

July 16, 2020



Nigeria Strategy Report

H2 2020

Domestic Economy and Markets

Monetary Policy: CBN to favor FX stability

Executive Summary

Akin to H2 2019, CBN maintained its focus on FX stability at the start of the year, whilst reducing its cost of liquidity management. Consequently, the MPC voted to increase the CRR by 500bps to 27.5% in January 2020, the first time in four years, leaving other parameters unchanged. Clearly, the decision reflects the apex bank's desire to reduce its cost of managing system liquidity as well as avoid speculation on the naira. This followed the decision to ban non-banks institution from participating in the OMO auctions. To add, feedback from market stakeholders revealed the CBN unusually debited banks who placed excess bids at both FX and OMO auctions prior to the announcement. However, events over subsequent months proved a hard one for the apex bank. Precisely, the CBN was faced with a double whammy of stimulating growth and maintaining FX stability following the impact of Covid-19 on economic activities and global oil prices.

Over the rest of the year, we believe much of CBN's policy will be centered on maintaining FX stability given its limited control in boosting economic growth. As mentioned earlier, despite increasing liquidity, the economy continues to lack inadequate absorbing capacity. Looking ahead, we anticipate maturities of ₦8.0 trillion, slightly lower compared to ₦8.5 trillion over H1 2020. We expect the CBN to continue its usual debiting of banks as a means of mopping up the excess liquidity, as a CRR hike would signal the apex bank's insensitivity to the prevailing economic condition. However, we see scope for a reduction in the MPR, signaling more support for economic growth. Meanwhile, we expect the CBN to shift focus to other monetary indicators which is more indicative of money supply in the system. One possible approach we believe the CBN could adopt is benchmarking lending rate to interbank rate. Thus, lending rate is determined by money supply. This way, the CBN can easily boost money supply which in turn, reduce lending rate and boost economic growth. Also, we see CBN focusing on driving down deposit rates and in turn, increase money supply.

In this report, we focus on developments in the Monetary space over H1 20 and delineate our outlook for monetary policy direction over the rest of the year.

Caught between the Devil and deep blue sea

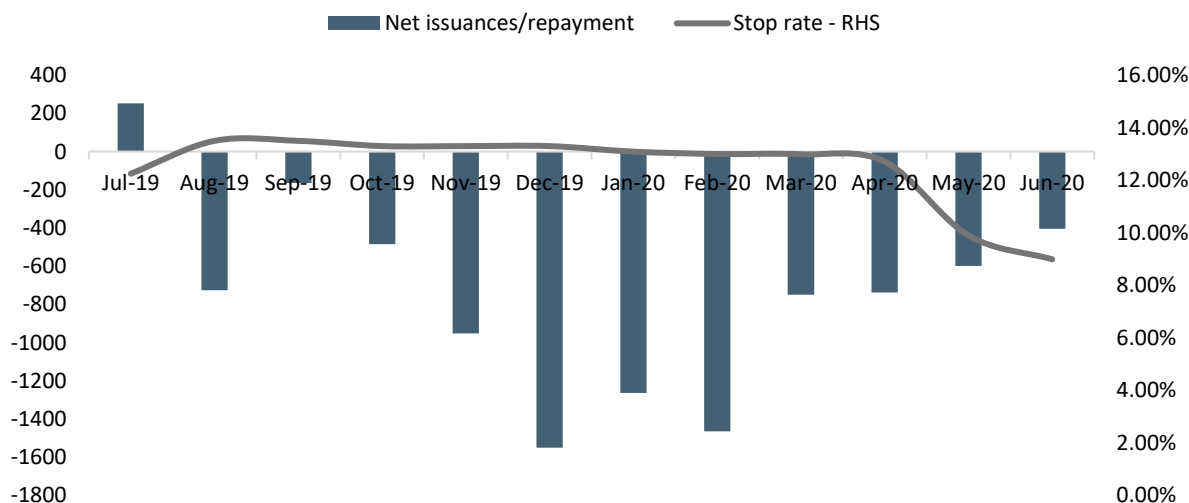
Akin to H2 2019, maintained its focus on FX stability at the start of the year, whilst reducing its cost of liquidity management. Consequently, the monetary committee voted to increase the Cash Reserve Requirement (CRR) by 500bps to 27.5% in January 2020, the first time in four years, leaving other parameters unchanged. Clearly, the decision reflects the apex bank's desire to reduce its cost of managing system liquidity as well as avoid speculation on the naira. This followed the decision to ban non-banks institution from participating in the OMO auctions. To add, feedback from market stakeholders revealed the CBN unusually debited banks who placed excess bids at both FX and OMO auctions prior to the announcement. However, events over subsequent months proved a hard one for the apex bank. Precisely, the CBN was faced with a double whammy of stimulating growth and maintaining FX stability following the impact of Covid-19 on economic activities and global oil prices.

