MERISTEM

Macroeconomic Update

MPC Monitor | July 2023

MPC Hikes Rate by 25bps

The Monetary Policy Committee (MPC) held its fourth meeting for the year on the 24th and 25th of July. Members of the Committee were largely divergent in reaching their decisions: 6 members voted to hike the Monetary Policy Rate (MPR) by varying degrees: four members by 25bps to 18.75%, and two members by 50bps to 19.00%. However, five members voted to maintain the rate at 18.50%. The overall result indicated the committee's less aggressive policy stance, with a slight majority favouring the 25bps rate increase. All other parameters were left unchanged, except for the reduction of the lower bound of the asymmetric corridor to -300bps from -700bps.

The Committee in its considerations, assessed the global and domestic developments that are expected to keep inflation at elevated levels throughout 2023. Key factors considered were the sluggish rebound of China's economy affecting global trade, the tight global financial conditions even as authorities combat inflationary pressures, and geopolitical tensions between Russia and Ukraine impacting the global food supply and leading to higher food prices.

On the domestic front, the Committee focused on the persistent increase in headline inflation and the moderate recovery of output growth as some of the factors shaping their outlook for the rest of the year. The Central Bank of Nigeria (CBN)'s output growth projection is moderate at 2.66% in 2023, 4.20% by the Federal Government's estimate and 3.20% by the International Monetary Fund. However, considerations were made around challenges that persist due to insecurity in food-producing regions, elevated energy and transport costs following the fuel subsidy removal, and the shift to a market-determined exchange rate.

Overall, the MPC's actions demonstrate a sustained commitment to tame inflation amid economic challenges. In our view, the impact on financial markets is expected to be limited. We do not expect any significant effect on the equities market. In the fixed income market, the likelihood of an upward yield trajectory depends on the extent to which the change in the asymmetric corridor tapers system liquidity.

Committee's Considerations

The Committee highlighted the IMF's upward revision of the 2023 global economic output growth forecast to 3.20% in their July World Economic Outlook, up from

2.80% in April 2023. However, impediments to global output recovery include China's slow economic rebound. At the same time, Russia's decision to renege on the black sea grain deal renewal could negatively impact both global trade and inflation. The MPC also noted that inflation in advanced economies showed signs of moderation but remained above the long-term targets set by central banks. In contrast, emerging economies continue to face persistent inflationary pressures.

For Nigeria, a major consideration was the continuous uptick in inflation, driven by increases in the food and core indexes, and its negative impact on economic growth and household real income. Additionally, the Committee was mindful of the inflationary pressure that could come with the recent policy decisions, including the removal of fuel subsidies and exchange rate unification. Thus, it stressed the need for decisive actions by the CBN to address potential liquidity implications on the economy. Likewise, the MPC emphasized the importance of deploying policies to bolster investor confidence and attract foreign investments, especially in the real sector.

Key Decisions

Overall, the MPC decided to:

- Raise the MPR by 25bps to 18.75%.
- Retain the Cash Reserve Ratio (CRR) at 32.50%.
- Retain Liquidity Ratio at 30.00%.
- Adjust the asymmetric corridor at +100bps/-300bps around the MPR.

Anticipated Impacts

Banking Sector

Increase in the SDF Cap is Necessary to Reduce System Liquidity

In our view, the rate adjustment by 25bps would only do little to change the trend of interest rates charged on loans and advances to customers. Also, the rate increase will have no impact on investment yield, as well as interest expense. Altogether, the net interest margin (NIM) is not expected to be affected by the 25bps increase in the MPR.

A more plausible effect is likely to come from the decision to reduce the lower bound of the asymmetric corridor to -300bps, which applies to the CBN's Standing Deposit Facility (SDF). To put it in context, banks' deposits with the CBN through the SDF window (up to a daily maximum of deposit of NGN2bn) earn an interest rate of MPR - 300bps (15.75%), which is higher than 11.75% when the lower bound was at -700bps. While on the surface, it appears that banks could be encouraged to keep more of their deposits in the SDF, the daily cap of NGN2bn effectively limits any potential incentive. However, we believe that the objective of the MPC's decision is to reduce system liquidity, which has been high and could fuel further inflationary pressure. **To achieve this objective and incentivize banks to reduce their liquidity by utilizing the SDF window more, we think it is pertinent for the CBN to increase the cap on the SDF**. **Doing this will be a more effective way to**

reduce system liquidity rather than the decision to reenact the 50% penalty on shortfall in the Loan-to-Deposit Ratio (LDR), which banks are not typically moved by.

