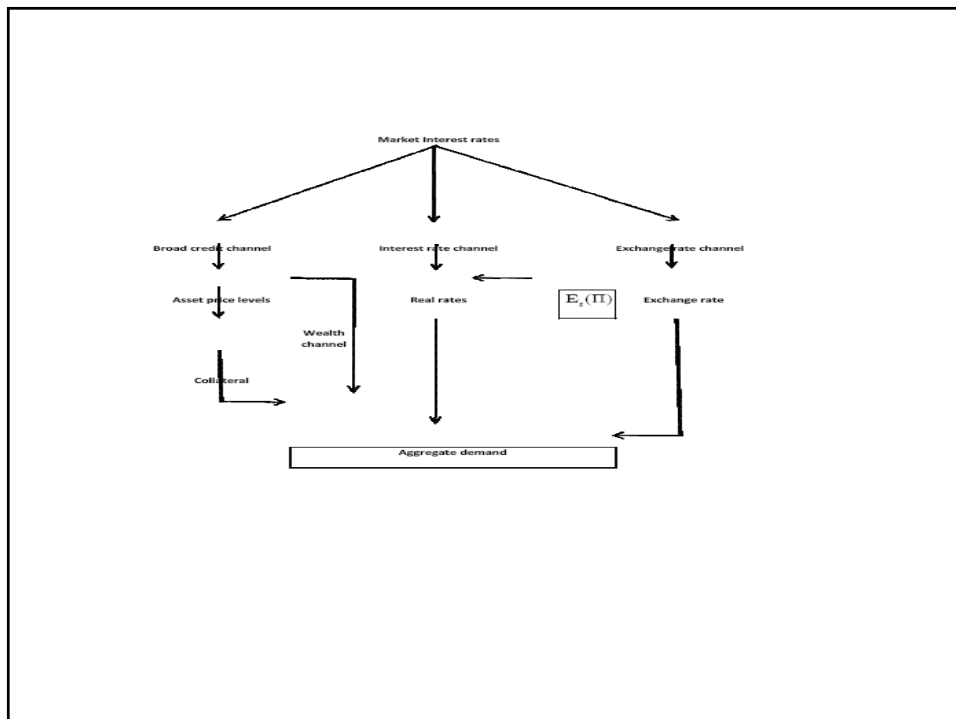


# IT Readiness Nigeria: the role of Financial Markets in the Operational Framework

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## Transmission Channels

### A. Effects on AD

- Interest rate Effects
  - Investment: cost of capital
  - Consumption: saving –interest rate(?)
- Wealth Effects
  - Consumption: life-cycle modes
  - Investment: q models
- Exchange rate Effects

### B. Effects on AS

- Working capital Effects

## ERE & WE Asset Pricing

- Unexpected movt in asset prices can impact on bank's inflation forecast
- Asset prices can carry information that improves forecast
  - a) Expectations about future economic activity
  - b) Inflation
  - c) Monetary policy

## Consider following rate scenario

- 90- day N      18% APR
- 90-day €€      15% APR
- Spot rate €€    N200
- 90-day swap    N0.0560

## Action

- Borrow €€ @ 15% APR
- Swap @ N0.0560 = 0.112% APR
- Generate N @ 15.112% APR
- Place N @ 18% APR
- Profit = 2.888% APR
- Equilibrium 90-day swap rate for €€ = N1.5000

## Interrogates DFA

- CIP:

$$F_t - S_t = i_t - i_t^*$$

- UIP:

$$S_{t+1}^e - S_t = i_t - i_t^*$$

- CIP & UIP  $\Rightarrow$

$$S_{t+1}^e \cong F_t$$

## Message

- Treasury operations tell us that Fwd rate is a predictor of future spot rate
- Interest differential as a predictor of exchange rate changes
- What does the market say?

$$S_{t+1} = S_{t+1}^e + \varepsilon_{t+1}$$

## Wealth Effects (premises)

- Standard life-cycle models
  - 1) Age of family members, family lifetime wealth
  - 2) Interest rate
  - 3) Composition of wealth should not matter
  - 4) Wealth defined measured as future labor income, pension, home equity, individual retirement, social sec

## Thaler (1990)

- Life-cycle with mental accounts
  - 1) Composition of wealth matters; MPC coded differently across mental accounts—asset a/c, current income, future income
  - 2) Size of gain and source of change in wealth matter
  - 3) Do all wealth changes produce similar change in current consumption? Hall & Mishkin (1982)

## Angeletos, Laibson, Repetto, Tobacman, Weinberg (2001)

- Life-cycle and psychological models of self control
  - If the representative Nigerian consumer is a hyperbolic but
  - Lacks both liquid wealth and access to revolving credit
  - Thus smoothens consumption by habituation?



**The (market) devil is in the details**



1. % household with high level of liquid wealth?
2. % household/popul with access to formal credit?
3. Why does PAN not have an acceptances corporation yet?
4. UAC, UTC for that matter?
5. Limited supply of direct participation instruments; why?
6. What about securitization?

### Further related Qs

1. What is driving quality of intermediation?
  - a) Nature of maturity transformation?
  - b) Menu of contracts on offer (range of instruments / products)?
2. Quality/ profile of customers or
3. Quality of institutions that underpin credit flow? i.e. bad photographer or ugly subject?
4. Rules of bankruptcy and contract enforcement (transaction costs)?

## Facts

- Unlike Europe and the US, wealth in housing not liquid
- High transaction costs in liquidating collaterals
- Quantum of asset backed lending thin
- Severe constraints on borrowing against future labor income; ditto credit cards
- Large informal economy relative to formal employment

## Investment: q models

- Market efficiency: how well do prices reflect fundamentals?
- Stock market crash, real estate booms and bursts, IPO underpricing
- 419, Ponzi schemes in evidence and historically; O'Connell and Zeldin (1992)
- So what?



## Yes...

- Insignificance of equities in household financial wealth but
- Increasing volatility of stock prices, exchange rate
- Insider dealings that are not vigorously checked
- And yes South Sea Company “purchased the King and Parliament”

## But

- Nigerian assets markets not yet robust
- High level of illiteracy compared to Zimbabwe
- Generally low level of market participation
- Market striving to attract investors and deepen

## Besides Zim

- For SA
- Total annual premiums (group life, individual life, annuity) as a prop of national income rated highest in the world
- Followed by UK, US, Canada (Vittas, 2003)
- Eliminating double counting, total assets of institutional investors including unit trusts in 2001 = 164% of GDP or ZAR1.56 trillion (US\$0.2230 t)

## Nigeria

- Cannot afford a complacency that comes from the cold comfort that other countries have managed IT with wacky financial markets and all sorts of Milken, Boesky, Keaton, Drexel, Bonfire of Vanities-type-shenanigans
- Strengthening DFAs is a priority