

Inflation Targeting: Perspectives of a Bond Market Vigilante

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Nigeria | Inflation Targeting

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Who am I?

- An International Investor
- US & UK-based, Africa Investments Specialist
- Emerging Markets Investment Banker/Bond Portfolio Manager & Trader (20+ years experience) during which –
- Advised EM Governments, mainly African, on Capital Market Access and Market Development issues.
- Currently advise and assist International Corporations & Institutions on investment decisions on African economies.

Who do I represent?

- Specialist EM Investment Funds, mostly US, UK & EU-based.
- Global Investment Bank EM Bond Dealers
- Investment firms directing portfolio investment flows to African Fixed Income Markets

What's my Agenda?

- Reflect views and perspectives on Nigeria held by International Investors, in general
- Share practical insights from my own analysis of the announced intentions of the Authorities
- Outline potential pitfalls,
- Offer useful tools that might be considered

My Basic Message:

- Inflation Targeting:
 - would be a welcome advance in Nigerian Economic Management, Monetary Policy in particular – however:
 - Has to be adopted credibly or not at all. Half measures and uneconomic compromises will cost you dearly.
 - Shifting to price stability/flexible exchange rate policy – implies various measures of Nigerian Institutional commitment; the likes of which may have not been seen or understood in Nigeria for generations.

1. Central Bank Autonomy

- Essential to generate the conditions necessary to apply monetary policy appropriately. It signals to economic agents that the Bank is aware of monetary policy's limits and that it is committed to price stability, thus reinforcing its credibility and effectiveness.

2. A Responsible, Predictable Fiscal Policy Approach

- A responsible, predictable fiscal policy approach, -- guarantees public sector solvency and eliminates any chance of monetary policy being subordinated to fiscal policy. This also increases macroeconomic policy's overall credibility and effectiveness among economic agents

3. Regulatory & Supervisory Framework – governing the financial system

- [with rigorously enforced prudential regulations and standards] – a stable, mature financial system has been crucial to applying monetary and foreign exchange policies effectively and ensures that monetary conditions and foreign exchange policies can be adjusted without putting financial system solvency at risk.

4. Integration with International Markets

- Integration with International Markets – Free capital inflows and outflows improve access to external saving and diversify risks facing the economy. Integration offers many advantages, but also exposes the economy to external shocks, whether they arise in financial or goods markets. To deal with these and limit their consequences, relative prices have to be corrected. A flexible foreign exchange approach is vital to making these corrections in the least costly manner possible and opening up room for monetary policy to support these efforts.

– [Banco Central de Chile].

If Nigeria is to establish successful Inflation Targeting, its Pillars of Policy must be well-grounded and understood to be practically unassailable.

What is IT?

- A holistic approach to monetary aspects of macroeconomic management.
- Shift in the conduct of Monetary Policy from quantitative to price targets;
- One of these price targets becomes an explicit nominal anchor of monetary policy,
- This explicit anchor is the means by which the effectiveness of monetary policy actions can be publicly assessed.
- Price Stability typically becomes the overriding policy objective of practising Central Banks
- Widely practised in developed economies (where markets are well-developed, meaning intermediation is high) to moderate business cycle amplitudes.
- Increasingly adopted by developing economies seeking to moderate boom/bust cycles and entrench macroeconomic stability – second generation reforms
- Developing country examples:
 - Israel, (1992)
 - Brazil (1999)
 - Chile (2000)
 - South Africa (2002)
 - Turkey (2006)
 - Egypt (in transition)

Pre-conditions

- A well-trodden path – preceded by:
 - Fiscal Adjustment
 - Exchange Rate Liberalization and Market Unification
 - Financial Sector Reform
 - Brazil – De-dollarization (inflation and multiple exchange rates)
 - Egypt – State-controlled Bank Privatizations (non-performing loans)
 - Turkey – Banking Sector De-dollarization (inflation)
 - Nigeria – Banking Sector Consolidation (undercapitalized banks)
 - Adoption of supportive Monetary Policy through Quantitative targets (Reserves, M2) leading to measures for dampening interest rate volatility (Interest rate corridor)

