Central Bank of Nigeria Communique No 107 of the Monetary Policy Committee Meeting of Monday and Tuesday 23rd and 24th May 2016

The Monetary Policy Committee met on 23rd and 24th May 2016 against a backdrop of challenging global and domestic economic and financial conditions. The Committee assessed the global and domestic macroeconomic and financial developments, the short-to medium-term prospects for the domestic economy and the outlook for the rest of the year. In attendance were 9 out of the 12 members.

International Economic Developments

The Committee noted with concern, the tapered growth and continued decline in global output since 2014. At an estimated 3.2 per cent, global output in 2016 was only 0.1 percentage point below the 3.1 per cent in the corresponding period of 2015. The sluggish global output was traced to weak fundamentals in both the advanced economies and Emerging Markets and Developing Economies (EMDEs), including increased volatility in global financial markets, sustained softness in commodity prices, sluggish global trade, resulting in persistent fragility, particularly in the EMDEs.

The United States (US) economy slowed to 0.5 per cent in Q1 2016, a steep decline compared with the 1.4 per cent growth recorded in the last quarter of 2015. The deceleration in US growth was attributed to contraction in non-residential fixed investment and energy businesses, a strong dollar which harmed exports, slowdown in government spending and moderation in private consumption expenditure (PCE). Japan which is currently in deflation is projected to grow by 0.5 per cent in 2016, the same as in 2015, on the back of persistently weak aggregate demand. The Bank of Japan's (BoJ) monthly asset purchase of ¥6.7 trillion (US$61.73 billion) resulted in the Bank holding about one-third of outstanding government bonds, while the economy remained largely intractable with a credit crunch, indicating that the programmme may have lost its steam. In response to the contraction in credit, BoJ since January 2016, adopted a negative interest rate policy.

Real GDP growth in the Euro area at 0.6 per cent in Q1, 2016 was a phenomenal improvement compared with the 0.3 per cent achieved in Q4 2015. The European Central Bank (ECB), at its meeting of 21st April, 2016 maintained the soft policy stance by holding its refinancing rate at 0.0 per cent, lending rate at 0.25 per cent and deposit rate at -0.4 per cent. The Bank also maintained its monthly asset purchase program of €80 billion (US$87.2 billion), hoping to further stimulate output growth and achieve its 2 per cent inflation target.

The Bank of England (BoE) also retained its monthly assets purchase programme, financed through the issuance of reserves at £375 billion (US$543.75 billion). At the end of its April 13, 2016 meeting, BoE retained its policy rate at 0.5 per cent, with a commitment to raise inflation to its 2.0 per cent long run path.

Weaknesses in major EMDEs, including low capital inflows, rising costs of funds and continuing geopolitical factors, have been identified as key constraints to growth. Adverse commodity prices continued to provide strong headwinds against growth, defining other economic and financial conditions in the EMDEs. Consequently, the IMF (WEO April 2016 Update) downgraded the 2016 growth forecast for this group of countries from 4.3 to 4.1 per cent.

Disruptions to oil supply in Canada, Nigeria and Kuwait and, demand spikes following expectations of a US interest rate hike and buildup of crude oil inventories, contributed to mild oil price recovery in April 2016. Inflation remains largely suppressed in the advanced countries but tepid consumption spending and vulnerabilities in the financial markets continue to hamper financial intermediation and growth. Consequently, the monetary policy stance in most advanced economies remained largely accommodative and most likely to be maintained throughout 2016. On the contrary, monetary policy in the EMDEs could continue to diverge substantially, reflecting the diversity of shocks confronting them.

Domestic Economic and Financial Developments

Output

In the first quarter of 2016, the economy suffered from severe shocks related to energy shortages and price hikes, scarcity of foreign exchange and depressed consumer demand, among others. Consequently economic agents could not undertake new investments or procure needed raw materials. Shortage of foreign exchange arising from low crude oil prices manifested in low replacement levels for raw materials, other inputs as well as new investments. In addition, the energy crisis experienced in the first five months of the year, resulted in increased power outages and higher electricity tariffs, as well as fuel shortages; which led to factory closures in some cases. The prolonged budget impasse denied the economy the timely intervention of complementary fiscal policy to stimulate economic activity in the face of dwindling foreign capital inflows. Aggregate credit to the private sector remained highly tapered while credit to government grew beyond the programmed benchmark for the period. The Committee, however, noted that many of the prevailing conditions in the economy during the review period were outside the direct control of monetary policy, but hopes that the implementation of the 2016 Federal Budget, supported by relevant sectoral policies and easing supply shocks in energy and critical inputs, would provide the needed boost to the economy.

Against this backdrop, data from the National Bureau of Statistics (NBS) for May 2016, indicated that domestic output in Q1, 2016 contracted by 0.36 per cent, the first negative growth in many years. This represents a drop of 2.47 percentage points in output from the 2.11 per cent reported in the last quarter of 2015, and 4.32 percentage point lower than the 3.96 per cent recorded in the corresponding period of 2015. Aggregate output contracted in almost all sectors of the economy, with the non-oil sector declining by about 0.18 per cent in Q1 2016, compared with 3.14 per cent expansion in the preceding quarter. Only agriculture and trade grew by 0.68 per cent and 0.40 per cent, respectively, while Industry, Construction and Services recorded negative growth of -0.93, -0.26 and -0.08 percentage point, respectively.

