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**UNDERSTANDING
MONETARY POLICY SERIES
NO 20**

PRICE STABILITY IN NIGERIA

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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 a people-focused Central Bank promoting confidence in the economy and enabling an improved standard of living”

Mission Statement

“To **ENSURE** Monetary, Price and Financial System Stability as a Catalyst for Inclusive Growth and Sustainable Economic Development.”

Core Values

Integrity
Partnership
Accountability
Courage
Tenacity

MONETARY POLICY DEPARTMENT

Mandate

To Facilitate the Conceptualization and Design of
Monetary Policy of the Central Bank of Nigeria

Vision

To be Efficient and Effective in Promoting the
Attainment and Sustenance of Monetary and
Price Stability Objective of the
Central Bank of Nigeria

Mission

To Provide a Dynamic Evidence-based
Analytical Framework for the Formulation and
Implementation of Monetary Policy for
Optimal Economic Growth

FOREWORD

The Understanding Monetary Policy Series is designed to support the communication of monetary policy by the Central Bank of Nigeria (CBN). The series therefore, explain the basic concepts/operations, required to effectively understand the monetary policy framework of the Bank.

Monetary policy remains a very vague subject area to the vast majority of people in spite of the abundance of literature on the subject, most of which tend to adopt a formal and rigorous professional approach, typical of macroeconomic analysis.

In this series, public policy makers, policy analysts, businessmen, politicians, public sector administrators and other professionals, who are keen to learn the basic concepts of monetary policy and some technical aspects of central banking, would be treated to a menu of key monetary policy subject areas that will enrich their knowledge base of the key issues.

In order to achieve the primary objective of the series therefore, our target audience include people with little or no knowledge of macroeconomics and the science of central banking and yet are keen to follow the debate on monetary policy issues, and have a vision to extract beneficial information from the process. Others include those whose discussions of the central bank makes them crucial stakeholders. The series will therefore, be useful not only to policy makers, businessmen, academicians and investors, but to a wide range of people from all walks of life.

As a central bank, we hope that this series will help improve the level of literacy on monetary policy and demystify the general idea surrounding monetary policy formulation. We welcome insights from the public as we look forward to delivering contents that directly address the requirements of our readers and to ensure that the series are constantly updated, widely read and readily available to stakeholders.

Hassan Mahmud, Ph.D

*Director, Monetary Policy Department
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PRICE STABILITY IN NIGERIA¹

Oluwafemi I. Ajayi²

Abstract

This series provides a concise explanation of price stability to gain some insight into the workings of monetary policy towards the achievement of stable prices. Price stability is a condition in which the change in the general price level is very minimal such that it does not exert significant influence on the welfare of economic agents. This article thus highlights several issues including the cost of price instability, measurement, management, and challenges associated with managing price stability in Nigeria. Overall, it recognizes price stability as a desirable goal of monetary policy because it facilitates transparency in macroeconomic management, promotes an improved standard of living, reduces the inflation premium, and eliminates unnecessary hedging activities, amongst others. The article, however, acknowledges the limitations of monetary policy in achieving absolute price stability, ceteris paribus. Consequently, there is the need for complementary measures involving fiscal and structural policies to achieve an enduring environment of price stability.

Keywords: Price stability, monetary policy, inflation, Gross Domestic Product

¹This publication is not a product of vigorous empirical research. It is designed specifically as an educational material for enlightenment on the monetary policy of the Bank. Consequently, the Central Bank of Nigeria (CBN) does not take responsibility for the accuracy of the contents of this publication as it does not represent the official views or position of the Bank on the subject matter.

²**Oluwafemi I. Ajayi** is an (Assistant Economist in the Monetary Policy Department, Central Bank of Nigeria) and revised/reviewed in 2021 by **Samson O. Odeniran** (Assistant Director, Monetary Policy Department, Central Bank of Nigeria)

SECTION ONE

1.0 Introduction

Price stability refers to a condition of relatively low change in the general price level over time. In other words, the degree of fluctuation or volatility is relatively low, suggesting the absence of inflation or deflation. Price stability is important to economic agents because inflation, a condition of a general rise in prices, is normally regarded as “*theft of value*”.

