

July 31, 2019

Nigeria Strategy Report

H2 2019



Domestic Economy and Policy Environment

Monetary Policy: Unorthodox policies to dominate

Executive Summary

In our H1 2019 outlook, we projected a downtrend in marginal clearing rate at OMO auctions over H1 19 on the back of dissipating inflationary pressure, FX stability and lower system liquidity with the monetary authority expected to hold on to the benchmark rate. In line with our expectation, marginal clearing rate moderated 252bps over the first half of the year. However, the MPC sprouted a surprise at its second meeting for the year cutting the symbolic benchmark rate by 50bps. Putting into perspective, after net issuing ₦2.6 trillion in OMO bills over the first three months of the year, the CBN receded in its sterilization with net issuances plummeting to ₦835 billion over Q2 19.

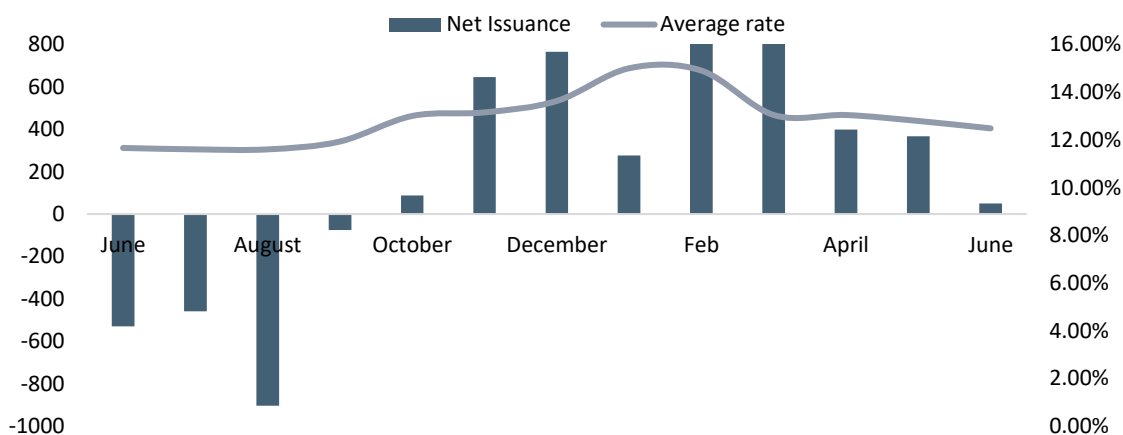
Over the rest of the year, we expect concerns on economic growth to dominate the monetary authority actions with an eye kept on inflation movement and FX stability. We see inflationary pressure dissipating over the rest of the year, while our outlook for the naira suggests a stable movement in the currency. Elsewhere, though recent body language of the monetary authority suggests a loosening given its predilection on stimulating economic growth, we however think the MPC would take a prolong pause over the rest of the year. Our view reflects the monetary authority's concern on a possible liquidity build up should loosening drive growth in consumer credit without proportionate adjustment in aggregate output. Specifically, we can't rule out a formalized restriction or cap of DMB's participation in CBN's auctions. Meanwhile, we believe the apex bank will opt for a slight increase in the marginal clearing rate at its OMO auctions towards the latter part of the year (Q4 19). Our view reflects expected high system liquidity coming from maturities over Q4 19 combined with the CBN's stance of avoiding speculation on the naira. Nonetheless, given that the apex bank is under less pressure relative to same period last year where the CBN was embattled with elevated system liquidity, surge in repatriation of foreign investments caused by higher yields in advanced economies and pre-election concerns, we see scope for a modest uptick in OMO rate between 12.5% and 13.5% by the end of the year.

In this report, we look at the major themes that dominated monetary policies in Nigeria over H1 2019 and delineate our outlook for CBN's monetary stance over the rest of 2019.

