

The Challenges of Ensuring Appropriate Inflation Rate, Exchange Rate and Interest Rate Regimes in Nigeria

A Background Presentation

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Outline

- 1.0 Introduction
- 2.0 Appropriate Inflation Rate
- 3.0 Appropriate Exchange Rate
- 4.0 Appropriate Interest Rate
- 5.0 Achieving the Trinity
- 6.0 Issues/Challenges

1.0 Introduction

- ◎ Mandate of the CBN includes:
 - ◎ Ensure monetary and price stability
 - ◎ Issue legal tender currency in Nigeria
 - ◎ Maintain external reserves to safeguard the international value of the legal tender currency
 - ◎ Promote a sound financial system in Nigeria
 - ◎ Act as banker and provide economic and financial advice to the Federal Government
- ◎ Price stability as key mandate of all Central Banks--
- issue currency and preserve its value (externally through stable exchange rate, and domestically through low/stable inflation)
 - ◎ Preserves asset values, and the purchasing power of local currency (the poor benefits most from low inflation: Inflation as easiest way to impoverish the citizens!)

Introduction Contd.

- ◎ Fosters certainty in savings- investment planning, hence the foundation for sustained economic growth.
- ◎ Which Price?
 - ◎ Exchange Rate? (Nominal vs Real Effective Rate)
 - ◎ Interest Rate? (Deposit vs Lending rate)
 - ◎ General Price level?
 - ◎ Core inflation (CPI less energy and food prices)
 - ◎ Non-core (Food and energy price)
- ◎ Challenge of ‘appropriate’ or ‘optimum’ levels of these prices, consistent with internal and external balances.
- ◎ Key challenge is the so-called “Impossible Trinity”: Cannot control the three at the same time. Which should be OBJECTIVE(S) and which should be INSTRUMENT(S)?

Introduction Contd.

CONTEXT:

Global Economic and financial crisis

- Falling oil price and pressure on Reserves and Exchange rate
- Global food crisis, and rising food price as well as core inflation
- Banks re-pricing of assets in response to existing and anticipated risks--- hence rising interest rates
- Relative stability of 2005, 2006, 2007, up to mid-2008 under threat
- CHALLENGE: Re-defining and ensuring 'appropriate' levels of these prices in the light of the global crisis.
- PURPOSE OF SEMINAR? To brainstorm!

2.0 Appropriate Inflation Rate

2.1 Inflation?

- ⊙ A **persistent** increase in the general price level (the emphasis here is on the word “persistent”), which implies a fall in the purchasing power of money
- ⊙ The rise in the prices of goods and services is generally measured by the rise in the consumer price index (CPI) over a period of time.

2.2 Why control Inflation?

- ⊙ The growing interest on price stability as a major goal of monetary policy is an acknowledgement of the observed phenomenon that low inflation provides a base for sustained economic growth and development.

2.2 Why Control Inflation Contd.

- ◎ Monetary policy seeks to limit money supply growth to a level that is consistent with the desired level of output and prices
- ◎ However, inflation is difficult to tackle largely because any meaningful attempt to curb it entails a trade-off among other important macroeconomic and social objectives such as increased employment, economic growth and social safety nets in the short-run.
- ◎ Whatever the type, inflation is to a large extent a monetary phenomenon in the sense that it cannot be sustained without an accommodating increase in money supply.

Why Control Inflation Contd.

- ◎ If money supply rises beyond the absorptive capacity of the economy, domestic prices will increase
- ◎ Inflation is costly. It arbitrarily benefits debtors and hurts creditors by decreasing the nominal value of outstanding debt
- ◎ It discourages savings and investment by creating uncertainty about future prices
- ◎ It forces businesses and individuals to spend time and resources predicting future prices and hedging against the risk of unexpected changes in the price level
- ◎ It distorts relative prices and undermines the efficiency of the market pricing mechanism.

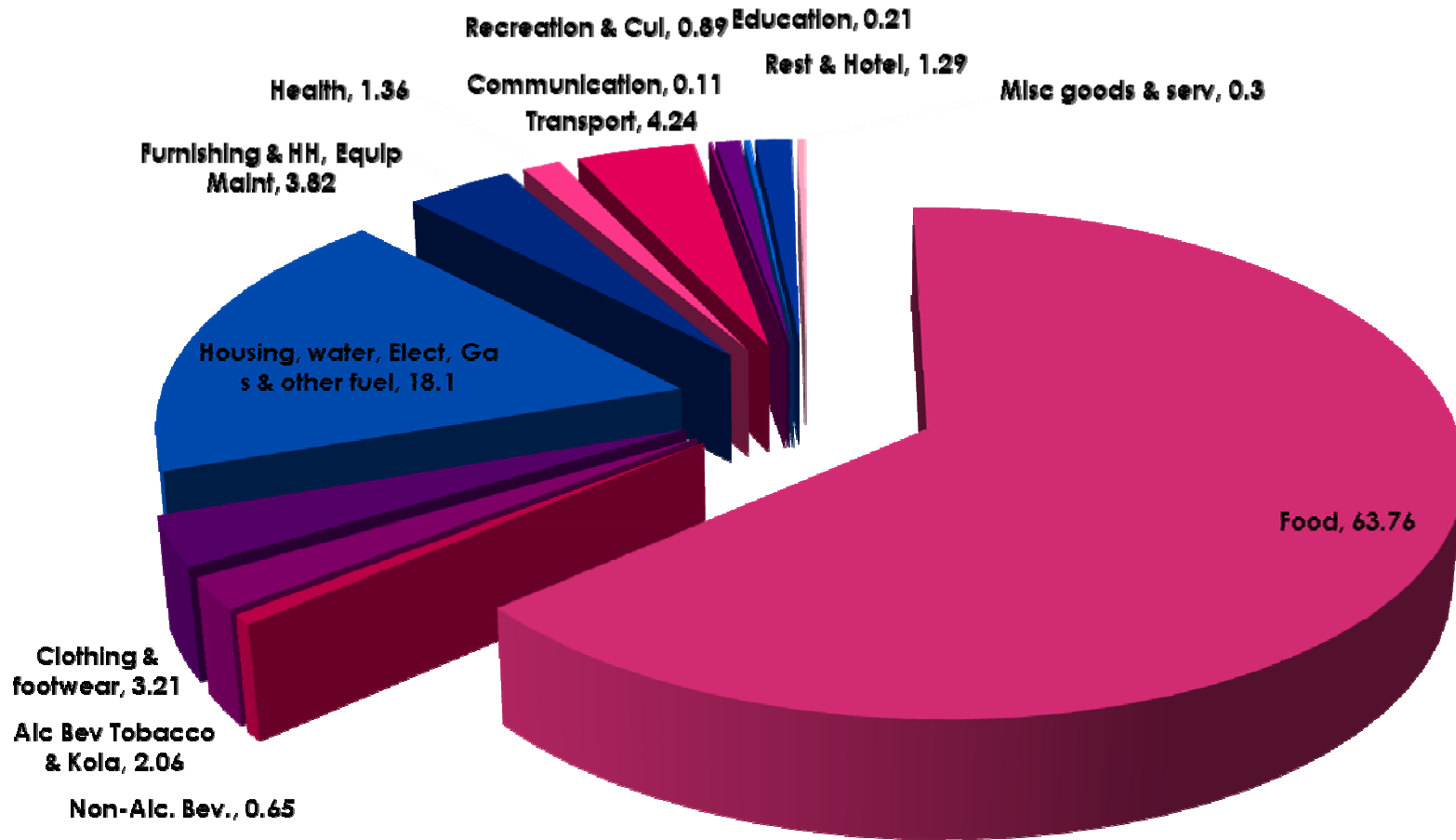
2.3 Inflation in Nigeria

- In Nigeria, inflation is computed as the changes in the Consumer Price Index (CPI) for “All Items” between two points in time usually yearly or monthly (point-to-point measurement).
- Inflation is also measured as a moving average of the CPI within a 12-month period

Inflation in Nigeria Contd.

