

Central Bank of Nigeria Communiqué No. 90 of the Monetary Policy Committee
Meeting of Monday and Tuesday, July 22 and 23, 2013

The Monetary Policy Committee met on July 22 and 23, 2013 with 10 out of the 12 members in attendance. A new member, Mr. Stephen O. Oronsaye, who is a Board member, replaced Professor Sam Olofin whose tenure as a Board member had expired. The Committee reviewed the economic conditions and challenges that confronted the domestic economy in the first half of the year, particularly since the last MPC meeting in May 2013. It also re-evaluated the short-to-medium term risks to inflation, domestic output, external balance and financial stability.

International Economic Developments

Global economic recovery remained weak, as new risks have emerged including the possibility of a further slowdown in growth in the emerging market economies. The old risks of a recession in the Eurozone have persisted alongside slowing growth in China and the possibility of tighter financial conditions when central banks gradually exit from their current monetary accommodation stance.

Consequently, global growth prospects have not improved. Blaming weaker domestic demand and slower growth in several key emerging market economies, as well as a more protracted recession in the euro area, the IMF in

July 2013 reviewed downward its global growth forecast. It also reviewed downward its growth forecast for the US and China to 1.7 and 7.8 per cent, from 1.9 and 8.0 per cent in April 2013, respectively, but raised the forecast for the UK from 0.7 per cent to 0.9 per cent in the same period. For the Eurozone which has seen its longest recession since monetary union, the IMF projects a further contraction of 0.6 per cent in 2013, which more or less doubled the earlier forecast in April. The IMF has also cut the growth forecast for Brazil, South Africa, India and Russia to 2.5, 2.0, 5.6 and 2.5 per cent from 3.0, 2.8, 5.8 and 3.4 per cent, respectively. Japan's growth rate forecast is projected at 2.0 per cent, up from a forecast of 1.5 per cent.

The slowdown in global growth is likely to impact on commodity prices and thus, adversely impact oil exporting countries like Nigeria. In addition, continued fragility in financial markets continues to generate bouts of capital flow reversals and inflows that are potentially disruptive to emerging and transition markets.

Domestic Economic and Financial Developments

Output

The National Bureau of Statistics (NBS) estimated the real Gross Domestic Product (GDP) growth at 6.72 per cent for Q2 2013, slightly higher than the 6.56 per cent recorded in Q1, and 6.39 per cent in Q1 of 2012. Overall, GDP growth for fiscal 2013 was projected at 6.91 per cent up from 6.58 per cent in 2012. The

non-oil sector remained the major driver of growth recording 7.91 per cent in contrast to the growth rate of -0.68 per cent for the oil sector during the second quarter of 2013. The drivers of the non-oil sector growth remained agriculture; wholesale and retail trade; and services which contributed 1.72, 1.47, and 2.90 per cent, respectively. The Committee noted the continued decline in the contribution of the oil sector to overall GDP and the underlying factors responsible for this state of affairs. These factors include; sustained oil theft which has led to a decline in output volumes in the face of an uncertain international oil market and price signals, weak infrastructure, and downside risks due to discovery of shale oil and the emergence of other African oil exporters competing for Nigeria's traditional oil market.

Prices

Inflationary pressures continued to moderate partly in response to the tight monetary policy and base effect. The year-on-year headline inflation decelerated to 8.4 per cent in June from 9.0 per cent in May. Also, core inflation declined significantly to 5.5 per cent in June from 6.2 per cent in May and 6.9 per cent in April. Food inflation, however, rose to 9.6 per cent in June from 9.3 per cent in May 2013. Notwithstanding the moderation in headline inflation, there are benign risks on the horizon, including the possibility of accelerated fiscal releases in the later part of the year and the effects of the upward review in electricity tariffs in line with the MYTO following the implementation of the full deregulation of the energy sector.

The six-month inflation outlook indicates that inflation would remain within single digit territory due to base effect and tight monetary policy. However, the current state of government finances is likely to generate increased borrowing. The key risks to the outlook, therefore, remain fiscal operations, increased pressure on the exchange rate due to excess structural liquidity in the banking system and the possibility of a capital flow reversal in the medium term.

Monetary, Credit and Financial Market Developments

Broad money supply (M2) grew by 0.71 per cent as at end-June 2013 over the level at end-December 2012. When annualized, M2 grew by 1.42 per cent, compared with the growth of 2.70 per cent in the corresponding period of 2012. Thus, M2 growth was also significantly below the growth benchmark of 15.20 per cent for 2013 and 7.60 per cent for Q2 of 2013.

Interest rates in the interbank money market moved in tandem with the level of liquidity conditions in the banking system. The average liquidity ratio was 67.79 per cent compared with the prudential requirement of 30.0 per cent. Thus, the average inter-bank call and open-buy-back (OBB) rates, which opened at 12.07 and 11.91 per cent on May 20, 2013, closed lower at 10.42 and 10.29 per cent, respectively, on June 28, 2013. However, the average inter-bank call and OBB rates for the period were 11.80 and 11.46 per cent, respectively.

The recovery in the Nigerian capital market continued, as equities market indicators were upbeat in the review period. The All-Share Index (ASI) increased

by 28.8 per cent from December 2012 to June 2013, while the equities Market Capitalization (MC) increased by 27.3 per cent from N8.97 trillion on December 31, 2012 to N11.43 trillion on June 28, 2013. Improved earnings and investor confidence in the economy contributed to the up-swing in stock prices. The equities market median price-earnings ratio rose above the long-run median by 9.0 per cent in June 2013 indicating that share prices were recovering faster than earnings and investor assessment of future returns was good.

External Sector Developments

At the Wholesale Dutch Auction System (wDAS), interbank and the BDC segments of the foreign exchange market, the exchange rate depreciated to N157.32/US\$, N161.25/US\$, and N163.00/US\$ on July 19, 2013 from N157.30/US\$, N158.30/US\$, and N159.50/US\$ on 21st May, 2013. The Committee noted the depreciation recorded in all segments of the foreign exchange market in the review period on the back of a general sell-off by portfolio investors in emerging and frontier markets following guidance by the US Federal Reserve Bank (FED) with respect to its quantitative easing programs. It also observed that the experience in Nigeria was not unique, as the spike in the US yields negatively impacted financial markets globally. However, calm has since returned to the financial markets following further clarifications by the FED that exit from quantitative easing is not imminent and does not necessarily mean monetary tightening. Thus, the Nigerian capital market has seen a rally, while the demand pressure in the foreign exchange market has somewhat moderated. The

Committee, however, noted the build-up of structural excess liquidity in banks balance sheets, which poses risks to the inflation and exchange rate outlook.

The Committee noted the increase in external reserves to US\$47.99 billion as at July 18, 2013 from US\$43.83 billion at end-December, 2012, representing a rise of US\$4.16 billion or 9.49% year-to-date. This level of reserves provides cover for approximately 11 months of import.

The Committee's Considerations

The Committee was satisfied with the prevailing macroeconomic stability achieved during the period, including the single digit inflation, stable banking system, exchange rate stability, favourable output growth, capital market recovery and growth in external reserves, thus sustaining internal balance and external viability. The Committee also noted the recent volatility in the foreign exchange market and also recognized that the commitment of the Bank to defend the currency in the face of capital flow reversal and significant revenue attrition has stemmed the depreciation of the naira. Consequently, the Bank has been able to sustain the objectives of financial and price stability.

The Committee observed the build-up in excess liquidity in the banking system, and expressed concern over the rising cost of liquidity management as well as the sluggish growth in private sector credit, which was traced to DMB's appetite for government securities. This situation is made more serious by the perverse

incentive structure under which banks source huge amounts of public sector deposits and lend same to the Government (through securities) and the CBN (via OMO bills) at high rates of interest.

The Committee expressed strong concerns about the risks posed to government revenues from oil theft, less than expected production, new discoveries of shale oil, the fast increasing number of African oil exporters, the dwindling market for Nigerian crude as well as the inevitability of a fall in global oil prices as well as capital flow reversal, which may impact the current global (dollar) carry trade, for which Nigeria has been a major beneficiary.

