ECONOMIC RESEARCH

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Post-MPC view
A preferred default position

Gregory Kronsten
+44 7979 235 127
+234 708 065 3174
gregory.kronsten@fbnquest.com

Chinwe Egwim
+234 1 279 8300 (ext 2276)
chinwe.egwim@fbnquest.com

Olayinka Onikanni
+234 1 279 8300 (ext 2788)
olayinka.onikanni@fbnquest.com

A hold to digest the previous rate cut

The monetary policy committee (MPC) left its policy rate of 12.50% and other parameters unchanged on Monday. This was our expectation. Two of the ten members voted for a rate cut. The committee might have been tempted to follow up the 100bp reduction in May with further easing and provide the textbook response to a deepening recession. It decided otherwise due to the CBN's primary mandate to achieve price stability, the main stimuli already deployed, a marginal improvement in the economic fundamentals and its wish to assess the impact of the reduction in May. Wait-and-see is the committee's favoured stance.

A highly exacting primary mandate

It may have been acceptable to ease at a time of rising inflation once but not twice in succession. The legacy structural issues that are keeping prices higher than fragile demand conditions would warrant can only be tackled over time. The CBN has the mandate but the FGN has the principal tools to deliver it.

Hopes of a strong recovery

The CBN's take on the economy this year and next is better than most. "Marginal negative territory" for 2020 and strong recovery next year is the call. A rise in aggregate credit of N3.3trn over the past 12 months will help, even with some new NPLs.

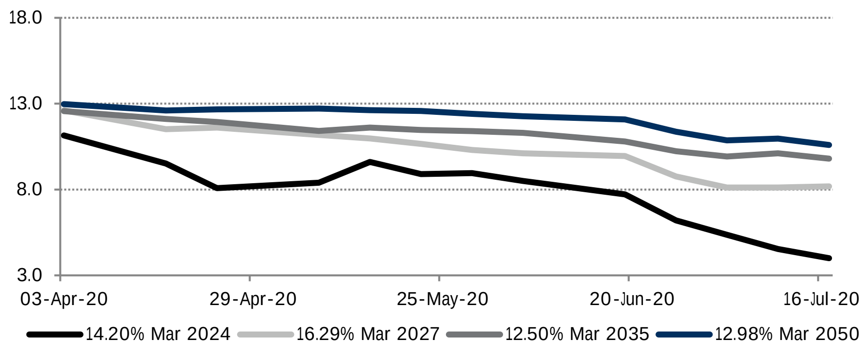
Endorsement of fx thinking

Exchange-rate policy is mentioned just once in the communique. The CBN is urged to stick with its mandate of rate stability. The agenda is unchanged. There is nothing worth adding.

A helping hand for the DMO

The doubling of the DMO's domestic funding target for this year to N1.60trn might ordinarily have caused a spike in yields. Yet domestic institutions have the appetite for FGN paper with returns that have crashed since Q4 2019: the banks - thanks to the CBN's ability to 'engineer' market liquidity in time for bond auctions, and the PFAs of course.

FGN bond yields (%)



Source: FMDQ, FBNQuest Capital Research

FBNQuest Capital 16 Keffi Street, Off Awolowo Road, S.W. Ikoyi, Lagos, Nigeria
Tel +234 (1) 2707180-9, + 234 (1) 2719286-5 **Fax** +234 (1) 2673974 | **Email** info@fbnquest.com
www.fbnquest.com
An FBN Holdings company

Inflation: a familiar story

Headline inflation y/y has picked up each month since August and stood at 12.56% in June. The increases have been small, amounting to 155 basis points (bps) over the ten months. They have mostly been rises in food prices although the core measure has moved into double digits over the period.

