

21 September 2020

Economic Research

Economic Commentary

MPC Preview: Balancing FX Stability and Moderating Economic Contraction

Summary

At its meeting in July, the Monetary Policy Committee (MPC) of the Central Bank of Nigeria elected to maintain status quo on traditional monetary policy tools. Specifically, the committee noted a further cut in Monetary Policy Rate (MPR) may not necessarily lead to a corresponding decrease in market interest rate, considering the current economic challenges. On the other hand, given the structural fallout that necessitated increases in consumer prices, an upward adjustment of the MPR at the time would have further heightened the cost of production which will translate to higher prices of goods and services while an upward increase would contradict the CBN cheaper credit aspirations.

Since the last MPC meeting, key economic data revealed the vulnerability of the domestic economy to external shocks and exposed structural issues in the economy. Economic performance data for H1 2020 contracted 2.18% YoY (with Q2 standalone contraction of 6.10% YoY) compared to 2.11% YoY growth in H1 19. While we reckon that the level of contraction over Q2 compares favorably to the rate of decline in advanced economies and even similar emerging market economies (See full report: [Gone Deep Enough, Recovery Could Lengthen](#)), we believe the speed of recovery will be much faster in the advanced economies given the series of support provided for businesses with even less casualty relative to Nigeria. Elsewhere, recent upward adjustment in electricity prices and rising PMS/diesel prices due to increasing global crude oil prices are adding more pressure to the inflationary trend over the next couple of months. Also, due to the limited supply of FCY and heightened speculation, the BDC-Interbank rate remains elevated despite the resumption of sales to BDC and intervention sales at the IEW. In our view, the monetary policy imperative of striking a balance between supporting the recovery of output growth and reducing unemployment while maintaining stable prices, have been largely challenged by structural issues in the economy. As such, any policy that focuses on stimulating credit growth alone without a major revamp of the structural bottlenecks in the economy will do little to provide cheaper credit (even credit in itself) to the growth stimulating sectors of the economy. At the end of the meeting tomorrow, we expect between 100-200bps downward adjustment in the MPR, with such move further adjusting the interest rate on savings account lower to 1.15%-1.05%.

Improving FX Supply... Still Not Enough

After five months of lockdown on FX sales at the IEW and BDC segments, the CBN resumed sales at both windows in the month of September. The initial sales to BDCs starting September was fixed at \$10,000 per BDC twice a week. By our estimate, this should result in total monthly sales to BDCs of \$295 million (compared to our earlier estimate of average of \$550 million monthly). Also, over the first two weeks in September, the CBN has intervened at the IEW to the tune of \$112 million. The combined sales at the BDC and IEW are yet to have any significant impact on the current market

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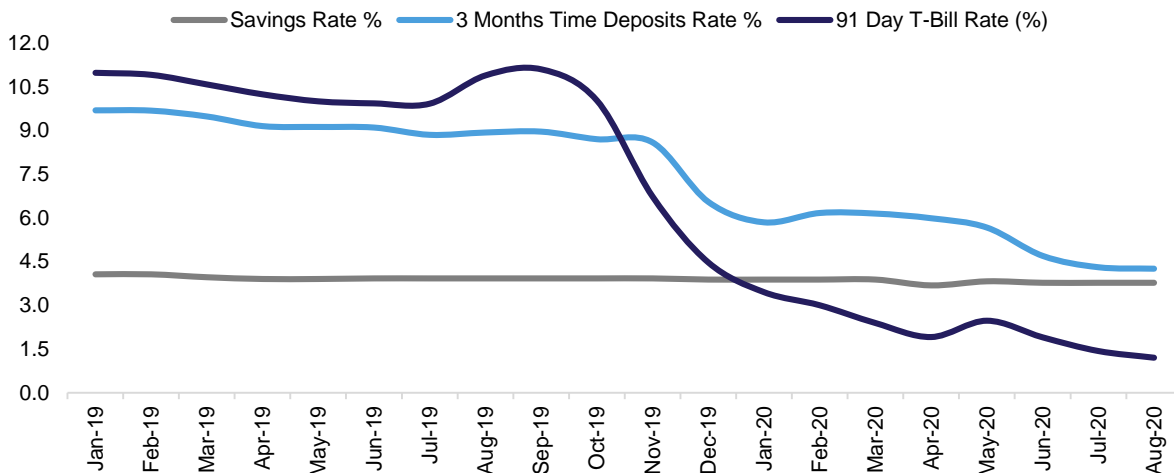
rates, especially BDC and parallel market rate, due to the low volumes compared to market demand and backlog repatriation demands. For the IEW specifically, we estimate the portion of offshore holdings of matured fixed income instruments at \$4.51 billion between April and August. As such, for the CBN to comfortably clear at least 50% of the backlog demand and even 50% maturing offshore holdings of fixed income instruments, we estimate that monthly sales at the IEW will at least average \$2.4 billion totaling \$9.47 billion over the next four months. At the BDC segment, acknowledging the lower demand for services occasioned by the still suppressed PTA and BTA demands, we had estimated that the appropriate dollar supply to clear market deficit should average \$550 million monthly. With the lower supply of just \$295 million, we believe it will take a considerable increase in the number of BDCs for the actual market volumes to start to have an impact on the BDC and parallel market rate.

