



CENTRAL BANK OF NIGERIA

**UNDERSTANDING
MONETARY POLICY SERIES
NO 3**

**CENTRAL BANK OF NIGERIA
MONETARY POLICY FRAMEWORK**

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Aims and Scope

The *Understanding Monetary Policy Series* is designed to improve monetary policy communication as well as economic literacy. The series attempts to bring the technical aspects of monetary policy closer to the critical stakeholders who may not have had formal training in Monetary Economics. The contents of the publication are therefore, intended for general information only. While necessary care was taken to ensure the inclusion of information in the publication to aid proper understanding of the monetary policy process and concepts, the Bank would not be liable for the interpretation or application of any piece of information contained herein.

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Central Bank of Nigeria

Mandate

- Ensure monetary and price stability
- Issue legal tender currency in Nigeria
- Maintain external reserves to safeguard the international value of the legal tender currency
- Promote a sound financial system in Nigeria
- Act as banker and provide economic and financial advice to the Federal Government

Vision

To be one of the most efficient and effective of the world's central banks in promoting and sustaining economic development.

Mission Statement

To be proactive in providing a stable framework for the economic development of Nigeria through the effective, efficient and transparent implementation of monetary and exchange rate policy and management of the financial system.

Core Values

- Meritocracy
- Leadership
- Learning
- Customer - Focus

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CHAPTER ONE

1.1 Introduction

In economic policy design, a number of approaches are often adopted to review economic conditions and set targets for achieving the objectives. This process which guides the initiation, analysis implementation and evaluation of policy is referred to as a policy framework.

The CBN has adopted a number of monetary policy frameworks over the years in response to the changing macroeconomic conditions. Due to monetary policy lags (time of policy initiation, time of policy implementation and the eventual outcome), the CBN has moved from a short-term monetary policy framework (annual) to medium-term monetary policy framework (biennial).

1.2 What is Monetary Policy?

Monetary Policy refers to the specific actions taken by the Central Bank (Monetary Authority) to regulate the value, supply and cost of money in the economy with a view to achieving predetermine macroeconomic goals. The Central Bank of Nigeria, like other central banks in developing countries, seeks to achieve price stability through the management of money supply. Money supply comprises narrow and broad money. Narrow money (M1) is defined as currency in circulation with non-bank public and demand deposits or current accounts in the banks. The broad money (M2) includes narrow money plus savings and time deposits, as well as foreign currency denominated deposits. Broad money measures the total volume of money supply in the economy. Thus, excess money supply (or liquidity) may arise when the amount of broad money is higher than the level required to sustain non-inflationary output growth in the economy.

The need to regulate money supply is based on the knowledge that there is a relatively stable relationship between the quantity of money supply and economic activity and that if the supply of money is not limited to what is required to support productive activities, it will result in undesirable effects such as inflation or deflation.

Several factors influence the supply of money, some of which are within the control of the central bank, while others are outside its control. The specific objectives and focus of monetary policy may change from time to time, depending on the level of economic development and economic fortunes of the country.

1.3 Objectives of Monetary Policy

In Nigeria, the major objectives of monetary policy include the attainment of price stability and sustainable economic growth. In pursuing these objectives, the CBN recognizes the existence of conflicts among objectives necessitating some sort of trade-offs. The targets of monetary policy are the operational target, the intermediate target and the ultimate targets. The Bank manipulates the operating target (reserve money) over which it has substantial direct control to influence the intermediate target (broad money supply, M2) which has impact on the ultimate objective of monetary policy, i.e., inflation and output.

1.4 Stance of Monetary Policy

The stance of monetary policy refers to either expansionary or contractionary actions of the central bank to control money supply.

- Expansionary Monetary Policy is a set of actions by the monetary authority to increase money supply in the economy. It is conventionally used to stimulate economic activity, usually in a recession.

Contractionary Monetary Policy on the other hand seeks to reduce the level of money supply in the economy. It is conventionally used to reduce inflationary pressures in the economy.

CHAPTER TWO

OVERVIEW OF MONETARY POLICY FRAMEWORK

2.1 Introduction

Generally, monetary policy is a tool of general macroeconomic management, under the control of the monetary authorities, designed to achieve government economic objectives. Monetary policy aims at achieving certain national goals which have historically included full employment (or a low unemployment rate), high output (or a high output growth), a stable price level (or a low inflation rate), and a stable exchange rate (or a desirable balance of payments). These are often referred to as the “ultimate goals” of monetary policy. These goals are usually achieved indirectly by the monetary authorities (central banks) through its use of monetary policy instruments. These instruments, though different from country to country, usually include open market operations (OMO), changes in discount/bank rate (both of which determine the monetary base), and required reserves (the minimum reserves the commercial banks must hold against the public's deposit with them).

The monetary policy framework, therefore generally refers to the institutional arrangements under which monetary policy decisions are made and executed. In view of this, an analysis of any monetary policy framework extends considerably beyond the confines of the central bank. Indeed, only in a few countries is much of the monetary policy framework decided by the central bank itself.