The Committee commended the Federal Government on its sustained efforts towards fiscal consolidation in 2012 and stressed the need to reverse the loose fiscal stance of 2013. The Committee articulated the monetary policy risks of dwindling fiscal revenues to include: the crowding out effect of government borrowing, depletion of excess crude savings and pressure on the exchange rate. Available data indicates that capital expenditure is the first casualty of dwindling government revenues as available resources are channeled into funding non-discretionary recurrent expenditure.

The Committee considered the inflationary outlook for the rest of the year as benign. However, principal risks remain largely due to the loose fiscal stance and rising deficit, excess liquidity in the banking system and risks to the

exchange rate due to a combination of revenue shocks and external developments.

Decisions

Having considered all the above factors, the Committee decided:

1. By a vote of 9 to 1 to hold the MPR at 12 per cent. One member voted for a 50 basis points reduction;
2. By a vote of 9 to 1 to maintain the symmetric corridor around the MPR at +/-2 per cent. One member voted for an asymmetric corridor;
3. Unanimity to retain the CRR at 12 per cent; and
4. 9 to 1 to introduce a 50 per cent CRR on public sector deposits. This will be applied on Federal, State and Local Government deposits and all MDAs. For other deposits CRR will remain at 12 per cent

Thank you.

Sanusi Lamido Sanusi, CON

Governor

Central Bank of Nigeria

23rd July, 2013

PERSONAL STATEMENTS BY MONETARY POLICY COMMITTEE MEMBERS:

1.0 ALADE, SARAH

Headline inflation decreased by 60 basis points to 8.4 percent in June from 9.0 percent recorded in May, 2013. While core inflation decreased from 6.2 percent in May to 5.5 percent in June, food inflation increased from 9.3 percent to 9.6 percent during the same period, following the commencement of the planting season. In the international scene, the overall risk to growth is on the downside. For Nigerian, there is a risk that global financial conditions may tighten if the anticipated unwinding of monetary policy stimulus in the United States crystalizes and could lead to sustained capital flow reversal with implication for instability on exchange rate stability and reserve build-up. On the domestic front, fiscal expansion remains elevated in 2013 compared to the level in 2012. In addition, although inflation rate is trending down, there are still upside risks to inflation. In view of these developments, I am inclined to support a hold in Monetary Policy Rate (MPR) and Cash Reserve Requirement (CRR) on private sector deposits, but 50 percent CRR on public sector deposits.

Downside risk to global growth has deepened as growth in some key emerging markets slows. The IMF WEO update of July 9, 2013 downgraded global growth for 2013 from 3.3 percent projected in April to 3.1 percent. This downgrade is predicated on weaker domestic demand and slowing growth in key emerging

markets, protracted recession in the euro areas and slower than expected expansion in the United States. *Second quarter GDP growth in China decreased to 7.5 percent against the projected 7.7 percent. Further risk to global growth is amplified by the possibility of the end of monetary easing in the United States and the implication of that decision on global financial conditions. In May and June, financial markets were very volatile as a result of recent increases in advanced economy interest rates and weakness in emerging market domestic economies. Most emerging market economies are experiencing increasing capital outflows and currency depreciation, which could further jeopardize growth if not properly managed. Against this background, monetary policy at this time should be focused at minimizing the downside risks to the domestic economy.*

Downward trend in inflation is a welcome development, however, all potential risks to inflation outlook should be considered. Headline inflation further decreased to 8.4 percent in June from 9.0 recorded in May, one of the benefits of past monetary policy tightening. However, there are still downside risks to inflation outlook in Nigeria. While the downward inflationary trend presents a strong argument for monetary policy easing, there are other compelling reasons to tread cautiously for the moment. One of the main reasons is the fear of sudden portfolio flows reversal which could crystalize on monetary easing and may have a destabilizing effect on the economy if not managed in an orderly

manner. In the midst of reversal of flows out of emerging markets, the ability to attract inflows into the economy is ringed upon tight monetary policy stance. Furthermore, in an environment where structural bottlenecks constrain the flow of credit to the real sector of the economy, lowering policy rate will not necessarily lead to increased credit expansion. Therefore there is need to maintain delicate balance between stability and growth objectives.

Gross Domestic Product (GDP) is trending below forecast. The 2013 first quarter GDP grew by 6.6 percent as against 6.99 percent recorded in the fourth quarter of 2012. The projection for second quarter forecast is also below expectation due to decline in oil output. Non-oil sector grew by 7.9 percent in the first quarter of 2013 compared to its contribution of 8.2 percent in the fourth quarter of 2012. The oil sector's contribution to GDP declined by -0.5 percent in the first quarter as against a decline of -0.2 percent decline in the last quarter of 2012. The projected second quarter decline is expected to be higher than -.07 percent. These developments can be attributed to a combination of insecurity in the northern part of the country that has affected agricultural production during critical planting season, oil theft and pipeline vandalism in the Niger Delta that have resulted in the shutdown of some oil wells and reduced oil production. Although National Bureau of Statistics (NBS) projections suggest a GDP growth of 6.91 percent for the year, the achievement of this goal will require careful planning and maintenance of stable macroeconomic environment.

The banking system continues to show high level of liquidity, suggesting that monetary easing at this time may be counterproductive. Banking system deposits at the CBN deposit lending facility has consistently been high prompting CBN to sell securities worth N7,608.27 billion January 2 and July 18, 2013, and this amount was substantially oversubscribed, suggesting excess liquidity in the system. The build-up of excess structural liquidity in the banking system poses risks to exchange rate stability and inflation outlook.

Consistent downwards trend in oil production is bound to put pressure on fiscal operations of the government. The continued slow-down of growth in key emerging markets like China coupled with lower than expected oil production due to pipeline vandalism and oil theft will affect revenue generation of the government and increased drawdown on savings. According to updated WEO, July 2013 report, average crude oil prices is expected to fall by 4.7 percent for the year on weak demand from emerging markets and continued gains in supply from the shale oil. If this trend persists, the Nigeria economy will be affected in terms of decreased oil revenue and external reserve build up. In the face of these developments, fiscal expenditure which has continued to trend upwards in 2013 compared to the level in 2012 will put pressure on the revenue of the three tiers of government and lead to increased borrowing and higher interest rate crowding out private sector and further constraining growth. To

alleviate these risks monetary policy should do all it can to dampen the adverse effects on the economy.

Against this background, I support a hold on Monetary Policy Rate and Cash Reserve Requirement (CRR) in private sector deposits at 12 percent, but a 50 percent increase in CRR for public sector deposits, to balance the concern on macroeconomic stability and growth objectives.

2.0 BARAU, SULEIMAN

1.0 DEVELOPMENTS SINCE THE LAST MPC MEETING

1.1 Inflation – Remarkable improvement was witnessed, as year-on-year (YoY) Headline Inflation (HI) declined to 8.40% in June compared to 9.00% in May, 2013. The month-on-month (MoM) inflation also declined to 0.59% in June from 0.67% in May. Core Inflation (CI) YoY declined to 5.5% in June from 6.2% in May. However, the YoY and MoM measures of Food Inflation (FI) showed marginal increase to 9.6% and 0.7% from 9.3% and 0.51% in June and May. It is clear from this development that we have achieved stable single digit inflation numbers in the last five months.

1.2 Growth remains robust as projected GDP of 6.72%, is above Sub-Saharan average of 5%.

1.3 Banking System continued to witness relative stability. Total industry assets grew marginally to N21.4 trillion in June compared to N21.0 trillion in

March. Average industry liquidity ratio stood at 68% as at end of June, roughly the same position as at end March, 2013. The huge liquidity is riding on the back of the refusal of banks to lend more aggressively, the monetization of Excess Crude Account balances due to augmentation and increased fiscal spending.

