FDC Economic Bulletin

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MPC Surprise Rate Cut: Limited Impact on Credit Growth

At its penultimate meeting in 2020, the monetary policy committee (MPC) surprisingly lowered the benchmark interest rate by 100bps to 11.5%p.a. from 12.5%p.a. This is the second rate cut in 2020 and the lowest MPR since 2016. The asymmetric corridor between borrowing and placing funds with the CBN has also been expanded to +100/-700bps from +200/-500bps. This means that access to the CBN discount window by the Deposit Money Banks (DMBs) is now cheaper. The standing deposit facility (SDF) will reduce by 300bps to 4.5%p.a. while the standing lending facility (SLF) will fall by 200bps to 12.5%p.a. The CRR and liquidity ratio were left unchanged at 27.5% and 30% respectively.

Contradictions between policy expectations and economic realities

The adoption of a more dovish stance runs contrary to the conventional logic that lower interest rate would fuel inflationary pressures. The assumption that a reduction in interest rates will automatically and immediately translate into output growth and lower inflation undermined the time lag between policy and impact.

According to the EIU, "Tolerance of high inflation by the CBN indicates that the issue will be left largely unchecked over the medium term, as its strategy to boost supply side of the economy plays out to a conclusion – and one that we expect to differ from the MPC's theory".

Headline inflation climbed to 13.22% in August, the highest level in 29 months and is projected to close the year at 14.5% due to higher PMS price and cost reflective electricity tariffs. Rising inflation could dampen investor confidence, squeeze consumer disposable income and reduce aggregate demand.

Shift in the underlying factors driving inflation

It appears that there is a shift in the committee's perspective about the underlying factors diving inflation. The committee attributed the build-up in inflationary pressures to structural rigidities and supply shocks, downplaying the exchange rate pass through and transmission effect between M2 growth and prices. The MPC had in the past ascribed the rise in the general price level to exchange rate pass through and growth in money supply. Moreover, the structural bottlenecks had existed in the past and are unlikely to be addressed

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Implications

Limited impact on credit growth

The CBN's dovish stance is expected to reduce cost of funds but is likely to have a limited impact on credit growth. This is due to the high level of risk aversion by Nigerian banks. Since the last rate cut in May'20, credit to the private sector grew in nominal terms but the rate of growth slowed to 6.94% in August compared with 7.47% in May.

Interest rate-inflation differential in favour of the US

Lower interest rate amid rising inflation increases the interest rate-inflation differential in favour of the US. This heightens the risk of capital flight, which will further increase the pace of external reserves depletion. Also, Nigeria being an import dependent economy stands the risk of higher import prices due to a stronger dollar. This will negatively impact the country's balance of trade and terms of trade levels. The CBN's ability to support the naira is undermined and hence we could experience some exchange rate volatility.

	Inflation (%)	90-day T/bills (%)	Inflation-interest rate differential (%)
Nigeria	13.22	1.2	12.02
US	1.3	0.12	1.18

Monetary easing to reduce marginal propensity to save (MPS)

The 100bps cut in MPR means a further 10bps reduction in the minimum interest rate on savings. This at a time when inflation is galloping implies that the negative real rate of return on savings will widen. The impact of this will be a reduction in the marginal propensity to save, which will translate to a higher marginal propensity to consume (MPC) and could stoke inflationary pressures.

Outlook

We do not expect a significant change to the monetary policy stance again this year. The committee will continue to monitor the impact of the rate cut and other policy pronouncements on economic growth and prices. However, a further spike in inflation could force the MPC to reverse its current monetary stance and tilt towards a tighter monetary stance in 2021.