

Central Bank of Nigeria Communiqué No. 79 of the Monetary Policy Committee Meeting, October 10, 2011

The Monetary Policy Committee (MPC) held an extraordinary meeting on 10th October, 2011 in response to unusual developments in the global and domestic economy, with potential negative impact on domestic liquidity conditions and renewed threats to price and exchange rate stability.

The global economic horizon remains highly uncertain, with the signs getting more ominous as policy makers find it increasingly difficult to take the necessary economic decisions that may avert a new wave of recession. Three self-reinforcing negatives continue to define the global economy: the sovereign debt crisis in the Eurozone, significant undercapitalization of internationally-active banks, and negative market sentiment leading to continuing flight to cash as a safe haven and deleveraging. The first and second aspects intensify the third, and without confidence and some appetite for financial assets and credit, the debt crisis and financial solvency concerns in turn become deeper.

As a result of these concerns about the Eurozone, coupled with the US deficit problem, inflation in emerging markets, debates about a soft or hard-landing in China and other pessimistic scenarios, there is a trend towards reversal of capital flows to emerging and frontier markets, and a recent depreciation in the national currencies of

many economies in Asia and Latin America including India, Indonesia, Malaysia, South Korea, Brazil, Chile, Colombia, and Mexico, among others. In Africa, the national currencies of Kenya, South Africa, Gabon, Ghana and Nigeria have also been under pressure. Central banks have generally responded through direct intervention in the foreign exchange market to stabilize the currency and, in some cases, a significant hike in policy rates. It is worthy of note that fund managers have not been eager to exit environments with relatively high real rates of interest and benign inflation outlook.

The Domestic Economy and Committee's Deliberations

The growth outlook for the economy does not appear to have changed much, driven largely by the positive forecasts for the non-oil sector as noted in the last MPC communiqué. Inflation had come down to 9.3 per cent in August but, as indicated in the same communiqué, a combination of monetary, fiscal and structural factors continue to advise against complacency.

The naira has come under increasing pressure, and has recently traded outside the band of N150 +/- 3.0 per cent. In the Committee's view, the increasing pressure on the domestic currency has been emanating from a number of sources not all of which can be addressed by purely monetary interventions. First, there are concerns about the likely impact of a double dip recession on oil

prices and already declining foreign reserves. Second, there are also concerns about the delay in implementing fundamental economic decisions that will shore up reserves. Specifically, it is estimated that simply passing the Petroleum Industry Bill (PIB) and removing subsidies on Premium Motor Spirit (PMS) will add at least US\$10 billion to national reserves annually. The petroleum subsidy for 2011 alone is estimated to be about US\$6 billion. A substantial part of oil production (about 40 per cent) is currently in deep offshore wells. Based on the terms agreed in the 1990s when oil price was under US\$30, royalty from oil wells deeper than 1,000 metres is zero per cent and the nation is paid only 20 per cent of the profit by oil companies after deducting their expenses. As a result, the country has had limited benefits from high oil prices and increasing output, with most of the gains going to multinational oil companies under an inequitable fiscal arrangement.

Similarly, the Committee expressed concerns about the genuineness of demand for petroleum imports. This year alone, oil importers have bought over US\$7.0 billion from wDAS, thereby, depleting the Nation's external reserves. This demand, in the Committee's view, might have been fuelled by rent-seeking and subsidies.

It is imperative that the enabling legislation for correcting fiscal terms be put in place under a Petroleum Industry Bill (PIB) that reflects

international best practice. Unfortunately, discordant voices are delaying these processes to the long-term detriment of the economy. Whereas the labour unions have genuine concerns about the impact of subsidy removal on the poorer segments of society, the stark reality is that the country is living above its means.

The Greek government recently passed a budget in which 33,000 public sector workers had to be retrenched as a result of failure to take difficult but necessary economic decisions in the past. Nigeria cannot afford to delay, any further, the reforms of the petroleum industry.

Third, the draft 2012 budget and the underlying assumptions are based on an oil price of US\$75 per barrel and an output of 2.4 million barrels per day. This makes the 2012 budget even more expansionary than the 2011 budget and further dampens any hope for an early fiscal retrenchment. The fiscal authorities have clearly signaled a commitment to medium-term consolidation and indeed the projected deficit in 2012 is lower than the deficit in the 2011 budget. This notwithstanding, the projected increase in spending, particularly the high levels of recurrent expenditure, would suggest increasing pressure on prices in general.

Fourth, structural bottlenecks in the Nigerian economy that perpetuate import dependence make import-demand highly inelastic.

Finally, real interest rates have been low, partly driven by a cautious approach to monetary tightening at a time of financial system instability. Although the MPC recognized inflationary pressures and has consistently acted prudently in policy tightening based on expectations, a gradualist approach has been the pattern thus far, given the situation with the banking system and equity markets.

