

Central Bank of Nigeria Communiqué No. 86 of the Monetary Policy Committee Meeting of Monday and Tuesday November 19 and 20, 2012

The Monetary Policy Committee (MPC) met with nine out of the twelve members in attendance. The Committee reviewed the domestic and global economic conditions and financial environment as well as the challenges that faced the Nigerian economy during the first ten months of fiscal 2012, with a view to reassessing monetary policy options in the near-to-medium term.

The International Economic Situation

The Committee noted the continued deceleration in global output, which resulted from a combination of austerity-driven euro-zone developments, weak recovery in some Asian economies, and slowdown in major emerging market economies. In addition, high and rising unemployment, fragile financial conditions, weak housing markets, and deterioration in both public and private sector balance sheets in some major industrial countries posed major risks to global economic recovery. Thus, global output growth in 2012, which was earlier projected at 3.5 per cent in July 2012 by the IMF was revised downward to 3.3 per cent in the October 2012 World Economic Outlook; that of 2013 was also revised downward from 3.9 to 3.6 per cent. According to the October 2012 projection, there is a high probability of global growth falling below 2.0 per cent in 2012 and this would mirror the recession in the advanced economies and the slowing output growth in key emerging markets and developing economies.

Growth in the advanced economies is estimated at 1.3 per cent in 2012 and 1.6 per cent in 2013, reflecting a downward revision of 0.1 and 0.3 percentage point, respectively. The US economy continued on the path of modest recovery as real output expanded by 2.0 per cent in the third quarter of 2012 compared with 1.3 per cent in the second quarter, reflecting the positive contributions from personal consumption expenditure, government spending, private inventory

and residential housing investment in the face of current low mortgage rates. However, the recent hurricane Sandy across the east coast of the United States, constitutes an immediate risk to the sustainability of the recent growth rally and its impact is expected to truncate US recovery in the last quarter of 2012. Another major risk to the medium term growth trajectory is the US "fiscal cliff". The IMF has suggested a gradual resolution of the fiscal impasse in order to avoid the possibility of a sharp contraction.

The Euro zone is officially in recession in addition to the persisting uncertainty over agreements on a fiscal union, the start of European Central Bank's (ECB) oversight of European banks and the fragility of the Greek, Spanish and other peripheral economies. Real GDP in the zone is projected to contract by 0.4 per cent in 2012 with unemployment rising to 11.50 per cent. The core economies in the zone are expected to experience low but positive growth during 2012-13 while most economies in the periphery are expected to suffer sharp output contraction in 2012 because of tight fiscal policies and weak financial conditions.

The German economy recorded slight recovery with unemployment falling to 6.5 per cent while the United Kingdom snapped out of a recession, recording a growth rate of 1.0 per cent after three successive quarters of contraction. Rising uncertainty about the viability of the Euro zone and the possibility that the euro area crisis will escalate remains a major downside risk to growth and financial sector stability. Overall, continued austerity measures in the euro area are having negative spill-over effect on the German economy which is now wobbling on the verge of a recession due to widespread drop in aggregate demand.

In emerging Asia, growth was estimated to have significantly weakened to less than 7 per cent in the first half of 2012. Latest data indicate that growth in China slowed for the seventh consecutive quarter to 7.40 per cent in Q3, 2012, lower than the Q2, 2012 figure of 7.60 per cent. The Peoples Bank of China (PBC) had already embarked on sequential monetary easing operations in order to loosen liquidity conditions and stimulate growth. This will, however, increase the risk of inflating real estate prices and a possible bubble with potential adverse impact on the Chinese financial system. In India, output is expected to expand by 5.80 per cent in 2012 as against 6.50 per cent in 2011 with the slowdown resulting from waning business confidence, sluggish structural reforms, policy rate hikes designed to rein in inflation, and flagging external demand. In other parts of Asia, growth has dipped, hampered by the weak performance of the Chinese economy. Most countries continue to be affected by weak export growth while the Monetary Authorities have responded with expansionary monetary policy.

