NIGERIA | MACROECONOMIC UPDATE | MONETARY POLICY | INSIGHTS

FUNDAMENTALS

NIGERIA MPC UPDATE: A NEW SHERIFF IN TOWN

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IN BRIEF

- The newly reconstituted Monetary Policy Committee (MPC) of the Central Bank of Nigeria (CBN), led by Governor Yemi Cardoso, convened its first MPC meeting this week amidst heightened expectations of a hawkish policy direction.

- Although this meeting marks the start of scheduled MPC meetings for 2024, the new CBN administration which effectively commenced in September 2023 had implemented a number of reforms in the FX market whiles tweaking the monetary policy transmission mechanism. However, we observed that the forex reforms implemented so far have been heavily focused on boosting FX supply while the persistent Naira liquidity overhang continues to fuel FX demand to overwhelm the limited forex supply.

- Against the backdrop of persistently loose Naira liquidity, the 12-member MPC expectedly delivered a 400bps hike in the monetary policy rate (MPR) to 22.75% (market expectation: 21.25%), amongst other liquidity management measures.

- Our assessment of the CBN Governor's policy tone since his appointment suggests a strong leaning towards reviving foreign portfolio investment as a critical source of forex inflows. We think this posture will keep the MPC hawkish as the market requires higher interest rates to complement the ongoing FX reforms. The MPR hike raises our hopes for a continued upturn in domestic yields, especially along the back-end of the T-bill curve into the medium-term segment.

- However, the reduction in the lower bound of the asymmetric corridor effectively neutralizes the impact of the MPR hike on the CBN's Standing Deposit Rate (SDR) which remains at 15.75%. This will likely keep short-term deposit rates largely unresponsive to the MPR hike, limit the CBN's capacity to effectively drain Naira liquidity and undermine the monetary policy transmission mechanism. Despite the optically hawkish hike in the CRR to 45.0%, the CBN's past daily deductions from banks' cash reserve above the previous 32.5% CRR will mute the liquidity-restraining impact of the latest hike. This suggests the need for more aggressive Open Market Operation (OMO) in the near-term to further tighten Naira liquidity.

A new era of monetary policy

The newly reconstituted Monetary Policy Committee (MPC) of the Central Bank of Nigeria (CBN), led by Governor Yemi Cardoso, convened its first MPC meeting this week amidst heightened expectations of a hawkish policy direction. Although this meeting marks the start of scheduled MPC meetings for 2024, the new CBN administration which effectively commenced in September 2023 had implemented a number of reforms in the FX market while tweaking the monetary policy transmission mechanism.

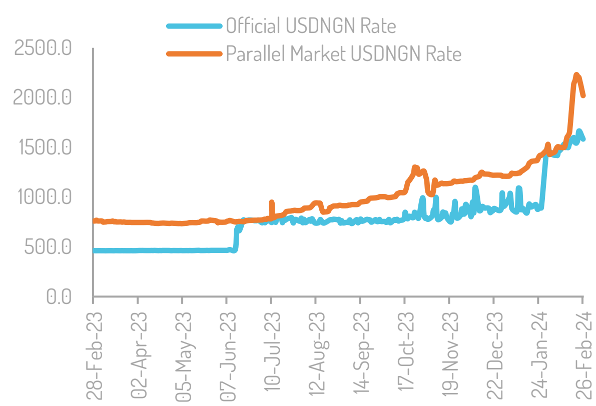
On the foreign exchange market, the CBN devalued the Naira twice in the past 8-months with a cumulative adjustment of 65.0% against the US Dollar as of end-January 2024. The sharp devaluation immediately narrowed the premium between the official NAFEM and the parallel market rates, largely pushing the Naira towards its fair value and eroding arbitrage opportunities.

The forex market reforms also included the re-introduction of the "Willing buyer, Willing Seller" model on the official FX market in June 2023, thereby allowing a market-based determination of FX rates. The CBN also capped commercial banks' net open position (NOP) at 20.0% short and zero-percent long of shareholders' fund. This effectively reduced the FX exposure of banks and redirected the excess FX exposure to the Nigerian Autonomous Foreign Exchange Market (NAFEM) to boost forex supply.

In our view, the FX reforms are decisive and charts a credible path for Nigeria's exchange rate policy under the new Central Bank regime. However, we opine that achieving the desired outcome of a stable Naira will require staying the course of policy reforms as the market gradually adjusts to the new era of monetary policy and exchange rate determination.

We also observe that the forex reforms implemented so far have been heavily focused on boosting FX supply while the persistent Naira liquidity overhang continues to fuel FX demand to overwhelm the limited forex supply. Consequently, the Naira has weakened by an extra 16.5% against the USD on the NAFEM post the January 2024 devaluation while the parallel FX market premium widened to 17.6% as of 27 February 2024 from 8.3%.

