CENTRAL BANK OF NIGERIA

# UNDERSTANDING MONETARY POLICY SERIES NO 5

# MONETARY AND FISCAL POLICY COORDINATION

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## Aims and Scope

Understanding Monetary Policy Series are designed to improve monetary policy communication as well as economic literacy. The series attempt to bring the technical aspects of monetary policy closer to the critical stakeholders who may not have had formal training in Monetary Management. 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

"By 2015, be the Model Central Bank delivering Price and Financial System Stability and promoting Sustainable 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 sector"

## Core Values

- Meritocracy
- Leadership
- Learning
- Customer - Focus

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# SECTION ONE

## Introduction

Fiscal and monetary policies are the two major strategies of managing resources and demand pressures in the economy. Monetary policy concerns the use of monetary instruments such as credit, money supply and interest rates to influence overall demand in the economy, while fiscal policy is the use of government taxes and expenditure, including debt to control aggregate demand in the economy. Monetary policy is implemented primarily by the monetary authorities, particularly the central bank, while fiscal policy is implemented by the fiscal authorities, particularly the Ministry of Finance or Treasury. Although monetary and fiscal policies pursue the same ultimate objective, i.e the attainment of high, stable and sustainable economic growth, they employ different instruments.

In many countries, monetary policy plays a supporting role to fiscal policy. Central banks have often been required to finance public sector deficits, including those arising from quasi-fiscal operations. In more recent years, however, there has been a worldwide trend towards increasing central bank independence and creating opportunities for the two policies to complement each other.

Fiscal policy actions could affect the effectiveness of monetary policy in various ways: via its impact on the general price level which cast doubts on the efficacy of monetary policy, via short-run effects on aggregate demand and by modifying the long-term conditions for economic growth and inflation. On the other hand, monetary policy may be accommodative to fiscal policy or counteractive. The need to offset the impact of expansionary fiscal policy on aggregate demand and inflation in the economy could prompt the central bank to tighten monetary policy, by raising interest rates or reducing credit in the financial system. The resulting high interest rates could depress economic activity, attract short-term and easily reversible capital inflows, thereby adding to inflation and appreciation pressures on the currency, and eventually damaging macroeconomic and financial stability. In the same vein, the central bank decision on interest rates influences how much and at what price governments can get fund from the public in form of debt. Effective monetary and fiscal policy may, therefore, require extensive coordination between the respective authorities. The success of one depends on the other. Thus, while monetary and fiscal policies may be implemented by two different bodies, these policies are far from independent. A change in one will influence the effectiveness of the other and thereby the overall impact of any policy changes on the economy.

In Nigeria, there were no concrete efforts at policy coordination until recently when the government set up a coordinating committee for monetary and fiscal policies. The focus of this write-up is to examine the issue of monetary and fiscal policy coordination with respect to Nigeria. The rest of the paper is organised as follows: Section two discusses the conceptual issues relating to monetary and fiscal interactions while section three dwells on the need for policy coordination. Section four focuses on the imperative of monetary and fiscal coordination in Nigeria while section five discusses the challenges of policy coordination.

# SECTION TWO

### Conceptual Issues in Monetary and Fiscal Policy Coordination

## 2.1 Monetary Policy

Monetary policy are measures taken by the monetary authorities aimed at enhancing economic growth and stability by adjusting the cost and level of money supply, to achieve broad macroeconomics objectives of price stability, output growth and full employment. Mordi (2009) describes monetary policy as a blend of measures or set of instruments designed by the Central Bank to regulate the value, supply and cost of money consistent with the absorptive capacity of the economy or the expected level of economic activity, without necessarily generating undue pressure on domestic prices and exchange rates.

By altering the level of money supply in the economy, central banks make money cheaper depending on the absorptive capacity of the economy at a particular point in time. Reaching a balance is especially vital in monetary policy, because a surplus or shortage beyond the optimum level, in the money supply may be detrimental to the realisation of the macroeconomic objectives.

### 2.1.1 Objective of Monetary Policy

The objectives of monetary policy are ultimately similar to the objectives of fiscal policy. After the Keynesian revolution, many people accepted the significance of monetary policy in attaining the following objectives:

- Price Stability
- Sustainable Economic Growth
- Exchange Rate Stability
- Favourable Balance of Payments (BOP)
- Full Employment
- Equitable Income Distribution

These are the general objectives which central banks unanimously attempt to selectively achieve by employing tools of monetary policy. In Nigeria, the CBN has always aimed at controlling the expansion of bank credit and money supply with the aim of achieving the following objectives.