Some of the factors that influence the choice of monetary policy framework by a central bank include:

- ◆ Structural differences: This includes the structure of the financial sector, types and level of debt, openness to trade, commodity dependence, fiscal discipline, etc.
- ◆ Degree of Indexation: This is very common with countries within various levels of economic integration which requires different types of indexation. In addition, there are other nominal rigidities that affect the speed of transmission from monetary policy instruments to inflation.
- ◆ Institutional arrangements: This refers to the number of institutions making up the monetary authorities, the enabling laws, data availability and

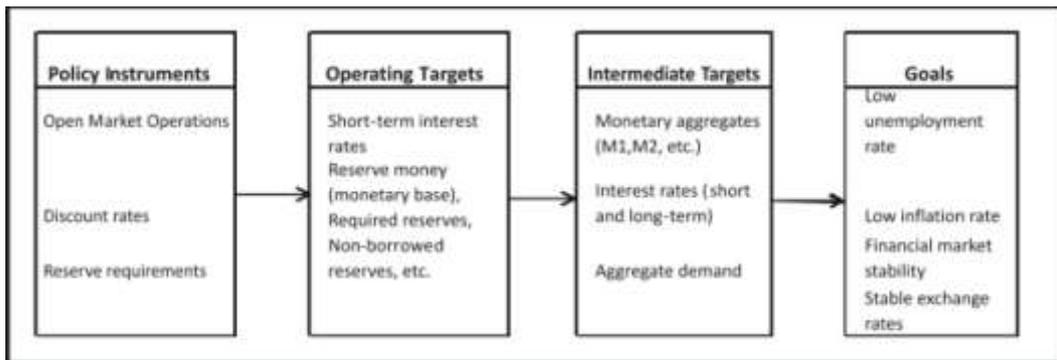
related factors that may influence the way in which monetary policy responds to macroeconomic developments.

In formulating monetary policy, the monetary authorities usually set targets whose values the policy maker wants to change. The targets could be ultimate (final goals, such as output/its deviation from the full-employment level, inflation rate (or the price level) or its deviation from a desired level, and employment; intermediate (variables that the central bank seeks to influence such as money supply or interest rate), or operating (variables the central bank can influence directly using the instruments at its disposal). However, since a given variable can fall in any of these categories, there is no hard and clear-cut separation between these categories. In addition, variables that provide information on the current and future state of the economy have to be identified.

2.2 Monetary Policy Goals, Intermediate Variables, Operating Targets and Instruments

At least three issues arise in the selection and use of the goals, intermediate variables, operating targets and instruments by the monetary authorities. The first concerns the existence or otherwise of stable and predictable relationships between the ultimate goal variables, intermediate variables and operating targets. The second has to do with whether the monetary authorities can actually achieve the desired level of the operating targets with the instruments at their disposal. The third deals with the lag structure (short or long) of the relationships with the implication that prediction of the future course of the economy will be increasingly less precise in the presence of long lags.

Figure 2.1 Monetary Policy Tools, Targets and Goals



Handa (2009:307)

There is also the issue of which of the two main intermediate targets (monetary aggregates and interest rates) monetary authorities should adopt. Generally, the choice between monetary aggregates and the interest rate depends on the policy objective of the monetary authorities, the structure of the economy and, to a lesser extent, the source of exogenous shocks to the economy.

2.3 Monetary and Interest Rate Targeting

Using the conventional IS-LM framework, Poole (1970) as expatiated by Handa (2009) demonstrated that where the shocks to the economy arise from the commodity market, targeting the interest rate produces greater fluctuations in aggregate demand than money supply targeting, implying that in such a situation monetary policy should target money supply. Interest rate targeting is preferable when the shock arise from the money market since targeting money supply instead would allow greater fluctuations in aggregate demand and interest rates. The problem of this conclusion is that since both types of shocks occur in the real world, the policy maker would have to determine the potential source of the dominant shocks to the economy before making the choice between monetary and interest rate targeting. It is also possible that the shock to the economy is from the supply side (supply shock) in which case the objective of stabilization becomes the price level or/and real output. In that case, and particularly if the shock is permanent, monetary targeting is preferable in the long run because interest-rate targeting involves a cumulative inflationary process.

The argument for the use of monetary targeting was supported by Milton Friedman. Consequently, most countries including the USA, Britain and Canada switched to targeting the monetary aggregates between mid-1970s and early 1980s. It was subsequently abandoned in favour of interest rate targeting because within the period, direct targeting of the monetary aggregates increased both the level and volatility of interest rates and was found to be quite destabilizing for the economy. Interest rate targeting was later found to be problematic because of the inability of the monetary authorities to control the differentials among interest rates in the same way as the general levels of interest rate. Since financial intermediation in an economy depends more on such differentials than the level of interest rate, the ability of the monetary authorities to influence the degree of intermediation through its discount rate becomes diluted.

There is also the problem of lags in the impact of changes in the interest rate on aggregate demand in the economy which at present is not very clear. Thus, it has been argued that interest rate policy must be accompanied by an appropriate money supply rule. Currently, monetary policy has shifted to inflation or price targeting. The argument is that since money is neutral in the long run, it

pays the monetary authorities to ensure a stable value of money (price level) rather than attempt to change the level and path of full-employment output.

CHAPTER THREE

STRATEGIES OF MONETARY POLICY IN NIGERIA

3.1 Introduction

The strategy of monetary policy involves modifying the amount of base money (M1) in circulation. This process of changing base money through the sale and purchase of government securities is called open market operations. Continuous market transactions by the monetary authorities modify the supply of money which affects other market variables such as short term interest and exchange rates.