Lower maturities spurs tail off in OMO rates

In our H1 2019 outlook, we projected a downtrend in marginal clearing rate at OMO auctions over H1 19 on the back of dissipating inflationary pressure, FX stability and lower system liquidity with the monetary authority expected to hold on to the benchmark rate. In line with our expectation, marginal clearing rate moderated 252bps over the first half of the year. However, the MPC sprouted a surprise at its second meeting for the year cutting the symbolic benchmark rate by 50bps. Putting into perspective, after net issuing ₦2.6 trillion in OMO bills over the first three months of the year, the CBN receded in its sterilization with net issuances plummeting to ₦835 billion over Q2 19. Starting out with Q1 19, high issuances over the period reflected an extension of a tight monetary policy from 2018 hinged on CBN’s quest to defend the naira amid high concentration of fixed income maturities. While the apex bank kept OMO rates elevated in the January, it subsequently slashed stop rate in February and March as elevated system liquidity resulted in high subscription and lower bids rate at the varying OMO auctions during the last two months of the quarter. At the end of the quarter, OMO rates were 200 bps lower compared to Q4 18. Entering the second quarter, the CBN became less apprehensive following lower system liquidity which implied less hurt to the naira. Also, lower inflation as well as CBN’s quest to boost economic growth led to further contraction in OMO rates by 56bps QoQ to 12.48%, with net issuances during the quarter declining by 67% QoQ to ₦814.5 billion.

Figure 1: OMO net issuance/maturity vs OMO rates



Source: CBN, FMDQ, ARM Research

Economic growth on the limelight

As mentioned earlier, the MPC surprisingly voted to cut the key benchmark rate by 50 bps to 13.5% at the second meeting (March) for the year, taking the Standard Lending Facility and Standard Deposit Facility to 15.5% and 8.5% respectively. While activities by the apex bank at OMO

auctions already signaled a dovish stance, a definitive cut of the benchmark rate was least expected. Notably, the MPR had been rendered ineffective for more than 2 years and the MPC had continued to hammer on near term risk to price and currency stability suggesting a neutral stance. In the justification for a rate cut, the committee expressed satisfaction with the relative stability in the price level and exchange rate, and thus sought to support growth. Particularly, following the calm outcome of the general election together with the recent resurgence of foreign portfolio investment into the country and continued deceleration in inflation reading, the CBN thought it imperative to signal a new direction.

Though the MPC left rates unchanged at its subsequent meetings in May and July, it however went a step further in signaling its quest to improving economic growth by issuing two guidelines to the Deposit Money Banks (DMBs) few weeks before the meeting in July. The first one entailed DMBs maintaining a minimum Loan to Deposit ratio of 60% by the end of Q3 19 (**See report: *Nigerian Banks: Love letter from the apex bank***), with the second coming in the form of a voluntary rejection of excess liquidity deposited by the banks to CBN via the Standard Deposit Facility (**See report: *Nigerian Banks: CBN delivers another news***). On the former, in a bid to direct funds to specific sectors, the CBN additionally attached a weight of 150% to loans disbursed to SMEs, Retail, Mortgage and Consumer Lending in computing the Loan to Deposit ratio.

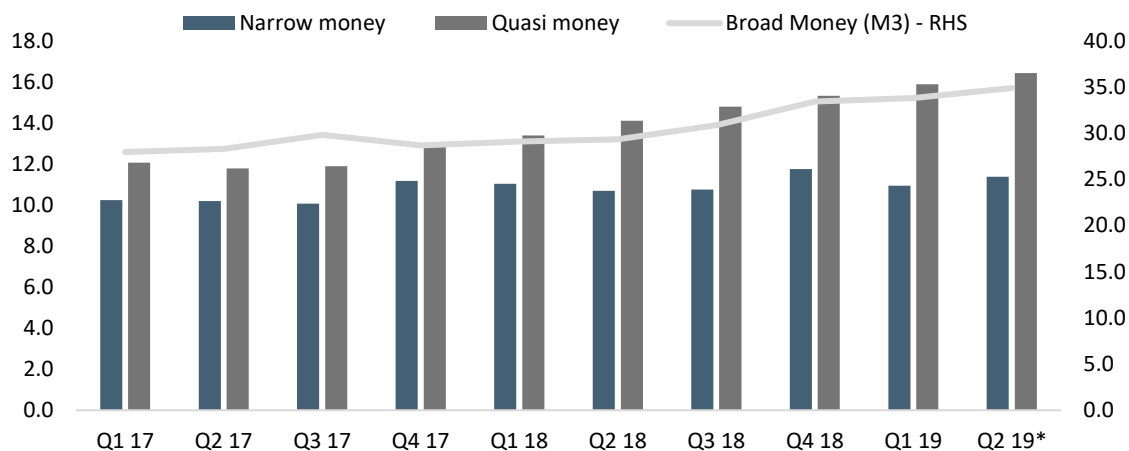
Elsewhere, the second guideline instructed that the daily maximum amount banks could place at the SDF window be capped at ₦2 billion (previously ₦7.5 billion). Given this new regulation, funds in excess of the ₦2 billion would earn zero interest. Not relenting on its new policy, the CBN in an unusual move restricted DMBs from purchasing bills with their funds other than their clients at its last OMO auction before the MPC meeting in July. Later at the MPC meeting in July, the CBN governor further hinted at the possibility of intermittently restricting DMBs in subsequent auctions. To our mind, we believe this is a move by the apex bank to indirectly coerce DMBs into giving out credit to the private sector rather than purchasing government securities.