#### Price Stability

This is the most important objective of monetary policy in Nigeria. All economies suffer from inflation and deflation from time to time. Both are harmful to the economy. Monetary policy, having an objective of price stability, tries to keep the value of money stable such that when the economy suffers from recession, it tends to be accommodating and when there is inflationary situation, monetary policy tends to be restrictive.

### Sustainable Economic Growth

Monetary policy can influence economic growth by controlling real interest rate and its resultant impact on investment. If the CBN opts for credit easing by reducing interest rates, investment in the economy can be encouraged. This increased investment can speed up economic growth.

### Exchange Rate Stability

Exchange rate is the price of a home currency expressed in terms of any foreign currency. If the exchange rate is volatile, the international community might lose confidence in the economy. Therefore, monetary policy aims at maintaining relative stability in the exchange rate by altering the foreign exchange reserves, tries to influence the demand for foreign exchange.

### Favourable Balance of Payments (BOP)

Imbalance in a nation's balance of payment occurs when payments made by a country are less than payments received. The CBN, through its monetary policy, tries to maintain equilibrium in the balance of payments. BOP Surplus is considered favourable because more currency is flowing into the country than is flowing out. Such an unequal flow of currency will expand the supply of money in the nation and subsequently cause a decrease in the exchange rate relative to the currencies of other nations. This then has implications for inflation, unemployment, production, and other sectors of the domestic economy. BOP Deficit on the other hand, stands for stringency of foreign inflow and high outflow of foreign currency. If monetary policy succeeds in maintaining monetary balance, then a BOP equilibrium is said to have been achieved.

### Full Employment

The concept of full employment was much discussed after Keynes's publication of the "General Theory" in 1936. It refers to the absence of involuntary unemployment. In simple words, 'Full Employment' stands for a situation in which everybody who wants a job gets one. However, it does not mean that there is zero unemployment. In that sense, the full employment is never full. Monetary policy can be used to achieve full employment. If the monetary policy is expansionary, then credit supply can be encouraged. It could help in creating more jobs in different sectors of the economy.

### Equitable Income Distribution

This refers to the manner in which income is divided among members of the society. A perfectly equal income distribution would mean everyone in the country has exactly the same income. Many developing countries, including Nigeria, are experiencing inequality in income distribution because resources are never equally distributed. Some labours are naturally more productive and better to produce wealth that consumers want and thus get more income. The same is true for capital, land, and entrepreneur. However, without government intervention, an unequal distribution of income tends to be self-perpetuating. Those who have more income, can invest in additional productive resources, and thus can add even more to their income. In recent years, economists have opined that monetary policy can help by playing a supplementary role in attainting income equality. CBN can make special provisions for the neglected sectors of the economy such as agriculture, small-scale industries, etc by providing cheap long term credit. This can prove fruitful for these sectors.

### 2.1.2 Instruments of Monetary Policy

They are broadly divided into two categories, namely: direct instruments and indirect Instruments.

- ***Direct Instruments*****:** Direct Instruments of monetary policy are directives given by the central bank to control the quantity and prices of financial assets/liabilities of deposit money banks (DMBs) and discount houses. These include interest rates fixing and credit ceilings. These may prove very useful in controlling price, quantity of deposit or credit and the direction of credit particularly in periods of temporary shocks. They may also be most effective and practicable in underdeveloped financial markets and in jurisdictions where the central bank lacks adequate techniques of indirect control. The downsides of the direct controls are absence of competition, inefficient use of resources and distortion of markets.

- ***Indirect Instruments:*** Indirect Instruments of monetary policy involve controlling the price or quantity of base money. Indirect monetary policy instruments include; open market operations (OMO), monetary policy rate (MPR), reserve requirement, discount window operations and repurchase agreements. This is the current trend in monetary policy formulation and implementation because it provides a liberalised environment necessary for the efficient allocation of savings and credit in the economy.

## 2.2 Fiscal Policy

Fiscal Policy is the process by which Government uses public expenditure, debt, taxation and other revenues to influence economic activities with a view to achieving the set macroeconomic objectives of full employment, favourable balance of payment, price stability and output growth among others. Idowu

(2010) and Okunrounmu (2003) described fiscal policy as the deliberate changes in the levels of government expenditure, taxes and other revenue as well as borrowing with a view to achieving national goals or objectives such as price stability, full employment, economic growth and balance of payments equilibrium.