Policy Issues and Dilemmas

In the face of the spectre of declining oil prices, declining foreign reserves, increased demand for foreign exchange, fiscal dominance and capital flow reversals, monetary policy must bear a larger burden of economic adjustment. The MPC has, therefore, to make difficult choices, each of which has clear costs and benefits.

One option is protecting reserves by reducing the supply of dollars at the wDAS. This will lead to a rapid depreciation of the currency and the emergence of a parallel market, leading to further pressures on the Naira, imported inflation and a general loss of confidence on the part of investors.

Indeed, the impact on price and exchange rate stability will be such as to undermine the key mandates of the Central Bank. Given the

highly inelastic demand for imports, it is doubtful that increasing the cost of dollars will significantly reduce quantity demanded. Indeed, genuine demand will be compounded by high levels of speculative demand.

A second option is to address monetary and liquidity conditions more aggressively. By tightening liquidity and raising domestic interest rates, a number of advantages follow. First, this is the logical response to fiscal expansion, especially with the anticipated capital releases in the fourth quarter as well as repayment of backlog of Nigeria National Petroleum Corporation (NNPC) debt to the Federation account. Second, it provides an incentive for reallocation of portfolios by improving real returns of holding the naira as a store of value. Third, it increases, after a lag, the rates paid on deposits and savings, thus reversing any tendency towards disintermediation and capital flight. Finally, it increases the cost of foreign currency positions held for speculative purposes, and reduces the tendency to pre-pay dollar obligations with naira liabilities.

The option has disadvantages in the form of high lending rates, financial cost to the banking system and possible losses on fixed income instruments due to capital losses. Besides, tightening of liquidity would run the risk of slowdown in credit growth.

Having considered the pros and cons of each option (and combinations of options), the Committee is of the view that given the completion of shareholder meetings on all banks and approvals from the courts for many, the risks to the banking system of tighter liquidity conditions have been significantly reduced, as the banks are in the process of receiving all approvals and fresh capital including AMCON bonds. Now that the banking system recapitalization is complete, monetary policy can be freed from concerns about its impact on financial system stability.

The Committee reaffirmed its belief that maintaining exchange rate stability, especially in times of global uncertainty, is crucial to the mandate of price stability. Moreover, the interest of the economy is best served, by maintaining an unequivocal stance of non-accommodative monetary policy, given the existing fiscal conditions.

The Committee also reaffirmed its commitment to improving returns on naira assets and protecting the capital of investors against erosion due to huge exchange rate losses, in order to encourage appropriate asset allocation decisions.

The Committee recognized the need to remain very clear on the Bank's primary mandate and maintain the credibility it has established so far by sending strong signals of continuing commitment to price and exchange rate stability.

Finally, the Committee noted that the Committee of Governors has already commenced full investigation of compliance with rules governing foreign exchange transactions by authorized dealers and endorsed the declared commitment to sanction all infractions and improve the level of supervision and compliance in the market.

Decisions:

1. The monetary policy rate (MPR) is raised by 275 basis points from 9.25 per cent to 12.0 per cent (by a vote of 8 in favor and 1 in favor of status quo);
2. Maintain the current symmetric corridor of +/-200 basis points around the MPR (by unanimous vote);
3. The cash reserve ratio(CRR) is increased from 4.0 per cent to 8.0 per cent from the maintenance period beginning October 11, 2011 by a vote of 7 to 2 (2 members voted for a 6.0 per cent CRR);
4. The net open position (NOP) is reduced from 5.0 per cent to 1.0 per cent of share-holders funds with immediate effect and with full compliance by Friday, October 14, 2011 (by unanimous vote); and

5. It was further agreed that the reserve averaging method of computation be suspended in favour of daily maintenance until further notice.

Sanusi Lamido Sanusi, CON
Governor
Central Bank of Nigeria

October 10, 2011

PERSONAL STATEMENTS BY MPC MEMBERS:

1.0 ALADE, SARAH

The renewed pressure on the foreign exchange market despite strong economic fundamentals is of serious concern to the conduct of monetary policy. To stabilize the foreign exchange market and restore confidence in the economy, there is need for monetary policy intervention to stem the sharp decline of the naira and reduce the pressure in the short run. Nigeria is not alone as emerging markets around the world are making efforts to shore up their falling currencies amid concerns that the global economic growth may stall. These responses have ranged from increasing monetary policy rate and/or reserve requirements, or restricted use of foreign reserves/sales. To rein in the intense pressure on the foreign exchange market and better anchor inflation expectation, I support an increase in monetary policy rate and Cash Reserve Requirements (CRR).