Monetary aggregates on a modest rise

In contrast to H2 18 which saw monetary aggregates expand on the back of FX induced growth, monetary indicators grew at a subdued rate over H1 19. Particularly, system liquidity over H1 19 was moderate on account of CBN's sterilization actions (OMO auctions and foreign exchange sales by the CBN). These actions combined to offset injections from FAAC, relatively lower repayment of maturing bills and rediscounting of bills. Consequently, broad money supply (M3) rose only moderately over the first half of the year, driven mainly by

claims on the Federal Government. Accordingly, annualized reading of 10.6% lagged broad money growth of 16.6% in 2018.

Figure 2: Money Supply trend (₦'trillion)

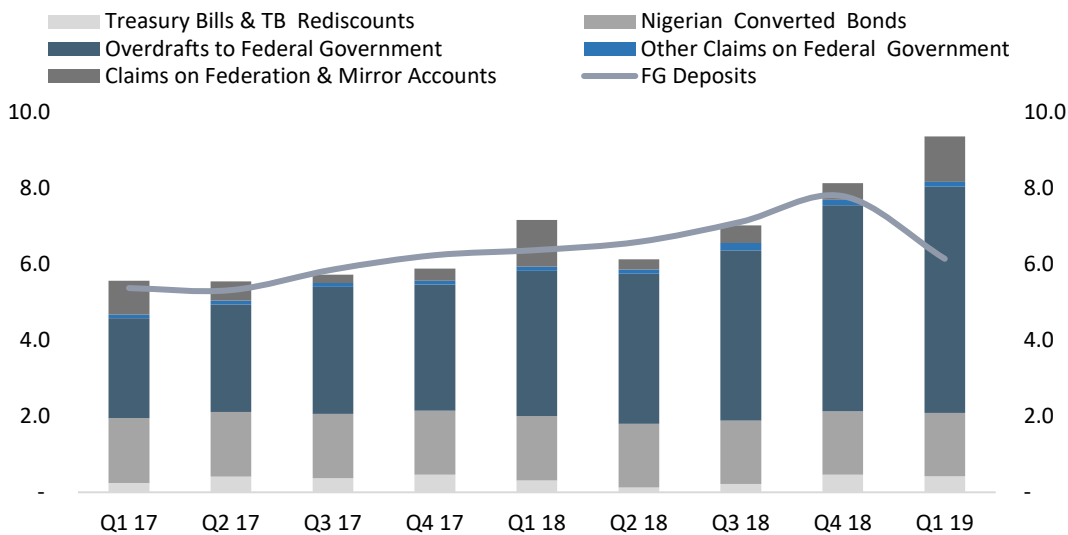


Source: CBN, FMDQ, ARM Research

Parsing through the breakdown, growth in M3 reflected expansions in quasi money and CBN bills held by money holding sectors. Elsewhere, faster increase in time and savings deposit of commercial banks largely spurred growth in quasi money. The overall increase in time and savings deposit with commercial banks stemmed from increases in both FCY and LCY deposits. Given the absence of FX translation impact, we believe growth in FCY deposits reflected speculation and expectations of a devaluation in the naira at the earlier part of the year. Narrow money on the other hand declined 3.1% on the back of moderation in currency in circulation (-9.4%) and Demand deposits (-1.6%).

On the asset side, growth in Net domestic credit surged 16.6% from the end of 2018 as net credit growth to the private sector (+9.4% to ₦24.9 trillion) increased together with a surge in net claims on the Federal government (+50.2% to ₦7.3 trillion). Parsing through the subparts of the credit growth over H1 19, increase in net credit to the private sector emanated mostly from CBN's net claim on the private sector via its various intervention programs. Meanwhile, net credit to the private sector by the DMBs continued to expand at a sluggish pace of only 1% to ₦15.6 trillion reflecting the banks' cautious approach to generating risk assets. On the other hand, higher net credits to the FG largely reflected a rise in CBN's net claim on the FG (+9x to ₦3.26 trillion). Further breakdown revealed faster increase in CBN's claims with the FG (from ₦8.1 trillion at the end of 2018 to ₦9.9 trillion in April 2019) as well as decline in FG deposits with the apex bank (from ₦7.8 trillion at the end of 2018 to ₦6.7 trillion in April 2019). The increase in CBN's financing mirrored higher overdrafts to the FG (from ₦5.4 trillion at the end of 2018 to ₦6.0 trillion in April 2019) and more importantly, an upsurge in the mirror account (From ₦436 billion at the end of 2018 to ₦1.7 trillion in April 2019).