The distinction between the various strategies of monetary policy lies primarily with the set of instruments, targets and variables that are used by the monetary authorities to achieve the desired goals (Table 3.1). The strategies of monetary policy could be classified as; monetary targeting, price level targeting, inflation targeting and exchange rate targeting

Table 3.1

Monetary Strategy	Policy	Target Variable	Long Term Objective
Monetary Targeting		Growth in money supply	A given rate of change in CPI
Price Level Targeting		Interest rate on overnight debt	A specific CPI
Inflation Targeting		Interest rate on overnight debt	A given rate/band of inflation
Fixed Exchange Rate		Spot price of the currency	A given rate of change in CPI

3.2 Monetary Targeting

Under this approach, the target variable is the growth in money supply designed to achieve the long-term objective of price stability. This is currently used by CBN. Under this framework, the central bank watches very closely growth in the monetary aggregates in order to predict the future size of money supply. If the monetary aggregates were growing too quickly, it could trigger inflationary pressures (more money chasing after the same amount of goods and services leads to rising prices) and cause the central bank to raise interest rates or otherwise halt growth in money-supply. While other monetary policy strategies

focus on a price signal of one form or another, this approach is focused on monetary quantities.

3.3 Price Level Targeting

Price level targeting is similar to inflation targeting in that both establish targets for a price index like the CPI. However, where inflation targeting only looks forward (i.e., a 2% inflation target per year), price level targeting actually takes past years into account when conducting open market operations. So, if the price level rose by 2% in the previous year (from a theoretical base of 100 to 102), the price level would have to drop the next year in order to bring the price level back down to the 100 target level. This could mean more forceful action needs to be taken than would be required if inflation targeting were used.

Price level targeting is generally considered a risky policy stance, and one not used by many central banks. It is believed to bring more variability in inflation and employment in the short run compared to inflation targeting. Most economies feel that a small amount of annual inflation is (up to about 2% per year) actually good for the economy.

3.4 Inflation Targeting

Inflation targeting is a monetary policy framework, in which a central bank estimates and makes public a projected, or "target", inflation rate and then attempts to steer actual inflation towards the target through the use of interest rate changes and other monetary tools. The likely actions of the central bank to raise or reduce the policy rate become more transparent under inflation targeting. If inflation is above the target, the central bank is likely to raise the policy rate. This usually (but not always) has the effect over time of cooling the economy and bringing down inflation. If inflation is below the target, the central bank is likely to lower the policy rate. This usually (again, not always) has an effect over time of accelerating the growth rate of the economy and raising inflation.

Under the framework, investors know the target inflation rate and therefore can more easily anticipate interest rate changes and factor these into their investment decisions. This is regarded by proponents of inflation targeting as leading to increased economic stability.

3.5 Exchange Rate Targeting

Under exchange rate targeting, the value of a currency is fixed in relation to another currency or a basket of currencies. This facilitates trade and investment between the two countries, and is especially useful for small economies where external trade forms a large part of their GDP. It can also be used as a means to control inflation. However, as the reference value rises and falls, so does the currency pegged to it.

CHAPTER FOUR

INSTRUMENTS OF MONETARY POLICY

4.1 Introduction

Monetary policy guides the central bank's supply of money in order to achieve the objectives of price stability (or low inflation rate), full employment, and growth in aggregate income. This is necessary because money is a medium of exchange and changes in its demand relative to supply, necessitate spending adjustments. Fiduciary or paper money is issued by the central bank based on an estimate of the demand for cash. To conduct monetary policy effectively, the central bank adjusts the monetary aggregates, the policy rate or the exchange rate in order to affect the variables which it does not control directly. The instruments of monetary policy used by the central bank depend on the level of development of the economy, especially the financial sector. These instruments could be direct or indirect.

4.2 Direct Instruments of Monetary Policy

4.2.1 Direct Credit Control

The central bank can direct Deposit Money Banks on the maximum percentage or amount of loans (credit ceilings) to different economic sectors or activities, interest rate caps, liquid asset ratio and issue credit guarantee to preferred loans. In this way the available savings is allocated and investment directed in particular directions as desired by the authorities.

4.3 Indirect Instruments of Monetary Policy

4.3.1 Reserve Requirements

This instrument is used by the central bank to influence the level of bank reserves and hence, their ability to grant loans. Reserve requirements are lowered in order to free reserves for banks to grant loans and thereby increase money supply in the economy. On the other hand, they are raised in order to reduce the capacity of banks to provide loans thereby reducing money supply in the economy.

4.3.2 Open Market Operations (OMO)

The most important and flexible tool of monetary policy is open market operations. It is the buying and selling of government securities in the open market (primary or secondary) in order to expand or contract the amount of money in the banking system. By purchasing securities, the central bank injects money into the banking system and stimulates growth whereas by selling

securities it absorbs excess money. Thus, if there is excess liquidity in the system, the central bank will in a bid to reduce the money supply sell the government securities such as Treasury Bills. On the other hand, in periods of liquidity shortages, the central bank buys government securities so as to increase money supply. Instruments commonly used for this purpose include treasury bills, central bank bills, or prime commercial paper.

OMO enables the central bank to influence the cost and availability of reserves and bring about desired changes in bank credit and money supply. This important instrument of monetary policy has a number of advantages because it is flexible and precise, it is implemented quickly and easily reversed and the central bank has complete control. The effectiveness of OMO, however, depends on the existence of well developed financial markets that are sensitive to interest rate movements.