- 1.4 Exchange Rate Management – the naira has witnessed mild depreciation against the USD particularly in the Interbank and Bureau De Change segments. Interbank rate depreciated by 1.86% to N161.25 (July, 19) from N158.30 (May 21). BDC rate also depreciated by 2.19% to N163.00 over the same period. The observed depreciation was due to the combination of decline in foreign inflows; increased demand and the change in market sentiment.
- 1.5 Interest rates - remained largely stable. However, there still remains huge spread of over 19% between average Maximum Lending Rate and Consolidated Savings/Deposit rate.
- 1.6 Foreign Reserves increased to \$48 billion as at July 18, 2013 from \$45 billion as at end June, 2013. This increase was despite the massive reversal of portfolio inflows during the period.
- 1.7 The global economy continued to be weak. Actual Q2 growth in the United States of America (USA) was 1.75% compared to forecast growth of 2.5%. The Euro Area continued to face their challenges. China's

growth also trended to 7.5% while the gains witnessed in Japan is still being watched. This development remains a concern for Nigeria. Besides, indications that the current QE embarked upon by the Federal Reserve System in United States of America may be reduced from October, 2013, led to upswing in yield on bonds/treasuries. This amongst others also led to the reversal of portfolio inflows and the hunt for yield in frontier and emerging markets.

- 1.8 Government spending – we have witnessed increased spending during the period January – July, 2013 when compared to the corresponding period of 2012, of about N370 billion. The fiscal deficit as at end July, 2013 though within budget, also increased by almost N135 billion relative to the corresponding period in 2012.

2.0 CONSIDERATIONS/PRESSURE POINTS/RISKS

In my view, the following are the key risks and pressure points the economy is facing.

- 2.1 The huge liquidity in the banking system, poses a clear threat to inflation and exchange rate. The outlook is that the system will continue to be liquid due to government's fiscal operation.

- 2.2 Fiscal risk from increased government spending has exacerbated systemic liquidity over time. The system is likely to witness increased government spending particularly as we approach pre-election year.
- 2.3 Reversal or reduction in foreign inflows, particularly portfolio inflows would continue to put downward pressure on foreign reserves and upward pressure on the naira exchange rate. This is compounded by the seeming end to the global hunt for yield in emerging and frontier markets following the potential phasing out of QE in the USA. MPC should take steps to stem the reversal of these flows or ensure their orderly exit.
- 2.4 Government revenues could continue to be pressured even as oil price is forecast to remain stable in the short to medium term. In the long run, the picture appears to be uncertain because of the variety of economic challenges facing the developed and emerging economies, including the discovery of Shale oil. This could elicit larger deficits and intensify inflationary pressure.
- 2.5 The above stated factors could combine to put pressure on foreign reserves, exchange rate and inflation.

3.0 RECOMMENDATION

- 3.1 Maintaining the tight monetary policy stance is a compelling case. The main challenge remains how to address the liquidity problem in the

system without directly driving market and lending rates up. Whatever prescription is advanced should seek to minimize the ultimate cost of policy.

3.2 It is in the light of the foregoing that I voted as follows:

- Maintain monetary policy rate at 12%
- Maintain the symmetric corridor of plus and minus 2% around the MPR for SLF and SDF respectively
- Maintain cash reserve ratio on private sector deposits at 12%
- Introduce cash reserve ratio of 50% on public sector deposits
- Keep net open position limit at 1% of shareholder's funds.

3.0 GARBA, ABDUL-GANIYU

Foundation for Decision

1. I voted for cut in MPR by 50 basis points at the last three MPC meetings (January, March and May). The primary reason was to discourage portfolio inflows which are distorting asset prices and triggering asset price bubbles and encouraging complacency among investors and undermining the stability of the financial system and the economy. The trend of portfolio flows from January 2012 is incompatible with short and medium term goals of price stability with growth. The *Bernanke effect* which crystalized a few weeks ago

and its contagion effects on Nigerian asset prices and net forex flows give weight to my consistent concern.

2. The short term volatility of portfolio investments in equities and the obvious asset bubble it has triggered in Nigeria raises at least three questions. First, what is the likelihood that post February 2008 bubble will not be repeated and if so, what are the likely costs? Second, what are the *real* economic benefits of the portfolio flows? To what extent do the flows increase investments; productivity growth, output growth, employment growth, incomes, consumption or, sustainable reserve growth? Three, what are the opportunity costs and the gains of countering reverse portfolio flows?
3. The threat of portfolio flows in 2013 arises from the fact that (1) asset price bubble is a global phenomenon; (2) financial markets are malfunctioning all over the world (assets and commodities are overpriced and, growth in credit to productive activities is tepid); (3) the quantitative easing regimes in the US, Europe and Japan and the structural changes that loosened the links between finance and the real economy have overtime, considerably weakened if not broken the transmission mechanisms of policies (monetary and fiscal) globally and (4) liberalism appears to have self-fulfilled its prophecy about a dichotomy between financial and real variables: financial variables now have stronger effects on financial variables and very weak effects on real variables even in the short run. More precariously, good real market news (lower rate of unemployment and better than expected real

growth) now trigger financial market instability (sell off in anticipation of easing of easing).

4. The fragility of the global economic system was revealed in the last few weeks following Bernanke's signal about an ending of QE3. The selloff that it triggered was global and with its exposure, the contagion effects on Nigeria were strong and the mechanism was as expected. This means clearly, that more volatility lie in the short term because easing of quantitative easing is just a question of when not if.
5. It is important for our policy process to recognize that portfolio flows and its volatilities are symptoms of deep seated failures or malfunctioning of markets and of fiscal systems globally also, of a progressive deterioration in the communitarian virtues that built many great economies. It is strategically important therefore, to deal with the underlying causes of malfunctions rather than the symptoms.
6. In recent times, one of the causes of malfunctions in the Nigerian financial system is the paradox of substantial government deposits in Deposit Money Banks (DMBs) and high government borrowing from the DMBs. As at June 13, 2013, the three tiers of government had N2.384 Trillion in the DMBs out of which about 90% are in zero interest bearing Current Accounts. To mop up the liquidity at 14% will cost ₦301.33 billion which is more than the annual budgets of most states. Clearly, governments are over-borrowing, are wasteful in the management of public resources and are undermining the

competitiveness of the DMBs. This corporate welfare, transfers or subsidy is clearly wasteful and costly. In addition, it undermines and corrupts the public sector and makes public resources to generate inefficient outputs and ineffective outcomes. Improving the market and the state demands the correction of the causes of distortions.

7. The Central Bank is the banker to the government. Government deposits belong with its banker: the Central Bank especially as the Federal Government is committed to a Single Treasury Account. Such a good initiative ought to be successfully implemented because it has many fundamental implications for the economy.
8. A policy of increasing CRR on government deposit will help the government to proceed quickly to the Single Treasury Account. By doing so, the government will better manage public resources, cut down wastes and costs. This will help the fiscal consolidation programme of the government and help government succeed in cutting down deficits and borrowing. Acting now is important given the inevitability of the end of Bernanke's QE3 and the corrections in asset and commodity prices that is most likely to follow. The expected crowding-out of crude exports by shale exports is another incentive for government to cut cost and borrow less now. The expressed desire of the government for lower interest rates is an additional incentive: lower borrowing will reduce borrowing costs and conduce easing.

9. An increase in CRR on government deposits will also “incentivize” the DMBs to seek for deposits from the private sector and, to lend to the private sector. After all, the DMBs and other organized private sector players canvass for a market driven economy. A dependence on Government Deposits breeds complacency among DMBs. This policy is thus compatible with a market driven economic model. The policy therefore, helps DMBs to rethink their business models which have lulled them into complacent rent seeking behaviours. Complacency is dangerous in a highly volatile world and complacent financial institutions are the least able to survive in a volatile and highly competitive world. Our recent history and, the costs of cleaning up the consequences of complacent mismanagement of the recent past makes it necessary to support DMBs to develop more sustainable business models. A rate of 50% is strong enough but not debilitating. The future direction is sufficiently strong signal for DMBs to quickly change their business model and adapt to new realities.

