CENTRAL BANK AND THE MACROECONOMIC ENVIRONMENT IN NIGERIA

By

CHIEF (DR.) J.O. SANUSI
GOVERNOR
CENTRAL BANK OF NIGERIA

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Director-General, NIPSS
Participants of the Senior Executive Course No. 24,
Distinguish Lecturers and Staff,
Ladies and Gentlemen

SECTION I

1. Introduction

1.1 I regard today as an important day in my annual calendar which I look forward to because of the opportunity it offers me to share my thoughts with the Course Participants at NIPSS on the macroeconomic developments in the economy. This year's lecture, the third in the series is, however, marred by the sudden death of our late friend and amiable former Director-General, Major General Joseph N. Garba (Rtd.) who passed on to eternal glory on June 1st, 2002. May the Lord comfort those he left behind and grant him everlasting peace.

1.2 My discourse focuses on the role of the central bank in meeting the challenges of maintaining a stable macroeconomic environment in Nigeria. The primary goal of monetary policy, is the maintenance of domestic price and exchange rate stability as a critical condition for the achievement of sustainable economic growth and external viability. More specifically, a stable macroeconomic environment will catalyse output and employment growth such that the standard of living of the citizenry would improve. The state of macroeconomic environment as well as the quality of institutional development, are major determinants of economic performance. In this regard, the Central Bank of Nigeria (CBN) has an important role to play in ensuring the maintenance of macroeconomic stability and a sound financial system. In particular, if supported by appropriate fiscal policy stance, the achievement of desired macroeconomic objectives is within the reach of central bank's monetary policy.

1.3 For ease of presentation, the paper is divided into eight sections. The section that follows this introduction outlines the mandate of the CBN against the background of the changes in the degree of its autonomy and operating procedure. The objectives and transmission mechanism of monetary policy are discussed in Section III, while Section IV reviews and appraises the impact of CBN monetary policy on macroeconomic performance. In Section V, issues on financial market reform and the implications for the effectiveness of monetary policy are examined, and Section VI considers the challenges facing the monetary authorities in monitoring a stable macroeconomic environment. Section VII deals with the recent Dutch Auction System and management of exchange rate and external reserves, while Section VIII provides the concluding remarks.

SECTION II

2. The Mandate of the Central Bank of Nigeria

2.1 The mandate of the Central Bank of Nigeria (CBN) and the specific objectives pursued in meeting this mandate derives essentially from the CBN Act of 1958, as amended in successive reviews and consolidated in Acts 24 and 25 of 1991 and the subsequent amendments in 1998 and 1999. Specifically, the Bank's primary objectives, as contained in the Act have remained largely unchanged, encompassing the following:

(i) issue legal tender currency notes and coins in Nigeria;
(ii) maintain Nigeria's external reserves to safeguard the international value of the legal tender currency;
(iii) promote and maintain monetary stability and a sound and efficient financial system;
(iv) act as banker and financial adviser to the Federal Government; and
(v) act as the lender of last resort.

2.2 Embedded in these broad objectives is the mandate to conduct monetary and financial policies with a view to promoting economic growth and development in Nigeria. With the evolution of the Nigerian economy, the mandate of the CBN has been broadened over time and along with it, the instruments of monetary policy. Thus, the Bank has assumed overall responsibility for administering the Banks and Other Financial Institutions (BOFI) Act No. 25 of 1991, as amended, which aims at ensuring high standards of banking practice and sustained financial stability. As part of its responsibility to promote a sound banking structure, efficient payments and settlement system and facilitate the development and deepening of the money and capital markets, the CBN has supervisory and regulatory responsibilities over the deposit money banks and other financial institutions.

2.3 The role of the CBN has evolved over time, influenced by the needs and circumstances of the economy. Thus, there has been a shift of emphasis from creating an appropriate institutional environment for central banking, which dominated the formative years through the mid-1980s to the maintenance of price stability for sustainable economic growth and development, which is currently the main focus of central banking worldwide. Moreover, the choice and emphasis of a central bank's activities are dependent on: the structure and openness (in terms of trade transactions with the rest of the world) of the economy, the stage of development of the financial sector, and nature of the relationship that exists with the fiscal authorities. In this regard, conditions in the macroeconomy plays a crucial role in shaping the specific objectives of a central bank, while, on the other hand, the central bank through its conduct of monetary and financial policies, strives to improve the macroeconomic environment in which it operates.

2.4 During the formative years, the objective of the CBN was biased towards the development of the financial infrastructure that would facilitate the effective conduct of its monetary policy. Thus, taking cognisance of the absence of the requisite institutional framework for conducting monetary policy, the Bank was actively involved in the establishment and development of money and capital markets, including a host of development finance institutions (DFIs). The establishment of government securities market was designed not only to assist the government in mobilising resources to finance its development projects, but also to facilitate the conduct of monetary policy.

2.5 The Bank has also been active in facilitating necessary financing for agricultural and industrial developments as well as export promotion through the introduction of the Agricultural Credit Guarantee Scheme Fund (ACGSF), Nigerian Export-Import Bank (NEXIM) and the small and medium enterprises loan scheme (SME II).

2.6 While the developmental role of the CBN has continued to date, greater attention has since the mid-1980s been focussed on creating the necessary enabling environment for the effective conduct of monetary policy through market mechanism. Thus, the adoption of the

Structural Adjustment Programme (SAP) in 1986, with structural reforms as key element, ushered in a new orientation in the conduct of monetary policy in Nigeria. The financial sector has been substantially liberalised and monetary control mechanism has moved toward a more market-oriented regime, designed to facilitate savings mobilisation and efficiency in the allocation of financial resources. The reforms established the necessary macroeconomic framework and financial environment for the new regime to operate unfettered.

SECTION III

3. Objectives of Monetary Policy, the Transmission Mechanism and Limitations

3.1.1 Objectives of Monetary Policy

3.1.1 The primary objective of monetary policy that cuts across the mandates of most central banks is the maintenance of price stability, which is fundamental to the attainment of sustainable growth. While the focus of central banking in an increasing number of economies is the fight against inflation, the CBN is still saddled with developmental functions, with the attendant risk of policy conflicts.

