Macro & Monetary Policy and the Promotion of an Advanced Financial System in Nigeria

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- There is a two way relationship between:
  1. macro policies
  2. the development of a sound and efficient financial system.
- On the one hand good quality macro policies (monetary and fiscal) are essential ingredients in developing a sustainable financial system.

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- On the other hand a developed financial system exerts the right kind of pressures to deliver good macro policies. It is thus extremely important for Nigeria to move on to the right track and let this positive feedback between the two to do its work

- The benefits of this will be evident not only in a modern financial system ,but also in the realization of Nigeria's enormous potential of sustainable economic growth for the benefit its population

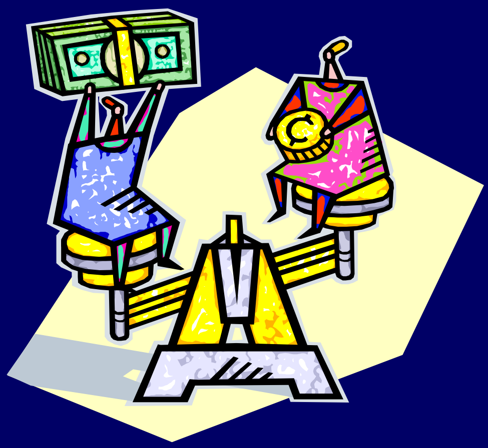
How Good Macro Policies Enhance the Development of an Efficient and Safe Financial System

- Stable predictable monetary and fiscal policies provide financial markets with a very important infrastructure which enables market participants to make their decisions.

- a major task of financial markets is to deal with risks an uncertainties .In carrying out this extremely important and useful job, they should be freed as much as possible from trying to interpret stop and go policies.

How Good Macro Policies Enhance the Development of an Efficient and Safe Financial System

- this implies that both monetary and fiscal policies should aim consistently at medium term goals and be free of political cycles.



Monetary Policy's Contribution

- a key element in well functioning financial markets is low stable inflation and low inflation expectations. High rates of inflation are known to be associated with high inflation volatility.
- This volatility is difficult to hedge (indexed bonds not withstanding) and is detrimental to the development of efficient and sound financial markets. In essence ,it acts like a variable unpredictable tax.

Monetary Policy’s Contribution

- at present Nigeria’s rate of inflation is consistently higher than in those courtiers Nigeria wishes to emulate.

- in order to reduce its rate of inflation and to anchor inflationary expectations at low single-digit levels Nigeria has to:
  1. enact a new CBN law where price stability is clearly and explicitly the primary objective of the CBN

Monetary Policy's Contribution

2. set a timetable for concrete actions to adopt in the future an inflation targeting regime (IT).

3. let the transmission channel of monetary policy to work without hindrances ,that means also getting used to the idea that the exchange rate is basically determined by market forces and that coping with FX risk is a fact of life which the business sector has to learn to cope with through various hedging instruments which exist in developed financial systems.

Monetary Policy's Contribution

4. It also means to start a gradual but persistent and transparent liberalization process, including time tables, for removing the remaining restrictions on goods and capital imports.

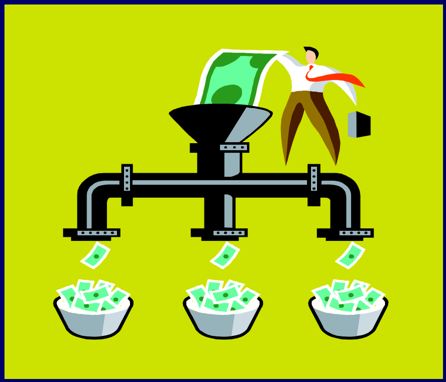
5. the conduct of monetary policy should rely on market friendly instruments such as repose, and an active interbank where market banks are incentivized through a variety of means to manage actively their liquidity positions.

Monetary Policy's Contribution

6. important parameters of ongoing monetary:
   a) the length of the liquidity maintenance period
   b) the scope for averaging required reserves within the liquidity period
   c) the width the interest rate corridor of
   d) the legal framework which governs the collateral arrangements of the interbank market
   e) the interest rate charged for using the CBN Lombard facility (the CBN should be the lender of last resort not the first resource) are all important elements for the development of a thriving Nigerian domestic money market. Thus, these elements should be regularly reviewed regularly and their contribution to the development of the Nigerian money market

Monetary Policy's Contribution

7. it should be realized that there are important elements ,outside the scope of monetary policy, such as the domestic SEC ,market makers arrangements and others.



Fiscal Policy's Contribution

- The development of a modern, efficient and robust financial system requires that private entities, wishing to raise funds, are not crowded out by the financing needs of the government.

- This requires:
  1. the government to sustain its achievement of reducing the debt/GDP ratio to its current low level of 3%.

Fiscal Policy's Contribution

2. to maintain a credible prudent fiscal policy, taking into account the fact that the price of oil can fluctuate greatly.
3. to continue the good work of the DMO by further extending the maturity of governments bonds
4. creating a demand for long term local government and private bonds .A key element in this regard is instituting an obligatory pension system which is important for to have for other good reasons

Fiscal Policy's Contribution

5. the above ,together with other measures related to efficient debt management principles, will result in the establishment of important benchmarks for long term borrowing in the form of mortgages and long private bond market. Such a development, together with an appropriate regulation environment, accounting standards ,legal framework, will contribute much to the development of the Nigerian capital markets.

The Feedback from Markets to Monetary and Fiscal policies

- the establishment of well functioning developed money and capital markets in Nigeria as well as in other places is important because it:

1. increases the efficiency of allocating savings into investments.
2. improves the capacity of the economy to absorb the various shocks to which it is constantly exposed.
3. facilitates better risk sharing arrangements between various sectors of the economy.

The Feedback from Markets to Monetary and Fiscal policies

- in addition a developed financial system has proven in many places ,including Israel, as a guardian against the sometime existing political incentive to prefer short term opportunistic gains to long run important objectives.

- the first example is the force exerted by the relationship between long term government bonds yields which serve as benchmarks for mortgage rates. Governments' fiscal behavior tend to be more prudent if they know that even the fear of imprudent fiscal behavior is likely to raise long term government yields and subsequently the rates on mortgages. They know that the bill will be sent fast to the "right address" so to speak.

The Feedback from Markets to Monetary and Fiscal policies

- the second example relates to the exerted by markets' participants inflation expectations (derived from various financial instruments or surveys) on the credibility of the Central Bank with respect its primary goal of price stability. If the public perceives the possibility that the CB losses its vigilance of keeping price stability (inflation within the target over the medium term) it will be reflected fast in rising inflation expectations. The possibility of the fact that inflation expectations are no longer anchored at the inflation target level ,and that this may become evident very quickly, is politically unattractive to any Governor. Put differently , in a well developed financial market the CB is likely to stay very focused on its main responsibility.

The Feedback from Markets to Monetary and Fiscal policies

- It is important to stress that even fully financial markets are not perfect and sometimes give wrong signals and often overreact. They are, nevertheless very important in enabling individuals and businesses to have so to speak “daily votes” (weighted by Nira).

- in this I am reminded of Winston Churchill saying that democracy may not be a very good system of government but that all the alternatives are much worse.