- ◎ Households in Nigeria allocate a large proportion of their income to food consumption.
- ◎ Currently, 63.76% of the weight of the CPI basket is allocated to food while other goods and services constitute the balance (*See chart overleaf*). This implies that the average Nigerian household spends N63.76 out of every N100 expenditure on food.
- ◎ Thus, changes in the price of food greatly influence the CPI and, hence, inflation in Nigeria. The index of farm produce prices thus is often monitored by observers. As food prices are highly volatile, it is useful to monitor also those items that are not subject to price volatility in order to know what has been termed “**core**” inflation.

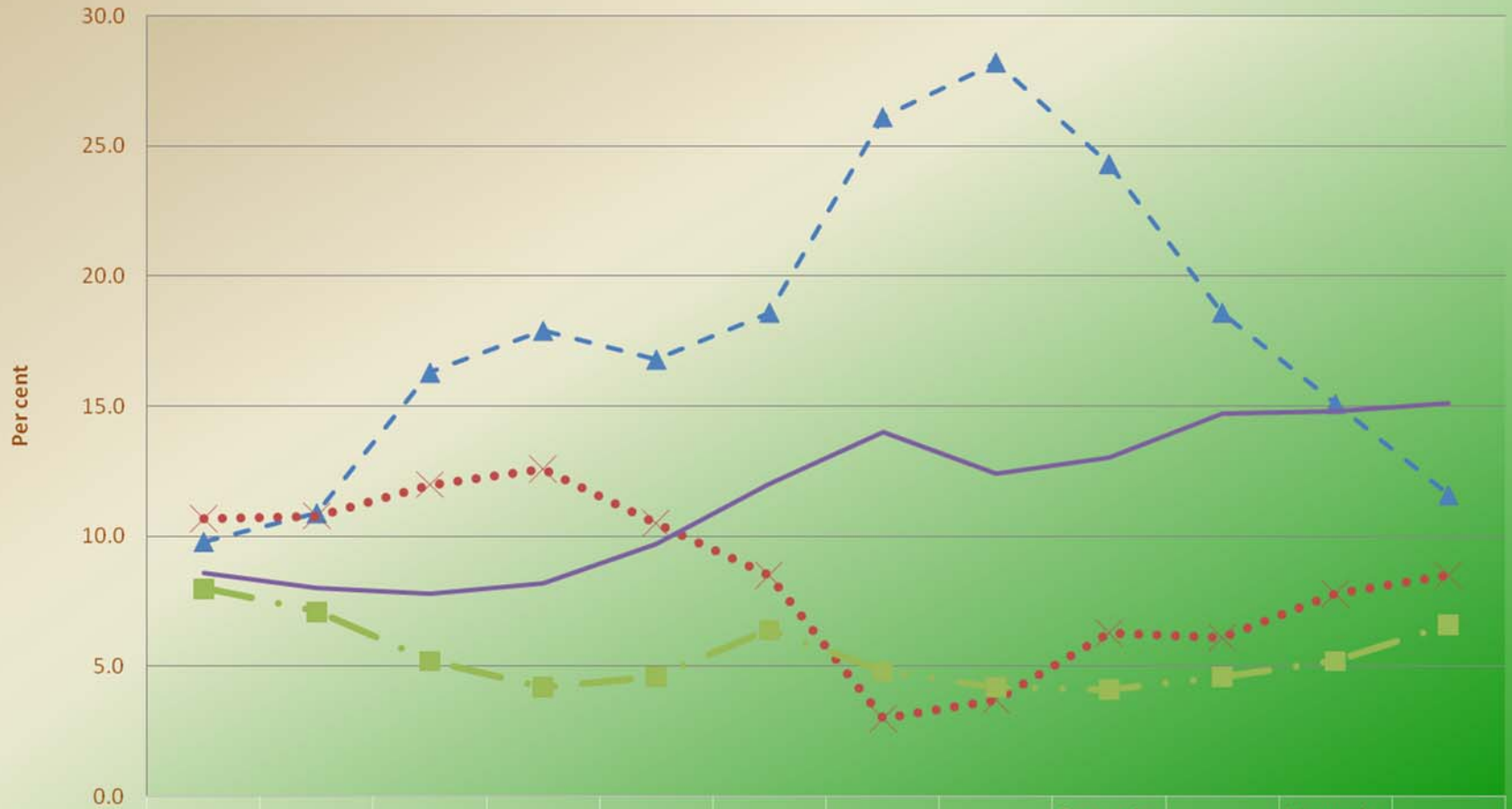
The Composition of CPI in Nigeria



Inflation in Nigeria Contd.

