Central Bank of Nigeria Communiqué No. 74 of the Monetary Policy Committee Meeting, January 24-25, 2011

The Monetary Policy Committee (MPC) met on the 24th and 25th January, 2011 to review domestic and international economic and financial developments in 2010 and the challenges facing the Nigerian economy in the year ahead.

On the global scene, the Committee noted the divergence in the economic performance of advanced and emerging economies in 2010. Economic uncertainties contributed to the weak recovery in advanced economies. As a result, growth was sluggish and concerns about inflation were dominant on account of the rising oil and commodity prices in the international markets and fears of fiscal stress in the years ahead. On the other hand, robust economic growth was recorded in emerging markets based essentially on strong domestic demand which offset weak export demand. Financial market conditions in advanced economies were, however, more stable than in the preceding two years while some emerging economies were confronted with challenges posed by large volatile capital inflows.

With regard to the domestic economy, the Committee noted with satisfaction the impressive economic growth, the continuing recovery of the capital market and the progress made towards restoring stability in the banking sector. It, however, observed that inflation had continued to be relatively high and reiterated the need for it to be reined in and for Government to further strengthen and deepen economic and structural reforms.

Key Domestic Macroeconomic and Financial Developments

Domestic Output

The Committee noted the sustained output growth recorded in 2010. Provisional data from the National Bureau of Statistics (NBS) indicated that real Gross Domestic Product (GDP) grew by 8.29 per cent in the fourth quarter of 2010, up from 7.86 per cent recorded in the third quarter. The overall GDP growth for 2010 was estimated to be 7.85 per cent, compared to the revised growth rate of 6.96 per cent recorded in 2009. The non-oil sector remained the major driver of overall growth, with agriculture, wholesale and retail trade, and services contributing 2.39, 2.04 and 2.08 per cent, respectively. The outlook for 2011 is projected to be generally favourable in view of the continued improvement in the international oil market and emphasis on the development of the non-oil sector.

Domestic Prices

The year-on-year headline inflation, as measured by the percentage change in the all-items consumer price index (CPI, November 2009=100), trended downwards during most periods of 2010. It declined to 11.8 per cent in December 2010 from 13.6 per cent in September. Similarly, core inflation declined to 10.9 per cent in December 2010 from 12.8 per cent in September. Food inflation also, dropped to 12.7 per cent in December 2010, from 14.6 per cent recorded in September.

The Committee noted that although inflation has been trending downwards, the single digit benchmark was not achieved in 2010, despite the relatively good harvest, improved supply of petroleum products and lower growth in monetary aggregates. This, according to the Committee underscores the need to address both supply and demand side factors that determine inflation dynamics in Nigeria. One of the ways to keep aggregate demand in check is to restrain debt-financed government spending in the medium-term. This calls for a review of subsidies and other recurrent expenditure categories that constitute a drain on the national budget as well as improving the revenue base. However, the Committee commended the government for recognizing the existence of these issues in the 2011 budget proposal especially the reduction in the proposed level of total spending. Although there has been a strong emphasis on capital expenditure and infrastructure development, the Committee noted that recurrent expenditure remained high at over 70 per cent of the total budget. For this reason, the MPC believes that the risk to price stability posed by fiscal operations will need to be constantly monitored if inflation is to be brought down to single digit levels in the short to medium term. However, the Committee noted that the general thrust of fiscal policy pronouncements is in the desired direction.

Monetary, Credit and Financial Market Developments

Provisional data showed that the growth in broad measure of money supply (M2) was generally below the indicative benchmark throughout 2010 when compared with the level at end-December 2009. Specifically, at end-December

2010, M2 growth was 6.70 per cent compared with the indicative benchmark of 29 per cent for 2010.