Specifically, temporary shutdown of economic activities, lower oil inflows as well as significant repatriation of foreign flows shook the FX reserves and in turn CBN's posture. In response, the CBN made a couple of adjustments to the exchange rates. Firstly, the official interbank rate was adjusted to ₦360/\$ from ₦306/\$. In addition, rates at the IEW were revised from prevailing rates of ₦360 – ₦365/\$ to a maximum of ₦380/\$1. By May, the impact of the pandemic was quite evident on the economy. Particularly, both manufacturing and non-manufacturing PMI declined to 42.4 pts and 25.3 pts in May from 59.2pts and 59.6pts at the start of the year. Consequently, the MPC cut the benchmark rate by 100 bps to 12.5% signaling a stronger stance to support growth. Prior to this, the CBN announced a couple of stimulus package in order to drive growth. This included: (i) Extension of principal moratorium on CBN intervention facilities by one year. In addition, the rates on all facilities were reduced from 9% to 5% effective March 1, 2020 (ii) Extend its intervention facilities to the pharmaceutical companies, hospital and healthcare practitioners as well as increasing the size of intervention facilities to the agricultural and manufacturing sectors (iii) Creation of a ₦50 billion credit facility for households and SMEs that have been particularly hit by Covid-19 (iv) Allowing banks to consider temporary and time-limited restructuring of the tenor and loan terms for businesses and household most affected by the outbreak of Covid-19, particularly to the Oil & gas, agriculture and manufacturing sectors (v) Encouraging banks to maintain credit to individuals, households and businesses as well as considering incentives to banks to give out longer tenured facilities (vi) Establishment of a ₦1.1 trillion intervention fund to support critical sectors of the economy.

CBN steers the ship at OMO auctions

At the early part of the year, the CBN continued to cut rates at the OMO auctions, albeit, at a moderate pace. Between January and April, the one-year stop rate was cut by a total of 57 bps. Again, this move continued to reflect the apex bank’s stance on reducing its cost of managing liquidity. As a matter of fact, the CBN entirely dissuaded banks from placing bids at OMO auctions through its regular debiting of banks with excess liquidity. Consequently, this made foreign investors the sole participant at the OMO auctions. By the end of April, outstanding OMO printed at ₦10.3 trillion compared to ₦12.9 trillion at the end of December 2019. Elsewhere, the CBN halted sales at the IEW since April despite low inflows, resulting to most foreign investors rolling over maturing OMO bills. Fast forward to May, the IMF disbursed a loan facility of \$3.4 billion which helped prop up the FX reserve. Consequently, this gave the apex bank greater leeway to reduce the OMO rate¹ by 281 bps MoM to 9.9%. Meanwhile, subscription (₦5.4 trillion) remained buoyant, however, the CBN sold (₦3.3 trillion) less than what it offered (₦3.4 trillion) as well as total amount maturing (₦8.0 trillion)² over H1 20.