Output growth for 2012, at 5.1 per cent, up from 3.3 per cent in 2011 for the Middle East and North Africa (MENA) region, could be considered robust in the face of global realities, but there is a sharp difference in growth performance between the oil and non-oil exporting countries in the region. For the non-oil exporting economies, growth is projected to register just above 2.0 per cent and 6.6 per cent for the oil exporting economies. Economic activities in the non-oil exporting countries have remained suppressed by the growth deceleration in the major trading partner-economies, internal conflicts and pervading political/economic uncertainties. The robust growth projection for the oil exporting countries, on the other hand, is anchored on increased government expenditure supported by historically high oil prices. Despite these developments, the Committee is of the view that growth for the MENA Region in the medium term is faced with the risk of weak external demand, instability in the region and an increasingly constrained environment for private sector

activity. However, Africa's robust growth is not likely to affect the downward trend in global output because of its small share (2.7 %) of global output.

Overall, the Committee believes that the fiscal gridlock in the US, the lingering euro zone financial and economic crisis, as well as the softening output growth in the key emerging Asian economies, could have serious implications for the domestic economy in the near-to-medium term. Specifically, any negative shock to the current high prices of crude oil would have adverse implications for fiscal revenue flows and the external current account position, even though current forecasts and developments in the Middle East do not suggest the possibility of a shock in the near term.

Domestic Economic and Financial Developments

Output

The National Bureau of Statistics has revised the real Gross Domestic Product (GDP) growth for fiscal 2012 downwards to 6.61 per cent from the earlier projection of 6.85 per cent, indicating that the economy is encountering growth challenges not previously anticipated. The estimates revealed a real GDP growth rate of 6.48 per cent in the third quarter of 2012, up from 6.39 per cent in the second quarter but lower than the 7.37 per cent recorded in the corresponding period of 2011.

The Committee noted with concern the continuing decline in the contribution of the oil sector to growth, in an area of strong oil price performance, which became apparent in the last half of 2011 and also the decline in the contribution of agriculture to growth since Q3, 2011, in spite of the investment in the Agricultural transformation initiatives of the Federal Government.

The relatively robust growth projections for 2012 despite the slowdown in the global economy reflected the continuing favorable conditions for increased agricultural production, the impact of the banking sector reforms and the initiatives by government to stimulate the real economy. In this regard, the Committee welcomed the recent improvements in electricity generation which has impacted positively on manufacturing activities and overall capacity utilization. The Committee enjoined the Federal Government to sustain the efforts.

The Committee, however, observed that the recent flooding in several parts of the country, current security challenges and corruption scandals posed serious downside risks to growth in the near-to-medium term. Indeed, it noted that the full impact of the widespread flooding was yet to manifest while the cost to the economy was yet to be estimated. The committee noted the combined effects of the high tariffs, floods and drought on global wheat supplies which have led to higher prices of wheat in Nigeria.

Prices

The Committee noted that inflationary pressure, which moderated in the third quarter of 2012, re-emerged in October 2012. The year-on-year headline inflation inched up to 11.70 per cent in October 2012 from 11.3 per cent in September while food inflation increased to 11.1 per cent from 10.2 per cent in September. Core inflation continued its sequential four-month moderation to 12.40 per cent from 13.10 per cent in September while the risk of food inflation remained hawkish, thus creating mixed price signals. The major drivers of inflation during the period include food and housing, water, electricity, gas and other fuels. The pick-up in food inflation contradicted recent trends and may not be unconnected with effects of the floods on farmlands, the impact of which poses an upside risk to inflation in the near-term, coupled with continued

imported food inflation. Although core inflation continued its moderation, the Committee considered the current level to still be elevated, driven largely by: processed foods (3.7 per cent); housing, water, electricity, gas and other fuels (4.2 per cent); clothing and footwear (1.4 per cent); transport (1.10 per cent); furnishing, household equipment and housing maintenance (0.7 per cent); and education (0.6 per cent). However, the major drivers of core inflation remained outside the scope of monetary policy alone which was helpless in addressing the structural components of inflation. In the meantime, fuel prices have risen generally above the official pump price even without the total removal of oil subsidy.