10. The trends of government revenue, expenditure and deficit in 2013 have been highly volatile around a growing trend for expenditure and deficits. The volatile trend may not be surprising given that the fiscal anchor (oil revenue) is volatile. Yet, it is also, surprising given (1) the adoption of the excess crude account as a stabilizing mechanism and (2) the fact that the “non-discretionary” component of the budget is very high. The data indicates (1) an expansionary fiscal policy and (2) over-borrowing in excess of the size of

fiscal deficit. Given the size of Federal Deposits in DMBs (about ₦1.16 Trillion) and Federal Deficits (₦413.52) there is no economic reason for the size of borrowing or the extent of drawdown on the excess crude account in the first half of 2013. With better cash management, the Federal, State and Local Governments will require much less credit from domestic and foreign sources.

11. Lower government borrowing will bring fiscal policy into alignment with monetary policy and have downward effects on interest rates, debt service and crowding-out effects. A rate cut in MPR will then be more likely passed on to borrowers. Creating the enabling conditions for a stronger transmission mechanism is a necessary first step to a potentially effective price stability with growth monetary policy regime. In the United States and in the United Kingdom with historically low interest rates, lending to the real sector is low and only carry traders are profiting the most. It is important to counter the adverse effects of “carry trading”. This begins for Nigeria with a fundamental change to the substantial and growing arbitrage opportunities offered by the spread between government deposit and government borrowing.

12. A significant decline in government borrowing will shrink considerably the *rent* (guaranteed above normal profits) appropriated from the games of government deposits and government borrowing. First, lower levels of government borrowing will directly reduce nominal rates on treasury bills and FGN Bonds. Second, lower guaranteed profits will force DMBs to shift from inverted intermediation to virtuous intermediation that is more likely to

expand access at lower cost to investors in real and service activities. The policy thus, is to help DMBs to transit from a precarious rent seeking model to more sustainable business models.

13. The excessive government borrowing has made it very costly to maintain price and exchange rate stability in the last two years. The expected impact of a 50% CRR on government deposit should significantly reduce OMO interventions and reduce considerably the costs of maintaining price and exchange rate stability. The *rent* from the *games of government deposits* and the associated *games of government borrowing* show up as demand for foreign currency in WDAS and interbank market and, as capital outflows in the balance of payments. The data shows that such suboptimal capital exportations have been financed by maintaining balance of trade surplus. The national account identity implies that when domestic output consistently exceeds domestic absorption, (1) investment is likely to be less than savings; (2) potential output is likely to far exceed actual output and (3) resources (including labor) are most likely underemployed. The costs of the games of deposit-borrowing arbitrage are systemic. Thus, eliminating the costs is critical to enhancing the effectiveness of both monetary and fiscal policies.

14. In my personal statement after the July 2012 MPC I argued for “a creative mix of policies and incentives changing actions to change the financial games to ones in which the rational game in town is one that produces rational reaction functions that (1) enhance the efficiencies of the money, bond and

FX markets; (2) deploy liquidity to create rather than destroy money by lending to sectors and activity with highest contributions to output and productivity growth and jobs instead of holding as war chest for speculative opportunities and attacks and; (3) enhances the effective management of liquidity at firm level and economy-wide." I argued further that the "creative mix" is necessary to (1) limit the capacity of speculative and rent seeking players and activities to damage the Nigerian financial system and economy and (2) empower efficiency driven economic agents and activities.

15. I am convinced therefore, that a 50% CRR on government deposit *in the first instance* is necessary to start the process of correcting market and state failures in a concrete and effective way. The very short-run effects and the likely reaction functions of key players have also been well analyzed and anticipated. The right institutions to support the policy are also clear and well within the capacities of the Banking Supervision Department of the Central Bank.

16. The data also shows that DMBs are maintaining liquidity ratios that are more than 30% above statutory liquidity ratios. In addition, DMBs are maintaining reserves with the Central Bank far in excess of the CRR requirements. Both behaviours are symptoms of the rent seeking business model.

17. In addition to the 50% CRR on government Deposits, I support (1) an asymmetric corridor for Special Deposit Facility (-4%) and Special Lending Facility (2%) and (2) zero remuneration for all CRR. Strengthening the

transmission mechanism of monetary policy requires the right incentives. A 10% interest on Special Deposit Facility (SDF) is a disincentive to lending and creation of money. Reducing the returns on DMB deposits under SDF will reduce such deposits. While this may generate changes in portfolio allocations (such as increase in demand for government securities, OMO bills or forex), I am not convinced that the benefits (lower costs and lower incentive for rent seeking) is outweighed by the risks of portfolio realignment. This is more so, since it is not a standalone policy but, complementary to the 50% CRR on government deposit.

18. I am not voting for a rate cut at this MPC for strategic reasons. At this point, changing the business model and correcting the failures in the market is primary. For unless, the transmission mechanism is strengthened, rate cuts will not pass on to borrowers. For instance, the latest data shows that in the last one year (June 2012 to June 2013), only ₦13.6 billion new loans was extended to the manufacturing sector. In contrast, professional, scientific and technical activities (₦61.34 billion) and administrative and support service activities (₦31.52 billion) attracted far more. Most worrisome, the DMBs revealed a preference to lend to the top five sectors with highest share of the non-performing loans acquired by AMCON: capital market, oil and gas, general commerce, construction and Transportation. The contributions of these sectors to GDP and employment are minimal relative to agriculture

and manufacturing which face the problems of access in addition to the problem of cost.

19. My vote at this MPC is a first step because there are more opportunities for a creative mix of policies to improve the efficiency of markets and the state. Once the arbitrage opportunities in the deposit-borrowing game are eliminated; price stability with job creating growth monetary policy will be feasible.

Decision

20. I vote:

- i. to raise CRR on government (Federal, State and Local) Deposits with Deposit Money Banks to 50%;
- ii. to retain CRR on Private Deposits with DMBs at 12%; and
- iii. for an asymmetric corridor of -4% (SDF) and 2% (SLF) around the MPR of 12%.

4.0 LEMO, TUNDE

Macroeconomic performance has been broadly positive since the beginning of the year. Inflation pressure has largely been subdued, headline being at single digit since January, while real GDP growth has also remained robust. However, the downside risks to the near and medium term outlook are quite significant. The major risk is from the external sector through likely sharp decline in the

international price of crude oil arising from the falling external demand due to the discovery of new oil technology (shale and fracking) by the Nigeria's major trading partners, notably the US and UK. This development poses a grave risk to the buildup of the external reserve. At the same time, the imminent tapering off of the quantitative easing by the Federal Reserve Bank has led to reversal of market sentiment against developing and emerging economies with the implication of capital outflows, adding further pressure to the foreign exchange market. Although a reasonable buffer has been built given that the external reserves stood at about US \$48 billion by July 19, which is within the range of optimal reserves for middle income commodity exporting country, the level is still below the pre global financial crisis era. This is indicative that the economy is less resilient relative to the pre global financial crisis period.

Another major cause for concern is the development in the fiscal sector. Actual revenue for fiscal operations showed a negative variance of about 17 per cent during the first half of the year. It is pertinent to note that the revenue is falling not from falling oil price but from shortfall in production. Oil production for the first half of the year averaged 1.9 mbpd, 22 per cent below the 2.52 mbpd assumed in the budget. Borrowing to finance the ensuing fiscal deficit would not only trigger inflation pressure but would also have serious implication for the real sector growth through the crowding out of the private sector credit. Besides, the reversal of portfolio flows, as indicated above, would impact on the pricing of Government debt instruments given that the yield curve on long

tenored government bond commenced an upward movement in May. Thus, the cost of raising funds by the Government might increase, with the implication of further weakening the fragile fiscal account.

