

## Economic Commentary

## MPC Preview: Tough Times... Limited Options

**Summary**

The outbreak of Covid-19 has tested the flexibility of monetary authorities across advanced and emerging economies. They have adopted accommodative policies, involving varying adjustments to benchmark interest rates and introduction of quantitative easing in every sense of it. Further to ensure easy transmission of the adjustments to the benchmark rates, monetary authorities have lowered the countercyclical buffer rates of commercial banks, as seen in the UK. Largely, the attention of monetary authorities has been focused on limiting the impact of the global shocks on economic growth by supporting consumption and limiting the impact of a slowdown in economic activities on operation of businesses.

In Nigeria, the CBN is between a rock and a hard place with limited policy options available. After initiating series of growth centric and balance sheet management policies over 2019, ongoing shocks are seemingly about to redirect the apex bank's focus strictly to price and foreign exchange stability. Although, we see limited impact of CBN's action on price stability given that they are largely reflecting structural factors, like the breakup of supply chains and the pending border closure. Reserve and FX stability on the other hand will critically test the apex bank's resolve and challenge the conflicting decision of growth and FX management. At the end of the Monetary Policy Committee meeting on Tuesday, we favor the committee maintaining status quo on key policy rates and pronouncement of some administrative measures to limit pressure on the reserve.

**FX Pressure Intensifying...**

At the MPC meeting in January, the pending fixed income maturity dominated discussion with the committee electing to increase the CRR by 500bps to 27.5%. At the time, the committee's argument largely focused on the impact of the exclusion of nonbank financial institutions and individuals from investing in OMO securities and the impact maturing OMO securities attributed to these class of investors could have on the overall system liquidity. Since the last meeting, the outbreak of Covid-19 breakup of the OPEC+ coalition with the attendant fall in the oil price have disrupted the committees thought process with FX pressure building up due to rising FPI outflows amidst paucity of inflows and likely domestic price instability from supply chain disruptions.

Over the first two weeks in March, the apex bank net FX sales totalled \$1.83 billion at the Investors and Exporters Window (IEW) compared to a full month net sale of \$1.68 billion in the month of February. Notably, while outflows recorded so far amounted to \$2.23 billion, foreign inflows was a meagre \$230 million, while local supplies (ex-CBN) was only \$490 million. The lower foreign inflows amidst sizeable selloffs largely reflect the impact of the global risk-off sentiment and the dwindling reserves, both of which have limited the rate of portfolio inflows, even as more funds exit the economy.

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Reflecting the risk-off sentiment, activities at last week's OMO auction depicted limited foreign portfolio participation. While the apex bank offered a total of N150 billion in response to maturing instruments of N304 billion, subscription came in at just N18 billion with range of bids for the 1-year instrument between 17-18% compared to 12-13% at the penultimate auction. Reflecting the mounting pressure on the exchange rate and gross reserve, the CBN on Friday initiated adjustments with the NAFEX and BDC rates now synchronized at N380/\$, and upward revision of the official rate to N359.5/\$ (from N307/\$) to support higher oil revenue in Naira terms. While the partial price adjustment suggests a year to date depreciation of 4% and 15% for the NAFEX and official rate respectively, they are both still below our fundamental based purchasing power parity rate of N405/\$. While we reckon that activities at the parallel market are not fundamentally driven, the likely N380/\$ at the NAFEX reflects current parallel market pricing.

**Recent Price Adjustment Will Have Limited Impact**

At today's settlement of interbank FX sales, compared to a range of N306-307/\$, CBN sold \$100k at N359.50/1 indicating an adjustment to the official rate. For us, this reflects the need to limit the impact of the crash in crude oil price by translating at a much higher rate. We see limited impact of the adjustment on the FGN revenue, it however supports the supposed deregulation of the downstream oil and gas sector. On FGN revenue, overlaying the higher exchange rate on our modelled FGN revenue, it translates to an increase of N415 billion and N201 billion for net oil revenue after 13% derivation and FGN share of oil revenue, respectively. The increase in our view is a drop in the ocean with limited impact on our modelled fiscal deficit (See report: [Dwindling Fiscal Revenue – History Repeating?](#)).

