Monetary Policy Implementation and Financial Sector Developments in Nigeria: The Journey so Far

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I. Introduction

The overall activities of the financial sector center on money and its by-products; it thus serves as the veritable channel for conveying monetary policy decisions to the entire economy. In consequence, there is no gain saying that decisions on money and its related activities as well as their impulses must necessarily be transmitted from the financial sector to other sectors of the economy. The financial sector promotes economic growth and development through savings mobilisation, investment funding, risks diversification and management, trading and provision of information on investment opportunities, monitoring borrowers and exerting corporate controls as well as facilitating the exchange of goods and services. Thus, financial sector vulnerabilities could lead to financial crisis with adverse consequences on economic growth and development. It is, therefore, imperative to monitor developments in this sector with a view to assessing the risk potentials and proactively mitigating likely consequences. Against this backdrop, developments in the financial sector are critical to the success or otherwise of monetary policy implementation and ultimately, achieving the objectives of policy.

In the light of the above, growth in financial sector, in terms of structural and

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infrastructural developments, promotes the efficiency of the transmission mechanism, the channels (interest rate, credit, price, assets channels) through which monetary policy decisions are relayed to the economy. Conversely, underdeveloped financial sector is usually characterized by structural rigidities, institutional weakness and infrastructural impediments that impair the transmission mechanism and limit the effectiveness of monetary policy decisions. Consequently, the success of monetary policy implementation is contingent on the development of a vibrant financial sector which markets are robust and seamlessly integrated with capabilities for responding effectively to monetary decisions. In the circumstance, the duration of monetary policy lags becomes shorter and enhances the speed and strength of the transmission mechanism to engender the effectiveness of monetary policy in achieving the desired macroeconomic objectives.

In this context, financial sector development is not only a necessary condition, but a sufficient condition for successful monetary policy implementation and policy effectiveness. Given the above background, the objectives of this paper are to examine Nigeria's financial sector development and identify constraints and challenges to monetary policy implementation. Following this introduction, section 2 discusses the conceptual issues relating to monetary policy, the objectives, instruments, targets and the methodology for the implementation of monetary policy decisions as well as policy monitoring and review. Section 3 analyses financial sector development strategy and the traditional (qualitative) as well as quantitative assessments of financial sector development. Section 4 evaluates financial sector development in Nigeria and the journey so far. In section 5, the paper examines the nexus between monetary policy implementation and financial sector development, while section 6 provides policy recommendation and concluding remarks.

II. Conceptual Issues

II.1 The Concept of Monetary Policy

Monetary policy refers to the control of the level of money stock by the monetary authorities through policy instruments to achieve desired macroeconomic objectives. This simply refers to specific actions taken by a central bank to regulate the value, supply and cost of money in an economy with a view to achieving government's macroeconomic objectives. These are the objectives of price stability, balance of payments viability (external stability), economic growth, employment generation and equitable income distribution. Monetary policy complements other policies to achieve these goals. It occupies a central role in maximising the welfare of households and the profitability of firms. The achievement of the macroeconomic objectives specified above are affected by the stance of monetary policy through a number of ways, including interest rate, credit, wealth or portfolio and exchange rate channels (Akhtar, 1997; Posen *et al*, 1991; CBN, 2006). The monetary authorities apply their discretionary power of influencing the money stock and interest rate to make money either more expensive or cheaper depending on the prevailing economic conditions and policy stance towards achieving price stability. This is why Wrightsman (1976), concludes that monetary policy is nothing but a deliberate attempt to control money supply and credit conditions for the purpose of achieving certain broad macroeconomic objectives.

II.1.1 Objectives of Monetary Policy

In general, most monetary authorities or central banks have been saddled with the specific mandate to control inflation, maintain a healthy balance of payments position to safeguard the external value of the domestic currency and, thus, promote economic growth. The specific objectives and the focus of monetary policy may change from time to time, depending on the level of economic development and economic fortunes of a country. The choice of instruments for achieving these objectives would depend on prevailing circumstances, largely economic conditions confronting monetary policy makers. For many countries, the objectives of monetary policy are explicitly stated in the laws establishing their central banks, while for others they are not. In other words, the objectives of monetary policy may vary from country to country, but there are basically two main variants. The first view calls for monetary policy to target price stability, while the second seeks to achieve price stability and other macroeconomic objectives.

In Nigeria, to achieve the objectives of monetary policy, the CBN has the mandate to ensure monetary and price stability, issue legal tender currency, maintain external reserves to safeguard the international value of the legal tender currency, promote a sound financial system, act as banker and provide economic and financial advice to the federal government. As per the Act, the CBN belongs to the second view.

