FDC Economic Bulletin

July 27, 2016

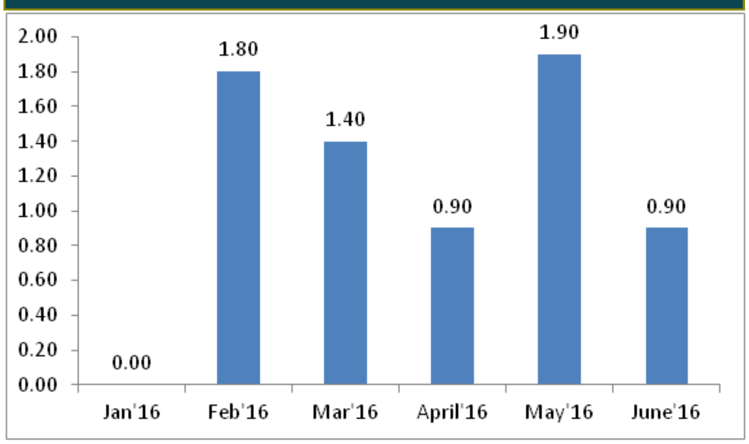
Hard Choice: Choosing to combat Inflation over Growth

Contrary to market expectations, the Monetary Policy Committee (MPC) made an audacious move by resuming a tightening monetary policy stance. The Monetary Policy Rate (MPR) was increased by 200bps to 14%p.a, with the asymmetric corridor retained at +200/-500bps. The other monetary parameters were left unchanged. Five members voted to increase the MPR, while three were in favour of maintaining the MPR. It is important to note that growth is a structural, long-term phenomenon that cannot be fully addressed with tactical responses such as tweaking the interest rate.

MPC silent on key factors

The MPC's communiqué was noticeably silent on the level of external reserves and the declining month-on-month inflation rate.

Chart 1: Month-on-Month rate of Inflationary Change (%)



Source : NBS, FDC Think Tank

Inflation has spiked to 16.5%

The anticipation surrounding this meeting was high, as it was the first meeting under a fully managed floating exchange rate system. Policymakers were confronted with the dilemma between tackling inflation

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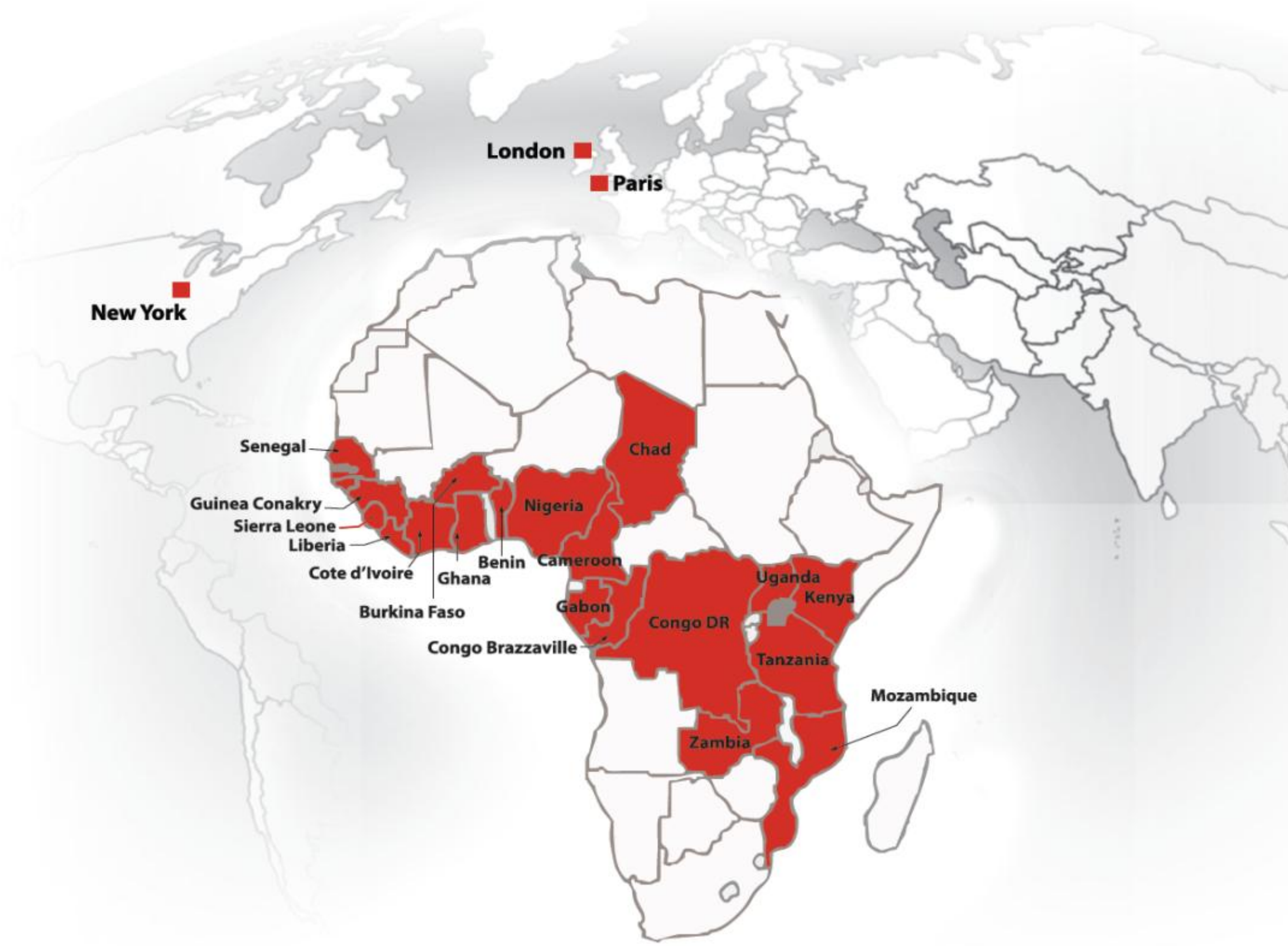