Fiscal Policy could be neutral, expansionary or contractionary. Fiscal policy is considered neutral when government spending is equal to its revenue. This is also known as balanced budget. When government expenditure is fully financed by tax proceeds, the budget has a neutral consequence on economic activities in the country. A government is said to be operating an expansionary fiscal policy when it has a deficit budget. In such a situation, the public expenditure is higher than the tax revenue. This is an advisable policy stance during a period of recession. Recent developments in the global economy especially in the euro area have however, underscored the limitation of deficit financing in an economy. On the other hand, a government with contractionary fiscal policy has a surplus budget such that, public expenditure is lower than tax revenue. This policy stance could be effective in curbing inflation.

### 2.2.1 Objective of Fiscal Policy

Fiscal policy is designed to achieve certain objectives including:

#### Rapid Economic Growth and Development

The principal objective of fiscal policy is to ensure rapid economic growth and development. Fiscal policy is applied to mobilise financial resources which can be deployed on projects and programmes that target growth and development. Financial resources can be mobilised through effective taxation. In addition, government can prioritise it expenditure in order to enhance public savings that can be used for more productive activities. The government can also borrow from the private sector by implementing a tax regime that gives tax benefits to holders of government securities.

#### Efficient Allocation of Financial Resources

The Federal and State governments have made considerable efforts at achieving efficient allocation of financial resources for developmental activities which include expenditure on education, health and infrastructure. Therefore, fiscal policy should be designed in such a manner as to encourage production of desirable goods and discourage those goods which are socially undesirable.

#### Reduction in Wealth and Income inequalities

Fiscal policies are also designed to achieve equitable distribution of income and resources among different sections of the society. The direct taxes such as income tax on the rich may be higher compared to the lower income groups. Indirect taxes on semi-luxury and luxury items may also be higher as they are mostly consumed by the upper middle class and the upper class. The government invests a significant proportion of its tax revenue in the implementation of poverty alleviation programmes to improve the conditions of the poor in society.

#### Employment Generation

The government makes efforts to increase employment in the country through effective fiscal policy measures. Investment in infrastructure has resulted in direct and indirect employment effects. Lower taxes and duties on small-scale industrial (SSI) units encourage more investment and consequently generate more employment. Rural employment programmes are implemented by government to empower and reduce poverty in rural communities. Other self-employment scheme are also undertaken to provide employment to technically qualified persons.

#### Balanced Regional Development

Another objective of fiscal policy is to bring about balanced regional development. There are various incentives from the government for setting up projects in backward areas such as cash subsidy, concession in taxes and duties in the form of tax holidays, finance at concessional interest rates, etc.

#### Reducing the Deficit in the Balance of Payment

Fiscal policy attempts to encourage more exports by way of fiscal measures such as tax exemptions on export earnings. Foreign exchange could also be conserved by providing fiscal benefits to import-substitution industries, imposing tariff and other duties on imports, etc. The foreign exchange earned by way of exports and saved by way of import substitution helps to correct balance of payments imbalance.

#### Development of Infrastructure

Infrastructure development is important for unlocking the growth potentials of every economy. Fiscal policy measures are often designed by government for the purposes of investment in strategic national assets. In Nigeria, infrastructure gaps in critical areas such as in power have subdued the growth enhancing activities for many decades.

### 2.2.2 Instruments of Fiscal Policy

Fiscal policy tools as earlier mentioned, are explained in greater detail to give insight into how these instruments are used to improve the economy.

**Public Expenditure** refers to the total amount of money spent by government of a country in a period. It includes all acquisition of goods and services, and transfer payments. An increase in public expenditure during recession/depression raises the aggregate demand for goods and services and leads to a boost in income, while a reduction in public expenditure, at a time of high inflation, shrinks aggregate demand and prices.

**Taxes** are financial charges and other levies imposed on an individual or legal entity by government such that failure to pay is punishable by law. Tax is enforced contribution imposed by the government on the governed to support governance. It is enforced because there is no "quid pro quo" associated with it i.e. the payer do not necessarily expect something in return. Revenue obtained from taxes are thereafter, deployed by the government to produce public goods. Reduction in taxes raises disposable income thereby increasing private consumption and investment expenditure. Reduction in tax level could be an effective measure during recession/depression.  On the other hand, an increase in taxes tends to reduce disposable income thereby, limiting consumption and investment expenditure.