Prices

The Committee noted a further increase in year-on-year headline inflation to 12.77 per cent and 13.72 percent in March and April 2016, respectively, from 11.38 per cent in February 2016. The increase in headline inflation in April reflected increases in both food and core components of inflation. Core inflation rose sharply for the third time in a row to 13.35 per cent in April from 12.17 per cent in March, 11.00 per cent in February and 8.80 per cent in January having stayed at 8.70 per cent for three consecutive months through December, 2015. Food inflation also rose to 13.19 per cent from 12.74 per cent in March, 11.35 per cent in February, 10.64 per cent in January and 10.59 per cent in December, 2015. The rising inflationary pressure continued to be traced to legacy factors including energy crisis reflected in incessant scarcity of refined petroleum products, exchange rate pass through from imported goods, high cost of electricity, high transport cost, reduction in food output, high cost of inputs and low industrial output.

The Committee observed that in an economy characterized by high import dependence, the shortage of foreign exchange provided some basis for price increases as currently being experienced. The Committee noted that the economy needed to aggressively earn and build up its stock of foreign reserves in order to avoid distortions when faced with severe shocks. The Committee further noted that the current inflation trend, being largely a product of structural rigidities and inadequate foreign exchange earnings would continue to be closely monitored, and in coordination with fiscal policy, with a view to addressing the underlying drivers of the upward price movements.

Monetary, Credit and Financial Markets Developments

Broad money supply (M2) grew by 3.49 per cent in April 2016, a 1.29 percentage growth from the March level of 2.20 per cent and compared with the 3.67 per cent in April 2015. When annualized, M2 grew by 10.47 per cent in April 2016 against the provisional growth benchmark of 10.98 per cent for 2016. Net domestic credit (NDC) grew by 7.87 per cent in the same period and annualized at 23.61 per cent. At this rate, the growth rate of NDC was above the provisional benchmark of 17.94 per cent for 2016. The development in NDC essentially reflected the significant growth in credit to government of 35.97 per cent in the month, annualized to 107.91 per cent. Credit to the private sector grew by 3.52 per cent in April 2016, which annualized to a growth of 10.56 per cent, below the benchmark growth of 13.28 per cent.

The Committee observed with concern, the continuous dismal performance of growth in credit to the private sector, noting that in spite of the Bank's efforts, DMBs continued to direct credit largely to low employment elastic sectors of the economy, a phenomenon that had significantly contributed to the low performance of the economy.

Money market interest rates reflected the continuing liquidity surfeit in the banking system. Average inter-bank call rate, which stood at 4.50 per cent on 21st March 2016, closed at 8.67 per cent on March 18, 2016. Between March 25th and 14th April 2016, interbank call rate averaged 2.00 per cent. The Committee noted a decline in activity in the inter-bank market in the period under review, which was due to the payment of FAAC statutory allocations and the maturity of CBN securities.

The Committee also noted a further improvement in the equities segment of the capital market as the All-Share Index (ASI) rose by 3.34 per cent from 25,899.91 on March 24, 2016 to 26,763.86 on May 18, 2016. Similarly, Market Capitalization (MC) rose by 3.14 per cent from N8.91 trillion to N9.19 trillion during the same period. However, relative to end-December 2015, the indices declined by 6.56 per cent and 6.70 per cent, respectively. Globally, however, the equities markets were generally bearish.

External Sector Developments

The average naira exchange rate remained stable at the inter-bank segment of the foreign exchange market during the review period. The exchange rate at the interbank market opened at N197.00/US$ and closed at N197.00/US$, with a daily average of N197/US$ between March 25 and May 13, 2016. The Committee, therefore, remains committed to its mandate of maintaining a stable naira exchange rate. The MPC noted the level of activity in the autonomous foreign exchange market especially, following the deregulation of the downstream petroleum sector with attendant increased demand in the interbank market, thus further exerting pressure on the naira.

The Committee recalls that over the last two consecutive meetings, it had signaled the imperative of reform of the foreign exchange market. In the intervening period, the Committee interrogated the issues around the current foreign exchange market regime, tracing them to the low foreign exchange earnings of the economy. Consequently, in the Committee's opinion, the key issue remains how to increase the supply of foreign exchange to the economy. The Committee observed that while the Bank has been working on a menu of options to ensure increased supply of foreign exchange, there was no easy and quick fix to the foreign exchange scarcity problem as supply remained essentially a function of exports and the investment climate.

The Committee is aware that a dynamic foreign exchange management framework that guarantees flexibility could not replace the imperative for the economy to increase its stock of foreign exchange through enhanced export earnings. Consequently, such a structure must evolve to provide basis for radically improved investment climate to attract new investments. The Committee recognizes the exchange rate as a very important macroeconomic variable, which must be earned by increased productive activity and exports, noting with satisfaction that the Bank had made very significant and satisfactory progress with the reforms framework.

