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Frequently Asked Questions (FAQs) on CBN’s **Monetary Policy Tools** in Nigeria

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The Central Bank of Nigeria (CBN) plays a crucial role in shaping the Nigerian economy through its monetary policy framework. Established under Section 2 of the CBN Act of 2007, the CBN is mandated to maintain monetary and price stability while safeguarding the financial system and the value of the naira. Over the years, the CBN has introduced various monetary policies aimed at boosting economic growth and fostering a conducive investment environment. In this article, we will be answering frequently asked questions on these monetary policy tools used by the CBN in Nigeria.

What is a **Monetary Policy?**

Monetary policy refers to the actions and strategies implemented by the CBN to regulate the supply of money, interest rates, and credit in the economy. The goal of monetary policy is to achieve stable prices, control inflation, and foster economic growth.

What are the main
Objectives of CBN's Monetary Policy?

The primary objectives of CBN's monetary policy are:

Maintaining price stability (controlling inflation); promoting sustainable economic growth; ensuring stability in the financial system; managing exchange rate stability; and facilitating employment generation

What are the
Types of Monetary Policies?

CBN's monetary policy can either be:

- Expansionary Policy: This is used to stimulate economic growth by increasing money supply and making borrowing cheaper. It encourages investment and consumption.
- Contractionary Policy: This is used to combat inflation by reducing the money supply and raising interest rates, thus slowing down economic activity.

What are the CBN's **Key Monetary Policy Tools?**

These are the various monetary policy tools utilised by the MPC. They include:

Monetary Policy Rate (MPR); Liquidity Ratio (LR); Open Market Operations (OMO); Cash Reserve Ratio (CRR); Standing Facilities (SF) and Asymmetric Corridor (AC); and Loan-to-Deposit Ratio

What is the **Monetary Policy Rate** (MPR)?

The MPR is the benchmark interest rate set by the CBN, which influences the cost of borrowing in the country. Simply put, the MPR is the rate at which the CBN lends money to commercial banks. By adjusting the MPR, inflation will drop and this in turn help the economy to grow. By making borrowing more expensive, consumer spending and investment level is regulated.

How does the **MPR Influence Inflation** and **Economic Growth**?

The CBN may raise the MPR to make borrowing more expensive, which reduces the money supply and dampens inflationary pressures. If the economy is sluggish, the CBN may lower the MPR to make borrowing cheaper, encouraging investment and consumption.

What is **Nigeria's Current MPR**?

Nigeria's MPR was currently increased by the MPC by 50 basis points (0.5%) to 26.75 per cent from 26.25 per cent in July 2024.

What is a **Liquidity Ratio** (LR)?

LR is the ability of a bank to pay off its short-term debt obligations. Simply put, LR is the percentage of money a bank is to have in reserve in relation to the deposits made into the bank. Adjusting the ratio determines how much left the bank has available to lend. Thus, the higher the liquidity ratio, the less available amount to lend and the more available sum to meet customers' withdrawal needs, while the lesser the liquidity ratio, the more available amount to lend.

If the CBN wants banks to lend less (which can help control inflation), it increases the ratio, making banks keep more money in liquid form. If it wants to encourage more lending to help the economy grow, it lowers the ratio. The CBN has maintained the liquidity ratio at 30% for over the last 10 years, this was also retained at the last MPC meeting in July 2024.

What is
Open Market Operations (OMO)?

Open Market Operations (OMO) are one of the primary tools used by the CBN to control liquidity in the financial system. OMO refers to the buying and selling of government securities, such as Treasury Bills, in the open market. The CBN uses this tool to either increase or decrease the amount of money available in the banking system, thereby influencing interest rates and overall economic activity.

When the CBN sells government securities to banks and other investors, the buyers pay cash in exchange for these securities. This transaction effectively removes money from circulation, reducing the liquidity (the amount of money) in the financial system. As a result, banks have less money to lend, interest rates may rise, and borrowing becomes more expensive. This approach is often used to combat inflation when there is too much money chasing too few goods and driving up prices.

When the CBN buys government securities from banks or investors, the sellers receive cash, which increases the liquidity in the financial system. With more money available, banks can lend more easily, interest rates may fall, and borrowing becomes cheaper. This encourages spending and investment, stimulating economic growth, especially when the economy is sluggish. The CBN carefully calibrates OMO to ensure that there’s neither too much money causing inflation nor too little money stifling growth. It is one of the most flexible tools available to manage short-term economic conditions.