The goals of monetary policy are the same as the macroeconomic objectives of non-inflationary growth of domestic output, balance of payments viability, and a high level of employment. However, Ojo (2000:64) observed that most monetary policy authorities tend to focus on the objectives of low inflation and external equilibrium because of the close association between monetary developments and the two variables. If the two goals are achieved at a reasonable degree, it is generally believed that monetary policy, in cooperation with other tools, will enhance domestic output and employment.

II.1.2 Instruments/ Targets of Monetary Policy

The monetary policy instruments (operating variables) are the direct means by which monetary authorities influence the intermediate variables to achieve the ultimate goals of policy. These instruments are usually divided into two categories, namely the direct control instruments and indirect or market-based instruments. The direct control instruments are discretionally manipulated to achieve some set targets, while the market-based instruments are employed in a well-developed financial system to influence market participants to achieve the desirable targets. The use of direct control instruments which include the imposition of credit and interest rate ceilings, imposition of credit expansion limits, sectoral credit expansion/allocation guidelines and moral suasion have been replaced by market-based instruments in Nigeria.

The market-based instruments are:

- Open Market Operations (OMO)
- Discount Rate (rediscount rate or MPR)
- Reserve Requirement
- Special Deposits

The major policy targets in Nigeria include the achievement of price stability in terms of a single digit inflation, high output growth, a healthy balance of payments position and employment generation.

11.1.3 Framework for the implementation of Monetary Policy

Prior to the banking sector consolidation that was concluded in December 2005, the framework for monetary policy in Nigeria had witnessed some transformation. This included the shift from short-term framework to a two-year medium-term framework in the conduct of monetary policy. Although the objectives of monetary policy remained basically the same and monetary targeting remained the policy thrust for achieving the ultimate objective of inflation, there were some fundamental changes in the strategies and instruments employed. These changes can be analyzed under two major phases, namely, the period before the Structural Adjustment Programme (SAP) that witnessed direct control method and post-SAP era when market instruments were employed.

II.1.3.1 Era of Direct Control (Pre-SAP)

Until the introduction of the SAP in mid-1986, the monetary policy framework placed emphasis on direct controls. The framework, which relied heavily on sectoral credit allocation, credit ceilings and cash reserve requirements, administrative fixing of interest and exchange rates as well as imposition of special deposits, failed to achieve the set monetary targets. It rather created a lot of distortions and bottlenecks in resource allocation, resulting in inefficiencies and sharp practices.

II.1.3.2 Period of Indirect or Market Approach (Post-SAP)

In line with the liberalization policy thrust of the SAP, there was a paradigm shift from the hitherto repressive direct monetary control method to an indirect approach anchored on the use of market instruments in monetary management. This was borne out of the desire to eliminate the distortions and inefficiencies in the financial system caused by the prolonged use of administrative controls and the need to engender competition among banks and other operators in the financial system. Two major policy regimes of short- and medium-term frameworks can be identified.

II.1.3.3 The Short Term and Medium-Term Monetary Policy Framework

The short-term monetary policy framework (1986-2001) was a yearly exercise, but in 2002, the CBN commenced a two-year medium-term monetary policy framework, aimed at freeing monetary policy from the problem of time inconsistency and minimizing over-reaction due to temporary shocks. The new monetary policy framework, still in operation, is based on the evidence that monetary policy actions affect the ultimate objectives with a substantial lag. Under the new framework, monetary policy guidelines are open to half-yearly review in line with developments in monetary and financial market conditions in order to achieve medium- to long-term goals. Thus, the recognition of a longer lag period for monetary policy and the need to review monetary developments half-yearly inform the shift from short-term to medium-term monetary policy framework from 2002 to date.

The major objectives of monetary policy have remained the same, while attention has also been focused on the need for a more competitive financial sector geared towards improving the payments system. The OMO has continued to be the primary tool of monetary policy and, is complemented by reserve requirements, discount window operations, foreign exchange market intervention and movement of public sector deposits in and out of the deposit money banks (DMBs). The CBN has also continued to ensure banking soundness and financial sector stability, not only to ensure the effective transmission of monetary policy to the real sector but also to enhance the efficiency of the payments system.

