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Indirect monetary control in Nigeria: problems and prospects

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INDIRECT MONETARY 'CONTROL IN NIGERIA: PROBLEMS AND PROSPECTS

(Being the text of a speech delivered at the 1991 Annual Dinner of the Chartered Institute of Bankers of Nigeria at L'Hotel Eko Meridien, Victoria Island, Lagos on 8th November, 1991)

I feel greatly honoured to be invited once again as Guest Speaker on the occasion of our Annual Dinner. Tonight, I wish to up-date you on the current status of the proposal by the Federal Government to shift the technique of monetary and credit management from the imposition of credit ceilings on banks to one which relies on the use of market-based instruments, that is, what is commonly referred to as 'indirect monetary control'.

Efforts so far made to deregulate the Nigerian economy under the Structural Adjustment Programme (SAP) introduced in 1986 have significantly influenced developments in the financial sector. Deregulation of the financial sector has taken the forms of simplification of the format for sectoral credit allocation, decontrol of bank deposit and lending rates, introduction of the auction system for dealing in treasury instruments and liberalization of procedures for establishing new banks. The next logical step in the process of financial deregulation is one under which the cost and availability of credit are determined through the financial markets. This step is the indirect approach to monetary control as against the direct approach which relies on the imposition of credit ceilings on banks by the monetary authorities.

You may recall that the Federal Government in its 1991 Budget Statement had indicated that the technique of monetary management would shift to the use of indirect monetary policy instruments during the year. However, Government did recognize the existence of many problems which should be tackled before the introduction of the new approach. While some measure of success has been achieved in the efforts to solve a number of the problems, the outstanding ones have precluded the introduction of the new technique within the time-frame originally envisaged.

I. SOME ELEMENTS OF THE INDIRECT APPROACH TO MONETARY CONTROL

Distinguished Ladies and Gentlemen, I wish at the outset, to highlight some of the elements of the indirect approach to monetary control in order to bring this address into proper perspective. Indirect approach to monetary control involves the use of reserve requirements, open market operations, the discount rate, etc in the financial markets to control the cost and availability of bank credit. It is thus different from the direct approach whereby credit control is directly achieved through the imposition of credit ceilings on banks by the monetary authorities without going through the financial markets. One of the tools of this approach is the cash reserve requirement which obliges banks to hold a specified proportion of their deposit liabilities as cash deposits with the Cenfral Bank, while another important instrument, Open Market Operations (OMO) involves the adjustment of banks' cash reserves the money creation ability through transactions in securities by the Central Bank. The third instrument, the discount rate, is at the disposal of the Central Bank for influencing the cost and the level of the Bank's credit to the banking system with a view to keeping its monetary base on set targets.

In the proposed indirect approach to monetary control, the permissible banking system credit to the economy would continue to be determined by the Central Bank but mainly for monitoring purposes. The CBN will primarily monitor the movement of its monetary base, defined as the sum of its net credit to government and the private sector, net foreign assets and other assets (net). The monetary base is held by banks as reserves and by the non-bank public as currency. The rationale for controlling the monetary base hinges on the principle that money creation by banks depends crucially on the monetary base itself.

I do not need to tell you that the movement towards indirect monetary control involves some preparatory efforts to improve the financial environment. In reality, it means building a financial system which will be more responsive to the needs of lenders and borrowers, and for monetary control purposes. This will require substantial improvements in the macroeconomic, legal and regulatory environment. As a developing economy which has been subjected to too many stringent controls in the past, it will also require broadening the range and improving the efficiency of the financial institutions and markets. In the main, the preparatory activities necessary for the take-off of the indirect approach to monetary control will focus on removing or reducing to the barest minimum the main obstacles which include excess liquidity, uncoordinated fiscal and monetary policies, the existence of insolvent banks, leakages due to the absence of effective monitoring of non-bank financial institutions, the absence of a virile secondary market for treasury securities, the poor data base, inadequate legal framework etc.

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II. PRESENT STATUS OF THE MOVEMENT TOWARDS INDIRECT MONETARY CONTROL

The CBN has made attempts to resolve some of the above-stated problems in recognition of the need to ensure a successful and smooth transition to the new techniques. The Bank has conducted studies with a view to enhancing its implementation capacity for the indirect monetary and credit control. As a result of the insight gained, monetary policy has been structured to facilitate the shift in policy. At the beginning of my speech, I mentioned a few of the structural changes already put in place. Other changes of particular interest to banks include the introduction of the prudential guidelines, the establishment of the Nigerian

Deposit Insurance Corporation, the requirement of higher capital base for banks, the promulgation of CBN Decree (No. 24) and the Banks and Other Financial Institutions Decree (No. 25) of 1991. The CBN has also issued guidelines for the operation of finance companies in Nigeria. Meanwhile, strenuous efforts are being made to enhance CBN's regulatory and supervisory capacity.

Further steps taken to ensure a favourable environment for the introduction of the new techniques include, first, the efforts made by the CBN to contain the excess liquidity of the banking system through the issuance of stabilization securities since August 1990. Although stabilisation securities are not intended to be a permanent feature of the management of monetary policy, efforts are being made, on the basis of the findings of a recent study undertaken by the Bank, to enhance its effectiveness and minimise its unintended side-effects.