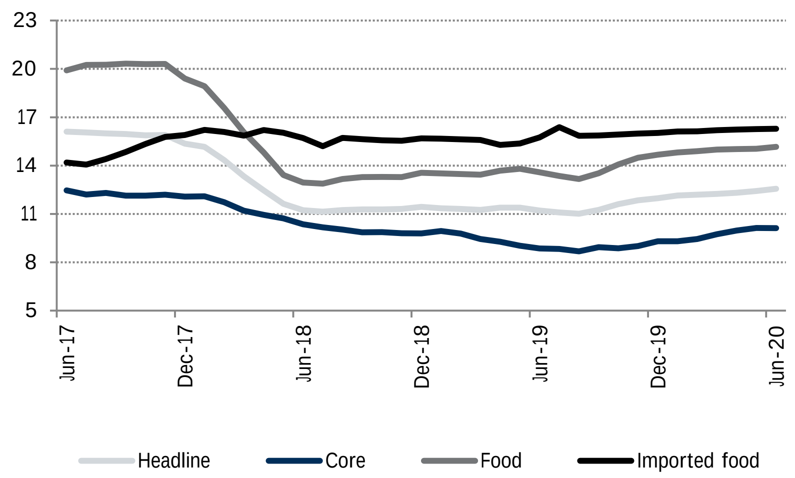
"Legacy structural factors" have been largely to blame. They are all familiar, and this time the MPC's communique highlights challenges from herder/farmer clashes, general banditry, poor transport and power supply provision, and the limited application of technology in the economy.

The land borders have been closed since August (ie long before the emergence of the Covid-19 virus) and no longer appear to be a significant source of inflation. Nor has the committee once acknowledged an impact from either the rise in the standard rate of VAT from 5.0% to 7.5% with effect from 01 February or from the exchange-rate adjustments it made in March and again earlier this month.

The main conclusion to draw from the inflation data is that structural factors on the supply side, mostly food related, are holding the rate some way above the levels one would expect in view of the prevailing subdued state of household demand. The current rate is also far above the official "reference range" of between 6% and 9% y/y that the committee periodically mentions, although not in this latest communique. (Core inflation was within the range for several months in mid-2019, incidentally.) This is not a formal target, which gives the authorities some room for manoeuvre.

We do not expect the story to change much this year and see a '12 handle' for the y/y headline rate throughout this year, with a modest downward trend to 12.16% in December. Price stability is the CBN's primary mandate but the committee does not have the tools to tackle the structural issues that are of the FGN's creation.

Consumer price inflation (% chg y/y)



Source: National Bureau of Statistics (NBS), FBNQuest Capital Research

Fiscal policy: another victim of the virus

The committee endorses the FGN's fiscal stimulus of course yet sees limits to it. It urges moves to boost revenue generation and calls for fiscal prudence with the use of funds disbursed by multilateral agencies in response to the virus. We have therefore a standard orthodox critique of the FGN's fiscal performance and policy, and are in full agreement with it.

The CBN is leading the policy response to the headwinds, both through its own interventions and as regulator of the deposit money banks (DMBs) because the FGN is hamstrung by the oil price crash.

The changes the FGN had to make to its 2020 budget proposals submitted in December highlight the fiscal squeeze. In the approved budget total revenue is 34% lower than in the proposals: for oil and non-oil revenue the decreases are 63% and 24% respectively. Our hunch is that the non-oil outturn will be still lower. Total spending is 16% lower than in the proposals, and the deficit 94% higher and so above the 3.0% of GDP threshold set in the Fiscal Responsibility Act 2007. The act allows for an overshoot in exceptional circumstances such as the pandemic.

Since the election of this administration in 2015, the objective has been to provide a modest fiscal stimulus through a counter-cyclical stance. We can see that the stimulus this year will be negligible. If revenue underperforms, then spending this year may well not reach the trimmed figure.

In any event, the size of Nigerian budgets relative to output is much smaller than in most developing countries. FGN expenditure in 2018 amounted to just 6.1% of the year's GDP, and in 2019 a little more, at 6.5%. To make a valid country comparison, we should add the spending of the state governments. The aggregate figure is still far short of comparable economies, which register +/- 20% of GDP.

