It is Time to Resolve Nigeria's Monetary Policy Conundrums

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Abstract

In the last six years, Monetary Policy Committee (MPC) decisions have included easing the monetary policy rate (MPR) just once, November 2015, and the cash reserve requirement (CRR) has been eased just twice, July and November 2015. In contrast, the MPR has been tightened ten times, including twice during the recession in 2016, and the CRR has also been tightened ten times, including once in 2016. It is very puzzling that MPC finds extraneous reasons, typically about banks or foreign exchange supply, to tighten monetary policy, even when the economy is contracting and can do with some liquidity boost.

This paper demonstrates how MPC decisions have become disconnected from economic realities, and suggests the urgent steps that must be taken to ensure a reconnect. We compare the patterns in historical monetary policy decisions across Soludo, Lamido, and Emefiele regimes to trace the emergence of the disconnect and establish the best strategies for reconnecting. We also clarify the numerous misconceptions about the nominal MPR, positive real interest rate, foreign portfolio inflows that are often expressed in the MPC communiques.

The economy is bigger and more important than the banks, but MPC statements continue to dwell on banks' conditions, rather than on economic conditions, indicative of lapses in banking supervision. Failures of micro/macro-prudential policies are spilling over into the monetary policy space, inflicting high growth and employment costs on the economy. What the UK government has done in reforming the Bank of England over the last two decades, especially in functionally separating responsibilities for monetary policy and micro/macro-prudential policies, is an example of the reforms required in Nigeria.

Apart from banks' conditions, MPC statements have also had a lot to say about the need to keep the policy rate high enough to attract foreign portfolio inflows, rather than ease rates to stimulate growth and investment, betraying another spill-over into the monetary policy space from weaknesses in the foreign exchange policies of the Central Bank of Nigeria (CBN). Nigeria's foreign investment policy must be recalibrated away from preoccupation with volatile and easily reversible portfolio inflows towards greater reliance on harder to reverse diaspora and foreign direct investment inflows.

We argue strongly for immediate reforms in Nigeria's monetary policy processes, Nigeria's banking supervision arrangements, and Nigeria's foreign investment policies. Those reforms are needed to ensure an orderly transition to a low MPR/low CRR regime that is urgently needed to boost growth and investment.

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1. Making Sense of Historical Monetary Policy Decisions

In the last six years, Monetary Policy Committee (MPC) decisions have included easing the monetary policy rate (MPR) just once, November 2015, and the cash reserve requirement (CRR) has been eased just twice, July and November 2015. In contrast, the MPR has been tightened ten times, including twice during the recession in 2016, and the CRR has also been tightened ten times, including once in 2016.

It is very puzzling that MPC finds extraneous reasons, typically about banks or foreign exchange supply, to tighten monetary policy, even when the economy is contracting and can do with some liquidity boost. We demonstrate that MPC decisions have been disconnected from economic realities, and urgent steps must be taken to ensure a reconnect. The economy is bigger and more important than the banks, but MPC statements continue to dwell on banks' conditions, rather than on economic conditions, indicative of lapses in banking supervision.

To make sense of the historical monetary policy decisions, we compare the patterns in policy decisions across the Soludo, Lamido, and Emefiele regimes. This uncovers significant and instructive insights across the regimes.

a. Soludo Era

		MPR	CRR		
			Unified	Private	Public Sector
	Jun-04				Withdrawal of N74.5 billion (75.6 %) of public sector deposits
2005	Jan-05	Reduced MRR from 15% to 13%	2-week maintenance period for CRR		
	Jun-05		CRR increased from 9.5 to 10 %		Withdrawal of ₦60 billion public sector deposit
	Nov-05				Withdrawal of NNPC deposits, sale of N60 billion CBN instrument
2006	Jun-06	Raised the MRR from 13% to 14%			
	Nov-06	Replaced MRR with MPR at 10%			
2007	Jun-07	Reduced MPR from 10.0 % to 8.0 %)			
	Oct-07	Raised MPR from 8.0 % to 9.0 %)			
	Dec-07	Raised MPR from 9.0 % to 9.5 %)			
2008	Apr-08	Raised MRR from 9.5% to 10%			
	Jun-08	Raised from 10% to 10.25			
	Sep-08	Reduced from 10.25% to 9.75%			
2009	Apr-09	Reduced from 9.75% to 8%			

[1] This paper is sequel to two earlier attempts to highlight puzzling developments in the monetary policy management in Nigeria: Teriba, A. (2013), 'Puzzles About Monetary Policy in Nigeria', September 1, 2013. Https://ssrn.com/abstract=2442602; and, Teriba, A. (2014), 'Recent Changes of Guards at the Central Bank of Nigeria', June 5, 2014. Https://ssrn.com/abstract=2446591.

