Nigeria's Macroeconomic Position: Controlling the Money Supply[•]

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Mr. Chairman,

Distinguished Ladies and Gentlemen,

Recognizing the critical role of macroeconomic stability to the achievement of sustainable investment and output growth, there has emerged a consensus that the long-term primary goal of monetary policy is domestic price stability. Although an increasing number of central banks have resorted to explicitly targeting inflation in their conduct of monetary policy, the link between money supply and inflation is no longer in doubt, at least in the long-run.

2. To us at the Central Bank of Nigeria (CBN), the ultimate goals of monetary policy has been the achievement of price stability, pursuance of a stable exchange rate regime that results in a balance of payments position that is viable and sustainable, and the achievement of high real economic growth. The pursuit of these objectives, and the extent to which they are met have important implications for investment decisions, and, indeed, international capital flows into Nigeria, especially in an increasingly globalised financial markets. First of all, when prices are stable, long-term investment decisions can be taken with the knowledge that price movements will not render returns on investment unprofitable at a later date. Therefore, when we emphasize liquidity

management in our monetary programmes, it is because we understand the need to maintain an optimal level of liquidity that is consistent with the absorptive capacity of the Nigerian economy so as to avoid overheating the economy.

3. Secondly, in our use of monetary control to pursue the objective of a viable and sustainable balance of payments position, we recognize that our exchange rate has to be competitive, if investors are to choose Nigeria out of the many economies they have to choose from. Simply put, our exchange rate should, and indeed, must reflect market realities to promote efficiency in resource allocation and productivity growth. It is, therefore, our goal at the CBN to pursue monetary policy that is consistent with the maintenance of a realistic and stable exchange rate regime, vis-à-vis those of our trading partners. To accomplish the objectives of monetary policy, the CBN has, overtime, adopted a mix of policy instruments as was needed to deal with specific circumstances, while the intermediate target has remained some monetary aggregates.

4. The objective of this presentation is to share with you a perspective of CBN's control over money supply since 1986, under the different macroeconomic epochs. In addition, the paper discusses some of the constraints faced by the CBN and why Nigeria's monetary policy outcome did not always meet the stipulated target. Permit me, Ladies and Gentlemen to begin with a review of the macroeconomic development in Nigeria from 1986 to date.

Monetary Policy and Macroeconomic Developments: 1986 - 2002

5. The introduction of the Structural Adjustment Programme (SAP) in September 1986 was meant to remedy the long period of macroeconomic disequilibria, characterized by lack-luster output growth, large fiscal deficits, large external debt stock and rising debt servicing burden, high rates of inflation, multiple exchange rates with widening premiums, a repressed financial sector and over-dependence on revenues from oil. In addition, problems of structural disequilibrium were manifested in the patterns of resource allocation, production and absorption, which impeded monetary policy transmission process.

(a) 1986 – 1993

6. The objective of the SAP was to eliminate domestic and external imbalances. The strategy was the adoption of tight fiscal and monetary policies that would promote domestic price stability by reducing domestic absorption while enhancing output growth. In particular, emphasis was placed on enhancing the role of price signals in the economy, including interest and exchange rates, through free market mechanism. The structural component of the programme focused on structural reforms aimed at eliminating the rigidities in the economy, improving the capacity of the economy to respond to market signals, and making the transmission of economic policies more efficient. Towards that end, the Government also embarked on the privatization and

commercialization of public enterprises, the abolition of commodity marketing boards, financial sector reforms, as well as trade and tariff reforms.

7. The SAP was successful in the initial years of implementation, as real GDP growth rate averaged 5.4 percent a year, while none oil GDP growth accelerated to 2.7 per cent from negative 7.3 percent annual growth rate in the pre-SAP. Moreover, the parallel market premium fell from 234 percent in the pre-SAP era to 19.6 percent during the SAP, while the growth in monetary aggregates also dropped marginally. (see Table 2). Unfortunately, after the first three years of the SAP, the economic reforms were discontinued and coupled with the distress in the banking system and the political crises of the early 1990s, progress was stalled.

(b) 1994 – 1998.

8. Following the poor performance of the economy after the initial success in the early years of SAP, a failed attempt at reintroducing direct controls was made in 1994 under the policy of guided deregulation to address the problems of macroeconomic imbalances, low growth rates and rising poverty. The centrepiece of the policy initiative was the need to curb the volatility of interest and exchange rates through the cautious application of market-based policies. The reforms focused mainly on the autonomous foreign exchange market, reform of tariffs and taxes and improvement in revenue collection mechanism, transition from direct control to market-based approach to monetary control in which open market operations is the primary instrument.