Global growth prospect has become grimmer. Developments in the global economy over the past few weeks are a matter of serious concern. The downgrading of the US sovereign debt rating, the continuing sovereign debt crisis in the euro zone and volatile commodity prices have led to increasing global anxieties. These events are taking place against the backdrop of a

slowdown in growth in many of the advanced economies. Growth momentum is weakening in the advanced economies amidst heightened concerns that recovery may take longer than earlier expected. Although Nigeria's exports have performed well in the recent period, this trend is unlikely to be sustained in the face of weakening global demand. This combined with intense pressure on the foreign exchange market calls for policy responses to help restore confidence and anchor inflation expectation.

While headline inflation declined to 9.3 percent in August, upside risk to inflation still exist. The global food and energy prices remain elevated, and as an import dependent country, global food prices could spill over to higher domestic prices. Food inflation inched up to 8.7 percent in August from 7.9 percent in July even in the middle of the harvest season. As global commodity prices continue to remain at an elevated level and given that the country import food stuff such as rice, there may be heighten upside risks to domestic inflation.

The planned removal of fuel subsidy and the increase in electricity tariff could pose upside risk to inflation in the short-run. The Federal Government resolve to remove the fuel subsidy coupled with the increase in electricity tariffs is bound to increase price inflation. Furthermore, real interest rate compared to neighboring countries continue to be negative. To attract inflows into

the country, this condition needs to be corrected with sensible monetary policy tool.

Fourth quarter capital releases by the Federal Government is expected to be huge. Expenditure in the fourth quarter is expected to be expansionary as government aims to complete capital projects started during the year by the end of the budget period. This bundled expenditure is bound to put upward pressure on both inflation and exchange rate as some of the capital procurement would have high import content.

While there are still pockets of downside risks in the domestic banking sector, the resolution action taken by AMCON is stabilizing the system. The return in confidence to the banking sector, and the AMCON injection of funds through sale of AMCON bonds could impact the level of liquidity in the banking sector. Rising policy rate may help channel the additional liquidity to productive uses in the economy rather than non-productive and speculative activities.

Based on the above, I will recommend an increase in monetary policy rate by 275 basis points and an increase in Cash Reserve Requirement (CRR) to help stabilize the currency and fend off inflationary pressures.

2.0 BARAU, SULEIMAN

A. Strictly guided by the context and framework that influenced my voting decision at the last Monetary Policy Committee meeting, I voted again today to support further tightening through the following specific measures;

A.1 Upward adjustment of the MPR by 2.75% to 12%

A.2 Upward adjustment of the Cash Reserve Ratio (CRR) from 4.0% to 8%.

A.3 Retention of symmetric corridor of plus and minus 2% around the MPR (Standing Deposit Rate of 10% and Standing Lending Rate of 14%).

A.4 Support other administrative measures to reign in demand for foreign exchange namely; reduction of the Deposit Money banks Net Open Position and adoption of appropriate sanctions for foreign exchange infractions and so on.

B. The rationale for voting the way I did is summarized as follows;

B.1 **Current liquidity levels** have supported increased speculative demand for foreign exchange. There is evidence of huge liquidity in the banking system as demonstrated by liquid asset holding of banks and their liquidity ratios. In effect, the huge liquidity injected in 2008 and the subsequent quantitative easing monetary policy measures in response to the global

financial crises have not been mopped up in spite of the recent aggressive stance. In addition, the system liquidity has been exacerbated by Governments fiscal operations including the monetization of excess crude account balances.

B.2 **The liquidity outlook** is also not so good in the light of anticipated AMCON liquidity injection and Government's fiscal operations particularly relating to further drawdown from the Excess Crude Account and the normal year and capital related activities of Ministries, Departments and Agency of Government.

B.3 **The obvious speculative attacks** on the Naira in the foreign exchange market continued in spite of various policy measures recently adopted by the MPC. Foreign reserves have continued to decline in spite of the recent significant improvement in inflows from the NNPC. Speculative demand could only be sustained in a regime of relatively low interest rates, lack of alternative profitable investment outlets, current and future anticipated liquidity position in the market. It has therefore become necessary to take further steps to tighten liquidity.

B.4 **Inflation is still a threat** and further tightening stance would help to arrest the threat. It is recognized that the measures recommended would increase money market and lending

rates and may affect lending and output growth. With inflation trending down, however, real interest rates would therefore be positive as a result of further tightening. Besides, in the context of current liquidity situation, liquidity outlook, threat to Naira exchange rates and declining foreign reserves, the measures recommended become even more compelling. Given the structure of our economy and observed historical reactions when the Naira depreciates, the greatest threat to inflation is a depreciating Naira and we have to do whatever is necessary to eliminate the liquidity driven speculative demand.

In effect, I hold the very strong view that any depreciation in the value of the Naira must be driven by fundamental and real factors. I'm convinced that the recent demand pressure on the Naira exchange rate is powered by factors that are speculative and technical factors, of course supported by huge market liquidity.