On the reserve, while current breakup in supply chains and the effect of the ongoing COVID-19 pandemic across countries would have resulted in a sharp decline in import demands and even services, we believe it will have limited impact on the reserve as long as inflows lag outflows. Recall, following a material decline in oil inflows in 2016 (which also necessitated lower non-oil inflows), total inflows to the CBN was \$21.07 billion (magnified by Swaps and other official receipt, both of which totaled \$9.95 billion). However, CBN funding of imports valid for FX totaled \$25.49 billion. Mathematically, our assessment of FPI holdings of maturing naira assets is estimated at \$11.66 billion (between March and December), which is an estimated Naira asset holding of N4.19 trillion. Assuming, the entire holdings are exited at the revised exchange rate of N380/\$, the apex bank would provide \$11.05 billion, saving just \$613 million from the price adjustment. Irrespective, we do not rule out the economic reasoning of a discouragement of imports and limiting further pressure. But in our sense, with limited inflows in sight and limited avenue to control outflows, the best option is for the apex bank to allow the exchange rate to float, with intermittent intervention to avoid unnecessary speculative attacks.

**Breakup in Supply Chain Portends Major Risk for Price Stability**

On price stability, beyond the disruptive impact of a breakup in the supply chain on manufacturing and trade activities, we believe it could also transmit to temporary higher prices due to feedthrough from scarce imported commodities and higher demand for local substitutes. Recall beyond the imported food impact on inflation over 2016 and 2017, the weakness of the Naira created incentives

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for local manufacturers to export already scarce local commodities. In a way, the border closure would to an extent limit the rate of export of local scarce commodities, but import disruptions (with China accounting for 25% of imports in 2019) could result in elevated demand for local substitutes and the transfer of the excess to other countries could result in higher prices for manufacturers. While we do not doubt its ability to continue to defend the Naira and provide import supplies, the invalid segment of the market will witness significant pressure as demand builds up at the parallel market. Even for the valid imports, we believe the active management of FX allocation could create scarcity and delays in allocation which will inevitably push importers to seek FX at the unofficial segment. In all, while we are yet to fundamentally assess the impact on key components of the Consumer Price Index bucket, we believe an upward adjustment might be necessary as supply disruptions intensifies.

### Initial Response or Final Answer?

In its recently released circular, beyond stating its resolve to provide liquidity backstops as lender of last resort, the apex bank unveiled the below initiatives effective March 1, 2020:

1. Extension of moratorium on principal repayment for all CBN intervention facilities by one-year.
2. Interest rate reduction on all applicable CBN intervention facilities from 9% to 5% per annum for one-year.
3. Creation of a N50 billion credit facility targeted at households and small- and medium-sized enterprises (SMEs) that have been particularly hard hit by Covid-19, including but not limited to hoteliers, airline service providers, health care merchants, etc.
4. Credit support for healthcare industry to meet potential increase in demand for healthcare services and products.
5. Regulatory forbearance to DMBs on temporary and time-limited restructuring of the tenor and loan terms for businesses and households most affected by the outbreak of Covid-19 particularly oil & gas, agriculture, and manufacturing.
6. Strengthening of the CBN LDR Policy through additional incentives to encourage extension of longer tenured credit facilities; and
7. N1.1 trillion intervention fund to support critical sectors of the economy.

While the CBN response is arguably yet to fully capture market expectations and realities of recent events, both in terms of reserve/FX pressure, risk to key economic sectors and persisting pressure on price level, they are viewed as initial steps and we hope for the adoption of more decisive policies at the end of the MPC Meeting on Tuesday.

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In the face of the present realities, the MPC will have to decide the appropriate balance of policies to limit economic disruptions and, achieve price and exchange rate stability. While these policies are conflicting, we elect to think from the MPC's perspective across the key objectives as regards the best policy option and the opportunity cost.