Figure 1: OMO net issuance/ repayment vs OMO rate

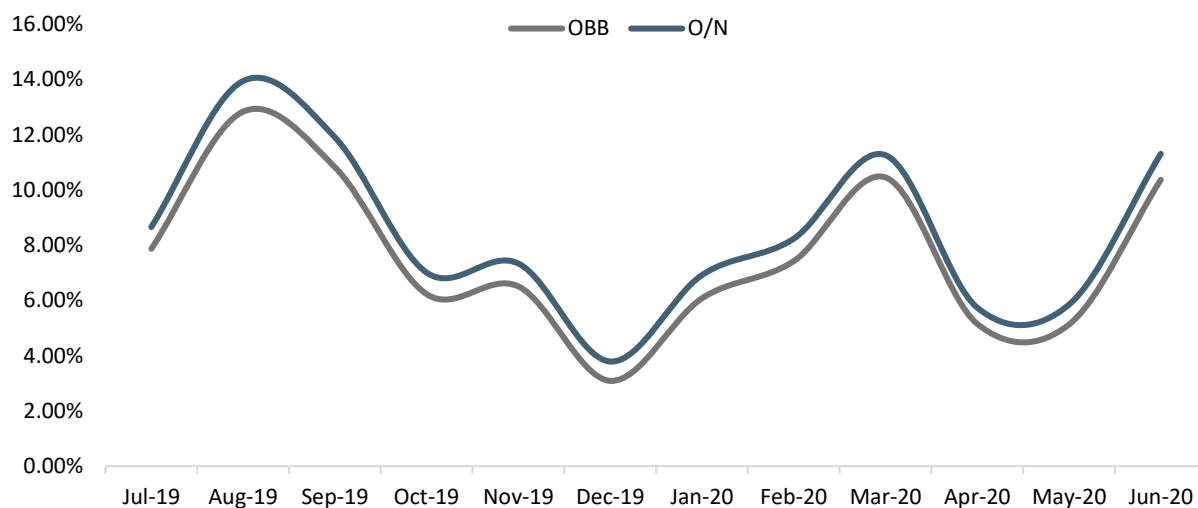


Source: FMDQ, ARM Research

Elsewhere, average interbank rates moderated slightly by 50 bps to 7.83% over H1 2020 reflecting the prevailing liquidity surfeit (avg daily system liquidity of ₦396 billion vs ₦355 billion in H2 2019) in the system. We believe the interbank rates would have declined faster barring CBN’s regular debiting of banks.

¹ One-year stop rate

² ₦5.6 trillion excluding non-bank financial institutions

Figure 2: Trend in interbank rates

Source: FMDQ, ARM Research

Monetary aggregates continue to lag

On monetary aggregates, broad money supply (M3) expanded by only 2.7% over the first four months of the year, compared to FY 19. This was on the back of increases in Net domestic asset and foreign assets. However, prorated money supply growth for the year of 8.0% continued to lag CBN's benchmark of 13.1% for 2020 which is the growth rate projected to drive sustainable growth in the economy. For over four years, actual money supply for each year has continued to lag benchmarks partly reflecting the economy's inadequate absorbing capacity for the amounts of liquidity and more importantly, banks averseness to creating new loans. Meanwhile, growth in net domestic asset is largely attributed to increase in credit to the private sector (₦961 billion increase)³. On the other hand, expansion in net foreign assets (₦597 billion) is linked to the technical devaluation earlier in March, which consequentially propped up the naira value of foreign assets.

CBN to favor FX stability

Going forward, despite CBN's administrative controls, we expect further depletion in the FX reserves on the back of lower inflows. While the \$3.4 billion IMF loan facility will provide a temporary relief, the CBN would be counting on disbursement of facilities from AfDB and World Bank. Thus, we forecast a depletion of \$7.8 billion over H2 20 with the FX reserve closing the year at \$28.8 billion which excludes expected inflow from World Bank (\$1.5 billion) and AfDB (\$222 million).