Available data indicated that growth in aggregate credit to the domestic economy (net) was similarly sluggish at 6.13 per cent in December 2010 compared with 59.6 per cent recorded in the corresponding period of 2009. This development is connected to the damaged balance sheets of the DMBs in the wake of the global financial and economic crises. However, aggregate credit to the Federal, as well as State and local governments grew by 67.83 per cent and 19.17 per cent, respectively, in 2010. Credit to the private sector contracted by 4.92 per cent in contrast to the indicative benchmark growth of 31.54 per cent for 2010. However, this outcome would need to be considered in the context of the purchase of non-performing loans with face value of over N 2 trillion from the DMBs by the Asset Management Company of Nigeria (AMCON) in 2010. These loans were purchased at a discount and paid for by AMCON-issued zero-coupon bonds. Adjusting for this factor, growth in credit to the private sector would appear to be positive, since the loans were transferred to the balance sheet of AMCON. The growth in credit to the three tiers of government against the backdrop of the decline in private sector credit is a reflection of the fact that government borrowing had to some extent crowded out private sector credit.

Developments in retail market interest rates indicated that the retail lending rates remained relatively high in 2010. The average maximum lending rate declined from 23.18 per cent in January 2010 to 21.86 per cent in December 2010. The average prime lending rate also declined consistently from 18.38 per cent in January to 15.74 per cent in December 2010.

Inter-bank and OBB rates moderated to 8.06 and 6.86 per cent respectively in December 2010. The weighted average savings rate declined consistently from 3.33 per cent in January 2010 to 1.51 per cent in December 2010. The consolidated deposit rate initially declined from 6.13 per cent in January to 2.07 per cent in September, 2010 but rose marginally to 2.24 per cent in December

2010. Thus, the spread between the average maximum lending rate and the consolidated deposit rate widened from 17.05 percentage points in January to 19.76 percentage points in December 2010. The Committee noted with concern the extremely low returns paid to savers and depositors as this poses a major dis-intermediation risk and is inconsistent with developmental goals of financial inclusion.

The domestic capital market recorded significant recovery in 2010, after the decline associated with the global financial and economic crises in 2008/2009. The All-Share Index (ASI) rose from 20,827.17 points as at end-December 2009 to 24, 770.52 points as at end-December 2010, representing a growth of 18.93 per cent. Market Capitalization (MC) rose from N4.98 trillion as at end-December 2009 to N7.91 trillion as at end-December 2010, representing a growth of 58.83 per cent. For the fourth quarter of 2010, the All-Share Index (ASI) increased by 7.5 per cent from 23,050.59 to 24,770.52 at end-December 2010 while Market Capitalization (MC) increased by 40.1 per cent from ₦5.65 trillion to ₦7.91 trillion. However, the number of deals, volume and value of shares traded declined as at December. The increase in ASI and MC was partly due to share price recoveries in the Banking, Food/Beverage, Insurance and Oil & Gas sectors. Nonetheless, the recovery process needs to be sustained through further strengthening of macroeconomic and structural reforms. The Committee noted the major role being played by the Securities and Exchange Commission (SEC) in reforming and improving governance processes in the NSE and encouraged the SEC to continue as this is necessary for restoring confidence in the Nigerian financial system.

External Sector Developments

The foreign exchange market remained relatively stable. Between end-2009 and end-2010, the Naira/Dollar exchange rate depreciated by N1.08 or 0.72 per cent, to N150.66/US$ from N149.58 /US$ at end-2009, as against 15.65 per cent depreciation recorded at the end of 2009. The average premium between the CBN transaction rate and the BDC's as at end-2010, was 1.83 per cent, compared with 8.58 per cent in 2009.

The Committee reaffirmed its conviction that a stable exchange rate regime is critical to maintaining price stability but noted that in the absence of complementary policies the regime is only sustainable at the cost of significant attrition in foreign reserves. The MPC, therefore, continues to emphasize that the solution to reserve depletion lies in the implementation of appropriate reforms with regard to industrial and trade policies aimed at reducing import-dependence, which are beyond the scope of monetary policy. Substantial foreign exchange is expended annually on JVC Cash calls and importation of petroleum products due to the delay in implementing much needed reforms in the oil sector. This is in addition to the huge amounts spent on petroleum subsidies which are likely to increase with higher oil prices. The country is also expending foreign exchange on import of food items such as rice whereas what is needed is the implementation of policies that will lead to food security and total self sufficiency. The Committee noted that external reserves stood at US$32.32 billion as at end-December 2010. It, however, rose to US$33.26 billion as at 20th January 2011.

