Central Bank of Nigeria Communiqué No. 72 of the Monetary Policy Committee Meeting, September 21, 2010

The Monetary Policy Committee (MPC) met on 21st September, 2010 to review domestic economic conditions during the first eight months of 2010 and the challenges facing the Nigerian economy against the backdrop of developments in the international economic and financial environments in order to reassess the options for monetary policy for the rest of the year.

On the global scene, the Committee noted that there had been a marked softening of the global economic recovery, with developments in the US and China giving cause for concern. While the US economy declined in the third quarter, reflecting the renewed deterioration in the housing market and the lackluster labor market performance with private sector job creation still weak, China's massive official stimulus packages, estimated at 14 per cent of GDP and focused on infrastructure and housing, did not only boost aggregate demand but also fed into a property bubble which the government is battling to contain. As a result, growth in China, which overtook that of Japan in the second quarter of 2010 to making the former, the world's second-largest economy, is now declining.

In the Euro Zone, a degree of calmness had returned to the debt market following the approval of a €750 billion (US$925 billon) European Financial Stability Facility (EFSF). However, fresh concerns have emerged regarding the high risk aversion in the market, as reflected in the widening of spreads between German bonds and those of weaker peripheral countries, such as Greece, Ireland and Portugal. In addition, many of the region's banks remained fragile and vulnerable to funding constraints due to their dependence on the wholesale markets. However, Greece whose fiscal problems ignited the Euro-zone crisis continues to make better than expected progress in fiscal reforms.

Notwithstanding the recent weakening of growth globally, the possibility of a double-dip recession is not very likely. The softening of growth could be seen as a natural adjustment from a period of unsustainably rapid stimulus-driven activity from mid-2009, to a slowing phase of consolidation.

On the domestic front, the MPC noted the relative stability achieved in the financial markets, while urging greater efforts in accelerating reforms in the other sectors of the economy, to attain self-sustaining growth. The MPC welcomed the continuing rebound in commodity prices which is helping to support growth in commodity producing regions, including Nigeria, but reiterated the need to diversify the economy to protect the country from the vagaries of oil price volatility. The Committee believes that the inflation risk of the rebound in energy prices appears mitigated by the continuing weak private demand, good harvest, and well-anchored inflation expectations.

Key Domestic Macroeconomic and Financial Developments

Output and Prices:

The Committee observed that the impressive output growth recorded in 2009 continued in 2010. Provisional data from the National Bureau of Statistics (NBS) indicates that real Gross Domestic Product (GDP) grew by 7.69 per cent in the second quarter of 2010 up from 7.36 per cent recorded in the first quarter. GDP has been projected to grow by 7.72 and 8.19 per cent in the third and fourth quarters of 2010, respectively. Overall GDP growth for 2010 is projected at 7.78

per cent which is higher than the 6.96 per cent recorded in 2009. The non-oil sector is expected to remain the main driver of overall growth, with agriculture, wholesale and retail trade, and services contributing 2.40, 2.04 and 2.08 per cent, respectively.

The Committee believes that the impressive growth forecasts reflect prospects for continuing favourable rainfall in the remaining months of the rainy season to support the production of major crops across the country, coupled with the current peace in the Niger-Delta, which has boosted crude oil and natural gas production. Crude oil prices are expected to remain fairly stable at their current levels in the international market following the slow but steady economic recovery being recorded in most advanced economies. The MPC, however, cautioned that the projected slowdown in economic activity in some major advanced economies, including the US and emerging Asia poses a clear threat to the economies of commodity-producing countries like Nigeria. While urging greater efforts at diversifying the economy, the Committee stressed the need for policy reforms to address the binding growth constraints on the domestic economy, especially, infrastructural inadequacy.

The MPC welcomes the recent revision and rebasing of the Consumer Price Index (CPI) by the National Bureau of Statistics (NBS) to reflect the current structure of consumption in the economy. Based on the revised and rebased CPI, the year-on-year headline inflation rose to 13.7 per cent in August 2010 from 13.0 per cent in July 2010. Similarly, core inflation increased to 12.4 per cent in August from 11.3 per cent in July 2010. Food inflation also trended upward to 15.1 per cent from 14.0 per cent in July 2010. The upward trend in the domestic price level could be attributed to the late commencement of rains in some food producing regions in the northern part of the country, which may have affected the production/supply of some staple food items, while some non-food components of the new CPI basket also recorded price increases.

The MPC reiterated its earlier position on the threat of inflationary pressure arising from several other factors including implementation of the new salary structure in the civil service, expected fiscal injections arising from electioneering expenses and the injections relating to AMCON purchase of non-performing loans of DMBs, spillover effects of the rising food prices from famine in neighboring Niger Republic and floods in Asia, deregulation of energy prices as well as the expected increase in household-spending toward year-end festivities. The Committee supports the deregulation policy of the Federal Government but would, continue to monitor price developments with a view to taking appropriate policy measures to stem any inflationary threat and ensure that the upside risk of inflation to growth is minimized.