The measures taken to strengthen the banking sector and consolidate the gains of monetary policy included the introduction of a 13-point reform agenda in the banking sector in July 2004. The major policy thrust was the recapitalization of DMBs to a minimum of N25.0 billion. The 2004/2005 monetary policy and credit guidelines were fine-tuned in 2005 in the light of changing macroeconomic environment. New policy measures introduced included maintenance of a tight exchange rate band of plus/minus 3.0 per cent, two-week maintenance period of cash reserve requirement and the injection/withdrawal of public sector deposits from the DMBs. The various measures put in place, complemented by greater fiscal discipline of the Federal Government, had salutary effects as monetary targets for 2004 and 2005 were generally achieved for the first time in about two decades. Also, during the year, the CBN introduced "swap" transactions which were carried out at the wholesale Dutch Auction System (wDAS) foreign exchange market to complement domestic money market instruments in bringing system liquidity under control.

II.1.3.4 Consolidation of the Banking System

The vision to propel Nigeria to the frontier of the world's leading financial hub was a key driver of the consolidation of the banking industry. The reform was intended, from the monetary policy point of view, to minimize macroeconomic instability arising from banking sector systemic distress, increase intermediation through the deepening of the capital market, promote productive growth in the private sector, particularly non-oil growth, minimize the counterfactual shocks of creating distortions in the money markets and the financial system, and encourage investment inflows through effective participation of the industry in the global financial system, among others. To be able to do these, a minimum capital base of ₦25.0 billion was specified for the DMBs, which could be achieved through a number of avenues including mergers, acquisitions or public offerings, etc.

Evidence has shown that the full implementation of the exercise witnessed a more than doubled increase in the capital base of Nigerian banks from about US$2.5 billion in June 2004 to about US$5.8 billion at end-December 2005. The CBN can now focus on a fewer number of banks for effective supervision and zero tolerance towards infractions, and with improved corporate governance, greater transparency is being enforced. The deployment of IT infrastructure (eFASS and RTGS) would facilitate efficiency in work processes and procedures.

With the emerging competitive environment, the CBN has put in place safety nets by way of encouraging partnership of foreign and domestic banks in Foreign Reserve Management/Custody. The Bank has continued to undertake the due diligence exercise on all banks in the system (verification of capital) to prevent "bubble capital". In addition, information technology and new ways of conducting business are being facilitated through the introduction of eFASS, RTGS and Temenos T24. The next phase of consolidation would be market driven and the challenge is for bank(s) with US$1.0 billion in capital base to receive at least US$500.0 million reserves to manage.

II.1.3.5 Introduction of Monetary Policy Rate (MPR)

The monetary policy framework, which is anchored on monetary targeting, has remained unchanged. The main policy thrust is to contain the surging liquidity in order to achieve price stability, promote an efficient money market and ensure non-inflationary growth. Thus, on December 11, 2006, the Minimum Rediscount Rate (MRR), which hitherto served as the nominal anchor for interest rates in the economy, was replaced with the Monetary Policy Rate (MPR). The new framework was aimed at ensuring stability in short-term interest rates to engender efficient liquidity management and encourage interbank trading. The MPR was fixed at 10.0 per cent with a corridor of 600 basis points, 300 basis points on each side of the MPR, for the upper and lower limits. Thus, the lending facility to the DMBs at the CBN attracted 13.0 per cent, while deposits with the CBN attracted 7.0 per cent.

II.1.4 Monetary Policy Monitoring and Review

Monetary policy monitoring and review is carried out within the New Institutional Framework of Monetary Policy. The structure of the framework starts with the Annual Monetary Policy Forum. This Forum has the responsibility to set the broad objectives and the priority of monetary policy for the year. At the bottom of the ladder is the newly constituted Fiscal Liquidity Assessment Committee (FLAC). The FLAC has the mandate to design and regularly update the framework for obtaining information for forecasting fiscal liquidity. Other institutional arrangements for policy monitoring and review of monetary policy are discussed below.

II.1.4.1 Monetary Policy Committee (MPC)

The MPC which meets once in two (2) months formulates and design appropriate strategies for the conduct of monetary policy. It also reviews, periodically, the effectiveness of the framework for monetary policy implementation and assesses its impact on major macroeconomic aggregates, and decide on the operating target of the Bank's monetary policy i.e. in key interest rates, the MPR.

II.1.4.2 Monetary Policy Advisory Group (MPAG)

The membership consists of both internal and external members and holds a one-day or two-day seminar on issue(s) assigned to it, thus bringing into it the experiences of professionals. The MPAG receives inputs from the MPTC. The proceedings from this meeting form part of inputs to the MPC. The Group meets once in two (2) months and is usually held at least three (3) working days to MPC meeting.