3.1.2 The pursuit of price stability, invariably implies the indirect pursuit of other objectives such as economic growth, which can only take place under conditions of price stability, and allocative efficiency of the financial markets. Economic growth is determined by many factors, some of which are within the ambit of central banks, while others are exogenous to monetary policy. Since inflation is generally considered as purely a monetary phenomenon, with significant cost to the economy, the primary goal of monetary policy is to ensure that the supply of money is at a level that is consistent with the growth target of real income, such that non-inflationary growth will be ensured. The pursuit of price stability, therefore, encompasses all the main areas in which the central bank can contribute towards stabilising the macroeconomic environment of the country.

3.1.3 With the achievement of price stability, the uncertainties of general price level will not materially affect consumption and investment decisions. Rather, economic agents will take long-term decisions without much reservation about price changes in the macroeconomy. In addition, the conditions in the financial market and institutions would create a high degree of confidence, such that the financial infrastructure of the economy is able to meet the requirements of market participants. Indeed, an unstable or crisis-ridden financial sector will render the transmission mechanism of monetary policy less effective, making the achievement and maintenance of strong macroeconomic fundamentals difficult. This is because it is only in a period of price stability that investors and consumers can interpret market signals correctly. Typically, in periods of high inflation, the horizon of the investor is very short, and resources are diverted from long-term investments to those with immediate returns and inflation hedges, including real estate and currency speculation.

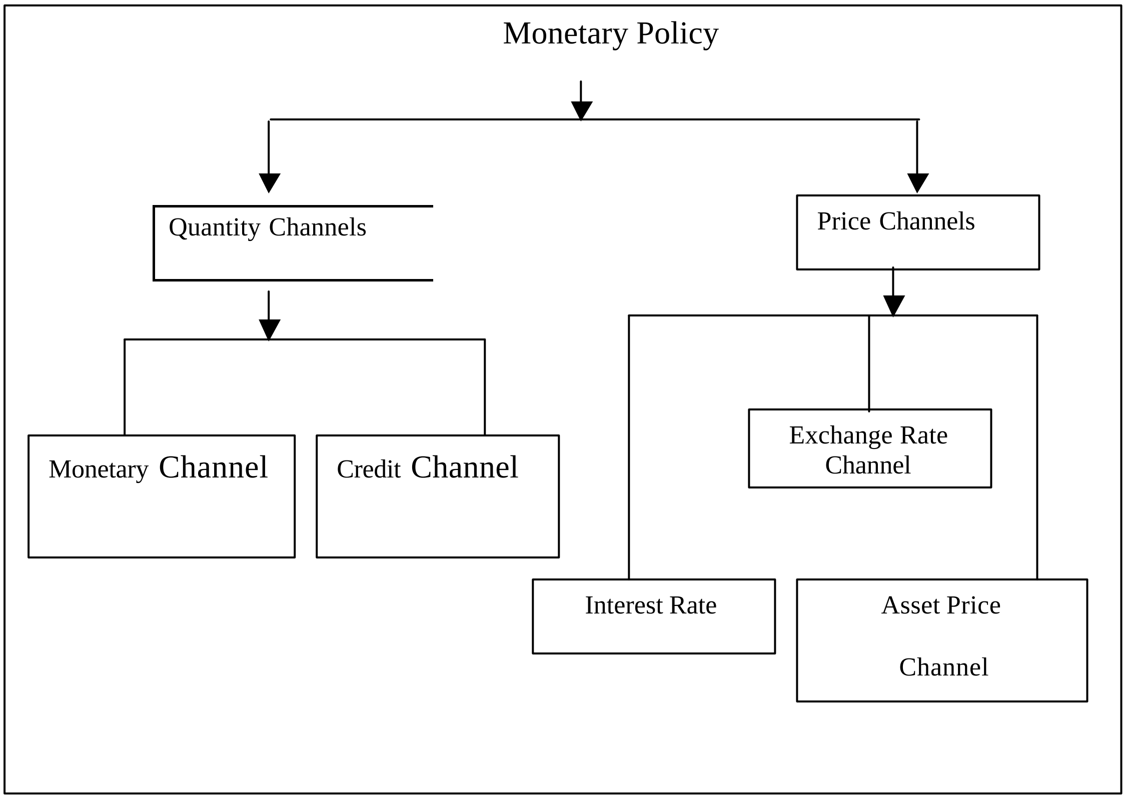
3.1.4 The goals of monetary policy might, however, conflict with other macroeconomic objectives in the short run, although in the long run their complementarity must be ensured. For example, high and unstable interest and real exchange rates are perceived to be harmful to investor and consumer confidence. This arises mainly from the perceived general increases in the cost of funds faced by market participants. In reality, however, such increases are usually of short term nature, which are ultimately in the *long-term* interest of the economy, provided that other macroeconomic variables are allowed to evolve along their equilibrium paths. A case in point is the devaluation of the naira in the mid-1980s, and correction of the misalignment, which was largely responsible for the debt overhang (The Paris Club), which today constitutes a serious drain on the country's resources. Although, the devaluation resulted in short-term high costs and job losses in some sectors, it succeeded largely in altering investment and consumption decisions, thereby creating the right atmosphere for growth of non-oil exports and for industries that were willing and able to substitute imported inputs with domestic alternatives to expand their production base. The current determination of the naira exchange rate through the Dutch Auction System is generally along the same principle. In this regard, the role of monetary policy has to be considered holistically.

3.2 The Transmission Mechanism of Monetary Policy

3.2.1 The transmission mechanism of monetary policy can be broadly described as the processes through which monetary policy actions affect the price and quantity of various financial instruments and, ultimately, real economic activities. The central bank cannot control inflation or influence output directly, except indirectly through an intermediate target, broadly classified as price and quantity instruments.

3.2.2 The price channel refers to the instruments that affect the cost of money, while the quantity channel refers to those instruments that affect the supply and availability of money. The price channel is further divided into the interest rate channel, the exchange rate channel and the asset price channel. The quantity channel can also be broken down into the monetary channel and credit channel (see Figure 1).

Figure 1: Monetary Policy Transmission Channels



3.2.3 It is useful at this point to make a distinction between direct and indirect techniques of monetary policy. Direct techniques set or limit the desired quantities of monetary variables.

They include interest rate ceilings and administrative determination of interest rates, quantitative restrictions on bank credit expansion, mandatory holdings of government securities and sectoral allocation of credit. The use of these techniques was widely abandoned in the 1980s when it became obvious that it resulted in substantial misallocation of resources, because prices did not reflect their true value, thus sending wrong signals to investors and savers.