Monetary, Credit and Financial Markets Developments

Broad money supply (M2) grew by 8.23 per cent in October 2012 over the level at end-December, 2011, which annualizes to 9.87 per cent. Aggregate domestic credit (net) declined by 3.48 per cent in October 2012. The decline in credit to government between June and October, implies that the Federal Government is increasingly becoming a net creditor to the banking system which perhaps reflects the impact of better fiscal management including the introduction of Treasury Single Account.

Interest rates in all segments of the money market moderated between September 19 and October 30, 2012, reflecting increased liquidity in the banking system induced by the release of statutory revenue to sub-national governments, the repayments of matured CBN bills and absence of repo operations during the review period.. The interbank call and OBB rates, which opened at 16.77 and 16.40 per cent on September 19, 2012, closed at 12.03 and 11.70 per cent, respectively, on October 30, 2012. The average interbank call and OBB rates for the period were 11.68 and 11.38 per cent, respectively.

The foregoing notwithstanding, the Committee was concerned that the moderation in money market rates was only beneficial to prime customers, who enjoyed a fair degree of reduction in rates on their loan facilities. The average prime lending rate declined from 16.96 per cent in July to 16.48 per cent in October. The average maximum lending rate, however, increased from 23.45 to 24.65 per cent during the period while the weighted average savings and term deposit rate stabilized at 5.30 per cent during the period. The Committee, therefore enjoined the Bank to fast track the financial inclusion strategy to ensure the effectiveness of the transmission mechanism of monetary policy with a view to improving the financial intermediation process, and reducing the high spread between deposit and lending rates in the banking industry.

The Committee observed that the rally in the Nigerian capital market continued as equities market indicators trended upward in the review period. The All-Share Index (ASI) increased by 22.37 per cent from 21,599.57 to 26,430.92 between June, 29 and October 31, 2012. Market Capitalization (MC) also increased, by 22.15 per cent, from N6.90 trillion to N8.42 trillion during the same period. The positive performance of the ASI and MC were due to strong investor confidence following improved second quarter financial performance of blue-chip companies, as well as excellent results from a reinvigorated banking industry.

External Sector Developments

At the Wholesale Dutch Auction System (wDAS), the exchange rate during the review period opened at N157.36/US\$ on August 30, 2012 and closed at N157.30/US\$ on October 31, 2012, representing an appreciation of N0.06k or 0.04 per cent. The average wDAS exchange rate during the period was N157.33/US\$. At the BDC segment of the foreign exchange market, the selling rate opened at N161.00/US\$ on August 30, 2012 and closed at N159.00/US\$ on October 31, 2012, representing an appreciation of N2.00k or 1.24 per cent for

the period. At the interbank segment, the selling rate opened at N158.10/US\$ on August 30, 2012 and closed at N157.06/US\$ on October 31, 2012, representing an appreciation of N1.04k or 0.66 per cent. The appreciation recorded in all segments of the market could be traced to the combined effects of tight monetary conditions, improved supply of foreign exchange to the market by oil companies; increased inflows from portfolio investors and the policy that barred the DMBs from accessing the CBN Lending window (SLF and Repo) and wDAS simultaneously.

The Committee noted with satisfaction the premia between the rates at the wDAS and the interbank and between the wDAS and the BDCs narrowed towards the end of the review period, from N0.74/US\$ and N3.64/US\$ to N0.03/US\$ and N1.68/US\$, respectively, suggesting the need to sustain and further complement existing measures to discourage speculative activities in the foreign exchange market. In general, the Committee noted that the decisions taken at the previous MPC meetings were yielding the desired results.

The Committee expressed satisfaction with the significant accretion to external reserves which stood at US\$ 45.68 billion as at November 15, 2012, representing an increase of US\$ 10.27 billion or about 29.00 per cent from the level of US\$35.41 billion at end-June 2012. External reserves had increased by US\$ 13.04 billion or 39.95 per cent over the December 2011 level of US\$ 32.64 billion. The increase in the foreign reserves level was driven mainly by proceeds from crude oil and gas sales and crude oil-related taxes, as well as reduced funding of the wDAS due to increase inflow of foreign direct investment. The foreign reserves level could finance over 10 months of imports. The Committee urged the Central Bank to continue to monitor the inflow and destination of FDIs and remittances conscious of the risks to financial stability of a rapid outflow of hot money.

