Fundamentals

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Macroeconomic update | Strategy | Monetary policy analysis | Nigeria

A bolt from the blue

IN BRIEF

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- Inflation is the buzzword for 2022 as it is stirring in all corners of the globe and monetary chieftains are already or are fully prepared to hike interest rates in ever-increasing increments to rein it in.
- Against this backdrop, the Central bank of Nigeria (CBN) took some pressure off the gas pedal by raising its monetary policy rate (MPR) by 150-basis points to 13%, as the withdrawal of global monetary accommodation gathers pace.
- In our opinion, the challenge going forward remains to find the policy balance to dampen rampant inflation without shrouding the fragile growth outlook - amid clouds of geopolitical conflict in Europe.
- Due to a policy lag, we anticipate a pause in action from the monetary policy committee (MPC) to allow for May's decision to permeate the economy, with continued implementation of its development finance initiatives to support its economic growth mandate.
- However, further policy action is unlikely to be as aggressive as May's decision in magnitude, but this is on the condition that the Russo-Ukrainian conflict will not substantially escalate to derail the current economic projections.
- But Nigeria's financial markets – just like other emerging markets – are at the mercy of the United States (US) Federal Reserve Bank (Fed).

After around six years of inflation tolerance, the Central Bank of Nigeria (CBN) unanimously voted to raise the monetary policy rate (MPR) by 150-basis points to 13%, in response to higher price pressures that pushed headline inflation farther away from its target range. This makes the CBN the fourth African central bank within our coverage universe (together with Egypt, South Africa, and Ghana) to tighten financial conditions in May's round of policy meetings. Although the tone from the CBN's monetary policy committee (MPC) is not as hawkish as that of the Bank of Ghana (BoG), the potential for inflation running faster than current levels remains a source of angst among members – informing the unanimous vote for a rate hike.

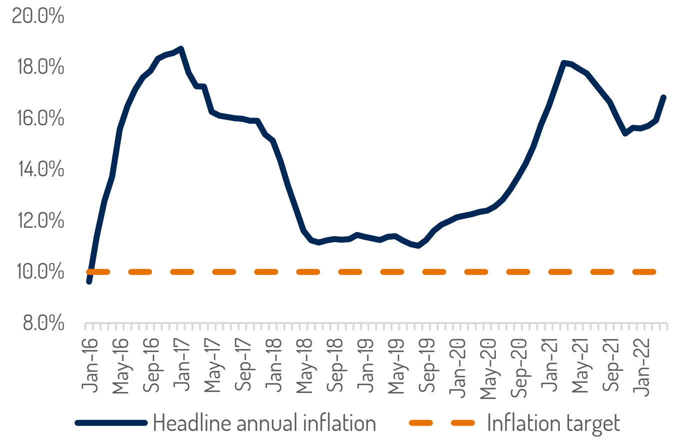
Going forward, however, we opine that the MPC will be divided on whether to go ahead with increasing the benchmark interest rate in subsequent meetings – should inflationary pressures remain higher for longer. Also, the policy response is going to be insufficient to rein in inflation as a majority of members favour a less aggressive rate action in the future. Therefore, Nigeria's monetary policymakers will still lag far behind its African peers in the current interest rate tightening cycle, and tighter global financial conditions remain the biggest risk to Nigeria's financial markets.

Inflation worries temper growth optimism

With darker inflation clouds on the horizon and the possibility of inflation running hot for a lot longer than policymakers and investors think, monetary policy needs to lean against these price pressures to prevent higher levels of inflation from being entrenched. This is because persistently high levels of inflation are "inimical" to economic growth, and can erode the economic gains realised from the bank's development finance initiatives. Nigeria's economy expanded further by 3.1% y/y in 1Q2022, as its animal spirits continued to recover from the pandemic squeeze amid development finance support from the CBN.

Inflation running above the central bank's target for over six years has entrenched price pressures in Nigeria's economy. The jump in April's headline inflation reading to 16.8% y/y reflects the near-term risks to consumer prices, given the prevailing geopolitical and monetary policy mood in the global economy.