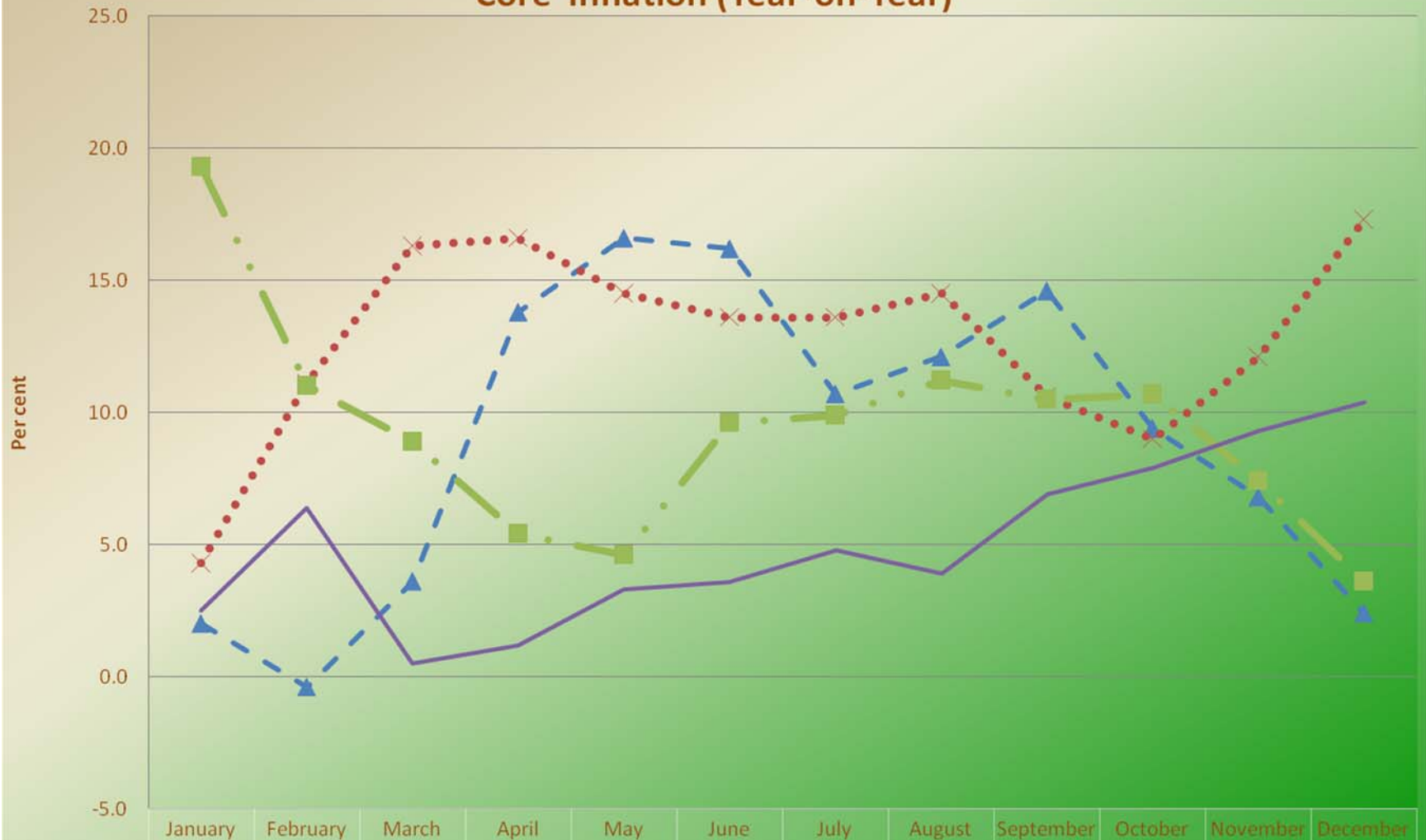
- ◎ Inflation was largely subdued in 2006, 2007 and first half of 2008. During these periods inflation was single digit (*see charts and tables overleaf*)
- ◎ It rose above single digit from June 2008, driven largely by the food component.
- ◎ Overall, food has been the main driver of inflation in Nigeria essentially because of the large weight in the CPI basket. From the latter part of 2007, the world economy has experienced a global food shortage and phenomenal increase in food prices

Headline Inflation (Year-on-year)



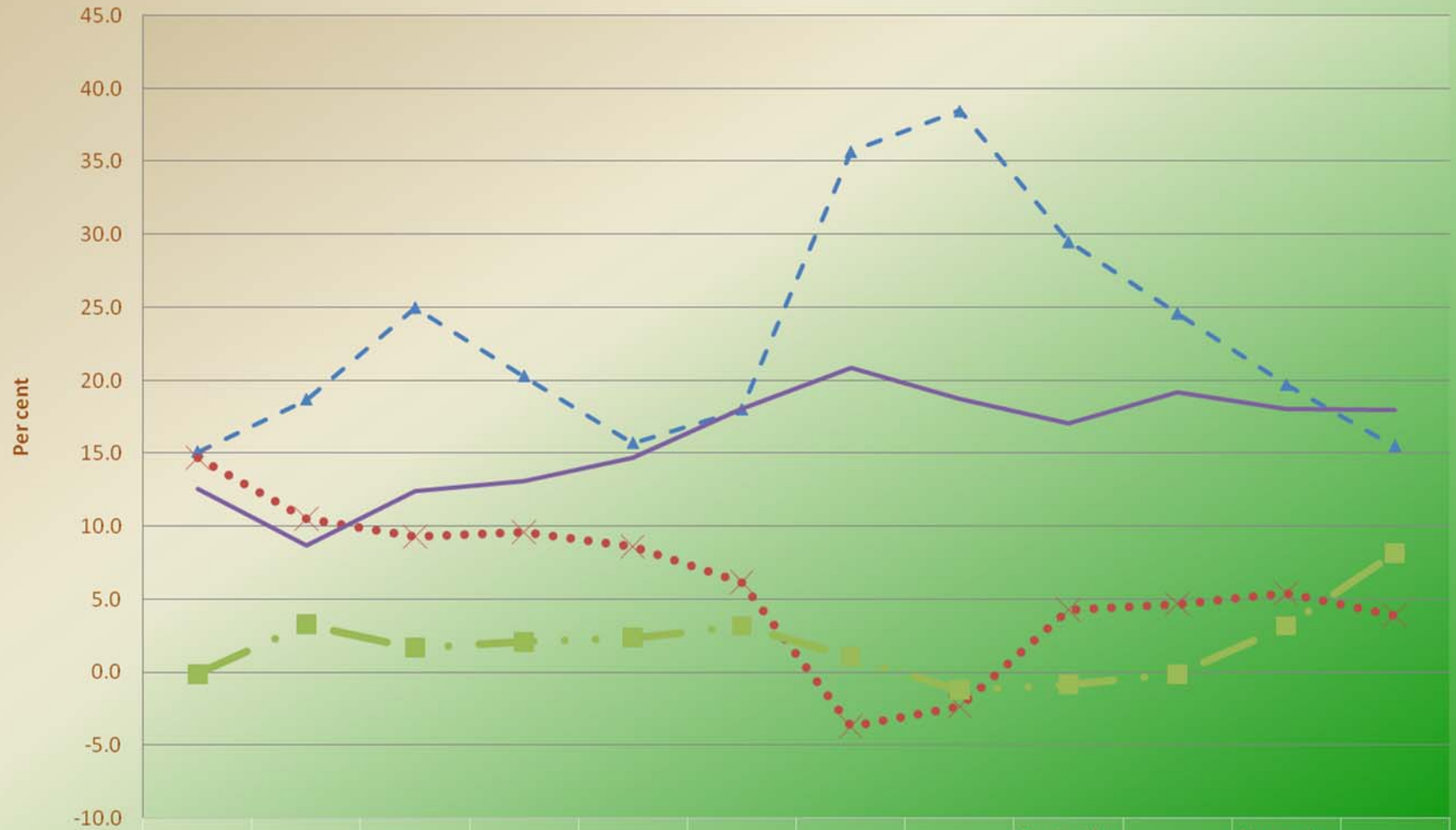
	January	February	March	April	May	June	July	August	September	October	November	December
—▲— 2005	9.8	10.9	16.3	17.9	16.8	18.6	26.1	28.2	24.3	18.6	15.1	11.6
...×... 2006	10.7	10.8	12.0	12.6	10.5	8.5	3.0	3.7	6.3	6.1	7.8	8.5
—■— 2007	8.0	7.1	5.2	4.2	4.6	6.4	4.8	4.2	4.1	4.6	5.2	6.6
— 2008	8.6	8.0	7.8	8.2	9.7	12.0	14.0	12.4	13.0	14.7	14.8	15.1