The Real Sector

Positive Indicators to Growth

Based on our assessment and leading economic indicators, we opine that Q2:2023 has largely marked recovery for the real sector, following the resolution of the currency crisis that engulfed the economy in Q1:2023. We expect growth in Q2:2023 to come in lower than the corresponding period as legacy issues (such as insecurity and FX illiquidity) impacting specific sectors like agriculture and manufacturing remain. Though to a minimal extent, the MPC's decision to maintain its aggressive stance is also expected to put further strain on production costs (via increased borrowing costs) amidst existing pressures from heightened PMS prices.

On a positive note, reducing CRR for Merchant banks (to 10.00% from 32.50%) should increase access to funding for the manufacturing, real estate, and agricultural sectors. The CBN's recent directive – *which states that Deposit money Banks with Loan-to-Deposit Ratios (LDR) below 65% would henceforth be debited with 50% of the shortfall* – should also be a catalyst driving credit to the real sector going forward.

On a balance of factors, we expect the Committee's decision to have a minimal impact on the real sector, given the conditions mentioned above.

The Fixed Income Market:

Positive Outlook for Treasury Yields

System liquidity has continued to drive the activities in the market for T-bills and Bonds as investors' demand for treasury instruments at both the primary and secondary markets remains high. This has primarily been the status quo, displayed by the significant increase in system liquidity, reaching a year-high of NGN1.14trn in June. As such, average stop rates at the T-bills PMA hovered within the range of 4.88% and 6.08% (from 5.09% at the last auction in May). Notably, in the first T-bills auction after the MPC meeting, stop rates of the 91-Day, 182-Day, and 364-Day instruments rose significantly by 314bps, 450bps, and 621bps to 6.00%, 8.00%, and 12.15%, respectively.

In the secondary market, unmet demands at the primary market found their way to the secondary market, thus, spurring bullish sentiment. Subsequently, average T-Bills and bond yields declined by 234bps and 130bps to 3.79% and 12.70% as of July 25, 2023.

In our view, reducing the asymmetric corridor's lower band to -300bps (from -700bps) is expected to taper system liquidity, which has been a significant driver of the fixed-income market. As a result, yields are expected to increase. Additionally, we expect the MPR increase to further trigger investors' demand for higher rates, given the rising inflation that has eroded real returns. Taking all factors into consideration, we anticipate a marginal increase in yields.

The Equities Market:

Investors Remain Optimistic on Policy Reforms

As witnessed in the preceding MPC meetings, investors in the equities market remained largely unresponsive to the further increase in Monetary Policy Rate. Several policy reforms from the new administration have fueled the local bourse. Notably, H2:2023 began positively; the All-share Index (NGX-ASI) has gained +8.24% MtD to reach 65,988.81pts as of 25th of July. On a sectoral basis, five of the seven indices we track have recorded gains, except for the **NGXCNSMRGDS** (-0.87% MtD) and **NGXINS** (-5.69% MtD) indices.

In terms of returns, the Nigerian equities market (+28.76% YtD) has outpaced the frontier market (+6.88% YtD), emerging market (+5.97% YtD), and the developed market (+12.04% YtD). Furthermore, the value of transactions by FPIs increased by 23.09% in June 2023 to NGN45.74bn (highest since November 2021) and contribution of FPIs to total market value remained strong at 11.25%. Henceforth, we anticipate investors' confidence to remain strong and the steady re-entrance of foreign investors to sustain the positive mood in the equities market. In addition, positive earnings releases from corporates for the H1:2023 performance are expected to influence market direction in the near term.

The decision of the MPC to continue its hiking cycle aligns with recent policy reforms and reflects the CBN's commitment to control inflation. However, we do not anticipate the hike to exert significant impact on the equities market performance as the market had already factored in the effects of hikes in its activities.

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