A general rise in price level is undesirable for various reasons. First, it is difficult for economic agents to effectively plan and efficiently deploy their resources to achieve their immediate and future economic goals. Second, high inflation undermines the capacity of the economy to generate gains in output, income, and employment. Third, for those with fixed incomes, it erodes the value of their investment and social well-being, and lastly, it encourages speculative activities in the financial markets relative to investments that boost production. Consequently, concerted efforts must be put in place to address issues relating to inflation if an economy must experience sustainable growth and development. It is against this perspective that maintaining a low and stable price level (Price stability) has been globally considered as the core objective of monetary policy.

The Central Bank of Nigeria is tasked with ensuring monetary and price stability in Nigeria. This function is executed through the formulation and implementation of monetary policy measures in Nigeria. The Bank has continued to perform this task over the years. However, it continues to be confronted with the challenge of effectively anchoring the expectation of economic agents, among others. This article thus provides some insight into the concept of price stability and highlights measures through which it is achieved by the Central Bank of Nigeria.

The article also highlights major challenges and policy recommendations needed for achieving and sustaining price stability in the Nigerian economy. The rest of the article is organized as follows: section two highlights the concept and measurement of price changes while section three reviews the benefits of price stability; section four discusses monetary policy instruments for the achievement of price stability, while section five highlights major challenges of price stability; and section six concludes the article with some recommendations.

SECTION TWO

2.0 Measuring Price Changes

There are two indices that are commonly employed in measuring the changes in price levels and these are the GDP deflator and the Consumer Price Index.

2.1 GDP Deflator

The GDP deflator is an economy wide index which measures the change in prices of all the goods and services produced in an economy within a given period. In essence, the basket of goods and services includes all the items in the computation of Gross Domestic Product (GDP).

The GDP deflator is computed as shown in equation 1 below

$$\text{GDPD} = \text{NGDP} / \text{RGDP} \quad \dots\dots\dots (1)$$

Where

GDPD= GDP Deflator

NGDP = Nominal GDP

RGDP =Real GDP

The inflation rate is calculated from a base year (Year 1) in the past to the current period, for example, year 10. To demonstrate the computation, we assume a hypothetical economy that produces only two goods X and Y. The computation is shown in Table 2.1 below

Table 2.1: Computation of Nominal and Real GDP

Base Year (1)	Current Year (10)	Real GDP Current Year (Year 10)
40 of X @ N25/unit =N1,000	50 of X @ N30/unit = N1,500	50 of X@ N25/unit = N750
25 of Y @ N50/unit = N1,250	40 of Y @ N60/unit = N2,400	40 of Y @ N50/unit = N2,000
Total = N2,250	Total = N3,900	Total = N2,750
Nominal GDP in Year 1 Naira	Nominal GDP in Year 10 Naira	Real GDP in Year 10 using the base year is N2,750

From table 2.1, nominal GDP is the number of goods produced in the given year multiplied by the prevailing price while real GDP is the quantity of goods produced in a given year multiplied by the price in the base year.

By substituting the Nominal and real GDP into the deflator formula in equation 1 above

$$\text{GDP Deflator} = 3,900/2750 = 1.418$$

This result indicates an inflation rate of about 42 per cent between year 1 and year 10.

2.2 Consumer Price Index

The Consumer Price Index (CPI) is the official measure of change in price level in most countries including Nigeria. It entails the use of statistical techniques and economic theory to analyze sample data from field/survey to produce a weighted measure of the average change in price in the economy. It measures the average change in the price of a basket of goods and services over time consumed by people on regular basis. The sample of goods and services that are representative of an economy are put together and called a market basket, and the price of the basket is computed and compared over time. All the selected items are captured using a weighting method to determine their relevance to the entire index. To compute changes in price, data are collected across the country on a representative average consumer basket. The example of CPI computation for Nigeria in 2008 and 2009 is shown in table 2.2 below.