Core Inflation (Year-on-Year)



	January	February	March	April	May	June	July	August	September	October	November	December
2005	2.0	-0.4	3.6	13.8	16.6	16.2	10.7	12.1	14.6	9.4	6.8	2.4
2006	4.3	11.1	16.3	16.6	14.5	13.6	13.6	14.5	10.6	9.0	12.1	17.3
2007	19.3	11.0	8.9	5.4	4.6	9.6	9.9	11.2	10.5	10.7	7.4	3.6
2008	2.5	6.4	0.5	1.2	3.3	3.6	4.8	3.9	6.9	7.9	9.3	10.4

Food Inflation (Year-on-Year)



	January	February	March	April	May	June	July	August	September	October	November	December
—▲— 2005	15.1	18.7	25.0	20.3	15.7	18.0	35.7	38.5	29.5	24.6	19.7	15.5
...×... 2006	14.7	10.5	9.3	9.6	8.6	6.2	-3.7	-2.3	4.3	4.7	5.4	3.9
—■— 2007	-0.1	3.3	1.7	2.1	2.4	3.2	1.1	-1.2	-0.8	-0.1	3.2	8.2
— 2008	12.6	8.7	12.4	13.1	14.7	18.1	20.9	18.8	17.1	19.2	18.1	18.0

2.4 What level of Inflation Rate is Most Appropriate?

- ⊙ In theory, 'optimal' inflation rate has to be greater than zero. But determining the 'right' rate for a particular economy at any point in time is a complicated issue.
- ⊙ In practice, low inflation of 2-3% has been the norm for developed countries and 5-7% for developing countries.
- ⊙ Conversely, high level of inflation promotes uncertainty, discourages savings and investment.

Excessively low inflation, tends to cause cyclical downturns that last unnecessarily longer.

- ⊙ A little inflation may make it easier for firms to reduce real wages necessary to maintain employment during economic downturns.
- ⊙ At very low levels of inflation, nominal interest rates would also be low, limiting a central bank's ability to ease policy in case economic activity experiences a downturn.

What level of Inflation Rate is most Appropriate? contd.

- ⦿ Low and stable inflation is, therefore, the best contribution monetary policy can make to efficient allocation of resources, economic development and growth
- ⦿ Experience, from Germany and the U.S., indicates that it is easier for a central bank with a reputation for low inflation to play an effective role in stabilizing business cycles.
- ⦿ In the current economic situation, it is possible for Nigeria to strive to achieve an inflation rate that is consistent with the high growth over a 3-year period.
- ⦿ In general, Central Banks take the inflation and output targets as given by the political authorities. In the 2009 Budget, the target inflation rate is 8.2% while the GDP growth rate is 8.9%. Are these the 'appropriate' rates?

3.0 Appropriate Exchange Rate

3.1 What is Exchange Rate?

- ◎ Exchange rate is the price of one currency expressed in terms of some other currency
- ◎ It determines the relative prices of domestic and foreign goods
- ◎ It also determines the strength of the external sector.
- ◎ Exchange rate regime can be fixed or floating. Within the floating regime, there could be variants (managed float vs freely flexible)

Exchange Rate Cont.

- ◎ Proponents of fixed exchange rate system:
 - Emphasize its simplicity
 - Transparency
 - Ease of operation
 - Ability to impose discipline on domestic monetary policy and effective control over inflationary pressures.

Exchange Rate Cont.

- ◎ Opponents of fixed rates argued on its:
 - Inability to deal with fundamental structural changes in a developing economy
 - Lack of freedom to conduct independent monetary policy (the Trilemma problem: under capital mobility, a country cannot simultaneously have a fixed exchange rate and have freedom for independent monetary policy)
 - Inability to adjust quickly to the challenges in changing international environment especially to shocks to the balance of payments

3.2 Determining an Exchange Rate Regime

- ◎ The particular exchange rate system appropriate for the nation has been the subject of debate among economists for a long time.
- ◎ Generally, there are some important considerations in the determination of an exchange rate regime for a country:
 - ❖ Import and Export volumes
 - ❖ Level of external reserves
 - ❖ General price level
 - ❖ It should reflect the resource endowments
 - ❖ It should reflect the actual and potential comparative advantage
 - ❖ It should also consider the ability to take advantage of rapidly shifting demand and supply conditions; countries which are primary producers or natural resources rich may face volatile/inelastic demand for their products
 - ❖ Choice may be deliberate to steer the economy from import dependent to export-led economy (Indonesia, China, etc)

3.3 What Drives the Naira Exchange Rate Movement?

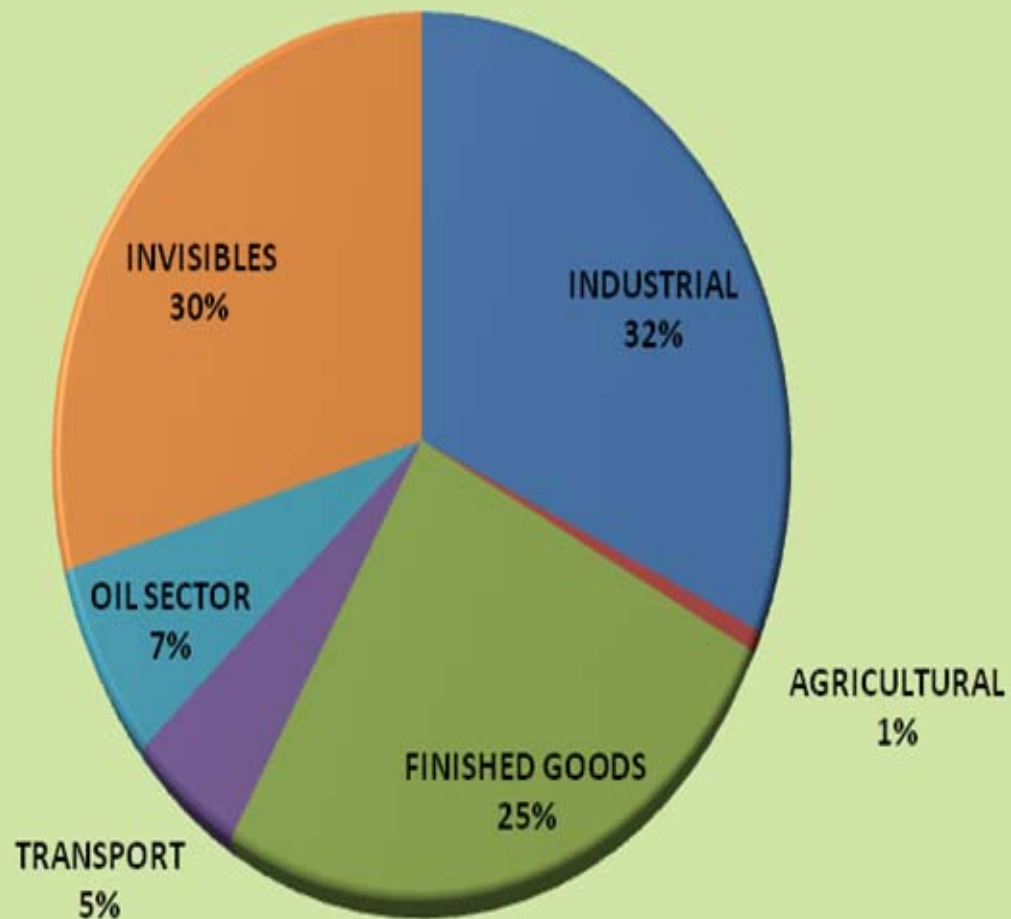
- Exchange rate in Nigeria is determined by the supply and demand for foreign exchange
- Key benefit of flexible exchange rate regime is to adjust in the face of external shocks
- Major currencies around the world have adjusted in the face of dwindling resource flows (UK pound sterling; South Africa Rand; South Korea Won; Ghanaian Cedi; Indian Rupee and many more)
- The Supply of Foreign Exchange in Nigeria:
 - Export proceeds from oil, and other exports
 - FDI and portfolio inflows
 - Remittances
 - Aid and foreign borrowing
 - Other miscellaneous inflows