9. The sustenance of tight monetary stance during the period resulted in macroeconomic stability in the economy. On the fiscal front, the overall fiscal balance swung from a substantial deficit in 1994 to a surplus in 1995 and 1996. Concomitantly, for the first time in decades, some of the monetary programme targets were virtually achieved, see Table (1). On the external front, demand for foreign exchange at the AFEM moderated resulting in exchange rate stability and low premium between the AFEM and parallel market exchange rates. Moreover, the huge balance of payments deficits recorded since the early 1990s narrowed persistently from 1995, and swung into a modest surplus in 1997, while external reserves accumulated to US$7,581.2 million by the end of 1997 compared with US$1,441 million at the start of the programme of guided deregulation. The overall improvement in macroeconomic performance during the period was able to reverse the persistent negative GDP growth of the preceding years, and the inflation rate also declined from an all time high of 72.8 percent in 1995 to a single digit of 8.5 percent in 1997, the lowest in eight years.

10. Reflecting the vulnerability of the Nigerian economy, when oil prices fell in 1998, some of the gains of the previous years were eroded, particularly as the pre-election year spending, financed mainly by the banking system, surged. Consequently, the growth in money supply accelerated and triggered the resurgence of inflationary pressure, the level of external reserves were depleted,

while real GDP growth rate declined. For example, the inflation rate rose from 8.5 percent in 1997 to 10 percent in 1998, real GDP growth fell from 3.2 to 2.5 percent, while the current account balance reversed from a surplus of 1.2 percent of GDP in 1997 to a deficit of 11.6 percent in 1998. Official reserves declined from the US$7.581 billion in 1997 to US$7.1 billion, during the same period.

[c] 1999 – 2002

11**.** In May 1999, when the democratically-elected government assumed office, domestic and external imbalances had resurfaced with rising fiscal deficit, further depletion of external reserves, persistent macroeconomic instability and serious structural bottlenecks. In addition, public infrastructures, such as those for electricity and energy had decayed considerably with the National Electric Power Authority (NEPA) barely supplying enough electricity and the supply of petroleum products very erratic, as major refineries had shut down resulting in long queues at the filing stations. The economy was virtually in a state of total collapse at the inception of the new government.

12. The optimism was therefore quite high, when the new government was sworn in, in May 1999. The government, therefore, started by tackling the problems of infrastructure decay, by committing huge public expenditure on the maintenance of oil refineries and NEPA equipment. In addition, inefficient public agencies including Petroleum Trust Fund (PTF), Family Economic Advancement Programme (FEAP) and Peoples Bank that had, hitherto,

constituted huge drains on public resources, were either closed down or restructured. It is instructive to note that, the adoption of an IMF staff monitored programme followed by a Stand-By Arrangement in Year 2000, influenced the tightening of macroeconomic policies and an accelerated pace of structural reforms, including the privatization programme. These policies led to a modest recovery in 2000, as real GDP growth rate rose to 3.8 percent, and overall balance of payments swung into a surplus of 7 percent of GDP. External reserves rose by 81.8 percent to US$9.9 billion, and fiscal deficit declined to 3 percent, from 8.4 percent in 1999. However, the tempo of adjustment could not be sustained.

13. In 2001, the excessive fiscal expansion financed through monetization of huge oil revenues and credit from the banking system, derailed the implementation of the Stand-By Programme. Monetary aggregates expanded beyond programme targets, and the exchange rate movement became volatile. Moreover, the inflation rate reverted to double digits. Today, the challenge for policy makers is how to design a home grown programme that would address both the issues of macroeconomic imbalance and enhance the long-term growth prospect of the Nigerian economy.

The Monetary Policy Framework

14. The macroeconomic outcomes outlined above have, at different historical epochs, been strongly influenced by monetary conditions.

The Role of the CBN

15. The statutory mandate of the CBN is to maintain "monetary stability". The pursuit of this mandate has been further strengthened by the "instrument autonomy", granted to the Bank in 1998, implying that the CBN has discretion over the use of any monetary policy instrument and could intervene in the financial market in pursuance of the objectives of maintaining monetary stability and a sound financial structure. Towards these ends, the Bank is to ensure that variations in the demand for and supply of money would be managed in such a way as to minimize disturbances in the general level of prices, the achievement of external sector viability and real output growth.