3.2.4 On the other hand, indirect (or market-based) techniques focus on the underlining demand for and supply of financial assets. In contrast to direct techniques, they target the balance sheet of the central bank while the direct techniques focus on the balance sheet of deposit money banks. In line with the policy of financial sector liberalisation that accompanied the Structural Adjustment Programme (SAP) in the second half of the 1980s, the CBN embarked on the transition process from direct to indirect techniques of monetary management.

3.2.5 The adoption of the indirect mechanism required interest rate policy to become the most important instrument of monetary management, aimed at regulating the cost of credit by deposit money banks, with the minimum rediscount rate (MRR) as the nominal anchor for all money market interest rates. The purpose of varying the interest rate is to alter the demand for and supply of financial assets in the direction that is consistent with the overall objectives of monetary policy, including output growth and inflation. For example, looking at Figure 2, a change in monetary policy stance, initiated by a change of the MRR, is initially transmitted to the nominal short-term interest rates, which influences the real interest rates, and finally affects the consumption and investment decisions of economic agents. While these interactions are going on in the financial sector, the effect is being transmitted to the real sector through its impacts on aggregate demand and the price level. Thus, the effect of monetary policy measures can be readily transmitted to the larger economy through changes in interest rates.

3.2.6 In addition, interest rate policy is also an instrument for regulating the growth of financial savings. Financial policy changes that result in positive real interest rates, such as happened in the 1980s, would generate growth in financial savings and influence the deepening of financial markets. The development of more efficient financial markets meant that open-market policies and other indirect techniques could more easily transmit their effects to the larger economy.

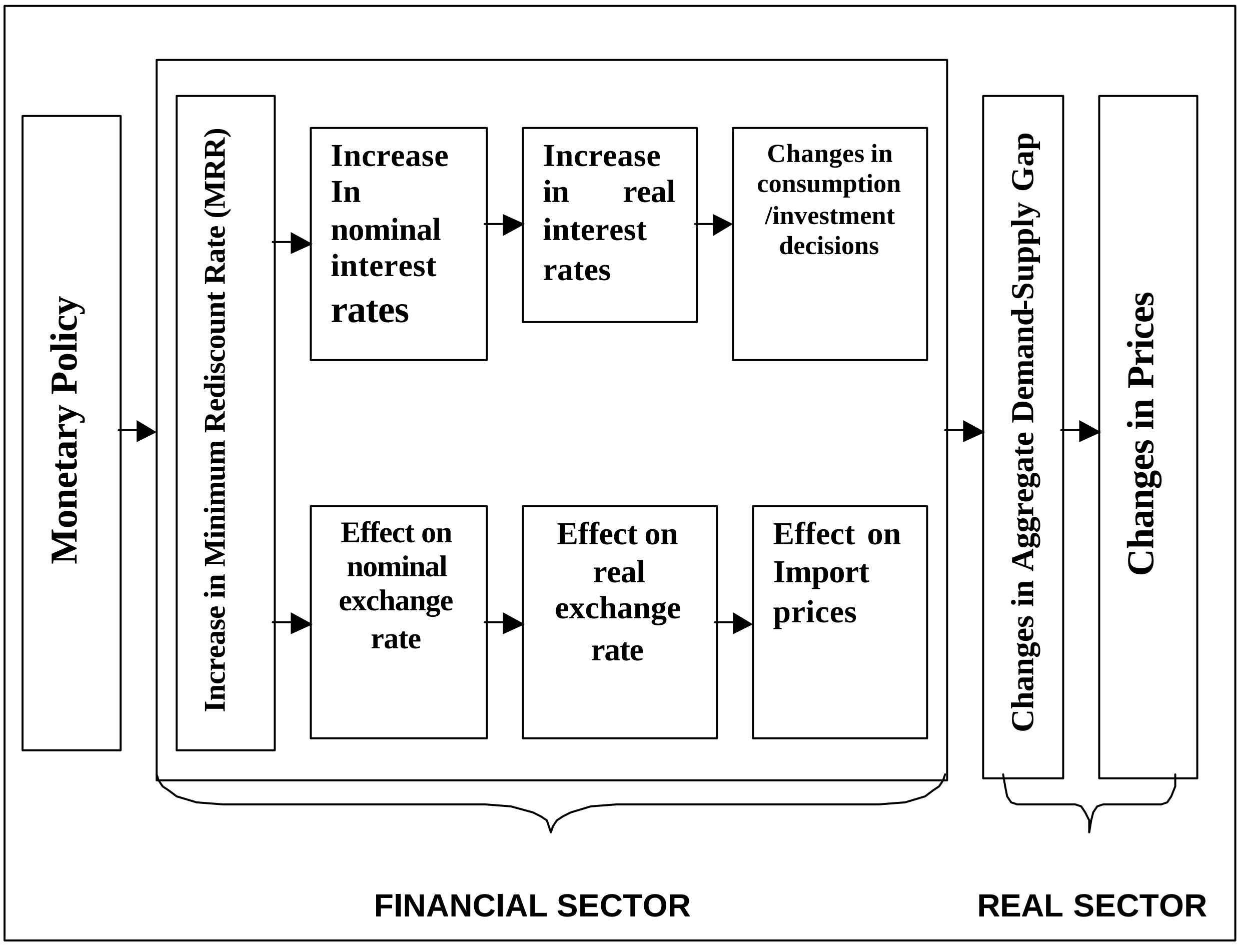
3.2.7 Other price-based mechanisms include the use of exchange rate policy. The exchange rate channel has been found to be particularly useful in an economy where the money market is shallow, but the foreign exchange market is deep. Overall, variations in price instruments affect the real sector, with varying degree of lags.

3.2.8 Quantity based instruments, mainly reserve money and other monetary aggregates, are chosen as intermediate targets for the purpose of achieving desired policy objectives. Most of them affect the availability (and also cost) of funds and, therefore, the decisions of economic agents. The quantity instruments operate mainly through Open Market Operations (OMO), where treasury bills purchases/sales increase/decrease the stock of reserve money, defined as the deposits, which banks keep with the central bank. Variable cash reserve ratio, the ratio of cash to deposit liabilities that a bank must hold, liquidity ratio, the ratio of liabilities to be held in liquid assets, and discount window operations are sometimes used to enhance the effectiveness of open market intervention, particularly in a relatively underdeveloped financial market environment.