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www.ubagroup.com e-Mail: cfc@ubagroup.com *Africa's global bank* and stimulating growth. The decision to hike up the MPR is attributable to the committee's discernment that the odds were stacked against price stability. Inflation skyrocketed to 16.5%, while the interest rate remained at 12%, with the former being fuelled by supply shocks and forex scarcity. Headline inflation YoY is not currently moved by monetary factors, making a rate hike less likely to curb rising price levels. However, it is important to note that headline inflation encapsulates the bias of base year effect. Hence, headline inflation rates are not fully representative of current month-on-month market realities.

Rationale behind decision

Coupled with rising price instability, concerns were raised about the adverse consequences of the negative rate of return on foreign investment inflows, which are needed to increase forex liquidity and support the Naira and markets. The MPC highlighted its quest to achieve a positive rate of return in a bid to attract foreign investors and deepen the forex market. The stronger Naira to emerge from this is expected to temper the rising cost of inputs and boost industrial production, thereby bolstering growth.

Impact

The impact of this decision will sip through 4 major channels. These include higher debt servicing costs for government and private enterprises, a stronger Naira through reduced effective demand for forex, and a reduction in regulatory arbitrage between banks and the CBN. Finally an influx of investment from international fixed income investors as well as hedge funds is likely to result from the MPR hike.

Money markets

Liquidity "squeeze" is a theoretical impact that should result from a higher MPR as the opportunity cost of holding cash becomes higher. The MPR is an anchor rate, which signals the direction that other interest rates should follow. In the past months, this has not been the case. Treasury bills rates have averaged 15%, with yields as high as 20%. The forex market liberalization has created a liquidity squeeze in the money markets. Hence, we do not expect any change in the current rates of Treasury bills.

Asset Classes

Increased activity is expected in the bonds market as higher interest rates have an inverse relationship with bond prices. Hence, bond yields are expected to increase. The increased returns from a less risky asset (fixed incomes) will trigger a run on equities. Investors will lean towards fixed income assets for capital appreciation and equities for dividend yields.

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Outlook

The marginal propensity to save (MPS), which is a function of interest rates, is relatively mediocre in Nigeria. An MPR hike is likely to elevate the propensity to save. However, in a recession, a tightening of monetary policy, where monetary conditions are clinched, may lead to the unintended consequences associated with the paradox of thrift. Therefore, the probability of plunging further into a recession is high. Finance challenges might become neutral if the naira appreciates to levels that offset a likely increase in borrowing costs.