Table 2.2: Computation of CPI for Nigeria in 2008 and 2009

Table 1 Composite Consumer Price Index (Base November 2009 = 100)														
		All Items Index (Farm Produce + All Items Less Farm Produce)					All Items less Farm Produce (includes Processed Food)				Food (Farm Produce + Processed Food)			
		Monthly	12-Month Average	Month- on change (%)	Year-on change (%)	12-Month average change (%)	Monthly	Month- on change (%)	Year-on change (%)	12-Month average change (%)	Monthly	Month- on change (%)	Year-on change (%)	12-Month average change (%)
Weights**		1000.0					513.10				507.06			
Please note that the above weights are only expenditure weights which are still adjusted by population across 37 states. They should not be taken as the final weights in the computation of the CPI														
2008	Jan	79.1	78.8	1.4	8.6	5.5	84.4	2.1	2.5	7.9	75.5	0.5	12.6	2.9
	Feb	79.3	77.3	0.3	8.0	5.5	85.5	1.4	6.4	7.5	75.2	-0.5	8.7	3.3
	Mar	79.9	77.8	0.8	7.8	5.8	82.2	-3.9	0.5	6.8	78.2	4.1	12.4	4.2
	Apr	81.1	78.3	1.6	8.2	6.1	83.5	1.5	1.2	6.4	79.4	1.5	13.1	5.1
	May	82.7	78.9	1.9	9.7	6.5	85.7	2.7	3.3	6.3	80.8	1.7	14.7	6.1
	Jun	85.7	79.6	3.7	12.0	7.0	87.9	2.5	3.8	5.8	84.5	4.6	18.1	7.4
	Jul	87.6	80.5	2.2	14.0	7.8	89.4	1.7	4.8	5.4	88.7	2.6	20.9	9.0
	Aug	88.6	81.3	1.2	12.4	8.5	90.0	0.7	3.9	4.8	87.7	1.2	18.8	10.7
	Sep	89.6	82.2	1.1	13.0	9.2	91.3	1.4	6.9	4.5	88.5	0.8	17.1	12.3
	Oct	89.0	83.2	-0.6	14.7	10.1	90.8	-0.8	7.9	4.3	88.0	-0.5	19.2	14.0
	Nov	89.0	84.1	-0.05	14.8	10.9	90.3	-0.5	9.3	4.5	88.1	0.1	18.1	15.3
	Dec	89.7	85.1	0.8	15.1	11.6	91.2	1.0	10.4	5.1	88.6	0.6	18.0	16.1
2009	Jan	90.2	86.0	0.5	14.0	12.0	91.1	-0.1	8.0	5.5	89.5	0.9	18.4	16.5
	Feb	90.8	87.0	0.7	14.6	12.6	91.7	0.6	7.2	5.6	90.2	0.8	20.0	17.5
	Mar	91.4	87.9	0.6	14.4	13.1	92.0	0.3	11.8	6.5	90.9	0.8	16.2	17.7
	Apr	91.9	88.8	0.6	13.3	13.5	92.5	0.6	10.9	7.3	91.6	0.7	15.3	17.9
	May	93.6	89.8	1.8	13.2	13.8	94.2	1.8	9.9	7.8	93.5	2.0	15.7	17.9
	June	95.3	90.6	1.8	11.2	13.7	95.3	1.2	8.5	8.3	95.6	2.2	13.1	17.5

Source: National Bureau of Statistics

The CPI, however, has some limitations as a measure of inflation. First, the CPI lacks individual relevance because it only captures the changes in the general price level and not the rise or fall in the price of any particular good or service. Thus, the result may not fairly reflect developments in prices if the commodity that experienced a rise or fall in price does not have a significant weight in the consumer basket. Second, the CPI does not take into consideration, the substitution effect, because the computation is based on a fixed basket of commodities. In reality, however, there is always an alternative for any commodity such that a rise or fall in price can prompt consumers to seek alternatives. Third, it ignores novelty because it takes a long period of consumption of a commodity before such a commodity can be included in the consumer basket. Lastly, the CPI does not capture the effect of the change of quality because quality is difficult to measure.

2.3 Benefits of Price Stability

Price stability, as an objective of monetary policy, is desirable for several reasons as indicated below:

- i. **It facilitates improved Standard of Living:** In a general context, both inflation and deflation have severe consequences on the standard of living via a reduction in the level of investment. A stable price regime facilitates investment planning, which would translate to a higher level of employment and invariably, a higher standard of living.
- ii. **Reduction of Uncertainty about Future Price Development:** Economic agents are less worried about future development in prices under a regime of price stability. Accordingly, it is easier for firms and individuals to make the right investment and consumer decisions. It also allows people to identify changes in the price of goods and services.
- iii. **It Reduces the Inflation Premium Risk:** Price stability allows creditors to discount or ignore the inflation risk premium as compensation for the risk associated with holding nominal assets for some time. This equally enhances the efficacy of monetary policy transmission because real and nominal variables are closely aligned, thereby strengthening confidence in the economy and invariably attracting investment inflows.
- iv. **Reduces or Eliminates Unnecessary Hedging Activities:** A considerable level of resources is devoted to hedging in an environment of high and rising price levels. This, invariably, represents a shift of resources from productive uses to hedging of inflation. If the price level remains stable, these resources could be put into productive use, leading to a rise in domestic output.
- v. **It Increases the Benefit of Holding Cash:** Generally, inflation brings about high transaction costs and therefore, increases household demand for cash. In a regime of price stability, the frequency of demand for cash is reduced, hence a reduction in the transaction cost associated with the use of cash.
- vi. **Prevents Arbitrary Re-distribution of Wealth and Income:** low and stable inflation prevents substantial and arbitrary redistribution of wealth and income. Economic agents respond to the anticipated changes in price levels through portfolio rebalancing. The immediate challenge from the rebalancing process is that the weak and the vulnerable are excluded

from economic activities since they have limited possibilities and are unable to participate in the process. This process from time to time may trigger a social and political upheaval which ultimately leads to further deterioration in economic conditions.

- vii. **Enhances Financial Stability:** Price stability enhances financial stability because it helps to avert inflationary shocks. A persistent and general rise in price levels constrains the use of money as a store of value. This implies that economic agents would reduce their level of savings with financial institutions which invariably weakens the intermediation capacity of the financial system.

2.4 Disadvantages of Rising Price Level

An unstable price level is a key source of concern to economic agents and monetary authorities given the far-reaching implications on the economy. The consequences of rising price levels include the following:

- **Inflation erodes the value of money:** A rising price level reduces the real value of money because a higher nominal value of money would be required to purchase the same basket of goods and services as a result of upward shifts in market prices.
- **It redistributes income from lenders to borrowers:** High inflation favours borrowers and makes lenders worse off. Savings are generally reduced in times of high inflation, particularly when savings are not index-linked. This tends to create disincentives for savers which ultimately reduce future investment.
- **Social unrest/political instability:** High inflation increases dissatisfaction among workers, as their purchasing power is consistently eroded, thus making it difficult for them to meet their daily needs. Therefore, during periods of high inflation, workers tend to ask for a wage rise to maintain their current purchasing power. Continuous agitation for wage increases would inevitably lead to social unrest and political upheavals.
- **It causes uncertainty:** High inflation may cause greater uncertainty for both households and firms. Inflation-induced uncertainty may cause firms to delay investment decisions to observe the trend of price development.
- **It can lead to rising in unemployment:** As inflation increases, the nominal interest rate would rise to accommodate the inflation premium. This, in

essence, would reduce the level of investment and thus lead to a rise in unemployment.

2.5 Types of inflation

Inflation is of various types, depending on the cause and impact. The most common types are presented below.

1. **Creeping Inflation:** This type of inflation refers to the slow and persistent rise in the general price of goods and services over a period. It is also known as mild inflation or moderate inflation. Creeping inflation is seen as moderate inflation because it is always in single digit.
2. **Chronic Inflation:** It is a situation where a country experiences high inflation for several years or decades. It is mostly an outcome of the persistence of creeping inflation, which is due largely to the uncontrolled expansion or increase in money supply within the domestic economy. It may lead to Hyperinflation if it continues to grow for a longer period without any decline.
3. **Walking Inflation:** This is a situation where the general rise in the price of goods and services is greater than 3.0 per cent for a period. It is called walking inflation because it is greater than 3.0 per cent but less than 10 per cent during the year. Walking inflation could lead to running inflation if it is not properly monitored. Additionally, if walking inflation is not quickly nipped in the bud, it can ultimately lead to Galloping inflation.
4. **Running Inflation:** This is double-digit inflation and is considered to be between 10 to 20 per cent per annum. It refers to a situation where there is a rapid increase in the rate of change of the general price of goods and services above 10 per cent in a year. The range for measuring this type of inflation has not been fixed, but when prices rise by more than 10.0 per cent per annum, it is considered to be running inflation.
5. **Galloping Inflation:** This is a situation where inflation increases speedily and appears to persist. Another term for galloping inflation is Hyperinflation, which often occurs during economic crisis, war, and socio-political disturbance. If the general price of goods and services rise by double or triple-digit per annum it is said to be galloping inflation. Galloping inflation occurs when prices of goods and services rise by more than 20 per cent per annum. India and some Latin American countries such as Argentina and Brazil experienced galloping inflation in the 1970s and 1980s.

