Central Bank of Nigeria Communique No 108 of the Monetary Policy Committee Meeting of Monday and Tuesday 25th and 26th July 2016

The Monetary Policy Committee met on 25th and 26th July 2016 against the backdrop of fragile global and domestic economic and financial conditions. The Committee evaluated the global and domestic macroeconomic and financial developments in the first six months of 2016 and the outlook for the rest of the year. In attendance were 8 members.

International Economic Developments

The Committee noted the continued sluggish growth in global output, being underpinned by weak demand and slowing productivity. In addition to existing risks, rising debt levels in the Emerging Market Economies (EMEs), volatile financial markets and the vote of the United Kingdom to exit the European Union “BREXIT” have lessened the prospects for a more prosperous global economy in 2016. Consequently, the International Monetary Fund (IMF), in July 2016, further downgraded its baseline forecast for global growth to 3.1 per cent from 3.2 in April. The Organisation of Economic Cooperation and Development (OECD) forecast for global output in 2016 is even less optimistic at 3.0 per cent. Slower global growth prospects is traced to weak trade, sluggish investment, protracted weak aggregate demand and low commodity prices; which have translated to output declines in the Emerging Market and Developing Economies (EMDEs). The Brexit vote has created widespread uncertainty and elevated volatility in the global financial markets.

The United States (US) economy grew by 0.8 per cent in Q1 of 2016, though, much lower than the 1.4 per cent growth recorded in the last quarter of 2015. The tapered growth was attributed to the goods sector which continues to struggle under the weight of declining factory activity; the hitherto resilient service sector is now losing steam while trade remains under pressure from a strong dollar and weak domestic demand.

The Japan economy grew at an annualized rate of 1.7 per cent in Q1 of 2016, a reversal of the negative growth recorded in Q4 of 2015. The Bank of Japan (BoJ) at its 15th-16th July meeting of the Monetary Policy Committee, maintained its monthly asset purchase at ¥6.7 trillion (US$63.93 billion), leaving the policy rate also unchanged at negative 0.1 per cent.

The Euro Area grew by 0.6 per cent in first quarter, 2016, up from 0.3 per cent, recorded in fourth quarter of 2015. Downside risks to the growth outlook have, however, risen following the Brexit vote. The Governing Council of the European Central Bank (ECB), at its meeting of July 21st, 2016, retained its key interest rates on the main refinancing operations, the marginal lending facility and the deposit facility at 0.00, 0.25 and -0.40 per cent, respectively, with the expectation that they would remain at present or lower levels for an extended period of time. The ECB also sustained its monthly asset purchases of €80 billion (US$87.91) until March 2017, with possibility of extension.

In anticipation of and to mitigate the impact of the Brexit vote, the Bank of England (BoE) voted to continue its ₤375 billion (US$495 billion) monthly assets purchase program, financed through the issuance of reserves and possible increase in the quantum should the need arise. The Bank also retained its policy rate at 0.5 per cent, with a commitment to stimulate inflationary growth towards its 2.0

per cent long run path. The Bank also hinted at a possible further easing of monetary policy in August, 2016.

Major EMDEs continued to face declining capital inflows, rising financing costs and geo-political tensions, all of which pose constrain to growth. Depressed commodity prices continued to tilt the balance of risk towards the downside, thus, dampening prospects for near term economic and financial recovery in the EMDEs. Consequently, the IMF (WEO July 2016 Update) downgraded the 2016 growth forecast for this group of countries to 4.1 from 4.3 per cent in the April projection.

In July, oil and other commodity prices rallied against the backdrop of better-than-expected economic data on China in the second quarter, sustained attacks on oil production facilities in Nigeria, and continued unrest in Libya. Nonetheless, global inflation remained subdued despite widespread easing of monetary policy. In the advanced economies, recent developments such as BREXIT has increased the uncertainty surrounding the future of the Euro zone thus further weakening demand and suppressing inflation. Consequently, while the stance of monetary policy in most advanced economies is expected to remain accomodative through fiscal 2016 in the EMDEs, it is expected to remain mixed, reflecting diversity and multiplicity of shocks confronting them.