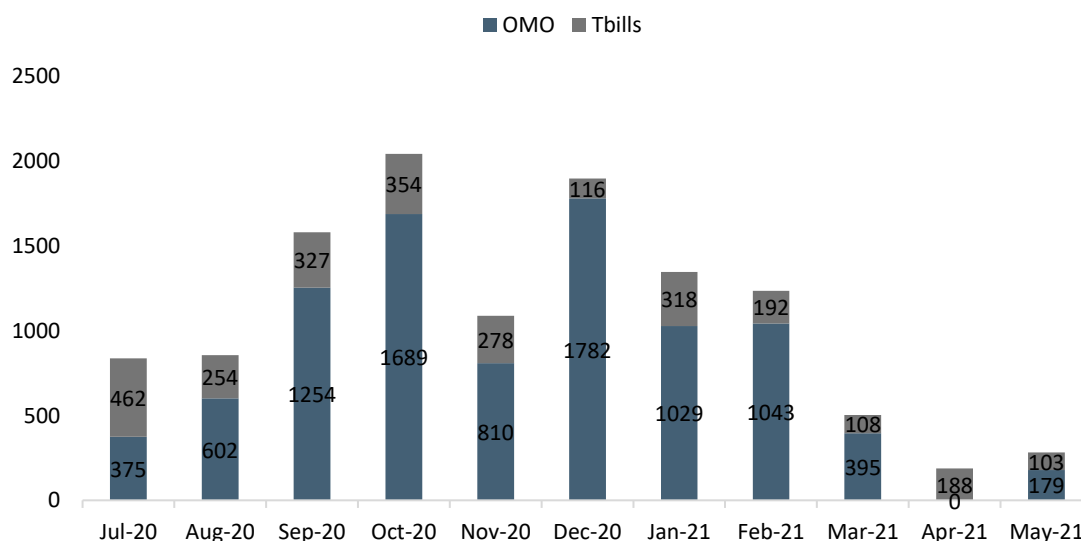
³ A fallout of CBN's LDR policy

Given our expected level of reserve relative to CBN’s proclaimed comfort level (\$30 billion), we see limited downside in FX rates over the rest of the year. However, we expect tight controls in Q4 20 on FPI outflows following a higher maturity profile (\$5.0 billion) in same period.

On inflation, without any established link between the increased system liquidity and headline inflation, we think focus would therefore be on addressing the structural issues as well as increased interventions to boost local production.

Over the rest of the year, we believe much of CBN’s policy will be centered on maintaining FX stability given its limited control in boosting economic growth. As mentioned earlier, despite increasing liquidity, the economy continues to lack inadequate absorbing capacity. Looking ahead, we anticipate maturities of ₦8.0 trillion, slightly lower compared to ₦8.5 trillion over H1 2020. We expect the CBN to continue its usual debiting of banks as a means of mopping up the excess liquidity as a CRR hike would signal the apex bank’s insensitivity to the prevailing economic condition.

Figure 3: Maturity Profile (₦billion)



Source: FMDQ, ARM Research

Given the ineffective transmission of the MPR to the economy, we resist the urge to give much importance to it. However, we see scope for a reduction in the MPR, signaling more support for economic growth. Meanwhile, we expect the CBN to shift focus to other monetary indicators which is more indicative of money supply in the system.

One possible approach we believe the CBN could adopt is benchmarking lending rate to interbank rate. Thus, lending rate is determined by money supply. This way, the CBN can easily boost money supply which in turn, reduce lending rate and boost economic growth. Also, we see CBN focusing on driving down deposit rates⁴ and in turn, increase money supply.

Elsewhere, we see limited upside to stop rates at the OMO auctions reflecting the apex bank's desire on reducing liquidity management cost. More importantly, expected inflows from AfDB and World Bank would give the CBN more leeway to maintain low rates.

⁴ The PBoC currently adopts this

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