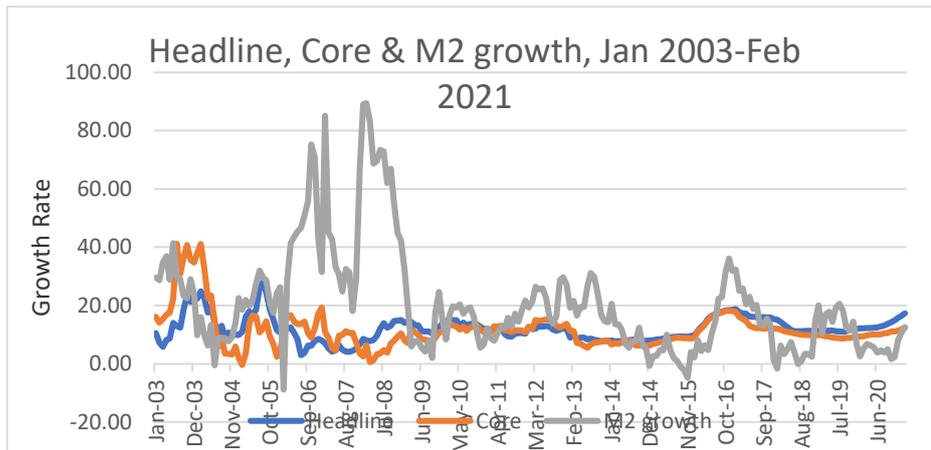
SECTION THREE

3.0 Inflation and Money Supply

Generally, the interaction of demand and supply determines the level of price in a free market economy. The demand and supply of goods and services are affected by several factors, including technology, innovation, weather, productivity, purchasing power of people, consumer preferences and the prices of goods etc. For example, in most developing countries with poor storage facilities, prices of agricultural produce decline during harvest due to increased supply and rises during off-season. The price of goods and services tends to increase during festive periods as demand tends to outstrip supply. However, changes in prices arising from seasonal factors would readjust within a short period, as some of the seasonal factors are temporary. Consequently, increase in money supply without a proportionate increase in the supply of goods and services is the primary driver of inflationary pressure. Likewise, when the supply of money is lower than available goods and services, production suffers, as there would be a reduction in demand for goods and services which might lead to slow economic growth and higher unemployment. Thus, some schools of thought have argued that inflation occurs in the long run because of the increase in money supply when compared with the level of economic activities.

The trend in money supply and inflation in Nigeria from 2003 to 2020 is presented in figure 3.1 below.

Figure 3.1: Trend in Broad Money and Headline Inflation in Nigeria (Jan. 2003-Feb. 2021)



The trend in Chart 3.1 above shows some co-movement in money supply and the two measures of inflation (headline and core inflation). There was, however, a divergence from mid-2006 up to the end of the review period as inflation remained virtually flat despite volatility in money supply. This development suggests that there may be other drivers of inflation in the Nigerian economy.

3.1 Channels of Monetary Expansion

There are two major channels of monetary expansion in an economy namely through the activities of the central bank and those of deposit money banks.

3.1.1: Money Creating Activities of Central Bank

Central banks across the globe influence the level of money supply through their liquidity management operations. The central bank could lend to the government to Deposit Money Banks (DMBs). The government runs into deficit when its revenue is less than its expenditure and the deficit is financed through borrowing. When a central bank lends money to the government or DMBs, it leads to an increase in money supply to the economy. On the other hand, loan repayment by the government to the central bank leads to a contraction money supply. In addition, when central banks purchase foreign exchange from the market, it expands the money supply. Money supply, however, shrinks when the central bank sells foreign exchange to the market. Central banks could also influence monetary expansion by the sale or purchase of treasury bills in the domestic market.

3.1.2: Money Creating Activities of Deposit Money Banks (DMBs)

Deposit Money Banks affect the volume of the money supply when they receive deposits and give credit. Most depositors only withdraw part of their deposits in the banking system, which allows DMBs to create credit with the resulting excess deposit liability at their disposal.