4.3.3 Discount Window Operations

This instrument is a facility provided by the central bank which enables the DMBs to borrow reserves against collaterals in form of government or other acceptable securities. The central bank operates this facility in accordance with its role as lender of last resort and transactions are conducted in form of short term (usually overnight) loans. The central bank lends to financially sound DMBs at the policy rate. This rate sets the floor for the interest rate regime in the money market (the nominal anchor rate) and thereby affects the supply of credit, the supply of savings (which affects the supply of reserves and monetary aggregate) and the supply of investment (which affects employment and GDP).

4.4 Other Instruments

4.4.1 Exchange Rate

The balance of payments can be in deficit or in surplus and this can affect the monetary base, hence the money supply, in one direction or the other. By selling or buying foreign exchange, the central bank ensures that the exchange rate is at an optimal level. The real exchange rate when misaligned affects the current account balance because of its impact on external competitiveness.

4.4.2 Prudential Guidelines

The central bank may require DMBs to exercise particular care in their credit operations in order to achieve specified outcomes. Key elements of prudential guidelines remove some discretion from bank management and replace them with rules.

4.4.3 Moral Suasion

The central bank issues licenses to DMBs and regulates the operation of the banking system. Thus, it can persuade banks to follow certain policies such as credit restraint or expansion, increase savings mobilization and promote exports through financial support, which otherwise they may not do, on the basis of their risk/return assessment.

CHAPTER FIVE

MONETARY POLICY MANAGEMENT IN NIGERIA

5.1 Legal and Institutional Framework for Monetary Policy in Nigeria

Monetary policy (formulation and implementation) is the responsibility of the Central Bank of Nigeria (CBN), established in 1958 through the Central Bank of Nigeria Act 1958. The Act made the formulation and execution of monetary policy the exclusive responsibility of the CBN. The various amendments to the Act between 1968 and 1970 curtailed the power of the Bank in monetary policy management by subjugating it to the supervisory purview of the Federal Ministry of Finance. Although the operational autonomy of the Bank was restored by the CBN Act of 1991, the 1997 amendment brought the Bank back to the supervision of the Ministry of Finance; a situation which was reversed by the 1998 amendment and confirmed by the Central Bank of Nigeria Act 2007. Thus presently, the CBN is the monetary authority in Nigeria with instrument autonomy in line with international best practice. One of the major innovations of the CBN Act 2007 was the creation of the Monetary Policy Committee (MPC) with the responsibility for monetary policy decisions. The Committee meets bi-monthly for policy decisions under the chairmanship of the Governor of the Bank. There are other committees involved in monetary policy management.

5.2 The Institutional Arrangement

5.2.1 The Monetary Policy Technical Committee (MPTC)

The MPTC keeps track of economic and financial system developments on monthly basis and provides technical documents on issues of interest for the MPC meeting. The Committee, chaired by the Deputy Governor, Economic Policy (DGEP), meets once every month and two weeks prior to the MPC meeting.

5.2.2 The Monetary Policy Implementation Committee (MPIC)

THE MPIC serves as the implementation arm of the MPC. It is chaired by the Deputy Governor (Economic Policy), with membership comprising ten Departments from Policy, Operations, Surveillance and Corporate Directorates, as well as the Monetary Operations Adviser (MOA) and the Consultant (Statistics). The Committee is responsible for the implementation of monetary policy as decided by the MPC. It meets weekly to assess the liquidity position of the banking system and reviews issues regarding banking system infrastructure as well as the health of the banking system.