Beyond the actual sales by CBN, the wide gap between the rate of sale to BDCs and IMTO sales, compared to the prevailing current market rate leaves a large room for speculation. While the apex bank supply dollars to BDCs at N384/\$ (with sale to end users at N386/\$), the current parallel market/BDC rate currently average N458/\$. Recall, following the introduction of the IEW in April 2017, the parallel-NAFEX premium was just 4.6% and moderated to 0.5% at the end of 2017 following improved dollar inflows and higher sales to BDCs. The premium currently stands at 19.2%, which suggest the need for a material convergence to neuter the level of speculation in the market. Based on our purchasing power parity model (PPP), the fundamental value of naira lies between N427/\$ and \$430/\$ (~11% overvaluation from current NAFEX rate of N386/\$), and a gradual convergence to our fundamental value will go a long way in neutering the parallel market premium and substantially reduce the market speculation. Notwithstanding recent measures implemented to lower the cost of funds of DMBs, we believe the state of the foreign exchange market will dominate discussions at the ongoing MPC meeting. Recall the apex bank recently issued a circular to control the destination of dollar demands, by abolishing company/agent or third-party "Form M" payment in a bid to discourage over-invoicing. Ostensibly, at the end of the meeting tomorrow we expect the apex bank to implement more stringent measures to moderate the level of speculations in the parallel and BDC segment and by extension neuter the wide premium between the interbank and BDC rate.