What Drives the Naira/\$ Exchange Rate Movement Cont.

- ◎ Nigeria is an open economy that depends heavily on oil exports for foreign exchange receipts and on imports for consumption and production of goods (*see distribution in chart overleaf*)

- ◎ Demand for foreign exchange in Nigeria increased recently due mainly to:
 - Demand by foreign investors in the stock market who are exiting
 - High level of imports, and likely to increase due to declining prices of goods abroad because of recession and drop in freight costs
 - Demand by Nigerians wanting to invest in cheaper assets abroad (stocks, houses, etc)
 - Demand for forex to meet maturing debt obligations
 - Foreign banks and institutions recalling existing loan facilities in the wake of global credit crunch
 - Demand by speculators who believe that the exchange rate may depreciate further in future given the developments in the oil price.

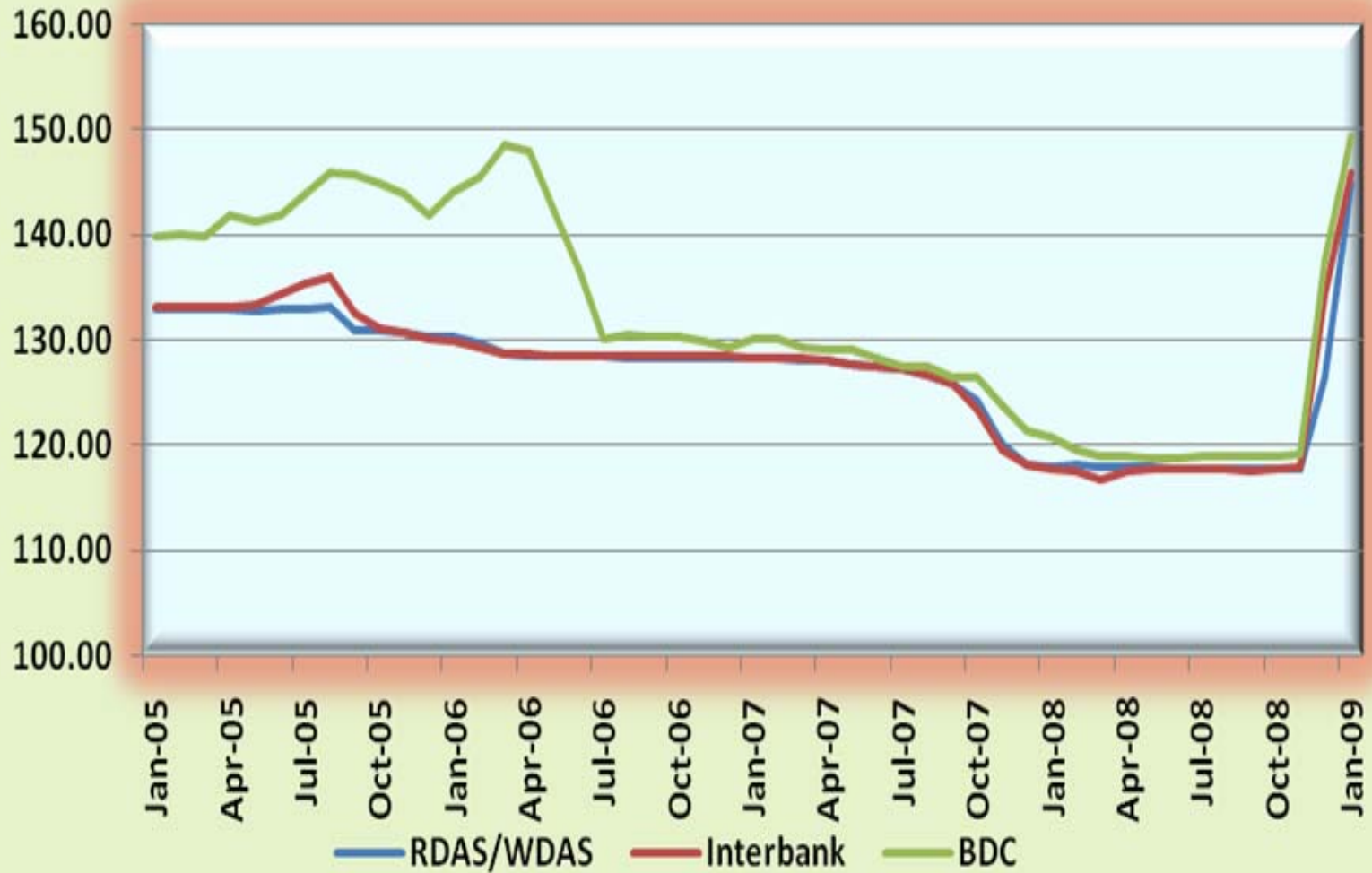
AVERAGE SECTORAL DISBURSEMENTS OF FOREIGN EXCHANGE 2005 - 2008



3.4 Recent Developments in Exchange Rate Movement In Nigeria

- ⊙ Exchange rate was generally stable from 2006 until Dec. 2008
- ⊙ For the first time there was a convergence of rate among the various segments of the foreign exchange market.
- ⊙ The average rate of the naira appreciated, with an average rate of 128.65 to a dollar at WDAS in 2006.
- ⊙ Stability/mild appreciation was sustained throughout 2007 and most of 2008 due to large foreign exchange inflows and deliberate policy not to allow rates to appreciate massively, thereby accumulating huge reserves (see tables and charts overleaf).
- ⊙ Nigeria avoided Real Exchange Rate appreciation despite the large capital inflows--- this was contrary to the experience of the 1970s
- ⊙ However, by mid-December 2008 the naira depreciated by approximately 14.5% to N134/\$ at the inter-bank segment.