5.2.3 The Liquidity Assessment Group (LAG)

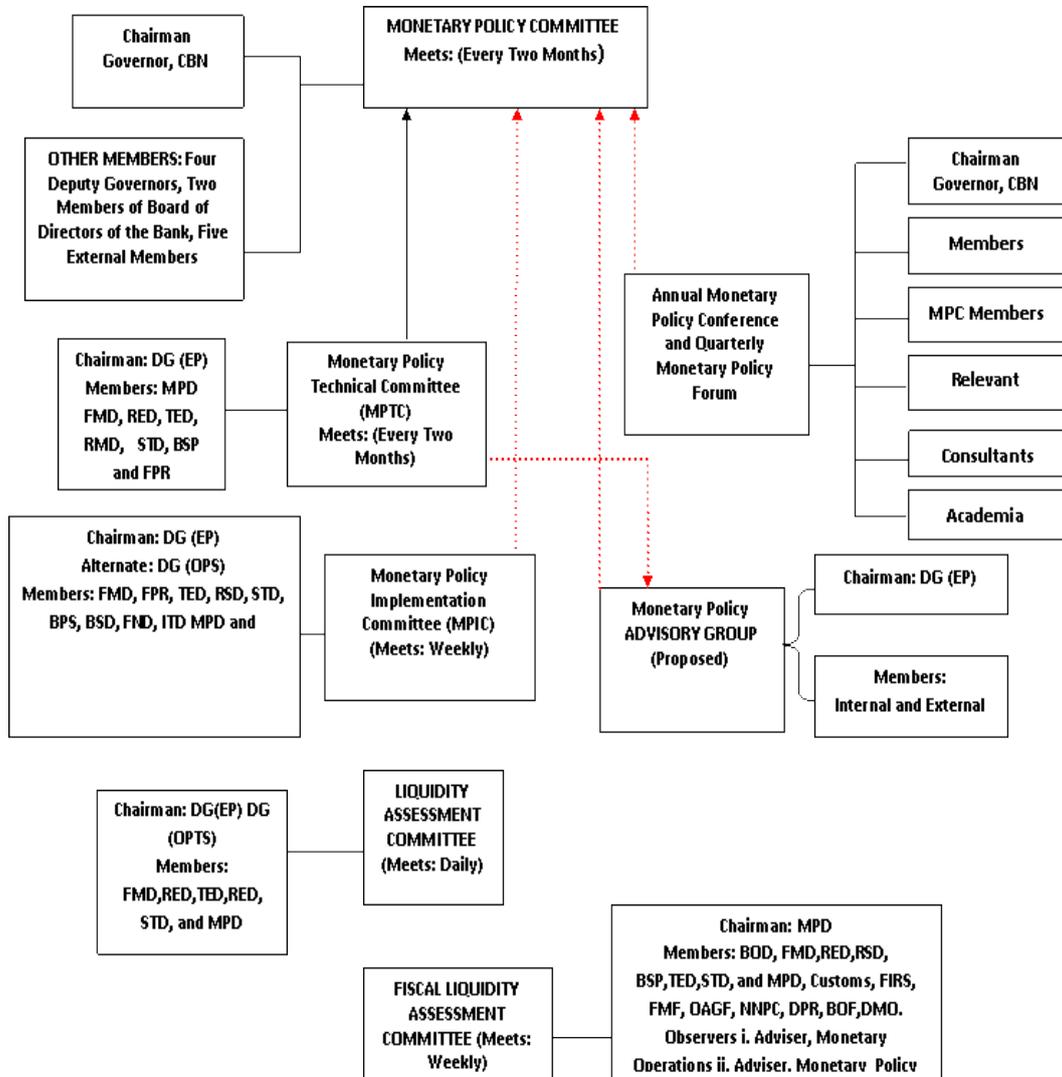
The LAG meets daily to assess the liquidity situation and to suggest policy actions to be taken on each day in both the foreign exchange and domestic money markets. It follows up the implementation of monetary policy measures and reports to the MPIC. The membership of LAG consists of the Monetary Policy Department (MPD), Banking & Payment System Department (BPSD), Trade and Exchange Department (TED), Reserve Management Department (RED), and Research Department (RD). It is chaired by FMD.

5.2.4 The Fiscal Liquidity Assessment Committee (FLAC)

The FLAC was inaugurated on April 26, 2007 by the Bank, with membership consisting of relevant CBN departments; and departments and agencies of the Federal Government involved in fiscal operations. The terms of reference of the Committee include: (a) providing information on the operations of the Treasury to the Liquidity Assessment Group (LAG) of the Bank for forecasting the level of liquidity in the economy; (b) providing policy advice on fiscal issues to the Management of the Bank; and (c) generating a robust database on the operations of the Treasury that have implication for domestic liquidity. The Committee meets weekly and is chaired by the MPD.

There is also the Annual Monetary Policy Conference and Quarterly Monetary Policy Forum which assesses developments in the economy and suggests broad directions for monetary policy. Figure 5.1 shows the current institutional framework for monetary policy.

Figure 5.1
CURRENT INSTITUTIONAL FRAMEWORK FOR MONETARY POLICY IN NIGERIA



5.3 The Monetary Policy Process in Nigeria

The process of monetary policy is complex and consists of a number of interrelated activities including setting of objectives, choosing the operating and intermediate targets, preparing the monetary programme, selecting appropriate policy instruments, implementing day-to-day routine activities such as liquidity management, adjusting policy rates, communicating policy actions, as well as evaluating outcomes and policy review. A key activity in the monetary policy formulation process is the preparation of financial/monetary programme.

5.3.1 The Financial Programme

A monetary programme is a comprehensive and consistent set of policy measures aimed at achieving certain desired macroeconomic objective for an economy. It is built within a forward- looking time frame (short to medium-term) using an accounting framework and key behavioural relationships all of which identify appropriate targets and instruments to help resources efficiently in line with their availability.

The distinguishing feature of a financial programme is that it seeks to achieve an orderly adjustment, through the early adoption of corrective policy measures, and through the provision of appropriate amounts of external financing where necessary. Preparation of a financial programme requires an assessment of economic challenges and the quantification of a coordinated set of policy instruments to achieve a given outcome. In this regard, an integrated system of macroeconomic accounts, covering real sector, the balance of payments, and the fiscal and monetary accounts provide the needed information. In the Central Bank of Nigeria, the four-sector economy-wide financial programming framework is used to derive both the operating (reserve money) and intermediate (broad money supply – M2) targets of monetary policy. Quarterly and annual targets of reserve money that are consistent with the policy of non-inflationary growth rate are set. Liquidity assessment and forecast are carried out on daily, weekly and monthly basis to determine the current liquidity position as well as its future path to guide policy decisions.

Presently, the process of monetary policy in the Bank is facilitated by:

- The adoption of two-week maintenance cash reserve averaging method;
- Improvement in payment system through interbank settlements, clearing system, e-payments and on-line-real time gross settlement (RTGS) infrastructures;
- Establishment of on-line Securities Trading System, April 2007;
- Deployment of new IT infrastructure (RTGS and T24) and linking banks to CBN through Temenos Internet Banking (TIB) and RTGS
- Online information dissemination (of auctions/results) to operators – using the Reuters Information System
- Appointment of 20 Money Market Dealers (MMDs) in money market instruments as counter parties for monetary operations.

