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A REVIEW AND APPRAISAL OF THE MONETARY AND OTHER FINANCIAL POLICIES IN THE FEDERAL GOVERNMENT BUDGET FOR 1997*

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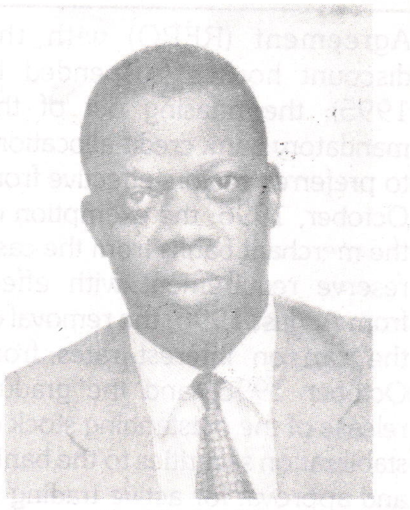
INTRODUCTION

Monetary management has been quite successful in Nigeria in the last two years (1995/1996). This was mainly because virtually all key macroeconomic policies have moved together in the same direction. This has, to a large extent, supported the contention of the monetary authorities in the past decade or so that when monetary policy is appropriately complemented by other policies such as fiscal and external sector policies, a large measure of macroeconomic stability can be achieved. However, recent developments in the economy appear to indicate that more challenges are facing monetary policy if macroeconomic stability is to be enhanced and sustained. With the benefit of hindsight, the recent action to liberalise the interest rate regime and eliminate direct credit controls is still creating some doubt in the minds of economic operators. Many observers fear that interest rates might once more rise to unprecedented levels as happened in the past when total deregulation was adopted. In addition, the buoyant liquidity situation in the economy at a time when the pace of productive activities has not picked up sufficiently is sending the signal that stabilization efforts cannot be relaxed. It is against this background that the monetary and other financial policies recently announced for fiscal 1997 have to be evaluated. Specifically, this paper should be able to provide an answer to the question: can monetary policy cope with the seemingly increasing challenge of stabilization and growth of the Nigerian economy?

In order to provide an appropriate background to the central focus of the paper which is to review and appraise the 1997 monetary policy package, an attempt is made in the second section of the paper to analyse the recent financial and economic conditions in the Nigerian economy after which the basis and elements of the monetary programme for 1997 are outlined in section three. Section four contains an articulation of some implementation modalities for the 1997 monetary programme. The final Section summarises and concludes the paper.



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2. A REVIEW AND APPRAISAL OF FINANCIAL AND ECONOMIC CONDITIONS IN 1996

The 1996 Federal Government Budget was one of fiscal consolidation designed to build on the modest gains achieved in 1995. The Budget sought to raise real output growth rate from 2.2% to 5.0%; reduce the rate of inflation from 72.8% to 30%; and maintain a more favourable balance of payments position. A tight monetary policy regime was designed to be complemented by a prudent fiscal stance so as to moderate inflationary pressures, strengthen external sector performance, stabilize the naira exchange rate and enhance output growth. Open Market Operations (OMO) continued to be the principal instrument of monetary management supported by the use of the rediscount rate and statutory reserve requirements. Specific monetary policy initiatives included the restoration of the Repurchase

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Agreement (REPO) with the discount houses (suspended in 1995); the phasing out of the mandatory bank credit allocations to preferred sectors effective from October, 1996; the exemption of the merchant banks from the cash reserve requirement with effect from August 1996; the removal of the cap on interest rates from October 1996; and the gradual release of the outstanding stock of stabilization securities to the banks and approval for active trading in the outstanding balances of such securities held by the banks in the inter-bank market.

The monetary and financial conditions in 1996 emanating from policy implementation and associated developments were characterised by relatively modest growth in monetary aggregates for the second consecutive year, general compliance by banks with regard to the maximum lending rate policy prescription, some reduction in the pressures on the balance of payments position, stability in the naira exchange rate, a lower inflation rate and modest growth in real output. The statistical evidence is quite revealing. Provisional data showed that M1 grew by 28.6% in 1996 compared with the target of 14.5%, while M2 increased by 29.8% as against the target of 16.8% (Table 1). The higher monetary growth in 1996 was caused by the expansionary tendency in the last four months of the year, but on an average basis, monetary growth in 1996 and 1995 were significantly more tolerable than in the previous four years. The major expansionary factors influencing money supply were the increases in net domestic credit and net foreign assets of the banking system. Total net domestic credit increased by 12.0% compared with the target of 12.0%. While credit to the government sector increased by 16.9% (0.0% was anticipated), private sector demand for credit increased by 20.1% much less than the 29.5% anticipated.

