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The Role of The Central Bank of Nigeria in Monetary and Banking Policy Measures*

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The establishment of the Central Bank of Nigeria (CBN) was motivated by the need to have an appropriate financial environment for development. When it was established it was charged specifically with the responsibility of contributing to growth and development through the provision of financial services. Although the law establishing it has undergone some changes over the years, the immediate functions for its establishment remain the same.

They include the issuance of legal tender currency, maintenance and management of external reserves, promotion of monetary stability and sound financial structure, provision of banking services to banks, and acting as banker and adviser to the government. Backed by its legal powers and in response to the macroeconomic environment, the CBN evolved monetary and banking policy measures over the years to discharge its statutory and non-statutory functions.

The objective of this paper is to examine the various monetary and banking policy measures which the CBN had applied both in the past and now in carrying out its functions and the role banking legislation plays in this regard. To this end, the paper is organised in four parts. Part I examines the legal and macroeconomic environment in which the Bank discharges its responsibilities. Part II reviews the measures taken by the CBN over the years in performing its functions while Part III identifies the problems which constrains CBN's performance, the external influences which cause or aggravate these problems and the role which banking legislation could play in resolving them. Part IV provides the summary and conclusion.

I. LEGAL AND MACROECONOMIC ENVIRONMENT

The role of a Central Bank is better understood in the context of the economy in which it operates. Consequently, a review of the CBN's legal framework and macroeconomic setting would enhance our understanding of the role of the Bank in the Nigerian economy.

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* Being the text of a paper presented by the CBN Governor at the Inaugural ceremony of the House Committee on Banking and Currency on 10th November, 1993 at Nicon Noga Hilton Hotel, Abuja.

Legal Framework

The main source of the legal authority of the CBN in discharging its responsibilities is the Central Bank of Nigeria Decree No. 24 of 1991 which supersedes the Central Bank of Nigeria Act of 1958 and its amendments. The Decree, like the repealed Act, states the basic or immediate objectives of the Bank, as highlighted earlier, which are designed to develop the financial sector and thereby enhance the growth and development and stability of the economy. The new CBN Decree has strengthened the powers of the Bank as the agency of the government charged with the responsibility for maintaining monetary stability and sound financial structure.

Furthermore, the Decree makes the Bank subject only to the authority of the President of the Federal Republic of Nigeria in contrast to the previous arrangement by which CBN had to report to the President through the Ministry of Finance.

The second major source of the CBN's legal authority is the Banks and Other Financial Institutions (BOFI) Decree 1991 which replaced the Banking Decree of 1969 and its subsequent amendments. The current Decree, like the repealed counterpart, is designed to provide effective regulation of financial institutions. The CBN and the BOFI Decrees, with the relevant statutes and occasional directives from the regulatory authorities, provide part of the environment which has influenced the pattern and direction of Central Bank policy measures. The other part is dictated by macroeconomic policies and developments.

Macroeconomic Environment

For a better appreciation of CBN's policy measures, it is necessary to note the structural changes in the economy. As you are aware, following the discovery of oil in the late 1950's and its commercial and large-scale exploitation, especially since the early 1970's, agriculture lost its leading position to the mining sector. Endowed with resources derived from crude oil, the government became the prime mover of the economy as it adopted the strategy of massive intervention in the economy and the production of goods and services.

When oil revenue and hence government revenue fell following the collapse of world oil prices during the world-wide recession in the early 1980's the reaction of the government was to tighten the existing austerity measures — stringent trade and exchange controls and regulation of the financial sector. In line with that policy regime of controls, the CBN relied mainly on direct controls to carry out its functions. However, with the adoption of the SAP in 1986 which emphasised greater reliance on market forces in macroeconomic management, CBN's approach to the conduct of monetary policy was modified to reflect the deregulatory stance.

II. POLICY MEASURES OF THE CBN

Despite the similarity of the objectives of CBN's policy measures prior to and since the SAP, the Bank's strategy for achieving the objectives has changed over the years to reflect the overall policy stance and direction of the economy.

CBN's Pre-SAP Policy Measures

As indicated earlier, in line with the stance of overall economic policy prior to the SAP, the CBN relied on direct controls to carry out its statutory and non-statutory responsibilities of contributing to economic growth and development through the development of the financial sector. The policy measures adopted by the CBN prior to the SAP to tackle these responsibilities could be grouped into two, namely, domestic monetary and banking policy and external sector policy.