Charles Chukwuma Soludo met the MPR at 15 percent, raised it on five occasions and eased it on five occasions over his tenure to leave it at 8 percent when he left. He met the CRR at 9.5 percent, raised it to 10 percent the month he took over, but also withdrew 60 billion public sector deposits from the banks in the same month, and subsequently preferred the later approach to CRR, which he effectively abandoned, making more withdrawals in November of that year. He cut policy rate from 15 percent to 8 percent, and cut CRR from 9.5 to 1 percent over his five-year term.

The strategy of withdrawing public sector deposits to mop up excess liquidity targeted the specific banks with excess liquidity problems, without putting any burden of increased CRR on banks that did not have the problem. Once the excess liquidity had been effectively mopped up, he was able to ease rates sustainably without any backlash, and market rates eased considerably for nearly one and a half years after he left, before his successor changed the strategy in September 2010.

b. **Lamido Era**

Sanusi Lamido Sanusi met the MPR at 8 percent, eased to 6 percent it at his first MPC meeting in July 2009, the only time he eased, then raised it to 6.25 percent fourteen months later in September 2010, and then raised at each the six meetings in 2011 to 12 percent by October, holding it at that level until he left. He met CRR at 1 percent, never eased it, but raised it on four occasions to 12 percent over an 18- month period from January 2011 to July 2012, he left it at that level on private deposits but raised the CRR on public sector deposits to 50 percent in July 2013, and 75 percent in September 2013, then raised the one on private deposits to 15 percent in November 2013, leaving the one on public sector deposits at 75 percent. Lamido raised the MPR from 6 percent to 12 percent, and raised the CRR from 1 percent to 15/75 percent in his time. He eased MPR once and raised it seven times. He never eased CRR, but raised it seven times.

		MPR	**CRR**		
			Unified	Private	Public
	Jul-09	Reduced from 8% to 6%			
2010	Sep-10	Raised from 6% to 6.25%			
2011	Jan-11	Raised from 6.25% to 6.5%	Raised from 1% to 2%		
	Mar-11	Raised from 6.5% to 7.5%	Raised from 2% to 4%		
	May-11	Raised from 7.5% to 8%	4%		
	Jul-11	Raised from 8% to 8.75%	4%		
	Sep-11	Raised from 8.75% to 9.25%	4%		
	Oct-11	Raised from 9.25% to 12%	8%		
2012	Jul-12		12%		
2013	Jul-13			12%	50%
	Sep-13			12%	75%
	Nov-13			15%	75%

Lamido shied away from confronting the individual banks with excess liquidity problem, preferring to hike both policy rate and CRR to ridiculous levels until he left. Banks without excess liquidity were forced to swallow the same CRR pills that should have been prescribed only for banks with excess liquidity.

Soludo's style of mopping up public deposits from specific banks with excess liquidity is indeed equivalent to a selective cash reserve requirement regime in which the hammer falls only on the banks that are likely to destabilize the system with excess liquidity. Some variants of that approach are now needed to demolish the ostensible MPR and CRR burdens that Lamido had unnecessarily heaped on the economy, which his successor is aggravating, and pave way for an orderly transition to a low MPR/CRR regime that is required to underpin a regime of low market interest rates and stronger liquidity support for real economic growth.

c. Emefiele Era

Godwin Emefiele met MPR at 12 percent when he took over in June 2014, raised it to 14 percent in November of that year, eased it to 11 percent a year later, the only time he eased, before raising it to 12 percent in March 2016, and raised it further to 14 percent in July 2015. He met a CRR regime of 15 percent on private deposits and 75 percent on public sector deposits, raised the one on private sector deposits to 20 percent in November 2014, maintaining 75 percent on public sector deposits, until he unified the two at 31 percent in May 2015, then cut it to twenty five percent in July 2015, and cut it further to 20 percent in November 2015, before raising it to 22.5 percent in March 2016. He has thus hiked policy rate thrice and eased it once, and hiked CRR thrice and eased it twice, to leave both levers tighter than he met them.