**Public Debt** as an instrument of fiscal policy is the borrowings by government to fund public expenditures not financed by current tax revenues. Government debts are classified mainly into two: domestic and external debt. Domestic debts are owed to lenders within the country, while external debts are owed to foreign lenders. Governments typically borrow by issuing treasury securities such as bonds, certificates and bills, or outright credit facilities from other governments, bilateral and multilateral organisations such as the World Bank and the International Monetary Fund (IMF).

# SECTION THREE

## Fiscal-Monetary Policy Coordination

### 3.1 Monetary and Fiscal Policy Interactions

Since both fiscal and monetary policies generally tend to achieve the same macroeconomic goals but through different instruments, coordination becomes highly essential in order to avoid conflict of interest in the implementation process. As pointed out in the previous sections, monetary policy aims at achieving macroeconomic stability by altering the cost and level of money supply, while fiscal policy tends to achieve the same objective through the use of public expenditures, taxes and debt. Some of the channels of interactions of the instruments of the both policies are discussed below.

### 3.2 Public Debt Management

Public debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, and meeting government financing need and payment obligations at the lowest possible cost over the medium to long term. For macroeconomic management, the government should seek to ensure that both the level and rate of growth in its public debt is fundamentally sustainable, and can be serviced under a wide range of circumstances while meeting its other objectives. Importantly, the impact of government financing requirements and debt levels on borrowing costs should be coordinated. This is because, poorly structured debts in terms of their interest rate, composition and maturity could induce or propagate economic crises in the country.

#### 3.2.1 Impact of Public Debt on Monetary Policy

Public debt could impact on monetary policy in a number of ways as described below:

**Inflation:** Rising public debt could lead to a level where the government would be unable to repay it financial obligation. Under such a circumstance, central banks may be compelled to monetise the debt by printing more money, leading to excess liquidity with the attendant higher inflation.

**Reduction in Output:** One of the major goals of monetary policy is the stimulation of output with a view to reducing unemployment. In an instance where public debt is financed by borrowing, it normally crowds out private sector credit with adverse implication on private demand for investment, hence reduction in output.

**Balance of Payment Problem**: When public debt is financed by domestic borrowing, it tends to put pressure on domestic interest rate, leading to inflow of portfolio capital in the short run. This phenomenon normally leads to appreciation of the exchange rate particularly under a flexible exchange rate regime with the attendant pressure on current account of the balance of payment.

In the light of the above mentioned channels, there is a need for continuous interaction as sound debt management would limit the build-up of liquidity exposures and other excessive levels of debt that result in higher interest rates, which can have adverse effects on real output with risks that could make the economy of the country vulnerable to external shocks. Therefore, sound interaction between the monetary and public debt managers is essential for the management of the economy because the private sector is faced with enormous problems such as high public debt which leads to liquidity crisis.

### 3.3 Impact of Public Debt on Fiscal Policy

A good understanding between the ways in which the different policy instruments operate, their potential to reinforce one another, and how policy tensions can arise will guide policy makers in shaping the policy direction of a country. The relationship between the two seems to be subtle but is real. Fiscal and monetary policies can reinforce one another in helping to lower the risk in the structure of long-term interest rates. Monetary authorities should inform the fiscal authorities of the effects of government debt levels on the achievement of their monetary objectives. Borrowing limits and sound risk management practices can help to protect the government from debt servicing shocks. Although, government debt management policies may not have been the sole or even the main cause of fiscal crises, the maturity structure, interest rate and currency composition of the government's debt portfolio, together with substantial obligations in respect of contingent liabilities have often contributed to the severity of the crisis especially in Nigeria. Even if the country has sound macroeconomic policy settings, risky debt management practices increase the vulnerability of the economy to economic and financial shocks with its attendant implications for fiscal policy.

Against the above, there is the need for an effective interaction between the fiscal and public debt management and possibly, the establishment of a Debt Management Office (DMO). If macroeconomic policy settings are poor, sound public debt management may not by itself prevent any crisis. It has also been argued that if the public debt market is well coordinated under an effective interaction of monetary and fiscal policies, it helps economies to weather financial shocks. Debt management needs to be linked to a clear macroeconomic framework, under which governments seek to ensure that the level and rate of growth in public debt are sustainable.

### 3.4 The Interaction between Fiscal Policy and Inflation

An expansionary fiscal policy exerts pressure on inflation rate. When a government spends under a loose fiscal regime, it tends to increase the level of money supply above the absorptive capacity of the economy and thereby, drives up the price level. The basic interaction between fiscal operations and inflation is that if a change in government expenditure does not lead to expansion in the productive capacity of the economy, it would generally translate to increase in the rate of inflation. As a result, clear interaction and communication between the fiscal and monetary authorities with respect to public expenditure could have several beneficial effects. Such a process would help to anchor expectations particularly on core inflation.