Monthly Average Exchange Rate Movements N/\$ Jan 2005 - Jan 2009



3.5 Why the Pressure on the Exchange Rate ?

- ◎ Fall in oil price (from a peak of \$147 to about \$34 in recent months)
- ◎ De-accumulation of foreign reserves as a result of decline in oil prices
- ◎ Limited foreign trade finances for banks—credit line may have dried-up for some banks
- ◎ Declining capital inflow in the economy—falling portfolio inflows, FDI and other remittances
- ◎ High import dependence of the economy

Exchange Rate Adjustment as an opportunity...

- Timely adjustment needed to avoid the disastrous consequences of delayed response or the 1982 Experience
 - Preserve the External Reserves (Russia lost about one quarter of its reserves in 6wks due to delayed adjustment; South Korea lost hundreds of billions, etc)
 - If the Reserves are allowed to be run down completely, the exchange rate would then adjust in a most drastic form which other countries have experienced (recall Ghana; and many others)
 - With cheaper import prices, it would be cheaper to import everything than produce them in Nigeria, and imports would wipe out domestic industries, thereby increasing unemployment. Exchange rate adjustment is a defence for local jobs

Exchange Rate Adjustment as an opportunity. . .

- Exchange rate adjustment ensures that Govt budget continues to function:
 - Recall the 1982 oil price shock and with FIXED exchange rate, with consequences including:
 - Abandoned projects all over Nigeria
 - Salary arrears
 - Massive retrenchment of civil servants, and unemployment
 - Austerity measures, including queuing up for the “Essential Commodities”
 - Massive import bans
 - Resort to import licensing, and even making it illegal to be found with foreign currency (recall the Fela trial)
 - Recall that 2009 budget is a deficit budget even with zero capital spending at \$45 per barrel; imagine the scenario at \$34 or less without exchange rate adjustment

Exchange Rate Adjustment as an opportunity. . .

- Will Depreciation be Highly Inflationary?
 - NOT Necessarily:
 - Prices of imported goods abroad have fallen significantly in many cases. Thus, a 20% depreciation could at most leave many prices unchanged. Any such price adjustment will be temporary and cannot be sustained once exch rate stability returns.
 - It depends on what happens to agricultural output, and other domestic production
- Strategy of Adjustment?
 - Shock Therapy--- quick adjustment to avoid the consequences of painful, long adjustment
 - Long drawn out depreciation would have wiped-off the Reserves before you get to the 'appropriate' level

Exchange Rate Adjustment as an opportunity. . .

- Outlook?
 - CBN committed to stable exchange rate regime (but avoid FIXITY).
 - Will keep the rate stable, and monitor the developments in the forex market. The Naira could strengthen further!
 - So far the official and bureau de change (BDC) rates remain within a margin of plus or minus 2 -5%----- signaling a convergence of the rates!
 - The Exchange Rate regime will continue to be a key shock absorber for the economy--- to keep internal and external balance.

4.0 Appropriate Interest Rate

4.1 What Interest Rate is and does

- ⦿ Interest rate is a reward for accumulating financial assets and foregoing current consumption, which influences the willingness to save (deposit rate)
- ⦿ It is also a cost of capital, which influences the demand for loanable funds by different types of borrowers (lending rate)
- ⦿ Interest rates generally affect people's decision or behavior with respect to consumption, savings and investment
- ⦿ Interest rate compensates lenders for loss of purchasing power and the risks they take.
- ⦿ It provides financial intermediaries with the profit that keeps them in business
- ⦿ Interest rate is a signal that directs funds to where they can earn the highest returns, or to where loans can do the most for the economy.

4.2 Is there an Appropriate level of Interest rates?

- ⊙ Economists assume that in the long run, nominal interest rates will tend toward the level consistent with the fundamentals in the economy (equilibrium, or "natural" real rate of interest) plus an adjustment that reflects the effects of expected long-run inflation.
- ⊙ This natural rate of interest (the interest rate consistent with output potential and stable inflation) (Bomfim 1997) takes a long-run perspective in that it refers to the level expected to prevail in, say, the next five to ten years.
- ⊙ The rate tells the truth about the availability of resources for meeting present and future consumer demands, allowing production plans to be kept in line with the preferred pattern of consumption.

Is there an Appropriate level of Interest rates? Cont.

- ⊙ Real interest rate movements, more than nominal rates, influence business decisions about investment spending and consumers' decisions about purchases of durable goods and, therefore, economic growth.
- ⊙ The gap between the natural rate and the real rate is related to the trend in inflation and if the real rate, (determined by credit market conditions and people's inflation expectations), is below the natural rate, (determined by production capabilities), a boom in investment-type spending ensues, eventually driving prices higher as resource use tightens. The contrary also holds.
- ⊙ The real rate of interest is used to determine whether the nominal rate charged is sufficient to compensate for depreciation of the loan fund as a result of inflation. Thus, real rates of interest have been adjusted to compensate for the effects of inflation

Is there an Appropriate level of Interest rates? Cont.

- ◎ Real rates of interest are important analytical tools for bankers because they help to ensure that they do not let inflation erode the value of their lending portfolios. With negative-real rates of interest, the value of a loan portfolio cannot be maintained.
- ◎ Therefore appropriate nominal interest rate should be at the level that must ensure low positive real interest rate.

4.3 Are Ceilings On Interest Rates Good For An Economy?

- ◎ What happens with interest rate ceilings, depends on where the ceiling is relative to the market rate.

Is there an Appropriate level of Interest rates? Cont.

- ◎ When the ceiling is above the market rate of interest
 - it has no effect at all and market forces of supply and demand are not bound by the ceiling.
 - The interest rate that rules in the market (equilibrium price) and quantity of credit are unchanged.
- ◎ However, when the ceiling is below the market rate of interest, it affects the market outcome.
 - decrease in the quantity of credit supplied : credit is not made available despite the fact that there is demand for it
 - adverse selection
 - Increase in non-interest fees and charges and therefore higher effective interest rate

4.4 It is not ideal to have a low interest rate regime when the rate of inflation is high and rising

- ⊙ In times of rising inflation, nominal interest rate adjusts to reflect changes in the price level if real interest rate is to remain constant.
- ⊙ Thus, holding real rate constant, a rise in inflation rate will result in a proportionate increase in the nominal interest rate. A rise in the nominal rate has the tendency of driving up the inflation rate where borrowing is used to finance production.
- ⊙ Moreover, rising inflation leads to higher expectations about further increase in inflation. Lenders will hedge against future inflation by charging higher nominal interest rate

It is not ideal to have a low interest rate regime when the rate of inflation is high and rising Contd.

- ◎ Very Low interest rates can produce some adverse effects.
 - depreciation of the exchange rate due to speculative outflows of capital owing to the relative attractiveness of assets denominated in foreign currencies.
 - Low rates of interest induce increase in aggregate demand, which may become excessive and in the face of inadequate supply and idle capacity lead to higher inflation
 - “The crisis’ underlying cause was the combination of very low interest rates and unprecedented levels of liquidity” --- Foreign Affairs, Jan/Feb. 2009, p.5

4.5 What Drives Interest Rates

4.5.1 Inflation Expectation:

- ◎ If the rate of inflation is expected to increase, the nominal interest rate needs to be sufficiently high to induce positive real interest rates, so that there is an incentive for savings.

