Central Bank of Nigeria Communiqué No. 85 of the Monetary Policy Committee Meeting of Monday and Tuesday, September 17 and 18, 2012

The Monetary Policy Committee (MPC) met on September 17 and 18, 2012, with 10 out of the 12 members in attendance. The Committee reviewed the conditions and challenges that confronted the domestic economy during the first eight months of 2012 against the backdrop of international economic and financial developments with a view to reassessing monetary policy options in the short-to- medium term.

The International Economic Developments

The Committee noted that the global economy showed signs of further weakness in the last three months, with the latest data not showing any evidence of improvement up to the beginning of the third quarter of 2012. The Committee also observed that the weak growth resulted from considerable financial market fragilities in the euro area with resultant negative spillover effects to other regions, uncertainty resulting from the Eurozone crisis as well as poor macroeconomic performance in other advanced economies. Rising food and energy prices is also a contributory factor.

In July 2012 IMF World Economic Outlook (WEO) update projected that global output would moderate to 3.5 per cent in 2012, which is 0.1 percentage point lower than the forecast of April 2012. Growth in advanced economies was projected to decline from 1.6 per cent in 2011 to 1.4 per cent in 2012, with the slowdown being most severe in the peripheral economies, where the dampening effects and uncertainty from tighter financial conditions are strongest.

In the US, real GDP grew at an annualized rate of 1.5 per cent in Q2 of 2012, down by 0.5 percentage point from 2.0 per cent in Q1. The sluggish growth was primarily due to declining aggregate consumption, government spending, and negative terms of trade.

The euro zone is on the brink of a double-dip recession following the contraction in output between April and June. Real output across the 17-nation bloc fell by 0.2 per cent in Q2 of 2012 while signs of further contraction are in the horizon. Rising unemployment and large scale fiscal retrenchment coupled with increased taxes in a number of countries constrained aggregate demand leading to cut-back on investment and low export growth. Unemployment level across the zone has attained a record high of 11.3 per cent, the highest since 1995, with Spain recording the highest level and Austria the least. Weak financial markets and the persisting sovereign debt crisis as well as rising energy prices led the European Central Bank (ECB) to retain its main refinancing interest rate at 0.75 per cent. EU members remain cautious about the ECB's Outright Monetary Transactions scheme, which is based on strict adherence to austerity measures and fiscal consolidation pact.

In Asia, most economies recorded significant slowdown in economic activity up to Q2 of 2012, mainly on account of weakening exports and investment. Export growth has moderated, reflecting the sluggish demand from Europe while investment remained weak due to heightened volatility of capital flows and the lagged effects of tighter domestic monetary policies. China's real GDP growth slowed to 7.6 per cent in Q2 from 8.1 per cent in Q1 due mainly to decline in net exports. Growth moderated in Japan especially in Q3 due to softening in manufacturing activity. India's real GDP, year-on-year, moderated to 5.5 per cent in Q2 of 2012 from 6.1 per cent in Q4 of 2011, mainly as a result of deceleration in private consumption. Overall, the growth trajectory for the remainder of the year tends toward a downturn, as downside risks, including weak external demand, elevated price levels, widening twin deficits, falling investments, and rising interest rates, remain heightened.

Robust economic activities in the MENA and Sub-Saharan Africa regions would partly offset the declining output growth in the advanced and emerging markets in 2012. Real GDP growth was projected at 5.0 per cent in each of the regions, underpinned by strong natural resources prices, new natural resources exploration and production in several countries, recovery from drought in the Sahel and parts of Eastern Africa, strong post-conflict recovery in some countries, improved governance practices and growing disposable income. Despite these developments, growth in the regions faces significant downside risks on the back of increased global uncertainties.

The Committee believes that the recent quantitative easing measures by the European Central Bank and the US Federal Reserve System could be responsible for the high crude oil prices in the international market. It highlighted the possible increase in carry trade and the risk of a bubble in the domestic capital market.

Domestic Economic and Financial Developments

Output

Recent macroeconomic data indicates that the economy is performing better than forecasts although growth in the first two quarters of 2012 has remained consistently below the corresponding growth rates in 2011. The provisional real GDP growth rate from the National Bureau of Statistics stood at 6.28 per cent in Q2 of 2012, up from 6.17 per cent in Q1 2012 but lower than the 7.61 per cent recorded in the corresponding period of 2011. The non-oil sector remained the major driver of growth recording a 7.50 per cent increase in contrast to the oil sector, which contracted by 0.73 per cent during the period. Overall GDP growth for fiscal 2012 has been revised upwards to 6.77 per cent from the earlier projection of 6.50 per cent. The Committee welcomed the promising growth performance although it expressed concern that the overall output growth projection for 2012 is still lower than the 7.45 per cent recorded in 2011.