# SECTION FOUR

## Need for Policy Coordination

Fiscal and monetary authorities in a country use fiscal and monetary policy instruments, respectively, to achieve macroeconomic objectives. To achieve these macroeconomic objectives, fiscal (Ministry of Finance or Treasury) and monetary (central bank) authorities employ two major instruments. For instance, the fiscal authority may use tax rate or tax revenue as policy instrument, while the monetary authorities may use interest rate and money stock as their own policy instruments. The objectives and implications of policy measures taken by the two institutions often conflict with each other, thus, necessitating the need to put in place appropriate mechanism for coordination between the two authorities in order to ensure effective functioning of the economy.

One of the areas of concern as regards the interaction between fiscal and monetary policies has to do with financing of the budget deficit and its resultant effects for monetary management. For instance, an expansionary fiscal policy will lead to increase in aggregate demand and ultimately lead to higher inflation. On the other hand, the monetary policy stance may affect the ability of the government to finance the budget deficit by affecting the cost of the debt service and by limiting or expanding the available resources of financing.

### 4.1 Role of Fiscal and Monetary Policies in the Stabilisation Process

Economists have expressed divergent views as to the roles of fiscal and monetary policies in the stabilisation process of an economy. Stabilisation of an economy involves the avoidance of large swings in economic activity, high inflation rates, excessive volatility in exchange and interest rates. Some regard monetary policy conducted by an independent and credible central bank as a predominant stabilisation tool for most economies. Others opined that fiscal policy plays an important stabilisation role in the economy if it is well coordinated with monetary policy. Some economists are however, of the view that no matter how independent a central bank is, its conduct of monetary policy may not be sufficient in determining the price level and that fiscal policy has a role to play. In this regard, as both fiscal and monetary policies are used to achieve set objectives, concerted efforts must be made to use them in a mutually reinforcing manner. Empirical evidence suggests that countries whose policies are not coordinated may suffer from high deficits and inflationary pressures. This is because fiscal authorities for instance, in an election year will be reluctant to decrease spending and hence, accentuate inflationary pressures. Monetary authorities, on the other hand, have harsher stance on deficit and inflation

(Bartolomeo and Gioacchino, 2008). Therefore, close coordination of fiscal and monetary policies is beneficial in order to effectively achieve the overall macroeconomic policy objectives of the respective authorities.

### 4.2 Rationale for Coordination between Fiscal and Monetary Policy

The basic rationale for the fiscal and monetary policy coordination and the associated institutional and operational arrangements derive from the following interrelated objectives:

- To set internally consistent and mutually agreed targets of fiscal and monetary policies with a view to achieving non-inflationary growth;

- To facilitate effective implementation of policy decisions to achieve the set targets of fiscal and monetary policies efficiently through mutually supportive information sharing and purposeful discussions; and

- To compel both central bank and government to adopt a sustainable policy.

It is important to emphasise that lack of coordination between the fiscal and monetary authorities will impact negatively on the overall economic performance. For example, lax fiscal policy will put pressure to tighten monetary policy, even if the latter cannot fully compensate for fiscal imbalance.

Secondly, the coordination process needs to take into account that monetary and fiscal policy adjustments operate in different time frames. For instance, monetary policy can be adjusted to alter monetary conditions on a daily basis. This makes it unsuitable for monetary policy to bear most of the burden of any “fine tuning” of stabilisation policies.

Thirdly, a fundamental requirement for efficient policy coordination is to ensure that the objectives and policies by the monetary and fiscal authorities are jointly determined. For instance, setting a very restrictive monetary policy to offset a lax fiscal policy may crowd out private investment and insignificantly increase the borrowing costs for the government.

### 4.3 Institutional and Operating Arrangements for Coordination

Effective coordination of monetary and fiscal policies relies on the support of strong institutional and operating arrangements to ensure optimal outcome. Some of the institutional arrangements needed to enhance monetary and fiscal policy coordination include independence of the central bank and a framework that ensures conflict resolution among policy implementing agencies. A key advantage of central bank independence in effective monetary and fiscal policy coordination is that it can control direct credit to the government which can negatively impact macroeconomic stability. On the other hand, to be able to minimize conflict between monetary and fiscal authorities, there is need to create institutions that can handle policy conflicts without jeopardizing macroeconomic stability and by implication, the overall economic objective of the state.

