



## **Central Bank of Nigeria Communiqué No. 84 of the Monetary Policy Committee Meeting of Monday and Tuesday July 23 and 24, 2012**

The Monetary Policy Committee met on July 23 and 24, 2012 with 11 out of the 12 members in attendance. The Committee reviewed the economic conditions and challenges in the first half of the year against the backdrop of developments in the international economic and financial environments with a view to considering the monetary policy options for the remaining part of 2012.

### **The Global Economy**

The Committee noted the continued fragility of global economic recovery and the increased downside risks to growth in 2012. In particular, the sovereign debt and financial sector problems, together with recession in the UK and some Euro zone countries and reduced growth rate in the US continue to affect China, India and Brazil's export-

driven growth. This has necessitated a downward revision of the projected global output growth for 2012 by the IMF in the July 2012 WEO Update. While the effort to fix banks and sovereign balance sheets by the European Central Bank using long term refinancing operations eased funding constraints and broadly rallied the assets markets, these gains were short-lived due to the intensification of policy uncertainty after the Greek and French elections, strong dampening effects of the financial fragility in the Euro Area peripheral states and public resistance of austerity measures. In the advanced economies, the weakness in the labor and housing market, the elevated debt level of the households and the need to fix the encumbered balance sheets of banks are likely to continue to constrain growth prospects. Consequently, the growth forecast in the advanced countries was downgraded by 0.2 percentage points to 1.4 per cent in 2012 relative to the April WEO estimates.

In the United States, reduced retail sales and investment, growth rate concerns about public debt and the uncertainty over domestic fiscal plans due to failure to

reach an agreement on near-term tax and spending policies constitute severe threats to economic recovery. Thus, output growth in the US for 2012 was revised slightly downward to 2.0 per cent from 2.1 per cent by the IMF in the July 2012 WEO.

In the Euro area, Real GDP growth is expected to contract from an annual rate of about 1.4 per cent in 2011 to -0.3 per cent in 2012 with France, Italy and Spain leading the contraction in growth. The revised growth rate of 1.0 per cent for Germany in July is an improvement of 0.4 per cent over the April 2012 IMF growth projections. The risk to growth in the euro area is amplified by geopolitical uncertainties and the risk of stagnation and long-term damage to potential growth as unemployed workers lose skills and new entrants find it difficult to join the active labor force.

In the UK, despite the Bank of England's monetary measures to stimulate growth, the effect of the Treasury's fiscal consolidation for reducing the budgetary risk remains strong, leading to weak business and consumer confidence. Thus, real GDP growth was projected at 0.2 per cent against

the initial projection of a contraction of 0.4 per cent. Spain's latest round of austerity measures failed to reassure investors and markets, as the country's borrowing costs continued to rise.

In emerging economies, the lag effect of past policy tightening has continued to weaken internal and external demand thereby limiting growth. In China, real GDP growth slowed to 7.6 per cent year on year in the second quarter of 2012, compared with 8.9 per cent in the fourth quarter of 2011, due mainly to weak external conditions, particularly sluggish demand from the euro area. Real GDP growth forecast for 2012 has been reduced to 8.0 per cent from earlier forecast of 8.2 per cent. India's real GDP growth moderated to 5.3 per cent, year on year, in the first quarter of 2012 compared with 6.2 per cent in the fourth quarter of 2011, with the projection for 2012 put at 6.1 per cent compared with 7.1 per cent in 2011.

Output performance in Sub-Saharan Africa is projected at 5.4 per cent in 2012. While exports to Europe have dropped, strong terms of trade and increased trade diversification towards emerging markets have helped

support growth in the region. A major issue in the region, however, is that inflationary pressures and reduced fiscal space present limited flexible policy options for manoeuvre, especially if downside risks materialize.

Overall, the slowdown in global economic activities would have serious implications for the Nigerian economy in the following respects: A softening in the demand for oil and consequent decline in oil revenues; reduction in foreign exchange earnings which would impair the build-up of external reserves and consequently exert pressures on the exchange rate; increased budget deficit as government would not be able to realize its revenue projections; and increased public sector borrowing to finance expenditure outlays.

## **Key Domestic Macroeconomic and Financial Developments**

### **Output and Prices**

The revised GDP growth rate projected by the National Bureau of Statistics (NBS) for the Q2 2012 at 6.37 per cent was higher than Q1 2012 level of 6.17 per cent, indicating increased momentum in the economy. Overall, GDP growth

for 2012 was projected at 6.38 per cent, down from the realized growth rate of 7.74 per cent in 2011. The projected decline in GDP growth for 2012 is attributable to a number of factors including: the estimated loss of about ₦207.41 billion in national output during the nation-wide strike in January; the dampening effects of low crude oil demand from major trading partners notably the US, Euro area, and China; falling oil prices, and weak aggregate domestic demand following rising prices across major segments of the economy; as well as the prevailing security concerns.

The non-oil sector remained the major driver of growth recording 7.52 per cent increase in contrast to the oil sector which contracted by 0.24 per cent during the period. The Committee noted the sustained slowdown in the growth in agricultural output of 4.08% in the second quarter compared with 4.15% in the first quarter, traceable to the continued security challenges which affected a large part of the farming population in the northern parts of the country during the period. The Committee also expressed serious concerns over the continued decline in the contribution of oil to GDP, which became apparent from

the second half of 2011, and intensified through Q1 and Q2, 2012. Its contribution to growth, declined by 0.40 per cent apiece in the third and fourth quarters of 2011, and declined to 0.40 and 0.04 per cent in Q1, 2012 and Q2 2012, respectively. There are serious concerns over continuing fiscal leakages, bunkering and oil theft in the Niger-Delta area.

This notwithstanding, the Committee was pleased to note that the growth projections were against the backdrop of severe weaknesses in the global economy. Thus, domestic output growth was anchored by the positive impact of the banking sector reforms as well as the initiatives by government to stimulate the real economy such as improvement in national electricity generation which rose to 2,900 MW/h as a result of increased gas supply to the thermal stations, increased water level at the hydro stations, and the resuscitation of some dormant generating stations.

The Committee noted significant downside risks to growth in the near-term, in particular the fall in the average spot price of Nigeria's reference crude, the Bonny Light, from US\$121.10 in the first quarter of 2012 to US\$109.32 in the

second quarter, and the current security challenges which continue to pose a threat to agriculture and manufacturing.

## **Prices**

The Committee noted the threat of Inflationary pressure which has re-emerged since the beginning of 2012. The year-on-year headline inflation rose to 12.9 per cent in June, 2012 against the 12.7 per cent in May 2012. Core inflation rose to 15.2 per cent in June, 2012 from the 14.9 per cent level in May, though food inflation, declined from 12.7 per cent in May to 12.0 per cent in June 2012. The major drivers of headline inflation during the period were food and non-alcoholic beverages and housing, water, electricity, gas and other fuels. The acceleration in core inflation in the second quarter was traced to increases in the contributions of processed food and housing, water, electricity/gas and other fuels.

The Committee noted that in addition to the lag effects of the partial removal of petroleum subsidy in January, other factors fuelling the upside risk to inflation in the near-term include borrowing by government to cover large fiscal

deficits in the 2012 budget, and the upward review of electricity tariffs and import Duty on wheat and rice in July 2012.

### **Monetary, Credit and Financial Market Developments**

Broad money supply (M2) grew by 1.35 per cent in June 2012 over the level at end-December, 2011, translating to annualized 2.70 per cent growth, which was lower than the growth rate of 10.77 per cent year-on-year. Relative to December 2011, aggregate domestic credit (net) declined by 2.73 per cent in June 2012, annualized to a decline of 5.46 per cent. The decline contrasted sharply with the growth of 49.76 per cent year-on-year. Although overall credit to the private sector increased by 3.60 per cent, the Committee noted that credit to state and local governments grew by 14.23 per cent or 28.46 per cent. On annualized basis, credit to core private sector grew by 3.2 per cent or 6.4 per cent when annualised. Consequently, the Committee reiterated its earlier advice that the CBN should put in place appropriate measures that would enhance the flow of credit to the core private sector, and fix the transmission mechanism.