		MPR	CRR		
			Unified	Private	Public Sector
2014	Nov-14	Raised from 12% to 13%		20%	75%
2015	May-15		31%		
	Jul-15		25%		
	Sep-15		25%		
	Nov-15	Reduced from 13% to 11%	20%		
2016	Mar-16	Raised from 11% to 12%	22.50%		
	Jul-16	Raised from 12 % to 14%	22.50%		

Like Lamido, Emefiele has continued to shy away from confronting the individual banks with excess liquidity problem, preferring to hike both policy rate and CRR to ridiculous levels. Banks without excess liquidity are still being forced to swallow the same CRR pills that should be prescribed only for banks with excess liquidity. Thus, while monetary policy conundrums, maintaining tight policy stance in the face of weak growth and employment realities, emerged in the Lamido era, it has been continued and slightly aggravated in the Emefiele era. Nigeria must seek an orderly return to the pre-Lamido era of low MPR/CRR combined with selective liquidity interventions.

2. Tightening monetary policy stance in a recession is very puzzling

While the Central Bank of Nigeria {CBN) Act created the Monetary Policy Committee (MPC) with a dual mandate as follows, 'facilitate the attainment of the objective of price stability and to support the economic policy of the Federal Government', the MPC tends to wrongly claim the first of the two mandates as its primary mandate.

There is a need for the MPC to pay more attention to the second mandate, especially now that the Federal Government is embarking on an Economic Growth and Recovery Plan. To support economic growth and recovery, the MPC must ease its policy stance by cutting monetary policy rate in an orderly manner to such a low level that will provide much needed liquidity support for investment and sustained growth.

Money is different from credit. Monetary ease is different from ease of credit. Monetary policy is first about money before it is about credit. Easy money will help economic recovery even if it does not translate to easy credit.

3. It results from conflicts from laxity in banking supervision/prudential regulation

One of the reasons given by the MPC for not easing its monetary stance was that, 'in the past, the MPC had cut rates to achieve the above objectives; but found that rather than deploy the available liquidity to provide credit to agriculture and manufacturing sectors, the rate cuts provided opportunities for lending to traders who deployed the same liquidity in putting pressure on the foreign exchange market which had limited supply, thus pushing up the exchange rate.'[2]

First, this highlights tensions between monetary policy and micro/macro-prudential policies: the MPC is not easing policy because banks' choices in response to policy easing may destabilize the economy. This MPC statement also confirms lapses in micro/macro-prudential policies: there are no supervisory/regulatory arrangements in place to ensure that banks' responses to policy easing will not destabilize the forex market.

Nigeria thus faces a situation in which the MPC will be unable to fulfil the second part of its dual mandate so long as banking supervision/regulatory arrangements remain lax. Stronger supervisory regimes in the central bank in the past would promptly mop up excess liquidity in the specific banks that have it, either by issuing stabilization securities or moving Federal Government deposits out of such banks into the central bank coffers, and go on to ease monetary policies for the sake of overall economic growth and stability. Banking supervision should not weaken to the point that the central bank gives excuses on behalf the banks it is supposed to supervise.

Second, the last part of the above quote, 'the rate cuts provided opportunities for lending to traders who deployed the same liquidity in putting pressure on the foreign exchange market which had limited supply, thus pushing up the exchange rate', also highlight tensions between monetary policy and foreign exchange policies: the CBN's policy of demand protection and price control is inferior to the alternative of confronting the limits on the supply of foreign exchange. More on this in Section 5.

4. Monetary and micro/macro-prudential policies must be realigned

The **CBN Act of 2007** rightly created the Monetary Policy Committee (MPC) in **Section 12** and the Financial Services Regulatory Committee (FSRCC) in **Section 43** to address different aspects of macroeconomic policy concerns. While the MPC has actively and transparently engaged its monetary policy mandate through six meetings a year, the FSRCC has been dormant and opaque, with the consequence that its errors of omission in the micro/macro-prudential policy space have spilled over into the monetary policy space and are now creating tensions in the pursuit of the growth and recovery objectives of monetary policy.