Interest rates were generally within the stipulated maximum. Most deposit rates moved up, while lending rates declined in many cases. As in the past, OMO was conducted by the CBN in the secondary market for treasury bills through transactions in the securities with the discount houses as principal dealers. The volume of transactions (sales) increased substantially from N158.2 billion in 1995 to N234.8 billion in 1996. The strong demand for short-dated treasury bills was attributable to a number of factors, including the slow growth in private sector borrowing from the banking system partly due to the lull in economic activities and partly to the cap on lending rates for the greater part of the year; the shortage of alternative money market assets following the conversion of all treasury certificates outstanding into bonds; the generally weak demand for foreign exchange; the injection of additional liquidity into the banking system through the disbursements by the Petroleum (Special) Trust Fund (PTF), expansionary government fiscal operations, and the phased release of banks' mandatory investments in the stabilization securities and the merchant banks' exemption from cash reserve requirement.

The distress in the banking system moderated slightly in the review period following the sustained implementation of the failure resolution framework introduced since 1994. In particular, action by the CBN to review banks' compliance with conditions for the lifting of the Holding Actions placed on some distressed banks resulted in the lifting of the restrictions placed on one of such institutions during the year, thereby putting the number of distressed banks at 52 as at the end of December, 1996. However, Holding Action was imposed on another bank during the latter part of the year, while 5 banks had been in liquidation since 1995. Furthermore, the CBN intensified its surveillance and monitoring activities on banks and other financial institutions through routine, target and special examinations. In keeping with the policy of sanitising the banking industry, some investigations were also carried out on cases of alleged malpractice by some banks, while many spot checks were undertaken to determine compliance by banks with respect to the provisions of the monetary policy guidelines.

The authorities continued to implement and review the distress resolution strategies for the financial sector. In this context, five (5) out of the seventeen (17) banks taken over by the CBN in September 1995, for which court approval for acquisition had been granted, had been offered for sale. Also, the authorities continued to arraign insider abusers and other delinquent debtors who contributed to the adversity of those banks before the Failed Banks (Recovery of Debts) and Financial Malpractices Tribunal with good results, as substantial debt recoveries were made. This has helped to improve the net worth of these banks. For instance, as at the end of December 1996, distressed banks' net total assets increased to N57.7 billion or 14.0 per cent of the entire system's assets from N52.5 billion or 13.0 per cent of the total as at December 1995. Similarly, their share of the deposit liabilities of the aggregate for the banking system amounted to N41.2 billion compared with N37.4 billion in the corresponding period of 1995.

The overall deficit in the balance of payments during the first half of 1996 for which information is firm was estimated to be US$336.7 million compared with the US$572.5 million recorded in the corresponding period of 1995. The deficit was traceable to the sharp deterioration in the capital account. In sharp contrast to the trend in earlier years, the current account swung to a surplus of US$587.8 million, a development attributable to the substantial improvement in the merchandise trade account and the improved surplus in the unrequited transfers account. Other notable developments in the external sector were the continued stability in the AFEM exchange rate as well as the substantial increase in the nation's external reserves from US$1,413.0 million to US$4,074.7 million in 1996.

Real Sector developments indicated that economic management recorded some achievement. Real GDP growth rate increased from 2.2 to 3.3%. Both agricultural and industrial production increased relative to 1995, while the overall rate of manufacturing capacity utilization increased from 29.3 to 32.5%. The unemployment problem generally worsened, while inflationary pressures moderated considerably with the inflation rate standing at 29.3% in December, 1996 compared with 72.8% a year earlier.

In summary, while the financial and economic conditions in 1996 were more favourable, relative to 1995 and 1994, better economic performance could have been achieved to support more rapid economic recovery. Thus, the 1997 Budget sought to identify the major outstanding economic problems to be addressed in the course of the fiscal year. Some of the problem areas which were the focus of policies were as follows:

(i) The macroeconomic problems include a high inflation rate, inadequate output growth, worsening state of unemployment and persistent external sector payments deficit;
(ii) The problem of excess liquidity persisted and the prospects for an increase in the level of such excess liquidity in 1997 are real. Other major problems in the financial sector were the negative real interest rate regime and the presence of a large number of distressed institutions;
(iii) While there has been evidence of fiscal prudence, there has nevertheless been increased government borrowing from the banking system. Besides, more rigorous execution of the political transition programme will require further growth in government expenditure;
(iv) In the external sector, the main problems were inadequate foreign exchange reserves, low value of the naira, persistent adverse terms of trade and heavy external debt burden; and
(v) In the real sector, output growth continued to be inadequate and the cost of production remained high, while the level of new investment was relatively low. Another major problem was the deteriorating conditions of the social services - education, health and water supply, as well as the continued degradation of the environment.