16. In the foregoing review of macroeconomic developments, it is clear that monetary policy had played a crucial role. The high inflation of the early 1990s, and exchange rate volatility of the same period were strongly underlined by excessive monetary expansion. The CBN recognizes that inflation imposes significant costs on the economy and has, as an ongoing endeavor, used the instruments at its disposal to absorb or inject reserves into the system.

Monetary Targeting

17. The CBN seeks to achieve the ultimate objectives of policy through a monetary framework that targets monetary aggregates/intermediate variables. The CBN monetary programme sets explicit targets for broad money (M2), the

key intermediate benchmark variable and base money as the operating variable. The factors, which influence the expansion or contraction of money stock include aggregate bank credit to the private sector and credit to government, net foreign assets and “other” domestic assets (net) of the banking system. The target for the intermediate variable (M2) is determined with reference to the programmed inflation rate, external reserves accretion and real GDP growth targets. The link between the ultimate goal of price stability, the intermediate targets of money stock (M2) and indicator variables like the inflation rate are not usually so direct, but there is a wide consensus about the relative effect of the proximate variables on the ultimate goals.

18. The question then arises as to, how does the CBN prepare its monetary programme? Prior to 1992, monetary and exchange rate policies were conducted through direct administrative control of the nominal interest rate, imposition of ceilings on interest rate and credit expansion, sectoral allocation of bank credit, foreign exchange control and quantitative restrictions. Though the reforms of 1986 liberalized the sector by adopting a flexible exchange rate regime and removing various forms of non-market interventions in the financial markets, the conduct of, monetary policy did not become fully market-determined until 1993 when the use of open market operations (OMO) was introduced. Since 1993, the conduct of monetary policy hinged on a formal programme that sought to contain the growth rate of nominal money stock to programme targets through the injection and absorption of reserve money. In

order to enhance the effectiveness of monetary policy, we complement the use of OMO with other instruments, including cash reserve requirement, which specifies the proportion of deposit liabilities of the banks that should be kept as cash reserves at the CBN; discount window operations, for the purpose of discounting or repurchasing of securities, and by implication the injection or withdrawal of reserves into / from the system; and finally the Minimum Rediscount Rate, the nominal anchor of CBN's interest rate policy, used to signal the direction of interest rate changes. The other instrument used, as the need arises include the transfer of public sector accounts in and out of the CBN.

19. The adoption of the indirect approach to monetary management since 1993 has significantly contributed to enhanced efficiency in resource allocation in the system, despite the fact that targets were not always met. Effective from 2002, the CBN has adopted a medium-term perspective monetary policy framework, for a two-year period (2002 – 2003) to replace the annual monetary programme. The shift was in recognition of the fact that monetary policy actions affects the ultimate objectives of policy with substantial lag and, therefore, aims to free monetary policy implementation from the problem of time inconsistency as well as minimize over-reaction to temporary shocks.

Monetary Programme Targets and Outcome

20. Perhaps some of our potential investors present at this forum would like to know how successful our monetary programme has been over the period. An

operational concern would be to consider the deviation of outcomes from targets, while another level of concern would be to question whether the achievement of programme targets are strongly linked to the achievement of the overall objectives of monetary policy. Let us examine the different epochs.

(a) 1986 – 1994

21 As stated earlier, monetary policy operations during this period was based largely on non-market interventions to influence programme targets. There were several areas of successes and failures. One remarkable area of success is the low inflationary outcome of the sharp devaluation that accompanied the floatation of the Naira in the late 1980s. The CBN was able to minimize the inflationary impact because a series of sterilization exercise was carried out prior to the floatation that effectively moderated the growth in money supply. A tight monetary policy stance was maintained in the initial programme years. The restrictive policies, and better coordination of monetary and fiscal policies resulted in low monetary expansion. However, this did not last for long. Firstly, exogenous increases in net foreign assets, following from the Persian Gulf War, was a major source of increase in base money. The effect of the contraction in aggregate demand, output and employment growth in the subsequent period was too painful for the government to bear, hence the expansionary budget of 1988. Finally, the distress situation in the banking system in the early 1990s precipitated by excessive credit expansion to the private sector, adversely affected Nigeria’s ability to meet programmed targets.