Preparatory Measures

- Eliminating market rigidities inhibiting capital and credit resource allocations in the economy
 - Competitive Banking System
 - Exchange Rate flexibility
 - Domestic Financial Markets offering ample investment choice and flexibility

Policy Requirements

International experience suggests that inflation targeting's success depends on meeting four essential requirements:

- absence of fiscal dominance (monetary policy independent of fiscal financing needs);
- absence of financial dominance (monetary policy independent of insolvent banks' rescue needs);
- absence of other nominal anchors,
- autonomous central bank with material & technical resources, and political credibility, necessary to manage monetary policy and achieve inflation targets.

Operational Requirements

- Mutual understanding of operative parameters under which independently acting Fiscal and Monetary policy bodies conduct their respective agendas.
- Effective Monetary Policy Transmission mechanism; drawing on multiple channels of transmission
 - Interest Rate Channel
 - Exchange Rate Channel
 - Asset Prices
 - Bank Lending
 - Balance Sheet
 - Expectations
- Credible communication of Monetary Policy and publicly transparent means of assessment (statistical credibility)
- Accountability Mechanisms – auditing process and responsibilities for corrective measures.

The shift from quantitative to price targets implies a break from past actions that tended to induce money price volatility – exchange & interest rates.

Our (Monetary) History:

- Direct and Indirect controls on the quantum of Money – Monetary Base levels (however defined).
- Money Supply > Money Demand \approx lower Money Prices (interest rates)
- Money Supply < Money Demand \approx higher Money Prices (interest rates)
- Slow, but improving, responses to macroeconomic shocks
- Outcome: High Nominal Interest Rates (**the variable**), Price Volatility, and higher inflation.

The (Monetary) Future we Face – if we get IT right

- Truly Counter-cyclical Monetary Policy
- Money Supply \approx Money Demand
- Condition: Low Real Rates \approx increased real investment – pro growth, when warranted.
- Condition: High Real Rates \approx Reduced (sub-optimal) real investment levels – cools growth, when warranted.
- Indirect controls on Prices (the value of money) – nominal interest and exchange rates.

