22 November 2016

MPC Preview.

Committee to Maintain Status Quo Today

The Monetary Policy Committee (MPC) meets this week, and -- except for emergency call for Extraordinary Meeting -- for the last time this year. Compared to the last meeting in September, it would appear that the forthcoming meeting is not widely anticipated -- especially among local observers -- given that the Committee is unlikely to unveil or announce any policy changes. Whilst expecting status quo, also in line with Bloomberg consensus, we look forward, specifically, to the Committee's report on its assessment of the impact of monetary tightening and flexible foreign exchange rate policy on the transmission of foreign inflows into the economy.

Sigh of Relief

The MPC took the wait-and-see option in September -- in line with our expectation -- doubling down on its decisions -- consisting two rate hikes and the introduction of flexible foreign exchange policy -- since March. At the last meeting, the Committee reemphasized the need to prioritize the use of monetary policy instruments in dealing essentially with stability issues around key prices (consumer prices and exchange rate) as prerequisites for growth.

Indeed, the NBS' recently released capital importation report revealed that an amount of USD1.82 billion was imported into the economy between July and September (Q3). Though the amount was 34% below the value of imported capital in Q3-2015, it was the biggest quarterly receipt in four quarters. In our view, the inflow reflected the impact of the flexible exchange rate policy introduced in July, which initially gained foreign institutional investor endorsement, especially as it was accompanied with (1) the clearance of the USD4.02 billion outstanding demand for forex at the time, and (2) the MPC's decisions in July and September meetings showing firm preference for portfolio inflows through policy tightening.

Figure 1: Total Capital Importation (USD million)

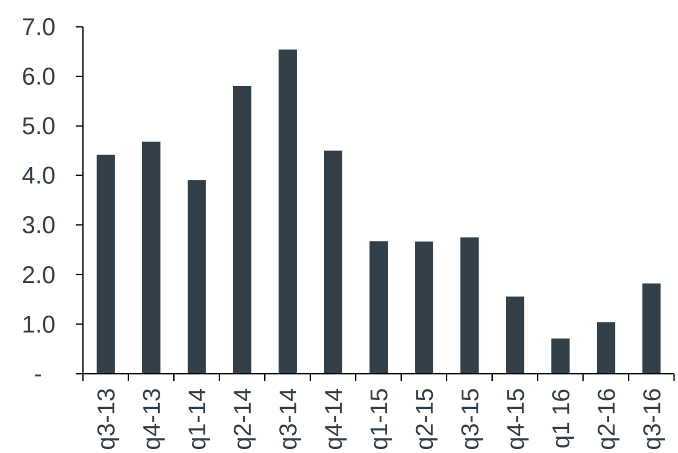
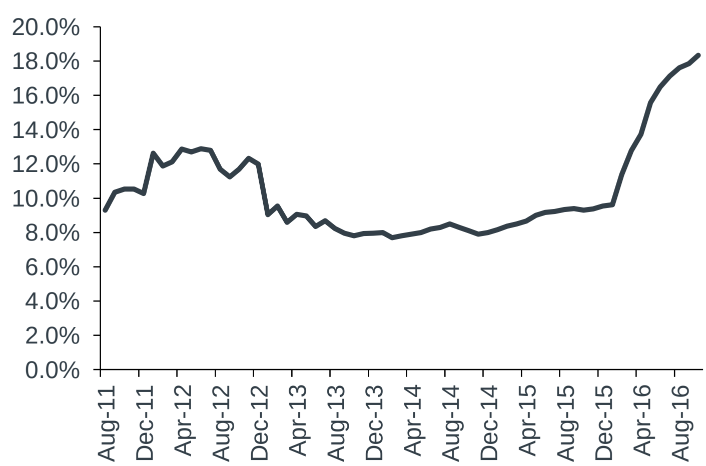


Figure 2: Y/y Headline Inflation



Source: CBN, NBS, Cordros Research

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Meanwhile inflation rose by 0.83% month-on-month in October, 3bps higher than the 0.8% m/m increase in September. The benign m/m increase, despite bucking a 4-month declining trend, adds to evidence that the momentum of price increases experienced thus far this year may be slowing.

Going into this meeting, the news on capital importation and month-on-month inflation have provided the MPC some breathing space. We think the MPC will find the fact that 50% of the total amount of imported capital came from portfolio investors -- for investment in equity (11%), bonds (20%) and money market instruments (19%) -- particularly comforting.