The Committee noted that rates in all segments of the money market trended upward between May 21 and July 11, 2012. Inter-bank call and OBB rates which opened at 14.61 and 14.43 per cent, closed at 15.55 and 15.50 per cent, respectively. The increase in the rates was a reflection of the tight liquidity in the banking system traceable to the aggressive open market operations, given that the MPR remained unchanged during the period.

Retail lending rates remained high in June 2012 as the average maximum lending rate remained unchanged at 23.44 per cent in June 2012. On the other hand, the consolidated deposit rate fell marginally from 3.83 per cent in May to 3.82 per cent in June. In view of these developments, the Committee reiterated its earlier call to put in place an appropriate mechanism for reducing the interest rate spread, while stabilizing interbank rates to sustain liquidity and facilitate intermediation in the banking system.

### **External Sector Developments**

Gross external reserves as at July 19, 2012 stood at US\$37.16 billion, representing an increase of US\$ 0.33 billion over the

level of US\$36.83 billion at end-May 2012. The exchange rate at the wDAS-SPT opened at N157.26/US\$ on May 21 and closed at N157.43/US\$ on 12<sup>th</sup> July 2012, representing N0.17k or 0.11 per cent depreciation during the period. At the interbank segment, the selling rate opened at N158.80/US\$ and closed at N161.20/US\$, with a period average of N161.60/US\$, representing a depreciation of N2.40k or 1.51 per cent. At the BDC segment of the market, the selling rate opened at N160.00/US\$ and closed at N163.00/US\$, representing a depreciation of N3.00k or 1.87 per cent for the period. During the period, the naira weakened to as low as N163.00/US\$ due to developments in the external economy and the CBN had to intervene significantly in the interbank market to restore stability. The Committee expressed concern about the declining accretion to external reserves. The Committee noted 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 urged the Bank to sustain the existing measures to discourage speculative demand in the market.

## **The Committee's Considerations**

Against the backdrop of the foregoing review of the global and domestic economic and financial environments, the Committee observed that monetary policy faces a difficult task in terms of delivering price stability. Domestic conditions indicate rising unemployment, poverty, declining growth and rising inflation. Consequently, the money and foreign exchange markets appeared to be operating at sub-optimal levels. It noted that with the weakened global outlook underpinned by the slowdown in economic activities in the US, and major emerging economies like Brazil, China and India, contraction in output in the Euro area along with the persisting debt crisis which is proving difficult to resolve, lower demand for crude oil and lower crude oil prices, coupled with the lower domestic output growth, build-up of inflationary pressures, slowdown in the accretion to external reserves and the attendant pressures on the exchange rate as well as possible shortfall in the projected revenue for 2012, the ominous signs for the domestic economy are evident. In this regard, therefore, monetary policy is faced with very difficult choices, as

whatever policy action taken must be weighed against the possible trade-off(s) and implications for the wider economy.

The Committee further noted that the inflation environment remained uncertain with the possible pressures coming from the core component in the medium term. Domestic inflation has maintained its upward trend, and is expected to remain within that region over the six month forecast period. More so, the Committee observed that since its meeting in May 2012, growth prospects continued to be threatened by developments in Europe, China, India and the US, as well as the very slow progress in structural reforms and poor implementation of the capital budget for 2012.

The Committee observed further that during 2008-2009 when oil prices declined sharply and the domestic currency came under intense pressure, the CBN was able to defend the Naira because the nation had buffers, having accumulated substantial foreign exchange reserves when oil prices were high, but that this time around that luxury does not exist, as the excess crude account has largely

been depleted, and is still being depleted by the tiers of government.

The Committee also noted that the upside pressure could be further exacerbated by pressures in the foreign exchange market in view of the high demand in the market and the likely impact of the decline in international oil prices in recent weeks on the country's external reserves. Bonny light crude oil prices have not rebounded from their recent lows of around US\$97 per barrel in June, partly due to the crisis in the Euro area, a major export destination of Nigeria's crude oil.

The Committee, therefore, identified a number of key concerns that it was confronted with:

- i. Stemming the inflationary pressures arising from both domestic and external sources;
- ii. Sustaining a stable exchange rate for the naira;
- iii. Creating a buffer for the external reserves; and

iv. Mitigating the impact of the continued slowdown in global economic activities, particularly, in the US, Europe and China on the Nigerian economy.

In the Committee's view, these challenges would persist in the medium-to-long term with the attendant consequences on oil receipts. The Committee noted the fears about Europe's debt crisis which flared recently as concerns intensified that Spain would be next in line for a government bailout. It noted that the potential cost of a Spanish bailout far exceeds what is available in existing emergency funds. Already, the European decline has taken its toll on oil demand and exports. The rising global uncertainty and weaker external demand are causing headwinds for export-dependent economies. The unfavorable outlook is further strengthened by the fragile domestic conditions. The MPC is of the view that growth could further decline during the rest of the year.

Thus, the MPC is confronted with basically three choices: first, lower the MPR in the face of sustained slowing domestic output growth and concerns about global growth

prospects. The MPC viewed that a lowering of the rates in the face of sustained slower growth of output and global growth prospects could further weaken the exchange rate and adversely affect reserves at a time when the country needs to build up buffers against external shocks. It also reiterated its view that the growth challenge is a result of poor record of implementation of structural reforms and the capital budget.

Second, to leave the MPR unchanged. This is against the background of upward trending inflation figures and the precarious picture painted by the six months inflation forecast of the Bank, revised upwards since the MPC meetings of May, 2012. Inflation is expected to average 12.0 per cent during the next six months with core and food inflation being much higher. The forecast is mainly due to the increase in electricity tariffs and the tariff on imported rice and wheat.

The Committee recognized that a logical response to the increasing inflationary outlook would be an increase in the MPR, especially considering the impact of sustained liquidity in the banking system on exchange rates. It was, however,

conscious of the impact of higher interest rates on small businesses and the potential for higher non-performing loans on the books of banks. In addition, it is important to leave room and flexibility for further tightening should conditions so warrant in the near future.

However, it is important to note that the significant liquidity on the books of banks has not led to intermediation and lending to the real economy. Banks have continued to take advantage of high yields on government securities to direct credit away from the core private sector. In addition, the liquidity has provided ammunition for speculative activity in the foreign exchange market with implications for inflationary expectation.

Against the foregoing, therefore, the MPC reiterated the need to choose a policy trajectory that would have the least negative impact on the wider economy, to the extent that the longer-term benefits to the economy far outweigh the short-term costs. It was therefore, imperative to reduce the liquidity in the banking system and minimize the upward movement in MPR.



## **The Committee's Decisions**

In view of the foregoing, the Committee, decided as follows:

- (i) Retain the Monetary Policy Rate (MPR) at 12.00 per cent with symmetric corridor of +/-200 basis points by a vote of 10 to 1. One member voted to reduce MPR by 25 basis points to 11.75 per cent.
- (ii) Voted by a decision of 10 to 1 to increase the Cash Reserve Requirement (CRR) from 8.0 per cent to 12.0 per cent with effect from July 25<sup>th</sup>. One person voted to retain the CRR at 8.0 per cent.
- (iii) Unanimously agreed to reduce the Net foreign exchange Open Position (NOP) to 1.0 per cent from 3.0 per cent with immediate effect.