The Committee was of the view that the current adverse global and domestic economic and financial conditions and the imperative imposed by the demand and supply shocks to the domestic economy and considering the express intensions of Government as enunciated in the 2016 budget, policy must respond appropriately as the market continues to demonstrate confidence in the Bank's ability to deliver a credible foreign exchange market. Accordingly, the MPC decided that the Bank should embrace some level of flexibility in the foreign exchange market. Given the imperative for growth, the Management of the Bank has been given the mandate to work out the modalities for achieving the desired flexibility that is in the overall interest of the Nigerian economy and when the implementation of the new framework would begin.

The Committee's Considerations

The Committee acknowledged the severely weakened macroeconomic environment, as reflected particularly in increased inflationary pressure, contraction in real output and rising unemployment. The Committee recalls that in July 2015, it had hinted on the possibility of the economy falling into recession unless appropriate complementary measures were taken by the monetary and fiscal authorities. Unfortunately the delayed passage of the 2016 budget constrained the much desired fiscal stimulus, thus edging the economy towards contractionary output. As a stop-gap measure, the Central Bank continued to deploy all the instruments within its control in the hope of keeping the economy afloat. The actions, however, proved insufficient to fully avert the impending economic contraction. With some of the conditions that led to the contraction in Q1, 2016 still largely unresolved, the weak outlook for growth which was signaled in July 2015 could extend to Q2. To this effect, today's policy actions have to be predicated on a less optimistic outlook for the economy in the short term, given that, even after the delayed budgetary passage in May 2016, the initial monetary injection approved by the Federal Government may not impact the economy soon, as the processes involved in MDAs finalizing procurement contracts before the disbursement of funds may further delay the much needed financial stimulus to restart growth.

The Committee noted that the CBN had implemented accommodative monetary policy from July 2015, with the hope of achieving growth, up until March 2016, when the MPC switched into a tightening mode. However, while the underlying conditions necessitating tight monetary policy remained largely in place, sundry administrative measures implemented by the Bank and recent macroeconomic conditions on the back of the 2016 Budget are expected to significantly dictate a key policy preference in the dilemma now faced by monetary policy - stagflation. Given the current limited policy space, it is imperative to balance stability with growth stance while working on options that in the short term, are certain to isolate seasonal and transient factors fuelling the current price spiral.

Other than credit to government, growth in all monetary aggregates remained largely below their indicative benchmarks, yet; headline inflation spiked in April 2016, far above the upper limit of the policy reference band.

Inflation has continued to be driven mainly by supply side factors such as fuel scarcity, increase in tariff and deterioration in electricity supply, increase in the price of petrol, higher input costs as a result of scarcity of foreign exchange, persistent security challenges and exchange rate pass-through to domestic prices of import. While the Committee believed that the recent deregulation of the downstream sector of the petroleum sector was in the right direction and would lead to increased supply, the pass-through effect of prices to other products has to be factored in policy considerations. Mindful of the limitations of monetary policy in influencing structural imbalances in the economy, the Committee stressed the need for policy coordination with the fiscal authorities in order to effectively address the identified pressure points.

The Committee noted that the continued excess liquidity in the banking system was responsible for the low level of activity in the interbank market. This is in addition to contributing to the sustained pressure in the foreign exchange market. The Committee expressed hope that efficient implementation of the recently passed 2016 Federal Budget, especially; the capital expenditure portion, would help invigorate growth in the economy as business confidence rejuvenates.

The Committee expressed concern over sustained pressure in the foreign exchange market and the necessity of implementing reforms to engender greater flexibility of rate and transparency in the operation of the inter-bank foreign exchange market. Accordingly, the Committee noted that it was time to introduce greater flexibility in the management of the foreign exchange market. The Committee reaffirmed commitment towards maintenance of price stability and reiterated the need to reappraise the coordination mechanism between monetary and fiscal policy and initiate reforms, for the purpose of more efficient policy synchronization and management.

The Committee's Decisions

The Committee, in its assessment of the relevant risk profiles, came to the conclusion that although, the balance of risks remains tilted against growth; previous decisions need time to crystalize. Consequently, in a period of stagflation, the policy options are very limited. To avoid complicating the conditions, the Committee decided on the least risky option to hold. The foreign exchange market framework, now ready, the MPC voted unanimously to adopt greater flexibility in exchange rate policy to restore the automatic adjustment properties of the exchange rate. Consequently, all 9 members voted to hold and introduce greater flexibility in managing the foreign exchange rate. The Bank would however, retain a small window for funding critical transactions. Details of operation of the market would be released by the Bank at an appropriate time.

In summary, the MPC voted to:

(i) Retain the MPR at 12.00 per cent;
(ii) Retain the CRR at 22.50 per cent;
(iii) Retain the Liquidity Ratio at 30.00 per cent; and
(iv) Retain the Asymmetric Window at +200 and -500 basis points around the MPR

(v) Introduce greater flexibility in the inter-bank foreign exchange market structure and to retain a small window for critical transactions.

Thank you for listening.

Godwin I. Emefiele

Governor, Central Bank of Nigeria

24th May 2016