II.1.4.3 Monetary Policy Implementation Committee (MPIC)

The MPIC is responsible for the weekly review and implementation of monetary policy as decided by the MPC. Specifically, it :

- Reviews the impact of monetary policy operations as advised by the Liquidity Assessment Group.
- Assesses the liquidity position of the banking system up to the current period.
- Directs the LAG on the line of action to take in liquidity management.
- Reviews issues regarding the health of the banking system. The MPIC receives reports/briefs on the liquidity situation and the health of the banking system from departments. The Committee meets every Friday at 10:00 am.

II.1.4.4 Monetary Policy Technical Committee (MPTC)

The MPTC performs the following functions:

- Keeps track of economic and financial system developments on monthly basis.
- Provides briefs and policy proposals on issues of interest for the MPC
- Provides the MPAG with background briefs, data and issues that require special expertise/attention for the latter's consideration and submission for consideration at the MPC.

This Committee meets once every month and two-weeks prior to the meeting of the MPC.

II.1.4.5 Liquidity Assessment Group (LAG)

The Group takes decisions on interventions in the domestic money and foreign exchange markets, as well as the mode and measure of such interventions required to achieve optimum system liquidity position. In specific terms, the LAG is responsible for making suggestions on policy actions to be taken by the Group each day in both foreign exchange and domestic money markets including, the need for intervention, timing of intervention and the size, type and tenor of instruments. The LAG also decides the choice of market through which intervention should be undertaken (whether domestic money market or forex market) and communicates its decision to the MPIC. The LAG builds a database on its expectations on daily/weekly/monthly/yearly basis to facilitate forecasts. It also follows up on the implementation of policy measures and reports to the MPIC.

II.1.4.6 Fiscal Liquidity Assessment Committee (FLAC)

The Committee is responsible for:

Daily collection and update of liquidity data arising from government fiscal operations by the MPD in determining the system liquidity. The FLAC is expected to forward the forecast of fiscal liquidity to the Liquidity Assessment Group. It assembles all available information on projected revenue and expenditure for the near future. The Committee also makes daily and monthly projections/forecast to determine the net fiscal injection and withdrawal of liquidity to/from the system. The FLAC meets daily in the morning. Currently, a formal meeting holds on Thursdays.

III. Financial Sector Development

The framework for assessing a country's financial sector development comprises the traditional and quantitative approaches.

III.1 The Traditional Approach for Assessing Financial Sector Development.

Under the traditional approach, the existence of institutional, regulatory, supervisory, legal, financial market liberalization and products diversification frameworks constitute financial sector development.

III.1.1 Institutional Framework

The existence of institutions to provide financial sector functions and services, which Levine (2004) identified as, savings mobilsation, risk management, acquiring information and investment opportunities, monitoring borrowers and exerting corporate controls and facilitating the exchange of goods and services cannot be overemphasized. Institutions are required to mobilize savings, channel them into investment, coordinate and manage associated risks, monitor borrowers' activities, and facilitate the production and exchange of goods and services in the real sector. Therefore, an effective institutional capacity is required for promoting financial sector development. Among others, the institutions include commercial and merchant banks or universal banks, development banks, insurance companies, mortgage institutions, pension funds, hedge funds, mutual funds, bureaux-de-change and stock exchange. The capabilities of these institutions in providing financial services at their various markets and when they are well integrated provide the basis for the effective implementation of monetary policy.

III.1.2 Regulatory Framework

The absence of a regulatory framework for guiding, coordinating and controlling the activities of financial institutions which compete in the money, capital and foreign exchange markets could be counterproductive without providing a level playing field. Regulatory institutions are required and saddled with the responsibilities for promoting, coordinating and maintaining trust and confidence in the financial system through the provision of macro-prudential measures. Regulators ensure that players observe rules in the market place to promote fairness and market efficiency. The role of regulators in any financial system encompass the following: provide rules for the orderly conduct of markets and take appropriate measures to correct market failures. The current massive bail-out measures for the banking crises in the United States (US), United Kingdom and countries in the Euro-area (e.g Germany) are eloquent testimonies of the importance of a regulatory framework for the financial sector.

III.1.3 Supervisory Framework

Apart from regulating economic activities to achieve desired macroeconomic objectives, there is also the need to have a viable supervisory framework for ensuring a sound and efficient financial sector. The supervisory framework focuses on the operations of banks and non-bank financial institutions to promote efficiency and competition, maintain market confidence, protect depositors and facilitate the attainment of systemic stability (World Bank, IMF and IBRD:2005). In this regard, and as noted by Bhole (2008), supervisors protect investors against dishonest, unfair, fraudulent, unethical and high risk practices which could lead to insolvencies and bankruptcies of players in the financial sector. Supervisors also, ensure that players observe all micro-prudential rules to promote fairness and market efficiency. Poor supervisory framework engenders supervisory gaps and arbitrage, thus, undermining the development of the financial sector.