- C. The measures recommended are no doubt very strong and would produce unintended impact on interest rates and credit growth. I am however aware that the next MPC meeting scheduled to hold in November, does provide an opportunity for a quick review of market developments and the measures taken.

3.0 LEMO, TUNDE

I have closely followed the review of the domestic and international economic and financial environments and observed some worrisome developments. Global economic conditions deteriorated as shown by the increased downside risks and sluggish growth caused by fiscal constraints and declining confidence in the resilience of the financial system. The potential eurozone banking system undercapitalization, rising global inflationary trends, declining public confidence in the euro and the US fiscal problems, are manifests of uncertain global economic outlook.

On the domestic front, the fragile global output, negative market sentiments and declining international oil prices have serious consequences for the domestic economy, particularly, the foreign exchange market and the country's external reserves position. I have also noted of late elevated forex demand, largely driven by speculation which resulted in the recent trading of the naira outside the band of N150 +/- 3.0 per cent. I also observed that although, headline inflation declined to 9.3 per cent in August from 9.4 per cent, in July, 2011, inflationary pressures may persist for the rest of the year due to the recent announcement effect of the proposed removal of petroleum subsidy, increase in electricity charges, anticipated expansionary fiscal stance in the fourth quarter of 2011, injection of new capital into the intervened banks by the new core

investors and the expected liquidity injections by AMCON before the end of the year, as well as high household expenditures associated with end of year festivities.

Overall, the recent unusual developments evidenced in the liquidity surfeit in the banking system fuelled the unprecedented demand pressures in the foreign exchange market. This situation had negative effects on the level of external reserves and sustenance of exchange rate stability. It is, therefore, necessary that a very non – accommodative stance be taken by the MPC so as to halt further deterioration in domestic economic conditions.

In view of the foregoing, I recommend further aggressive monetary tightening stance. In this regard, I vote for an increase of 275 basis points in the Monetary Policy Rate (MPR) and maintain the symmetric corridor of plus or minus 2 per cent around the MPR; an increase in the Cash Reserve Ratio from 4 per cent to 8 per cent and a reduction of the Net Open Position of banks from 5 per cent of shareholders' funds to 1 per cent. In conclusion, I also agree that the reserve averaging method of computation of Cash Reserve Ratio be suspended in favour of daily maintenance until further notice.

4.0 MOGHALU, KINGSLEY CHIEDU

At this Extraordinary Meeting of the Monetary Policy Committee, confronted with the context of a threatening economic environment – the naira under increased pressure, the

announcement of the Federal Government's plan to remove petroleum subsidy in the forthcoming 2012 budget and the inflationary expectations thus unleashed, and imminent, massive liquidity injections by the fiscal authorities and the Asset Management Corporation of Nigeria (AMCON) – the MPC clearly needs to take strong action.

This is so especially in relation to the naira as a store of value, with the markets factoring in widespread but mistaken sentiment that the naira is about to be devalued. Should this mistaken notion take hold, it will result in a massive run on the naira. Combined with the ongoing and anticipated liquidity injections, a depreciation of the naira at this time would undoubtedly result in a marked increase in inflation that would have a destabilizing impact on the Nigerian economy.

It is necessary to reassert the commitment of the Central Bank of Nigeria to the stability of the naira and to restraining inflation in no uncertain terms. The restoration of increased stability to the banking system through the successful recapitalization of the eight intervened banks makes such strong action at this time possible without significant adverse consequences for financial stability. This time, however, the MPC needs to deploy a combination of tools designed to prevent the excess liquidity - including within the banking system - that is feeding continued

speculation on the value of the naira. Against this backdrop, I vote for:

(i) An increase of the Monetary Policy Rate by 275 basis points from the current 9.25 per cent, and maintaining a symmetric corridor of plus or minus 2 per cent.

(ii) An increase in the Cash Reserve Ratio of 100 per cent from the current 4 per cent to 8 per cent.

(iii) A reduction of the Net Open Position of banks from 5 per cent of shareholders' funds to 1 per cent.

