MONETARY, CREDIT, FOREIGN TRADE AND EXCHANGE RATE POLICY GUIDELINES FOR FISCAL 2004/2005
[Re: Monetary Policy Circular No. 37]

Amendments and Addendum

Introduction

The Central Bank of Nigeria (CBN) has since 2000 adopted a medium term monetary policy framework. The current Guidelines, issued for 2004 and 2005 (***Monetary Policy Circular No. 37***) are still valid until the end of 2005. However, as indicated on Page 1 of the document, there is a need for periodic "amendments in the light of developments in the financial markets and performance of the economy during the programme period".

Since the current Guidelines were issued in January 2004, several important developments in the financial sector as well as the general economy have occurred. In 2004, the developments in the financial sector necessitated the 13-point reform agenda announced in July aimed at preventing an imminent systemic crisis, promoting transparency and competitiveness in the sector and strengthening it to become an important part of the global financial system. A key element of the reform agenda is the amendment requiring banks to increase their total capital base (shareholders' funds) to N25 billion to be met by end December 2005. These reforms have introduced new dynamics into the financial system and the consolidation process is proceeding satisfactorily, albeit with several challenges to be overcome in 2005.

On the larger economy, the Federal Government appears to be resolutely committed to the implementation of the National Economic Empowerment and Development Strategy (NEEDS). The implementation of the 2004 budget was generally a success as the Government kept within the broad targets set. The excess earnings from crude oil (in excess of the budget benchmark price of US$25 per barrel) were saved, and this amounted to about US$5,943.60 million. We commend the fiscal authorities and the state governments for the fiscal restraint, and this played an important role in achieving broad macroeconomic stability in 2004. Other aspects of the NEEDS agenda, especially in the areas of liberalization of downstream oil sector, greater spending on the social sectors (health and education), improvement in capital expenditure and infrastructure delivery, institutional reforms, milestone legislations by the National Assembly (such as the Pension Reform Act; Anti-Money Laundering Act; etc) also appeared to be on course. The commitment to the success of the NEEDS agenda is extraordinary given the history of similar plans in Nigeria in the past. For the first time in decades, the Government seems to have kept to the effective implementation of its plan, and the broad targets set have been achieved or even surpassed in many cases.

The CBN was successful in keeping to its targets. For the first time in almost two decades, the CBN met the monetary policy target on growth of broad money (M2) in 2004. The 2003 end-period inflation rate of 23.8 percent was drastically reduced to about 9.5 percent by the end of 2004, which is consistent with the single digit inflation target set under the NEEDS, although the 12 months moving average inflation remained at 15 percent. Similarly, the provisional GDP growth rate of about 5.5 per cent in 2004, exceeded the set target. As shown in table 1.1, the outcomes for 2004 were outstanding, and the challenge is to sustain and improve upon them.

Table 1.1: Key Macroeconomic Indicators on NEEDS 2004

	TARGETS under NEEDS for 2004	Outcome (Actual) for 2004
GDP Growth Rate (%)	5 %	Estimate 5.5%[1]
Growth of credit to the private sector (%)	30%	28%
Growth in Money supply (M2)	15.0%	15.2%
Fiscal Deficit/GDP Ratio (%)--- Federal Govt.	3.0%	2.1% (cash basis)
Nominal Exchange Rate (Naira to US$)	N142.0 (end Dec. 2003 = N137/US$)	N132.85
Stock of External Reserves	US$ 7.68 billion	US$ 16.9 billion; $18.5 billion end-January
Inflation (%)	10.0%	9.5 end December[©]

[1] Provisional estimate.

[©] **Inflation year-on-year**

The naira exchange rate stabilized and also appreciated marginally (3%) in nominal terms against the U.S. dollar which is Nigeria's major currency for international transactions, while the level of reserves at end December 2004 exceeded the target of US$7.68 billion by 120 percent to US$16.9 billion (or nearly 14.0 months of import cover compared to the West African Monetary Zone's target of 3 months of import cover). Indeed, by end January, 2005, the stock of reserves was about $18.38 billion (16.0 months of import cover). The indications so far are that the reform programmes, including the monetary and exchange rate policies, are on track.

The objective of the amendment and addendum to the Monetary Policy Circular is to consolidate and improve upon the economic gains achieved in 2004.

The Challenge for Monetary Policy Management in 2005:

Fiscal year 2005 will be challenging to the CBN in maintaining macroeconomic stability, especially given the apparent expansionary fiscal policy stance in 2005. The part sharing of the 2004 excess crude earnings plus the higher budget at a higher benchmark oil price of $30 per barrel relative to $25 for 2004 will exert serious pressures on major prices, i.e. exchange rate and the general price level. The challenge of monetary policy management is to devise and implement a robust mix of monetary policy instruments necessary to sustain macroeconomic stability, despite the fiscal policy stance.