<u>Monetary, Credit and Financial Market Developments:</u>
Provisional data showed that relative to end-December 2009, broad money (M2) grew by 7.0 per cent in August 2010, which, when annualized represented a growth of 10.50 per cent. Reserve money (RM), which stood at N1,653.86 billion at end-December 2009, fluctuated downward and by September 13, 2010, stood at N1,407.51 billion.

Available data showed that in August 2010, aggregate domestic credit (net) grew by 18.0 per cent over the December 2009 level, and by 27.0 per cent when annualized. Credit to government (net), which grew substantially by 65.81 per cent over end-December 2009 (or 98.72 per cent on annualized basis), was the major contributor. Credit to the private sector, on the other hand, declined by 0.91 per cent (or 1.37 per cent on an annualized basis). The Committee believes that in order to provide the private sector with the necessary credit to grow the economy, further efforts were needed to restore confidence to the credit market and to unlock the flow of credit to the real economy. In general monetary aggregates are growing but remain below indicative benchmarks for the year.

The rates at the interbank segment of the money market remained stable and low, owing to the prevailing banking system liquidity and the de-risking of the market through the CBN guarantee of the interbank transactions. Consequently, in August 2010, the average inter-bank call and open-buy-back (OBB) rates fell significantly to 1.26 and 1.25 per cent, respectively, representing decreases of 233 and 195 basis points from the 3.59 and 3.20 per cent recorded in the preceding month. In line with the decrease in rates at the inter-bank call and OBB segments, the 7- and 30- day NIBOR rates decreased by 62 and 196 basis points to 3.85 and 4.55 per cent, respectively, from 4.47 and 6.51 per cent in July. As at September, 17, 2010, inter-bank call and OBB rates increased averaging 3.56 and 2.91 per cent, respectively.

Developments in retail market interest rates indicated that the retail lending rates were still relatively high. The average maximum lending rate rose to 22.31 per cent in August 2010 from 22.27 per cent in July. However, the average prime lending rate declined to 16.89 per cent in August 2010, from 17.40 per cent in July.

The weighted average savings rate dropped to 1.41 per cent in August 2010 from 1.62 per cent in July. The consolidated deposit rates declined to 2.27 per cent in August 2010 from 2.40 per cent in July. Thus, the spread between the average maximum lending rate and the consolidated deposit rate rose marginally to 20.04 per cent in August 2010 from 19.87 per cent in July.

The Committee noted that the key policy challenges remained the continuing sub-optimal growth in money supply coupled with the negative growth in private sector credit as well as the subsisting high retail lending rates in the face of substantially low wholesale inter-bank and retail deposit rates.

The Nigerian capital market, which was showing signs of recovery, recently turned bearish. The All-Share Index (ASI) decreased from 25,384.14 at end-June 2010 to 22,993.77 as at 17th September, 2010, or by 9.4 per cent. Market capitalization (MC) - equities only, decreased by 8.7 per cent from N6.17 trillion to N5.63 trillion over the same period. The number of deals, volume and value of shares traded decreased by 4.6, 14.8 and 6.1 per cent, respectively. The decrease in ASI and MC was principally due to the share price decreases in the Banking, Food & Beverage, insurance and Oil/Gas sectors. The Committee believes that an early resolution of the leadership impasse at the NSE and effective take-off of the Asset Management Corporation (AMCON) would facilitate the return of the stock market to the path of recovery.

<u>External Sector Developments:</u>

The foreign exchange market remained relatively stable over the review period. The total foreign exchange inflow in July 2010 was US$2.25 billion, representing an increase of US$0.19 billion or 9.22 per cent over the US$2.06 billion recorded in the preceding month. Of this inflow, crude oil/gas revenue was US$2.16 billion or 93.97 per cent while other inflows represented the balance of US$0.09 billion or 6.03 per cent.

Total outflows or payment in July 2010 amounted to US$4.03 billion, representing an increase of US$0.15 billion or 3.78 per cent above the US$3.88 billion recorded in the preceding month. Consequently, the net outflow during the review period was US$1.78 billion.

Inflows from autonomous sources for the months of July and August 2010 were US$5.3 billion and US$4.7 billion, respectively. Over the period January to August 2010, total foreign exchange inflows to the market amounted to US$ 52.00 billion comprising funds from the CBN amounting to US$14.09 billion or 27.1 percent, while the balance of US$37.91 billion (or 72.91 percent) came from autonomous foreign exchange sources such as oil companies, international institutions and home remittances. The Committee noted with satisfaction that the autonomous inflows had helped in moderating demand pressure for foreign exchange in the WDAS segment of the foreign exchange market. Thus, the autonomous inflows continue to augment the official inflow to ensure steady supply of foreign exchange to the market.