(b) 1995 – 1998.

22 During this period, programme performance was impressive, as targets were met or even surpassed (See Table 1). The success achieved was mainly as a result of fiscal consolidation and expenditure restraint. However, the achievement of macroeconomic balance was at painful cost to aggregate domestic demand and output, since government spending was the major source of liquidity to the economy.

[c] 1999 - 2002

23. Since 1999, when a democratically-elected government came into power, monetary management faced new challenges, as programme targets have once again proved difficult to achieve because of fiscal dominance. One of the reasons for this was the last round of increases in crude oil prices, which though a desirable development from the point of view of resource inflow and the accumulation of external reserves, became worrisome in the face of the expansion in base money occasioned by the rapid monetization of the proceeds of excess crude earnings. Secondly, in a democratic setting, sterilization operations not backed by constitutional provisions have proved very difficult.

(d) Constraints / Limitations

24. There are clearly constraints to the achievements of money supply targets, and there are limits as to what is achievable. A major constraint has been inadequate coordination between fiscal and monetary polices. Clearly, the

control of money supply was more successful in those historical epochs when fiscal discipline was exercised, particularly in the early days of the SAP and the period of guided deregulation. At periods of fiscal dominance, achievement of targets has been circumscribed.

25. It is also important to note that the financing arrangement between the Federal Government and the CBN has often resulted in an accommodating monetary policy in which the CBN issues and underwrites Government securities. Any unsubscribed portion is automatically taken up by the Bank. Many countries have overcome such problems by laws, preventing Governments from borrowing directly from the central bank.

26. Finally, structural and institutional weaknesses also constrain the ability of the CBN to meet its target. These include the existence of large informal sector and an oligopolistic structure of the banking system. The fact that a large proportion of financial resources are not intermediated in the formal financial sector, restricts the effectiveness of monetary policy instruments from impacting on the control of money supply. Moreover, the bottlenecks arising from inadequate financial sector reforms constrain the efficiency and effectiveness of monetary policy. Of particular relevance are the inefficiency in the settlement and clearing system, as well as lack of timely and credible information for policy formulation and implementation. These affect the ability to set targets that are realistic and achievable. In addition to these constraints to the achievement of programme targets, there are other limitations, the main one

being the issue of multiple goals of monetary policy. This is a non-trivial question, considering the trade-offs that exist among the different goals, examples of which abound in this presentation. The focus of monetary policy in most countries is maintenance of price stability and where there is, in addition, a mixture of growth and stabilization objectives, the practice is to have a hierarchical mandate that subordinates these other goals.

Conclusion

27. In conclusion, Distinguished Ladies and Gentlemen, let me conclude by stating that, although we have identified the challenges of controlling money supply in Nigeria, I would like to assure you that the weaknesses are being effectively addressed in the context of our on going financial sector reform. There are also positive indications that the Executive arm of government has recognized the urgent need for fiscal prudence and the imperative of effective coordination between monetary and fiscal policies.

28. I thank you for your time.

July 17, 2002

APPENDIX

Table 1: Monetary Programme Targets and Actuals

	Narrow Money (M1)		Net Domestic Credit		Credit to the Government		Credit to the Private Sector		Broad Money (M2)	
	Target	Actual	Target	Actual	Target	Actual	Target	Actual	Target	Actual
1992	24.3	52.8	13.2	69.1	7.7	109.7	17.7	34.6	26.8	52.8
1993	20	54.4	17.5	91.4	14.5	121.6	20	51.6	18	49.8
1994	21.4	47.8	9.4	29.2	0	32.2	32.2	27.7	14.8	39.1
1995	9.4	8.1	11.3	36.2	5.6	69.6	21.9	18.4	10.1	10.3
1996	14.5	14.5	12	-23.4	0	-55.6	29.5	23.9	16.8	16.8
1997	13.5	18.2	24.8	-2.8	0	-53.5	45.4	23.9	15	16.9
1998	10.2	17.2	24.5	55.7	0	199.3	33.9	27.3	15.6	21.2
1999	4.1	18	18.3	30	10.2	32	19.9	29.2	10	21.6
2000	9.8	62.2	27.8	-23.1	37.8	-162.3	21.9	30.9	14.6	48.1
2001	4.3	28.1	15.8	75.8	2.6	79.7	22.8	43.5	12.2	27