CHAPTER SIX

MONETARY POLICY FRAMEWORK AND IMPLEMENTATION IN NIGERIA

6.1 Introduction

Since inception, CBN has used two monetary policy frameworks for the implementation of monetary policy namely: exchange rate targeting and monetary targeting. Exchange rate targeting framework was used between 1959 and 1973 while monetary targeting has been in use from 1974 to date. The shift to monetary targeting was largely informed by the collapse of the Breton Woods system of fixed exchange rates in 1974 and change in strategy to demand management as a means of containing inflationary pressures and balance of payments imbalances.

6.2 Exchange Rate Targeting (1959-1973)

The conduct of monetary policy in Nigeria prior to independence was influenced by economic developments in Britain. The instrument of monetary policy at that time was the exchange rate. The Nigerian pound was fixed in relation to the British pound in line with prevailing world economic conditions at the time. The fixing of the exchange rate provided a more effective mechanism for the sustenance of balance of payments position and the control of inflation in the Nigerian economy. The fixed parity lasted until 1967 when the British pound was devalued. However, the Nigerian authority did not devalue the Nigerian pound in line with the devaluation of the British Pound to which the Nigerian currency was pegged. The devaluation of the British pound occurred during the Nigerian civil war and the authorities did not devalue the Nigerian pound for the following reasons. Firstly, large amounts of the country's resources were being used to finance the war. Secondly, there was the fear that the devaluation of the Nigerian pound would only raise the domestic price of imports without significant impact on exports. This would worsen the already existing unfavourable balance of payments position. Consequently, the authorities decided to peg the Nigerian currency to the US dollar, but imposed severe restrictions on imports using strict administrative controls on foreign exchange transactions.

In the 1970's, a global crisis erupted which led to the devaluation of the US dollar. Nigeria had its own national currency (the Naira), pegged to the US dollar in line with the emergence of the Bretton Woods System of adjustable pegs. Due to the downside risks of pegging to a particular currency, the authority in 1978 decided to peg the Naira to a basket of 12 currencies of the major trading partners (Nnanna, 2001).

The Nigerian economy witnessed significant structural changes in the 1970s that greatly affected the conduct of monetary policy. The discovery of oil exerted significant impact on exports. Oil constituted about 57.6 per cent of total exports in 1970 and grew to 96 per cent in 1980, while non-oil exports, mostly agricultural produce, declined rapidly from 42.4 per cent in 1970 to 4 per cent in 1980. Following the increased revenue accruing to Government from oil, Nigeria's external reserves rose sharply. The favourable terms of trade at the time led to considerable growth in public expenditure and thus, intensified inflationary pressures. Consequently, the authorities adopted a new monetary policy framework; Monetary Targeting.

6.3 Monetary Targeting Regime

Monetary targeting involves the use of direct or market-based instruments. The major focus of monetary policy here is on controlling growth in the monetary aggregates, a policy based on the belief that inflation is essentially a monetary phenomenon. The ability to control money supply relative to the levels required to sustain output growth would, all things being equal, control inflation. The internal balance condition is imposed by setting the inflation and output growth rates at targets that are consistent with the expansion in aggregate demand.

6.3.1 Direct Controls

The direct method of monetary policy lasted from 1959 – 1985. Between 1960 and 1962, the CBN operated a passive monetary policy regime in which the focus was on developing and maintaining a sound domestic currency. In 1962, the focus changed to development issues with the need to ensure adequate supply of credit to the economy with minimal inflationary pressures. In the latter part of 1964 and 1965, the primary objective of monetary policy changed to the achievement of balance of payments equilibrium and the policy tool was credit rationing in the form of guidelines that placed ceilings on the rate of expansion of commercial bank advances. Credit restriction was lifted in November 1966 so as to provide government with enough money to prosecute the civil war. The result was the post-war inflationary pressures, a deteriorating balance of payments position, and a rapid increase in deficit financing. Subsequent policies were directed at reducing inflationary pressures, restoring normal economic conditions, relieving the pressures on the external payments position, increasing Government revenue and reducing government's reliance on the banking system. What followed was monetary restraint, particularly between April 1972 and March 1976. At that period, the twin objectives of expanding domestic output and curtailing inflation remained the major focus of monetary policy. Also, during the same period, government finances and foreign exchange reserves improved owing to increased oil earnings. This resulted in increased aggregate demand and money supply. The task of monetary management became complicated resulting in

excess liquidity. Consequently, the selective credit control policy was retained, supported by interest rate and exchange rate policy in the latter part of the period. Stabilization securities were also introduced in an attempt to reduce the liquidity level of the commercial banks.

The CBN continued with its monetary restraint policy between April 1976 and December 1981 due to the persistence of excess liquidity in the system. Direct credit ceiling, cash reserve ratios, stabilisation securities, the exclusion of deposits against letters of credit from eligible liquid assets and interest rate changes were combined to address the liquidity surfeit.

Between 1981 and 1985, the monetary policy instruments were broadly the same as in the period preceding it, 1970-1980. The instruments were fine-tuned in line with the challenges faced. Some major highlights during the period include:

- Prescription of permissible aggregate credit expansion ceilings;
- Guidelines on the sectoral allocation of banks' loans and advances which continued to favour the preferred sectors-agriculture and manufacturing;
- Selective credit controls to encourage indigenous businesses, small-scale enterprises and the rural areas;
- Unchanged CRR during the period; and
- Marginal upward adjustments of interest rates.

