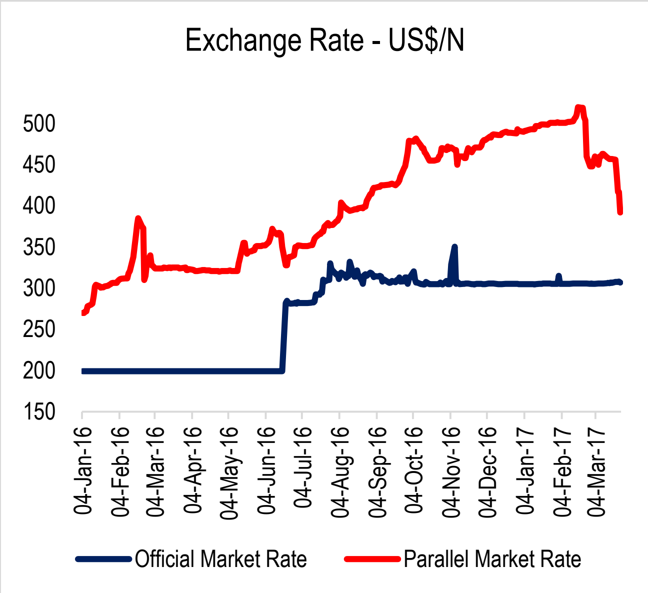
IS IT TIME TO REDUCE RATES?

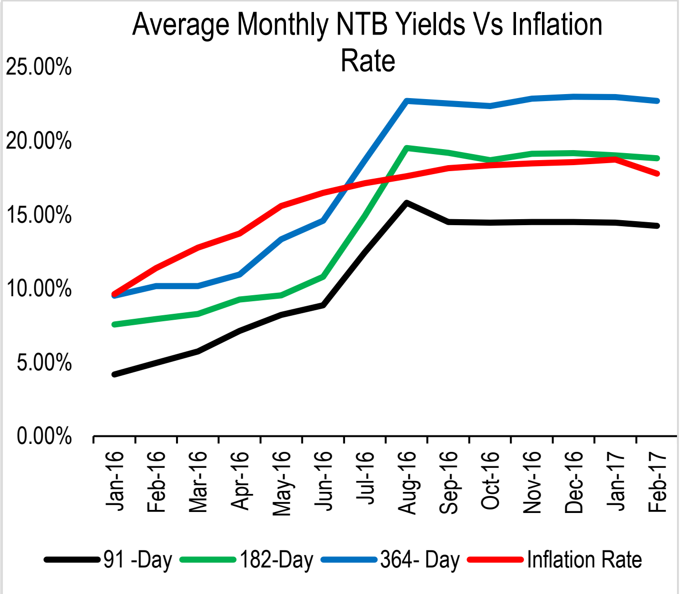
Some experts have expressed concern regarding the recent decision of the Monetary Policy Committee (MPC) not to cut rates. They believe the current high yields on the Nigerian Treasury Bills (NTB) do not encourage lending to the real sector of the economy.

It is an established fact that export earnings in Nigeria are predominantly dominated by one product – crude oil (82% as at 2016), while the country imports a variety of goods, ranging from raw materials, machineries for manufacturing, to intermediate and consumer goods. Most of these imports either have no local substitutes or the current structures do not give Nigeria a competitive advantage in local production. Thus, the economy relies heavily on imports and as a result, given the narrow export base, the exchange rate has remained under some pressure. The Central Bank of Nigeria (CBN) adjusted the yields on the NTB upward to prevent capital flight, attract foreign capital and also to compensate local investors for the erosion in the value of Naira caused by rising inflation rate.

Looking at the external developments, the Federal Open Market Committee (FOMC) of the U.S Federal Reserve System (The Fed) increased the Federal Funds Rate (The Fed Rate) by 0.25% in March 2017 to a range of 0.75% - 1.00%. There are indications that the FOMC will increase the Fed Rate further in 2017, as the Fed’s median projection in 2017 is 1.4%. The implication of the rate hike in the U.S is that yields on Dollar denominated fixed income securities may rise. This may lead to capital flight from emerging markets to the U.S, and cause an appreciation in the value of the U.S Dollar. This may also lead to a drop in the price of crude oil – Nigeria’s main foreign exchange earner. The possible increase in shale oil production is another factor that may put downward pressure on crude oil prices. All of these call for a careful analysis and perhaps patience before an adjustment to the monetary policy will be beneficial to the Nigerian economy.

Whist the inflation rate dropped in February 2017 to 17.78% (the first drop in 15 months) as a result of a base effect, we note that the month-on-month change of 1.49% was the highest increase since July 2016. This means that inflationary pressure persists in Nigeria. Notwithstanding the fact that our analysis shows that inflation rate may continue to drop because of base effect; the decision of the Federal Government of Nigeria (FGN) regarding the pump price of Petroleum Motor Sprit (PMS) and the electricity tariff will ultimately determine the actual path that the inflation rate will follow in the short-term.





The recent efforts of the CBN to increase the supply of foreign exchange in the interbank market have narrowed the gap between the official and parallel market exchange rates. The CBN was able to increase the supply of foreign exchange in the interbank market because of accretion to external reserves. The increase in oil price to about US$50/bbl and increase in crude oil production in Nigeria that has resulted from the reduction of militant activity in the Niger Delta, are the major drivers of this improvement. The agreement between the Organization of the Petroleum Exporting Countries (OPEC) and Non-OPEC members to cut oil supply has led to an increase in oil price at the international market. There is no guarantee that this increase will be sustained. If it is not and the crude oil price drops faster than growth in local crude oil production, Nigeria's export earnings may drop. Such a development would impede the ability of the CBN to sustain the improved supply of foreign exchange.

The foregoing may have informed the decision of the MPC to hold rates at its March 2017 meeting. In our opinion, the CBN in the last few months has been using interest rates to maintain price stability in the country in line with its statutory mandate. Until the functional infrastructure required to increase the country's productivity and boost production in the non-oil export sector is put in place, it may be difficult to establish a sustainable low-interest rate regime.