USDNGN EXCHANGE RATE DYNAMICS



SOURCE: FMDQ, IC INSIGHTS

Here comes the hawks with a dove in the mix

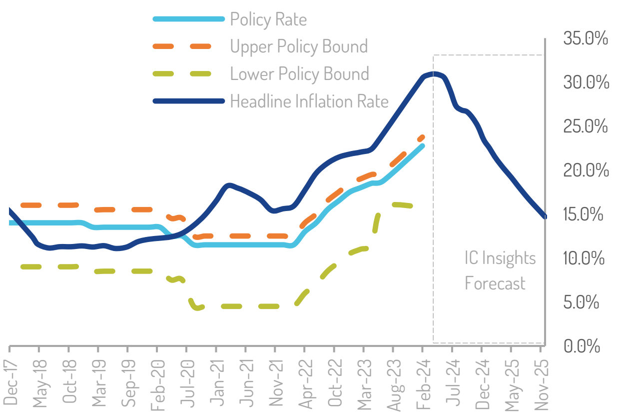
Against the backdrop of persistently loose Naira liquidity, the 12-member MPC expectedly delivered a 400bps hike in the monetary policy rate (MPR) to 22.75%, amongst other liquidity management measures. Whiles in line with our expectations, the hawkish decision exceeded market expectation of a 250bps hike, emphasizing the new regime's commitment to restore price stability. Highlights of the decision includes:

- Raise the MPR by 400bps to 22.75%
- Adjust the asymmetric corridor around the MPR to +100/-700 basis points from +100/-300 basis points
- Raise the Cash Reserve Ratio by 1,250bps to 45.0%
- Retain the Liquidity Ratio at 30.0%

The outsized hike in MPR is favourable for price stability and hastens the step to positive real policy rate. We view the authorities' bold decision to hike the policy rate to 22.75% as a strong message of commitment to restore price and FX stability. The new MPR with +100bps corridor brings the CBN's Standing Lending Rate (23.75%) closer to the 12-month Nigerian Interbank Treasury-bill True Yield (NITTY), which closed at 24.9% as of 26 February 2024 (+10.5pp YTD). With inflation at 29.9% in January 2024 and potentially peaking along the 30.0% – 35.0% range in 1H2024, real interest rates will remain in negative territory in the near-term. However, we expect the start of disinflation in 2H2024 as the impact of the fuel subsidy removal and FX devaluation wanes while the MPC remains hawkish at subsequent meetings.

Our assessment of the CBN Governor's policy tone since his appointment suggests a strong leaning towards reviving foreign portfolio investment as a critical source of forex inflows. We think this posture will keep the MPC hawkish as the market requires higher interest rates to complement the ongoing FX reforms. The IMF's recommendation in early February 2024 for continued hike until the real policy rate turns positive suggests the MPC may favour additional hikes of between 150bps – 250bps at future meetings later this year.

INFLATION AND POLICY RATE PATH



SOURCE: CBN, NBS, IC INSIGHTS.

The wider asymmetric corridor however leaves us concerned about the policy transmission. The MPR hike raises our hopes for a continued upturn in domestic yields, especially along the back-end of the T-bill curve into the medium-term segment. However, the MPC's decision to reduce the lower bound of the asymmetric corridor around the MPR from -300bps to -700bps dampens our optimism about continued upward adjustment in shorter-term yields. The reduction in the lower bound of the asymmetric corridor effectively neutralizes the impact of the MPR hike on the CBN's Standing Deposit Rate (SDR) which remains at 15.75%. This will likely keep short-term deposit rates largely unresponsive to the rate hike, create a divergence with the policy rate and undermine the monetary policy transmission mechanism. We recognize the adverse impact of a higher SDR on the CBN's interest expense on monetary sterilisation. In our view however, a narrower interest rate corridor which raises the SDR towards the 6-months NITTY of ≃17.0% would drain additional Naira liquidity, improve the policy transmission mechanism, and restrain the demand-induced price and FX pressures.

In an optically hawkish move, the MPC also hiked the cash reserve ratio (CRR) by 1,250bps to 45.0%, adding emphasis to its tilt in favour of a hawkish policy stance. Hypothetically, this CRR hike should drain Naira liquidity from the market and ease our concern on the widened asymmetric corridor around the MPR. However, the CBN had in the past executed daily debiting of banks' accounts under the 32.5% regulatory cash reserve ratio. Although the CBN announced cessation of these daily debits in early February 2024, commercial banks indicated that the previous deductions have increased their cash reserves held at the Central Bank above the 32.5% requirement. Against this backdrop, we believe the latest hike in the CRR to 45.0% mostly regularizes the new ratio with the current holdings of banks at the CBN. Consequently, we expect the optically jumbo hike in the CRR to exert only a modest drain on Naira liquidity to align with the new regime. This suggests the need for more aggressive Open Market Operation (OMO) in the near-term to further tighten Naira liquidity.

A formal adoption of inflation targeting (IT) framework did not materialize but we remain hopeful for adoption in 2024. We had anticipated an official announcement of a change in monetary policy to IT framework at the February MPC meeting after the CBN Governor offered a hint during his late-2023 presentations. However, our expectation did not exactly materialize ostensibly because the authorities are yet to complete the draft framework. Reassuringly, the Committee noted that the proposed transition to an IT framework is essential to addressing the persistent inflationary pressures. This indication deepens our hope for adoption of inflation targeting in Nigeria before end-2024. We believe an explicit inflation target which is clearly communicated to the market will enhance the transparency of monetary policy operations and anchor inflation expectations in the short-to-medium term.

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