- ◎ Lenders/savers will want to be compensated for inflation and will push the nominal interest rate up to get the desired real rate of interest

What Drives Interest Rates Contd.

4.5.2 Volume of Savings:

- ⊙ Higher volumes of savings drive down interest rate and promote investment. Conversely lower volume increases interest rate and lowers investment.
- ⊙ The domestic interest rates, in conjunction with the rate of return on foreign financial assets, and the expected change in exchange rate determine the allocation of accumulated savings among domestic financial assets, foreign assets and goods that are hedged against inflation.
- ⊙ Raising the levels of long-term savings is therefore vital for achieving the desired level of interest rates as well as sustaining high investment and output growth.

What Drives Interest Rate Contd.

4.5.3 Fiscal Deficits:

- ◎ Government fiscal deficits financed by the banking system crowd-out the private sector.
- ◎ Real interest rates rise as the government attracts funds away from the private sector. High interest rate has the effect of reducing the private sector's demand for capital.
- ◎ Government fiscal deficit as a percentage of GDP in Nigeria has dropped significantly, averaging less than 1% in the last three years, but will rise significantly in 2009.

What Drives Interest Rate Contd.

4.5.4 Risk Profiles:

- ◎ Borrowers' (including sectoral) risk profile and the pricing of risks by the DMBs play an important role in determining the level of interest rates charged by banks.
- ◎ Where a borrower/sector or project is assessed to be high risk, a higher than “normal” nominal interest rate is charged.
- ◎ This explains why some customers are charged a higher interest rate than others under similar conditions.

4.6 Interest Rate: The Nigeria's Experience

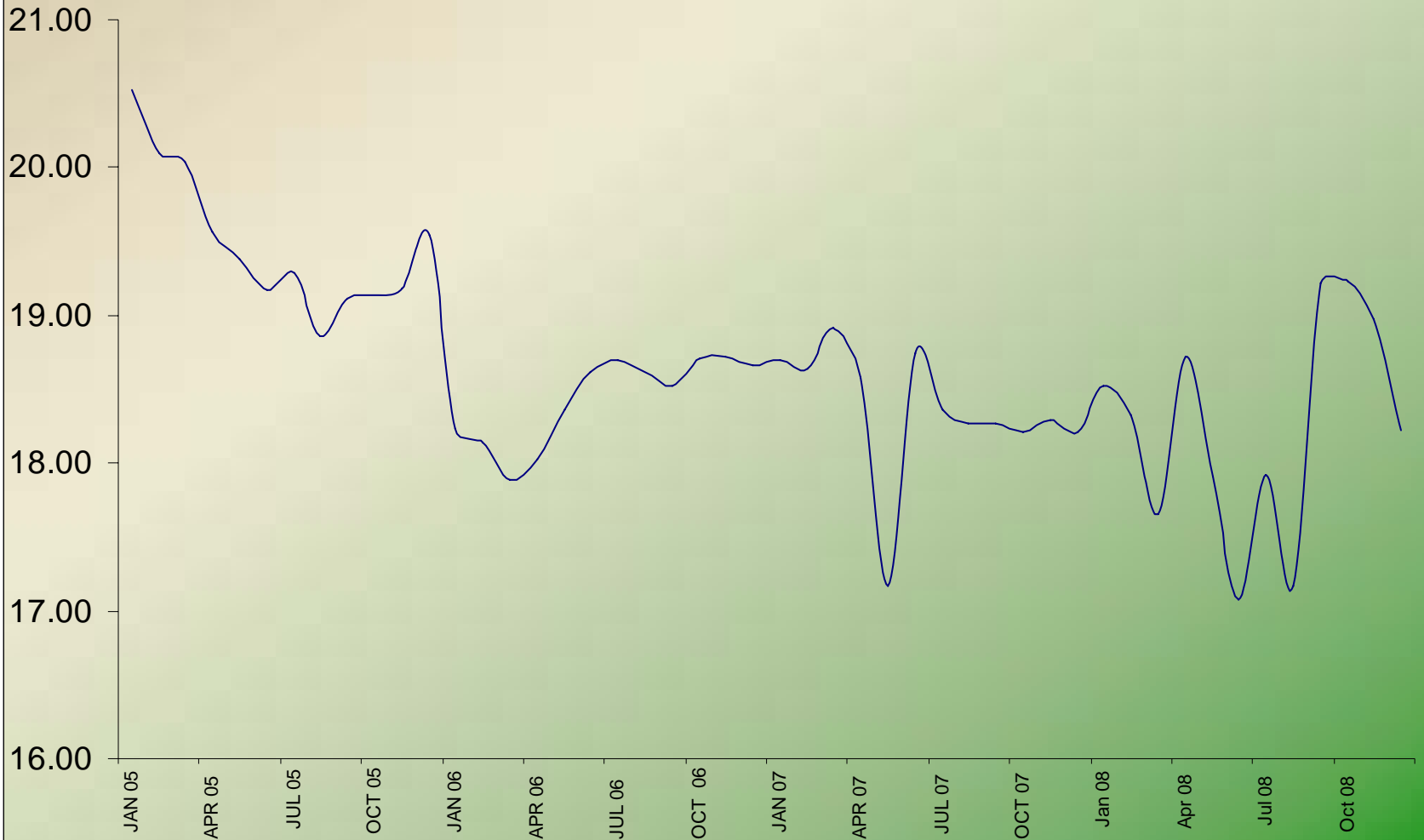
- ◎ Prior to 1986, there was administrative fixing of rates, but
 - It failed to achieve the desired policy objective of promoting investment and growth in the real sector
 - Resulted often in real low interest rates when inflation picked up, thereby discouraging savings and the financial sector remained grossly underdeveloped
 - Perpetuated inefficient pricing and misallocation of resources
 - Discouraged competition

Nigeria's Experience Contd.

- ◎ Market determined interest rates introduced with the deregulation of the financial sector in 1986
 - But interest rate deregulation was partial between 1987 and October 1996 when “full” deregulation was implemented
 - Allowed banks to determine their deposit and lending rates according to market conditions
 - The CBN's policy rate, the MPR, indicates the rate that reflects economic conditions, particularly the rate of inflation and liquidity situation in the banking system and signals where the other short-term market interest rates could rule. It helps to formulate yield curve and influence long-term expectations of interest rates.