III.1.4 Legal Framework

A well-developed financial sector must also evolve a mechanism for knowing the rights and responsibilities of market players and for dispute resolution. Basically, the legal framework highlights issues pertaining to creditors and debtors rights, insolvency and bankruptcy laws, corporate governance laws (accountability, honesty, transparency, accounting, auditing, roles of shareholders, board members, director - all of whom should be fit and proper persons), property laws and distress laws (withdrawal of licenses, imposition of new management, restructuring or liquidation). Others include laws on ownership, contracts, financial safety nets, information disclosure, payment system (non-cash electronic credit and debt cards, swift-based terminals, real time gross settlement system), land, tax and anti-money laundering. Also, there should be laws for enforcement, special courts and out-of- court settlement mechanisms.

These provide fundamentals for confidence, trust, orderly and healthy development of the financial system. Regulators, supervisors and players in the various financial markets should be fully aware of their rights and responsibilities and will, therefore, observe and conform to the rules in the market place. Such an orderly legal infrastructure provides the basis for proper conduct and behaviors in the financial sector.

III.1.5 Financial Market Liberalization

The existence of a liberalized financial sector allows the markets to function effectively and efficiently, thus promoting the process of rapid growth and development. A liberalized financial system is devoid of government controls, interventions and restrictions in areas such as credit rationing, interest and exchange rates controls and sometimes, the imposition of interest rate ceilings or fixing of nominal interest rate, ceilings on deposits, and prescription of high reserve ratios. Financial liberalization creates an enabling environment for interest rates on financial assets to move and adjust competitively to its market level. This promotes the prospects for higher savings, investment, supply of real credit and, thus, the potential for financial deepening.

III.1.6 Financial Market Products Diversification

Financial sector development should, among others, include markets development and product diversification. Basically, the markets include money, capital and other non-bank and specialized financial markets. These markets provide a variety of products which support the needs of participants and players alike. The products make for an effective and efficient financial sector that allocates resources for economic growth and development. Some of these products include call money, treasury bills, commercial bills, commercial papers, certificates of deposits, discount facilities, financial guarantees and foreign exchange market. Others are government securities, equities, bonds, and derivatives in the capital market. Non-banks and specialized financial products include insurance, mortgage loans, pension/provident funds, microfinance and other financial and specialized funds. With these products, the financial sector performs the important roles of savings mobilization, investment lending, risk management, provision of information about investment opportunities, monitoring borrowers, exerting corporate control and facilitating the exchange of goods and services (Levine:2004).

These collective functions provide the basis for monetary policy transmission channels for achieving macroeconomic goals.

III.2 Quantitative Approach to Assessing Financial Sector Development Strategy

The traditional or qualitative approach to financial sector development only identifies the structural development of institutions, markets and products, but does not capture the robustness of the financial sector, markets strength, sophistication and the degree of integration among the component parts, which creates a seamless, monolithic financial structure in which a policy shock could transmit freely across the entire markets unimpaired.

This approach provides macro measures for market size or depth, access, efficiency and stability. They indicate real macro fundamentals of financial sector growth and development, and the degree of financial markets' sophistication and resilience. These measures include the ratio of broad money (M2) to gross domestic product (GDP) or Deposit Money Banks (DMBs) assets to GDP which are indicators of overall market size or depth or liquidity. The ratio of private sector credit by DMBs to GDP or private sector credit to total DMBs deposits, measures the size of intermediation. Market access is measured by average loan (deposit) size to GDP or branch density or cost of opening account. The ratio of operating cost to operating income or the spread between deposit and lending rates or the number of days to clear cheques measure financial markets efficiency while financial sector stability is measured by either loan to capital or non-performing loan to real credit growth.

These measures could also be applied to the capital market and other non-bank financial institutions. However, for the purpose of this assessment, emphasis will be laid on the banking sub-sector, which is the most predominant in Nigeria, to provide the lead indicators of Nigeria's financial sector development. This empirical analysis is provided in the next section.

IV. Evaluation of Financial Sector Development In Nigeria: The Journey so Far

The methodology for the evaluation of Nigeria's financial sector development include an assessment of the adequacy of the traditional approach to financial sector development strategy and the quantitative approach. Both assessments will provide a clear indication of the strength of Nigeria's financial sector and implications for the conduct of monetary policy.