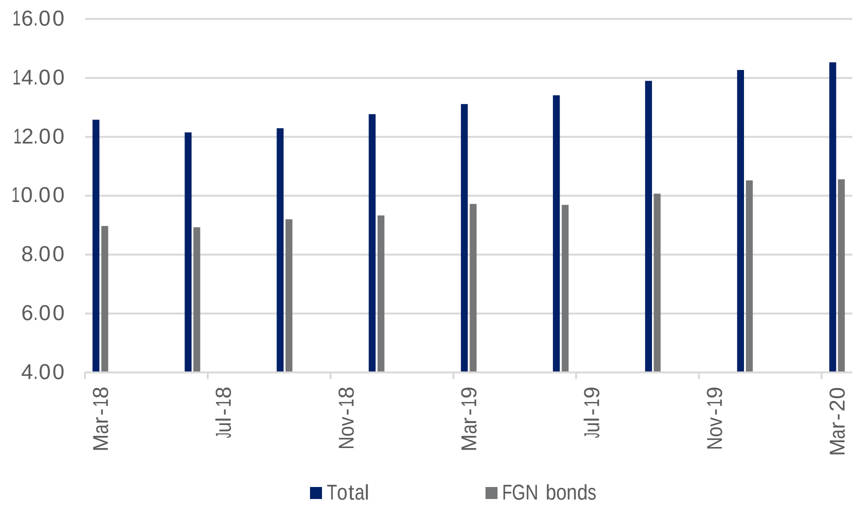
To spend more, the FGN has to transform its revenue collection, which has been poor for many years. Gross revenue (ie before distribution to the three tiers of government) was a paltry 7.1% of GDP last year. There was the modest rise in the standard rate of VAT in February. Tax exemptions are again being reviewed, and the steady expansion of the banked economy, along with the rapid expansion of mobile money, are together creating more taxpayers. The improvements are gradual, however.

The public debt stock ratio is very strong, with a burden in March 2020 (FGN and states, external and domestic combined) of 19.9% of GDP. This excludes the bonds issued by AMCON (and sitting on the CBN's balance sheet), and the liabilities of the NNPC and other public agencies. The bonds and pro-notes to meet contractor and other claims on the FGN of up to N2.7trn, subject to verification, are being added in stages. The stock of such issued instruments outstanding stood at N960bn at end-March.

These extras would raise the burden to a maximum 30% of nominal GDP, which would still be very healthy in an EM context. Looking ahead, the federal finance ministry has floated the possibility of securitizing the FGN's drawings from the CBN under the Ways and Means mechanism. Our estimates do not cover either the CBN's issuance of bills for liquidity management or the FGN's unfunded deficit (that part not funded by the DMO and effectively an overdraft at the CBN). We have followed convention in both cases.

In contrast, the domestic debt service burden of the FGN has rapidly mounted. Payments have soared from N701bn in 2012 to N2.09trn in 2018. The projection of N2.67trn for total debt service in the 2020 budget represents 48.1% of FGN revenue. Our knee-jerk reaction is to say that the outturn is likely to be substantially worse, given the track record for overly optimistic revenue projections.

FGN domestic debt (N trn)



Source: Debt Management Office (DMO), FBNQuest Capital Research

In the FGN's favour we should note that domestic payments, which comprise more than 80% of the total, have begun to stabilize in the past 18 months. Rates on FGN debt instruments have fallen steeply, by more than 1,000bps across the curve for NTBs (Nigerian T-bills) since October 2019. The trend has been similar, although less pronounced, for FGN bonds. Nor can we see any significant retracement coming.

Exchange rate: a fleeting mention in passing

Following its reforms of March/April 2017, seen at the time as the launch of a multiple exchange-rate regime, the CBN presided over fx stability for close to three years. The premium at the investors' and exporters' window (I&E or NAFEX) and at the bureaux de change over the CBN/official rate was steady, and the parallel rate on the local media's favourite fx website did not move.

There had been a steady stream of exits by foreign portfolio investors (FPIs) in fixed-income instruments in response to a deterioration in the global landscape. There followed in early March a very steep fall in the crude oil price after OPEC+ failed to reach a new agreement, and Saudi and Russia vowed to boost production to seize market share. Nigeria's official reserves were falling and, although still at a decent level as a buffer against external shocks, it was difficult to see how the tide would turn. The virus was a threat to developed economies too, and their markets sold off in panic mode.

In this environment the CBN tweaked its fx policy on 20 March in what President Buhari termed a "realignment". It transacted at N360 (rather than N307) at its official rate for preferential deals, and at N380 with FPIs on NAFEX. It adjusted the official rate again on 07 July to N381 (although curiously the home page of the CBN website still shows N360). The rate on NAFEX has drifted to N388.50.

The only mention of fx policy in the communique is that the committee urges the CBN to give "particular attention to its mandate of exchange rate stability." This may disappoint those who call for a free market. Such, however, has never been on the CBN's agenda.