**Sanusi Lamido Sanusi, CON**

Governor

Central Bank of Nigeria

**24<sup>th</sup> July 2012**

## PERSONAL STATEMENTS BY MPC MEMBERS:

### 1.0 ALADE, SARAH

*Headline inflation edged up to 12.9 percent in June from 12.7 percent recorded in the previous month. In the international scene, growth prospects remain fragile and weak. The contraction in the euro area is expected to be more protracted than previously anticipated and in emerging markets such as China and India growth is slowing with overarching consequences to the world economy. On the domestic front, the anticipated easing of oil prices in the international market on the back of declining global growth point to greater uncertainty about the future. These developments, call for a cautious approach to monetary policy to mitigate some of the risks coming from the global economy while addressing domestic concerns. Based on this, I will support a **no change** in monetary policy rate and an increase in Cash Reserve Requirement (CRR).*

**Headline inflation edged up to 12.9 percent in June from the 12.7 percent recorded in the previous month.** While this modest increase can be explained by the usual seasonal effect of the planting season, the spillover effect of the recent increase in electricity tariff which took effect in June cannot be discounted. Despite this explanation, inflationary threat remains elevated for the remainder of the year especially if oil prices remain dampened and the drought in the USA and other regions threaten global food security. In addition, outlook for inflation for the next two months is expected to remain elevated for headline, core and food inflation. Headline inflation is expected to further increase in July from 12.9 percent recorded in June.

**Gross Domestic Product (GDP) is projected to grow by 6.38 percent in 2012.**

First quarter GDP growth remained at 6.17 percent, down from 7.13 percent recorded in the corresponding period of 2011. The revised growth rate was, however, higher than the earlier estimate of 5.34 percent, an indication of some level of resilience in the economy. The National Bureau of statistics (NBS) is projecting a growth rate of 6.37 percent for the second quarter of 2012. The non-oil sector remained the major driver of growth recording 7.53 per cent increase in contrast to the oil sector which contracted by 0.24 per cent during the period. The growth drivers among the non-oil sector remained agriculture, wholesale and retail trade, and services, although the contribution of agriculture declined to 4.08 percent in the second quarter from 4.15 percent in the first quarter of 2012 due to continued security challenges affecting a large part of the farming population in the northern part of the country.

**In the money market, rates increased during the period under review.** Inter-bank call and OBB rates averaged 15.55 and 15.50 percent, respectively, during the period under review. The increase in the OBB and inter-bank rates can be attributed more to market segmentation rather than the level of liquidity in the banking system. In the Nigerian stock exchange, activities remain mixed; while foreign investors are patronizing the market, domestic confidence and participation still remain low. The exchange recorded some milestones, including positive performance for six straight weeks and the All Share Index reaching 23,000 points during this period.

**The risk of fiscal expansion in the next two months is very likely.** There is pressure to increase the speed of implement of the budget by the legislative arm of the government in the third quarter. Additionally, there is a real likelihood that excess crude will be monetized and shared by the three tiers of government. This will put upward pressure on both inflation and exchange rate. Therefore all efforts should be made to ensure that excess liquidity in the system that is not channeled into productive activities should be sterilized.

**Global economic outlook has become more uncertain since the last MPC meeting in May 2012.** Economic and political stress in the euro area has been rising, with fears growing that one or more countries may leave the currency union. This, along with a slew of weaker than expected economic data in Europe and America, has seen the global outlook deteriorate. Major bond yields, global equity and commodity prices such as oil have been on the decline. Investor preference towards lower risk assets has driven government bond yields in many countries to fresh lows, including in the United States, and government bond yields for troubled nations like Italy and Spain have risen sharply. Signs of stress have re-emerged in some funding markets, solidifying the global market sentiment. The lack of meaningful progress towards the resolution of the Eurozone crisis continues to be a source of instability for the world economy.

**The Continued global slowdown will have an impact on the Nigerian economy.** If the slowdown in growth of Nigeria's main trading partners persists, this could lead to a softening in demand for and price of oil with negative impact for Nigeria's oil revenues. The fallout will be the weakening of the naira, reduction in

foreign exchange earnings, and pressure on exchange rate. This may further lead to increase budget deficit and public sector borrowing to finance the expenditure outlays.

**Although looming inflationary threat** would suggest a hike in monetary policy rate, the need to support growth with lower interest rate will require a mixture of options. I am inclined to tilt my decision this time to balance both global risk and national vulnerabilities. Consequently, I will support a no increase in monetary policy rate and a 400 basis points increase in Cash Reserve Requirement (CRR).

## **2.0 BARAU, SULEIMAN**

### **a. Context Setting**

This is clearly a very difficult meeting of the Monetary Policy Committee for the following reasons:

- 1.1 There is very clearly huge resurgence of inflationary threat. While Year on Year (YoY) Headline Inflation (HI) at 12.9% in June was at the same level compared to April, it is a marginal increase over May level of 12.7%. Besides, and more significantly, the YoY Core Inflation (CI) measure spiked to 15.20%, substantially higher than the three year average of 10.97%. Food Inflation however trended marginally down to 12%. These developments occurred, inspite of the successful tightening stance in monetary policy. The inflation outlook particularly for the Core Inflation (CI) measure is also disturbing.
- 1.2 There is also evidence of **high liquidity in the banking system**. Unfortunately, the bulk of this liquidity is largely invested in government securities leading to the crowding out of the private sector where the liquidity should be channeled to generate the much needed growth.

- 1.3 While there has recently been huge build-up of demand for foreign exchange the **spike in demand at the WDAS window, which peaked for this year at \$4.6 billion in June, 2012, is a particular cause for concern.** Consequently our foreign reserves and the Naira/USD exchange rate has come under pressure. In spite of the increase in foreign reserves to \$37.16 billion as at July 19, 2012, which is higher than the month end levels in the preceding one year, **it is clear that the outlook for reserves would be a decline due to the recent increase in demand for foreign exchange if this trend is not quickly reversed.**
- 1.4 **The threat posed by the mild depreciation in the Naira/USD exchange rate in the three segments of our foreign exchange market is remarkable.** While the premium between WDAS rate of N157.26/USD and N161.24/USD on May, 18 2.97% is within tolerable level, we have clearly burst the upper limit for the interbank market rate of N160/USD, with the interbank rate closing at 161.24/USD during the same period.
- 1.5 **Gross Domestic Product (GDP) growth estimate of 6.37% for the second quarter shows further decline when compared with GDP growth rates of 6.96%, 7.98% and 7.74% recorded in 2009, 2010 and 2011, respectively.** This has led to a review of year end growth projection to 6.38%.
- 1.6 In the international arena, **there has been sustained negative signal.** The IMF recently reviewed downward the global growth estimate as a result of the continued downside risks to growth emerging from sovereign debt and financial sector crises in the Euro Zone countries and slower growth rates in China, Brazil and India. This development would continue to exert downward pressure on oil price. This may in turn impact negatively on government revenues, foreign reserves and ultimately the exchange rate.

**b. Discussion**

- 2.1 After a review of the above and other developments in the economy, the question is firstly, **whether to maintain or change stance in policy?** Given

the huge downside risks, I have no doubt that the argument in favour of maintaining the tightening stance is compelling. The second question is, **should we further tighten? The current spike in Core Inflation (CI), the pressure on the exchange rate and the declining foreign reserves driven by the liquidity in the banking system make a compelling case for further tightening.**

2.2 I am, however, aware of the impact of further tightening on financial stability and growth. In consideration of the impact on financial stability, it is clear that the regulatory and supervisory framework put in place and the conclusion of significant aspects of the banking reforms have ensured that the issue of the huge mark to market and the other major risks faced by banks have been identified and measures are being put in place to resolve them. However, in further tightening, I will recommend the use of monetary policy tools that will not exacerbate systemic risks. On the impact of further tightening on growth, given the recent slowing down, I doubt that our past strong GDP growth is largely due to the impact of bank lending. It is true that bank lending is critical to growth but what is more important now is structural reform that would create viable borrowers and elicit desirable private sector credit growth.