Although it is probable to assume a fair degree of fiscal prudence given that the actual fiscal deficit of N413.99 billion at the end of first half of the year was within the proportionate level assumed under the 2013 budget, this was, however, achieved at the expense of the Excess Crude Account (ECA). The current ECA is about 50 per cent of the position at end-December 2012, suggesting that the whole ECA could be completely depleted by the end of the year, if the trend continues. This, invariably, suggests limited fiscal space to respond to the impending adverse developments in the global oil market.

Finally, the episode of liquidity surfeit seems to have re-emerged in the banking sector. The market rates: Overnight Buy Back (OBB) and Interbank call rates (IBCR), have virtually remained at the lower end of the MPR corridor since the beginning of the year, suggesting that the market has completely adjusted to the prevailing stance of monetary policy. The foreign exchange market has been hard hit by this development.

On the balance, it is noteworthy that inflation has maintained consistent deceleration in the recent times, providing a valid premise to review the MPR downward or at least maintain the current level. On the other hand, the risks posed to the external reserve, through the developments in the external sector

as well as the emerging liquidity surfeit in the banking system from large deposit balances on public sector accounts, require a strong policy action.

In the light of these concerns, I vote for the retention of the MPR at 12 per cent and the symmetry corridor of 200 basis points with a view to addressing the likely inflation pressure from fiscal slippage. With respect to the CRR, however, I vote for a CRR of 50 per cent on public sector deposit while the current rate of 12 per cent be maintained on private sector deposit. This is with a view to altering the conduct of the market and curtailing pressure on the foreign exchange market.

5.0 MOGHALU, KINGSLEY CHIEDU

The overarching context for the decision of this meeting of the Monetary Policy Committee is a benign inflation environment in the near-term, with headline inflation reduced to 8.4% and inflation expected to remain in single digits for the remainder of 2013, a volatile global environment, and fundamental concerns about the prospects for the Nigerian economy in the medium term owing to a combination of structural economic defects and global developments. The question, then, is whether the MPC should reduce the monetary policy rate in the face of an immediate inflation outlook that is benign, or hold rates at their current point of 12% for other reasons that are important as well.

Considerations

International Environment: The global environment is characterized at this time by three factors, all with important implications for the Nigerian economy. First, slowing growth in China, continuing recession and rising unemployment in Europe, and still-sluggish recovery in the United States economy, alongside a decline in manufacturing output in these three economies, point to a reduction in their levels of importation since they are producing at less than their capacities. This will have adverse implications for Nigeria's oil exports and thus for the country's earnings from such exports, on which the Nigerian economy singularly depends.

Second, increased production of shale oil and gas in the United States and some other countries through "fracking" technology combined with increased oil finds in a number of other African countries means that competition for oil markets is increasing and Nigeria is already losing the U.S. as a major importer of Nigerian crude. It also has implications for the future price of oil. This situation poses a serious strategic threat to Nigeria's economic growth trajectory as an undiversified, mono-product economy. Combined with oil output production that is well below the benchmark of 2.5 million barrels of oil per day as a result of leakages, oil theft, and shut-ins, the overall outlook for Nigeria is one that justifies deep concern. Lower oil earnings put pressure on the naira exchange rate because such reduced earnings will lead to declining foreign exchange reserves.

Another dimension of the global environment with important effects on the Nigerian monetary sphere is the trajectory of quantitative easing (QE) by the U.S. Federal Reserve Bank. The Fed's accommodative monetary policy stance has important implications for emerging market economies including Nigeria's because it affects decisions on asset allocation by portfolio investors, who, in a search for yield, have invested significantly in Nigeria's financial instruments for a higher yield than is available in more mature economies. This of course has implications – positive and negative – for the stability of the naira exchange rate. Positive because the high MPR of 12% attracts financial flows that help monetary stability in Nigeria, and negative because of the risks posed by the prospect of possibly sudden reversals in capital flows.

The major development since the last meeting of the MPC has been the volatility of the financial markets as a result of the Federal Reserve's unsuccessful attempt at “forward guidance” – an effort to point to an orderly tapering off of QE over the next 18 months, which led to portfolio outflows from Nigeria. But QE will inevitably end at some point. What then for Nigeria as a major beneficiary? This situation suggests what could be described as Faustian bargain with what the U.S. Federal Reserve Bank Governor Richard Fisher has described as the “feral hogs” of the global financial markets.

Economic Fundamentals, Fiscal Deficits and the Political Cycle: When we combine the international environment with Nigeria's economic fundamentals of a mono-product economy vulnerable to external shocks and internal challenges, plus fiscal concerns over elevated government spending (most of it non-discretionary), borrowing and depletion of the excess crude account, we are left with the unpleasant reality that exchange rate stability and its implications for price stability, is presently a factor of outsized importance in Nigeria's macroeconomic management. It is likely that this will remain so for the near to medium term until structural and infrastructure reforms take place and help diversify the economy away from oil.

Maintaining exchange rate stability therefore remains vital for price stability. The MPR is a decisive factor. Furthermore, although the inflation outlook remains benign in the near term, government spending will likely increase as the 2015 elections draw closer, with potential inflationary impact.

Banking System Liquidity Surfeit: We also have structural excess liquidity in a banking system in which chasing government deposits far outweighs bank lending to the real sector in importance as a business model. Average liquidity ratio stood 67.8% at end-June 2013, indicating that funds that could be intermediating in the real economy were sitting in banks or being lent mainly to governments at a handsome profit ironically produced by a (justified) MPR of

12%. It is important that the Nigerian banks' unhealthy dependence on government deposits – which in most countries sit in a central bank – be broken in order to prevent dangerous buildups of liquidity and encourage banks to offer private depositors more returns in order to obtain their savings.

Conclusions

Overall, the question is whether the MPC should tighten, hold the MPR at its present level, or ease monetary rates. Here, the findings of the CBN Macroeconomic Model of the Nigerian Economy (CBN MAC II) have offered decisive guidance and address a number of popular – but erroneous – beliefs about the MPR. From this model it is clear that a reduction of the MPR at this time is not the right path to take. It will affect the stability of the naira because the all-but-certain massive capital outflows will put pressure on the currency which will precipitate either a serious run on our foreign reserves or a depreciation/devaluation of the currency that will be a channel for inflation in an import-dependent economy. Moreover, the model empirically establishes that reducing the MPR will not have a decisive downward impact in lending rates or stimulate credit to the real sector. Rather, what will make a difference is removing the perverse incentives Nigerian banks presently enjoy in depending on government deposits in banks.

Thus, the benign inflation outlook is not a compelling outlook for easing monetary policy yet. A scenario rate of an 8% MPR, at which lending rates will fall significantly, would trigger the highest depreciation of the naira exchange rate, with the consequences outlined above. Maintaining the MPR at 12% results in a high lending rate but will yield a stronger and more stable naira. Remarkably, the CBN MAC II shows that the impact on output growth of its three scenarios of an MPR at 12%, 10% and 8% is similar. In other words, the present MPR is not a drag on growth, which is influenced by far more structural factors. All three scenarios in the model yield a projected output growth rate of 6.5%.

Vote

Based on the above considerations and conclusions I vote to:

- Maintain the MPR at 12%
- Maintain symmetric transmission corridor of plus or minus 2%
- Maintain the Cash Reserve Ratio (CRR) for private deposits in deposit money banks at 12%
- Increase the CRR on public sector deposits to 50%
- Maintain the Net Open Position (NOP) of banks at 1%

6.0 ORONSAYE, O. STEPHEN

Preamble

The Monetary Policy Committee (MPC) meeting of July 22-23 was my first, and I was warmly welcomed by the committee.

Like every other Nigerian concerned about the country's economy, I have been following the trend of MPC decisions and reasons advanced for such decisions.

Although we are yet to arrive at the economic post we desire – low single-digit inflation rate, favourable exchange rate, and strong foreign reserves - I am persuaded to believe that we are on the right path to even greater macroeconomic stability.

