

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

## Concerns of the Committee

The key concerns noted by the Committee were:

1. Declining oil prices resulting from heightened uncertainties in the global scene
2. Declining foreign reserves
3. Increasing pressure on prices in general
4. Rising demand for foreign exchange some of which may be speculative demand
5. Fiscal dominance brought about by projected increase in spending, particularly the high levels of recurrent expenditure
6. Reversal of capital flows to emerging markets arising from concerns about the Eurozone, US deficit problem and inflation in emerging markets

## Decisions of the Committee

1. Increased Monetary Policy Rate (MPR) by 275 basis point from 9.25% to 12.00%
2. Maintained the current symmetric corridor of +/-200 basis point around the MPR
3. Increased Cash Reserve Ratio (CRR) from 4% to 8%
4. Reduced net open position (NOP) of banks from 5% to 1% of shareholders funds with immediate effect and with full compliance by October 14, 2011; and
5. Suspended the reserve averaging method of computation in favour of daily maintenance until further notice

## Our opinion

In a drastic departure from the hitherto gradualistic approach at monetary tightening, the Monetary Policy Committee hiked the MPR by 275 basis point to 12% at its extraordinary meeting that held on October 10, 2011. This was necessitated by the urgent need to defend the value of the naira which has recently traded outside the band of N150 +/- 3.0%.

This very bold move has significant implications for the economy and other macroeconomic variables as detailed below:

### Interest rates

It is expected that the recent hike in the MPR would further increase the cost of borrowing and reduce credit expansion. In our opinion, the increase in Cash Reserve Ratio from 4% to 8% would reduce the liquidity of banks and the supply of money.

### **Foreign Exchange**

The higher interest rate may address the concern of the MPC on the reversal of capital flows by attracting foreign capital with the attendant increase in exchange rate. However, this can only be achieved if inflation is kept in check. It would also become more expensive for currency speculators to bet against the Naira and hopefully this should translate to stability of the Naira. In addition, we expect the reduction in the Net Open Position of banks from 5% to 1% to reduce the pressure on the naira.

### **Stock Market**

The drastic hike in MPR is expected to translate into higher deposit rate. This would encourage a flight to cash in the light of the persistently bearish stock market. The performance of leveraged quoted companies with variable interest rate debt may be marred by high interest expense that may significantly lower dividend payments and dividend yields to the investors. Stock prices may decline further.

### **Fixed Income Market**

As interest rates rise, the prices of existing bonds are likely to fall to realign the yield in line with current market conditions while new bonds would have to be issued at higher coupon rates.

### **The Macro Economy**

In concluding, we expect the increase in MPR to reduce disposable income of Nigerians that have borrowed at variable interest rate, lower aggregate demand, reduce private investment and the profitability of firms. We expect the government to incur higher interest expense on domestic debt. If this trend continues in the long term, taxes may be increased.

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