3.2.9 The effect of changes in any of these variables eventually impact on the real sector (see

Figure 2). Therefore, in pursuance of the goals of price stability, the central bank is mindful of the fact that its actions have important repercussions on the real sector.

Figure 2: The Transmission Mechanism of Interest Rate Change



3.3 **The Limitations of Monetary Policy**

3.3.1 Monetary policy works best where financial markets are efficient and well developed, and market participants are committed to the achievement of overall national economic goals. In the absence of a well-structured financial market, the conduct of market-based monetary policy is problematic and often produces perverse results or truncates the transmission mechanisms of monetary policy. For example, as argued earlier, raising interest rates in a liberalized financial market could increase the savings rate, the marginal productivity of capital and possibly, the rate of investment, as more financial resources are available to be channeled from savers to investors. However, this outcome cannot be taken for granted in an imperfect and oligopolistic financial market. In such circumstances, high interest rates may actually not only discourage investments and slow economic growth, but could possibly precipitate financial sector crisis. Financial crises become unavoidable when financial intermediaries finance high-risk quick-return projects with low value added (e.g. merchandise trading) rather than more productive long-term economic activities.

3.3.2 Similarly, monetary policy cannot achieve much in a situation where there is fiscal dominance, and/or the central bank is turned into a "printing press" for financing large government budgetary deficits. By the same token, financial intermediaries that are conscious of short-term gains or whose horizons are too short would always make choices that render monetary policy objectives difficult and sometimes, impossible to achieve in the long run.

3.3.3 Another serious limitation to monetary policy is the degree of autonomy enjoyed by the central bank. Although central banks are ultimately responsible for the creation of money, the process is largely influenced by government's fiscal operations, in terms of the size and pattern of spending, while responding to political questions of: "who gets what, when and how". An independent central bank ensures that the power to spend money is divorced from the power to create money. It is encouraging to say that the CBN currently enjoys instrument and operational independence, and has exercised the power for the general good of the economy and people of Nigeria.

SECTION IV

4. <u>Review and Appraisal of the Impact of Monetary Policy on Macroeconomic Performance – 1970 to 2001</u>

4.1 <u>The 1970s</u>

4.1.1 Given the Bank's mandate to promote macroeconomic stability through the conduct of monetary policy, it is pertinent to examine how monetary policy has faired vis-à-vis the attainment of it's stated objective to achieve domestic price stability as a necessary condition for promoting high output and employment growth and a healthy balance of payments position. However, maintenance of price stability is often difficult to attain, at least in the short term, because of its apparent conflicts with other macroeconomic objectives, such as output and employment growth. Consequently, monetary management invariably involves some trade-offs with other national economic policy objectives.

4.1.2 In the specific economic environment of the 1970s, the emphasis of monetary policy was the maintenance of domestic price stability and a healthy balance of payments position, as well as accelerating the pace of economic development. As earlier discussed, during the period and up until the adoption of the SAP in 1986, the conduct of monetary policy in Nigeria relied mainly on direct control measures, involving the imposition of aggregate credit ceilings and selective sectoral control, interest rate controls, cash reserve requirements, exchange rate control and call for special deposits. The use of market-based instruments such as open market operations was not feasible because of the under-developed structure of the financial market, characterized by limited menu of money market instruments, fixed and inflexible interest rates, and restricted participation in the market.

4.1.3 The focus of sectoral bank credit allocation was to stimulate activities in the productive sectors of the economy, while interest rate ceilings were imposed to promote investments and output growth. Moreover, the imposition of compulsory deposits on banks, call for advanced deposits on imports and issuance of stabilisation securities were designed to curtail the ability of banks to expand credit in order to reduce pressures on domestic prices and the balance of payments position.

4.1.4 However, the conduct of monetary policy came under severe pressure emanating mainly from increased government monetization of oil revenue and large fiscal deficits financed largely by the CBN. With the growth in government expenditure, including the award of large salary increases and significant bank credit expansion, the Nigerian economy experienced an accelerated growth of monetary aggregates during the 1970s. Consequently, inflationary pressure intensified while output growth slowed down and the pressure on the external balance increased. More specifically, the Federal Government fiscal deficits increased to an average of 6.1 per cent of nominal GDP annually in 1975-79, GDP growth slowed from 10.3 per cent in 1970-1974 to 6.4 per cent in 1975-1979 while the inflation rate accelerated from 10.40 per cent to 20.3 per cent during the same period. The balance of payments position swung from a comfortable surplus to deficit within the decade (Table 1). In essence, the period witnessed bouts of macroeconomic instability fueled mainly by government spending.

4.2 **The 1980s and 1990s**

4.2.1 As the oil boom of the 1970s came to an abrupt end, the overall economic environment under which monetary policy was conducted deteriorated in the mid-1980s. When the spot oil price for Bonny light collapsed from US$38.82 per barrel in 1980 to US$30.0 in 1983 and further to US$14.16 per barrel in 1986, oil export earnings plummeted from US$25.47 billion in 1980 to US$11.76 billion in 1983 and further to US$6.89 billion in 1986. Consequently, Government's development strategy changed. First, the direct control measures designed to reduce aggregate demand and restore external equilibrium were tightened. Indeed, the Economic Stabilisation Act, which was enacted in April 1982, was expected to stem further deterioration of the economy through the adoption of more stringent exchange control measures and import restrictions that supported tight monetary and fiscal policies.

4.2.2 However, the objectives and instruments of monetary policy remained largely unchanged. The focus was still that of stimulating output and employment growth as well as the promotion of domestic price stability and balance of payments viability. In particular, the direct monetary management framework was retained. It is relevant to note that the era of oil boom brought in its trail two fundamental developments that had serious implications for macroeconomic management. These were the heavy dependence on the oil sector as the main source of foreign exchange earnings and government revenue, and the extraordinary expansion of the public sector, and the unsustainable growth in government spending, arising from the massive investments in social, physical and economic infrastructure.

4.2.3 In general, compliance with credit guidelines issued during the period was unsatisfactory. As is evident in Table 2, the macroeconomic environment remained generally under pressure, as the growth in domestic liquidity accelerated further, with broad money (M2) rising at an average annual rate of 32.08 per cent during the period. The expansion was spurred by the rapid increase in bank credit to the domestic economy, particularly to Government.