Domestic Economic and Financial Developments

Output

The Nigerian economy is still saddled with the effects of the shocks of the first quarter of 2016; which led to a contraction in output arising from energy shortages, high electricity tariffs, price hikes, scarcity of foreign exchange and depressed consumer demand, among others. Whereas the influence and persistence of some of the factors waned in the second quarter, it is unlikely that the economy rebounded strongly in the quarter as setbacks in the energy sector continued owing mainly to vandalism of oil installations. In addition, the implementation of the 2016 budget in the second quarter remained slower than expected in the second quarter. The Committee noted that most of the conditions undermining domestic output growth were outside the direct purview of monetary policy. It nonetheless, hopes that the deregulation in the downstream petroleum sector and the liberalization of the foreign exchange market would help bring about the much needed relief to the economy.

Data from the National Bureau of Statistics (NBS) indicate that domestic output in the first quarter of 2016 contracted by 0.36 per cent, the first negative growth in many years. This represented a decline of 2.47 percentage points in output from the 2.11 per cent reported in the fourth 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 virtually all sectors of the economy, with the non-oil sector recording a decline of about 0.18 per cent, compared with the 3.14 per cent expansion in the preceding quarter. Agriculture and Trade were the only sectors with positive growth at 0.68 per cent and 0.40 per cent, respectively, Industry, Construction and Services contracted by 0.93, 0.26 and 0.08 percentage point, respectively.

Prices

The Committee noted a further rise in year-on-year headline inflation to 16.48 per cent in June 2016, from 15.58 per cent in May; 13.72 per cent in April, 12.77 per cent in March and 11.38 per cent in February 2016. The increase in headline inflation in June reflected increases in both food and core components of inflation. Core inflation rose sharply for the fourth time in a row to 16.22 per cent in June, from 15.05 per cent in May; 13.35 per cent in

April; 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 15.30 per cent in June, from 14.86 per cent in May; 13.19 per cent in April; 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 was largely a reflection of structural factors, including high cost of electricity, high transport cost, high cost of inputs, low industrial activities as well as higher prices of both domestic and imported food products.

The MPC expressed strong support for the urgent diversification of the economy away from oil to manufacturing, agriculture and services; and called on all stakeholders to increase investment in growth stimulating and high employment elasticity sectors of the economy in order to lift the economy out of its current phase.

Monetary, Credit and Financial Markets Developments

Broad money supply (M2) grew by 8.26 per cent in June, 2016, a 4.80 percentage points increase from 3.46 per cent in May compared with the 0.54 per cent contraction in June 2015. When annualized, M2 grew by 16.52 per cent in June 2016 against the provisional growth benchmark of 10.98 per cent for 2016. Net domestic credit (NDC) grew by 12.52 per cent in the same period and annualized at 25.04 per cent. At this rate, the growth rate of NDC exceeded the provisional benchmark of 17.94 per cent for 2016. There was no change in the level of banking sector net credit to government in June, contrasting the 31.45 per cent growth in May. Credit to the private sector grew by 14.45 per cent in June 2016, which annualizes to a growth of 28.90 per cent, outperforming the benchmark growth of 13.38 per cent for the year. The MPC expressed cautious satisfaction over the improved performance of credit to the private sector and urged the Bank to ensure that the tempo is sustained inorder to stimulate recovery of output growth.

The MPC noted that the level of money market interest rates largely reflected the liquidity situation in the banking system during the review period. Average inter-bank call rate, which stood at 20.0 per cent on 17th June 2016, closed at 50.0 per cent on July 15, 2016. The increase was attributed in part; to the newly introduced foreign exchange framework and the mop up of naira liquidity due to increased sale of foreign exchange by the CBN during the period. Generally, the period under review witnessed a decline in volume of activity in the inter-bank market owing to injections by FAAC and maturity of some CBN securities.

The MPC also noted the decline in the indices of the equities segment of the capital market. The All-Share Index (ASI) declined by 6.55 per cent from 29,597.79 on June 30, 2016, to 27,659.44 on July 22, 2016. Similarly, Market Capitalization (MC) declined by 6.26 per cent from N10.17 trillion to N9.50 trillion during the same period. Relative to end-December 2015, the indices fell by 3.43 per cent and 3.55 per cent, respectively. Globally, however, the equities markets remained generally bearish, in the aftermath of the Brexit vote.

External Sector Developments

The MPC noted the actions taken by the Bank as part of the implementation of the flexible foreign exchange regime decided at its meeting in May which was designed to improve liquidity and stabilize the foreign exchange market. The Bank introduced a flexible exchange rate regime in the inter-bank market; introduced a Naira-settled OTC-FMDQ-OTC trading platform, adopted two-way quote trading platform at the inter-bank foreign exchange market and appointed foreign exchange primary dealers.

