CBN keeps MPR on hold at 12%

- **MPR unchanged at 12%.** The Central Bank of Nigeria (CBN)'s Monetary Policy Committee (MPC) kept its Monetary Policy Rate (MPR) unchanged at 12% and maintained the symmetric corridor around the policy rate (standing deposit facility [SDF] at MPR-200 bps [10%]; standing lending facility [SLF] at MPR+200 bps [14%]) at its 30-31 Jan meeting. Additionally, the CBN also held the cash reserve requirement (CRR) ratio steady at 8%. We expected a neutral interest rate decision given the stabilisation in the USD/NGN exchange rate in a 160-162 range in recent weeks, but also because CBN Governor Lamido Sanusi had already indicated that a hike would be premature at this stage and that the central bank would not respond directly to the first round of inflationary effects from the 50% increase in fuel prices in Jan. Besides, the sharp tightening in monetary policy between Sep 2010 and Oct 2011 has already resulted in the MPR, SDF, SLF and CRR being raised by 600 bps, 900 bps, 600 bps and 700 bps, respectively, which makes Nigeria an outlier in the global rate cycle (along with East African countries such as Kenya and Uganda).

- **Inflation likely to pick up.** The MPC noted that an upward adjustment in the price of petrol has historically had a short-term impact on the rate of inflation and even underlined that the full deregulation of the petroleum market will have beneficial structural effects in the long-run. That said, the shift in fuel prices in early 2012 will cause a m/m jump in consumer prices in Jan, a view shared by the MPC. Moreover, it will translate into a transitory inflation shock this year which we estimate at around +190 bps on average, pushing up annual inflation to 12.8% y/y (from 10.9% y/y in 2011) as the CPI moves to a higher base.

- **Tight liquidity conditions to persist.** Still, the 364-d T-bill yield has fluctuated in a narrow range of 18%-20% in the secondary market in recent weeks, and CPI-adjusted yields will remain in robust positive territory even if inflation peaks at 14%-14.5% y/y in Jul-Aug. Furthermore, the CBN continues to rely on open market operations (15.7%-20.7% in Jan across various tenors) to aggressively mop up liquidity, especially when monthly Federation Account Allocation Committee (FAAC) proceeds are disbursed to the three tiers of government. This suggests tight monetary conditions will persist in 2012 as the CBN seeks to preserve exchange rate stability at +-3% around the 155 level and mitigate further fiscally sponsored liquidity pressure on USD/NGN. In fact, the MPC explicitly stated that there would be no shift to accommodative monetary policy this year.

- **Fiscal concerns.** The 2012 budget draft points to some modest fiscal restraint, with the government freezing recurrent expenditure and planning to modestly reduce the budget deficit to 2.77% of GDP, but significant risks to the fiscal outlook cannot be discounted. Indeed, there is a concern that the National Assembly may decide to raise the oil price benchmark to USD75 pbl (or even USD80 pbl), from USD70 pbl in the budget proposal, which highlights the political challenge facing the Finance Ministry as it attempts to initiate some form of fiscal consolidation. Should this revision materialise, the practical impact will be the limited FX reserve accretion in the excess crude account. In such a scenario, the MPC also indicated that the probability of another round of interest rate hikes would increase. Additionally, the deficit of the Federal Government budget is not really relevant since this figure does not capture the position of the states, above-the-line expenditure and fiscal savings. There is no doubt that an oil-producing country like Nigeria should have posted a massive consolidated fiscal surplus amid elevated oil prices, but the continued monetisation of excess crude account proceeds (NGN810.1bn in Q3:11 alone) prevents any qualitative improvement in this area, particularly given the imbroglio over the effective launch of the Sovereign Wealth Fund. On the upside, the MPC stressed the partial removal of the fuel subsidy and improved prospects for the Petroleum Industry Bill had the potential to support the FX reserve and USD/NGN outlook. In any case, it is difficult to imagine how the CBN could start cutting policy rates as long as there is no tangible accumulation of fiscal savings, making monetary policy still biased towards further tightening.

- **Market implications.** Although T-bills and bonds will potentially gain in the immediate short-term, the effect is likely to be modest because the flat interest rate decision had been largely anticipated. We think the deteriorating inflation expectations will actually lead the yield curve to progressively disinvert. As such, we continue to see limited medium-term value in 7- to 10-y bonds being issued at less than 16.5%-17% in coming months. There will also be short-term duration opportunities in H1:12, but the timing, liquidity conditions and key turning points (inflation data, MPCs, FAAC allocations) will be critically important to derive such trading strategies. Meanwhile, the carry trade at the short end of the curve remains exceptionally attractive. T-bill yields in the primary and secondary markets are unlikely to significantly trend downward as long as the CBN sterilises liquidity via open market operations while a sizeable increase from current levels also looks improbable.