Both committees are chaired by the Governor of the Central Bank, but while the MPC includes all the four Deputy Governors of the CBN and two other Members of the CBN Board, the FSRCC includes only the CBN Governor. While the membership of the MPC gives no room for any other institution to be represented apart from the CBN, the FSRCC membership includes representations from five other institutions, viz: Nigerian Deposit Insurance Corporation (NDIC), Securities and Exchange Commission (SEC), National Insurance Commission (NAICOM), Corporate Affairs Commission (CAC) and the Federal Ministry of Finance (FMF). The MPC includes three individuals to be appointed by the President, and two individuals to be appointed by the CBN Governor, who are selected for their expertise in economic analysis, the FSRCC does not include any individual appointee.

[2] See MPC Communique No. 108 of July 2016.

The search for realignment between monetary policy and micro/macro-prudential policies in England initially led to the creation of a Financial Services Authority (FSA), and eventually splitting its responsibilities between two new agencies: the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA) of the Bank of England. The PRA is the UK's prudential regulator for banks, insurers and major investment firms, and is chaired by the Governor of the Bank of England. Four members of the Board are Bank staff, including The Governor and three Deputy Governors. Independent external members have a majority on the PRA Board, including the Chief Executive of the Financial Conduct Authority and six others selected for their experience and expertise in financial services. Nigeria urgently needs to strengthen the supervisory component of the FSRCC mandate along the lines of the UK FRA.

5. Policy rate does not have to be kept high or positive in real terms

High interest rate environment orchestrated by unnecessarily high levels of the MPR and CRR is hurtful to investment and growth. The MPC had justified the July 2016 tightening thus:

> 'The MPC in putting forward for tightening considered the high inflationary trend which has culminated into negative real interest rates in the economy; noting that this was discouraging to savings. Members also noted that the negative real interest rates did not support the recent flexible foreign exchange market as foreign investors attitude had remained lukewarm, showing unwillingness in bringing in new capital under the circumstance. Members further noted that there existed a substantial amount of international capital in negative yielding investments globally and Nigeria stood a chance of attracting such investments with sound macroeconomic policies. Consequently, members were of the view that an upward adjustment in interest rates would strongly signal not only the Bank's commitment to price stability but also its desire to gradually achieve positive real interest rates. Such a decision, it was argued, gives impetus for improving the liquidity of the foreign exchange market and the urgent need to deepen the market to ensure self-sustainability.'[3]

Evaluating the above quotation from MPC Communique No. 108 of July 2016, it is necessary to make the following clarifications:

i. The argument by the MPC that the policy rate must be kept high to ensure a positive real rate and encourage savings is rather hollow and distracting from the objectives of the MPC because there are many other rates in the market that should be used to attract and reward savers with positive real returns.
ii. Monetary policy rates in some leading economies are currently negative, zero or slightly above zero, and well below the rate of inflation. This has not precluded the existence of much higher rates that continue to attract savings in those markets and offer positive real returns.
iii. In any case, why would anyone be trying to encourage savings rather than encourage investment in a recession? The two require diametrically opposite policy stances, there is a current challenge of getting the MPC to adopt a policy stance that is supportive of increased investment for economic recovery and growth in the short term.
iv. The gesture gets more speculative when the savings in question is foreign portfolio inflows. The MPC 'feels that there was the need to continue to encourage the inflow of foreign capital into the economy by continuing to put in place incentives to gain the confidence of players in this segment of the foreign exchange market.'[4] Sacrificing economic recovery, growth and employment for easily reversible portfolio inflows that may never arrive is too much costs on the economy, the policy stance should be eased to give growth a chance.

[3] See MPC Communique No. 108 of July 2016.
[4] See MPC Communique No. 108 of July 2016.

v. Nigeria's foreign investment policy must be recalibrated away from preoccupation with volatile and easily reversible portfolio inflows towards harder to reverse diaspora and foreign direct investment inflows[5].