What is **Standing Facilities** and **Asymmetric Corridor** (AC)

Standing Facilities are instruments of liquidity management. Standing Facilities are either Standing Lending Facilities (SLF) or Standing Deposit Facilities (SDF). SLF is the rate at which the CBN lends to Banks when they find themselves short of funds, while SDF is the rate at which banks deposit to the CBN when they are in possession of excess cash. The Standing Facilities are ways that the banks and the CBN control their liquidity. The SLF was previously suspended by the CBN, however this suspension has been lifted by a circular of the CBN dated 26th August 2024.

AC is the formular to calculate the rate in which the CBN either lends to or borrows from banks – Standing Facilities. The CBN sets different interest rates for commercial banks depositing money to the CBN as opposed to when they borrow money from the CBN. The calculation is the MPR +/- the relevant basis point.

The CBN at the 296th MPC meeting in July 2024 adjusted the asymmetric corridor around the MPR to +500/-100 from +100/-300 basis points. This means that where a bank has excess cash and decides to lend to the CBN, the CBN will borrow at an interest rate of MPR – 100 basis points (1.0%) = 25.75%. However, where the bank intends to borrow from the CBN, the CBN will lend at an interest rate of MPR + 500 basis points (5%) = 31.75%.

This makes the SLF rate at 31.75% and the SDF rate at 25.75%, making it unattractive for banks to either borrow from or lend to the CBN.

What is
Cash Reserve Ratio (CRR)?

This is the percentage of deposits that a bank is to deposit to the CBN as reserve. This money cannot be used for lending or any other purposes. The adjustment of the CRR hence will affect the availability of cash for lending purposes and in circulation.

What is
Nigeria's Current CRR?

In February 2024, the MPC increased the CRR of deposit money banks from 32.5% to 45%, while in March 2024, the MPC increased the CRR of merchant banks to by 4% from 10% to 14%. This CRR was maintained as at the last MPC meeting in July 2024.

What is
Loan-to-deposit Ratio (LDR)?

The Loan-to-Deposit Ratio (LDR) is a monetary policy tool used by the CBN to ensure that banks lend a certain percentage of their deposits to the public. The LDR measures a bank's willingness and ability to lend by comparing its total loans to its total deposits. It is expressed as a percentage, and the CBN sets a minimum threshold that banks must meet.

The CBN uses the LDR to ensure that banks don't hold too much of their funds in reserve but instead lend them out to stimulate economic activity. A higher LDR means banks are required to lend more of their deposits, which in turn will encourage lending and investment in the economy.

What is
Nigeria's Current LDR?

In April 2024, the CBN increased the LDR from 65% to 50% which is a 15% decrease from the previous LDR rate.

When does the CBN Make **Decisions to Utilize Monetary Policy Tools?**

The CBN typically makes decisions regarding the use of the monetary policy tools during its Monetary Policy Committee (MPC) meetings. These meetings are held every two months, where members of the MPC review the country's economic conditions, including inflation, interest rates, and exchange rates, as well as global economic trends. Based on their assessment, the MPC decides whether to raise, lower, or maintain the MPR and adjust other monetary policy tools.

The MPC's decisions are aimed at achieving macroeconomic objectives, such as controlling inflation, promoting economic growth, and ensuring stability in the financial system. The outcome of these meetings is closely monitored by financial institutions, businesses, and investors, as it provides a key indicator of the central bank's approach to economic management in the near term.

What is the Impact of the **Monetary Policies on the Economy?**

The analysis of the monetary policy tools and current monetary policy ratio by the CBN reflects a target to reduce the money supply in the country, increase existing interest rate and increase the national currency rate, in order to reduce the inflation rate which is currently at 34.2% as of June 2024.

Monetary policy tools are essential for the growth and development of any nation. By carefully implementing these policies, the CBN seeks to promote economic growth and price stability. With the present devaluation of the and the growing inflation, it is important that the CBN constantly reviews and keep in check monetary policies to foster economic development.

Understanding the monetary policies of the CBN is essential to better appreciate the current economic situation of the country and position your business in response to whatever respective adjustments is made by the CBN to the policy.

About Stren & Blan Partners

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Stren & Blan Partners is a full-service commercial Law Firm that provides legal services to diverse local and multinational corporations. We have developed a clear vision for anticipating our client's business needs and surpassing their expectations, and we do this with an uncompromising commitment to Client service and legal excellence.

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