The growth drivers within the non-oil sector remained agriculture; wholesale and retail trade; and services; which contributed 1.94, 1.69, and 3.16 per cent, respectively. The Committee noted that the relatively robust growth projections despite the slowing global economy reflected the continuing favorable conditions for increased agricultural production, improved security situation and power supply.

Prices

The Committee observed that the inflationary pressures experienced during the first half of 2012 appear to be moderating in the third quarter. The year-on-year headline inflation declined to 11.7 per cent in August 2012 from 12.8 per cent in July while core inflation decelerated to 14.7 from 15.0 per cent during the same period. Also, food inflation declined sharply to 9.9 per cent in August 2012 from 12.1 per cent in July. The significant decline in year-on-year food inflation was attributed to the decrease prices of both processed foods (from 4.2 to 3.6 per cent) and farm produce (from 7.9 to 6.4 per cent). The Committee observed that the inflationary pressures from the partial removal of petroleum subsidy in January, 2012 appear to have waned in Q3, 2012, and that given the relatively stable exchange rate regime, the pass-through to domestic prices was low during the period. The Committee, however, recognized the upside risk to inflation in the near-term to include increased spending in the fourth quarter and monetized capital flows following the US QE3.

Monetary, Credit and Financial Markets' Developments

Broad money supply (M2) grew by 3.50 per cent in August 2012 over the level at end-December, 2011, which annualized to 5.25 per cent.

The annualized growth rate is significantly lower than the growth rate of 15.43 per cent recorded in 2011. Aggregate domestic credit (net) declined by 3.82 per cent in August 2012, annualized to a decline of 5.73 per cent from the level at end-December 2011 level. The decline in aggregate domestic credit (net) in August 2012 was due to a huge fall in credit to Government (net), which declined by 246.47 per cent or 369.71 per cent on annualized basis. This development reflected the combined effects of the significant growth in Federal Government deposits with the banking system and contraction on claims to government. The introduction of a Treasury Single Account (TSA) appeared to have had the desired effect of reducing government borrowing.

Interest rates in all segments of the money markets rose initially, in response to the increase in the Cash Reserve Requirement (CRR) by 400 basis points at the MPC meeting of July 21 and 22, 2012. The rates, however, trended downwards toward the end of the review period. The inter-bank call and OBB rates, which opened at 17.85 and 14.99 per cent, closed at 14.19 and 13.56 per cent, respectively, during the review period. Developments in the interest rate structure indicated that the retail lending rates remained high in August 2012. The average maximum lending rate increased marginally to 23.76 per cent in August 2012 from 23.45 per cent in July. However, the average interest bearing deposit rate declined to 6.24 per cent in August 2012 from 6.64 per cent in July. Thus, the spread between the average maximum lending rate and the average interest-bearing deposit rate widened to 17.53 per cent in August 2012 from 16.81 per cent in July. The Committee expressed concerns that lending rates have remained high and enjoined the Bank to sustain its efforts towards the reduction in interest rate spread, while stabilizing interbank rates to sustain liquidity and facilitate intermediation in the banking system. The Committee noted that this can only be achieved by sustaining the current efforts at reducing overheads in the banking industry and deepening capital market reforms to diversify sources of finance for the real economy, and complement bank loans.

The Committee observed that the recovery in the Nigerian capital market continued during the review period, as equities market indicators were positive. The All-Share Index (ASI) increased by 9.96 per cent between June 29, 2012 and August 31, 2012, while Market Capitalization (MC) increased by 9.64 per cent during the same period. Equity Market Median PE ratios at 9.86 in August 2012, fell below the long-run median of 10.77 by 0.91 or 8.44 per cent, suggesting bargain valuations and an imminent rebound. The Committee observed that the performance of the NSE during the period was consistent with the global trends, especially in the wake of monetary expansion.

