

## Economic Commentary

## MPC Preview: Dovish stance but hawkish actions

**Summary**

Regardless of one's position on the Central Bank of Nigeria (CBN) heterodox policies, the CBN did achieve a handful of objectives in 2019. Private sector credit expanded to N16.8 trillion as at November 2019, increasing by 1.6 trillion and N1.7 trillion when compared to January and June 2019 respectively. Also, associated loan to deposit ratio (LDR) increased to 62.87% in November from 60.71% and 57.64% in January and June respectively. While the paucity of foreign portfolio flows and rising services import demand resulted in depletion in the gross external reserves, the CBN maintained FX stability over 2019, with the parallel market and BDC trading at discount to the NAFEX rate.

The year 2020 is a new one, filled with series of uncertainties including likely lower crude oil prices, still slow economic growth, paucity of foreign portfolio flows, higher consumer prices, expanded fiscal deficit and elevated maturity profile. While the above listed risks will dominate monetary policy decisions over 2020, we believe the apex bank will continue to adopt unorthodox policies and will test newer policies in 2020 to ensure FX stability, support growth and limit the pressures emanating from liquidity induced inflation. In its first meeting in 2020, we expect the Monetary Policy Committee will leave the MPR unchanged. However, while it is counterintuitive and not supportive of its growth mantra, we believe the MPC could vote to raise the cash reserve ratio sometime in the year. Our thinking is largely informed by the CBN's recent unusual CRR debits of DMBs with 'excessive' bids at both OMO and SMIS FX auctions in a bid to reduce its cost of liquidity mop-up and prevent FX speculation. We also do not rule out some other administrative pronouncement which could limit FX demand.

**Views from November MPC meeting and The Governor's Presentations**

At the last MPC of 2019, all Committee members voted to retain all policy parameters, MPR at 13.5%; Cash Reserve Ratio at 22.5%; Liquidity Ratio at 30% and Asymmetric corridor at +200 and -500 basis points around the MPR. Going by the personal statements, the Committee members view was unanimous on the need to allow time for the recent monetary policy measures to demonstrate their full effects, especially in ensuring financial sector soundness and increasing credit to the real sectors of the economy. In a different twist to the unanimous view, a committee member stated the need to monitor developments and also remain prepared to adjust monetary policy in future if required so as to support overall growth in economy, whilst keeping on track the targeted inflation band. Also, all the members appraised the series of unorthodox policies by CBN and encouraged a more targeted approach to reach small scale businesses. In all, we believe the monetary policy stance largely favored preservation of the foreign exchange and also incentivizing economic growth.

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At the 54th Chartered Institute of Bankers of Nigeria dinner in December 2019, the CBN Governor listed the Central Bank's policy direction for 2020 in a bid to support economic growth, price and exchange rate stability. The Governor stated that:

1. Monetary policy stance will remain judicious, research driven, adequate and supportive of the real economy subject to underlying fundamentals. The current tight stance is expected to continue in the near-term, especially in view of rising inflation expectations and exchange market pressures.
2. On foreign exchange, the CBN acknowledged the current capital reversals and expected pressure on market rates. However, the Governor stated the Bank's resolve to maintain exchange rate stability in the near to medium term, anchored on the strength of the reserves.
3. The Governor also stated the Bank's resolve to deepen intervention programs to support the real sector. Also, that the LDR policy will be sustained and strengthened to ensure the attainment of an inclusive, diversified and sustainable growth.
4. To ensure the LDR policy does not result in deterioration in the quality of loans, measures have been put in place to improve credit risk assessment via consumer credit database to help determine credit worthiness of borrowers. Also, standing instructions on account of borrowers with other banks have been implemented.

### **Inflation maintains upward trend**

Not so farfetched from the MPC expectation, inflation rate for the month of December rose to 11.98% YoY from 11.85% in November 2019, with headline inflation in 2019 averaging 11.39% compared to 12.15% average in 2018. Much of the expansion over the past four months stemmed from the feedthrough of the land border closure on food prices, which more than outweighed the onset of the main harvest season, with food prices expanding 18bps to 14.67% YoY from 14.48% in November. The impact of the higher foods prices is further compounded by increase in the core index for the second consecutive month by 33bps to 9.32%YoY compared to 8.99% in November.

As stated in our NOVA Economic Outlook (NEO) H1 2020 (See report: [NOVA Economic Outlook H1 2020](#)), we stated that the confluence of higher electricity tariff, VAT increase, persisting border closure and FX depreciation will determine the inflationary trend over 2020. While most of these triggers are expected to materialize over the second half of the year (especially the electricity tariff hike and currency depreciation), we believe the first half of the year will be impacted by the restriction on imports through the land border and feedthrough impact of the VAT increase (albeit minimal). Recent update by Famine Early Warning Systems Network (FEWS NET) revealed that market supplies have increased, while market demand continues to decline. The lower demand reflects limited export to Niger, Chad and other neighbouring countries. However, this has resulted in lower staple prices, save for the price of other imported food items like rice. In the same vein, we expect core prices to also decelerate post the travelling rush which usually results in higher transportation costs and higher PMS and diesel demand.

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**OMO Demand remains buoyant despite lower FPI Flows**

From a low of \$401 million in November, foreign portfolio investment rose to \$651 million in December 2019. Similar to the beginning of the year 2019, FPI inflows surged in the first two weeks of January, with the IEW recording FPI inflow of \$1.52 billion. Coupled with OMO maturity of N1.53 trillion (with estimated FPI holding of 33%) over the same period, subscriptions at CBN OMO auctions have been higher than the offered amount. So far in January, compared to the apex bank N850 billion offer at OMO auctions, subscriptions totalled N1.37 trillion with the apex bank selling just N1.09 trillion. With CBN's restriction of DMBs at OMO auctions, we believe the higher subscription level largely reflects FPI participation. Given the resurgence in FPI inflows amidst limited maturity, it is safe to assume, most of the maturing funds are being reinvested.

As stated in the currency section of our NEO H1 2020, we believe the apex bank will run on lower reserves during the year occasioned by lower FPI flows and relatively lower crude oil prices. Accordingly, we modelled that the FX reserves could touch as low as \$33.56 billion at the end of December 2020, which excluding possible foreign borrowings of \$2.8 billion. Adjusting the modelled reserves for the foreign borrowings, we could see the reserve remain at \$36.4 billion by the end of the year, which we view as good enough for the apex bank to continue its stability of the exchange rate. We however, noted that FX pressures could intensify if crude oil prices stay below \$60/bbl over a longer period.

**Expected MPC Outcome**

With foreign investors still active at OMO auctions, expected inflationary pressure largely driven by supply side factors and positive impacts of LDR limit on private sector credits (at least for now), we believe the odds largely favor a hold of monetary policy parameters, especially the MPR at the end of the MPC meeting on Friday. However, recent events have suggested the CBN concerns for elevated liquidity in the system. Our channel checks revealed the apex bank has been adopting unusual CRR for DMBs with higher than usual bids at OMO and FX auctions. Accordingly, we do not rule out institutionalization of a higher CRR sometime in the year to combat rising system liquidity. We also expect continued differentiated CRR depending on banks' loan to deposit ratio compared to the regulatory limit of 65%. Therefore, at the end of the MPC meeting Friday, we posit that the committee will:

- Retain the MPR at 13.5%;
- Retain the asymmetric corridor at +200/–500 basis points;
- Retain the CRR at 22.5%; and
- Retain liquidity ratio at 30.0%
- Announcement of further administrative measures