Another step taken to improve the financial environment is the identification of technically insolvent banks and the design of cost-effective options for dealing with them. Considerable effort has been made in this respect and more progress is expected in the light of the enhanced legal provision for dealing with problem banks. Also, as a means of developing a secondary market for government debt instruments with a view to reducing government dependence on CBN financing, discount houses have been identified as a necessary institution in the nation's financial system. Their primary role will be to intermediate funds among financial institutions as well as promote the market for government securities. The preparation of guidelines by the CBN for the operation of discount houses in Nigeria has reached an advanced stage and the guidelines would be issued before the end of this year. Finally, some efforts have been made to improve the quality and timeliness of financial data. Time series data on financial and economic variables which may be useful in the projection of some key variables, have been compiled. The Bank has established a machinery for up-dating the series as soon as information is made available by banks and other agencies. Availability of data on a current and regular basis will definitely enhance the Bank's efficiency in of implementing the new approach.

While some satisfactory results have been achieved in the process of tackling some of the problems hindering the implementation of the new approach to monetary management, a lot still remains to be done. Important problems which could adversely affect policy achievements include the prevalence of excess liquidity in banks and lack of co-ordination between fiscal and monetary policies. Some of these problems are already receiving the attention of Government.

III. CONCLUDING REMARKS

Distinguished Ladies and Gentlemen, I have explained in a simplified manner what the indirect approach to monetary control means and involves. I have also discussed its instruments and modalities as well as the pre-conditions for its introduction in Nigeria. The state of preparedness for the introduction of the new approach to monetary management has also been reviewed. It may be concluded that the weight of the problems outstanding and the current status of some of those already addressed do not indicate immediate shift to the new approach to monetary control much as it may be a desirable goal. A lot of caution is called for and the situation requires careful and continuous review

Consequently, the strategy to be adopted for achieving macroeconomic policy objectives would continue to rely on the existing instruments. The use of market-based instruments for monetary management will evolve, I hope in the very near future, when the environment becomes more conducive. However, when the shift in policy is deemed suitable, members of the banking community will be informed. Meanwhile, I wish to appeal for more co-operation to ensure greater success in the implementation of this important financial policy reform, realizing the objective is to bring about an overall improvement in economic performance. Of particular importance is the role of banks in the conduct of open market operations. The CBN, in its attempt to achieve a target level of the monetary base will, on regular basis, either purchase or sell treasury and other relevant instruments. The response by banks to such transactions is crucial for attaining the desired target. In this connection, the current attitude of banks to the taking up of newly issued treasury instruments needs substantial improvement as we move into the use of market-based monetary instruments. It is, of course, recognised that the ultimate solution lies in attractive market-based rates for such instruments.

If sound financial practices and higher level of confidence could be engendered in the financial system as intended by the guidelines, the economy will ultimately benefit but the primary beneficiaries are the banks themselves

Another important area where the cooperation of banks is also needed is in the implementation of the prudential guidelines. The reasons of issuing the guidelines are obvious and generally accepted. If sound financial practices and higher level of confidence could be engendered in the financial system as intended by the guidelines, the economy will ultimately benefit, but the primary beneficiaries are the banks themselves. Moreover, it is well for banks to realize that their continued survival under the regime of indirect monetary control depends on adequate provisioning for non-performing credits as well as a more responsible and professional approach to bank lending.

The successful implementation of the indirect approach to monetary control requires prompt and regular availability of reliable statistical data. The returns rendered by banks either fortnightly, monthly, quarterly or annually have been the primary sources for the compilation of such data. Banks should therefore cooperate with the authorities and ensure a hitch-free implementation of the new approach by rendering their returns accurately and promptly. They should also intensify the implementation of their computerization programmes with a view to deriving the advantages of quick data access, compilation and dissemination.

Finally, I wish to touch on the issue of interest rates charged by banks. Whether an economic system is controlled or deregulated, equity, justice and efficiency in resource allocation demand that the prices of goods and services should be related to the cost of producing them. Similarly, whether the technique of monetary management is direct or indirect, bank lending rates should be related to the banks' cost of funds in order to achieve efficiency in the allocation of financial resources. Moreover, it is desirable for the spreads between deposit and lending rates to be reasonable and should generally reflect average returns to investment in other economic sectors.

Distinguished Colleagues, Ladies and Gentlemen, I have deliberately kept my address short, avoiding detailed exposition of the subject, in order not to unduly task your patience after this sumptuous dinner. I hope, in the near future, to circulate to you a more comprehensive material on the subject I have touched upon this evening in order to enhance your appreciation of the issues involved.

I thank you for your kind attention.

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that the open-door policy of this government still continues and that we will welcome any useful ideas and suggestions that could lead to the better management of our economy. And, as in the past, we will also welcome constructive criticisms.

Members of the Armed Forces Ruling Council, Honourable Ministers, Co-Directors, Distinguished Ladies and Gentlemen, I thank you for again providing me with the opportunity to address this partnership.

I wish you all, a very happy and prosperous New Year.