External Sector Developments

At the Wholesale Dutch Auction System (WDAS), the exchange rate during the period, July 25 – August 31, 2012, opened at N157.40/US$ and closed at N157.36/US$, representing an appreciation of N0.04k. The appreciation was due to the combined effects of the increase in Cash Reserve Requirement, reduction in the Net open position and the policy barring DMBs/Discount Houses from accessing Lending windows (SLF and Repo) and WDAS simultaneously. At the interbank segment, the selling rate opened at N160.05/US$ and closed at N158.15/US$, representing an appreciation of N1.90 or 0.01 per cent. The appreciation experienced in this segment was due to increased supply of foreign exchange by oil companies to the interbank market. At the BDC segment of the foreign exchange market, the selling rate opened at N163.00/US$ and closed at N161.00/US$, representing an appreciation of N2.00k or 0.01 per cent for the period. The appreciation recorded in this segment was traced to the low demand of foreign exchange by end users vis-à-vis the high supply of foreign exchange at the interbank market and the apparent taming of speculative activities.

The Committee noted with satisfaction that 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, and therefore encouraged the Bank to sustain and complement existing measures to discourage speculative demand in the market. In general, the Committee noted that the decisions taken at the last meeting of the MPC had produced the desired result.

In the same vein, the Committee expressed satisfaction with the significant accretion to external reserves during the period. Gross external reserves as at September 5, 2012 stood at US$ 41.81 billion, representing an increase of US$ 6.40 billion or 18.07 per cent above the level of US$35.41 billion at end-June 2012. External reserves increased by US$ 8.88 billion or 27.0 per cent on a year-on-year basis compared with US$ 32.93 billion at end- August 2011. The increase in the reserve level was driven mainly by proceeds from crude oil and gas sales and crude oil related taxes. The foreign reserves level could finance over seven months of imports.

The Committee's Considerations

Given developments in the global and domestic economy and the financial markets, the Committee noted that the weak global growth indices called for cautious optimism by policymakers. The resolution of the euro area debt crises remains a major concern even with the approval of the efforts of the European Central Bank to address the debt crises in the euro area by the German Constitutional Court. It further noted that its decisions at the July MPC Meeting appeared to have had some positive impact in a number of areas, namely: a deceleration in year-on-year inflation in August 2012, stability of short term interest rates around the Monetary Policy Rate (MPR), buildup in external reserves and stability in the exchange rate. However, core inflation is still high at 14.7 per cent in August. The threat of increased inflow of hot money arising from the actions of the US Fed to further stimulate the economy through its QE3 activities and its capital reversal implications were noted.

The Committee noted the rise in oil prices but cautioned against a hasty deployment of the windfall to immediate consumption as the trend could be reversed. Monetary policy could not, therefore, under the circumstance, react to what may be purely temporary developments.

Despite the threats from a combination of global and domestic factors, the Committee noted that the level of economic growth in the third quarter of 2012 remained robust and the year-end forecast would likely be met owing largely to the improvements in power supply and the steady progress of reforms, actions in respect of the alleged fraud in the petroleum subsidy regime and improved fiscal operations. The Committee noted that these measures, generally take time to impact the real economy.

With this development, the Committee observed that the inflation outcome for the remaining period of the year is likely to be lower than the initial forecast of 14.7 per cent. The Committee would continue to monitor developments in the price level, and remain firm in its commitment to price stability as its mandate. The Committee also noted that the growth rate of real output, though impressive by global trends, was on the downward trend since Q1 2010 most especially in the agricultural sector. It was of concern to the Committee that the declining output in the agricultural sector was traceable to the security challenges and high intensity of rainfall which has led to flooding in several parts of the country. It noted that the measures taken at the last MPC meeting have succeeded in stabilizing the foreign exchange market as well as enhancing the build up in external reserves.

Overall, the MPC believes that the current rise in crude oil prices and the tight monetary policy regime presented an opportunity for building reserve buffers in the light of the uncertainties surrounding the global economy.

The Committee, therefore, identified the key policy challenges to include:

1. Protecting the domestic economy and building external reserves buffer;
2. Potential large inflow of "hot money" resulting from further monetary easing in the US and Europe and improved yield on fixed income instruments;
3. Persisting high core inflation rates;

The Committee noted that this moderation in headline inflation has not been accompanied by a significant decline in core inflation. Given the unpredictability of food prices, there is a need to watch this trend as we approach year-end before altering the present monetary stance.

Decisions:

In view of the foregoing, the Committee by a unanimous vote decided as follows:

1. Retain the Monetary Policy Rate (MPR) at 12 per cent with +/-200 basis points corridor;

2. Retain the Cash Reserve Requirement (CRR) at 12.0 per cent.

3. Retain the Net Open Position at 1.0 per cent.

Thank you.

Sanusi Lamido Sanusi, *CON*

Governor

Central Bank of Nigeria

18th September, 2012