SECTION FOUR

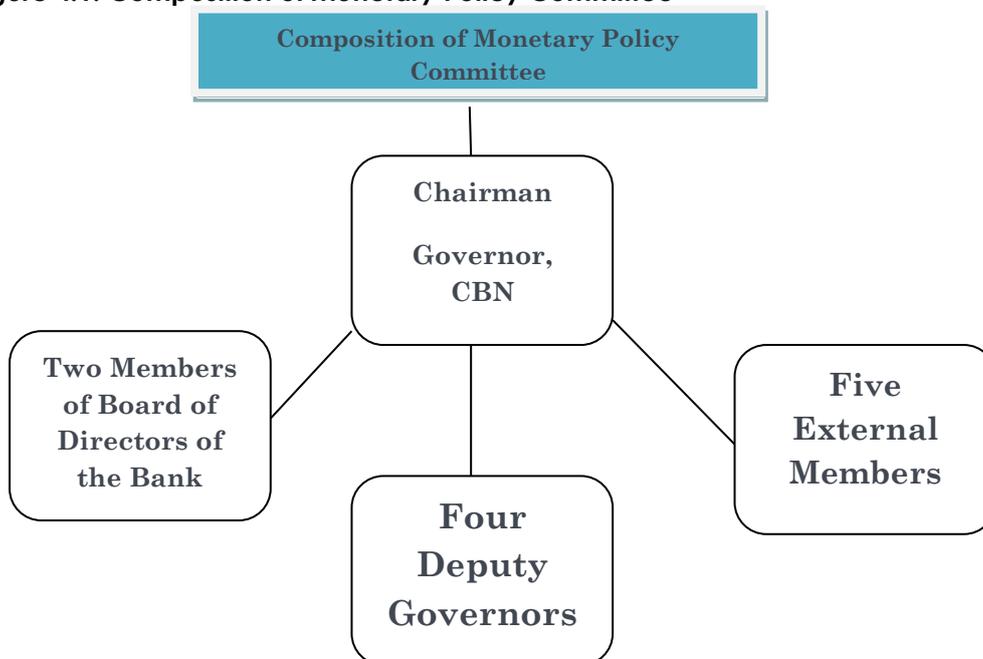
4.0 Monetary Policy and Price Stability in Nigeria

In most jurisdictions, central banks are assigned the task of ensuring price stability based on their exclusive role in the determination of the level of money supply in the economy. Central banks perform this function through the formulation and implementation of monetary policy to influence the cost and level of money supply in an economy. To achieve a stable price level, the monetary policy aims to achieve a condition where the quantity of money demanded equals the quantity of money supplied. The price at which the supply of money equals its demand is the equilibrium price level. Thus, price stability is achieved when economic agents do not hold excess or less money than required to make intended transactions.

The task of formulation and implementation of monetary policy in Nigeria is vested in the Central Bank of Nigeria (CBN) through the CBN Act of 2007. The Act provides instrument autonomy to the CBN and recognizes the Monetary Policy Committee as the body responsible for monetary policy in the Bank.

The composition of the Monetary Policy Committee of the Bank is presented in figure 4.1 below.

Figure 4.1: Composition of Monetary Policy Committee



The Monetary Policy Committee (MPC) comprises 12 (Twelve) members made up of the Governor (Chairman), the four deputy governors, two members from the Board of directors, and five external members. The Committee meets six (6) times a year on a bi-monthly basis to review macroeconomic developments in both the global and domestic economies.

4.1 Instruments of Monetary Policy in Nigeria

The instruments of monetary policy used by a particular central bank will depend on the level of development of its economy. In Nigeria, the CBN has employed both direct and indirect instruments over time.

4.1.1 Era of Direct Instruments

Direct tools were employed by the Central Bank of Nigeria from 1959 to 1993. These tools were used to influence the price of money (interest rate) as well as direct allocation of bank credit thus bypassing the market mechanism. Some of these tools are.

Credit Ceiling: Here, the CBN specifies the level of credit that banks can grant to various sectors of the economy and monitors performance regularly. In addition, the various sectors are classified into preferred and less preferred in determining the level of credit allocation.