More Work to Do

Despite these developments, there are some good reasons to believe that the MPC's work is not yet done. Most importantly, notwithstanding the improvement in capital imported, the forex markets are still significantly short of liquidity, hence the wide spread between the official and parallel exchange rates. The CBN remains the biggest seller of the USD in the interbank market, evidenced by the bank's frequent intervention in the market in recent months. In October alone, the external reserve reduced by USD580 million as the CBN defended the Naira. The initial confidence in the administration of the flexible exchange rate policy has waned, as the CBN appears to have resumed control of the exchange rate. Last week, apparently driven by the ambiguous forex mechanism, the FMDQ OTC Securities Exchange announced the suspension of the FMDQ Spot FX Closing Rate, sighting the misalignments that exist in the FX market. Visibility on how the forex market operates is very low and if anything, could cause capital inflows to slow down to pre Q3 levels in the coming quarters.

Figure 3: Gross External Reserves (USD Billion)

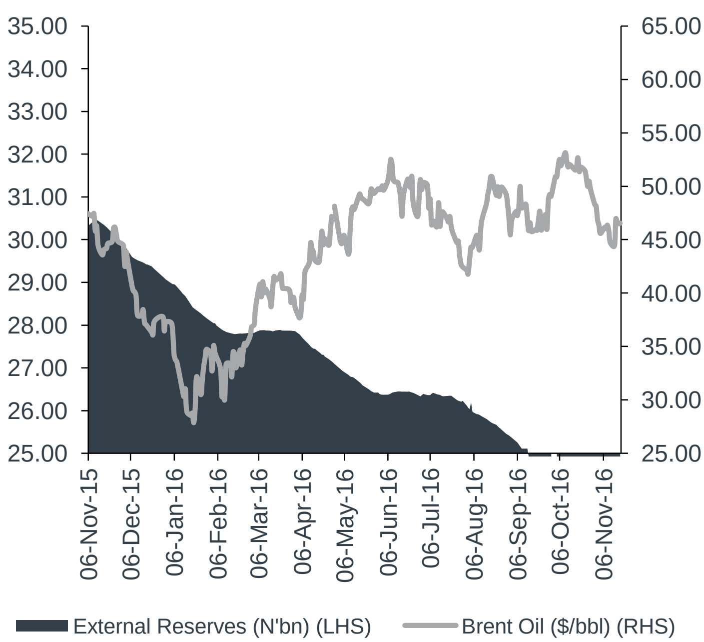
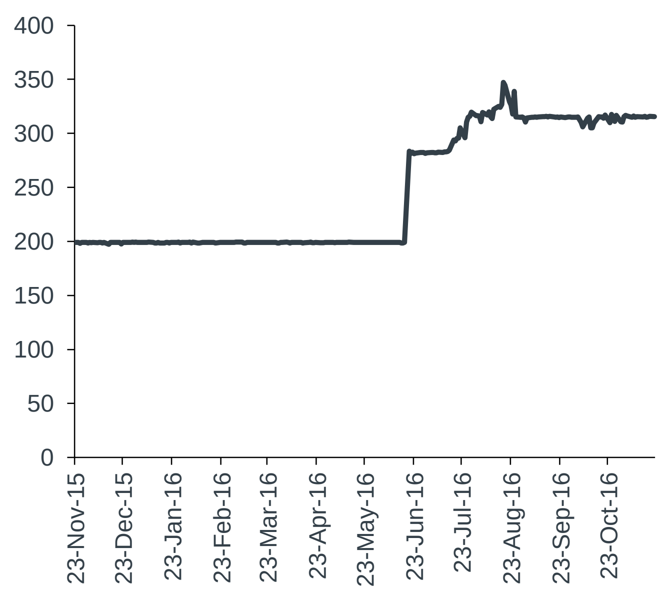


Figure 4: Naira vs. USD Exchange Rate



Source: CBN, Bloomberg, Cordros Research

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Even the moderation in monthly inflation does not suggest that the structural factors behind the sharp price increases witnessed thus far have been addressed. For the records, the management of most quoted manufacturing companies that have announced July to September earnings confirmed to have taken price actions in recent months to offset rising forex-linked costs (from raw materials to energy). FEWSNET also reported recently that the scarcity of forex continues to impact the prices of local agricultural commodities. Consensus view is that upside risk to prices through the forex channel remains elevated. Going forward, producers will be more responsive to costs, as they seek to protect margins -- in the event that they continue to augment USD requirements with purchases from the volatile alternative sources.