5.0 OLOFIN, SAM

This is an emergency meeting which by its very nature suggests new developments that have implications for the economy have occurred since our last meeting, and for which urgent corrective measures may be required before the next statutory meeting of the MPC. Without necessarily wanting to sound like an alarmist reading of the current situation, recent developments at the foreign exchange market which no doubt reflect market reaction to both domestic as well as external disturbances have been quite worrisome. The various market signals suggest a declining confidence in the Naira as a store of value, and hence the unabated ever rising demand for the dollar. This has led to a sharp

decline in the level of foreign reserves by US\$2.65 to \$31.36 billion or nearly 8 percent decline by Oct. 6, 2011, compared with the figure of \$34.01 billion as at September 20, 2011. Similarly the rate of exchange has over the same period moved above the upper three percent bound set around the target rate of N150: \$1 that has been sustained over the last several months. Evidence available to us at this meeting shows that Reserve Money (RM) has fluctuated above the quarterly indicative benchmarks set for quarters 1, 2 and 3, in 2011 suggesting the existence of excess liquidity in the system that may among other factors be fuelling the hedging against the Naira, and the resulting rapid decline in the level of reserves. If these facts are put side by side with the developments in the global economy which suggest the likelihood of a double-dip recession in the advanced economies and likely fall in demand for energy in both developed and emerging economies, we are likely to be confronted in the short to medium term with a possible decline in the price of oil which would further accentuate the pressure on the Naira.

As a highly import depend economy with less than elastic demand for imports and exports, it would be futile to contemplate foreign exchange adjustment or outright devaluation to ease the pressure on the Naira. It is our strong view that not only would devaluation further exacerbate the pressure on the Naira, it would heighten the current surge in the demand for foreign exchange.

We may therefore in no time have to be confronted with the bleak prospects not only of halting the accretion but of a possible wiping out of existing reserves! There is therefore an urgent need for a combination of both administrative and appropriate monetary policy measures to stem the growing speculative attack on the Naira and level of foreign reserves. Given the current and foreseeable developments in a turbulent if not depressing outlook of the global economy, a stable exchange rate and a rising accretion rate in the level of reserves are about the most effective insurance the economy has against any likely external disturbances, and for being able to sustain current level of economic activity as well as promote growth.

Every indication on the fiscal side shows that inflationary pressure reduction through fiscal consolidation is not likely to be achievable in the short term, at least not in the 2011-2012 budget periods. Similarly the structural constraints to growing credit and lending to the real sector are not likely to improve in the short run, given the current interest inelasticity of investment in the real sector. We are therefore still left with a considerable room of leverage for a policy stance that may raise the level of interest rate without necessarily or unduly harming the prospects for growth in the short to medium term. Secondly we are still far behind competing countries like Ghana and South Africa in bringing our MPR to a positive level that would make us more

competitive in attracting both FDI and portfolio capital. A positive real interest rate is also desirable for encouraging growth in domestic saving.

In the light of the foregoing, our current challenging situation leaves the MPC with little or no choice but to utilize every available means within its reach to halt the current run on foreign reserves and weakening of the Naira. This would require a combination of very strong monetary tightening signal beyond the symbolic levels hitherto undertaken, coupled with necessary administrative measures, to arrest the growing attack on the level of reserves and the Naira. I would therefore vote for an upward adjustment of the CRR from its current level of four to eight percentage points, and the MPR raised by 275 basis points from its current level of 9.25 to 12 percent, and retaining existing symmetric corridor. Our next meeting within the next one month would offer the opportunity for evaluating the effectiveness of these measures in achieving the desired goals of reducing inflation rate, maintaining a stable exchange rate and drastically reducing the speculative demand for foreign exchange.

6.0 OSHILAJA, JOHN

Inflation expectations in Nigeria are correlated with expectations of adverse changes in exchange rates for the Naira. Nigeria's is

currently a highly import-dependent economy. Accordingly, a goal of Monetary Policy has to been to maintain relative price stability by also supporting (using tools at its disposal) relatively stable exchange rates. Since FY 2009, it has been the policy of the Central Bank to maintain exchange rates for the US Dollar within a +/- 3% range around N 150.00; i.e. at a "quasi-pegged rate". There are fundamentally only two ways to do this. The Central Bank can ensure the supply of sufficient foreign currency, by drawing upon its reserves to meet the nation's demands at the desired price. Or, it can adjust levels of available Naira needed to pay for foreign currency. The first approach has been the CBN's principal Exchange Rate Management strategy. This mostly explains why, over a 2-year period characterized by high oil prices and high capacity export production, the CBN's holdings of foreign currency reserves have fallen from a high of approximately N 60 billion, and have been hard pressed to exceed the top of a N 32-36 billion range observable so far in FY 2011.

Since our meeting of 20 September, despite repeatedly expressed concerns about the impact of fiscally-sponsored liquidity in our markets, and measures taken to mitigate clear threats to local currency values, exchange rates for the Naira have breached and remained above desired target-levels. Which brings us to where we stand today – with the Naira trading as high as N 164 in

interbank markets, annual inflation at 9.3%, and the Monetary Policy Rate progressively increased from 6% to 9.25% within a 12-month time span. Market behavior and expectations now seem to be running well ahead of policy action, thus compounding the Central Bank's targeting efforts. Fast-breaking developments of the past few weeks also bring into stark relief the challenge Monetary Policy faces in utilizing exchange rate targeting to anchor price stability when Fiscal Policy is lax. The effectiveness of Central Bank liquidity management tends to be harmfully diluted when Naira amounts drained by the Central Bank are inevitably replenished, and thus cancelled out, by Government spending operations. This is the liquidity that invariably throws the currency market system out of balance by promoting disproportionately outsized demands for foreign currency, which thereby weakens the Naira. Under these circumstances it makes little sense to throw good reserves (i.e. hard currency) after bad (i.e. soft currency). Especially, when further options remain available for tackling demand sides of this currently, unbalanced equation.