2.3 **The third question is how do we further tighten?** Liquidity in the banking sector is what we should aim to reduce. The necessary measures to reduce pressure on exchange rate including the reduction in Net Open Position limit (NOP) of banks would increase the Naira holdings of the banks. Liquidity mop up will carry short term pains but the ultimate benefit is that this would impact positively on inflation and stem the pass through effect on inflation of any further decline in the value of the Naira. The most effective way of targeting liquidity, is in my view, through desirable adjustment in the Cash Reserve Ratio, while maintaining the Monetary Policy Rate (MRR) given that any upward adjustment of MPR would directly impact negatively on lending rates and to a limited extent, on growth. Leaving the MPR unchanged will enable us to retain the fire power in our

war chest to be deployed towards maintaining inflation at a desirable level in due course.

**c. Recommendation**

In view of the foregoing, I recommend as follows:

- Maintain Monetary Policy Rate (MPR) at 12%
- Maintain the symmetric corridor at plus and minus 2% around the MPR for Standing Lending and Standing Deposit facilities, respectively
- Increase the Cash Reserve Ratio (CRR) from the current level of 8% to 12%
- Reduce the Net Open Position (NOP) Limit from 3% to 1%

**3.0 GARBA, ABDUL-GANIYU**

At the last MPC, the main concerns were

1. The growth in GDP had been declining since the first quarter of 2010.
2. Inflation Pressures were observed in core inflation.
3. The growth in public debt was crowding out private investments, and the debt service on government borrowing is rising and crowding-out non-debt expenditure particularly capital expenditure.
4. The Deposit Money Banks had unacceptably high exposures to government securities and to vulnerable economic sectors.
5. Expected Supply shocks in the second quarter of 2012 in the form of expected increase in electricity tariff in June and possible increase in the prices of petroleum products would have stagflationary effects worsening already precarious socio-economic conditions.

6. There were possibilities of external shocks – (1) commodity price shocks linked to the low demand season and possible decline in global demand linked to possible persistence in global economic vulnerabilities and (2) the potential risks of financial shocks given current exposures to hot money and the heightened global risks and uncertainties linked to the Euro-zone Crisis and political changes in key Euro-zone countries and the US elections.

Since the last MPC the state of the economy has been weighed down by:

1. Slowing growth; high unemployment (about 24% with youth unemployment in excess of 50%) and poverty rates exceeding 70%
2. Unequal gains of tightening: (a) growth in bank profit by 90% in First Half of 2012 compared to First Half of 2011; (c) persistent net loss of jobs in the banking industry since 2009; and (b) average 4.4% growth in sales of top 17 real sector quoted firms; 21.2% growth in sales costs and only 4.9% growth in capital formation in First Quarter of 2012 compared to first Quarter of 2011.
3. A growing disconnect between financial sector and the real sector: much of the profit in the financial sector not dependent on new credit to the real sector and, credit to the real sector being crowded-out by lending to government through investments in FGN Bonds and in Treasury Bills.
4. Inconsistencies between on the one hand, positive trade and financial balances and, continuing pressures on the Naira on the other. This inconsistency draws attention to the dangers of hot financial flows when money markets are malfunctioning and the urgent need to creatively

and smartly alter the incentive system against speculating activities and speculators (Nigerian and foreign). One of the enduring lessons of the global financial crisis is that monetary authorities must be smarter and innovative in by passing malfunctioning markets that is, market driven by perverse incentives that cause them to react rationally in ways that optimize rent at the expense of optimal market driven allocation of credit, growth in private sector investments, employment, growth and price stability.

5. Inconsistencies between on one hand, excess liquidity in the books of DMBs and, negative or low growth in monetary aggregates (Base Money declined on average by 1.62%, M1 declined on average by 2.6% and M2 rose on average by 0.94% in the first half of 2012). These numbers are indicative of systemic destruction of money through a shut-down in the credit market as stock of liquid assets are built up to take advantage of arbitrage opportunities. In the process, financial intermediation is arrested. The size of spread between savings and lending rates and between savings and treasury bills rates and the widening of that spread since tightening started in third Quarter of 2010 is indicative of a progressive deterioration in the allocative efficiency of the money market a fact that is indicated by the structure of the loan book relative to the structure of the GDP.
6. Inefficiencies caused by perverse incentives in money market (credit, treasury bills and SLF) which gave DMBs greater incentives to exploit arbitrage opportunities between SLF and Treasury Bills markets rather

than create money by lending to sectors that are, the growth drivers in the economy.

7. Unsustainable growth in public debt, expansions in FGN Bonds and Treasury Bills and rising debt service. Overall, fiscal operations remain expansionary and government debt has risen from NGR4.92Trillion in the third Quarter of 2010 to NGR6.9Trillion in the first quarter of 2012. This means in just six quarters, the public debt has risen by 40%! This is incredible and portends medium to long term problems particularly in the light of the slow-down in the global economy. The idea of a borrowing threshold of 40% is meaningless and unwise for a nation that was misled by the same "marketing sophistry" in 1978 causing the nation great cost in terms of development and capacity for clear headed economic policy making until the exit from Paris Club in 2006. Also, because wise economic decisions are taken on the margin and with due considerations to the principles of trade-off; opportunity costs and cost-benefit analysis.
8. Weaknesses in the nexus between government fiscal operations and the money and bond markets is a major weakness also, in the nexus between the money, capital and bond markets on one hand, and the real sector on the other. It is important to change the existing nexus to a virtuous one. Sooner rather than later. It is also, important to alter incentive systems against speculative activities that undermine the efficient functioning of markets and their capacities to generate output and productivity growths, innovations and jobs.

The goal of monetary policy is to deliver price stability conducive to growth. This implies stable domestic prices, stable exchange rates and a growing economy. While it is true that the three objectives conflict, available evidence from empirical analysis indicates that exchange rate has strong pass through effects on prices and, on growth in Nigeria. Further, that monetary policy does impact prices and exchange rate through interest rates and monetary aggregates. Also, that harmony between fiscal and monetary policies amplifies the impact of monetary policy on prices and growth while a discordant fiscal policy weakens the effectiveness of monetary policy. Discordant fiscal policy thus, causes monetary policy to be necessarily aggressive in targeting price stability. In addition, discordant fiscal policy undermines incentive systems in the money and bond markets and destabilizes system liquidity turning markets into a hunting ground for rational forward looking agents to exploit the perverse incentives in ways that undermine financial sector and economy-wide efficiency. These actions (fiscal and market) make price stability, exchange rate stability and economic growth more difficult to achieve.

It is clear from available evidence that the key financial markets (money, capital, bond and FX) are inefficient and that they are not producing private and public reaction functions conducive to efficient prices (interest rates and yields) and, price stability (domestic prices and exchange rate stability) with growth. Furthermore, tightening has had the unintended result of conducting speculative activities particularly in the money, bond and FX markets that seem to be reinforcing. The “party” for speculators has to end if the economy is to resume growth, create jobs and address the massive challenges it faces. It is highly

desirable that government fiscal operations complement the monetary authorities to help government achieve its macroeconomic objectives. However, the monetary authorities have responsibilities and do have the tools and mandate to correct market failures to ensure that the market, market intermediaries and market infrastructures deliver a sound fiscal system. It is recognized globally that no financial system could be stable and sound if it does not support innovation, output and productivity growth, employment and price stability.

Given the current state of the macroeconomy (real and financial) and the failures in the money, bond and FX markets to efficiently allocate resources in the Nigerian economy, there are compelling reasons not to increase the MPR despite the rise in inflation numbers released by the NBS. It is clear that domestic and foreign speculators do not desire a rate cut. Yet, a rate cut is required to support growth and job creation also, to discourage speculators who have been exploiting the stated commitment to exchange rate stability and tightening regime to undermine the efficiency of the markets. The issue of inflation threshold has raised the question of how much growth and employment and welfare can the economy sacrifice to maintain price stability? Also, how strong is the effect of MPR increases on inflation given the supply shocks of January 1 2012 and the rise in prices of electricity on June 1 2012?

