Economic Commentary

MPC Preview: Economic Stability Regains Priority but Policy Options Still Limited

Summary

Despite accommodative policies and introduction of quantitative easing across developed and emerging economies, the MPC elected to leave all policy parameters unchanged at its March Meeting, which was in no way a surprise (See March Pre-MPC Report: Tough Times… Limited Options). The committee stated COVID-19 is a public health crisis which will undermine any monetary stimulus and time is needed to allow its direct intervention measures to permeate the economy. More importantly, they agreed to allow the pandemic to plateau before deciding on policy measures to support aggregate demand and supply in the recovery phase of the economy.

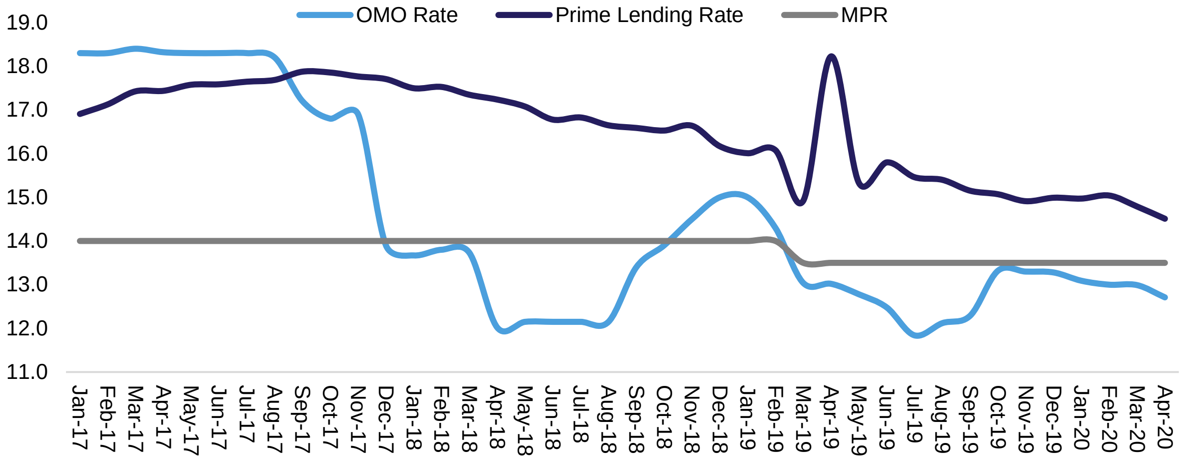
Since the last MPC meeting, the number of COVID-19 cases have grown astronomically, while the government implemented a full lockdown in some states to limit the spread of the virus. Following the measures adopted to contain the virus amidst breakup in supply chains, we estimate the economy will contract by 1.6% YoY in 2020 (See full report: Great Lockdown Necessitates Further Downgrade to GDP). With the gradual reopening of the economy and the large informal sector back to work, we believe the pandemic is peaking. As such, we explore possible options available to the MPC to strengthen aggregate demand, assuming we are already at the recovery phase of the pandemic. While we reckon it is necessary at this stage for the MPC to adopt the most accommodative policy to restore the economy and moderate the rate of economic contraction, we do not see any of its traditional policy tools having a material impact at this time given the liquidity squeeze occasioned by the varying sterilization of DMBs funds by the CBN. Given the impact unusual debits have had on system liquidity and overall interbank rates, we believe a gradual refund of excess CRR will have a more positive impact on rates in the interim, but actual lending by DMBs will require a fundamental change in the economic environment and more efficient measures around the LDR. At the end of the MPC meeting on Friday, we favor the committee maintaining status quo on key policy rates, especially the MPR as we believe it will do little to support aggregate demand given that LDR has had more significant impact on lending rates.

Assessing the Viability of Policy Options

While the disruptions occasioned by Covid-19 are obvious and ominous, the MPC in our view has limited options in its reservoir to address the conflicting policy options. While we believe economic growth and exchange rate stability are the key conflicting priorities, we see economic stability dominating discussions at the MPC meeting starting tomorrow. On exchange rate stability, we stated in our March Pre-MPC note that given the risk of capital reversal, the apex bank will have to maintain or raise the OMO rates modestly as events unfold (Also see our most recent report: Rising Reserves Pressure Could Result in More Stringent Policies). However, given that an upward adjustment of the OMO rate could attract banks and reduce the appetite for lending, we stated the CBN will continue to apply the strong hammer. With economic stability dominating discussion, we elect to think from the MPC's perspective as regards the viability of traditional policy options in supporting aggregate demand and supply at this time.

Monetary Policy Rate: At its last meeting, the MPC accepted the limited transmission impact of its MPR in driving a downward adjustment of lending rates. Categorically, the MPC stated that a reduction in the MPR will not encourage DMBs to reduce lending rates, but an increase will be taken by the DMBs as invitation to increase rates. While a downward adjustment of the MPR would have been favored, it will largely be 'audio' without any impact on interbank rates and by extension the lending rate. Also, while our argument would have favored a likely downward revision of the asymmetric corridor around the MPR and the standard lending facility (SLF) rate, the CBN sterilization of banks CRR (through unusual debits and LDR punitive measures) already signals minimal interest from banks in taking cheap funding from the apex bank. However, our channel checks revealed banks are more in favor of a downward adjustment of effective CRR compared to a lower SLF rate.