6. Concerns about monetary policy considerations

i. Economic recovery should currently be the overriding consideration for monetary policy, and the MPC should set a threshold for GDP growth, below which it cannot tighten.
ii. Inflation should currently not be a consideration for monetary policy decision because it is cost-pushed, and would taper off by itself. Cost push inflation are transitory. It is the demand-pulled inflation that are persistent. As such, it is only demand-pulled inflation that call for policy tightening. The MPC has acknowledged the benign outlook of inflation in the medium term, this should provide a basis for doing more for the economic recovery objective.
iii. Ensuring that the policy rate is positive in real terms to attract savings should never be a consideration for setting monetary policy rate (MPR) because the MPR is an overnight rate that should define the intercept of the upward sloping yield curve. It is some of the longer maturity interest rates along the yield curve that should be higher than the *expected inflation rate*[6] to deliver positive real interest rates to savers, but short maturity rates like the MPR should not be expected to be higher than the expected inflation rates. Other countries' experiences currently show that it is not even necessary for the policy rate to be positive in nominal terms, much less positive in real terms.
iv. FPI inflows should not be a consideration for monetary policy. MPC should leave private banks, bond and equity traders to attract FPI and concentrate on using MPR to regulate liquidity and provide support for growth.

7. Concerns about MPR

i. MPC needs to ease the MPR considerably but in an orderly manner to pave way for the low interest rate environment required for rapid economic recovery and growth.
ii. MPC should adopt an economic growth threshold for hiking rates.

MPR Benchmarks[7]

i. The Monetary Policy Rate is *negative* in Sweden, and Switzerland.
ii. It is *zero* in European Monetary Union (EMU) and Japan.
iii. It is *close to zero* in the UK, US, Denmark and other developed markets.
iv. It is *considerably higher than zero* in BRICS (Brazil, 14%, Russia, 10%, India, 6.25%, China, 4.25%, South Africa, 7%) and MINT (Malaysia, 3%, Indonesia, 6.5%, Nigeria, 14% Turkey, 7.5%). Nigeria and Brazil have the highest policy rates across the developed countries, BRICS and MINT.
v. Inflation rate is twice or thrice as large as the policy rate in many developed markets, but well below the policy rate across BRICS and MINT.

8. Concerns about CRR

i. There is also an urgent need to ease CRR and keep it low.
ii. CRR was a mere 1% in Nigeria in 2009, before the MPC began to raise it since September 2010. It should be reiterated that prior to 2010, excess liquidity concerns were addressed by withdrawing Federal Government funds from the banks with such excess liquidity. Such interventions were bank-specific, and therefore more efficient than the practice of asking all banks to observe the same CRR, even when some of the banks have no excess liquidity. CRR should only be selectively observed by the individual banks with excess liquidity.

[5] A discussion of the steps Nigeria must take to stabilize foreign investment inflows is provided in Teriba, Ayo, (2017), 'Nigeria's Economic Outlook in 2017', March. https://ssrn.com/abstract=2939899.
[6] Not the historical inflation rate that the MPC erroneously continues to relate policy rate to in its communiques.
[7] List of countries by central bank interest rates, Wikipedia

iii. CRR now seems to have replaced micro-prudential and macro-prudential policies, at great costs to the economic growth and employment objectives of monetary policy.

CRR Benchmarks[8][9]

i. *Countries with 0% cash reserve requirements:* Canada, UK, New Zealand, Australia, and Sweden all have 0% cash reserve requirements;
ii. *Countries with non-variable reserve requirement:* Eurozone 1%, Slovakia, 2%, Switzerland, 2.5%
iii. *Countries with variable cash reserve requirements:* US maintains 0%, 3% or 10%, Czech Republic and Iceland 0% or 2%, Poland 0% or 3.5%, Hungary 0% or 5%, Japan 0.05% to 5%, Turkey 6% or 11%, Korea 1% to 5%

Summary/Outline of Monetary the Policy Conundrums

a. Lessons from historical decisions

i. MPC is most likely hold …
ii. … more likely to tighten …
iii. … and most unlikely to ease!