3. FEATURES OF THE MONETARY PROGRAMME FOR 1997

In the light of the above outstanding problems of the Nigerian economy, monetary policy in 1997 is expected to continue to play its supportive roles of stabilization and efficient resource allocation. Thus, while the stance of monetary policy will continue to be restrictive, the financial sector would provide adequate funding for private sector productive activities. Monetary policy objectives for fiscal 1997 include:

(i) a significant reduction in the inflation rate;
(ii) stimulation of output and employment growth; and
(iii) strengthening external sector performance and ensuring continued naira exchange rate stability.

The monetary programme assumes a GDP growth rate of about 5.0 per cent, an inflation rate of not more than 15.0 per cent and some modest accretion to external reserves. The choice of this alternative indicates the following monetary and credit targets for 1997:

(i) growth in abroad (M2) and narrow (M1) money not exceeding 15.7 and 13.5 per cent, respectively;
(ii) an increase of not more than 20.0 per cent in aggregate bank credit to the domestic economy;
(iii) increases of bank credit not exceeding 5.3 and 39.8 per cent to the government and private sector, respectively; and
(iv) an increase of not more than 16.0 per cent in the domestic assets of the banking system.

Most of the monetary policy measures adopted in the recent past to attain policy objectives are retained in 1997 as contained in the Monetary Policy Circular No. 31. Mention should be made of key policy instruments and measures:

(i) Open Market Operations (OMO) will continue to be the major instrument of monetary policy and will, as usual, be supported by the use of discount window and reserve requirement policies. However,

to be formally established. The Committee, to be chaired by the Federal Minister of Finance, has as members the CBN, NDIC, SEC and National Insurance Commission.

far to improve fiscal discipline and the deregulation of interest rates. Apart from the issue of appropriate pricing of government securities, discussed in the next sub-section, the biggest problem facing the use of OMO instrument

actions that will enhance the effectiveness of its OMO instrument, including the securitization of its direct advances to the government, the replacement of the low-yielding treasury bonds (already available in the market) by in the event of anticipated resurgence of liquidity in the economy and a shortage of treasury securities for effective conduct of OMO, the CBN would stand ready to issue its own securities, with the clear indication that co-operation

in 1997 such that its operation will signal to the market impending changes in monetary conditions as well as enhance efficient mobilization and allocation of financial resources;

(v) The monetary authorities will

preferred sectors which became effective from October 1996 is retained in 1997. In addition, mandatory loans to rural borrowers and small-scale enterprises are to be dispensed with;

(viii) Efforts are to be made to

a negotiable instrument and clear separation of the market for monetary and debt management which is contrary to the present practice in the primary issues market. In the medium to long-run, the CBN could consider a separate intervention instrument, most probably held by the Bank itself as it now obtains in some developing countries such as Ghana and Chile, However, this has serious cost implications for central bank operations. Even when a central bank issues its own intervention instrument, there is need for co-ordination between the fiscal and monetary authorities. Indeed, at the early stage of this instrument, it should be used to support the treasury securities.

4.2. Interest Rate Management

Interest rate management is critical for the effectiveness of monetary policy. Interest rates can be both a monetary target and a monetary indicator. As a target, the interest rate variable is a transmission channel to the policy goals, while as an indicator, it reveals early signals of the economy's monetary conditions.

To all intents and purposes, interest rate management should be easier in 1997 and beyond provided the present conditions of the financial markets persist and indeed are enhanced. In the first case, the macroeconomic distortions of the recent past have reduced considerably. Such distortions include the crowding out of the private sector in credit allocation, the use of stabilization securities to mop up excess liquidity, the large number of insolvent banks engaging in distress borrowing and the skewed distribution of bank reserves. These distortions have since 1995 been effectively countered by the authorities. In the second place, the decapping of interest rates with effect from October 1996 should facilitate the deepening and broadening of the financial markets and provide an efficient mechanism for liquidity management in the banking system. But as these distortions are being removed, the monetary authorities will face the challenges of making interest rate policy an active instrument of liquidity management and resource mobilization and allocation. There are several possibilities, all depending on the prevailing profile of the financial sector.