# SECTION FIVE

## Monetary and Fiscal Policy Coordination: Nigerian Experience

Macroeconomic policies are meant to achieve ***non-inflationary growth***. This ordinarily means the deliberate manipulation of policy instruments to achieve acceptable level of employment, production and prices and the attainment of growth in real output. In Nigeria, monetary instruments are employed by the central bank while fiscal instruments are employed by the Ministry of Finance. The objectives and implications of policy measures of these two institutions often conflict. Hence, it is important to have a mechanism of coordination between the two authorities for better functioning of the overall economy.

There are two basic methods to achieve monetary and fiscal policy coordination: (i) interaction between the monetary and fiscal authorities to decide jointly on aspects relating to policy strategy and implementation, or (ii) establishment of a set of rules and procedures. The first option, which is applicable in Nigeria, often takes place through the establishment of formal or informal committees. These committees are normally composed of officials of Ministry of Finance or Treasury, DMO and CBN, who meet on a regular basis. The platform allows stakeholders to learn about each other's objectives and operating procedures, while helping to build a consensus on how monetary management and debt management should be conducted to be mutually reinforcing. The monetary and fiscal policies coordination in Nigeria has moved from an era of tacit coordination through the central bank's subordination to the fiscal authorities from 1960 to 2001, to the era of financial reforms in 2004 and legislative support which have ushered in an era of closer cooperation and coordination by all stakeholders. Some of the coordinating bodies and committees are discussed below:

### 5.1 Board of Directors and Monetary Policy Committee of the CBN

The membership of the Board of Directors and the Monetary Policy Committee (MPC) comprises members from the Federal Ministry of Finance; representation from the private sector and academia; appointees of the President and the CBN Committee of Governors.

Section 12 of the CBN Act of 2007 provided for the establishment of a MPC to facilitate the attainment of the objective of price stability and to support the economic policy of the Federal Government. According to Section 12 (3) of the CBN Act of 2007, the MPC, has the responsibility within the Bank for formulating monetary and credit Policy. Of the three members appointed by the President to the MPC, one is the Permanent Secretary, Federal Ministry of Finance. From the foregoing, it could be seen that at the highest level of the Bank's policy formulation, members of the fiscal authority are directly involved.

## 5.2 Monetary and Fiscal Policy Coordination Committees

### 5.2.1 Fiscal Liquidity Assessment Committee (FLAC) of the CBN

The Fiscal Liquidity Assessment Committee (FLAC) was set up on April 26, 2007 following the recommendation by the International Monetary Fund (IMF) Mission on the Third Quarter Policy Support Instrument (PSI) to Nigeria. The Committee is set up to enhance effective coordination of fiscal and monetary policies through regular high level interactions between the monetary authorities and the relevant departments of the fiscal authority. This interaction is to facilitate obtaining high frequency data on fiscal operations of the Federal Government that impact on price stability.

Membership of the Committee from the fiscal side comprises representatives of Federal Ministry of Finance, Debt Management Office (DMO), Office of the Accountant- General of the Federation (OAGF), Budget Office of the Federation (BOF), Nigerian National Petroleum Corporation (NNPC), Nigeria Customs Service (NCS), Federal Inland Revenue Service (FIRS) and the Department of Petroleum Resources (DPR). From the Central Bank of Nigeria, members are drawn from the Monetary Policy Department (MPD), Financial Market Department (FMD), Branches Operations Department (BOD), Banking & Payment Systems Department (BPSD), Statistics Department (SD), and the Research Department (RD). The Committee meets once every week and has succeeded in eliciting the cooperation of relevant departments from the fiscal authority whose operations impact on domestic liquidity. It has helped to establish a platform for regular interaction with relevant Ministries, Departments and Agencies (MDAs) of government.

FLAC has developed a database on the operations of the relevant MDAs and a template for forecasting the Treasury's operations as input to the Bank's Liquidity Assessment Model.

Currently, the output of the FLAC serves as input to the Monetary Policy Implementation Committee (MPIC) and has improved interaction between the central bank and the government.

