Financial Sector Reforms and the Real Economy

Central Bank of Nigeria

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Outline

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I: Introduction

II: Financial System as Hub of the Economy

III: Three Reforms as Pillars for New Economy

- Banking sector revolution?
- Exchange rate reforms?
- Macroeconomic Stabilization: unholy trinity?

IV: Other Complementary Reforms?

V: Conclusions

Introduction

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- Thanks for the Invitation
- Presentation, not a written paper
- Focus more narrowly on some CBN Reforms--- not all Financial system
- Context: Popular questions include:
  - Effects of reforms on common man?
  - Are the reforms sustainable?
- Will try to provoke than provide answers

Financial System as Hub of the Economy

- Nigeria’s economic potentials to be among 20 largest economies
  - $112b GDP; 140 m people; natural resources; $38b resv
- Success Factors? (World Bank survey of OPS in Nigeria)
  - Security; Infrastructure; Finance; institutions for market economy—rule of law/contracts, etc
- Why Financial system matters?
  - Credit/capital as basis for modern economy
  - Efficient payments system
  - Macroeconomic stabilization
  - Insure and mitigate risks and uncertainty
  - System as lubricant of the economy….
  - Financial system as ‘supply-leading’ or ‘dd-following’?

Three Reforms: Banking Sector

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Goal?: Nigeria as Africa's financial hub; and Nigerian bank in top 50- 100 in 10 yrs

A transparent, competitive system that depositors can trust and investors can rely upon

A banking system that intermediate rather than as rent-seekers;

Earlier system with 89 banks too fragile for the economy with credit at 24% of GDP compared to SSA average 57%

All 89 banks were the size of 4th largest in South Africa.

Today, 25 strong and reliable banks

9 Nigerian banks in top 1000 (none in 2003)

De-listing by FATF: Sovereign credit risk rating

Banking sector strongest it has ever been in our history

Increased credit lines to Nigerian banks

Partnership with foreign banks in reserve management

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Banking Sector

BANKS: Key indicators	Dec 2003 N'b	March 2006 N'b
Shareholders' Fund	292	811
Total Assets	2,768	4,974
Total Gross Credits	1,162	2,056
Total Deposits	1,409	2,835
Unsound banks	11	0
Net Profit	9	41

Banking Sector

Assets growth rate	= 79.7%
Capital growth rate	= 177.74%
Deposit growth rate	= 101.21%
Credit growth rate	= 76.94%
Earnings growth rate	= 355.56%
Liquidity growth rate	= 75.78%

Higher Single obligor limit and capacity to fund larger projects

New products (BDCs; e-payments

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Banking Sector

- CBN had carried out a post consolidation due diligence on banks to ensure the absence of bubble capital
- Post consolidation integration, people, processes, system etc being monitored by the CBN
- New code of corporate governance had been issued on march 1, 2006
- Moving to Risk-based supervision and re-training/re-orientation of banking supervision Department
- Microfinance policy and SME financing

Banking Sector

Challenges

Concluding liquidation of the 14 failed banks

- NDIC has obtained final court order to wind up 7 banks- Allstates, Lead bank, Assurance bank; Hallmark; and Trade bank
- Provisional order had been obtained for - Afex bank; and Fortune bank
- Two other banks for which orders were granted have appealed judgement
- Total deposits of private sector in these banks = 78%
- FIRST TIME Depositors are guaranteed !!!

Training for Commercial banks staff and Directors of Banks---compulsory!

New Banking system for the 21st century emerging and on course to achieve the goals of the Reforms!

b. Reserves and Exchange Rate Management

Why accumulate external reserves?

- To defend international value of Naira– stable regime
- Measure of confidence in economy
- Credit worthiness and for imports

Level of Reserves? (About $38b after debt payment)

- Federal Govt (over $10b
- CBN (over $27b)

New framework for reserve magt involving partnership with Nigerian banks

Full liberalization of forex market and tight monetary policy led to:

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- Convergence of rates in all markets
- Parallel market appreciated (20% premium removed--- first in 20 yrs)
- Efficiency as distortions/rents gone
- Easier access to forex by end users
- Helped to keep price inflation in check and reduced cost for producers and consumers
- Naira as the ‘store of value’ again!
- Pressure on export, tourism, and FDI
- Policy as proof that economic theory works well in Nigeria if implementation is effective
- Is this sustainable? YES

c. Macroeconomic stabilization---the unholy trinity?