Given the declining growth since first Quarter of 2010, the high level of unemployment (excess of 23.9% national and more than 50% for youths), high level of poverty (over 69%), weak performance of the real economy and the growing security challenges, the cost is already too high. It is of course, axiomatic that insecurity raises transaction costs and lowers competitiveness because

insecurity increases uncertainties and risks. Moreover, the evidence shows very clearly that speculative activities have thrived most under a regime of higher MPR as indicated by the asset structure of the DMBs, interest rate spreads, profit structures in the economy and, the sustained speculative attacks on the Naira. It is important that we do not forget that because the malfunctions of the global financial markets threatened stability of the major economies in Europe, North America and Asia, their Central Banks by-passed the financial markets to target the effects of the malfunctioning markets. This has been causal to the unlocking of credit markets and the resumption of growth.

Strategically, what is required therefore; is a creative mix of policies and incentives changing actions to change the financial games to ones in which the rational game in town is one that produces rational reaction functions that (1) enhance the efficiencies of the money, bond and FX markets; (2) deploy liquidity to create rather than destroy money by lending to sectors and activity with highest contributions to output and productivity growth and jobs instead of holding as war chest for speculative opportunities and attacks and; (3) enhances the effective management of liquidity at firm level and economy-wide. The “creative mix” is necessary to (1) limit the capacity of speculative and rent seeking players and activities to damage the Nigerian financial system and economy and (2) empower efficiency driven economic agents and activities.

My vote therefore is to:

1. Reduce MPR by 25 Basis Points;
2. Increase CRR from 8% to 12% from July 25, 2012; and

3. Reduce the Net Foreign Exchange Open Position (NOP) from 3% to 1% with effect from July 24<sup>th</sup>, 2012.

#### **4.0 KIFASI, DANLADI**

The high crude oil prices in the international market during the first quarter of 2012 have started weakening in recent months owing to the slowdown in the economies of major trading partners including US, Europe and China, with adverse implications for government finances, external reserves and foreign portfolio flows.

Inflation concerns remain largely elevated in response to the partial removal of fuel subsidy, increase in electricity tariff, and the recently announced tariff measures on importation of wheat flour/wheat grain/rice. The year-on-year headline inflation rate increased to 12.9% in June, 2012 from 12.7% in May, 2012. Projections of inflation performance in the next 6 months indicate that the year-on-year headline inflation would increase to 13.7% in July, reflecting largely the expected acceleration in food inflation during the month. However, the headline inflation forecast is expected to decline to 13% in August and 11.7% in October and then inch up to 12.7% in November before moderating to 11.9% in December, 2012.

The emerging risk to global growth appears to be the sluggish recovery of the US economy, the debt crisis-induced recession and fiscal austerity in the Euro zone and the slowdown of the Chinese economy due to efforts to contain its housing bubble. The weakness in the labour and housing markets in major advanced economies as well as the need to fix balance sheets of banks are likely to continue

to act as impediment to the pace of growth in the global economy. Global output growth was 3.9% in 2011 and the prospects for higher growth in 2012 appear slim. This is due to the weak growth expected from Europe, notwithstanding the proactive policies adopted by the European Central Bank to reduce vulnerabilities. In emerging economies, growth has been moderating because of past policy tightening and weaker internal and external demand, but it remains solid overall, thereby contributing significantly to global economic growth.

The NBS projected a growth rate of 6.37% for the Nigerian economy during the second quarter of 2012. Overall, real GDP growth for 2012 is projected at 6.5% down from 7.36% in 2011. The projected decline in GDP growth is attributable to expected drop in the volume of trade with our major trading partners whose economies are currently experiencing recession and weak recovery as well as inflationary threats in the domestic economy. However, the various intervention programmes by the Government would help to generate employment as well as moderate the adverse impact of global economic developments on growth in the economy.

The Federal Government fiscal operation is oil-based and the 2012 budget is based on oil benchmark price of US\$72 per barrel, with production quantity of 2.48 mpbd. In the unfolding scenario, where oil prices are falling sharply from US\$128 per barrel in March to US\$98 per barrel in June and the production level is also not met due to operational challenges and insecurity, this would have far reaching implications on the Nigerian economy, if the trend continues.

Relative stability was achieved in the foreign exchange market in the first half of 2012 with substantial injection of autonomous funds into the market. The exchange rate witnessed modest depreciation in all the segments of the foreign exchange market. The premium between the rates at the WDAS and inter-bank market and that between the rates at WDAS and the BDCs narrowed in July 2012, suggesting the need to sustain and complement existing measures to discourage speculative pressures in the market.

In view of the above, there is need to sustain the current tight monetary policy stance. This would assist in moderating inflation as well as sustain the relative stability achieved thus far in the foreign exchange market. Consequently, the current level of MPR at 12% with the symmetric corridor of +/-200 basis points should be retained for the next two months when another review will be due for consideration. The cash reserve requirement (CRR) could, however, be increased from 8% to 12% to address banking system liquidity concerns.

## **5.0 LEMO, TUNDE**

The challenges confronting the domestic economy have continued to intensify since the last MPC meeting in May 2012. The latest information released by the National Bureau of Statistics revealed the persistence of inflationary pressure as headline inflation rose to 12.9 per cent by Q2 of 2012 from 12.1 per cent at the end of Q1. A more disturbing development is that core inflation which used to be lowest has significantly increased above other inflation metrics since February 2012, rising to 15.2 per cent by June 2012, against a 3-year average of 10.97 per cent. The major drivers, however, are imported food items and administered

prices, which may be a little bit difficult to manage except through a significant reduction in aggregate demand. Although the revised real GDP for Q1 at 6.17 per cent was higher than the earlier estimates of 5.34 per cent, it is still significantly below the 3-year average of 7.43 per cent.

## **Considerations**

The policy decision in this meeting is much more complex than earlier expected given the prevailing macroeconomic outcomes in the face of the current stance of monetary policy. The reasons to hold the current stance of monetary policy are as convincing as the reasons to tighten further. The performance of credit to the private sector should naturally be a source of concern to the monetary authority given that it is a leading indicator of economic activities in most economies. Since the beginning of the year, credit to the private sector has been following a dismal performance with credit to the core private sector in particular showing a sluggish growth. The level of broad money supply (M2) is another area of concern. At the least, M2 growth should equal growth in nominal GDP even in an economy with full employment of resources. Actual M2 growth at the end of the first half has been estimated at 1.35 per cent or 2.70 per cent on annualized basis, compared to a 3-year average of 13.30 per cent. Given that growth in real GDP has been projected at 6.50 per cent for 2012, the current level of money supply is lower than equilibrium level. Furthermore, the imminent decline in oil revenue as a result of the prevailing global crisis should make it compelling for the monetary authority to rebalance the economy by stimulating investment and external demand.

The arguments presented above support the policy option of maintaining the status quo. My reservation, however, as pointed out in my previous statement, is that the issue of weak growth could be better addressed by complimentary structural reforms that deal with the obvious bottlenecks to production. Relaxing monetary policy in the face of structural rigidities in the economy could further filter into higher price level.

In view of the fact that the subsisting stance of monetary policy has been in place since the third quarter of 2011, it may be in order to examine whether we are comfortable with the current macroeconomic outcomes as well as the likely outcomes in the near term. Core inflation at 15.2 per cent at the end of first half is unacceptable to rational economic agents, particularly for an economy that is highly desirous of foreign direct investment to stimulate growth and by extension alleviate poverty. More worrisome is the fact that the real interest rate is still negative, leading to a further reduction in the competitiveness of the economy for foreign investment. In addition, the upside risks to inflation in the medium term remain very strong, including: the lag effects of the partial removal of subsidy on the PMS; the effect of the upward review of electricity tariffs; upward review of tariff on import of wheat and rice; and the possibility of a supplementary budget to utilize subsidy savings.