However, the policy of stringent monetary restraint targeted the conservation of foreign exchange reserves and the maintenance of price stability. Measures taken to reduce foreign exchange disbursements included the re-introduction of pre-shipment inspection and the imposition of pre-import deposits ranging from 10 per cent to 250 per cent. In addition, interest rates were raised to encourage savings and investment and reduce demand for foreign exchange.

6.3.2 Indirect Controls

As conditions in the economy worsened, concerted effort was made to eliminate unnecessary economic controls from 1986. This prompted the introduction of the Structural Adjustment Programme (SAP) in July, 1986. The purpose was to ultimately institute a more efficient market system for the allocation of resources, with the implication that excessive controls of the previous two decades would be gradually eliminated or reduced to levels that would not inhibit development.

The three major planks for achieving this overall goal included exchange control liberalisation, adoption of relevant pricing policies in all sectors of the economy and further rationalization and restructuring of public expenditure and customs tariffs. Thus, monetary policy was expected to play an important role in the new economic management process. Indeed, the ultimate objectives of monetary policy remained as in the pre-1986 period. However, in the specific environment of financial and economic liberalization, monetary policy was also to stabilize the economy in the short-run and to induce the emergence of a market-oriented financial sector. At the start of SAP, traditional instruments were fine-tuned to deal with the excess liquidity in the economy. In August 1986, the CBN, for instance, required banks to deposit in a non-interest bearing deposit account at the Bank, the naira equivalent of all outstanding external payment areas. Also, the 10.0 per cent ceiling imposed on the rate of credit expansion by banks fixed in January 1986 was reduced to 8.0 per cent in July and maintained until August 1987 when it was further reduced to 7.4 per cent.

Several measures were also added to stem the growth in excess liquidity. There was the abolition of the use of foreign guarantees/currency deposits as collateral for naira loans which implied that deposit money banks were no longer to grant domestic loans denominated in naira on the security of foreign guarantees or deposits held abroad and in domiciliary accounts with the banks.

In May 1989, the Federal Government directed that all public sector accounts be withdrawn from the banks. Its immediate impact was the reduction in banking system's liquidity. A reverse policy took place in 1999 when the retail functions of the CBN were transferred to the DMBs. Other policy measures included:

- Rationalization of sectoral credit controls so as to give a larger measure of discretion to banks in respect of credit operations in 1986 and 1987;
- Abolition of all mandatory credit allocation mechanisms by the CBN from October 1996;
- Adjustment of CRR to embrace total deposit liabilities (demand, savings and time deposits) instead of the earlier method of computing demand deposits alone;
- Deregulation of interest rates;
- Reintroduction of the use of stabilization securities in 1990;

- Enhancement of DMBs minimum paid-up capital from N20 million to N50 million in 1997, N500 million in 1999 and N1.0 billion from January 2000; and
- Shift to use of OMO in 1993 with the intention to shift monetary management from the system of direct controls of credit growth to a market-oriented approach.

In line with the liberalization policy thrust of SAP, there was a paradigm shift from the hitherto repressive direct monetary control method to an indirect approach anchored on the use of market instruments in monetary management. This was borne out of the desire to eliminate the distortions and inefficiencies in the financial system caused by the prolonged use of administrative controls and the need to engender competition among banks and other operators in the financial system. Two major policy regimes of short- and medium-term horizon can be identified:

6.4 The Short Term Monetary Policy Horizon (1986-2001)

Following the liberalization of the economy in 1986, monetary policy was refocused based on one year perspective. Consistent with the broad objective of monetary policy, a number of monetary targets and instruments were adopted during the one-year monetary policy horizon. OMO, conducted wholly using the Nigerian Treasury Bills (NTBs), continued to be the primary instrument of monetary policy. This was complemented by the cash reserve requirement (CRR) and the liquidity ratio (LR). Other policy instruments employed included the discount window operations, mandatory sales of special NTBs to banks and a requirement of 200 per cent treasury instruments to cover for banks' foreign exchange demand at the Autonomous Foreign Exchange Market (AFEM). Interest rate policy was deregulated through the proactive adjustment of the minimum rediscount rate (MRR) to signal policy direction consistent with liquidity conditions. Surveillance activities of the CBN focused mainly on ensuring sound management and maintenance of a healthy balance sheet position on the part of deposit money banks (DMBs). On the external front, the official and interbank exchange rates were unified in 1999.

6.5 The Medium-Term Monetary Policy Horizon (2002-Date)

In 2002, the CBN commenced a two-year medium-term monetary programme aimed at freeing monetary policy from the problem of time inconsistency and minimizing overreaction due to temporary shocks. The new monetary policy horizon, still in operation, is based on the evidence that monetary policy actions affect the ultimate objectives with a substantial lag. Under the medium-term, monetary policy guidelines are open to half-yearly review in line with

developments in monetary and financial market conditions in order to achieve medium- to long-term goals.

Attention has also been focused on the need for a more competitive financial sector geared towards improving the payments system. The OMO has continued to be the primary tool of monetary policy, and is complemented by reserve requirements, discount window operations, foreign exchange market intervention and movement of public sector deposits in and out of the DMBs. The CBN has also continued to ensure banking soundness and financial sector stability, not only to ensure the effective transmission of monetary policy to the real sector but also to enhance the efficiency of the payments system.