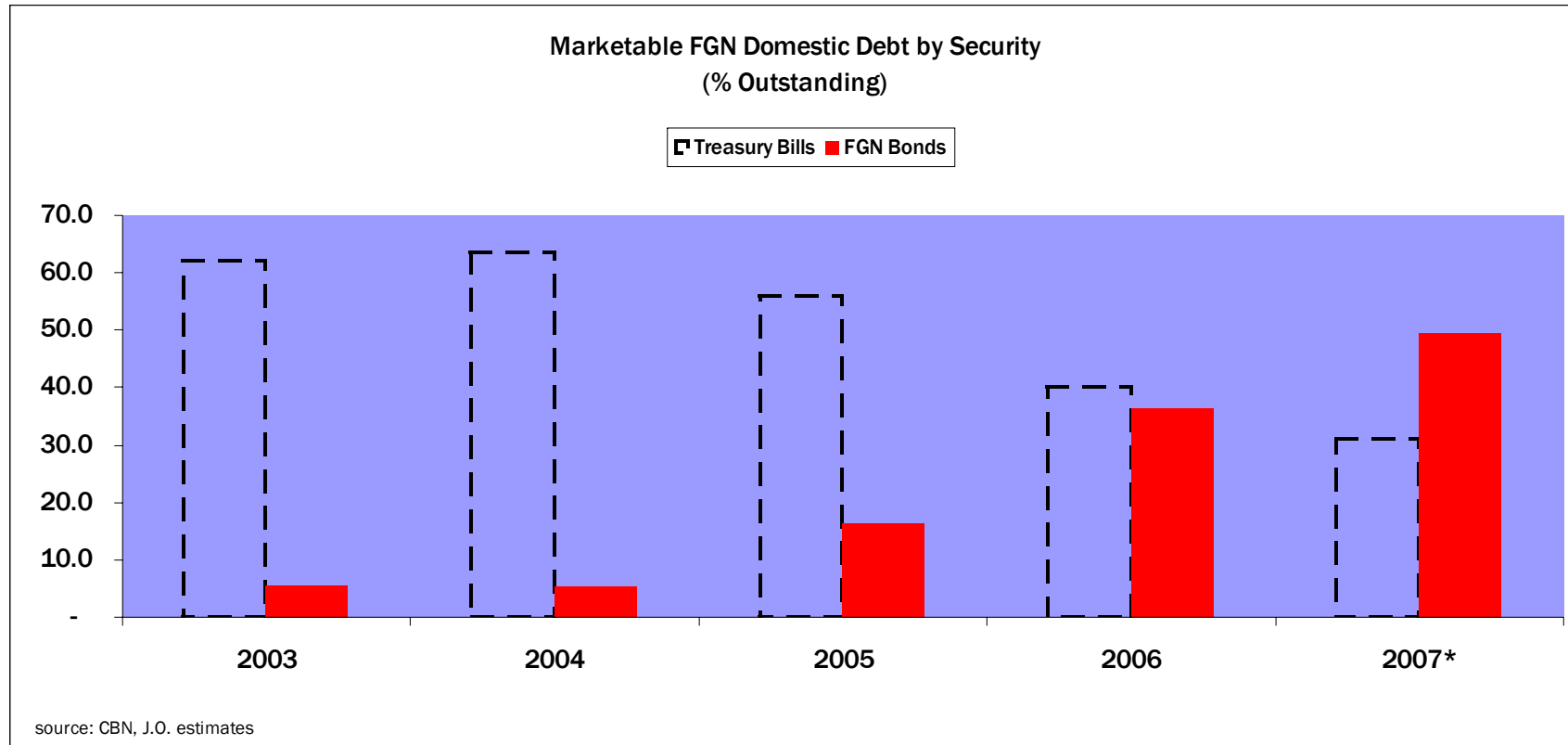
Near-to-Intermediate Term Outcomes

- Initially – High Real Interest Rate Volatility (the variable) – we’re not going to get this right first time out.
- Inherently wider variability in Monetary Base levels (i.e. Supply)
- Volatility in Exchange Rates (initially) / “Fear of Floating” official and private
- Stable Real Rates – inflation itself – will depend on quality of MP AND FP execution, which depends on quality of available tools – i.e. market infrastructure
- Productivity becomes key, (i.e. what and how we invest, and not investment for largely speculative reasons).
- Clearer economic rewards for High Quality Investment Decisions.