### 5.2.2 Monetary and Fiscal Policy Coordinating Committee (MFPCC) of the DMO

Besides monetary management, another main sphere of interaction between monetary and fiscal policies relates to the financing of the budget deficit and management of the public debt. The stance of monetary policy affects the capacity of the government to finance the budget deficit by changing the cost of debt service and by limiting or expanding the available sources of financing. To institutionalise public debt management in Nigeria, the Debt Management Office (DMO) was established by the Debt Management Office Act 2003, to manage the country's public debt--external and domestic. This is part of the integrated financial management of the government and is closely linked to budget execution and operations of the Federal Ministry of Finance. In addition to the establishment of the DMO, the government has constituted multi-agency advisory committees such as Monetary and Fiscal Policy Coordinating Committee (MFPCC) to clarify and harmonise the objectives of public debt strategies, fiscal and monetary policies; and to articulate and resolve possible conflicts in the implementation of debt policies and, strategies on the one hand, and monetary policies and strategies on the other.

The Committee is charged with promoting stability in the financial markets, especially the fixed income securities. The Market Planning Unit, Market Development Department of the DMO is responsible for the Monetary and Fiscal Policy Coordinating Committee activities. The members of the Committee comprise: Federal Ministry of Finance, Budget office of the Federation (BOF), Office of the Accountant-General of the Federation (OAGF), National Planning Commission (NPC), Securities & Exchange Commission (SEC), Nigerian Stock Exchange (NSE), Pension Commission (PENCOM), Federal Inland Revenue Services (FIRS), National Insurance Commission (NAICOM), National Assembly and the Central Bank of Nigeria (CBN).

The Committee meets once every two months to appraise and offer suggestions to government on the performance of the domestic economy; especially the impact of debt (domestic and external) on the Nigerian economy. This is with a view to mitigating the adverse impact of debt burden and deepening the evolving bonds market in the financial system. In furtherance of its activities, the Committee organises workshops to upscale the knowledge of members, share ideas and build confidence to enhance the dissemination of relevant data and information.

### 5.2.3 Cash Management Committee of the Federal Ministry of Finance

Closely related to the activities of the Monetary and Fiscal Policy Coordinating Committee of the DMO is the Cash Management Committee of the Federal Ministry of Finance. The Committee is responsible for the monitoring and projection of the Federal Government revenue and expenditure. The membership of the Committee comprises: OAGF, BOF, All Revenue Generating Agencies of the Government and the CBN. The Committee meets monthly to review the performance of the budget and identify the various potential sources of revenue and make essential projections to execution of the budget. The projections are made usually for three months and reviewed every month depending on domestic and global developments. The meeting also proposes borrowing avenues in the event of revenue short fall.

### 5.2.4 Others

There are other ad-hoc fora where government policies are x-rayed with suggestions and recommendations for proper articulation of policy actions. Such platforms like the Bankers' Committee conferences, National Economic Council, Federal Executive Council, Economic Management Team and Manufacturers' Associations of Nigeria, etc. equally assist in policy coordination. Although, they are not standing committees for monetary-fiscal policies coordination, they provide necessary interactions for macroeconomic policy and coordination from time to time.

## 5.3 The Treasury Single Account

The fragmented system of government cash receipts and payments through the banking system was a major weakness of the public finance management that needs to be addressed. This was the practice in Nigeria, where MDAs held multiple accounts and in some cases these accounts are dormant. The new initiative to adopt a Treasury Single Account (TSA) was proposed to the federal government by the International Monetary Fund (IMF) in 2010. The proposal was to replace the current practice where government cash management procedure were fragmented, creating opportunities for idle funds domicile in some DMBs that were unknown to the government and unnecessary recourse to borrowing by government. The TSA was to overcome these institutional deficiencies in multiple several ways. First, idle cash balances in banks accounts normally fail to earn market related remuneration. Second, the government, being unaware of these resources, incurs unnecessary borrowing cost on raising funds to cover an observed cash shortage. Third, draining this extra liquidity through the open market operations imposes a cost on the central bank. Finally, idle government cash balances in the commercial banks are never idle as it is used for several economic purposes by the banks.

The TSA implementation in Nigeria is expected to achieve the unification of all bank accounts of MDAs, eliminate floats in the system, and allow Ministry of Finance or Treasury a comprehensive coverage of all sources of revenue to the Federal Government and on real time basis. Other prospects include:

- Control and monitor funds held in single account of Federal Government
- Eliminate idle cash balances of MDAs at both CBN and DMBs due to non-utilisation

- Promote prompt payments to contractors
- Improve data base for Government financial transaction
- Promote accountability and transparency of Government transactions; and
- Prevent MDAs from unauthorised utilisation of internally generated revenue belonging to CRF.