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Context: Nigeria used to be among top 10 most volatile macro environs

Why Fight Inflation?

- Preserves purchasing power esp for the poor who have little assets
- Spiral of high inflation, pressure on exch rate, and also high interest rate as agents demand real returns on assets
- No long term savings under high inflation (70% of deposits as short term) and investment in speculation, trading--- thus low growth.
- Without long-term savings, no long-term lending by banks
- Currency substitution into foreign currency as hedge
- Summary: Inflation impoverishes citizens; creates uncertainty; low savings and investment and hence low growth; diverts investment into short-term speculative activities; government deficit and uncompleted capital projects due to fluctuations in prices

Price Stability as Primary Job of Central Banks

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- Low Inflation and stable exchange rate as objectives of policy
- Interest rate/monetary policy and fiscal policy as instruments
- Unholy trinity: you can't control the three prices at a time. Interest rate is an instrument, not an objective under a market framework.
- If you want to control interest rate and exch rate as we did in 1970s-80s, inflation should then fall where it may
- Everywhere in the world, 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.

- CBN now refocused on its core mandate--- price stability
- New Monetary policy Dept, and effective policy in place

What Do We want?

The 4 things you can't have at the same time in Nigeria or elsewhere

- Increased Govt spending
- Stable Exchange Rate
- Low price inflation
- Low interest rate

If lucky, we may have any Three at a time, and something has to give as the Fourth.

Now we have chosen the first three, and the Fourth is what gives

Is Interest Rate in Nigeria too ‘high’?

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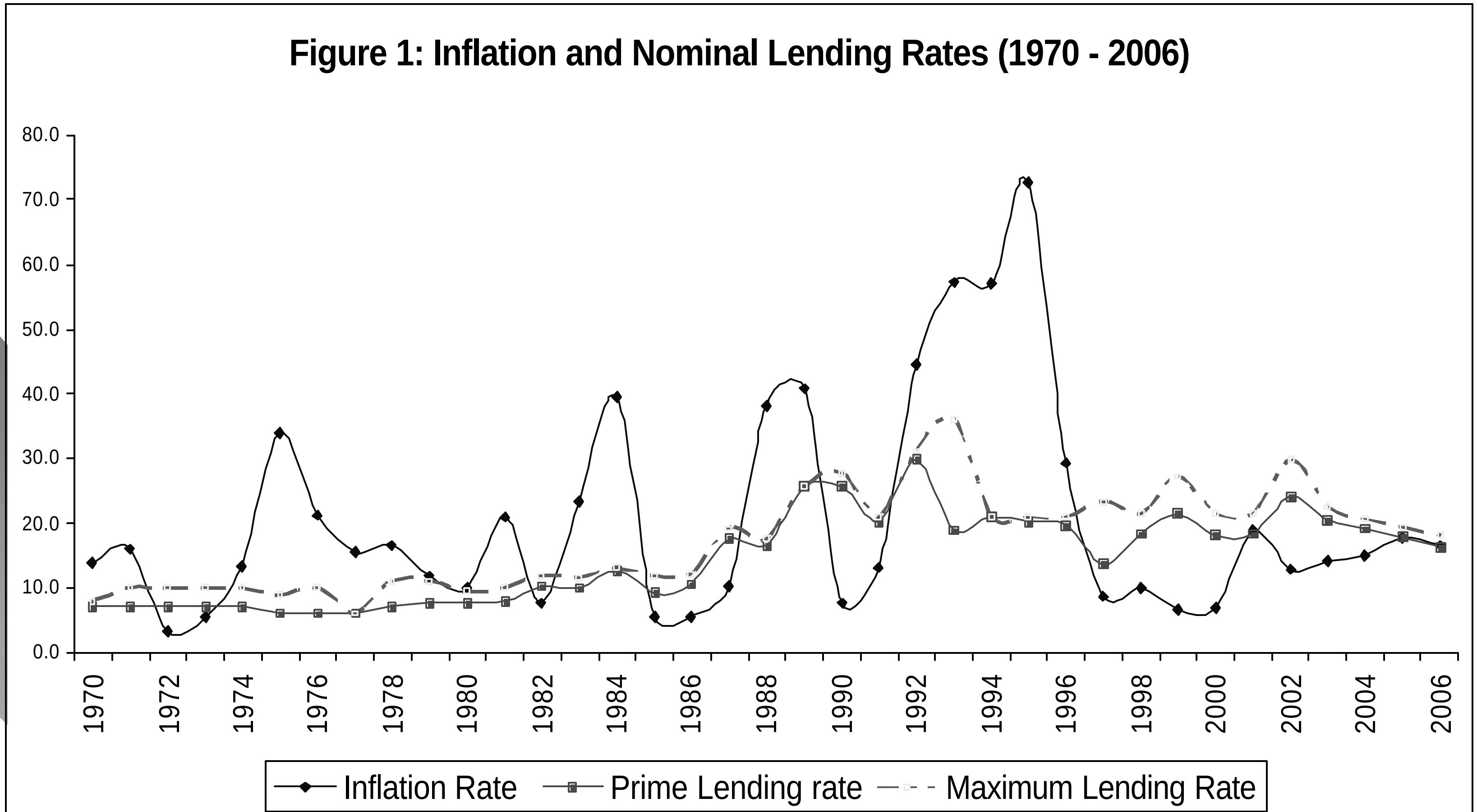

