Central Bank of Nigeria Communiqué No. 70 of the Monetary Policy Committee Meeting, May 10-11, 2010

The Monetary Policy Committee (MPC) met on 10th and 11th May, 2010 to review domestic economic conditions during the first four 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 course for monetary policy for the remainder of the year.

On the global scene, the Committee noted that the recovery in global economic activity, which started in the second half of 2009, has evolved better than expected although large fiscal deficits continue to pose a threat. The recovery, which was driven largely by the unprecedented fiscal and monetary policy stimuli undertaken in both the developed and emerging market economies in response to the global economic slowdown, was progressing at varying degrees across the different regions. In the advanced economies, recovery is progressing. Among emerging and developing economies, Asia is taking the lead although growth is solidifying in key Latin American countries. Sub-Saharan African countries have thus far, weathered the global crisis well, and their recoveries are expected to be stronger than in previous global downturns.

Across the globe, real and financial activities have been mutually supportive in their recovery. Although the money markets have stabilized, and corporate bond and equity markets have rebounded, access to credit remained difficult for some sectors, especially small firms and households that lack access to the capital markets. Although, the tightening of bank lending standards and the credit crisis appear to be bottoming out, the resumption of credit growth in many emerging and developing countries has been weak. In the advanced economies, eroded bank capital is likely to remain a constraint on growth as banks continue to repair their balance sheets. In a few advanced economies, particularly the Euro area, rising public sector deficits and debts accumulated in the wake of the crises as part of measures to stimulate growth, have heightened sovereign risk premia, thereby posing additional risks to the recovery process.

The MPC observed that the domestic financial markets have recovered remarkably faster than expected, though still fragile, and urged greater efforts in accelerating the reforms in the different segments of the financial system to promote financial sector stability which is critical to economic growth. In particular, deep and liquid capital markets and strong and effective insurance companies, pension funds and other institutional investors are critical for establishing the balance required for the attainment of financial system stability. While noting that financial market inefficiencies and supervisory and regulatory failures were at the root of the current crisis, it welcomed the relative stability that has been achieved in most segments of the market in response to the various measures taken by the regulatory authorities and emphasized the need for its sustenance.

The MPC also noted the continuing rebound in commodity prices, particularly crude oil prices, which is helping to support growth in commodity producing regions, including Nigeria. However, the inflation risk of the rebound in energy prices appears to be mitigated by the subsisting low levels of capacity utilization, weak private demand and well-anchored inflation expectations.

Key Domestic Macroeconomic and Financial Developments

Output and Prices:

The Committee observed that the robust 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 6.68 per cent in the first quarter of 2010, down from 7.44 per cent in the fourth quarter of 2009, but up from the 4.50 per cent recorded in the first quarter of 2009. NBS also projected that the GDP is expected to grow by 7.24, 7.36 and 8.51 per cent in the second, third and fourth quarters of 2010, respectively. Overall GDP growth for 2010 was projected at 7.53 per cent which is higher than the revised estimate of 6.66 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 2.61, 2.09 and 2.14 per cent, respectively. The Committee noted that the impressive growth forecasts reflect prospects for moderate rainfall in 2010, which is expected to support the production of major crops across the country, and the sustained peace in the Niger-Delta, which would boost crude oil and natural gas production. The MPC, however, noted that at a mere 4 percent share of GDP, the manufacturing sector needed revamping to enhance its role in boosting growth and employment generation. In this context, it called for appropriate sector-specific policies to drive manufacturing growth.

The year-on-year headline inflation rose from 12.0 per cent in the last quarter of 2009 to stabilize at 12.3 per cent in January and February 2010 and declined to 11.8 per cent in March 2010. Similarly, core inflation rose from 9.7 percent in the last quarter of 2009 to stabilize at 10.1 per cent in January and February 2010, before declining to 9.5 per cent in March 2010. The downward trend in the domestic price level could be attributed to a number of factors, including the continuing underperformance of monetary aggregates, with the associated constrained demand, availability of food stuff, and improvement in the supply of petroleum products, amongst others. Notwithstanding these developments, the Committee restated its earlier position that the threat of inflationary pressure in the near-to-medium term remains real given the expansionary stance of the 2010 Federal Government budget and the anticipated increase in spending usually associated with the run-up to election across the country. In this regard, the MPC confirmed that it will continue to monitor price developments in the months ahead with a view to ensuring that the downside risk of inflation to growth is minimized.