Interest Rate Control: The regulatory authority specifies the maximum lending rate for the various sectors of the economy. Similarly, the interest floor and cap on various categories of deposits are specified, implying that the interest spread is equally fixed.

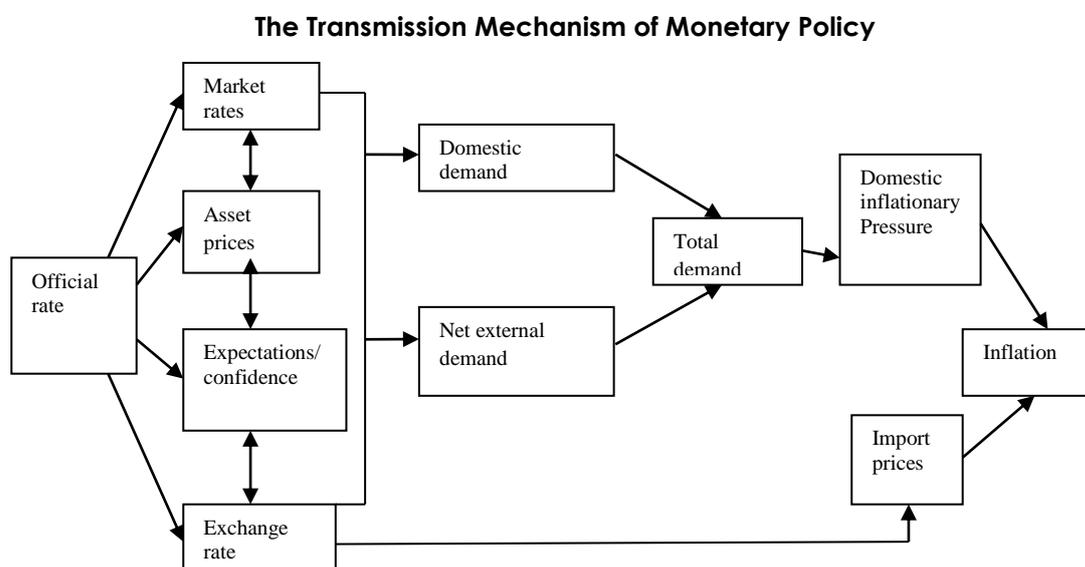
Movement of Government Deposit: The regulatory authority could give directives on movements of public sector deposits to influence liquidity conditions in the economy.

4.1.2 Indirect Instruments

As the financial markets deepened over time following economy-wide macroeconomic reforms that commenced in the mid-1980s, the CBN started the process of shifting from the use of direct instruments to market-based instruments. The most significant move in the new direction came in June 1993 when the Bank introduced OMO. Currently, OMO is the major instrument of monetary policy implementation at the CBN. Other supporting instruments are the discount window operations, moral suasion, forex sales, and the standing facilities windows.

The indirect instruments are discussed below.

- i. **Open Market Operations and Price:** The CBN can influence the level of the money supply through its Open Market Operations (OMOs). Through these operations, the Bank buys or sells money market securities to influence the growth rate of the money supply. The securities that are frequently used in OMO operations include Central Bank of Nigeria bills and Nigerian Treasury Bills. Thus, if the CBN intends to moderate the rate of price increases, it would sell one or a combination of the above-listed securities to reduce the money supply and vice versa.
- ii. **Discount Window Operations:** The central bank's discount window comprises the floor, also known as the Standing Deposit Facility (SDF), and the ceiling, also known as the Standing Lending Facility (SLF). The central bank's policy rate, also known as the Monetary Policy Rate (MPR), sits between the floor and the ceiling of the discount corridor. The central bank performs its lender of last resort function at the SLF window, where banks can borrow overnight to shore up their closing balance. On the other hand, banks with excess liquidity can deposit overnight with the CBN at the SDF window. Money market rates are expected to fluctuate between the SDF and MPR to encourage an active interbank credit market and minimise volatility in market rates.
- iii. **Moral Suasion:** This is a strategy used by the Central Bank to persuade deposit money banks to follow the direction of a given policy such as an expansion of credit or increase mobilization of savings to support growth.
- iv. **Reserve Requirement:** This is a situation where the Central Bank may require DMBs to hold a fraction of their deposit liabilities with the Central Bank. This reserve requirement limits the number of loans that banks can make to the domestic economy and thus limit the supply of money.
- v. **Interest Rate:** The CBN uses the policy rate (MPR), to lend money to financially sound DMBs at a most favorable rate. The policy rate serves as the nominal anchor rate that gives direction to the money market, thus affecting the supply of money and monetary aggregate and full employment as well as the GDP.