IV.1 Evaluation of Nigeria's Traditional Approach to Financial Sector Development

Financial sector development of countries all over the world, commenced with financial sector structural development which includes the establishment of institutions and markets to provide the critical functions and also serve as the basis for conducting monetary policy. Structural development of the financial sector were largely a deliberate public policy to provide an enabling environment, support and direct involvement in the promotion and development of financial institutions and markets. In like manner, Nigeria's financial sector has been driven by deliberate public policy which encouraged the development of commercial and merchant banks, the first of which were established in 1894 and 1960 respectively. By 1992 (CBN Briefs), the number of commercial banks and merchant banks had increased to 66 and 55, respectively. Following the banking distress, a number of banks were closed down, while in the era of financial sector deregulation and liberalization between 1986 and 1990, there were increases in the number of commercial and merchant banks which stood at 51 and 38 in 1999 respectively, (CBN Briefs). By January 1, 2001 when the CBN policy on universal banking came into operation, the number of consolidated DMBs were 89 banks. These banks continued operations but had structural problems such as low capital base, huge non-performing loans, weak corporate governance and banking ethics as well as overdependence on public sector deposits. Consequently, in 2005, the CBN introduced the banking consolidation exercise to strengthen the existing banks. It required all banks to recapitalize their capital base from ₦2.0 billion to ₦25.0 billion. By the end of 2005, which was stipulated for the completion of the exercise, only 25 banks (through mergers and acquisitions and raising of funds through IFOs) emerged. Of those 25 banks, two merged in 2008, leaving the total number of banks at 24.

In similar fashions, other money and capital market institutions, development finance institutions and specialized banks and other financial institutions were promoted. As a result of the restructuring exercises aimed at promoting institutional capacity, financial system soundness and stability, a number of these institutions were merged or recapitalized. Presently, the following institutions now exist in Nigeria's financial industry: Discount houses; Nigerian Stock Exchange (NSE) with trading floors in Port Harcourt, Kano, Kaduna, Ibadan, Onitsha, Yola, and Abuja; Bank of Industry (BOI), Nigeria Agricultural Cooperative and Rural Development Bank (NACRDB); Nigeria Export-Import Bank (NEXIM); Federal Mortgage Bank of Nigeria (FMBN); Urban Development Bank (UBN); and Nigeria Education Bank (NEB). Others include finance and insurance companies, primary mortgage institutions, unit trust scheme and bureaux-de-change. All of these institutions provide diverse financial services and products to meet the needs of their clients. The identified financial products in section 3, both in the money and capital markets exist in Nigeria. However, derivative products for hedging and risk management are relatively underdeveloped.

With respect to the regulatory and supervisory frameworks, Nigeria has robust institutional capacities such as the Central Bank of Nigeria for banking and microfinance regulation and supervision; Nigeria Deposit Insurance Corporation (NDIC) for the protection of banks' deposit, the Security and Exchange Commission (SEC) for the regulation of the capital market; the Federal Ministry of Finance (FMF) for the regulation of some institutions in the financial system and National Insurance Commission (NAICOM) for the regulation of insurance companies. Other regulatory bodies in Nigeria include Federal Mortgage Bank of Nigeria for primary mortgage institutions; and the National Pension Commission (PENCOM) for the regulation and supervision of pension funds institutions. Undoubtedly, Nigeria has institutional capability for financial sector regulation and supervision.

Similarly, the CBN Act of 1958 and the Banking Act of 1969, and other subsequent legislations and amendments (such as the CBN Act 24 of 1991, amended in 1997, 1998, 1999 and 2007; while the Bank and Other Financial Institutions (BOFI) Act 25 of 1991, amended in 1997, 1998, and 1999), provide the legal infrastructure for financial sector development in Nigeria. The 1986 deregulation and liberalization programme and the 13-points agenda of 2004 for financial sector reforms have further liberalized and enhanced financial sector soundness and operations of the financial industry in Nigeria. Beyond the banking consolidation programme, Nigeria has improved substantially in other financial sector infrastructural development such as transformation of Nigeria's payment systems through the provision of National Automated Clearing System (NACS); the CBN Inter bank Funds Transfer System (CIFTS) using the Real Time Gross Settlement System (RTGS) which links the 24 DMBs and five discount houses; the National Central Switch (NCS) for facilitating interconnectivity of different electronic funds transfer switches. Others include the T-24 banking application of the CBN for the automation of securities trading and the reduction of cheque clearing cycles for up-country cheques to T + 3 from T + 5 days while local cheques remain at T + 2 days. Other payment systems introduced to boost the activities in the financial system include: electronic Financial Analysis Surveillance System (eFASS) for data transfer and statistical analysis; Automated Teller Machines (ATMs), Automated Clearing Houses (ACHs), Point-of-Sales Terminals (POSTs), Mobile Phones and Internet Payments and Electronic Cards (Debit and Credit Cards).