Monetary, Credit and Financial Market Developments:

Provisional data showed that relative to end-December 2009, broad money (M2) grew by 2.3 per cent at end-March 2010, which, when annualized represented a growth of 9.02 per cent, compared to the indicative growth target of 29.26 per cent for 2010. Reserve money (RM), which stood at ₦1,668.50 billion at end-December 2009, declined to ₦1,574.33 billion and ₦ 1,636.60 billion in January and February 2010, respectively, but rose to ₦ 1, 782.21 billion in March 2010. As at April 27, 2010, the RM level of ₦1, 497.1 billion was below the provisional 2010 second quarter indicative benchmark of ₦1, 872.80 billion by ₦375.52 billion or 20.06 per cent.

Available data showed that in March 2010, aggregate domestic credit (net) grew by 6.1 per cent over the December 2009 level, and by 24.5 per cent when annualized, which is far below the 2010 indicative target of 55.54 per cent. Credit to government (net), which grew by 28.4 per cent (or 113.6 per cent on annualized basis), was the major contributor to the growth in aggregate credit (net) in March 2010, as credit to the private sector declined, by 1.7 per cent (or 6.8 per cent on annualized basis). The annualized growth rate of credit to the private sector of -6.8 per cent was far below the provisional growth benchmark of 31.54 per cent for 2010. The substantial growth of credit to government (net) reflects the risk aversion of the DMBs to lending to non-government borrowers, implying the crowding out of private sector credit.

During the first four months of 2010, the downward trend in interest rates in the domestic money market, which began in July 2009, following the Bank's decision to guarantee interbank transactions, continued. The low rates provide ample evidence of sufficient liquidity and restored confidence in the money market. The weighted average interbank call rate, which was 2.89 per cent as at end-December 2009, declined to 2.48, 2.17, and 1.50 per cent in January, February and March 2010, respectively. The downward trend continued to 1.27 per cent on April 30, 2010. Similarly, the securitized open-buy-back (OBB) rate, which was 2.64 per cent at end-December 2009, declined to 2.46, 2.20, and 1.31 per cent in January, February and March 2010, respectively. The rate further declined to 1.11 per cent on April 30, 2010, compared with the monetary policy rate (MPR) of 6.00 per cent and Standing Deposit Facility rate of 1.0 per cent.

The falling interbank rates appear to reflect marginally on the DMBs' lending rates. The retail lending rates have started declining *albeit* by far lower magnitudes than the decline in inter bank rates. The average maximum lending rate dropped to 22.88 percent in March 2010 from 23.32 and 23.18 per cent in February and January 2010, respectively. The rate was 23.45 per cent in December 2009. Also, the average prime lending rate dropped to 18.06 per cent in March 2010 from 18.28 and 18.38 per cent in February and January 2010, respectively. In December 2009 the rate was 19.03 per cent. Similarly, the weighted average savings rate dropped to 3.20 per cent in March 2010, from 3.33 per cent in January 2010 and 3.38 percent in February. As at end-December 2009, the average savings rate stood at 3.36 per cent. The consolidated deposit rates declined to 3.88 percent in March 2010, down from 5.44 per cent in February and 6.13 percent in January 2010. As at end-December 2009, the consolidated rate was 6.13 per cent. Despite the decline in deposit rates, the spread between the average maximum lending rate and the consolidated deposit rate widened to 18.99 percentage points in March 2010, up from 17.88, 17.05 and 17.34 percentage points in February and January, 2010, and December 2009, respectively. The Committee noted that the key policy challenges remain the negative growth in credit to the private sector, and subsisting high lending rates in the face of declining inter-bank rates and relative liquidity surfeit in the banking system.

Compared to the last quarter of 2009, the Nigerian capital market is recovering. The All-Share Index (ASI) increased by 27.0 per cent from 20,827.17 as at end-December 2009 to 26,453.20 on 30th April, 2010.

Market Capitalization (MC) also increased, by 28.3 per cent, from ₦4.98 trillion at end-December 2009 to ₦6.39 trillion over the same period. The number of deals, volume and value of shares traded increased by 58.1, 87.7 and 216.0 per cent, respectively, during the review period. The increase in ASI and MC was partly due to share price increases in the Banking, Food & Beverage and Oil/Gas sectors.

The Committee welcomed the continuing improvement in the stock market, and noted the potentials for further recovery with the passage of the Asset Management Corporation (AMCON) Bill. It, however, emphasized that the recovery of the capital market does not necessarily translate to economic recovery as the reforms initiated in other sectors of the economy needed to be carried through to complement financial sector reforms in order to grow the economy. The Committee would, however, continue to monitor the recovery of the capital market to ensure that a bubble is not once again being formed.