The MPC decisions taken today may be characterized as a "stake" the Committee has driven into the ground – a stake based on Central Bank Liquidity Demand Management measures. Tethered around this stake will be a number of administrative and market-oriented measures to be rolled out, for the following purposes expressly:

1. Increase the Naira's attractiveness as a store of value
2. Ensure that non-speculative demands for foreign currency continue to be met
3. Promote a conducive Monetary environment for enhanced Foreign Investment

Accordingly, the first thing that has to go is the implicit cost-subsidy the investing public affords governments for sovereign and sub-national investment securities; i.e. Bills and Bonds. Savers utilizing domestic fixed-income markets must be paid competitive, real-term, rates of interest. Hence the MPC's initiation of a real interest rate regime, by an elevated increase in the MPR to 12%, with corresponding normal symmetries for the CBN's Deposit and Lending Facilities; i.e. -/+ 2% respectively.

The second measure entails addressing the level of perverse investment incentives in the banking sector. Nigerian DMB's appear to be holding (and funding) extraordinarily high levels of Naira assets, in the form of tax-free Government Treasury Bills and Bonds. This represents a conversion of surplus bank liquidity into comparatively risk-free assets. Most seem to be paying for these lucrative holdings with far cheaper deposit monies. I see nothing wrong with any bank turning an easy Naira profit, given prudent and legal opportunities to do so. However, in the current environment, I believe the costs our banks incur in temporarily

transforming such holdings into cash, to meet higher yielding demands (such as for business loans), is unacceptably low. This is also to say that current spreads between FGN Government securities' yields and penal CBN repo rates – for which the same securities are required as collateral – are too low. Especially given that a significant proportion of the proceeds of such credits are likely to hit currency markets under fiscally-boosted demand for imports. The increase in the Cash Reserve Ratio is intended immobilize further surplus banking liquidity; with added aims of compelling our banks to moderate their current security holding preferences, and challenging current cash management practices in the industry.

Lastly, upon our review of the available evidence, Committee Members concurred with the Central Bank's view that changes to present exchange rate targets remain unwarranted. Such considerations cannot be justified by present and near-term trends in the country's current account balance. Neither would investment needs of the country be served by target-adjustment at this time.

As I see it, conditions in current Naira markets have been brought about by cumulatively ineffectual Liquidity Management by the Central Bank. This is not to imply that the CBN has been derelict in its duties. The Central Bank, in recent quarters, regrettably failed to adequately compensate (monetarily) for large doses of

liquidity periodically injected into the financial system through fiscal operations of government. The heightened demand for FX observable in recent months reflects the progressive accumulation of this liquidity, in import bills and bank asset portfolios, eventually washing up, demanding to be dealt with onshore. What the Central Bank as our “financial weatherman” forecasted to be “heavy showers” (and accordingly took precautions against) is turning out to be a drenching monsoon. Could we have done better?

Given the inherently political nature of these liquidity injections, with attendant uncertainties around their size, distribution and timing, and given the inherently conservative disposition of the CBN as an institution, this type of failure is understandable, and may be even pardoned – occasionally. The Central Bank of Nigeria now clearly appreciates what further needs to be undertaken, its gloves are off, and it is proceeding with even more purposeful determination. Hence, I endorse the measures agreed upon with fellow MPC members today, and voted accordingly. I hope that we will have begun to successfully engineer the desired turns in market conditions. However, should even further actions be called for when next we meet in a month or so, then these too shall be voted on with due care and diligence.

7.0 SALAMI, ADEDOYIN

Recent weeks have seen the exchange rate of the Naira outside the outer limit of the band of $\pm 3\%$ around the midpoint of N150/US\$. Worse still market sentiment, driven by the reducing level of Nigeria's foreign reserves and sharply increased demand for foreign currency at the Central Bank of Nigeria (CBN) WDAS window, has begun to question the ability of the CBN to keep the Nigerian currency stable and within the band. All this, after a further tightening of monetary conditions at the end of our last meeting almost a month ago.

The importance of exchange rate policy to inflation management cannot be over emphasised. Significant components of our national economy depend on imports – energy and food! Allowing the currency to lose its external value will almost certainly reverse the gains recorded in inflation management. Is there a case for allowing erosion of the currency's external value? Without doubt, the falling level of reserves, coupled with the rising prospect of easing commodity prices - especially for our oil exports, as the global economic growth slows; provide the strongest reason for market doubts about the ability to sustain the Naira's international value. It is thus not surprising that positions are being taken against the Naira.