Source: Central Bank of Nigeria Annual Reports, various years

Table 2: Nigeria Selected Economic Indicators

		1980-85	1986-90	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
National Income and Prices*														
Real GDP Growth rate		-0.12	5.42	4.8	2.9	2.3	1.3	2.4	3.40	3.20	2.5	2.8	3.8	3.9
Oil GDP		-7.26	2.72	9.2	2.7	-2.6	-6	2	6.9	1.4	-4.9	-4.2	0.6	-4
Inflation Rate***		20.56	22.1	13	44.5	57.2	57	72.8	29.3	8.5	10.0	6.6	6.9	18.9
Index of Industrial Production***		100	118	138.8	148.5	129.4	129.2	128.7	132.3	140.5	133.9	129.1	139	145.3
Capacity Utilization Rate		37.1	32.9	39.4	40.4	36.2	30.4	29.3	34.7	34.2	34.9	36	36.1	39.6
Gross Domestic Investment ratio		20.48	20.74	23.4	24.5	16.8	17.7	16.2	19.8	15.5	17.9	18.2	20.1	n/a
Gross Savings ratio		19.58	15.54	23.5	22.6	13.9	15.2	12.1	12.8	13.9	9.2	18.3	28.3	26.2
Fiscal Sector**														
Federally collected revenue		24.5	24.8	31.2	31.1	27.6	18.3	23.26	11.53	13.57	11.23	16.61	32.19	26.01
of which oil		20.6	20.4	25.9	26.1	22.8	13.7	16.40	13.60	14.70	11.92	9.95	23.55	16.46
Federally retained revenue		18.6	18.0	17.8	15.3	15.3	10.9	12.63	11.85	12.39	10.90	18.30	16.50	14.5
Expenditure and net lending		26.0	22.7	25	26.7	33.6	19.9	12.30	12.92	14.63	12.52	28.1	19.5	18.5
Overall Fiscal Balance		-7.4	-8.1	-6.8	-7.9	-18.1	-8.8	0.05	1.35	-0.2	-4.7	-8.4	-2.9	-4
External Sector*														
Exports f.o.b.	in billions of US$	15.1	9.02	12.1	12.3	11.3	9.5	10.00	15.7	13.2	9.3	12.9	19.4	18.9
of which oil:	in billions of US$	17.6	8.56	11.7	12	11	9.3	8.9	12.5	10.6	7.5	12.6	18.9	18.6
Imports c.i.f.	in billions of US$	-12.8	-6.26	-7.9	-8.7	-8.1	-6.7	-4	-5.6	9.5	9.2	8.6	8.7	10.4
Average official exchange rate		0.7	5.142	9.91	17.3	22.05	22	22	69.84	71.75	76.81	92.34	101.65	111.9
Parallel Market Premium (%)		324.0	19.6	35.2	17.4	64.3	173.2	281.7	279.60	3.6	4.10	8.1	9.2	18.5
External Sector**														
Trade balance		-3.3333	-2.12	0.1	-1.9	-2.9	-2.4	-9.4	8.5	1.2	-11.6	0.4	13.7	4.8
Overall Balance of Payments		-2.8833	-11.62	-7	-24.2	-10.6	-6.1	-9.87 -	1.94	0.04	-8.11	-3.1	7	0.5
External Reserves****		1086.7	3885.5	4486.7	712.6	1330.1	1658.8	1,441.00	4074.7	7581.2	7100	5450	9910	10455.8
Monetary Aggregates														
M1*		18.28	13.25	15.03	13.79	16.58	18.74	10.22	14.5	18.2	20.5	18	62.2	28.1
M2*		32	22.08	24.4	22.85	27.13	28.41	15.89	16.8	16.9	23.3	31	48.1	27
Domestic Credit*		44.12	23.66	21.79	29.41	38.45	41.53	21.49	23.4	-2.8	46.8	30.1	-23.1	75.8
12 Months Deposit Rate		10	22	20	22	26	17	13.53	13.43	7.46	10	14.3	11.2	18.4
Lending Rate		9.43	25.3	20.04	24.76	31.65	20.48	20.23	18.76	13.64	18.36	21.3	21.3	26

Sources: CBN Bulletins

Notes:

* Annual percentage changes, unless otherwise indicated

** In percent of GDP

*** End period

**** US$ millions, end period