4.2.4 Although the impact of monetary policy on the overall economic performance is not easy to isolate, empirical evidence shows that there are links between the two. In the period under review, the objectives of monetary policy were, in general, not fully realized. Real output (GDP) and employment growth remained sluggish, averaging 0.9 per cent annually between

1980 and 1985 and 2.99 per cent between 1986 and 2001. The strong growth performances observed in 1985 and from 1988 to 1990 were not sustained. The inflationary pressures, which were building up in the second half of the 1970s intensified, averaging 17.8 per cent annually in the period 1980–1985 and 27.44 per cent in 1986–2001 and reached an all time high of 72.8 per cent in 1995. Also, the external sector came under severe pressure, resulting in the depletion of external reserves to a level less than the three months of imports conventionally accepted as the minimum.

4.3 Recent Developments

4.3.1 Since 1999, series of reforms that commenced with the coming of the civilian government brought renewed hope for the economy. Privatization of government enterprises, implementation of structural reforms, and vigorous external public image enhancing policy measures have been pursued. In fiscal 2000 and 2001 however, with increased earnings from crude oil and its accelerated monetization, fiscal dominance re-emerged to over-burden monetary policy and undermine the achievement of macroeconomic stability.

4.3.2 In year 2000, monetary policy focused on maintaining internal and external balance as well as achieving a single digit inflation rate by containing the growth of excess liquidity in the banking system, enhancing the viability of the external sector and sustaining the stability of the financial system. There was reasonable fiscal constraint and as expected, there was some savings from the earnings from oil. Early in 2001, against advice, Government decided to spend the savings made in 2000 even though the receipt from oil was still good.

4.3.3 During year 2001, the external sector experienced renewed pressure, resulting in a lower overall balance of payments surplus of ₦29.2 billion or 0.5 per cent of GDP in contrast to the 6.3 per cent recorded in 2000. Similarly, the level of external reserves rose by 5.5 per cent to US$10.4 billion compared with an increase of 81.8 per cent in the preceding year. These developments posed serious challenges to macroeconomic management and exchange rate policy. Owing in part to the external sector developments, other sectors of the economy under performed, compared with the preceding year. For example, the fiscal deficit rose to 4.2 per cent of GDP in 2001 from the 2.9 per cent of GDP recorded in 2000. Inflationary pressure intensified as the inflation rate accelerated to 18.9 per cent from 6.9 per cent in year 2000. The agricultural sector recorded a growth rate of 5.1 per cent, while the industrial production fell marginally by 1.0 per cent. However, manufacturing capacity utilization rose to 39.6 per cent from 36.1 per cent in the preceding year. Overall, the real GDP growth rate only marginally increased from 3.8 per cent in 2000 to 3.9 percent in 2001. The gross external reserves at end-December 2001 stood at $10.45 billion, up from $9.91 billion in 2000. This, however, did not result in an appreciation of the naira as the general productivity of the economy did not justify such. Market participants embarked on speculative attack on the currency and there was accelerated increase in imported goods and services. In general, the growth performance remained weak due largely to the poor state of economic infrastructure resulting from past neglect, which requires more time to correct. The overall growth was, therefore, sluggish with negative consequences for poverty alleviation.

4.3.4 During the first-half of year 2002, developments in the economy were mixed. Domestic output, as mirrored by agricultural and industrial production, increased as provisional data indicated that agricultural production grew by 4.1 per cent, while manufacturing capacity utilization rate rose to 40.1 per cent, compared with 35.5 per cent in the first half of 2001. The pressure on domestic prices moderated as inflation rate, which, was 18.9 per cent in December, 2001 fell to16.8 per cent in May, 2002 and was projected to have fallen further to an estimated

16.5 per cent by end-June 2002. The budgetary operations of the Federal Government resulted in a large fiscal deficit, financed mainly by the banking system, leading to injection of excess liquidity into the system with the attendant problem for monetary and exchange rate management. The external sector was under severe pressure during the first half of 2002, resulting in a huge overall balance of payments deficit. This development was accounted for by the low export earnings from oil while the propensity to import remained high. The overall balance of payments deficit was financed by the draw-down of external reserves and the deferment of the payments of scheduled debt service obligations totaling ₦187.2 billion or $1.56 billion. Consequently, the nation's stock of external reserves fell by 17.0 per cent from end-December 2001 level of $10.45 billion to $8.67 billion as at end-June 2002. The pressure on the foreign exchange market continued unabated resulting in further depreciation of the naira exchange rate.

4.3.5 In line with its developmental role and in an attempt to accelerate the rate of economic growth, the Bank, in collaboration with the Bankers' Committee, established the Small and Medium Industries Equity Investment Scheme (SMIEIS) in 2001. Under the Scheme, operating banks were expected to set aside 10.0 per cent of their profits before tax for equity investment in small and medium scale industries. As at end-July, 2002, over ₦7.5 billion had been set aside towards the realization of the broad objectives of the Scheme, while ₦1.76 billion had actually been invested. Similarly, the capital base of the Agricultural Credit Guarantee Scheme Fund (ACGSF) was increased from ₦1.0 billion as at end-December, 2000 to ₦3.0 billion in 2001. Consequently, loan guarantee limits under the Scheme were raised for all categories of borrowers. Furthermore, the Nigerian Agricultural Cooperative Bank (NACB) was restructured to form the Nigerian Agricultural Cooperative and Rural Development Bank (NACRDB) while the Nigerian Industrial Development Bank (NIDB), Nigerian Bank for Commerce and Industry (NBCI) and Nigerian Economic Reconstruction Fund (NERFUND) were merged to form the Bank of Industry (BOI). The NACRDB and BOI took off during 2001 with authorized capital of ₦1.0 billion and ₦50.0 billion, respectively. While the authorized capital of the NACRDB was fully paid, that of the BOI was yet to be paid. Also, with effect from January, 2002, the CBN introduced the Rediscounting and Refinancing Facility (RRF), designed to encourage banks to lend medium to long-term to the productive sectors of the economy at concessionary interest rates.

4.3.6 Generally, it would be observed that the problem of the Nigerian economy is that macroeconomic policies have been inconsistent over the long-run as periods of internal and external imbalances were more pronounced than periods of strong underlying macroeconomic fundamentals. The result is that most of the policies pursued resulted in poor macroeconomic outcomes, as actual performances have generally fallen below specified targets. Movements of key macroeconomic indicators, such as GDP growth rate, overall fiscal balance, capacity utilization and the balance of payments position were generally unstable. It is particularly noteworthy that the generally excessive growth of monetary aggregates was often reflected in high and unstable domestic price level, thus lending support to Milton Friedman's proposition that, inflation is always and everywhere a monetary phenomenon.