Monetary and Banking Policy

Monetary and banking policy has been designed to foster macroeconomic stability and a sound financial structure. In the Pre-SAP period, there was a vast arsenal of instruments for the execution of monetary and banking policy which included the following: cash reserve requirement, liquidity ratio, special deposit, stabilization securities, direct regulation of interest rates, direct credit controls, moral suasion and general directives. Furthermore, the CBN adopted a policy of influencing the developmental process by promoting money and capital markets, development banks and related institutions and schemes.

External Sector Policy

In line with the government policy which favoured stringent trade and exchange controls in order to keep prices of goods at affordable levels, the CBN pursued the policy of administratively fixing the exchange rate, thereby shielding it from market forces. At the same time, the Bank sought to maintain adequate volume of external reserves to preserve the international value of the domestic currency.

The fixing of the exchange rate resulted in the fostering of imports and import dependency while penalizing domestic production. Consequently, imports increased excessively, payment arrears accumulated and non-oil exports declined.

CBN's Policy Measures and Strategies Since the SAP

With the adoption of the economic reform package under the aegis of the SAP by the government, the direction of the CBN policies and measures increasingly reflected the deregulatory stance of the package. Consequently, the CBN started to rely more on market forces in the design and implementation of its monetary, banking and external sector policies.

(a) Monetary and Financial Sector Management

The main objectives of policy since the inception of the SAP were: moderation of inflation; increased domestic savings and efficient resource allocation; improved capital inflow; increased local production and employment; increased earnings from non-oil exports; enhanced external reserves; and stable naira exchange rate.

To achieve the broad objectives highlighted above, a number of policy instruments or measures were adopted. These measures could be grouped broadly into three, namely: credit, interest rate, and other financial sector policies.

(i) *Credit Policy Measures*

Credit ceiling, a major instrument of monetary policy prior to the SAP, remained important under the SAP until September 1992 when it was lifted for banks whose performances were considered sound. To maintain an appropriate monetary growth which would ensure stability in both the domestic and external sectors of the economy, credit ceiling was adjusted to deal with perceived excessive or deficient credit in the system as deemed necessary.

In addition to credit control through credit ceiling, indirect measures to reduce the ability of banks to extend new loans included the recall of naira counterpart of outstanding payment arrears from banks to the Central Bank of Nigeria in 1987, mopping up excess liquidity by the re-introduction and modification of stabilization securities since October 1990, increase in commercial banks' cash ratio in 1989 and 1990 and the introduction of cash ratio for merchant banks in 1990. Furthermore, within the context of economic liberation, the sectoral credit guidelines were reformed to give banks the much needed flexibility in their credit operations. Effective September 1992, indirect methods of credit and monetary control received a boost with the selective lifting of credit ceilings for banks which had met the performance criteria. In June 1993, Open Market Operations (OMO), designed for the conduct of indirect monetary and credit policy, commenced in a modest way. Experience from the first eleven sessions of OMO shows that the treasury securities sold out of Central Bank portfolio were consistently over-subscribed, and there had been less reliance on the use of stabilisation securities.

(ii) *Interest Rate Measures*

Interest rate management under the SAP departed radically from the pattern of the past when interest rates were administratively fixed. The policy based on market forces was necessitated by the need to promote competition in the finance industry as well as enhance efficient resource allocation. In August 1987, all controls on bank deposit and lending rates were abolished while the CBN continued to fix the rediscount rate to indicate the direction of interest rate changes. After the re-introduction of some forms of control in January, 1991, all controls on deposit and lending rates were abolished in 1992. However, banks were enjoined to observe a maximum of 5 percentage points between their average cost of funds and their maximum lending rates merely as a performance criterion.

(iii) *Other Financial Sector Measures*

In line with measures taken by the government to encourage the growth of banks and other financial institutions, the CBN stepped up its traditional and developmental functions and set in motion measures to reorganise the sector so that it could play its role under a deregulated economy. Efforts made to strengthen the system include: raising of the capital base of banks; improving the structure of regulation and supervision; adoption of mandatory uniform accounting standards and prudential guidelines; identification of ailing banks and adopting a programme for the resolution of their problems; adoption of the auction system for issuing treasury securities; and the establishment of discount houses.