Source: Central Bank of Nigeria

The key objective of monetary policy as earlier mentioned is price stability, which is regarded as the ultimate target. To achieve the ultimate target, policy implementation passes through operational and intermediate targets and sometimes with a lag. The monetary policy transmission mechanism, therefore, is the process through which changes made by the monetary authority (central bank), affect the general price level in the economy. Monetary policy actions are transmitted to the economy through the following channels:

- (i) **The interest rate channel:** under this channel, the Bank influences aggregate demand through an adjustment of its policy rate a signal to market and retail rates to follow suit. An upward adjustment in the policy rate constrains aggregate demand, while a downward adjustment boosts aggregate demand.
- (ii) **The credit channel:** under this channel, central banks influence the volume of credit allocated by banks to economic agents through its policy actions or moral suasion.
- (iii) **The exchange rate channel:** this channel involves the adjustment of the policy rate in an open economy to achieve a change in money supply, thereby leading to a change in the exchange rate. An upward adjustment in the policy rate will lead to a contraction in the money supply, and thus an appreciation of the exchange rate.

(iv) The wealth channel: this channel describes the process through which monetary policy changes affect the interest rate, which in turn influence asset value such as bonds, stocks, and real estate.

Most central banks place greater emphasis on the interest rate and credit channels as the most effective channel of transmitting monetary policy.

SECTION FIVE

5.0 Challenges to Achieving Price Stability in Nigeria

Price stability in Nigeria is confronted with several challenges as discussed below:

- (i) **Fiscal imbalance:** This is a situation where government revenues do not match its expenditure. In such a circumstance, the government may resort to central bank financing of its deficit, which could cause structural inflation.
- (ii) **Extraordinary Liquidity Crisis.** The central bank as a lender of last resort is meant to supply liquidity in times of financial distress in the economy. The central bank intervention would be appropriate to stem the financial crisis, but the level of intervention in question may have long-term consequences on inflation expectations.
- (iii) **Unpredictable Medium-Term Fiscal Strategy:** Another major challenge of monetary policy is the unpredictability of the medium-term expenditure and revenue of the three-year frameworks, normally employed by the Government. The estimated revenue from oil determines the size of the budget, and Government may resort to the banking system to meet its financing needs if the expected revenue is affected by an external price shock.
- (iv) **Lack of Clear Understanding of the Concept of Price Stability:** The term price stability is ambiguous in most jurisdictions, making it difficult for economic agents to key into various measures that could moderate rising price levels. It is generally recognized that a certain degree of price increase (inflation) is required to stimulate the production of goods and services.
- (v) **Credibility of Central Banks:** In an environment where central banks have a pedigree for policy inconsistency, anchoring inflation expectation becomes difficult. This, invariably, would affect inflation expectations, which is a key driver of actual inflation performance.
- (vi) **Structural Issues:** The instruments at the disposal of the monetary authorities are largely for managing the demand side of the economy but it is increasingly being recognised that supply-side issues play a significant role in price development in many economies. The achievement of price stability through measures taken by central banks would largely remain

elusive in as much as supply-side issues continue to play a dominant role in price evolution.

- (vii) **Weak Transmission of Monetary Policy:** The transmission mechanism of monetary policy is weak in many climes due to several factors including the inadequacy of monetary policy instruments, the dominant role of the informal sector, oligopolistic financial structure, excess banking system reserve, and poor financial market infrastructure, among others.

SECTION SIX

6.0 Conclusion

The monetary policy objective of price stability has several benefits in contrast to the adverse social, economic, and political costs of high inflation. Too much money chasing too few goods is the key reason for upward inflationary pressure in most economies. Other factors that may contribute to upward inflationary pressure include structural issues such as poor power supply, poor transportation networks, and insecurity. In addition, excess liquidity in the banking system and fiscal imbalances continue to pose a challenge to price stability. Despite these challenges, there are concerted efforts through efficient liquidity management strategies, improved coordination between the fiscal and monetary authorities, and strengthening of the banking system towards achieving price stability.

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