We Do Not Expect the MPC to Hike . .

The MPC has maintained its stance on prioritizing the use of monetary policy instruments in dealing essentially with the stability of consumer prices and exchange rate. But there have been some doubts over the possibility of attracting the amount of forex required to bring about stability of the naira using its current unpopular measure of exchange rate management. There are even more doubts over investors' perception of Buhari's government, given the challenges it faces with its economic recovery and diversification programmes. At the centre, the economy has deteriorated even further, with the third quarter negative 2.24% growth beating consensus' -2.05% estimate. Activity indicators such as October PMI -- which was stuck below the 50 threshold that separates expansion from contraction for the tenth consecutive month -- suggest that economic and business activities are yet to considerably pick-up, and supports consensus expectation for GDP contraction this year. We are far from convinced that the MPC will attract new capital flows by simply raising interest rate. In fact, we expect the Committee to drop interest rate when inflation starts falling (owing to base effects) as from February next year.

Figure 5: Real GDP Growth

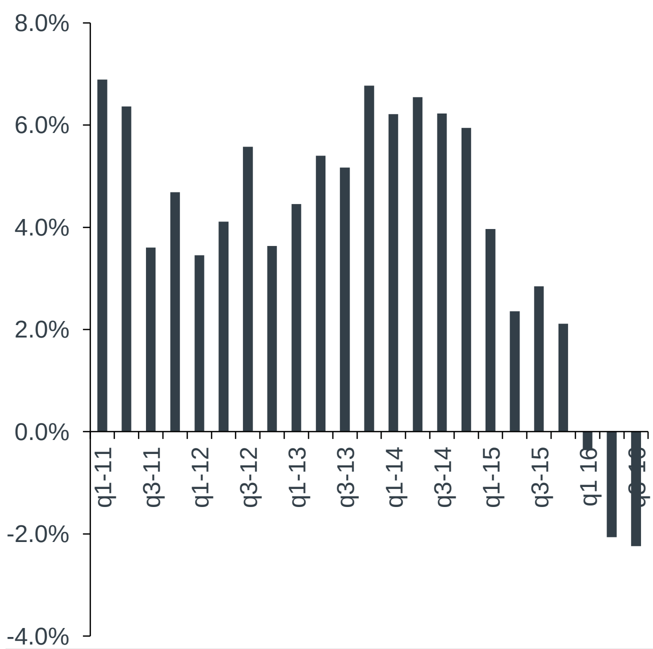
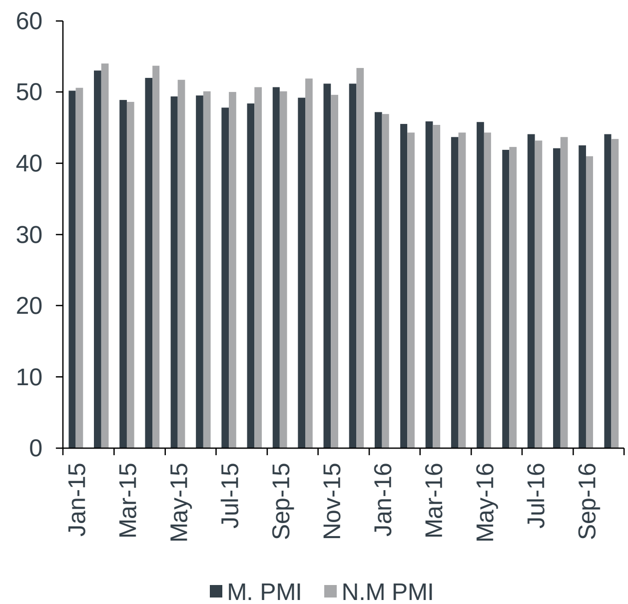


Figure 6: Manufacturing and Non Manufacturing PMI



Source: CBN, NBS, Cordros Research

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. . . Or Cut Interest Rate

At the last meeting, the MPC defied calls -- including from the Finance Minister -- for rate cut. The MPC has already given indications that monetary policy has been substantially burdened and stretched, and will continue to emphasize improved fiscal activities (at restarting growth) to complement monetary policy. Against this background, we think the Committee will hold the line on interest rate once again.

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