In the Committee's view, implementation of these reforms along with the improved outlook for oil price and output should go a long way in reversing the negative trend in our foreign reserves position.

The Committee's Considerations

The considerations of the MPC following from the above review suggest that while the general outlook on growth is highly favourable, it is important to be vigilant on prices and financial market developments. The likelihood of improved oil output and rising oil prices in the international market would contribute to growth and help rebuild external reserves which is vital to sustain consumer and investor confidence in the economy.

The Committee noted that the risk of inflation is on the upward side as a result of the liquidity injections from the likely increase in government spending in the run up to the April 2011 elections, and AMCON purchases, as well as rising global energy and food prices and the expected pass-through to the domestic economy. It noted that the existing subsidy regime on petroleum products is not sustainable in view of government's current finances. In view of these factors, the Committee noted, that inflation remains a major concern that cannot be ignored in the short- to medium-term.

The MPC also noted with serious concern the existing low rates of about 1.0 percent paid on savings deposits and its implications for financial intermediation and the mobilization of long-term funds which is critical for enhancing investment in real sector economic activities, and hence, economic growth. The Committee felt that in preparation for the removal of the CBN guarantee of inter-bank market, banks need to provide reasonable incentives for the mobilization of savings for growth and financial inclusion. The Committee, however, stated its commitment to continue to monitor developments with a view to coming up with appropriate measures to address the issue.

With regard to external reserves, the Committee observed that the fundamental structural problem of the country as an import-dependent economy was largely responsible for the continuing depletion of the external reserves. The continuing decline in reserves was accounted for by the payment for JVC cash calls, amounting to US$6,867 million and US$5,657 million in 2009, funding of the foreign exchange market to the tune of US$24,835.65 million as against US$25,070 million in 2009 in the case of WDAS. Sales to BDCs amounting to US$5,337 million in 2010 compared with US$4,734 million in 2009, in addition to the payment of subsidies on petroleum product as well as other government external payment obligations. The Committee stressed that a significant portion of the foreign exchange outflow will be stemmed with the Petroleum Industry Bill because JVC Cash Calls alone accounted for a large proportion of the total net outflow in 2010. The Committee observed that if exchange rate had not been managed in a stable manner, inflation would not have moderated. The policy thrust on exchange rate stability is informed by the overwhelming impact of exchange rate pass-through on inflation, given the import-dependent nature of the economy.

The MPC identified the greatest challenge facing the economy as the lack of flow of credit to the critical sectors, and the consequent need to unlock the flow of credit for critical investments in agriculture, SMEs and manufacturing sectors. To achieve this, government would need to create the right policy and regulatory environment, including the sustained fight against corruption, strengthening of transparency and institutions, as well as implementing critical reforms. On its part, the CBN will continue to engage banks and take the lead in programmes and interventions to channel credit to the real economy. To this end, the Committee noted the initiatives being pursued by the Bankers' Committee and urged speedy implementation.

The Committee further stated that the economy is affected not only by monetary and fiscal policy measures but also by political risk and concerns about national security which affect investors' confidence in the economy. In this regard, the Committee stressed the need to pay greater attention to the issue of security and how to manage uncertainty in the political environment.

MPC Decisions

In the light of the above considerations, the Committee is committed to maintaining price stability by pursuing the current policy thrust of monetary tightening in view of the perceived inflation risks in the near term. The Committee took the decision to further tighten monetary policy. This was a decision taken by a majority of 11:1. The following measures were approved:

1. Raise the MPR by 25 basis points from 6.25 per cent to 6.50 per cent with immediate effect (a majority vote of 11:1);
2. Maintain the symmetric corridor of +/- 200 basis points by 7-5; 4 members voted for asymmetric corridor by 50 basis points increase in Standing Deposit Facility rate;
3. Raise the Cash Reserve Requirement (CRR) Ratio by 100 basis points from 1.00 per cent to 2.00 per cent with effect from February 1, 2011 with a majority vote of 11:1; and
4. With effect from March 1, 2011, raise the Liquidity Ratio (LR) by 500 basis points from 25.00 per cent to 30.00 per cent with a majority vote of 11:1.

Sanusi Lamido Sanusi
Governor,
Central Bank of Nigeria
Abuja
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