Following the implementation of the measures in the Vision 2020 document, which is expected to develop Nigeria into an international financial centre in Africa and also as one of the top 20 economies in the world, the financial sector will be upgraded to international status.

IV.2 Quantitative Analysis of Nigeria's Financial Sector Development

The relevance of quantitative measures stems from the fact that the traditional or the qualitative approach only indicates numbers and variety of financial institutions, markets, products and the changes thereof. The quantitative approach on the other hand reveals the size, depth, access, assets quality, market share, efficiency, stability and, thus, the overall state of health of the financial sector. In other words, while the traditional approach highlights the variety of institutional numbers, the quantitative approach provides overall health status of the financial sector.

In this regard, the quantitative analysis could be applied across the financial sub-sectors, namely banking, capital market, insurance, finance companies, mortgage institutions, foreign exchange market, other specialized financial institutions and development banks. Of the sub-sectors in Nigeria, the banking industry is the most predominant and its quantitative indicators will fairly approximate developments in the financial sector. Consequently, for the purpose of this paper, the quantitative analysis will focus entirely on the banking sub-sector, particularly the DMBs.

The size, depth and degree of resource mobilization in the financial sector could be measured through DMBs assets/GDP, DMBs deposits/GDP and broad money (M2)/GDP. The ratio of DMBs assets to GDP stood at 45.8 per cent in 2007, up from 36.3 per cent in 2006. Similarly, the ratio of DMBs deposits to GDP and broad money (M2) to GDP, moved from 15.4 and 19.8 per cent in 2006 to 17.6 and 21.1 percent in 2007, respectively. The three ratios accounted for only banking sub-sector's size to the GDP, degree of deposits or resources mobilization and the depth of financial deepening, respectively. Overall, the improvement in the ratios shows the banking sub-sector capacity for providing financial support to facilitate the production of goods and services (see Table 1.)

Table:1 Quantitative Measures of Financial Sector Development, 2006--2007 (in Percentage)

A: Measures of Size and Depth	**2006**	**2007**
DMBs Assets / GDP	36.3	45.8
DMBs Deposit / GDP	15.4	17.6
Broad Money (M2) / GDP	19.8	21.1
B: Measures of Intermediation		
DMB Private Sector Credit / GDP	13.5	21.7
DMBs Private Sector Credit/Total Credit	334.9	224.8
DMB Total Credit / Total Deposits	65.1	70.9
Currency Outside Banks/ M2	18.8	15.2
C: Measures of Access		
Total number of banks and branches :		
(i) Total DMBs	25	24
(ii) Total branches	3,468	4,579
(iii) Branch density (per 1000 population)	40	32
D: Measures of Profitability and Efficiency		
Efficiency of banks operations :		
(i) Yield on earnings assets	8.4	6.3
(ii) Return on assets	1.6	3.9
(iii) Return on equity	10.6	23.8
(iv) Efficiency ratio (operations cost efficiency)	71.4	65.9
Number of cheques clearing days	T+2 / T+5	T+2 / T+3
Spread between deposits and lending rates:		
Market share (10 largest banks) :		
(i) Total assets	72.3	71.4
(ii) Total deposits	71.5	70.6
(iii) Total credits	66.6	74.1
(iv) Capitalisations	58.5	76.6
Savings rate	3.3	3.2
Average term deposit rate	8.6	8.9
Average maximum lending rate	18.7	18.2
Savings / maximum lending rates spread	15.4	15
Average term deposit / maximum lending rates spread	10.1	9.3
E: Measures of stability		
Capital adequacy ratio	22.6	20.9
Bad debt / total credit	6.3	8.1
Non - performing loans / total credit	8.8	8.4