SECTION V

5.0 Financial Markets and Reforms

5.1 The CBN also monitors the performance of the financial markets, recognising that a sound banking system and an efficient financial market are necessary for the effectiveness of monetary policy in the attainment of macroeconomic objectives. Efficient financial markets improve financial intermediation and, therefore, the process of physical capital accumulation. Furthermore, interest rates that are positive in real terms invariably contribute to increased financial savings and, thus, stimulate investment by ensuring availability of credit and moderation of interest rates.

5.2 In addition to the traditional roles of financial markets, sound and efficient financial intermediaries facilitate economic growth by mitigating the costs of obtaining information and transaction costs. Stable and well-functioning financial markets also increase the proportion of savings channeled to investments, the growth rate of national savings, and the marginal productivity of capital. More importantly, there are strong linkages between financial sector reforms and effective conduct of monetary policy. The significance of these linkages becomes more obvious as a country transits from direct to indirect technique of monetary management. A smooth transition requires that the country adopts a comprehensive programme of reforms of its financial institutions, the money market arrangements and its payments system in a mutually reinforcing and coordinated fashion. Such reforms help to develop an efficient framework for an effective monetary management.

5.3 In view of the important role, which a well developed financial market can play, the CBN is placed in a unique position to ensure the soundness and efficiency of the financial sector and market operations at both the micro and macro levels to support the economic objectives of government. The CBN has, in this regard promoted policies that enhance the health and vibrancy of the financial sector. To ensure orderliness and a crisis-free financial sector that enjoys the confidence of depositors and private investors, the Central Bank of Nigeria has not succumbed to the "too big to fail" doctrine. Rather, it has adopted various policy options to address problems of distressed banks.

5.4 More recently, the Bank has embarked on the adoption of a set of prudential guidelines and international accounting standard, strengthening of the capital base of banks, and promotion of transparency in banking operations through interactions with stakeholders. The introduction of universal banking removed the dichotomy between commercial and merchant banks, thus enabling licensed banks to freely choose which activities to undertake in both the money and capital markets. In return, they will be exposed to multiple regulatory authorities.

5.5 The recent increase in the capital base of banks is designed to ensure that banks are adequately capitalized, liquid and solvent, considering the high cost of facilities and equipment. Specifically, the paid-up capital for new banks has been increased to ₦2 billion, while existing banks are required to raise their capital base to ₦1 billion by end-2002 in order to strengthen their operations.

5.6 The CBN is also at the forefront of improving the payments and settlement system. Efficient and well-functioning payment systems improve the transmission mechanism of monetary policy, financial sector stability and the transactions velocity of money. In view of CBN's commitment to the reform of institutions for the management of a free market economy, significant progress has been made in the payments area in Nigeria. Recognising that Nigeria is a predominantly cash and carry economy, higher denomination currencies were introduced to facilitate transactions. The Nigeria Automated Clearing System (NACS) began operation in 2001, while efforts to adopt a Real Time Gross Settlement System for settlement and clearing are on-going. All these are expected to result in a more viable, efficient and reliable financial sector.

SECTION VI

6.0 Challenges Facing the CBN in Macroeconomic Stabilisation

6.0.1 Since monetary policy is a key element of macroeconomic management and its effectiveness is critical to Nigeria's overall economic performance and prospects, its role in ensuring an overall macroeconomic stability cannot be over-emphasized. Although, appreciable progress has been made in this regard since the introduction of various financial sector reform programmes in 1986, the regulatory and supervisory, as well as the legal and operational framework for monetary policy in Nigeria continue to face several challenges. To facilitate a better understanding of the nature of these challenges, I will like to discuss them under the following headings: relationship between the CBN and the government; objectives of monetary policy; transparency and accountability in the conduct of monetary policy; and financial system stability.

6.1 Relationship Between the CBN and the Government

6.1.1 The CBN Act assigns the CBN Board the authority to determine the Bank's monetary policy and to take necessary actions to implement it. However, the success of the Bank in pursuing its monetary policy goals depends largely on the extent to which it is insulated from short-term political interference in its operational decision-making. While the Government recognises the Bank's independence, which has been reinforced by its instrument autonomy granted in 1999 on monetary policy matters, in line with the global trend, short-term developments in the financial markets that are inconsistent with government's short-term objectives, more often than not, pose a serious threat to this independence. In this context, it is important that the fiscal authorities continue to respect the Bank's independence as provided for in the statute so that the effectiveness and efficiency of monetary policy would be enhanced and at the same time, send the right signals to the financial and goods markets.

6.1.2 Related to the above is the issue of complementarity of monetary and fiscal policies. A situation where monetary policy stance is restrictive to stem the overheating of the economy and fiscal policy is expansionary, the efficacy of monetary policy is undermined and diminished, instead of the two complementing each other. The situation becomes even more worrisome when the expansionary fiscal stance is financed by the banking system. While the CBN recognises the legitimate concern of the fiscal authorities with regard to growth and employment creation, it is also pertinent for the fiscal authorities to appreciate the substantial costs of high inflation rate on economic activity and decision-making by economic agents. In this regard, therefore, closer coordination of the monetary and fiscal policies is necessary in ensuring successful macroeconomic stabilisation. So far, while it has been much easier to dialogue with and influence the Federal Government to exercise fiscal restraint, it has not been the same with other tiers of government which at times of higher than normal revenue receipts are always bent not only on spending all their income and in fact, borrowing from the banking system. When there is down-turn in oil prices as it has been the trend in the past or oil revenue is lower than expected, as currently experienced, such loans will certainly run into the problem of non-performing.

6.1.3 It was the concern for macroeconomic stability and banking system soundness and implications of bank credit expansion to government, that led the CBN to issue the circular directing all licensed banks to provide, at the end of their accounting year, 50 per cent and 100 per cent, respectively, for performing and classified outstanding credits to all tiers of government. This action was by no means intended to stop banks from lending to government. It was only a prudential measure meant to forestall the distress situation we experienced in the early 1990s, which was partly triggered by non-performing public sector indebtedness to the banking system. I should state further that the CBN also extends limited credit to the Federal Government through its Ways and Means Advances. The limit is 12.5 per cent of expected revenue of the Federal Government and designed to smoothen out cash flow problems. However, the Federal Government is required by law to liquidate the credit before the end of the fiscal year.