However, the average naira exchange rate weakened at the inter-bank segment of the foreign exchange market during the review period following the liberalization of the market. The exchange rate at the interbank market opened at N197.00/US$ and closed at N292.90/US$, with a daily average of N244.95/US$ between May 25 and July 19, 2016. The initial weakness was attributable to the normal market reaction to a new regulatory reform. The MPC reaffirmed its commitment to its statutory mandate of achieving a stable naira exchange rate.

The MPC's Considerations

The MPC recognized the weak macroeconomic environment, as reflected particularly in increasing inflationary pressure and contraction in real output growth. In view of this, the MPC underscored the imperative of coordinated action, anchored by fiscal policy, to initiate recovery at the earliest time. Members called on the Federal Government to fast-track the implementation of the 2016 budget in order to stimulate economic activity to bridge the output gap and create employment. In the same vein, the MPC expressed concern over the non-payment of salaries in some states and urged express action in that direction to help stimulate aggregate demand. On its part, and as a complementary measure, the MPC restated its commitment to measures and deployment of relevant instruments within its purview to complement fiscal policy with a view to restarting growth. The Committee also enjoined deposit money banks (DMBs) to partner with Government and the Bank in this direction, by redirecting credit from low employment generating sectors to those capable of supporting growth, reducing unemployment and improving citizen standards of living.

Members agreed that the economy was passing through a difficult phase, dealing with critical supply gaps and underscored the imperative of carefully navigating the policy space in order to engender growth and ensure price stability. The MPC therefore, summarized the two policy options it was confronted with as restarting growth or fighting inflation. The MPC was particularly concerned that headline inflation spiked significantly in June 2016, approaching twice the size of the upper limit of the policy reference band.

The Committee noted that inflation had risen significantly, eroding real purchasing power of fixed income earners and dragging growth. The MPC was further concerned that while the situation called for obvious tightening of the monetary policy stance, the recession confronting the economy and the prospects of negative growth to year-end needed to be factored into the policy parameters.

The arguments in favour of growth were anchored on the premise that the current inflationary episode was largely structural. In particular, members noted the prominent role of cost factors arising from reform of the energy sector, leading to higher domestic fuel prices and electricity tariffs and prolonged foreign exchange shortages arising from falling oil prices leading to higher inputs costs, domestic fuel shortages, increased transportation costs, security challenges, reform of the foreign exchange market reflected in high exchange rate pass-through to domestic prices of imports. Consequently, the current episode of inflation, being largely non-monetary but largely structural, tightening at this point would only serve to worsen prospects for growth recovery as the Bank had in June 2016, withdrawn substantial domestic liquidity through the foreign exchange market upon introduction of the flexible foreign exchange market regime. Members however, noted the negative effect of inflation on consumption and investment decisions and its defining impact on the efficiency of resource allocation and investment.

The MPC further noted the prolonged non-payment of salaries, a development which has affected aggregate demand and worsened growth prospects. It also noted that at the May MPC meeting, members weighed the risks of the balance of probabilities against growth and voted to hold, allowing fiscal policy some space to stimulate output with injections, but this has been long in coming.

The MPC in putting forward for tightening considered the high inflationary trend which has culminated into negative real interest rates in the economy; noting that this was discouraging to savings. Members also noted that the negative real interest rates did not support the recent flexible foreign exchange market as foreign investors attitude had remained lukewarm, showing unwillingness in bringing in new capital under the circumstance. Members further noted that there existed a substantial amount of international capital in negative yielding investments globally and Nigeria stood a chance of attracting such investments with sound macroeconomic policies. Consequently, members were of the view that an upward adjustment in interest rates would strongly signal not only the Bank's commitment to price stability but also its desire to gradually achieve positive real interest rates. Such a decision, it was argued, gives impetus for improving the liquidity of the foreign exchange market and the urgent need to deepen the market to ensure self-sustainability. Members were of the opinion that this would boost manufacturing and industrial output, thereby stimulating growth which is desired at this time.

The Committee's Decisions

The MPC, recognizing that the Bank lacked the instruments required to directly jumpstart growth, and being mindful not to calibrate its instruments in such a manner as to undermine its primary mandate and financial system stability, in assessment of the relevant issues, was of the view that the balance of risks remains tilted against price stability. Consequently, five (5) members voted to raise the Monetary Policy Rate while three (3) voted to hold.

In summary, the MPC voted to:

(i) Increase the MPR by 200 basis points from 12.00 to 14 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

Thank you for listening.

Godwin I. Emefiele

Governor, Central Bank of Nigeria

26th July 2016