There is also evidence that the global economic environment is, not unexpectedly, beginning to take an adverse toll on capital flows to frontier markets such as ours. In this context, continuing negative inflation adjusted returns on Naira deposits undermines the Naira's attractiveness thus encouraging asset allocation decisions against it.

The challenge of managing the implications of fiscal dominance continues unabated. Beyond the effect of the usual monthly Federation Account activity, there are a number of fiscal actions on the immediate horizon which indicate that larger-than-normal injections of liquidity. This is compounded by the strong liquidity position of our Deposit Money Banks.

Simply stated, MPC must provide a credible reason to hold Naira denominated assets. This can only be done by hastening the process of restoring its attribute as a store of value. Furthermore, the strong and growing sense of an imminent depreciation of the currency has to be dealt with. Given the MPC's mandate of maintaining price stability and the surrounding economic context, depreciation of the Naira is not a credible option.

The adverse effects of higher interest rates, which are limited to some sectors of the economy, are in my judgement preferable to the negative economy wide impact of devaluation. I have no

reservations in supporting sterilisation of the strong banking system liquidity by raising the Cash Reserve Ratio. Furthermore, I believe that my argument on previous occasions for movement towards a positive 'real' interest rate remains valid in the present situation. I expect that sterilisation of liquidity will finally begin the process of restoring competition for liabilities, hitherto put in abeyance by the Central Bank's guarantee on Interbank Market transactions, leading, eventually, to positive real rates for domestic depositors.

As we come to the end of the process of 'banking sector rescue', it is my view that we must now revisit the definition of liquidity which had been expanded as we sought to manage the potential systemic dislocations arising from the spectre of bank failure.

8.0 GARBA, ABDUL GANIYU

Decision: I vote for:

- I. Holding the MPR at 9.25%
- II. Maintaining the Asymmetric Corridor for SLF and SDF
- III. Increasing the CRR from 4% to 6%

Observations

Since the last MPC Meeting in September,

- a. the crisis in the global economy has deepened and political leaders in Europe and the Americas seem unable or unwilling to put together a potentially effective solution package to address the debt, growth and unemployment problems.
- b. The rating agencies have downgraded sovereign debts and banks with significant exposures to sovereign debts especially in the EURO Zone and the UK raising fears of a deepening of the banking/financial/economic crises in Europe. The volatilities in the global currency, equities and commodity markets have risen and, are unlikely to abate soon.
- c. Inflation has declined slightly in Nigeria. However, the demand for foreign exchange has been rising well above trend and had become more volatile in the last few weeks leading to above trend pressures on the exchange rate. In addition, the equities market remains bearish and the job market has not shown any sign of improvement. The external accounts has underperformed and coupled with demand pressures, the external reserves have also underperformed.

Commitment to Stable Exchange Rate Policy and Effective Enforcement of Transparent and Non-Discriminatory Rules

1. I strongly support the commitment of the MPC to a stable exchange rate policy: exchange rate volatilities in an uncertain and risky world is a potentially disastrous policy option more so, given (i) the likely adversarial effects on production and distributions costs, investments, jobs, income and, well-being of a majority of citizens and (ii) that Nigeria's exports and imports are exchange rate inelastic.
2. I also strongly support the decision of the MPC to strengthen the enforcement of existing rules of the game to discourage **opportunistic and market destroying** speculative behaviors that is, behaviors that distort the market fundamentals and by so doing, undermine the effective functioning of the financial markets. I am convinced that the financial markets will work more effectively if the costs of undermining the market to a "**rouge player**" greatly exceed the benefits. The simple rule is: actual costs of rouge playing must significantly exceed actual and potential benefits.

Deciding Issues

1. **Evidence:** The data shows that since the tightening regime began in September 2010, the liquidity (Monetary Base, M1, QM and M2) has risen significantly, the structures of banking

system liabilities has shifted significantly against savings deposits and time deposits in favor of foreign currency deposits. Quasi money has exceeded M1 suggesting that MPR may not be as effective as expected in targeting the “harmful speculative liquidity”. I am convinced that a regime of tighter and timely enforcement of existing laws to de-incentivize “harmful speculative activities” will be more effective. Further, a complementary rise in CRR by 200 basis points would be adequate to immediately reduce liquidity that may be used by players to speculate on the foreign exchange market instead of intermediating.

- 2. Commitment to Limiting Constraints to struggling higher job elastic and higher value-adding Players/firms/activities:** It seems that while MPR has so far been less effective in “removing harmful speculative liquidity”, its effects on lending rates and small business value-added and jobs may not to be insignificant. In these uncertain times and with the high level of unemployment, small businesses can do with all the help that is feasible to extent to them without adding to the uncertainties and menu of risks they already face.