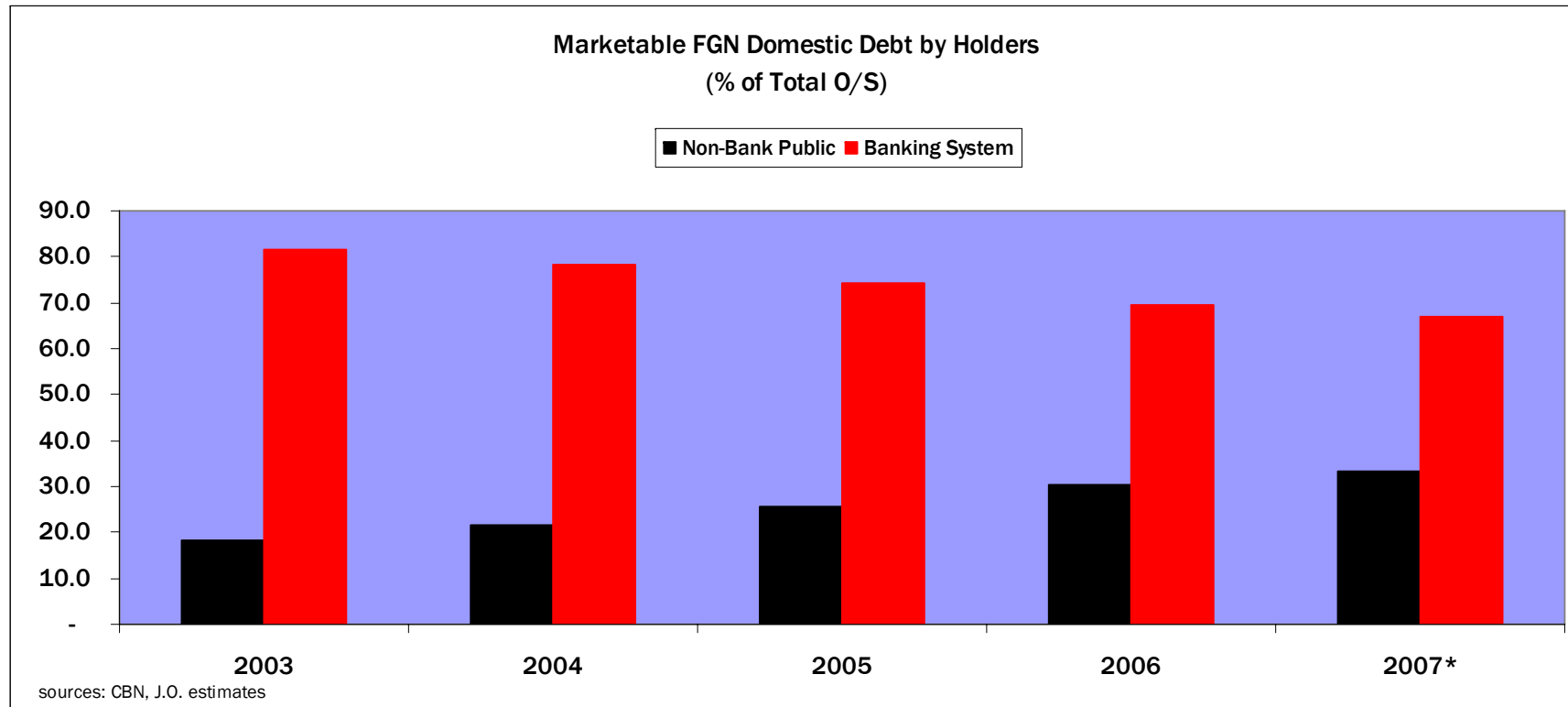
Who is Affected?

- EVERYBODY!!! (including West African economic neighbors)
- Nigerian Fixed Income securities Issuers and Investors, in particular -- which means: Employers, Banks, Insurance firms and Pensions.