- ◎ Lending rates have trended downwards in Nigeria in recent times, yet they have remained “high” in real terms (*See chart and table over leaf*)

Average Maximum Lending rate 2005 - 2008



	2005	2006	2007	2008
BANKS DEPOSIT RATES				
Savings	3.83	3.13	3.55	3.03
7 Days	5.29	4.69	5.59	5.69
1 Month	10.00	9.36	10.26	11.30
3 Months	10.53	9.76	10.25	11.83
6 Months	10.38	9.29	9.74	11.55
12 Months	10.82	8.34	8.10	11.24
Over 12 Months	8.68	8.28	9.47	11.78
Consolidated Rate	8.50	7.55	8.14	9.49
Average Rate				
LENDING RATES:				
Prime	17.95	16.92	16.94	16.01
Maximum	19.49	18.43	18.36	18.25
Average Term Deposit Rates	9.28	8.29	8.90	10.57
Interbank Call Rates	8.26	7.38	7.85	11.86
Spread				
Savings-Max lending	15.67	15.30	14.82	15.22
Consolid-Max lending	10.99	10.88	10.23	8.76
Average Term Deposit-Max lending	10.21	10.15	9.46	7.68

4.7 Causes of “High” Lending Rate

- ⊙ Cost of funds
 - ⊙ Interest rate on deposits
 - ⊙ Cost of doing business by banks, including power, security, water, taxes, etc
 - ⊙ Monetary policy stance (e.g. CRR, LR)
- ⊙ Differential pricing and re-pricing of risk by banks
 - ⊙ Individual borrower’s risk
 - ⊙ Sectoral risk
 - ⊙ General business environment (systemic)
- ⊙ Excessive Demand Pressure relative to supply of loanable funds
 - ⊙ Low savings rate means lower supply of loanable funds
 - ⊙ Reduced supply of foreign credit lines
 - ⊙ Govts’ deficits means govt competes for credit with private sector
 - ⊙ Growing business opportunities put pressure on demand

5.0 Achieving the Trinity?

- ⦿ No Central Bank has got the magic wand to control these three prices simultaneously, without resorting to direct regulation.
 - ❑ Direct control is a failed policy
- ⦿ The exchange rate and interest rate can be kept low and stable only if we succeed in keeping inflation low and stable over time
- ⦿ If the Central Bank artificially keeps the interest rate low, the economy must be prepared to live with a depreciated exchange rate

Achieving the Trinity Contd.

- ⦿ In most monetary policy regimes, interest rate is used as a policy instrument while low Inflation and stable exchange rates are objectives of policy.
- ⦿ In most economies, interest rate is varied to fight inflation and positive real interest rate is the norm.
- ⦿ For interest rate to fall on a sustained basis inflation must fall and inflationary expectations must be low.
- ⦿ If interest rate and exchange rate are controlled as we did in Nigeria in 1970s- 80s, then we should be prepared to live with any level of inflation outcome that will result from such controls.

Achieving the Trinity Contd.

- ◎ The conclusions that can be drawn are as follows:
 - ◎ Under a high inflation environment, a low nominal interest rate regime is not only inconsistent but is also not feasible, as creditors would demand a high interest rate to compensate them for parting with their funds and the erosion of the purchasing power induced by the high inflation.
 - ◎ In such circumstances, the policymaker desirous of achieving low and stable inflation (price stability) will be compelled to raise its base policy rate to:
 - ◎ signal a tight monetary policy stance
 - ◎ Influence (drive-up) market interest rates to constrain aggregate demand (through lower consumption and investment spending) and ultimately lower inflation
 - ◎ Over time, this outcome will be expectedly elicit a lower interest rate regime when all adjustments must have taken place.
 - ◎ A low interest rate regime in an environment of high inflation leads to an inefficient use/allocation of financial resources, as “sub-optimal” investments which do not promote economic growth will be undertaken.

Achieving the Trinity Contd.

- ◎ Furthermore, a high inflation environment is inconsistent with a “strong” and stable currency.

- ◎ In an open economy such as Nigeria, a high domestic price level (high inflation) relative to those of the trading partners accompanied by a highly appreciated domestic currency vis-à-vis trading partners’ currencies will induce the following:
 - ◎ Reduce the country’s competitiveness in the international market
 - ◎ Discourage exports (in Nigeria’s case, non-oil exports)
 - ◎ Encourage imports
 - ◎ Discourage foreign investment, portfolio and other inflows
 - ◎ Encourage capital outflows
 - ◎ Encourage foreign exchange arbitraging and emergence of a thriving parallel market for foreign exchange
 - ◎ Deplete external reserves

- ◎ Thus, in order to ameliorate such adverse developments, the policymakers desirous of bringing sanity to the economic system will deploy the instruments available to it, such as pursuing an interest rate policy that will significantly moderate inflation, encourage domestic savings, encourage capital inflows and mitigate capital outflows.

Achieving the Trinity Contd.

- ◎ Thus, there is an inherent trade-off in trying to strike an appropriate balance among the three key price variables—interest rate, exchange rate and inflation rate.
- ◎ This is the reality of the situation that every economy, whether developed, emerging market or developing, has to contend with.

Achieving the Trinity...

- ⊙ What are the necessary and sufficient conditions for the achievement of low and stable exchange and interest rates in Nigeria?
- ⊙ Definitely, moral suasion (preaching) will not do it!!
- ⊙ Controls over an extended period is also a failed policy
- ⊙ We need the following:
 - Stable and low inflation rate
 - A diversified productive and export base which will enhance the supply of foreign exchange; improving business environment and productivity
 - We need to improve the physical and social infrastructure of the economy which would reduce the cost of doing business
 - Fiscal prudence must be practised by the 3-tiers of government and full implementation of the Fiscal Responsibility Act
 - Banks must improve their operational efficiency by limiting their overhead cost.
 - Others....

ISSUES/CHALLENGES

- 1. In what ways should the conduct of monetary policy be different in the context of the challenges of the global crisis?
 - OECD countries facing recession and even deflation
 - Nigeria and some developing countries face inflation/exch. Rate depreciation, with positive GDP growth
- 2. What should be the “appropriate” rates of GDP growth, inflation and exchange rate to target? (If we take the rates announced in the 2009 budget, credit to the private sector should not grow by more than 33%--- implying much lower growth than the 60.1% in 2008). If ‘high’ interest rate does not ration the credit, how do we do so, and remain within the band announced by Govt?

ISSUES/CHALLENGES...

- If Inflation concerns remain, what kind of inflation-targeting (hard or light) should be consistent with growth and exchange rate stability? (over a three year period?) Which Inflation Rate should we target (Core or Non-core)?
- What mechanisms of exchange rate management would ensure 'appropriate' but stable rates? Should we target Nominal or RER?
- How do we "control" interest rates in the face of rising Govt deficits (Federal and States) and growing risks facing the banks because of the business environment while ensuring banking sector soundness?
- Given inflation rate of 15% by Dec. 2008, and objective of exchange rate stability, should Central Bank also be loosening monetary policy at this time? World Bank and the IMF Assessment Reports caution against the "excessive" growth of credit, and the dangers it poses to the banking sector. How do we reconcile this with the cry of 'high' interest rates?
- What should be the role of Development Banks in a time like this in directing subsidized credit to certain sectors?

ISSUES/CHALLENGES

- Globally, the primary concern is with the soundness of the financial system. Excessive risk taking by banks, engendered by 'easy credit' is the major cause of the global crisis. How do we ensure soundness of our banks over time with 'excessive' credit growth?
- Do we have enough instruments to simultaneously ensure sound financial system, low inflation and interest rate, as well as stable exchange rate?
- How do we avoid RER appreciation and misalignment so that we don't repeat the mistake of the 1970s?
- What further Developmental Role should Central Bank play at this time?

THANK YOU FOR LISTENING