Objectives of Policy in 2005

The specific objectives of monetary policy for 2004/2005 include:

- Continued drive to lower single digit inflation rate by the end of 2005.
- Gradual reduction in the cost of borrowing for private sector investors by reducing interest rates, and thereby improving capacity utilization and output growth.
- Maintenance of monetary stability and;
- Sustaining exchange rate stability

Major Policy Thrusts

a) Commitment to exchange rate stability, by targeting and maintaining the naira exchange rate to the US dollar within **a tight band of plus or minus 3 percent**. This will anchor expectations, and enable investors (portfolio and real sector investors) and savers to plan, based on realistic calculations of exchange risk exposures.

b) Maintenance of positive real interest rates while also minimizing the spreads in the term structure of rates, and ensuring lower cost of capital for investors

c) Addressing the problems associated with the high cost of funds to the deposit money banks

d) Consolidation of the banking system

e) Continued institutional reforms of the CBN for more effective and efficient conduct of monetary management

f) Quarterly review of the MRR

g) Reform of the Payments system

h) Ways and Means Advances to Government strictly set to Zero. In the extreme, if any accommodation is to be made, it should not exceed 5% of previous year's actual revenue but to be cleared to zero at the end of each quarter

(i) The gradual withdrawal/re-injection of public sector deposits with commercial banks for liquidity management.

POLICY MEASURES

- **Exchange Rate Band (of Plus/Minus 3.0%)**

  Under the West African Monetary Zone Exchange Rate Mechanism (ERM) arrangement, member countries are required to maintain a band of plus/minus 10.0 per cent. However, given the appreciable level of external reserves and the relative stability of the naira exchange rate which were achieved in 2004; the CBN shall seek to maintain a narrower band of plus/minus 3.0 per cent during the course of 2005. The band is intended to anchor expectations and to enable investors and end-users of forex to plan and to minimize transaction costs. It is also hoped that the band shall discourage the destabilizing practices of speculation, hoarding and carrying of large inventories by businessmen. However, the success of this policy will depend on the adherence of the announced fiscal policy targets in the 2005 budget.

- **<u>Interest Rate Policy (section 3.2.4)</u>**

  Over the years, the spread between banks' deposit and lending rates has remained unacceptably wide with adverse implications for savings mobilization and investment promotion. With the declining trend in the rate of inflation, there is no justification why the MRR should be currently fixed at 15.0 per cent, when the year-on-year inflation rate for December 2004 was about 9.5 per cent. The CBN is moving to a regime of more active monetary policy, with decisions on interest rate regime reviewed every quarter. The CBN shall henceforth, anchor its Minimum Rediscount Rate (MRR), on the year-on-year inflation rate adjusted for seasonality, which reflects the current fundamental policy changes in the economy; as opposed to the traditional practice of anchoring the MRR on the 12 month moving average rate of inflation, which reflects both current and past policy errors. The adoption of this new strategy in 2005 shall render the MRR more proactive and allow it to become a true anchor on which other rates in the money market would be predicated. Accordingly, the MRR has been reduced to 13.0% in the first quarter of 2005.

- **<u>Wholesale Dutch Auction Forex Market (DAS)</u>**

  In order to deepen the foreign exchange market and ensure sustained exchange rate stability, the CBN will establish a framework and guidelines for the introduction of a Wholesale Dutch Auction System after the successful completion of the recapitalization and consolidation of the banking industry by end-December, 2005. Also, the CBN will ensure the installation of requisite infrastructure to monitor banks' open position for the effective implementation of the DAS. It is envisaged that the introduction of a Wholesale Dutch Auction System will not only deepen the forex market, but will also assist in the convergence of the DAS and the interbank exchange rates and eliminate rent-seeking behaviour by the authorized dealers.

- **National Savings Certificate (section 3.2.7)**

  To enhance liquidity management and ensure monetary stability, the National Savings Certificate (NSC), will be launched in 2005. It is expected that the issuance of the NSC would encourage the growth of domestic savings, as well as address the problem of excess liquidity in the economy on a more sustainable basis.

- **Cash Reserve Requirement (CRR) Two Week's Maintenance Period**

  The CRR will complement OMO in ensuring that excess liquidity in the banking system is minimized. The maintenance period of the CRR averaged 8 weeks in 2004. Consequently, it did not effectively serve the purpose for which it was intended. The existing ratio of 9.5 per cent shall remain in force in 2005. However, the maintenance period shall be two weeks. The computation of the CRR will be based on each bank's total deposit liabilities (i.e. demand, savings and time deposits of both private and public entities), certificates of deposit, and promissory notes held by non-bank public and other deposit items.

- **Public Sector Deposits (section 3.2.12 (g)**

  Consistent with its traditional function as the banker to the government, the withdrawal of public sector funds from deposit money banks to the CBN was initiated in 2004 to address the problem of excess liquidity in the banking system, and to encourage the banks to mobilize savings from traditional sources other than the public sector. Its brief implementation proved very effective in liquidity management. However, this measure was suspended because of the apparent mixed signals which it conveyed to the public at the beginning of the banking system recapitalization exercise. Depending on the liquidity condition in the banking system, the CBN may resort to this instrument for liquidity management in 2005. Accordingly, banks are strongly advised in their own self interest not to rely heavily on public sector funds for their portfolio management. The CBN shall give a two weeks notice to the banks and the relevant public agencies whose funds are to be withdrawn. However, the withdrawn funds will be returned to the banks when and, if the liquidity condition improves.

- **Settlement/Clearing Banks (3.2.10 (iii)**

  Seven (7) banks that met the requirement for maintaining settlement account with the CBN were appointed and designated as "Settlement Banks" to perform clearing and settlement functions for other banks with effect from 1st April, 2004. Cognizant of the need to provide collateral commensurate with the volume and value of cleared items and the need to further enhance the settlement and clearing systems of the banking industry, the guidelines will be appropriately reviewed in 2005.

CENTRAL BANK OF NIGERIA
ABUJA
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