Votes

I voted for the following:

- a) Retaining the MPR at 12%;
- b) Maintaining the symmetric corridor around the MPR at +/- 2.0%;
- c) Retaining the CRR at 12%; and
- d) Introducing a 50% CRR on deposits from the Public Sector.

Bases for my decision

It is gratifying to note decelerations in headline and core inflation rates on year-

on-year basis. This, in my view, indicates that the monetary policy measures put in place are delivering the desired results – macroeconomic stability. However, we must continue to tread with caution given the fact that there is likely to be increased Government spending in the course of the year. This is a risk to inflation which is forecasted to remain within single-digit as a result of tight monetary policy.

There have been arguments by stakeholders on the need to reduce MPR in order to free more credit to the real sector, however, the economic reality has shown that a reduction in the MPR does not necessarily translate to more credit for the real sector or the SMEs for that matter.

Conversely, there have been arguments that holding the MPR at 12% has continued to reduce inflation and ensure price stability, which is a core mandate of this Committee. The simple economic question that arises is: If holding the rates at 12% has worked, why do we need to reduce the rate at a time when inflationary pressures can resurface.

Having carefully assessed both arguments, I am persuaded to go with the latter hence my vote to retain MPR at 12%. Relatedly, I voted that the symmetric corridor be maintained around the MPR at +/- 2.0.

Available evidence indicates that there is a build-up of excess liquidity in the banking system. Indeed, records show that DMBs receive deposits from Government (public sector) but do not lend to the real sector. Rather, these

deposits are loaned out to government at high interest rates. This, in my view, should not be encouraged.

In voting for the introduction of a 50% CRR on deposits from the Public Sector, I vote for an ethical business model that encourages greater intermediation in the economy.

7.0 OSHILAJA, JOHN

The Monetary Policy Committee concluded its 233rd meeting with the decision that the Central Bank of Nigeria will begin demanding Differentiated Reserve Requirements (DRR) from all reporting Deposit Money Banks. As of the next Banking Reserve Maintenance Period, all Public Sector Naira deposits shall be held against a Reserve Requirement of 50%.

A Reserve Requirement is the amount of funded liabilities (in this case, deposits) a bank must itself hold as deposits with the central bank. In Nigeria, where the CBN oversees a fractional reserve banking system (like most central banks), this requirement is expressed as the Cash Reserve Ratio, or CRR. As the CRR for all private deposits remains unchanged at 12%, the new requirement on public funds represents an increase of 38%.

I agree, in principle, with MPC colleagues on purposes to be served by the CBN's adoption of a DRR Regime. I however disagree with the timing and pace of regime change. For this reason, I cast the sole dissenting vote on this measure

which, in my view, was prompted by the desire of the CBN (among other longstanding reasons) to curb its escalating Liquidity Management costs.

Reserve requirements offer central banks a cheaper way of draining surplus liquidity; cheaper than the practice of selling government securities outright. It's a simple solution, really. Like any bank, central banks are also obligated to pay interest on debts sold to banks and the investing public. Similarly, central banks are also not obliged to pay interest on demand deposits. While this tactic is typically easier on a central bank's purse strings, it is not always the case for the economy at large. In Fractional Reserve Banking, increasing Reserve Requirements curtails the availability of credit by contracting the lending capacities of banks.

My concerns about differentiating the CRR in Nigeria at this time center around the expected and potential impacts of such a measure on a weakening economy, with shallow financial markets, coupled with poor visibility on the preparedness of the banks (including quite possibly the CBN itself) to manage likely fallouts of a widely unanticipated Liquidity shock.

I would have preferred to see the CBN provide forward market guidance on the measure; publicly and effectively pre-announcing its intentions, and undertaking further collaborative steps (communicated via circulars and such) ahead of implementation, to minimize the potential for public confusion and market disorder. The perverse incentive the CBN now seeks to address is not

peculiar, and has existed in Nigeria since colonialists established formal banking in the country. Hence, any time and money taken to ensure a smooth transition would, in my opinion, have been time and money well-spent. The MPC values its market credibility and works to build and sustain this with its transparency and judicious use of Regulatory Power. But these are not the only means available to Monetary Authorities. Demonstrating competence, even-handedness and due reciprocal respect can be just as effective in promoting regulatory credibility and market confidence. On this occasion, I also would have preferred that we placed more reliance on these latter qualities of the Central Bank than the former.

Think of this latest move by the CBN as a system-wide margin call – by my calculations, a N885 billion margin call.

My vote signified misgivings about the potential for disorderly asset liquidations in our securities markets; as local banks and other leveraged investors scramble to raise cash. Some borrowers may face calls from their bankers to accelerate loan repayments. Newly approved, though undisbursed, credits may now be renegotiated for shorter tenors; thus squeezing carefully prepared company expansions and projects for investible cash. Projects in developmental stages may also be deferred; being now unable to meet the lowest returns required by investors. And even if all of the above should thankfully not occur, costs of borrowing in the economy are now set to rise across the board. As I see it, this mandated general increase, in the cost of funds to the economy, is premature.

This turn of events unfolds at a time when public expectations (and Bank forecasts) of inflation continue to be subdued, exchange rate pressures are considered to be easing, and private sector lending is showing signs of revival. On an annualized basis, credit to the Core Private Sector is growing at just over 7.5% – a category of credit that grew at just under 6% for the whole of last year. It remains to be seen if this latest assault on excess bank liquidity will meaningfully grow Private Sector credit as desired in the coming months. Nonetheless, in the shorter term, I would advise private borrowers not to hold their breaths.

Roughly N3 Trillion of Nigeria's N15 Trillion deposit-base are public sector deposits. Under the old Reserve Requirement of 12%, Public Sector deposits alone provided banks with a capacity to lend of up to N24 Trillion. With DRR, this potential is now reduced to N6 Trillion. There remains a further N12 Trillion of private deposits that endows banks with a maximum lending capacity of N96 trillion. Clearly, expectations of the MPC are that more of this remaining and largely unused capacity (now N102 Trillion in total) will be used to grow the economy more productively. If this looked to be the case, in an anticipated declining interest rate environment, I most certainly would have voted differently. Which brings me to the root cause of the developments outlined so far: the fiscal position and dominance of Government in Nigeria which, in my opinion, once again threatens to obliterate any reasonable possibility of achieving single-digit Naira borrowing rates within the foreseeable future.

Government in Nigeria has been a net creditor to the economy for years; a principal source of funds flowing, through the banking system, to feed and build through paychecks and credit. However, rather than investing these flows in credit-risky loan assets, Nigerian banks demonstrate an understandably prodigious appetite for credit-riskless assets – such as those created by Government financing operations e.g. Treasury Bills and Bonds. This condition also happens to be the means by which banks everywhere, as custodians and intermediaries of the public's funds, capitalize on a perverse incentive promoted by Financial Authorities themselves. Supply begets its own Demand, and this incentive is not unique to Nigeria, or developing countries. It also exists in advanced economies, rewarding banking systems for performing the aforementioned economic functions. Compensations thereby derived are also intended to be additional to the rewards of expert risk-taking and management when conducive credit market structures and conditions prevail. Hence, it is to Nigeria's further economic loss that its banks have been allowed for decades to build entire business models around what is in effect a subsidy; and what in normal circumstances elsewhere are secondary and even tertiary sets of business priorities.

In low income economies, characterized by smaller formal Private Sectors, less robust credit distribution channels – structural economic and market deficiencies in general – the Public Sector's use of credit tends to feature

prominently when net exposures in financial systems are tallied by sector. As China and others in Asia and Latin America have shown, Fiscal Policies can be powerful forces for constructive economic development. It simply depends on the purposes for which Policy and associated Official borrowings are designed. Economies tend to deliver Income and Job Growth when continuous effective investment, in physical and social infrastructure, are dominant drivers in sensible Government borrowing and revenue mobilization. Growth of such desirable qualities is not the typical outcome if all an economy does is deplete irreplaceable natural and economic resources, to pay for foreign goods and services, while financing inequitable subsidies and sub-standard production at home.