<u>External Sector Developments</u>:

The foreign exchange market remained relatively stable in the first four months of 2010. At the WDAS, the review period opened with an exchange rate of N149.08/US$1 and closed at N150.10/US$1, with an average closing rate of N149.92/US$1 for the period. When compared with the average closing rate of N147.36/US$1 recorded in April 2009, this represented a depreciation of N2.56 (0.017 per cent). The average exchange rate depreciated at the inter-bank market from N150.35/$ in the fourth quarter of 2009 to N150.80/$ in April 2010. The premium between the average WDAS closing rate of ₦149.94/US$1 and the average selling rate of ₦150.80/US$1 at the inter-bank foreign exchange market widened to ₦0.86/US$1 (0.57 per cent), from ₦0.51/US$1 (0.35 per cent) recorded in the first quarter of 2009, while that between the WDAS average exchange rate and the BDCs rate narrowed to ₦2.53/US$1 (1.69 per cent), from ₦13.61/US$1 (9.27 per cent) in the first four months of 2009.

The Committee observed that the naira exchange rate has remained stable in all segments of the market during the review period, reflecting increased confidence in the Naira and the efficacy of the current exchange rate policy stance of liberalizing the foreign exchange market which has enhanced foreign exchange supply from autonomous sources. It believes that the relative stability in the foreign exchange market is likely to be sustained in the near term. The Committee will, however, continue to monitor developments in the market to ensure that measures are taken to eliminate speculative demand and volatility in the market.

The gross external reserves stood at US$40.31 billion as at 30th April, 2010, representing a marginal decrease of US$0.37 billion or 0.91 per cent relative to the level of US$40.68 billion as at 31st March 2010. The MPC noted that although the level of external reserves were sufficient to finance 17 months of current imports, which is well above the internationally recommended benchmark of 3-months import cover, it believed that with the rising price of crude oil in the international market in recent months, coupled with the improvement in output with peace in the Niger Delta, there is likely to be an accretion in the level of foreign exchange reserves in the near term.

The Committee's Considerations

The key concerns for policy in this era of global recovery were identified as follows:

1. Ensuring that the growing risk of fiscal deficit accumulated in the wake of the abating global financial and economic crises does not endanger the stability of financial markets. In most of the affected countries, the huge fiscal deficits arose not only from increased spending but also from reduced revenues, thus suggesting the need for greater focus on revenue generation in the finances of government.

2. Monitoring imbalances in capital flows across industrial and emerging markets resulting in different rates of recovery. This is to ensure that inflows of capital into the country are sustainable and thus avoid formation of asset price bubbles.
3. The continuing global credit crunch despite unprecedented measures taken by central banks to inject liquidity in troubled financial institutions/markets. This underscores the need for focus on both supply side (monetary) and demand side (fiscal factors) in unlocking the credit markets.

With regards to the continuing credit crunch, the MPC reemphasized that credit growth is a function of demand and supply factors. As the Central Bank is working to improve the supply side through the various reform measures to strengthen the DMBs' balance sheets, remove toxic assets, and generally repair the banking system to promote the flow of credit, the demand side would necessarily require critical reforms in the real sector, particularly power, energy, and key infrastructure to reduce the cost of doing business and improve investment climate to generate bankable projects.

The MPC noted with satisfaction that, overall, the Bank has achieved its mandate of price and financial stability, as reflected in relatively stable exchange rates, interest rates and moderating inflation. By the time the

AMCON Bill is harmonized and finally passed by the National Assembly and implemented, the repair of banks' balance sheets would unlock the flow of credits to the real economy. In this regard, the MPC enjoins other stakeholders in government to undertake complementary measures to enable economic agents translate the stable macroeconomic environment into economic growth and development.

Overall, the Committee decided that there is a need to maintain and extend the focus on stability and avoid decision that may cause disruption. In view of the inflation outlook in the short-term, it was felt that the reversal of accommodative monetary stance at this time would be premature.

The Committee however, noted that in the next quarter monetary expansion may be driven by increased government spending, the purchase of toxic assets by the AMCON and recapitalization of distressed banks. These expansions may translate into the risk of higher inflation, asset price bubbles or pressure on exchange rate and foreign reserves. The next MPC in July will assess these risks and take appropriate actions.

Decisions

In the light of the above, the MPC decided as follows:

1. Leave the MPR unchanged at 6.0 per cent.

2. Retain the asymmetric corridor of interest rates at 200 basis points above the MPR and 500 basis points below the MPR for the Standing Lending Facility and Standing Deposit Facility, respectively

3. Extend the CBN guarantee for all interbank transactions and foreign credit lines as well as pension funds' placements with banks from December 31, 2010 to June 30, 2011. This is to provide ample time for the conclusion of the banking sector resolution and the publication

of audited accounts for the period up to December 2010. It is expected that by June 2011 all creditors and investors will have sufficient information to take an independent view of the risk of individual counterparties.

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