The Committee's Considerations

The Committee noted that developments in the global economy characterized by general uncertainty on the back of the deceleration in global growth sustained by the fragile financial conditions, weakening labor and housing markets and deteriorating public and private balance sheets across advanced and emerging economies, have implications for the domestic economy and, therefore, demand careful consideration in arriving at an appropriate decision of monetary policy. The uncertainty surrounding the resolution of the fiscal cliff in the US and the downside risk created by Hurricane Sandy on US output in Q4 are also important factors to consider. The Committee noted that if the fiscal cliff was not resolved quickly, it would negatively impact the already ballooning deficits and subsequently tip the economy into a recession with downside risks to oil price developments. The Committee noted that the lack of clear direction for the resolution of the Euro area crises will continue to signal a likely recession in the area in the near term. Developments in the domestic economy in the past three months highlight some new pressure points to macroeconomic stability. The Committee was of the view that despite the high interest rates, additional shocks to the economy emanating from the devastating floods, imported inflation and the upward adjustment in electricity tariffs continue to stoke inflationary pressure. The Committee noted the conflicting price signals coming from the latest inflation numbers from the National Bureau of Statistics, with headline and food inflation trending upwards, while core inflation rate continued to moderate for the fourth consecutive month. This according to the Committee has created uncertainty as to the appropriate policy stance at this time. However, since the factors underpinning the inflationary pressures were mainly structural, a monetary response may not be appropriate at this time. Furthermore, the Committee observed that while there were compelling arguments for monetary easing at this time based on the continuous

moderation of core inflation, slowdown in GDP growth and evidence of fiscal prudence, the short-term gains may not be sufficiently adequate to overturn the long term implications of sending a wrong signal that the tightening cycle was permanently over.

With regard to the balance sheet of the Federal Government, the Committee was of the view that it has become imperative to shift away from looking at the size of the deficit and borrowing alone, to emphasizing the quality of expenditure and decisions on the allocation of resources. The Committee commended the fiscal authorities for keeping the fiscal deficit firmly in line with the 2012 budget and improving the revenue profile of the Federal Government by plugging several of the fiscal leakages. It called on the Government to significantly increase capital spending and increase its focus on improving on governance and transparency in the public service. On the oil price benchmark used in the 2013 budget, the MPC reaffirmed its support for the maintaining the US\$75/barrel proposed by the fiscal authorities and noted that this has become even more critical in light of evidence that output projections may have been overly optimistic. In this regard, the Committee called on the Government and the National Assembly going forward, to borrow from the Chilean experience with regard to the setting of the parameters for the preparation of the National Budget to avoid the perennial rancor between the Executive and the Legislature on benchmark oil price. Specifically, the Committee called for the setting up of an independent legal structure that will set the benchmark output and price underpinned by the long term trajectory of output and price, by independent experts who are shielded from political interference and interests.

In view of these developments, the Committee was faced with three choices:

- (i) An increase in rates in response to the up tick in headline and food inflation;
- (ii) A reduction in rates in view of declining core inflation and GDP growth;
- (iii) Retaining current monetary policy stance in view of conflicting price signals and global uncertainties;

The Committee's Decisions

The Committee considered and rejected option 1 as being potentially pro-cyclical considering the structural nature of recent inflationary pressures. While acknowledging the merit of the arguments in favour of option 2, it was also rejected as likely to send wrong signals of a premature termination of an appropriately tight monetary stance.

The Committee therefore, decided by a unanimous vote to maintain the current policy stance i.e. to retain the MPR at 12 per cent with a corridor of +/- 200 basis points around the midpoint; and retain the CRR at 12.0 per cent and the Liquidity Ratio at 30 per cent.

Thank you.

Sanusi Lamido Sanusi, CON

Governor

Central Bank of Nigeria

20th November, 2012