Interest Rate?

For Depositors?

- Deposit rates are generally low, except for the period between 1986-1989 immediately following liberalization and 1990-1995 period of banking sector distress.

For Lenders/Borrowers?

- Relative to the periods 1986-1998, lending rates in the last three years have been low largely because inflation has declined on a sustained basis.
- This is the first time in 20 years that lending rates have recorded such a feat.

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Is Interest rate too high?

Table 1: Comparative Average Lending Rates (%) as at May 2006

Country	Average Lending rate	Inflation rate	Real Lending rate
Ghana	26	10	16
Kenya	13.5	8.0	5.5
South Africa	10.5	4.3	6.2
USA	8.25	3.7	4.55
Nigeria	16.97	10.5	6.47

Messages on Interest rate

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- The last two years witnessed sustained decline in nominal/real lending rates
- Relative to some selected countries, Nigeria's real and nominal lending rates are not outliers.
- The wide gap between lending and deposit rates in Nigeria is dominantly explained by: the depth of financial markets, level of inflation, risks and uncertainty; cost of doing business of banks
- Hardly any two customers are charged the same interest rate:
  - Assessment of riskiness of customers
  - Information available to the customer
  - Prime customers attract lower lending rate than others

Messages on Interest rate?

What drives interest rates? Essentially, interest rate level is affected by movement in price level or inflation rate, fiscal policy stance, and intermediation cost (cost of funds), how deep and developed are financial markets, level of risks and uncertainty, among other factors.

The higher the Govt spends, the lower must the private sector spend to keep stable prices. Thus, increased spending (whether by borrowing from mkt or increased benchmark oil price) will drive interest rate up--- as CBN must mop up or sterilize the inflows.

If riskless Govt instruments attract 13%, why would banks lend to risky private sector at lower?

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Summary on Macro stability

- CBN has kept stability despite the difficult environment: Inflation could have escalated to over 30%; but about 10%---
- Exchange rate stability is a win-win
- It has cost CBN N72b Jan-July to conduct monetary policy and ensure stable prices
- CBN committed to price stability, and will work with Govt to ensure that the trend continues, and exchange rate stability endures!
- Nigerian producers and consumers are the winners under stable macro environment

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Other Complementary Reforms?

- Currency and payments system reforms; NSPM, plc?
- Mortgage and Capital market reforms
- Africa Finance Corporation (in-formation)
- Micro finance and entrepreneurship development
- Facilitating the establishment of commercial courts
- CBN and Financial System 2020 Strategy Document
- Project EAGLES at CBN---- Institutionalizing the reforms and mainstreaming the ‘Can Do' Spirit.

Conclusion

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- It is the Economy, full stop.
- Macro stability and sound financial system constitute the foundation and lubricant for the new economy
- CBN has refocused to its core function
- The real sector and Nigerian consumers are the prime beneficiaries of the reforms.