6.2 **Objectives of Monetary Policy**

6.2.1 The framework for the operation of monetary policy is specified in the CBN Act, from where the Bank derived the objectives of its monetary policy functions. The CBN is increasingly focusing more on price stability, recognising the importance of macroeconomic stability for economic sustainable output and employment growth. The pursuit of growth objective, which is included in the CBN mandate very often conflict with stabilisation objective. Nevertheless, the major challenge to the CBN to subdue inflation, which is often threatened by excessive expansion in fiscal outlays and the structural rigidities in the economy. These odds, notwithstanding, the CBN remains committed to the pursuit of a low and stable inflation regime that is consistent with the objective of a stable macroeconomic environment.

6.2.2 In order to ensure the effectiveness of monetary policy, based on market-mechanism, the development of a mature, sound and efficient financial system remains a challenge for the CBN. The present oligopolistic structure of our banking system and the inefficient payments and settlement system do not engender adequate and timely policy response to changes in monetary conditions thus making it difficult for the monetary authorities to gauge the pulse of the financial system for purposes of fine-tuning its policy measures. The effectiveness of monetary policy also depends, to a very large extent, on the quality, adequacy and timeliness of statistical information available to the Bank. There is an urgent need for all stakeholders in Nigeria to recognise the importance of proper record keeping and the importance of computerisation. This is not a task for the CBN alone, it is a shared responsibility among all stakeholders in the economy. Inaccurate information leads to wrong decisions, which may lead to undesirable outcomes, and a vicious circle.

6.3 **Transparency and Accountability**

6.3 .1 Getting the general public to understand what we do at the CBN is a challenge facing the Bank, for it is only when this is achieved that the public will appreciate the actions of the CBN with regard to monetary policy changes. Monetary policy should be conducted in an open and forward-looking manner because monetary policy changes affect economic activity and other key macroeconomic variables, including inflation, with a lag. In addition to simplifying the objectives of monetary policy so that it can be easily understood, it is pertinent that the Bank regularly reports on developments in the economy and their implications for future performance. In recent times, steps have been taken to make the conduct of monetary policy more transparent through regular consultations and dialogue with all major stakeholders, during which policy changes and initiatives are discussed and explained. For example, a Monetary Policy Forum has been established to promote the exchange of ideas among policy makers and other important stakeholders in the economy with a view to making the conduct of monetary policy and exchange rate policies more transparent and participatory. So far, five Monetary Policy Forum (MPF) series have been held where issues pertaining to exchange and interest rates policies were discussed. In addition to the regular Policy Forum, a Monetary Policy Conference was held in November 2001 to discuss ways of growing the Nigerian economy. The CBN has also commenced the publication of abridged versions of the minutes of the Monetary Policy

Committee (MPC) meetings, as part of efforts to improve transparency and further enlighten the public.

6.4 Financial System Stability

6.4.1 It is a major challenge for the CBN to ensure that financial disturbances in any part of the financial system do not become systemic or threaten the health of the economy. As earlier explained, a well-functioning financial system is critical to the economy's well-being because it is so intimately linked to other sectors of the economy through its intermediation role. When large-scale failures occur among financial institutions, the supply of deposits and expansion of credit dry up and quickly lead to cutbacks in economic activities. In addition, the financial sector is very susceptible to crises of public confidence, such that a problem that affects one part of the financial sector, could quickly spread to the rest of the wider economy.

6.4.2 In the pursuit of its surveillance functions, the CBN seeks to prevent excessive risk taking in investment decisions and limits the potentially adverse effects of financial crises when they occur. The issue of banking system distress that devastated the financial sector in the late 1980s to early 1990s, remains fresh in our minds. The remote and immediate causes were traceable to the unsustainable expansion of the sector arising from the liberalisation of banks' licensing requirements, poor assets quality and low earnings, weak management, insider abuses, portfolio mismatch, overtrading and political interference. These were compounded by weak regulatory and supervisory framework, and complacency on the part of the regulatory and supervisory authorities. The present emergence of foreign exchange malpractices, in clear violation of laid down rules and regulations, should be worrisome to all stakeholders in the Nigerian economy. While these shortcomings are being effectively addressed, the prevention of future reoccurrence remains a challenge to the Central Bank of Nigeria.

6.4.3 An important aspect of CBN's role of ensuring financial stability is the analysis of developments, in the macroeconomy, financial markets and institutions, as a basis for assessing the health of the financial system. A precondition for this exercise is an understanding of how macroeconomic imbalances develop, the nature of risks in the financial system as a whole, the relationship between financial fragility and macroeconomic performance, and the policy instruments that may best be used to bolster financial stability. This requires that the CBN should upgrade its information and communication technology so as to improve its operational efficiency through adequate and appropriate manpower development particularly, against the background of the recent adoption of the universal banking practice and the globalisation of the world financial markets. These issues are already receiving attention through the Bank's comprehensive restructuring and re-engineering project, code-named ***"Project Eagles".*** The first two phases of the project has been concluded and implemented.

SECTION VII

7.0 Dutch Auction and Exchange Rate/Reserve Management

7.1 Distinguish Ladies and Gentlemen, I must not end this lecture without commenting on the recent Dutch Auction System (DAS) and the CBN reserve and exchange rate management. The DAS has been extensively used in many countries, especially the oil producing ones, as an effective means of allocating scarce and concentrated foreign exchange resources and for determining the realistic value of national currencies, which makes goods produced in the domestic economy competitive with their imported counterparts. In spite of the growing commitment to globalisation and liberalisation, no economy is totally dependent on importation of goods and services, which an over-valued currency tend to encourage. Thus, the interest of the Nigerian people will be best served by an exchange rate policy that makes the Nigerian economy competitive, especially in its own markets, encourages domestic production and job creation at home, not abroad, eliminates unemployment and poverty, and boosts income.