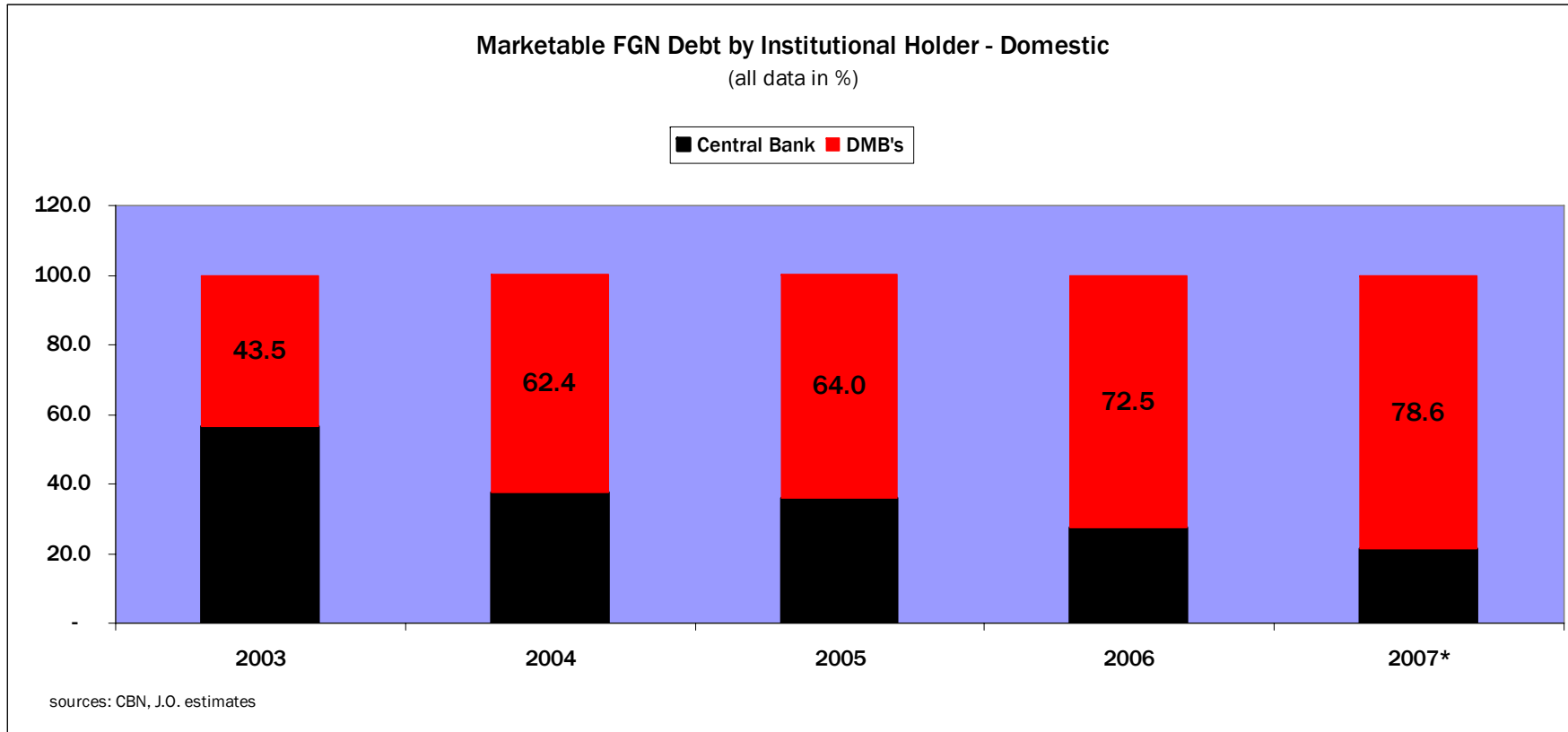
So much for understanding. I now wish to draw attention to the likely challenges a transition to Inflation Targeting will pose to the Banking Sector. WHY?



- The profile of the domestic public debt is shifting from short term Treasury Bills ($\leq 1Y$) to longer dated FGN Bonds ($\geq 3Y$)
- A shift into increasingly rate sensitive, fixed-income securities – the longer the maturity, the more sensitive the market value of the bond.
- We are developing a growing systemic risk exposure to market risk – viz. rising financial sector sensitivity to changes in interest rates and exchange rates.
- A by-product of domestic debt restructuring, with which Nigeria’s banks have had no significant prior experience.



- For the Central Bank: restructuring provided the opportunity to divorce Budget Deficit Finance from Monetary Policy.
- For the Government: debt restructuring represented the opportunity to diversify its sources of funding (by cultivating Non-Bank sources of finance).
- *Really?*



- While CBN has successfully orchestrated its exit from the Public Finance business.
- The Federal Government of Nigeria is yet to diversify its domestic funding sources.
- DMB holdings – as a proportion of outstanding marketable FGN debt – have almost doubled in 5 years.
- The CBN holds no FGN Bonds i.e. marketable long-dated securities.
- And CBN should never have to! (under normal circumstances)

Arising debt restructuring benefits may now appear to conflict with further pre-conditions to be met in advance of full-fledged IT. Holding such a view misses the bigger picture, however. The fact is that Public Debt Management and Monetary Policy are key areas where stronger collaborations between their Authorities can actually strengthen market infrastructure AND Policy transmission mechanisms; establishing robust foundations upon which BOTH policies can thrive.