The CBN is under pressure due to the exit of FPIs and the weakness of the oil price. It has not supplied NAFEX since late March, so a large pipeline of delayed external payments has developed. These are mostly the repatriation proceeds of FPIs. On the surface, reserves have stabilized or at least the depletion has slowed. To arrive at the true picture, we should deduct the estimated pipeline from reserves. Estimates range up to US$5bn.

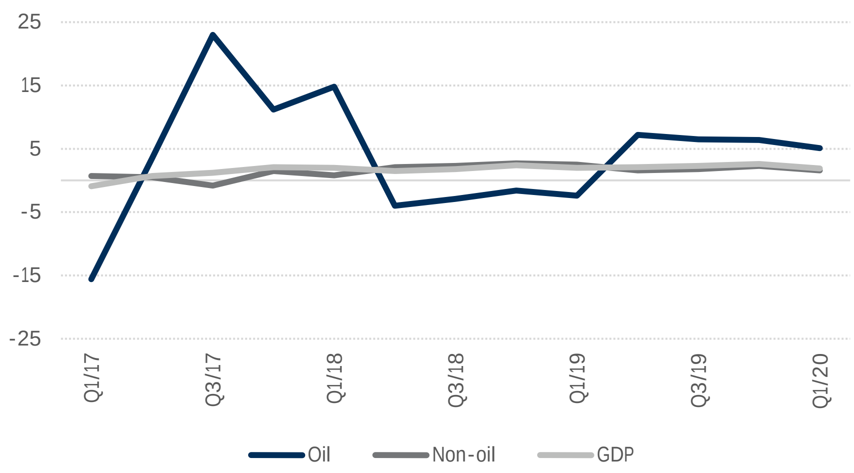
In response to the pressure, the CBN has made few concessions. It adjusts/guides rates, as we have noted, when it no longer has any choice. Its mindset is to manage exchange rates with the help of administrative and other measures. Transactions on NAFEX are on a "willing buyer, willing seller basis".

The FGN and the CBN have both pledged to move towards unification and "more market-determined rates". They will move at their own speed. Unification may come relatively soon. By far the largest transaction to enjoy the official rate has been the import of petroleum products. Both the FGN and the NNPC have insisted that the age of fuel subsidies has ended. Further, private marketers are re-entering the import market and the Dangote refinery will start operating at some point. In these circumstances the rationale for the preferential rate is greatly weakened.

Growth: the latest of several setbacks

The first case of Covid-19 in Nigeria was announced at the end of February so GDP growth was still positive in Q1 2020. It grew by 1.87% y/y (5.06% for oil and 1.55% for the non-oil economy). Household spending had not recovered from the recession that ran from Q1 2016 to Q1 2017 before the latest hit from the virus and the oil price.

GDP, oil and non-oil growth (% chg; y/y)



Source :National Bureau of Statistics (NBS), FBNQuest Capital Research

The communique cites a CBN staff forecast of a -1.03% y/y contraction for Q2. This is too hopeful in our view for the quarter that coincided with the partial lockdown in Nigeria and the same in its main trading partners (other than China). The view for the year is that Nigeria may end the year in "marginal negative territory" and has strong recovery prospects for 2021.

We link the hopes for a rebound to the successful tightening of the CBN's loans-to-deposit ratio (LDR), such that aggregate credit has increased by N3.33trn from N15.56trn in May 2019 to N18.90trn at end-June. The communique notes that the main beneficiaries included manufacturing, consumer credit, general commerce and agriculture. This is a large step in the right direction. The y/y increase for credit to the domestic private sector was 18% in May, and therefore ahead of the rate of nominal GDP growth. Credit extension remains around 20% of GDP so May's figure needs to be repeated many times over.