7.2 You will recall that the Inter-bank Foreign Exchange Market (IFEM) was introduced in October, 1999 with the objective of broadening the supply of foreign exchange in the economy, in order to achieve a realistic exchange rate for the naira. However, after its initial success, the market became narrow, shallow and flattened as the CBN continued to be the dominant supplier of foreign exchange contrary to policy expectations. The IFEM seized to be a dynamic process for determining exchange rate as the two-way quotes received from banks became converged while CBN virtually met all demands from banks. Moreover, the IFEM was characterised by sharp practices by banks, persistent and speculative demand pressures and multiple exchange rates, with the concomitant substantial drain of our external reserves. Apparently, because the exchange rate was subsidised, there was an intrinsic rent which was exploited by banks through arbitrage.

7.3 The Dutch Auction System does not give or at least gives less room for distortions, speculation, opportunism and sharp practices, which were inherent in the IFEM. I must warn, however, that in exchange rate management, there are no miracle solutions. Whatever regime is adopted is bound to be defective over time as the passage of time will reveal its strengths and weaknesses. The critical factor is that the productivity of the economy must increase. Exchange rate policy is dynamic and must be reviewed from time to time.

7.4 Indeed, for now, with the introduction of the DAS, we have succeeded in reducing the demand for foreign exchange as bidders are now required to pay at their respective bid rates. Furthermore, the arbitrage premium – the incentive for round-tripping - has been substantially reduced. The parallel/black market for dollars will, however, persist if the activities of tax–dodgers and impostors who avoid tariffs through non or inappropriate documentation are not curtailed.

7.5 Distinguished Participants, this creates for all stakeholders, a challenge to which our Custom Services must respond forcefully through an effective 100 per cent inspection. If the policy is sustained and complemented by prudent fiscal policies, DAS is expected to address substantially the problems of foreign exchange speculation, capital flight, massive importation of finished goods and the unwholesome practice of dumping. We remain optimistic that the system will succeed, as the CBN will play its role with all sense of responsibility and expect all other stakeholders to play theirs in the overall interest of our national economy.

7.6 The Director General of Raw Materials Research and Development Council (RMRDC), Alhaji Abubakar Abdulahi recently started a nation-wide campaign aimed at discouraging the importation of raw materials by both government and the organised private sector. While he advocated increased tariff and total ban, both of which can be evaded by tax-doggers, I believe he needed to add a market-based instrument which is potent and unevadable – an appropriate exchange rate.

7.7 An exchange rate regime that carries subsidy which makes imports cheaper than it should is destructive of domestic production, either of agriculture or manufactured products. An overvalued currency wrecks havoc on agriculture and industrial sectors and the service sector as well. This is particularly so considering the ease with which the country’s borders are violated by smugglers.

7.8 The current state of our mono product economy – oil dominance in foreign exchange earnings and in government revenue, has remained for too long. The economy must be diversified and domestic productivity must be increased. These can not be achieved with a subsidised and overvalued exchange rate. Nigerians have been too sensitive for too long on the value of the naira, forgeting that the value can only be the product of the productivity of the economy. Our sensitivity to naira exchange rate derives from our import dependency which is facilitated by earnings from oil. I have said it on many occasions that it is unacceptable and unsustainable for Nigeria to use its earnings from oil to create jobs in other countries.

7.9 The CBN's management of the exchange rate in late 1999 and in year 2000 was highly criticised because the naira was not allowed to appreciate even at the time the earning from oil was good. We at the CBN recognised the volatility of the oil price and the fact that an appreciation of the naira that would make import cheap and increase its volume was unsustainable because it was not backed by the real fundamentals of the economy. That is, although there were increased earnings from oil, the productivity of the economy did not increase. The exchange rate policy adopted then and the careful management of the oil receipts resulted in our ability to build up reserve, which today serves as a cushion for the naira preventing it from the massive depreciation that would have been the automatic consequence of the current low foreign exchange earnings.

7.10 You would recollect, Distinguished Participants, that we at the CBN at that time equally advised the three tiers of government to save some of the receipts not only to avoid the over-heating of the economy but also to save for the rainy day. Our advice, if taken, could have obviated the resultant inflation and prevented the current crisis whereby Local/State Governments and even Federal Government are today having problem paying salaries and meeting other recurrent expenses regularly and indeed creating a situation that leaves little or nothing for current capital development.

SECTION VIII

8.0 <u>Concluding Remarks</u>

8.1 An attempt has been made in this paper to articulate the role of the CBN and, particularly the stabilization of the macroeconomy in line with its mandate as provided in the CBN Act, 1991. Over the years, the Bank has strived to meet this mandate through its conduct of monetary and financial policies, subject to the constraints imposed by the domestic and external environments. These constraints include, fiscal dominance, underdeveloped nature of the financial markets, external debt overhang, extreme volatility in oil prices/earnings which affect both the exchange rate management and the government revenue, persistent domestic and external imbalances and structural rigidities in the economy. Despite these limitations, significant progress has been made in enhancing the efficiency and effectiveness of monetary management, with positive results. For example, the liberalisation and reform of the financial sector as a whole, including the shift from direct monetary control regime to a market-based system, have engendered increased competition and dynamism in the financial sector.

8.2 Furthermore, as the Nigerian economy evolved, emphasis shifted from developing and building financial infrastructure and institutional framework to strategies for ensuring macroeconomic stability under which economic agents are able to make decisions that will promote rapid economic growth and employment through efficient resource allocation. In this context, the CBN has, in consonance with the global trend, placed greater emphasis on ensuring price stability in its conduct of monetary policy. The CBN is, therefore, committed to pursuing monetary policy that will complement and enhance the attainment of the overall economic goals of the government.

8.3 In conclusion, let me note that, the ability of the CBN to pursue an effective monetary policy in a globalised and rapidly integrated financial market environment, depends on several factors. These include: instituting appropriate legal framework, institutional structure and conducive political environment, which allows the Bank to operate with reference to exercising its instrument and operational autonomy in decision-making; the degree of coordination between monetary and fiscal policies to ensure consistency and complementarity; the overall macroeconomic environment, including the stage of development, depth and stability of the financial markets as well as the efficiency of the payments and settlement systems; the level and adequacy of information and communication facilities; and the availability of consistent, adequate, reliable, high quality and timely information to the Bank. Indeed, seeking a proper role for monetary policy in promoting strong and sustainable growth in a stable macroeconomic environment in Nigeria is an on-going challenge for the Central Bank.

8.4 I thank you for your kind attention.

Chief (Dr.) J. O. Sanusi
Governor
Central Bank of Nigeria

19th August, 2002

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