Many observers have suggested that the Minimum Rediscount Rate (MRR) should be the nominal anchor for CBN's interest rate policy, which is saying the obvious. The question to ask is, how? On short-term basis, the primary objective is to evolve an MRR which is related to lending and deposit rates through the regulation of supply of bank reserves. In order to do this, the CBN would need to have an appropriate indicator that would suggest when to intervene in the money market. International experience shows that the MRR (or more generally the Bank Rate (BR)) may be set either below or above market rates. In either case, the spread between the BR and the market rate (such as the inter-bank funds rate) usually indicates the thrust of policy. The central bank's open market operations through its cut-off price can be used to influence movements in the inter-bank rates. This series of complex actions all depend on the sophistication and responsiveness of the financial markets. The Nigerian financial markets are still being nurtured. On an experimental basis, the CBN's MRR could be set at a penalty mark-up over the treasury bill issue rate (TBR) such that the spread between the MRR and TBR would suggest the thrust of policy which the CBN would strive to defend. This implies that the CBN would monitor the movement in the bid rates in the treasury bill tender market. Depending on the CBN's perception of the liquidity situation, the weekly OMO will be used to increase or drain bank reserves by employing the cut-off price in the transactions. This approach assumes that at a particular MRR, there is also a given level of bank reserves that is consistent with the OMO cut-off price which also determines banks' deposit and lending rates. As indicated earlier, the financial conditions in Nigeria today are quite delicate and may not make the financial markets readily susceptible to the application of the standard interest rate management. There is an overhang of excess liquidity, while the treasury bill issue market may not portray the exact liquidity pressure in the banking system. We have also raised the issue of the effectiveness of OMO in our environment. Under these circumstances, supplementary actions will need to be adopted to evolve a viable mechanism for interest rate management. For instance, the monetary authorities may need to utilize available information on interest rate developments in the entire financial sector, create its own open market intervention instrument as suggested earlier, co-operate with the government to move resources between the banks and the CBN and indeed apply moral suasion to ensure that interest rates would perform their roles in support of economic stability and sustainable economic growth.

4.3. Improving the Performance of the Financial Sector

Deregulatory financial mea-

TABLE 1
SELECTED MACROECONOMIC INDICATORS, 1991-1996

(PERCENT)

	1991		1992		1993		1994		1995		1996 3/	
	T 1/	A 2/	T	A	T	A	T	A	T	A	T	A
Growth in Monetary Aggregates												
Money Supply (M1)	14.6	32.8	24.3	66.4	20.0	54.6	21.4	47.8	9.4	8.1	14.5	28.6
Money Supply (M2)	–	32.7	26.8	49.2	18.0	49.8	14.8	39.1	10.1	10.3	16.8	29.8
Domestic Credit	10.6	46.3	13.2	73.0	17.5	75.9	9.4	29.2	11.3	36.0	12.0	12.0
Credit to Private Sector	16.4	23.7	17.7	34.7	20.0	16.6	32.6	28.3	21.9	51.8	29.5	18.4
Credit to Government	0.0	82.5	7.7	109.6	14.6	120.7	0.0	27.7	5.6	27.6	0.0	16.9
Fiscal Deficit - GDP Ratio		-11.0		-10.2		-15.4		-7.7		0.1		1.9
Real GDP Growth		4.7		3.0		2.3		1.3		2.2		3.3
Manufacturing Capacity Utilization		39.4		41.8		37.2		30.4		29.3		32.5
Inflation Rate		13.0		44.6		57.2		57.0		72.8		29.3
Average Exchange Rate (N/$)												
– Official		9.9095		17.2985		22.0468		21.8861		21.8861		21.8861
– AFEM										81.1491		81.2527
Balance of Payments Position (% of GDP)												
– Overall		-4.9		-18.3		-5.1		-4.7		-3.1		-5.6
– Current Account		-3.9		-0.9		-2.4		-5.4		-5.6		-0.7
External Reserves (US$ million)		4487		713		1330		1659		1441		4074.7

NOTES

1/ T = Target
2/ A = Actual
3/ Provisional

Source: Central Bank of Nigeria.

balance of payments position. The expansion of CBN's supervisory responsibilities to include all banking institutions will certainly impose a bigger demand on the capacity of the Bank, but it should reduce leakages in the overall monetary control process. If some of the actions suggested in the previous section of this paper are taken, the fiscal, external and real sector components of the Budget should provide a more conducive environment for the financial sector to meet the needs of the entire economy.

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