Towards it implementation, the Federal Ministry of Finance anchored by the Office of the Accountant-General of the Federation (OAGF) in active collaboration with the Central Bank of Nigeria set up a technical committee that comprise selected MDAs with Revenue Collecting Agencies. The major stakeholders in the project included; BOF, DMO, Federal Inland Revenue Service (FIRS) and Nigeria National Petroleum Corporation (NNPC); While, the World Bank and IMF provide expertise and technical assistance for the implementation of the TSA.

To achieve the objective of the TSA, the implementation of the project was planned in phases with timelines. The first phase commenced in August 2011, with the Consolidated Revenue Fund (CRF) Account of the Federal Government linked with MDAs capital account balances to derive, a consolidated balance. The second phase commenced in January 2012. This phase consolidated balances to CRF including moving MDAs balances from commercial banks to Federal Government single account (CRF) or connected accounts in CBN. Similarly, the Government Integrated Financial Information System (GIFMIS) took off in the 3rd – 4th quarters of 2012 to support the planned TSA banking arrangement of a single account when all the transitional accounts are closed and the balance transferred to the TSA. Meanwhile, a link of Donor funds and Government controlled trust / social security funds to TSA/CRF account would be operational in 2015.

# SECTION SIX

## Challenges of Policy Coordination

Coordination of monetary and fiscal policies poses some challenges. As previously discussed, while monetary policy is mainly concerned with maintaining price stability using instruments such as the central bank's policy rate or monetary aggregates (money supply), fiscal policy is mainly focused on ensuring high growth and development using government expenditure and taxes. Since fiscal and monetary policies can work against each other, there is the need for effective coordination to ensure that they are in tandem.

In addition, the need for policy coordination arises because individual policy instruments typically have an impact on more than one policy target. Although they can help policy makers achieve a desired value for one policy target, they may disrupt the attainment of a desired value for other policy targets. For example, expansionary fiscal policy can help achieve a high rate of economic growth, but it can also make the inflation rate too high if the resulting fiscal deficits are financed by the central bank. Conversely, a tight monetary policy aimed at stabilising prices may make the rate of economic growth drop if it pushes up the interest rate too much.
Since more than one policy instrument will be needed, appropriate values of these instruments should be decided and implemented in a coordinated fashion by central banks and finance ministries. In the absence of coordination, the government may fail to attain the objective of stable and non-inflationary economic growth. Some of the challenges of policy coordination include:

### Inadequate Channels for Effective Communication between the Monetary and Fiscal Authorities

Although communication channels exist to aid coordination between the monetary and fiscal authorities, these channels sometimes do not work effectively. This could be the fault of either or both of the institutions concerned. Deliberate efforts have to be put in place to ensure that the different levels of communication channels work effectively.

### Non Adherence to Laid-down Procedures for Coordination

Failure to adhere to established procedures and guidelines for policy coordination invariably, create conflicts and distortions in policy execution. Consequently, monetary and fiscal authorities must work in unison in order not to subvert established guidelines and procedures for policy coordination. This could be regular attendance of meetings, sharing of relevant information on a timely basis, etc.

### Conflict between Policy Targets of the Monetary and Fiscal Authorities

It is not impossible for monetary and fiscal authorities to sometimes have conflicting policy targets or objectives. Usually, the fiscal authorities are mainly concerned with achieving high GDP growth, while the monetary authorities are mainly concerned about maintaining low and stable prices. For instance, government spending to achieve high GDP growth can put pressure on the economy and cause inflation.

### Lack of Well-developed Financial Markets

Financing of budget deficits in rudimentary and thin financial market may put upward pressure on the domestic cost of credit. In that situation, the central bank has less room for manoeuvre because it may want to use its monetary policy tools partly to ease this pressure on the cost of credit and, ultimately, on economic growth. Such easing, however, may risk pushing up inflation.

### Fiscal Dominance

This can be defined as a situation when fiscal policy or a large fiscal deficit of the government puts pressure on the monetary authorities to monetise debt, thereby producing rapid monetary growth and high inflation. This is a huge challenge for monetary policy effectiveness.

### Financing of Budget Deficit

The manner in which budget deficits are financed has implications for macroeconomic management. It is important that fiscal deficits are prudent and financed from windows that portend long-term sustainability and are non-inflationary.

### Varying Time Horizon of Policy Impact

It usually takes a longer time to change the fiscal stance through policy action, while monetary policy can be altered on a daily basis. Therefore, monetary policy usually bears the burden of fine-tuning the economy.

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