Transitional Challenges

- High exchange rate pass-through characteristic of the Nigerian economy (i.e. contribution of FX rate changes to CPI changes)
- Central Bank's inflation-fighting credentials (a mixed record)
- Improved, timely assessment and reporting of Monetary Aggregates (high frequency data reports)
- Potentially protracted negotiations of clear and credible Policy Rules (mission creep)
- Increased interest/exchange rate volatility (South Africa)
- Widening Asset/Liability duration mismatches (i.e. "gapping").
- Official & Private "Fear of Floating" – higher intervention and "test-flight" temptations (respectively).
- Potential Capital Impairments, induced by higher trading and mark-to-market losses

Operation of the Transition Process itself would best be transparent, with operators accessible to the Public through their various representative channels. It needs to be publicly explained and accepted, from the "get-go", that the transition to Inflation Targeting will not be pain or error free. Both Monetary and Fiscal Authorities will likely be required to consistently demonstrate their Public commitments to minimizing transitional pain.

Enduring Challenges

- Maintaining Forecast & Data Integrity (avoiding appearances of manipulation)
- Measuring and Managing Inflation Expectations
- Accountability Mechanisms (potential misuse)

Suggestions for coping with the challenges outlined essentially fall into the following 3 categories of measures to be considered:

Strengthening Banking Supervision

- CBN may need to accelerate/intensify moves towards Risk-Based Banking Regulation
- Most important: Revitalize enforcement; paying particular attention to –
 - Lowering Asset Liability Duration mismatches
 - Mitigating Currency mismatches
 - Portfolio Concentrations – which now need to address not just credit but market risks as well.
- Banks need to reduce their fiscal/public finance dependencies.
- Enforcement of Prudential Banking Rules – the best sustainable means of minimizing widespread, unhealthy mark-to-market losses, and capital impairments in Nigerian banking.

Promote Risk Management Tools & Instruments

- Start with Repos (liquidity promotion):
 - what's really lacking here appears to be adoption of market standards (trading & documentation) that carry the enforcement credibility of CBN backing.
- FX Derivatives & Contracts:
 - CBN Trade & Exchange started remarkable work in harmonizing Exchange Control implementation with global market practices in the best risk management interests of the industry. Don't stop now. Keep going.
- Interest Rate Derivatives & Contracts:
 - here again there is urgent work for CBN's TED and Banking Operations to be done in collaboration with Industry (Bankers' and Money Market associations). Any official intention to adopt inflation targeting in the future makes the availability of interest rate risk management tools an upgraded priority.

Promote “age-appropriate” Marketable Securities

- Examples for serious consideration –
- Zero Coupon Government Bonds
 - For true and liquid yield curve development
- Inflation Indexed Government Bonds (3, 5 & 10Y)
 - Possibly the most expedient, objective and effective means open to CBN for assessing inflation expectations.

- CBN: Clearly not considering this (IT) lightly.
- Nigeria holds a precarious position in the global economy; the country's exposure to international trade is notably high
- Nothing short of full-fledged IT (challenging as this may be) has reasonable chances of success.
- CREDIBILITY IS EVERYTHING.
- Hence, the less subjectivity permitted to govern our monetary and fiscal management processes (and inherently arising conflicts), the better.
- Last suggestion: Codify required institutional behavior. Seriously consider a Policy Target Agreement or similarly purposed public contract.
- In any event, domestic and international Public scrutiny will be intense. The Authorities should welcome this -- if thoughtfully well-prepared, have transparent (policy) operating mechanisms and are prepared to be publicly and rigorously accountable on this subject. Concurrently, you may have to publicly commit to minimizing inevitable pains and missteps of transition. IT transition could be a lengthy process, time-wise.
- However, be wary of cannibalizing, via the Banking Sector, the interest rate channel you intend to create and nurture.
- As private, well-capitalized, market-driven institutions, CBN can now reasonably expect most Nigerian Banks to behave like "big boys". i.e. with maturity.
- Serious players will "get it"; accepting that, in Nigeria, there may be substantially higher rate and exchange volatility in transitional periods ahead.
- But higher volatilities ("vols") – without the tools to manage risks and protect our capital? That would be asking for too much – if not patently unfair.
- In such conditions, many of us would be understandably inclined to vote with our feet – AND CAPITAL
- Well conducted, IT is in EVERYBODY'S interests – domestic and foreign.

THANK YOU!