Another major pressure point is the weakening external demand arising from the global financial and economic crisis. The current weakening of the international oil market has led to a fall in the average spot price of Nigeria's reference crude oil, the Bonny Light (37<sup>0</sup> API), from US\$121.10 in the first quarter of 2012 to US\$97.19 by the end of the second quarter. This represents a decline of about 20

per cent. Although, the price has inched up to about US\$103/barrel in early July 2012, the current global economic reality points to the fact, it is not sustainable over a medium term period. The average exchange rate has started to depreciate in all segments of the foreign exchange market coupled with the widening of the premia between WDAS window and the other windows of the foreign exchange market. This is clearly an indication of resurgence of speculative demand in the foreign exchange market. To complicate this position, there is high possibility that there may be significant liquidity injection in the second half of the year from the fiscal authority as a result of improvement in the implementation of the capital budget.

In the light of the foregoing, the major risks to the economy in the short to medium term are inflation and depreciation of exchange rate. At the current level of the MPR, a further increase in the rate to address inflation concerns may impose a lot of burden on the end users of fund particularly the manufacturing sector. In as much as we may be willing to trade off the inflationary risk in order to give some breathing space to end users of fund, the necessity to address the speculative demand in the foreign exchange market should be given utmost priority. This is against the backdrop of building a strong buffer in terms of foreign reserves to withstand the likely downturn in global financial and economic environment.

Consequently, I vote for a retention of the MPR at the present rate of 12 per cent and maintenance of the symmetric corridor. In addition, I propose an upward review of the CRR from the present level of 8 per cent to 12 per cent.

## **6.0 MOGHALU, KINGSLEY CHIEDU**

The choice before this meeting of the Monetary Policy Committee is one between the implications of monetary policy decisions such as interest rate hikes on the wider economy giving continuing inflationary pressures and the choice of first principles, which is to say, the core mandates of the Central Bank of Nigeria, including the maintenance of price stability. That choice, in my view, should be exercised within two important contexts. The first context is that the situation, regrettably, is that Nigeria does not have a productive economy today in any real sense, which results in a disproportionate dominance of the financial sector or the “financial economy” that is disconnected from the real economy. Structural economic reforms to reduce dependence on oil as the overwhelming revenue earner and kick-start domestic production have not yet taken place. In this context, the economic logic that drives and should drive the monetary policy decisions of a central bank appears to many to be harmful to the real economy and sometimes even to the intermediation function of the banking sector.

The second context is that, accepting then that the maintenance of price stability is a core mandate of the CBN, the central bank must keep its eye on the ball of its primary mandate, accept in effect that the economy it co-superintends along with the fiscal authorities is one marked far more by financial dominance than by the real sector, and take the necessary decisions that will ensure price stability. This is because the implication of the absence of a substantial real economy is that, whilst monetary policy decisions can be perceived as creating difficulties for intermediation to small and medium scale enterprises (which difficulties in reality are due far more to the lack of structural reforms than to monetary policy), a

collapse of price stability would have far more serious consequences. Such a scenario would be a real train wreck. Nevertheless, one is mindful of the importance of economic growth and the need to avoid, to the extent possible, monetary policy that impedes growth.

What is the state of monetary aggregates that the MPC is confronted with today, and how does the foregoing contextual backdrop provide guidance?

A number of factors are obvious. The most important one is that inflationary trends continue, and may increase if we fail to take appropriate action. As at June 2012, headline inflation increased to 12.9%, core inflation increased to 15.2% but food inflation reduced to 12%. The main drivers of the inflationary pressures include the recent partial removal of fuel subsidy and, I believe, the inflation expectation created by the possibility of the removal of the remaining fuel subsidy, as well as the increase in electricity and import tariffs on wheat and rice. Fiscal expenditures such as releases from the excess crude account and budget implementation pressures, in particular the large portion of the budget devoted to recurrent expenditure, also play a significant role in increasing liquidity in the banking system.

The second major factor is that of the prevailing global trends and their implications for the Nigerian economy, in particular the external reserves and the exchange rate stability of the Naira. Although there has been a reversal in the recent downward trend of the price of crude oil, the economic recession in Europe, sluggish economic recovery in the USA, and the slowing down of economic growth in emerging markets such as China suggest that global demand

for oil is likely to dwindle in the medium term. Crude oil demand from the USA faces a longer term trajectory of decline as the country opens up new oil fields and pursues a strategic policy of promoting alternative sources of energy. Moreover, security and operational challenges mean that Nigeria's crude oil production is not meeting projected levels.

All of these will lead to reduced revenues from oil and a strong adverse impact on the level of external reserves that are needed as a buffer in a negative global environment that is likely to be sustained. These factors will also have an adverse impact on the exchange rate.

Against this background, the broad choices are to hold the Monetary Policy Rate steady, increase the MPR or adopt additional or alternative measures to rein in inflation. In this context it is relevant to consider which or what instrument will address inflation concerns while inflicting as little damage as possible on (a) the banking system, which is only just recovering from a bout of instability owing to reform measures by the CBN but which could build up large non-performing loans if the MPR continues an unrelenting upward trajectory, and (b) the real sector.

This policy conundrum requires the MPC to choose carefully the anti-inflation instrument to utilize at this time, and to keep in reserve the option of further rate hikes to be deployed only as and when necessary. Thus, it is important to address what is at this time, the real McCoy: the liquidity surfeit in the system that encourages Nigerian banks towards arbitrage opportunities in Federal Government of Nigeria (FGN) securities rather than intermediation, as well as

speculative behavior in the foreign exchange market which consistently puts the Naira under pressure.

For these reasons, I vote to:

- (a) Hold the MPR and its corridor steady at 12% and +/- 2% respectively;
- (b) Increase the Cash Reserve Ratio (CRR) from its present 8% to 12%;
- (c) Decrease the Net Open Position (NOP) of banks from 3% of shareholders' funds to 1%.

## **7.0 OLOFIN, SAM**

Some major developments have occurred in the domestic economy since our last meeting that warrant attention from a policy adjustment perspective. As at the end of second quarter in 2012 (Q2 2012) staff reports show that the downward trend in overall growth performance of the economy had not been significantly reversed. Real GDP growth rate is projected at 6.37 percent compared with 7.45 percent in 2011. Manufacturing sector growth estimate has declined from 7.59 percent in 2011 to 5.15 percent, and so has overall industrial production, declining from 1.30 percent in 2011 to 0.65. There is strong evidence of growing inflationary pressure with headline inflation remaining at 12.90 percent, food inflation at 12.0 percent and worryingly core inflation put at 15.2 percent compared with 10.80 percent in 2011 and a three year average (2011-2009) figure of 10.97 percent. Federal Government fiscal operations from Jan – May 2012 show a slight reduction in the budget deficit to N73.53 Bill compared with

N488.84 over the same period in 2011. While this represents a positive development, any further decline in oil prices is likely to have significant impact on fiscal revenues and possibly widen the fiscal deficit. Similarly, the non-full resolution of fuel subsidy removal remains a pressure point on inflation; so does the hike in electricity tariffs, and the likely fiscal injections from oil subsidy savings in Q3 & Q4 2012..

Exchange rates of the Naira have depreciated due to demand pressure and concerns over the decline in international crude oil prices. The rate at the WDAS has depreciated by 11 percent from N157.26 in May 2012 to N157.43 as at July 20, 2012; interbank rate and BDC rates have similarly depreciated by 1.6 percent and 2.5 percent respectively over the same period. The weakening of the Naira may have abated slightly and stability in the foreign exchange market restored, following recent major market intervention by the Bank to the tune of \$4 billion plus. This has resulted in a marginal drop in the level of foreign reserves which prior to the intervention witnessed an increase from US\$32.64 bill. as at end of Dec. 2011 to US. \$ 37.16 as at July 19 2012. This represents a rise of about 13.85 percent; this increase notwithstanding, the rate of accretion is still lower than may be required to beef up buffers, necessary for hedging against likely major external shock to oil prices.