With longstanding revenue vulnerabilities of Government vigorously reasserting themselves – through below target oil production, slowing export markets and now oil-export theft – the Federal Government (FG) is commendably, at N414 billion, 7% short of its deficit target in an already expansionary Budget. Nonetheless, the FG is funding an actual 2.1% of GDP deficit against the 1.85% it originally estimated for 2013. According to CBN staff calculations, Federal and Consolidated Government net revenues are currently 21.3% and 22.5% below their respective targets. The FG's expenditures (notably those slated for capital investment) are down 18.5% while, on a consolidated or FAAC basis, nondiscretionary recurrent expenditures are barreling along at a 10.3% higher run-rate than 1H 2012 levels. Government, in Nigeria, appears quite happy to

“share” revenue benefits, but is not as exuberant in managing commensurate responsibilities for expenditure management. The bottom line is that Nigeria’s public revenues are falling twice as fast as the running costs of Government are rising. And to cover this widening gap, despite deferrals (on public investment) and draw-downs (on fiscal savings), an increasingly squeezed FG and spendthrift sub-national counterparts are increasingly turning to debt markets for sustenance.

So far this year, the Federal Government alone has incurred debt service costs of N309 billion. Knowledgeable back of the envelope estimates puts the cost of CBN Liquidity Management over a similar timeframe in the region of N200 billion. Simply stacking these figures in total against the N595 billion earned in Net Interest Margins this year to date – by CBN-reporting banks – brings the symbiotic relationship between Government and Banking in Nigeria into stark relief (overseas institutions are prohibited from investing in CBN’s Liquidity Management debts). I am all for realigning this dysfunctional systematic relationship to derive meaningful improvements in the delivery of Public Services and values added to the Nigerian economy. In my professional opinion, however, successfully attaining goals of this nature and scope demands much more of the CBN, MPC, and Government itself than the mere stroke of a regulator’s pen.

8.0 SALAMI, ADEDOYIN

My pre-MPC reflections had centered on 2 issues: how badly had Nigeria been affected by the US Federal Reserve's 'forward guidance' about the likely timing of the commencement of its unwinding of the Quantitative Easing (QE) programme; and the impact on Nigeria's fiscal position of the continued gap between the budget's assumption on oil revenues and realised income. As it was, the issues with respect to the impact of QE became secondary – although not without leaving a mark! This left our fiscal challenges at the centre of attention.

Whilst the 'Fed' has since gone about dousing the fires ignited by its initial announcement, Nigeria, like many other emerging and frontier markets, has seen a reversal of capital flows. Available data shows cash outflows in May and June 2013 amounting to US\$9,132mn and inflows, in the same period of US\$6,205mn. The outflow of US\$5,898 in June 2013 exceeded the level for the same month a year earlier by approximately 29 percent. The net outflow of US\$2,789mn in June 2013 came on the heels of net outflows of US\$81mn and US\$138mn in April and May 2013. The net outflows in May and June contrast with net inflows for the same months a year earlier.

Unsurprisingly, Nigeria's external reserves dropped from US\$47.7bn in May 2013 to US\$44.98 the following month. Perhaps most heartwarming is that our foreign

exchange reserves had, by mid-July, recovered to US\$47.99bn. The US\$3bn improvement in reserves between the end of June 2013 and Mid-July 2013, if sustained will result in the best month-on-month improvement in reserves since Jan 2012. It appears that the challenge of whether to haemorrhage reserves in response to speculative capital outflows or to employ exchange rates as the instrument of adjustment is thus deferred.

Poor performance of oil production, and thus revenues, despite rising prices meant the fiscal position and outlook would be a source of concern. Available figures show a Federal Government budget deficit of NGN413.99bn in the first half of the year. Though marginally better than the NGN443.52bn provided for in the 2013 budget of the Federal Government, this compares unfavourably with NGN277bn for the same period a year ago. The extent of change in fiscal posture worsens when it is borne in mind that the Federation Reserves, otherwise known as the Excess Crude Oil Account, fell from US\$11.46bn in December 2012 to US\$5.52bn in June 2013. At this rate of utilisation, the Federation Reserves will be exhausted before year-end!

Concern about the loose stance of fiscal policy is exacerbated by a realisation that emerging evidence points to alignment of the spending and electoral cycles. This pending alignment suggests that based on the pattern defined by the growth in government spending since the restoration of democratic rule,

control over government spending is unlikely to be restored this side of the next General Elections – especially given the high proportion of nondiscretionary spending. The loose stance of fiscal policy creates a challenge to which monetary policy has to respond. Questions are: “When is the right time?” and “How should Monetary Policy respond?”

The very high liquidity of the Deposit Money Banks continues to pose a risk to monetary stability – especially the exchange rate. Whilst the Central Bank has deployed its Open Market Operations in liquidity management, slow growth in the expansion of nongovernment lending creates vulnerabilities. In this context, it is may be pertinent to provide incentives which stimulate intermediation – albeit at the cost of raising lending rates!

While lending rates will rise, I expect that sterilizing government deposits (well, half of the government's deposits) will also raise deposit rates. The disruptions should be weighed against the risk, which a highly liquid banking system poses to the currency.

On a positive note, the rise in domestic prices has been well anchored. For the sixth month in a row, the rate of increase in aggregate prices (allowing for seasonal influences) remains in single digit. National Bureau of Statistics' data for June 2013 show Headline, Core and Food prices rising by 8.4 percent, 5.5

percent and 9.6 percent respectively. More importantly, Staff estimate a benign outlook for prices, forecasting a peak in headline inflation of 8.9 percent between July and August, followed by a steady decline thereafter to 7.4 percent by year-end.

Staff year-end projections for the other components of inflation are no less encouraging. Despite Staff expectations of a rise in core inflation in the four months to end-October 2013, when this count is expected to peak at 7.2 percent, non-food inflation is expected to close the year at 6.7 percent. On the basis of these projections, year-end 2013 close for core inflation will be 700bps lower than it was twelve months earlier! The projections for the rate of increase in food prices, adjusted for seasonality, are no less cheerful. Staff predict that food price inflation, though more variable, will close this year at 7.8 percent. In 2012, food inflation ended the year at 10.2 percent.

9.0 UCHE, U. CHIBUIKE

There is a reasonable degree of consensus that the root cause of the recurring economic difficulty in Nigeria has been our inability to diversify the economy away from oil rents. As a result of the above, our economic health has been tied directly with world oil prices and domestic oil output. Both variables, which have until recently been on the increase have helped fodder the fiscal dominance stance of government and the emergence of our country as a rentier state. The

above scenario has made the formulation of monetary policy extremely difficult especially during periods when our recurring fiscal expansion has been entwined with falling crude oil production and/ or prices.

The result is that over the years monetary policy has been preoccupied with dealing with the consequences of fiscal expansion which include: high interest rate, high inflation rate and pressures on the exchange rate of our currency. By far the most grievous consequence of our tight monetary policy stance is the fact that it discourages lending to the real sector. Inadvertently, we are now mainly concerned with treating the symptoms while at the same time aggravating the root cause of our economic problem. While it is true that the focus of MPC is price stability, I have consistently maintained that this cannot be an end in itself. The very essence of our price stability mandate is to help promote economic growth and real sector development.

Recent developments point to the possibility that even with the best of intentions and using our conventional monetary policy tools, we may no longer be in a position to ensure price stability in the medium term. Few, for instance, would disagree with the fact that with the continuing discovery of huge reserves of shale oil around the world; increasing oil theft in our country and the improving technology for the refining of heavy crude, the current downward trend in our revenue from oil will likely be sustained at least in the short and medium term. The increasing shortfalls in oil revenue, in recent times, which has led to increased government borrowing in the current year is not likely to abate

in the near future. It is instructive that even OPEC had now advised Nigeria to diversify her economy.