Figure 3: CBN Claims on FG (₦trillion)

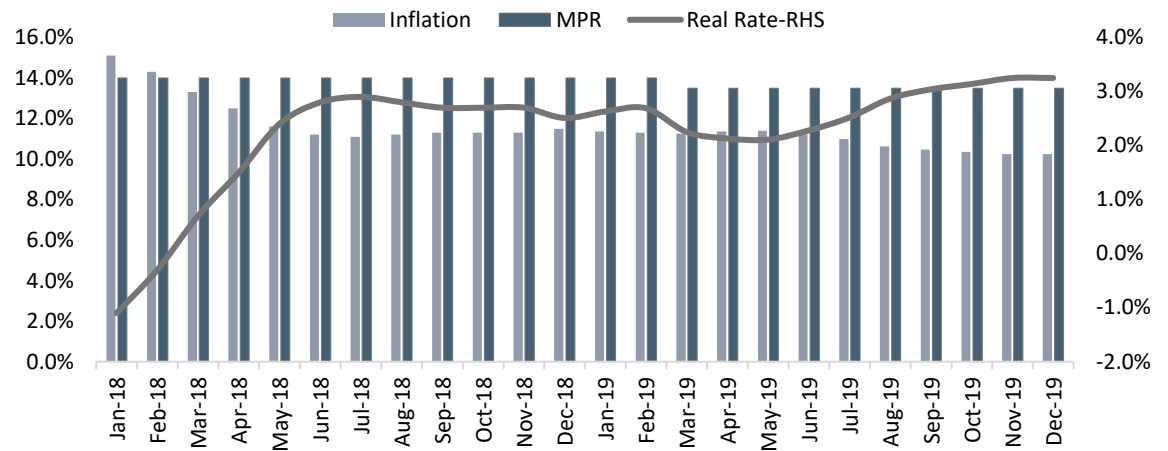


Source: CBN, FMDQ, ARM Research

Dovish tone set for the rest of 2019

Over the rest of the year, we expect concerns on economic growth to dominate the monetary authority actions with an eye kept on inflation movement and FX stability. Addressing the latter, we believe food inflation will sustain its downtrend over the rest of the year on the back of a well lubricated market supply together with main harvest kickstarting in October. Similarly, core inflation is expected to remain low reflecting a stable FX as well as petrol prices. On balance, we project headline inflation of 11.2% YoY over 2019 (2018: 12.2% YoY). On the other hand, our model (**See report: *Near-term FX stability remains intact***) suggests FX reserve ending the year at \$43.8 billion after adjusting for inflows and more importantly increased outflows in the latter part of the year from higher fixed income maturities and repatriation of offshore holdings of maturing FI instruments. That said, we believe the CBN will still be in a comfortable position to shield the naira. Shifting focus to domestic economic growth, Nigeria’s GDP has continued to expand at a slack pace since the country exited recession in 2017. While growth in the non-oil sector (Q 19: +2.5% YoY, Q4 18: +2.7% YoY) has not been too fantastic, the oil-sector on the hand has fared worse having contracted for four consecutive quarters (Q1 19: -2.4% YoY, Q4 18: -1.6% YoY). As a matter of fact, our model suggests a growth of only 2.2% YoY over 2019 compared to 1.9% YoY in 2018 largely driven by modest growth in the non-oil sector. Though recent body language of the monetary authority suggests loosening given its predilection to stimulating economic growth, we however think the MPC would take a prolong pause over the rest of the year.