Reduction in Savings Rate... Market Correction Beyond Doubt

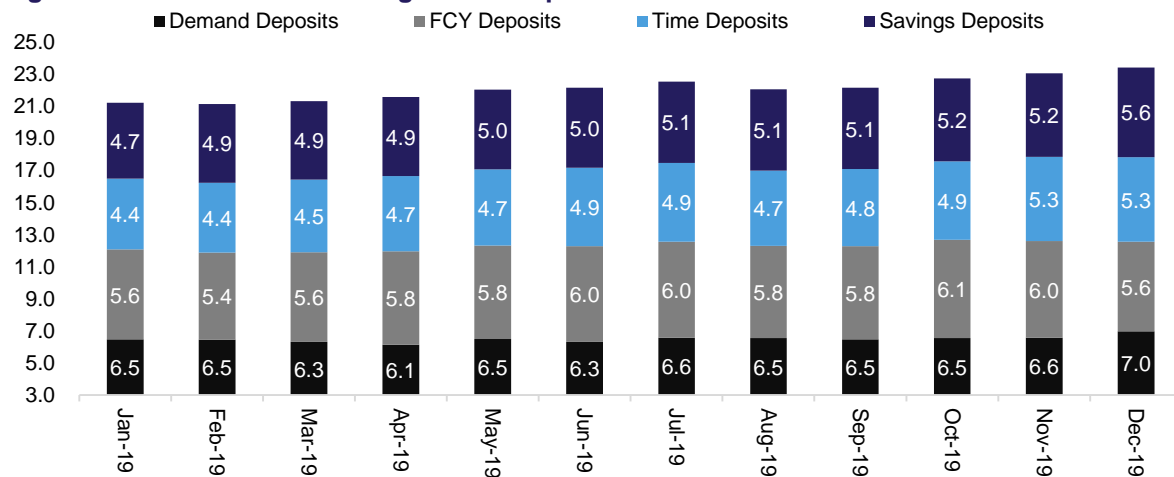
The CBN in a recent circular reviewed the minimum interest on savings account lower to 10% of the MPR from 30%. The adjustment translates to a new rate of 1.25% from 3.75% previously. The apex bank linked the revision to a further step in stimulating credit flow to the real sector. The move aligns with our view of likely more deliberate attempt to soften interbank rates and by extension the lending rate. However, we see the adjustment as long due and beyond just lowering the cost of funds of banks. Since March, the average stop rate at NTB auctions had falling below the rate of interest on savings account. Specifically, the 91-Day treasury bill stop rate fell to 3.45% in January, while the savings rate had remained above it at 3.89%, suggesting higher returns on a savings deposit compared to returns on a much longer dated 91-day NTB. Also, the rate on the 3-months deposit rate, which is largely negotiated, only offer a premium of just 48bps above the savings rate.

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Figure 1: Historical Money Market Rates and Interest Rate of DMBs

Source: CBN, Nova Research

With the CBN adopting a more direct approach to reducing the cost of funds of DMBs and by extension attempt to moderate the cost of borrowing, we do not rule out further downward adjustment of the MPR to further lower the savings rate much closer to the rate on the 91-day treasury instrument. By our estimate, a further downward adjustment of the MPR by 100-200bps (with minimum interest on savings account remaining constant at 10% of the MPR) would translates to a further fall in savings rate to between 1.15%-1.05%. While this will still largely benefit banks with sizeable savings account, a restructuring of savings deposit to longer dated time deposits, will further moderate rates on time deposits and by extension the cost of funds of the overall banking system.

Figure 2: Share of Total Banking Sector Deposits as at December 2019

Source: CBN, Nova Research

Recovery Phase and Softening Global Interest Rate Favors Moderation in MPR

With the economy contracting at the highest rate in history over Q2 2020, and outlook largely favoring much lower rate of contractions in subsequent quarters, it is safe to assume the economy is nearing the recovery phase. Beyond any doubt, it is necessary at this stage of the recovery cycle for the MPC to adopt the most accommodative policy to moderate the rate of economic contraction in subsequent quarters. Also, the current lower rate on fixed income instruments also favors such a move by the

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MPC, as they diverge materially from the current MPR rate.

At the last meeting, the committee noted that loosening of monetary stance could have implications for domestic private investment and capital mobilisation to support the huge domestic financing gap. While the view is justified given the current FX risk that has bewildered investment in Nigeria, we believe the current near zero interest rates in advanced economies have offered the CBN a large avenue to attract foreign investors with modest increases in treasury instruments rates. Beyond even the adjustment of rates upwards, we believe the adjustment of the exchange rate to our fundamental rate would further consolidates the drive to mobilize foreign capital.

While we do not see any of the traditional monetary policy tools having a material impact on growth and lending rate at this time given the liquidity squeeze occasioned by the debits of banks who fail to comply with the LDR policy of 65%, we believe a focus on adjusting the cost of funds of DMBs lower will have more far reaching effect. Beyond actual nominal interest rates, the cost of funds across the banking system is adjusted higher by the CRR impact to arrive at a CRR weighted cost of funds. As such, we believe a gradual refund of CRR will have 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 to further support credit creation. Notwithstanding, we believe the current attempt by the CBN to lower the cost of funds of banks could trigger a change in the MPR. As such, we expect between 100-200bps downward adjustment in the MPR at end of the MPC meeting tomorrow, with such move further adjusting the interest rate on savings account lower to 1.15%-1.05%.