Unless we diversify our economy, this problem can only get worse. Monetary tightening to guarantee price stability, which will definitely come at the expense of real sector economic growth and development, will yield little meaningful result even in the short run. The structural nature of our monetary policy problem is perhaps best brought out by the fact that our commercial banks are increasingly shying away from their traditional intermediation function. Handsome returns earned from investments in risk free government securities have helped promote this unfortunate behavior by banks. Under the above scenario, banks have simply become the conduit for transferring private sector savings to the government which has shown little restraint for fiscal expansion. Another worrying trend is the practice where government place huge sums of money in banks at little or no interest and then turn back to borrow from such banks, directly or through treasury bills, at double digit interest rates. This trend is clearly not sustainable. While the incentive for this perverse behavior may be open to debate, we must find creative ways of using monetary policy to curb such harmful practices. One way to do this is to apply a very high CRR on government deposits. At the very least this will make it less lucrative for banks to target government deposits. More prudent fiscal management by government will also no doubt help reduce the impact of government fiscal dominance on monetary policy.

The idea that MPC should adopt a blanket tight monetary stance, possibly through the increase of CRR is in my view not well thought out especially at the present time. This is especially so when one considers the fact that such an action will hurt the real sector more. The Nigerian Government does not have a very good record of showing restraint especially when it comes to increasing interest rates to attract investments in its debt securities. The real sector clearly does not have this privilege. We must devise creative ways of using monetary policy to encourage banks to lend to the real sector.

Furthermore, I personally find it difficult to justify a blanket tightening of our monetary policy when available evidence suggests that inflation has indeed ameliorated and it is also unlikely to be a threat in the near future. Rather, I am of the humble view that the current scenario provides us with a modest opportunity to signal our determination to encourage credit to the real sector by reducing MPR by 50 basis points. Admittedly, as I noted in a previous decision statement, reducing MPR alone will not be the sole solution to this problem. We must find creative ways of addressing the issue of the rising spread between deposit and lending rates. It is for instance no exaggeration to conclude that our current policy of relying on moral suasion to attain the above objective has failed. The exploitative and predatory nature of our banking system is further highlighted by the impunity with which some banks defraud the public through fraudulent schemes like the overcharging of interest rates. Thankfully, the CBN has already started to expose such schemes. I however believe that the time

has come for us to create a regulatory regime that will provide a strong economic disincentive against such practices.

Finally, the current foreign exchange volatility we experienced in the past month or so makes it prudent for me to again express my reservations with respect to the “popular view” that maintaining high MPR makes Nigeria competitive with respect to attracting Foreign Direct Investments. This is because most of these so called FDIs are simply speculative capital looking for short term profit outlets. This kind of capital does not develop economies. Admittedly, attracting such FDI usually help central banks to curtail exchange rate pressures. This however happens only in the short run. Experience has shown that in the long run, speculative capital is always volatile and economically disruptive. The reverse flow of such capital can easily put pressure on both currency exchange rates and the capital market. FDI makes sense only when it is applied to real sector economic development. Recent developments have reinforced my belief that the time has come for a rethink of our FDI policies. As a start, we must formulate policies that discourage the inflow of short term FDI.

In conclusion therefore, I will like to see monetary policy focus more on policies that will help the diversification of our economy. This is the root cause of our current economic problems.

In the light of the above factors, I hereby vote as follows: (1) to reduce MPR by 50 basis points to 11.50 percent with interest rate corridor of + 200/- 200 basis

points; (2) to retain CRR at 12 percent but increase CRR on government deposits to 50 percent; and (3) to retain Liquidity Ratio at 30 percent.

10.0 SANUSI, LAMIDO SANUSI, GOVERNOR OF THE CENTRAL BANK OF NIGERIA AND CHAIRMAN OF THE MONETARY POLICY COMMITTEE

The Environment

We are meeting at a time the Financial Markets are beginning to calm down after weeks of turmoil. If the recent strong, almost irrational reaction of markets to the guidance of Chairman Bernanke may have had a disconcerting effect, its real value lies in reminding us about the fickleness and fragility of markets and the ease with which capital moves across borders. Bernanke stated an obvious fact: that at some point, the U.S economy will recover and the Fed will have to stop its QE performance. The Fed chairman did not say that QE termination is imminent. Also a tapering of QE is not monetary tightening. It simply represents a slowdown in the rate of expansion of the Fed's Balance Sheet.

In spite of this, the world saw a sudden, wide-spread, knee-jerk reaction with yields in US treasuries spiking and huge sell-offs by investors in Emerging and, to a lesser extent, Frontier markets. The lesson for us is to remember that, in the short-term, markets are not necessarily rational. They are also very fickle. For this reason, we cannot afford, as some analyst have suggested, to simply play

around with the exchange rate (by moving the mid-point or widening the band). This is because once the markets doubt our commitment to exchange rate stability and start betting against the Naira the costs can be very high. Similarly, we cannot afford to ignore the build-up of systemic risks. The very high excess liquidity in the system (as evidenced not just by high Liquidity Ratios but also by the sheer size and frequency of OMO activities) is a case in point. So also is the sharp rise (on an annualized basis a doubling over 2012) in the borrowing by the Central Government, at a time when the Federation has spent over N700b out of the excess crude savings accumulated in 2013.

I have just covered, above, the main areas of concern, to my mind. Headline inflation in June printed at 8.4%. It will rise a bit, accordingly to staff forecasts, in the third quarter, but will remain below 10% and may even end the year at below 8%. We have had our own share of selloffs and pressure on our currency, but in line with our plans for this eventuality, we have maintained relative stability at little cost to Reserves. The Naira is trading slightly out of our preferred band but it will return there soon and hopefully the investors will return. Banking sector indices are all satisfactory and the capital market is in a healthy state. By all indices we really do not need to do anything.

Despite all of that we need to be sensitive to other facts. The fiscal deficit in H1:2013 was N413.99b compared to N277.8b in H1:2012. The Federation has

drawn N706.3b from the Excess Crude Account. We know about 52% of this goes to the Federal Government, a figure in excess of N350b. If the savings had not been drawn, the deficit would have been in the region of N770billion in H1:2013 alone. Let us recall that the total deficit in the 2013 budget was estimated at N887billion. At this rate the actual deficit will be over N1.4trillion at the end of the year. Net consolidated revenue stood at N3.5trillion in H1:2013 i.e. 22.5% below target, yet FAAC distribution amounted to N4.22trillion (averaging N703b a month) i.e. 96.3% of target. On a forward looking basis this is a build-up of inflationary risks that will be compounded by election spending. To keep monetary conditions unchanged is to be overly accommodating of fiscal exuberance. Clearly, the Government has derailed from the path of Fiscal consolidation followed in 2012.

The Banking system is also sitting on so much liquidity and not deploying it to the real economy including large amounts held as public sector deposits. So the Government has borrowed over N2trillion from the banks yet Government agencies have over N1.3trillion sitting interest free in the same banking industry. I am convinced that this systemic liquidity, if not dealt with, will constitute a risk to price and exchange rate stability, in addition to being a perverse facilitator of rent seeking and arbitrage.

My vote

Having weighed all the options open to us I vote as follows:

1. I support leaving the MPR at 12% principally to leave space for raising MPR in the event of increased spending during the electoral cycle. Also, the very high costs of OMO would advise complementing the MPR with other tightening measures. I see no benefit to lowering MPR at this point that will outweigh the risk of currency depreciation, capital reversal and further encouragement of Fiscal Dominance;
2. I do not support the proposed asymmetric corridor because a lower remuneration of SDR is an easing signal. This contradicts our view that conditions are already loose. I vote with the majority for retaining the symmetry.
3. I concede that we should leave CRR on non-public sector deposits at 12% for the same reason as above. I will therefore refrain from voting for an increase so long as the option is kept open should the need arise in the future.
4. I vote for increasing the CRR on Public Sector deposits to 50% as this will achieve the multiple objectives of
 - a) Improving market conduct;
 - b) Supporting the Naira and

c) Tightening liquidity conditions.

It also sends clear signals of commitment to stability on all fronts.

I vote accordingly.