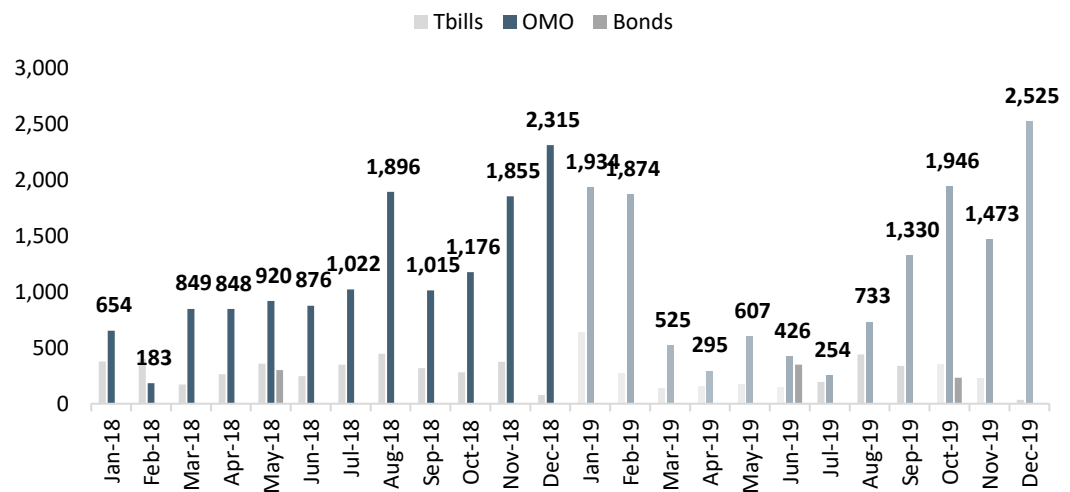
Figure 4: MPR vs Inflation and real rate



Source: CBN, FMDQ, ARM Research

Our view reflects the monetary authority’s concern on a possible liquidity build up should loosening drive growth in consumer credit without proportionate adjustment in aggregate output. Nonetheless, we believe the CBN will rethink its monetary policy tools given the DMB’s reluctance to create new loans. Specifically, we can’t rule out a formalized restriction or cap of DMB’s participation in CBN’s auctions. Overlaying the foregoing with global monetary dovish policy, we expect the monetary authority to remain dovish over the rest of the year.

Figure 5: Maturity Profile (₦billion)

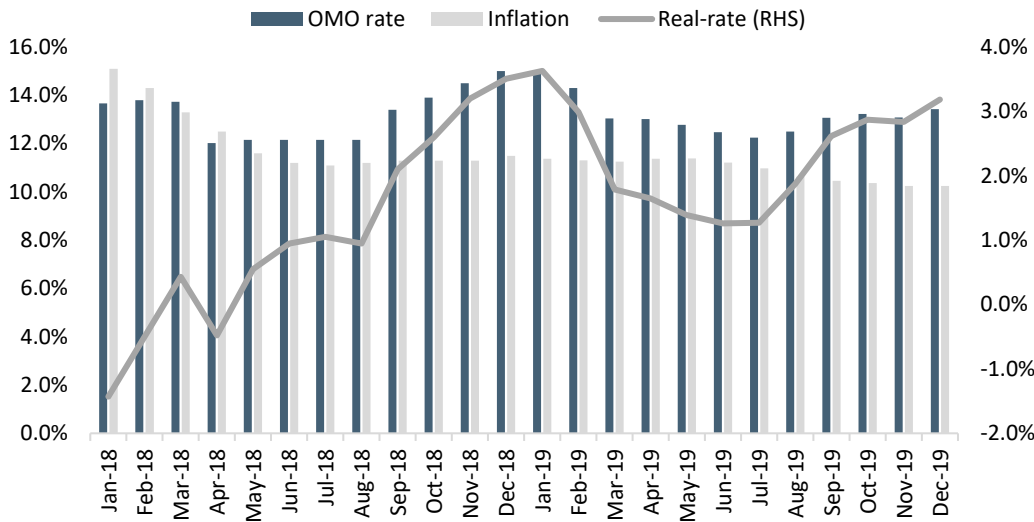


Source: CBN, FMDQ, ARM Research

Meanwhile, we believe the apex bank will opt for a slight increase in the marginal clearing rate at its OMO auctions towards the latter part of the year (Q4 19). Our view reflects expected high system liquidity coming from maturities over Q4 19 combined with the CBN’s stance of avoiding speculation on the naira. Specifically, a total of ₦10.1 trillion is expected to mature over H2 19 (H1

19: ₦7.5 trillion) split into ₦8.3 trillion OMO bill, ₦1.6 trillion T-Bills and ₦234 billion bond papers with a larger chunk to mature in Q4 19. Nonetheless, given that the apex bank is under less pressure relative to same period last year where the CBN was embattled with elevated system liquidity, exodus of foreign investments caused by higher yields in advanced economies and pre-election concerns, we see scope for a modest uptick in OMO rate between 12.5% and 13.5% by the end of the year.

Figure 6: OMO vs Inflation and real rate



Source: CBN, FMDQ, ARM Research

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