In August 2010, the WDAS rate opened at N150.01/US$1 (inclusive of 1% commission) and closed at N150.78/US$1, at an average exchange rate of N150.27/US$1 for the month. This represented a depreciation of 17 kobo (0.11 per cent) when compared with the average closing rate of N150.10/US$1 recorded in July 2010. As at 17th September, 2010 the exchange rate depreciated by 18k to N150.96/US$1 (plus 1% commission) from N150.78/US$1 recorded on August 31, 2010.

The BDC segment of the market recorded average selling rates of N152.23/US$1 and N152.41/US$1 in the months of August and July 2010 respectively, representing an appreciation of 0.11 per cent. At the inter-bank market, the average selling rates for August and July 2010 were N150.70/US$ and N150.27/US$ respectively, and represented a 0.3 per cent depreciation. As at September 17, 2010 the interbank and BDC rates were N152.05/US$1 and N153.50/US$1 respectively. The WDAS, interbank and BDC segments of the foreign exchange market witnessed mild naira exchange rate depreciation.

Thus, the stability of the naira exchange rate attained in the foreign exchange market since the first half of 2009 continued into the third quarter of 2010.

The Committee observed that the naira exchange rate had remained stable in all segments of the market during the review period, reflecting increased confidence and the efficacy of the current exchange rate policy stance. The MPC believes that the relative stability in the foreign exchange market was likely to be sustained in the near term. The Committee would continue to monitor developments in the market to ensure that measures are taken to eliminate speculative demand and exchange rate volatility.

The gross external reserves stood at US$36.636 billion on 13th September, 2010 and represented a decrease of US$0.50 billion or 1.3 per cent when compared with the level of US$37.16 billion as at end-July 2010. The Committee, however, noted that the current external reserves level is still adequate and is expected to remain robust in view of the favorable outlook for oil price and output. Consequently, there is no compelling reason to alter the existing exchange rate regime stability will remain a priority.

The Committee's Considerations

The Committee, after a review of the domestic and international financial and economic developments, noted with satisfaction the sustained macroeconomic stability and welcomed the explicit commitment of the federal government to resume implementation of power sector reforms in line with the committee's recommendations at prior meeting. The Committee, however, sounded a note of caution on the possibility of inflationary build up arising from several other sources as has been highlighted earlier.

The Committee noted that the resumption of growth in M2 is a welcome development, as it has reversed the stagnation recorded from January through June 2010. The Committee also observed the gradual restoration of financial stability and anticipated repair of banks' balance sheets when the Asset Management Corporation of Nigeria becomes operational. In view of the foregoing the MPC underscored the importance of balancing the inflation risk with financial sector stability objective.

The MPC observed that the large demand for foreign exchange noticed during the review period resulted from among others, remittance of dividends by some companies and enhanced importation of refined petroleum products due to the Federal Government sovereign debt instruments. Thus there was no evidence of speculative demand or capital flight observed in the foreign exchange market.

The Committee noted the federal government's efforts to raise funds from the domestic capital market to execute vital infrastructural projects and urged for continuous coordination of monetary and fiscal policy as well as underscored the need for fiscal consolidation so as to ensure macroeconomic stability. The Committee commended the commitment of the Federal Ministry of Finance/Securities and Exchange Commission to the reforms in the capital market and efforts to get the oil/gas and telecommunication companies listed on the Exchange. The MPC further observed that the declining share of the banking sector in market capitalization is a positive development, which is good for rebalancing the market to reduce the overwhelming influence of the banking sub-sector.

The MPC commended the government for resuming the power sector reforms and its decision to fast track them, which it believes will impact positively on the cost structure of the economy. Furthermore, the MPC commended and endorsed the CBN discussion with PENCOM aimed at realizing part of the accumulated pension funds to finance power sector projects on a long term basis. It noted that this initiative will assist in shielding the power sector funding from the vagaries of the volatility of the international capital market, and exchange and interest rate risks.

Conclusion

Having considered the above factors, the Committee considered it imperative to commence policy actions aimed at moderating the inflationary pressures in the economy, particularly given the outlook for government spending in an election year and the liquidity implications of the purchase of non-performing loans (NPLs) by AMCON. The Committee is satisfied that sufficient progress has been made in banking sector reforms to mitigate the risk of moderate tightening in financial institutions.

<u>Decisions</u>

In the light of the above, the MPC took the following decisions:

1. The Resumption of active Open Market Operations for the purpose of targeted liquidity management;
2. An increase in MPR by 25 basis points from 6.0 to 6.25 per cent ; and
3. Adjustment of asymmetric corridor to 200 basis points above and 300 basis points below the MPR for the Standing Lending Facility and Standing Deposit, respectively. This effectively increases interest payable on standing deposits with the CBN by 225 basis points forthwith.

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