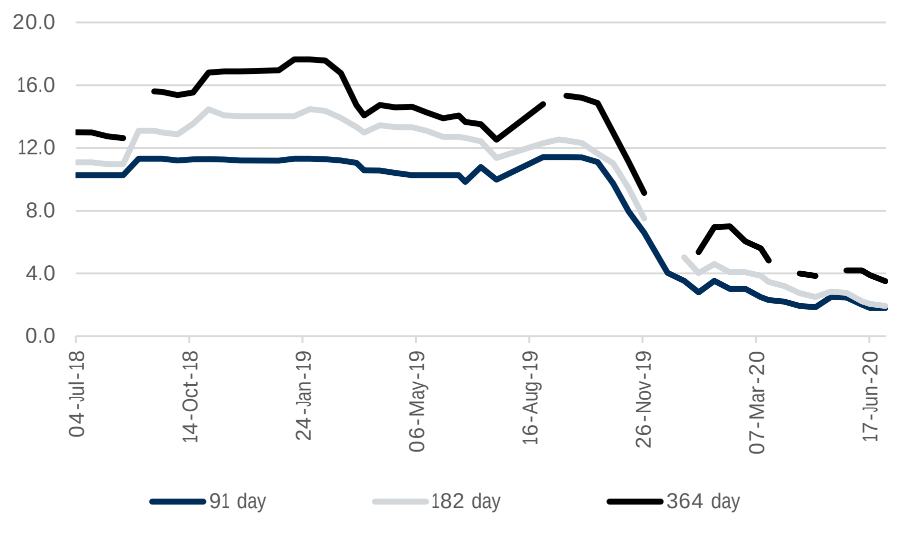
The CBN, as we have noted, has lead the response to the twin threat from the virus and the oil price. We can read the extent of the drawdowns to date on its various new interventions in the communique. Along with other measures such as interest rate reductions, they provide a stimulus totaling N3.5trn (or 2.4% of 2019 GDP). Looking ahead, we should mention the planned N15trn, CBN-led infrastructure development company that is aired in the communique. The aim is to disburse over five years.

Bond market: a pause for breath

Changes in banks' cash reserve requirement (CRR) ratios, federation account distributions and open market operations by the CBN, and its regular fx sales, have been the main drivers of market liquidity and short-term rates (NIBOR and short tenor NTBs). These can make for sharp fluctuations. The pass-through to FGN bonds is modest.

There is one group of captive investors for FGN paper, the local institutions. The banks can earn 7.5% on the CBN's standing deposit facility under the asymmetric corridor but up to a daily ceiling, which the CBN has now dramatically reduced to N2bn per institution: once this is exhausted, they buy short-term paper. Alongside the banks, the other core domestic institutional investors are the pension funds (PFAs).

True yields at NTB auctions (%)



Source: FMDQ, FBNQuest Capital Research

These funds are steadier investors in FGN bonds, not least to match assets with their long-term liabilities. The latest data from their regulator (PenCom) show total assets under management (AUM) increasing by 16.0% y/y at end-April to N10.58trn (US$27.3bn). FGN bonds accounted for 54.6% of AUM and NTBs a further 10.7%.

An additional reason for the PFAs to invest in the bonds has been their exclusion since October 2019 from the CBN's open market operations (OMO), along with other domestic non-bank players. The work of the Debt Management Office (DMO) would be much more challenging without this robust demand of the PFAs for FGN bonds.

We can all make different valuations of local currency FGN paper. In other markets we might emphasize inflation but in Nigeria's case we focus on CBN guidance, fiscal factors, supply and demand considerations, and, for the FPIs, exchange-rate risk.

Having been excluded from the market in OMO bills, the PFAs became very large buyers of NTBs. This switch saw yields on the NTBs tank. They then moved their attention to FGN bonds, and the DMO's monthly auction in January saw a record total bid of N625bn including N372bn chasing the long bond popular with the pension funds. Yields tumbled and subsequently fell further.

The FGN bonds are held predominantly by domestic players. The FPIs started to exit from Q3 2019 on global market concerns. The exit gathered momentum in January and February on Covid-19 and would have continued had the CBN not stopped supplying fx to NAFEX. FPIs lived with market and operational imperfections as long as they could exit the market at will. That no longer applies due to the pipeline and their role in the market is now very small as a result.

The DMO has a mammoth domestic funding target of N1.60trn this year, raised from N750bn once the FGN pledged not to tap the Eurobond market in 2020. It has started well. It is no longer solely dependent on FGN bond issuance but has broadened its product mix with smallish contributions from *sukuk*, green bonds and savings bonds.

We might have thought that such a large increase in supply would push up debt yields. However, the DMO has been meeting its monthly targets and achieved a steady decline in stop rates. The FGN is likely to post its largest ever fiscal deficit in 2020 and enjoy an easing of its borrowing costs. The CBN is instrumental in guiding liquidity management for its ends: this means good liquidity for FGN bond auctions but not so much that the banks "speculate" in fx. We see the '27 and '28 maturities still with an 'eight handle' at the time of the MPC's next scheduled meeting in September.

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Lagos