b. Challenges

i. Monetary policy must be made more supportive of economic recovery and growth
ii. Micro/macro-prudential spillovers into monetary policy considerations must be curbed
iii. Predictable and transparent framework for micro/macro-prudential supervision needed
iv. Foreign Exchange management spillovers into monetary policy must be curtailed

c. Distractions

i. Tension between monetary policy and micro/macro-prudential policies
ii. Not easing policy because banks' choices may destabilize economy
iii. MPC communique confirms micro/macro-prudential policy lapses
iv. Arrangements to ensure policy ease will not destabilize forex market needed

d. Realignment

i. MPC engages its mandate regularly and transparently, with too much on its plate
ii. FSRCC needs to be made active, more transparent, with enough on its plate

e. Decisions

i. Monetary policy decisions should henceforth concentrate exclusively on the MPR
ii. CRR should no longer be discretionary, but set as rules by FSRCC, not MPC

f. Considerations

i. Growth and price stability outlook, and tradeoffs between them should dominate MPC considerations
ii. Financial stability and threats of banks' actions should be addressed in parallel by the FSRCC, or a reformed FSRCC, not MPC

g. Instruments

i. MPR should remain the exclusive discretionary prerogative of the MPC
ii. CRR should be a non-discretionary, rule-based, instrument of the FSRCC

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[8] O'Brien, Yueh-Yun C. (2007), **Reserve requirement systems in OECD countries**. Finance and Economics Discussion Series No. 2007-54, Divisions of Research & Statistics and Monetary Affairs Federal Reserve Board, Washington, D.C.

[9] Reserve Requirements, *Wikipedia*

Historical Policy decisions: Why has Nigeria's MPC more often tightened than eased policy?

		MPR	CRR		
			Unified	Private	Public Sector
Soludo Era					
	Jun-04				Withdrawal of N74.5 billion (75.6 %) of
2005	Jan-05	Reduced MRR from 15% to 13%	2-week maintenance period for CRR		
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Lamido Era					
	Jul-09	Reduced from 8% to 6%			
2010	Sep-10	Raised from 6% to 6.25%			
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	Mar-11	Raised from 6.5% to 7.5%	Raised from 2% to 4%		
	May-11	Raised from 7.5% to 8%	4%		
	Jul-11	Raised from 8% to 8.75%	4%		
	Sep-11	Raised from 8.75% to 9.25%	4%		
	Oct-11	Raised from 9.25% to 12%	8%		
2012	Jul-12		12%		
2013	Jul-13			12%	50%
	Sep-13			12%	75%
	Nov-13			15%	75%
Emefiele Era					
2014	Nov-14	Raised from 12% to 13%		20%	75%
2015	May-15		31%		
	Jul-15		25%		
	Sep-15		25%		
	Nov-15	Reduced from 13% to 11%	20%		
2016	Mar-16	Raised from 11% to 12%	22.50%		
	Jul-16	Raised from 12 % to 14%	22.50%		

Sources: Central Bank of Nigeria, Annual Report and Statement of Accounts, various issues, and 'MPC Decisions', available at: http://www.cbn.gov.ng/MonetaryPolicy/decisions.asp.

Green is for easing (only five in the last 10 years, but just once in the last six years for the policy rate, and just twice in the last six years for the CRR), Red is for tightening (as much as fourteen in the last ten years, ten times in the last six years for the policy rate, and ten times in the last six years for the CRR). The table includes only meetings in which a tightening or easing decisions were taken on either the policy rate or CRR or both, that is, meetings in which all policy levers were unaltered were excluded from this table.

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He is well known for articulating his views on Nigeria's economic policy imperatives through articles, interviews and comments in the mass media. From 1996 to 1998, he spearheaded the advocacy for re-denomination of Naira notes and coins that led to the successful introduction of N100, N200, N500 and N1000 between 1999 and 2005. N50 note was the highest denomination prior to the advocacy.

His current advocacy research is on what could be done to ensure democratic effectiveness in achieving desirable economic outcomes in Nigeria; how Nigeria can take necessary steps to open foreign investment inflow, and engage the world about investment opportunities in the country; and, the Nigeria's economic, fiscal and financial federalism can be reconfigured to strengthen the States.

Before becoming the CEO of EA in 2004, Ayo worked as Chief Economist and Member of Editorial Board at ThisDay Newspaper Group (2001-2004), Faculty Member at the Lagos Business School (1995-2001), Head of Research at the Lagos Chamber of Commerce (1993-1995), and Company Economist at UAC of Nigeria (1992-1993). He has served as Consultant to many blue-chip companies, Federal Ministry of Information, Senate Committee on Banking and Finance, several State Governments, DfID, USAID, UNIDO, World Bank, and was a Visiting Scholar to the IMF Research Department in Washington DC.

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