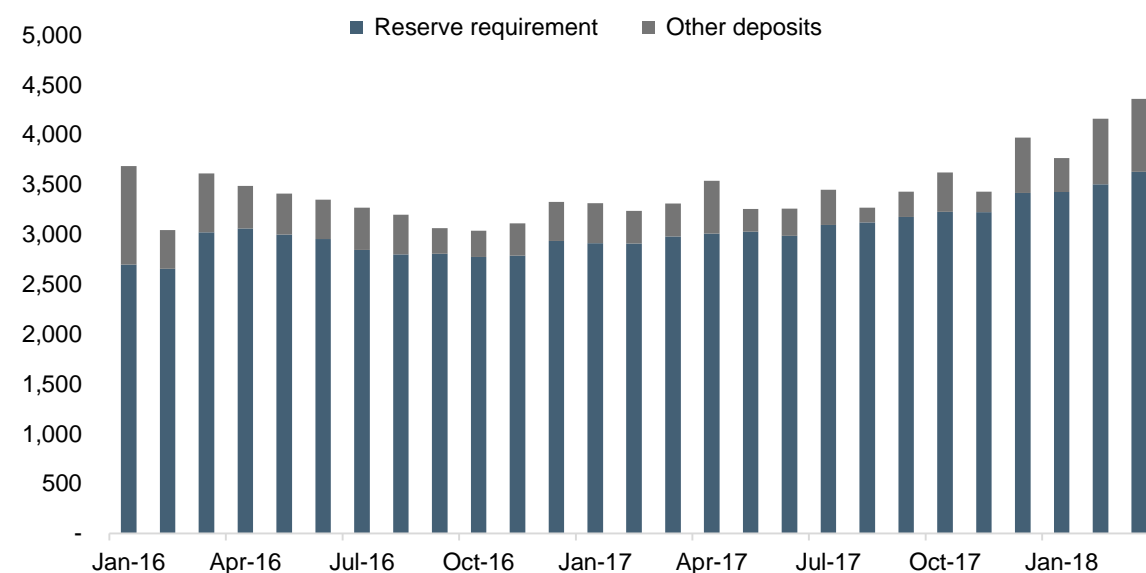
That said, it appears the monetary authorities are in a dilemma, a classic case of Catch-22, as efforts to attain price and exchange rate stability has constantly sent a contrary signal to economic growth. To add, the apex bank seems to have come to terms with the fact that the MPR may have lost its signaling effect to the market, and thus a cut in interest rate may not necessarily spur lending to drive growth. To address this, the MPC introduced two measures at its last meeting, focusing on stimulus measures aimed at increasing the flow of credit to the real economy. In basic tone, the CBN is looking to inject cash into the real sector, by purchasing commercial papers (CPs) of large corporations (excl. banks) and introduce a separate cash reserve requirement (CRR) for banks, channeling credit at 9% to priority sector. First, the CBN is encouraging credit constrained businesses, particularly large corporations, to issue commercial papers (CPs) to meet credit needs, which the CBN may buy indicating its appetite to directly inject money to the private sector. Also, the apex bank guided to the implementation of a separate cash reserve requirements (CRR) for banks, to direct credit at 9%, with a minimum tenor of seven years and two years moratorium, to employment elastic sectors, particularly, manufacturing and agriculture.

As it stands, the CBN's credit to private sector (non-financials) has been insignificant at ₦46.5 billion (excl. Interventions) as at March 2018, while credit to banks stands at ₦1.86 trillion – credit to the FG and state governments at ₦6.75 trillion and ₦606.5 billion accordingly. Clearly, we expect the

central bank's fresh appetite for private sector debt to steer a flux of CP issuances with a reverberating effect on lending rate. Irrespective, in the short term, looking at typical pattern of sucking up liquidity via OMOs and channeling the funds to lend the FG as well as existing interventions, the short-term impact on interest rate environment will hang on the source of funds, either paper printing or from OMO issuance – a case of mopping up at 12% and lending to real sector at lower rates, which will distort the market and intermediation power of the banks. That said, if CBN purchases from the secondary market, wider rates will have to compress and thus, the body language of the CBN is effectively easing while the face is saying MPR at record 14% is hawkish. On balance, due to the inefficiency of the MPR as a benchmark interest rate, CBN indirect signal of easing will bring lending rates lower.

In terms of the differentiated and dynamic CRR, with details yet to be released, our thoughts are in two scenarios. On one side, we think the CBN will likely set a new CRR for banks that lend to the priority sectors (manufacturing and agriculture) at a rate of 9% and minimum tenor of seven years. In another twist, the CBN may provide credit to the banks, using the standard lending rate of 9% (MPR – 500bps), to on-lend to the priority sectors. On balance, this means more liquidity for the banks chasing the similar borrowers.

Figure 5: Banks reserve with the CBN (N'billion)



Source: CBN, ARM Research

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