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**Economic Growth:** In our recent assessment of the impact of Covid-19 and the OPEC+ rift (See Report: [Economic and Price Stability – Clouds Gathering, Downpour Insight?](#)), we stated that the ravaging pandemic, could dampen growth over 2020 both in terms of supply chain disruptions (resulting in material downshift of manufacturing activities) and weakness of the external sector. We noted that the key sectors at risk are the manufacturing, construction and trade, which combined accounted for 29% of 2019 GDP. With the escalation of Covid-19 and increasing cases in Nigeria, we do not rule out impact on other key sectors.

In the face of the risk to economic growth, the MPC would have to decide on the appropriate measure to support the already fragile economic growth. Recall, the CBN achieved material loan growth over the second half of 2019 and is expected to further strengthen the LDR policy over 2020 (at least before the oil price crash). As such, we do not believe any downward adjustment to the MPR (supposedly to support consumption, reduce borrowing cost and possible downward repricing of risk assets by the banks) will have any material impact on growth, given that banks are more concerned about liquidity and systemic risk with current conditions. On the other hand, an increase in the MPR would counteract the CBN's efforts to support growth. Although, while we think a downward revision of the standard lending facility (SLF) rate would further give credence to the apex bank's drive to support growth, the CBN sterilization of banks CRR already signals minimal interest from banks. However, our channel checks revealed banks are more in favor of a downward adjustment of effective CRR compared to a lower SLF rate. Further buttressing the previous point, we see CBN maintaining the cash reserve ratio (CRR) at current level, while strategically providing backstop liquidity in the form of excess CRR refunds to banks with declining liquidity.

**Price and Exchange Rate Stability:** Given that the major risks to domestic price stability are driven largely by supply shocks and largely structural (like the breakup of supply chains and the pending border closure), we see limited policy option from the apex bank to address price stability in the interim and do not expect the MPC to attempt to find a temporary solution. As such, based on the balance of probabilities facing the economy in the near term, we see the CBN focusing strictly on FX stability and reserve management.

In our recently published report on the impact of Covid-19 (See Report: [Recent Gross Reserve Depletion are a Child's Play...](#)), we had estimated further depletion in the reserve to \$26.73 billion at the end of the year and stated that the apex bank would first adopt some administrative measures, roll out further unorthodox policies or reversal of some of the policies implemented in 2019 to curb further dwindling of the reserves before necessarily succumbing to adjusting the FX rates. However, recent transactions between FPIs and the CBN being consummated at N380/\$ and interbank sales at N359.50/\$ speaks to faster accumulation of pressure on the apex bank than we had anticipated. Our assessment of FPI holdings of maturing naira assets is estimated at \$11.66 billion (between March and December). The \$2.22 billion outflow so far in March signifies a total of \$9.44 billion is still yet to exit the economy. Interestingly, compared to the massive sell-off in the prior weeks, the market was relatively stable last week with traders suggesting limited FPI participation following the adjustment of the Fed's fund rate to near 0%.

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Also, given that most of the capital flows are largely hedged, with limited alternatives of attractive carry trades, we see the CBN adopting a soft approach to retain some funds. As such we see the CBN maintaining or raising the OMO rates modestly as events unfold. However, given that an upward adjustment of the OMO could attract banks and reduce the appetite for lending, we believe the CBN will continue to apply the strong hammer.

On the balance of factors, given the limited impact an MPR adjustment would have on market fundamentals and the confusion it creates in the system (either upward or downward revision) we favour the MPC maintaining status quo on traditional monetary policy tools. However, we expect pronouncement of some administrative measures to limit pressure on the reserves. As such, we summarize our expected outcome of the MPC meeting blow:

- Maintain the MPR at 13.5%
- Maintain the corridor around the MPR at -500% and +200% respectively.
- Maintain the CRR at 27.5%
- Retain Liquidity ratio at 30%
- Announcement of further administrative measures related to FX management