Figure 1: Historical Relationship Between MPR, OMO Rate and Prime Lending Rate

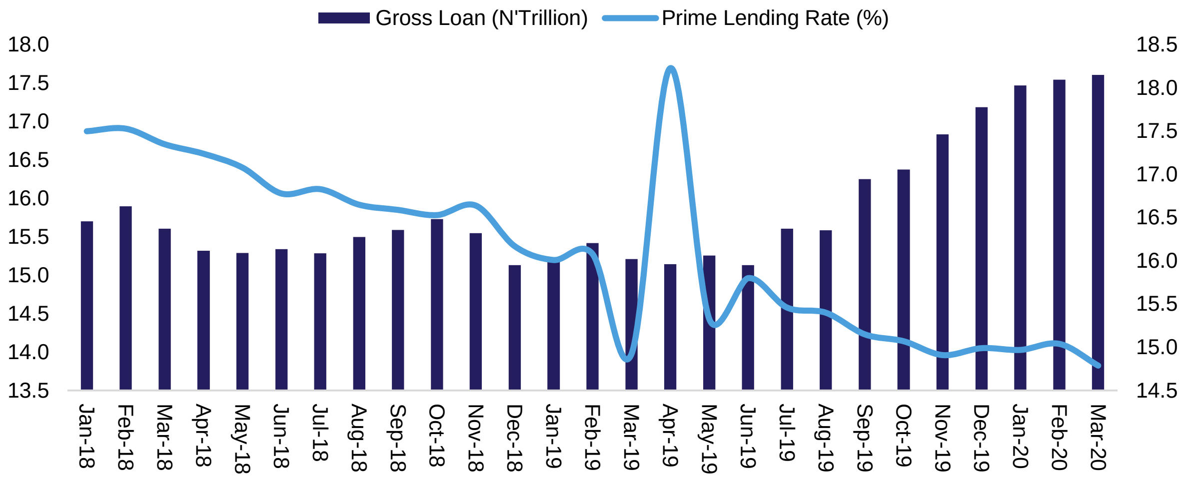


Source: CBN, Nova Research

Cash Reserve Ratio: The MPC at the end of its January meeting raised the CRR by 500bps to 27.5%, while maintaining other variables. 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. The increase of the CRR was meant to help the CBN achieve two goals: 1) reduce cost of liquidity mop-up within the banking system and; 2) combat possible foreign currency speculation induced by the impending liquidity. While the policy was counterintuitive, as it resulted in an increase in banks' CRR weighted average cost of funds, the impact of the LDR policy more than outweighed the higher cost without any material adjustment to lending rates. With effective CRR ranging between 40% and 70% across different banks, a downward adjustment of the CRR will not have any impact in boosting overall system liquidity. Paradoxically, an increase will further constrain system liquidity with further upward adjustment of the CRR weighted average cost of funds. While we understand current sterilization is largely punitive (both in terms of LDR compliance and staging off possible FX speculation), it has to a large extent constrained banks appetite for lending, when measured against systemic risk.

Loan to Deposit Ratio (LDR) Policy: Notwithstanding the counterintuitive nature of the increase in CRR implemented in January, total gross credit of the banking system increased by additional N353.85 billion in Q1 2020, accompanied by moderation in the prime lending rate. Beyond doubt, the LDR policy has proven to be more potent in driving real sector lending and at the same time moderating the cost of borrowing due to the increased competition for corporate names. Compared to overall gross credit of the banking system in June 2019 before the introduction of the minimum LDR on July 3rd 2019, the overall private sector credit has grown by N2.3 trillion to settle at N17.6 trillion in March 2020. Over the same period, the prime lending rate moderated 199bps to end March 2020 at 14.8%. Despite the aggressive loan growth, overall system liquidity remained stable at the end of March at 43%.

Figure 2: Trend in Banking Sector Credit and Prime Lending Rate (%)



Source: CBN, Nova Research

Notwithstanding the potency of the LDR policy in driving credit creation and moderating lending rates, the distribution of loans continues to favor largely the prime sectors and lenders, with limited transmission to the CBN's preferred sectors of SMEs, retail, mortgage, and Consumer lending.

In all, given that banks are more concerned about liquidity and systemic risk with current conditions, 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 banks) will have any material impact on growth. On the balance of factors, we favour the MPC maintaining status quo on traditional monetary policy tools. However, we expect the CBN to focus on reflating the banking system and to adopt more efficient measures around the LDR to further support credit creation, especially to consumption stimulating sectors. Post the meeting, we do not rule out pronouncement of some administrative measures to limit pressure on the reserves.