FDC Economic Bulletin

September 22, 2017

Likely split decision at MPC, status quo to be maintained

As the Monetary Policy Committee (MPC) meets on September 25/26, the financial and business community will be awaiting with bated breath the outcome of one of the most important and symbolic meetings of the committee in recent times. This is because it is happening at a time when political and populist considerations will overshadow the policy and economic imperatives. *The most likely outcome is a split decision and a compromise around the maintenance of the status quo with fringe adjustments to the CRR and the width of the asymmetric corridor.*

Major considerations will include but are not limited to:

An imminent increase in U.S interest rates by 25bps in November and its implications for reverse capital flows to emerging and frontier markets

The U.S. Federal Reserve retained interest rates at 1%-1.25% p.a. at its September meeting. However, several members of the Federal Open Market Committee (FOMC) reiterated the possibility of another rate hike at its next meeting in November. *This will make international borrowing more expensive and reduce availability of credit to emerging market entities.*

GDP moves into positive territory

As widely anticipated, Nigeria's real GDP growth rate in Q2'17 moved to positive territory of 0.55% from -0.91% in Q1'17. After five consecutive quarters of negative growth, Nigeria is technically out of recession. However, the challenge is that growth is fragile because excluding the oil and agriculture sectors, second-quarter growth was negative (0.22%). Therefore, this is not a broad-based and impactful recovery. *Given this context, there is increasing pressure on the central bank to adopt a pro-cyclical policy in order to compliment the fiscal stimulus and sustain the upward trend in economic growth.*

Money supply growth remains below CBN's target

Broad money supply (M2) declined by 5.08% to N22.20trn in July 2017 from N23.39trn in December 2016. This is far below the CBN's money supply growth target of 10.29%. The contraction in money supply aggregates, combined with the sterilization of significant portions of money by way of cash reserve ratio

deposits, has reduced liquidity and aggregate demand in the economy. There is a positive correlation between money supply and inflation. *If with a contraction in M2, inflation reached 16.01%, the hawks will argue that with monetary accommodation, inflation will spike to hyperinflation territory, maybe above 20%.*

Headline inflation continues to decline

Nigeria's headline inflation fell for the seventh consecutive month in August to 16.01% after reaching a high of 18.7% in January. The main contributor of inflation is the food inflation sub-index, which declined to 20.25% in August from a record peak of 20.28% in July. Food inflation remains high because traders are smuggling food products to neighbouring countries, such as Benin Republic, Cameroon, Chad and Niger. *The weaker naira relative to the CFA franc is an incentive for traders to sell their products across the border rather than the domestic market. If the naira weakens further due to increased liquidity, high food inflation will remain an albatross for policymakers.*

OPEC places cap on Nigeria's oil production

OPEC placed a cap on Nigeria's production at 1.8mbpd at its meeting with other oil producing countries in St. Petersburg in July. According to OPEC's monthly report, Nigeria produced 1.86mbpd in August, excluding condensates estimated at 400,000bpd-440,000bpd. At a recent OPEC ministerial meeting in Vienna, the cartel considered including Nigeria in the production cut pact, however, discussions are yet to be finalized. *Having said this, a rate hold might be appropriate, given the prospects of reduced foreign exchange earnings from lower oil production. A tight monetary policy stance will continue to attract foreign investors.*

Exchange rate relatively stable at parallel market

At the parallel market, the exchange rate has traded within the range of N363/$-N370/$ since the last MPC meeting. In the period under review, the IEFX rate recorded a 2.1% appreciation to close at N359.40/$. Also noteworthy is the duration of recent forex forward contracts that has been extended from 15 days to 90 days. This brings the effective exchange rate to N340/$. *There is a direct correlation between the currency's appreciation and the amount of the CBN's interventions. Lower oil proceeds will inhibit the CBN's ability to continue defending the naira.*

External Reserves maintains upward trend

The level of gross external reserves continued to increase on higher oil production and prices. Currently at $31.88bn, the reserves level has increased by 3.78% ($1.23bn) since the last MPC meeting. According to a CBN official, the level of external reserves has increased to $33bn. However, official data lags the pronouncement.

Regional considerations

With respect to monetary policy, most sub-Saharan African (SSA) countries left their monetary policy rates unchanged at their last MPC meetings with the exception of Ghana and Zambia. The South African Reserve Bank kept its benchmark repo rate at 6.75%p.a. at its September MPC meeting. This defied expectations of a cut based on a sluggish recovery from a recession in the first half of the year. South Africa and Nigeria both emerged from a recession at the same time. The hawks among the MPC might be affected by the copycat syndrome and argue that South Africa maintained status quo because of the upside risks to inflation, in spite of the country's weak economic performance.

Likely Scenarios

In the final analysis, we expect an acrimonious debate amongst the committee members and we do not see a unanimous decision. Given the developments in the domestic and international markets, the most likely outcomes in our view are:

Scenario A – 55% probability: Maintain Status Quo

- MPR: 14% p.a. with the asymmetric corridor at +200bps/ -700bps
- CRR at 22.5%p.a.
- Liquidity ratio: 30%p.a.

Scenario B – 45% probability: Token shift to accommodative monetary policy

- Maintain MPR at 14% p.a.
- Lower the CRR from 22.5% to 21.5% but this will be tied to real sector lending
- Reduce the width of the asymmetric corridor by 150bps
- Maintain the liquidity ratio at 30%p.a.