6.6 Setting the Operating Target (Base Money) and Intermediate Target (Broad Money)

Essentially, this involves obtaining an ex ante monetary survey (a consolidated balance sheet of the banking system, i.e., central bank and deposit money banks), which may or may not be consistent with the desired growth in money supply. Then, financial programming is used to determine the optimal money supply that is consistent with the predetermined ultimate targets. The underpinning premise is the quantity theory of money which is based on the link between the stock of money (M) and the market value of output that it finances (PY), where P is the price level and Y is the output. M is related to P with a velocity of money, V .

$$MV = PY \quad (1)$$

The outcomes of the medium term framework have been mixed. Growth in monetary aggregates exceeded targets by substantial margins in most of the years due mainly to excessive fiscal operations of government. In addition, outcome of inflation rate was mixed as it remained single digit in 2006 and 2007 but reverted to double digits in 2008 owing to the global food shortages and financial crisis.

The medium term perspective of monetary policy framework continues to face a number of challenges, which include:

- Untimely data on real aggregates required for policy making, for example, data on real GDP;
- unreliable statistical returns from banks;
- expansionary fiscal operations of government, and time inconsistency;

- conflicting government policies; and
- structural bottlenecks.

6.7 Major Challenges in Monetary Policy in Nigeria

- (i) A major challenge has been the unreliability of the three-year revenue and expenditure forecasts used in the medium-term expenditure and revenue frameworks. This is borne out of the unpredictability of crude oil prices and production volumes that are exogenous to the fiscal authorities. Given that the budget size is largely determined by estimates of oil revenue, the reliability of the budget as an indicator of the future direction of fiscal policy becomes doubtful, thus emphasizing the relevance of policy coordination. Given that monetary expansion is heavily dependent on crude oil revenue, unstable revenues arising from the global oil and commodity price shocks may increase budget deficits and impair the goal of monetary policy, particularly, when the government is compelled to resort to the banking system to meet its financing needs.
- (ii) Other challenges include the lack of coordination among the tiers of government. To achieve macroeconomic coordination, all the tiers of government need to enact fiscal responsibility Acts and other aspects of legal reforms such as the public procurement legislation and adopt due process certification, public accountability and transparency in budget formulation and execution. Given the nature of Nigeria's fiscal federalism, the challenge of applying fiscal rules at the sub-national level needs to be overcome for the effectiveness of reform policies.

This is because the current revenue-sharing formula allocates nearly half of the total revenue to the lower tiers of government that are also directly responsible for nearly half of consolidated government expenditure. They possess significant independence in their expenditure decisions, thereby significantly influencing the ability to design and implement appropriate public policies. It is thus important for States and Local Governments to improve on their budget transparency, strengthen public expenditure management and adopt the due process mechanism by formulating and implementing credible public procurement legislations if the challenges of macroeconomic coordination are to be surmounted.

- (iii) Another major challenge to the coordination efforts is the absence of a constitutional provision that backs the creation of an excess crude

account where excess revenues could be saved. The constitution provides that all revenues should be transferred to the Federation Account and shared among the three tiers of government.

6.8 Conclusion

This module of the *Understanding Monetary Policy Series*, reviewed the monetary policy framework in Nigeria. The operating, intermediate and ultimate targets of monetary policy in Nigeria were also discussed. The Module 3 explained the stance of monetary policy over the years, noting that it was either expansionary or contractionary. It was also noted that the strategies of monetary policy involved modifying the level of base money in circulation which will in turn affect money supply, inflation and output. The instruments and target variables used by monetary authorities in implementing monetary policy were also highlighted.

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Glossary of Selected Terms

Balance of Payments Equilibrium: This is a statistical accounting framework where all receipts (credit entries) must be equal to payments (debit entries) for all transactions between residents of a country and rest of the world.

Bretton Woods System: After the Second World War, the Bretton Woods System consisted of rules, institutions and procedures for regulating the international monetary system. In these regards, the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD), now part of the World Bank Group were established.

Financial Programming: The programme is used to evaluate macroeconomic and structural conditions of an economy and determine a monetary programme for achieving policy objectives.

Fiscal Dominance: This is when the Federal Government's fiscal operations through excessive deficit financing lead to expansionary money supply which renders monetary policy ineffective.

Gross Domestic Product (GDP): This is the total output of goods and services in a country measured through market prices. It is therefore the summation of the production of goods and services of all residents in a country within a year.

Minimum Rediscount Rate (MRR): This was the former anchor policy interest rate of the CBN. It reflected long-term interest rate and was indicative of the direction of policy on interest rates structure.

Monetary Policy Rate (MPR): When interest rates were insensitive to changes in MRR, the MPR which is a short term anchor rate replaced the MRR in December, 2006. It is designed to influence short term money market rate and promote policy efficiency.

Policy: Guidelines or set of decisions for achieving some objectives or solving problems.

Policy Design: Setting down the process of problem recognition and identification, nature of the problem and stating the objectives of what the policy intends to achieve. It also identifies the processes for policy analysis and implementation.

Policy Formulation: It involves the specification of policy objectives, analysis to develop alternative policy options, the process of decision making, setting up implementation strategies, monitoring and periodic reviews

Target Variables: These are the policy targets set within a policy horizon. Examples are single digit inflation, 7.0 per cent growth rate, etc.