(b) Foreign Exchange Management

CBN's foreign exchange management policy seeks to maintain adequate level of foreign exchange reserves and an appropriate naira exchange rate consistent with allocative efficiency. Under the deregulatory stance of the SAP, the Bank's determination of the naira exchange rate has been subjected to market factors. In this connection, there had been experimentation with several techniques of conducting the foreign exchange market between 1987 and 1992 to facilitate the achievement of policy objectives. Eventually, on March 5, 1992, the policy of complete deregulation of the FEM was announced in response to the emergence of a large parallel market premium and abuses by many operators. Consequently, the existing foreign exchange system was to be replaced by an inter-bank foreign exchange market where authorised dealers and the CBN were expected to buy and sell foreign exchange. The role of the CBN was mainly to intervene to sell or buy foreign exchange in order to stabilise the existing rate. The new policy was not fully implemented because of the continued depreciation of the naira exchange rate as the supply of foreign exchange continued to lag behind demand. The factors which militated against Central Bank measures are considered in the next section along with other constraints to policy.

III. CONSTRAINTS TO THE CENTRAL BANK'S PERFORMANCE

In spite of some gains made through CBN's role in Nigeria's recent economic reforms, the desired objectives, such as stability and rapid growth with minimal unemployment, are still elusive because of a number of constraints. These are reviewed briefly.

(a) Rapid Growth in Liquidity

Rapid growth in liquidity has impacted adversely on the naira exchange rate and domestic price level. Although excess liquidity during the period is linked immediately with the monetisation of foreign exchange and rapid growth in aggregate credit, the real problems are those factors which influence these monetary aggregates. The greatest problem in this respect is the financing of large government deficits by the CBN.

(b) High Interest Rates

Another problem is the prevailing high interest rate regime. Although interest rate deregulation has stimulated competition and efficiency in resources allocation thereby paving the way for indirect monetary control, it has nevertheless encouraged high lending rates which are detrimental to investment in fixed plant and equipment and therefore anti-growth. The high lending rates could have been lower than the current level but for the oligopolistic structure which permits a few banks to act as the prime suppliers of funds to the market. The rise in the number of insolvent banks has worsened the situation because such banks had engaged in distress (desperate) borrowing at phenomenally high rates in order to stay afloat.

(c) Financing of Federal Government Deficits by the CBN

The greatest problem which has severely constrained the effectiveness of monetary and banking policies in Nigeria in the last few years has been the persistence of large government deficits and its mandatory financing by the CBN. The financing of government deficits by the CBN increases the monetary base and the level of excess liquidity of the banking system. A related problem is the mandatory role of the CBN in the underwriting of primary issues of government securities thereby constraining the CBN's ability to regulate reserves.

(d) Exchange Rate Depreciation and Inadequate Inflow of Foreign Exchange

The fall in the value of the naira exchange rate over the years has been a source of serious concern. Despite the reforms so far, the naira exchange rate has remained unstable and therefore not conducive to planning. Besides, the margin between the official market and parallel market rates, which was narrowed by the 5th March, 1992 exchange rate action, has since widened substantially while the inflow of foreign exchange has remained inadequate. This state of affairs may continue as long as the constraints to inflow remain while expansionary influences on domestic liquidity persist.

(e) Legal Constraints

One of the major problems of the CBN in discharging its responsibilities is the inadequacy of legal provisions. For example, despite the fact that insolvent banks were identified before 1990, it was only in 1991 that the law was amended to give the CBN some of the necessary authority to deal with such banks. Similarly, although it is generally accepted that the Central Bank would function more effectively (especially in the pursuit of an anti-inflation mandate) if granted full independence subject only to the country's National Assembly, no legislative initiative has been taken in that direction. Since monetary and banking policies and measures are dynamic in nature, the enabling legal environment should also be responsive to emerging needs and circumstances.

(f) Other Constraints

A number of other constraints for which considerable progress had been made to resolve are scarcity of professional staff, data constraint, inadequate computerisation, and undeveloped integrated electronic information system.

IV. SUMMARY AND CONCLUSION

This paper has reviewed CBN's efforts within the broad context of economic management. To that end, the paper had reviewed the background, stance, objectives and problems of monetary policy measures before the SAP in 1986 and the need to change the stance of policies following the adoption of the SAP by the government. The efforts made by the CBN to align its policies were examined next, with particular reference to monetary, financial and external sector policies. Finally, it was noted that some constraints had continued to bedevil the conduct of monetary policy and undermine its effectiveness.

In conclusion it would be appropriate to say that the prospect of the CBN's policies and measures would depend largely on: ability to deal with the constraints to effective domestic liquidity management, especially the mandatory financing of fiscal deficits by the CBN; success in shifting the underwriting of government debt instruments to the private sector; prompt response in legislation to support desirable changes in money and banking policies; success in measures being taken to stimulate competition in the supply of funds to the money market and to resolve the problems of insolvent banks; and the speed with which the inadequacies in money and banking infrastructure are addressed.