The foregoing developments in the domestic economy notwithstanding, they are not as worrisome as the developments in the global economy, capable of having potentially destabilizing effects on the domestic economy. The rumblings in the Euro market zone with their contagion effects on the U.S and emerging market economies are beginning to indicate a further weakening of a fragile and sluggish

recovery. The euro zone crisis and the resulting global economic consequences could result in further decline in net capital inflows and lowering of oil prices. These would put further pressure on the foreign exchange market and the level of external reserves. The fall in oil prices would significantly reduce government revenues and widen the fiscal deficit. These are highly significant potential developments for a highly import dependent economy in which structural constraints continue to limit the extent to which the real sector can be expected to pick up any slacks resulting from external shocks. Consequently major policy challenges before us at this meeting leave us with very difficult trade-offs between easing the cost of borrowing to stimulate growth, and the need for further tightening in the face of growing inflationary pressures. There is also the challenge of weakening the Naira to ease the pressure on the foreign exchange market without compensating gains in export earnings to bolster reserves as well as reduce domestic and imported inflationary pressures.

On balance, our overriding concern should be on how to continue to ensure satiability in the economy, as efforts are made to address the structural imbalances inhibiting growth in the real sector. We should also pay attention to building adequate buffers to sustain the economy through any major shocks that may result from anticipated developments in the economies of the country's major trading partners. I would therefore vote for the retention of the MPR at 12 percent and its existing corridors, to signal the need to continue to encourage growth particularly in SMEs, and raising the CRR from 8 to 12 percent to tackle the excess liquidity that continues to serve as major source for financing speculative demand at the foreign exchange market. Furthermore it would be

necessary for existing administrative measures to be strengthened, and new ones explored to enhance the rate of accretion to foreign reserves as necessary buffers for tackling anticipated external shocks.

## **8.0 OSHILAJA, JOHN**

The vote I cast today formed a part of the majority of members on the MPC, who voted to increase the Cash Reserve Ratio (CRR) imposed by the CBN, on all banks, from 8% to 12% of deposits. There was also the decision taken to lower the permissible Net Open Position Limit (NOL) from 3% to 1% of capital, for which the voting was unanimous. The CRR is the portion of lendable funds (i.e. customer deposits) each bank is required to maintain on deposit at all times with the Central Bank. The adoption of these measures is consistent with the current tight-policy stance of the Committee.

The increase in CRR drains the banking system of surplus funds, with the potential of contracting the size of banking balance sheets. The reduction in NOL lowers the amount of foreign currency banks may hold in “inventory”, i.e. for their own account and general corporate purposes by roughly, N 48-60 billion. Given total banking deposits of approximately N 12,000 billion, today’s decision effectively immobilizes an additional N 480 billion in excess bank liquidity, roughly 10% of which will likely be off-set by sales of foreign currency for NGN.

When largely driven by consumption-oriented government operations, and not effectively recycled for productive real sector development purposes, surplus banking liquidity can present significant threats to price stability – in the Nigerian context, weakening the currency and thereby fuelling inflation. Evidence

presented to the Committee, over much of the first half of this year seems to suggest that, when not parked in government securities and high grade corporate credits, excess banking system liquidity invariably ends up exerting pressure on foreign exchange rates for the Naira – largely through disinvestment activities. Naira weakness becomes particularly worrisome when this plays a determinant role in adverse price-levels changes. The measures decided upon today, may be therefore viewed as a form of direct intervention by the monetary authorities, intended to curb excess disinvestment from fundamentally Naira-based positions.

#### **9.0 SALAMI, ADEDOYIN**

On the face of it, a rise in inflation from 12.7 percent to 12.9 percent may not warrant significant attention. After all, the figures for headline inflation remain well within the 14.5percent which Staff estimates had projected at the beginning of the year. A closer look at the figures does create room for concern. Specifically, core inflation, supposedly the primary target of Monetary Policy, continues to surge - 15.2 percent in June 2012. An important element in explaining rising Core inflation is the changes in the regime of Administered prices – especially of utilities!

Beyond inflation, circumstances surrounding both the global and domestic economic environments afford cause for concern. Since the last meeting of the MPC, there has been no fundamental improvement in the international environment. The downside risks to global economic activity remain dominant. Notwithstanding the recent rally in spot market prices for crude oil and

indications from futures markets, market fundamentals continue to indicate greater likelihood of weaker crude prices. Lower prices imply that oil based forex inflows are likely to ease with potential adverse consequences for reserve accumulation but especially for the exchange rates. Beyond oil, the drought in the USA and its likely implications for the price of grains is worthy of some attention. While the government has announced the first steps in a programme designed to reduce wheat and rice imports, the effects of the measures announced cannot ameliorate the impact of higher prices on Nigeria.

There is increasingly more evidence in support of slowing domestic activity. Provisional figures, announced by the National Bureau of Statistics (NBS) had indicated 6.17percent growth in GDP for Q1 2012. Its projection for Q2 2012 is 6.37 percent. Both of these numbers are significantly lower than for corresponding period a year earlier. Indeed, the full year projection for output growth is 6.5percent –lower than either the 7.98percent or 7.45percent achieved in 2010 and 2011 respectively. Evidence from corporate performance also provides further support for slowing activity.

Sluggish growth in monetary and credit aggregates – Year-to-date growth of 1.35percent for M2 and 3.6percent for Credit to the private sector – indicates limited intermediation by the financial system. Unsurprisingly, high levels of liquidity continue to characterize the banking system. The puzzle of sharply higher banking profitability in the face of limited credit growth is resolved when we note that the current high interest regime, significant government borrowing coupled with low deposit rates afford financial intermediaries low risk high return

opportunities. In contrast, profitability of non-finance sector corporates is under pressure.

Staff projections for inflation for the rest of the year continue to show Headline inflation in double digits for the rest of the year. It is expected to peak at 13.7percent in July and decline to 11.9percent in December – it is anticipated that the pattern of easing inflationary pressure after July will be disrupted in November, when inflation is projected to rise to 12.7 percent.

My thinking suggests that external influences and structural factors are likely to play dominant role in the determination of inflationary pressure. From the external side, impact of drought in the US on food prices and the strengthening of the US\$ as the flight to safety continues will be key. Domestically, structural factors expected to stoke inflationary pressure revolve around rising administered prices – there is a strengthening likelihood that fuel prices may have to be adjusted to keep the budget within parameters set. In this scenario, the best that monetary policy can do is to minimize that damage which the factors identified can do to the management of inflation. Monetary policy, in this situation, focuses on keeping adverse exchange rate fluctuations.

Banking system liquidity is perhaps the biggest threat to exchange rate stability and inflation management. Raising the policy rate simply affords banks an opportunity to raise lending rates, more than proportionately! In other words, it is another opportunity for the rising banking system profitability. Rising lending rates also portend challenges for financial system stability as loan repayment

ability is impaired and the losses on the portfolio of bonds held by banks – estimated at slightly over NGN210bn - worsen. The Cash Reserve Ratio (CRR) affords a ‘blunt’ instrument to deal with the massing banking system liquidity. It is clear that higher CRR will inflict higher cost on banks and may translate into higher lending rates, the imperative of diffusing the potential pressure on the exchange rate cannot be overemphasized. Indeed, a successful effort at keeping the exchange rate stable will also serve to reduce the rate of foreign exchange reserve depletion. Most importantly however, it is likely to keep inflation from spiraling out of control.