9.0 SANUSI, LAMIDO SANUSI

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

The extra ordinary Monetary Policy Committee Meeting called today is in recognition of the need for a more frequent review of dynamic global and domestic economic conditions that may contain threats to macroeconomic stability. Indeed, at the next MPC meeting in November we may find it useful to start holding monthly meetings until the situation stabilizes.

We have always known that after resolving the banking system crisis the very next challenges would be the risk posed by elevated levels of liquidity resulting from fiscal spending, AMCON bonds (if not carefully managed) and credit expansion from recapitalized banks. This situation has been further compounded by the global economic situation, particularly the sovereign debt, banks solvency and market confidence crises in the Euro zone, the US deficit problem and risks of inflation and economic slowdown in key EM economies like China, Brazil and India.

The global situation has led to reversal of capital flows from EM and frontier economies. In the case of Nigeria, there are genuine concerns about oil price outlook with attendant impact in external reserves. Even though market fundamentals would suggest a slight moderation, rather than a big collapse, in oil prices, markets are unpredictable especially when the bears take over and confidence dips to a level where we have mass flight to less risky assets and deleveraging.

The published information about the draft 2012 budget suggests a base price assumption of \$75/b and output of 2.4mbpd. Our view is that these assumptions are based on a rather optimistic (though not entirely unrealistic) set of assumptions. In any event, this would place spending at N4.8trillion compared to the N4.4trillion budgeted in 2011. With over 70% still in recurrent expenditure and given the historical tendency of revenues to fall short of projections, the real fiscal deficit is likely to be higher than the 2.7% projected. It is also

worthy of note that the last quarter of the year is when a significant part of capital releases will occur. In sum, my view is that the 2012 budget as proposed continues with the procyclical trend set in 2011, even though I must state that fiscal authorities have informed us of the possibility of reviewing the benchmark price downward to \$70/b before the final presentation to the legislature. Until that reduction materialises the markets will anticipate elevated fiscal spending and this feeds into inflation and exchange rate expectations.

The combination of factors above has led to renewed pressures on the exchange rate, with the potential, through translation effect of compounding the inflationary implications of the fiscal stance. In view of the uncertainties in global outlook, we need to seriously consider the implications of maintaining the current interest rate and exchange rate stance, with a view to making such adjustments are necessary to avoid a rapid depletion of reserves and rapid depreciation of the naira at the same time. Such an occurrence will

lead to a major dent in confidence and plunge the economy into a self – reinforcing inflationary cycle.

Our exchange rate stance, defined by our commitment to stability, is informed by two arguments which are compelling. The first is that exchange rate stability is central to our price stability mandate, given pass-through effects of imported items (diesel, petrol, food, processed food, manufactures, raw materials etc) on CPI. Whereas the weight of these items may be indeed smaller than that of farm produce, they represent at least one class of items that we can influence through careful management of the exchange rate. The second is that a depreciation in currency does not automatically translate into improved balance of payments. The demand for many imported items is highly inelastic. In the case of subsidized petroleum products for example, depreciation simply increases the naira value of the subsidy (other things being equal). This in turn increases the margin for arbitrage and rent seeking and may actually provide an incentive for increasing import demand. The perverse incentive system of petroleum subsidies may very well lead

to an upward sloping demand curve, with petroleum imports increasing as naira price increases rather than the inverse. In addition, depreciation fuels speculative demand and capital flight, leading both to further depreciation and reduction in reserves. For this reason, while I am inclined towards flexibility in managing the exchange rate, I am of the firm view that any depreciation must be a last resort and should be carefully managed and carried out from a position of strength. We need to send clear signals of our commitment to support the naira in these times.

The foregoing analysis leaves us now with a number of options at our disposal. We can increase CRR, thus tightening liquidity significantly and depriving speculators of the liquidity to give effect to their demand. This I support strongly.

We can further increase the MPR significantly both as a signal and as an incentive for portfolio reallocation into naira assets as real interest rates move well into positive territory. This also increases the holding

cost of long positions. In view of progress on banking resolution I also support this measure.

In addition we need to reduce net open position limits to reduce speculative holdings, and implement recommendation from the recent examination of foreign exchange transactions by bank examiners to address issues around non-compliance and abuse of existing regulations. Appropriate sanctions must be applied.

I do not support capital controls and I am pleased that all members agree on this point.

My vote is for

1. Increase in CRR from 4% to 8%, and suspension of reserve averaging as the method of computation;
2. Increase in MPR from 9.25% to 12% while maintaining symmetric corridor: and
3. Reduction in net open position limit from 5% to 1%.