Evolution of Nigeria's inflation rate



Source: National bureau of statistics (NBS)

CBN doves capitulate under prices pressures

In our opinion, the policy direction is right (tightening), but the speed of hikes might be too slow for the kind of inflation pressures the country is contending with. Surging prices have brought an end to the fudging over inflation by committee members, and have nudged reluctant central bank hawks off the fence of monetary accommodation. Against the backdrop of a strong economic performance in 1Q2022, inflation changed the balance of power at May's MPC meeting as a majority of the members in attendance (6/11) voted for a 150-basis points rate hike - while the others favoured a more cautious magnitude.

However, we do not see this as an indication of further tightening in the coming months. This is because an aggressive withdrawal of monetary support risks wasting the trillions that have been spent by the bank on pandemic recovery efforts, leaving a worse cure (i.e. a recession) than the illness (i.e. inflation). Therefore, the decision to tighten monetary taps to non-priority sectors might have been unanimous but does not signal that the MPC is now more open to raising rates in the coming months.

The majority of members may default to waiting to see the full impact of May's policy action since policy works with a lag. As such, Nigeria's monetary policymakers will lag far behind its African peers in the ongoing policy tightening cycle – a move that can propel inflationary pressures to become increasingly generalised across commodity groups.

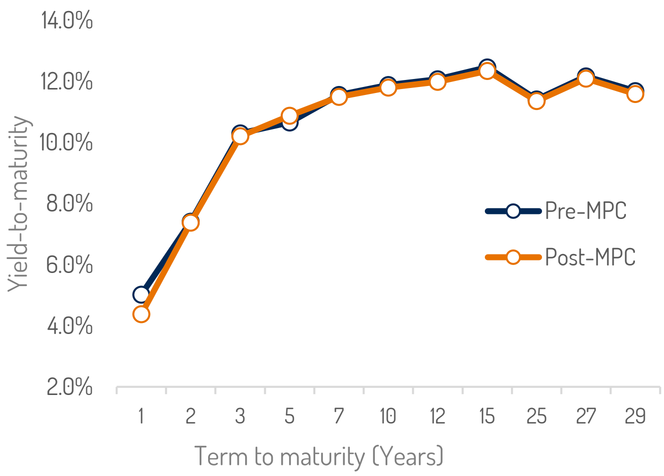
US Fed hawks remain the biggest market risk

We expect government bond yields to drift higher as we have switched to a tighter monetary policy regime. However, liquidity play among market players will always open windows of opportunities to cash in on short-lived rallies. As a result, we recommend a reduction in duration exposure and a market weight allocation to Nigerian papers in your portfolio – due to idiosyncratic fiscal risks.

Eurobonds yields could receive some more whiplashing from further tightening by global central banks, even though the 13% hike in the MPR was welcome by Eurobond investors. After the MPC decision announcement, Eurobond investors gave it the nod and yields moderated slightly by an average of 10 basis points across the yield curve.

In the currencies market, the naira may be a petro-currency but weakness is expected to prevail due to weak global risk appetite, and politics-induced speculative demand for the greenback - as oil receipts remain weak, and other foreign currency sources remain crimped. A slice of the currency weakness may also owe something to the uncertainty about monetary policy going forward following the recent political shake-up.

Nigeria's Eurobond yield curve



Source: Bloomberg

Conclusion

The CBN has made a pivotal shift to combating inflation and restoring price stability, even though most of the factors pushing up inflation are external. Strong 1Q2022 growth numbers point to a continuation of the powerful recovery, but persistent price pressures in the coming months are a no-brainer.

In our opinion, the decision to tighten was a step in the right direction – even though the CBN is taking a reactive approach to combating inflation unlike the Bank of Ghana (BoG) and the South African Reserve Bank (SARB) that have been a bit more proactive. Forward guidance, however, suggests a more cautious approach to balancing the inflation-growth nexus as a strong inflation crackdown now could be counterproductive to the fragile economic growth prospects.

Unfortunately, the rate of interest is a very blunt instrument that cannot be raised just a bit to reduce inflation only marginally. To be effective, it must be raised significantly to tame the inflation current. With the prospects of inflation racing farther from target and the outlook shrouded in uncertainty due to monetary and geopolitical risks, investors will need to take a page from the US Fed's dot plot.

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