#### **10.0 UCHE, CHIBUIKE**

I am of the opinion that the most important ingredient in achieving sustainable economic development is growing the real sector. Inflation targeting and its attendant price stability objective can therefore only be useful if it helps to achieve the above goal. Unfortunately, in a rentier economy, where fiscal dominance and sub optimal fiscal policies reign supreme, the above goal is difficult to achieve under an inflation targeting regime. In such a scenario, it is always tempting to interpret the meaning of price stability out of context by assuming that the attainment of a single digit inflation rate is the supreme objective of monetary policy. I personally do not agree with such a view. One argument usually canvassed by the proponents of the above view is that keeping inflation low at whatever cost helps to attract foreign investments. This may well be true on the surface. The question to ask however is what kind of foreign investment can we attract under such a regime? The evidence suggests that

under such a scenario one is likely to attract mainly speculative capital. Such FDI which contribute nothing to growing the real sector has the potential to cause more harm than good to our national economy.

Another important point to consider is the implication of further tightening on the stability of our financial system. Although the distress resolution scheme of the current CBN leadership has greatly ameliorated the instability in the financial system, it is clear serious systemic risks which at least in part are being fuelled by the pursuit of monetary policy where containing inflation is the primary objective are beginning to emerge. The high interest rates that have emerged from this regime and the fiscal behaviour of government have led to increased government borrowings from the financial system. Arguably the most disturbing part of such borrowing is the long term debt instruments backed by recurrent rent income streams. As is now understood within the Central Bank, rising interest rates have ensured that any attempt to mark such government bonds to market prices even at the present time would cause serious problems for financial system stability. Furthermore, it has been established that there is a clear relationship between increase in interest rates and non-performing loans of banks. The question therefore is: at what level will continued tightening of interest rates trigger another banking crisis? In my view therefore, Inflation targeting has doubtful utility in a rentier economy.

Admittedly, it has been rightly argued that historically in Nigeria, single digit MPRs do not have a strong positive relationship with the growth in real sector credit and thus have never really benefitted that sector which no doubt has a plethora of other problems to contend with. While I concede this point, I am of the view

that operators in the real sector should be seen as victims of the structure of the Nigerian economy rather than villains. More important however is the fact that since it is extremely difficult to meaningfully grow our economy without growing the real sector, monetary policy has no choice but to explore novel ways of supporting this important sector. At the very least, we need to remove impediments to the growth of this important sector. In this direction, for instance, it is troubling that in the past, increasing interest rates have only led to increased margins between deposit and lending rates. This is no doubt the classic scenario in an oligopolistic market where collusion thrives. A margin of almost 20 percent between savings and borrowing rates is clearly not supportive to both savings and growing the real sector. The role of banks in the intermediation process can be likened to the role of establishments that buy and sell goods in the market with mark-ups of almost one thousand percent. Clearly, this cannot be healthy or acceptable in any economy. We therefore need to consider putting in place some kind of controls on the intermediation margins of Nigerian banks. Another innovative way that can help reduce the margins associated with intermediation is to design policies that can help promote the activities of profit and loss banks. On the balance, I am also of the opinion that the current high intermediation margins cannot be in the long term interest of Nigerian banks. It is also remarkable that jobs in the Nigerian banking sector have shrunk consistently in the past three years. The two possible outcomes from the above policy choices: reduction in lending rates or increase in savings rates would be of great benefit to our economy. Adopting market prices for securities without doing same for savings distorts development by encouraging the outflow of local savings and the inflow of speculative FDI. The growing portfolio of domiciliary accounts in

Nigerian banks is a clear pointer to this. Low interest rates on savings, is no doubt positively correlated with capital flight.

Finally, I am of the view that while an MPR hike may look attractive given the current increase in inflation rates and especially in a situation where price stability is seen as an end in itself, it is of doubtful utility in our current circumstance. This is so because such a hike will negatively impact on real sector credit; encourage inflow of speculative FDIs; and discourage local savings. I have therefore carefully come to the conclusion that our best chance to impact positively on real sector economic development is to maintain the status quo. I therefore vote as follows: (1) to retain MPR at 12 percent and the interest rate corridor of +/- 200 basis points; (2) to retain CRR at 8 percent; and (3) to retain Liquidity Ratio at 30 percent.

## **11.0 SANUSI, LAMIDO SANUSI**

### **Governor of the Central Bank of Nigeria and Chairman of the Monetary Policy Committee**

Recent developments in the Nigerian economy coupled with the continued global economic crisis have posed some challenges for the achievements of monetary policy goals. Generally the economic environment has witnessed with significant pressures on both domestic prices and the foreign exchange rate. Inflationary pressure has not abated, threatening price stability objectives. As at June 2012 headline inflation rate rose to 12.9 in June, 2012 from 12.7% in May, 2012, while core inflation rose to 15.2% in June 2012, of which imported food inflation rose to

18.5%. Real GDP growth rate also slowed and was estimated at 6.37% in Q2 2012 compared to 7.45% as at end of 2011. Growth in Industrial production has declined from 5.82% in 2010 to 1.30% in 2011 and 0.65% as at Q1 2012 while manufacturing output growth declined from 7.59% in 2011 to 5.15% in Q1 2012. Agricultural output growth has not performed better, rising marginally from 5.7% in 2011 to 5.71% in Q1 2012.

The monetary sector has been awash with significant liquidity in the banking sub-sector without significant expansion in credit to the real sector or a decline in lending rate. The spread between the deposit and maximum lending rate has remained very wide discouraging mobilization of domestic savings. The spread between the average maximum lending rate and the consolidated deposit rate widened to 19.62% as at June 2012. The exchange rate weakened in between MPC meetings due to external shocks in the forms of declining crude oil prices but recovered recently as oil markets strengthened a bit. At the interbank market, the naira exchange rate has depreciated to N161.24 as at 20<sup>th</sup> July, 2012 from N158.60 - representing 1.66% depreciation, while at the BDC the rate depreciated to N164 from N160 – representing 2.5%

The global scene has remained uncertain with further escalation in the financial crisis of the euro area periphery and slow growth in emerging market economies. The fragile and weaker external environment suggests decline in export growth as global demand shrinks and volatility in commodity prices persist

Given this scenario, there are indeed serious concerns about domestic prices, particularly inflation, declining international oil prices, external reserve depletion,

weakening of Naira exchange rate and decline in real output growth rate. Certainly a large proportion of these concerns can best be curtailed by addressing the structural rigidities bedevilling the economy, which is beyond the policy space of monetary policy.

It is clear to me that there is strong evidence to suggest a significant correlation between interest rate and GDP growth rate. It is also clear to me that the current slowdown in GDP growth rate is not necessarily due to the high cost of fund or freeze in credit to the real sector. This suggests the need for caution in the expectation of the efficacy of using of interest rate as a tool for stimulating real sector growth or general economic activities. Focusing on the core mandate of the MPC Committee of price stability conducive for growth, I am compelled to lean more towards addressing the immediate impact of the rising inflation rate and depreciation of the naira. The policy choices are quite limited and the trade-offs are complex given the weak inter linkages of the economic sectors.

While a hike in the policy rate is not necessarily an unavoidable option, the need to address the liquidity excesses of DMBs in order to curtail the demand pressures in the forex market and build external reserves buffers against the threat of future revenue decline is very clear to me. In order to effectively sterilize the excessive liquidity in the banking system, the need to adjust the CRR is inevitable. My initial interest is also for an increase in the MPR in order to send a clear signal of our commitment to the primary goal of price stability. However, I am not totally in disagreement with the sound view of the majority that a MPR hike may also show insensitivity to the plight of the real sector borrowers. For this reason, I

will join the majority and vote for a hold in MPR at current bands subject to increasing CRR.

It is extremely important to reiterate that price stability (or stability in general). Is not everything Growth and development have to happen and this requires structural reforms and a better record of implementation of the Budget. However, although stability is not everything, without stability there is nothing. The dark clouds on the global horizon mean we have to prepare the economy against external shocks and build the right buffers. The costs to the borrowers and to the banks are known but unavoidable.

For the above reasons, I vote for:

1. Retention of MPR at 12 per cent (+/- 2 per cent)
2. Increase in CRR from 8 per cent to 12 per cent and
3. Reduction in NOP from 3 per cent to 1 per cent.