Source: 2007 CBN and Banking Supervision Annual Reports

Other indicators of banking sub-sector size are the degree of financial intermediation as measured by DMBs private sector credit to GDP, DMBs private sector credit to total credit and DMBs private sector credit to deposits (World Bank: 2008). Another measure of intermediation is the ratio of currency outside banks (COB) to broad money (M2). The four intermediation measures for 2007 were 21.7, 224.8, 70.9 and 15.2 per cent, as against 13.5, 334.9, 65.1 and 18.8 per cent, respectively, in 2006. Of the four intermediation ratios, the measures of the provision of credit to the entire economy (private credit/GDP) and provision of credit in relation to the deposits generated improved significantly (21.7 and 70.9 per cent) above their levels in 2006. For instance, of the total savings (deposits) mobilized in 2007, 70.9 per cent was granted as credit to firms and households. However, the ratio of private sector credit to total domestic credit and COB/M2 declined in relation to those of 2006 levels (Table 1). Rather than crowding out the private sector in credit allocation, government has prudently managed its finances such that it increased its deposits with the DMBs, which resulted in the high percentages of private credit to total credit. This, however, dropped in 2007. The currency outside bank to M2 intermediation ratio also decreased in 2007. This was attributed to the increased use of electronic and other payment cards, thus, improving the payment system.

The access to banking facility is measured by the number of banks' branches and branch density per 1000 persons. Currently, the number of banks in Nigeria is 24 compared to 25 in 2006. However, the number of branches increased by 32.0 per cent from 3,468 in 2006 to 4,579 in 2007. When compared to Nigeria's population estimated at 140.0 and 140.5 million in 2006 and 2007, it was evident that access to DMBs services declined from 40 to 32 branches per thousand population in 2006 and 2007, respectively (See Table 1).

In terms of operational efficiency, the DMBs have improved significantly. For instance, the measure of profitability (which enhances efficiency) in areas such as the returns on assets and, particularly, equities have increased from 1.6 and 10.6 per cent in 2006 to 3.9 and 23.8 per cent in 2007. Currently, the operations cost efficiency, which relates operational expenses to income, decreased from 71.4 per cent in 2006 to 65.9 per cent in 2007, indicating that the DMBs' improvement in cost reduction measures by 5.5 per cent. Other banking efficiency criteria include, the number of cheque clearing days, the spread between deposit and lending rates and market share of the biggest banks. While intra-city cheque clearing remained at T+2 days in 2007, those for intercity clearing have been reduced from T+5 days in 2006 to T+3 days in 2007. By this, the CBN has improved the effectiveness of money transfer mechanism in the banking system. In terms of the spread between deposit and lending rates as a measure of market efficiency, the DMBs have continued to be very inefficient in the sense that, the spreads are usually very high and largely in double digits. For instance, in 2006 and 2007, the spreads were 15.6 and 10.1 per cent as against 15 and 9.3 for savings/term deposits and maximum lending rates, respectively. The high lending rates remain a major problem of the banking industry with adverse effects on the economy in general.

Market share of the biggest banks is a measure of concentration on assets, deposits, credit and capitalization, which gives an indication of the level of competition. The 10 biggest banks in Nigeria controlled 71.4, 70.6, 74.1 and 76.6 percent of total DMBs assets, deposits, credits and capitalization in 2007, while the balances went to the remaining 14 banks. Since the concentration ratio is not limited to 3 banks which is the threshold, it gives a fair degree of the market competition among the DMBs. With the exception of interest rate spread, the DMBs have significantly improved in profitability and efficiency levels, thus, signifying overall management efficiency in the banking sub-sector. The last sets of measures are those related to DMBs stability, namely capital adequacy and the ratio of bad debt to credit. High capital adequacy or solvency ratio is an indication that the DMBs have improved their capacity to absorb losses. At 22.6 per cent in 2006 the solvency ratio declined marginally to 20.1 per cent. However, viewed against the threshold of 10.0 per cent, the solvency ratios were at very comfortable levels. On the other hand, higher ratio of non-performing loans (NPLs) to total credit reduces earnings potentials and capital base. Against the stipulated benchmark of 35.0 per cent, Nigeria's DMBs recorded impressive NPLs/total credit ratios which stood as 8.8 and 8.4 per cent for 2006 and 2007, respectively. Similarly, the provisioning for bad and doubtful debts/total credit has the same effects as NPLs/total credits. Higher ratios reduce the capacity of banks to expand credit and the potential to increase the level of NPLs. These ratios were as low as 6.3 and 8.1 per cent in 2006 and 2007, respectively.

Generally, the outcomes of the foregoing quantitative diagnostic test for Nigeria's financial sector development were largely favourable. The market size, depth and intermediation criteria, the measures of profitability and efficiency as well as those of financial stability, which revealed improved management efficiency and financial soundness, were impressive. With the exception of poor banking access and interest rate spread inefficiencies, the macro indicators suggest that Nigeria's banking sub- sector could be given a clean bill of health.

V.0 The Nexus between Monetary Policy Implementation and Financial Sector Development.

It is a well known fact that the financial sector plays a key role in the channels of monetary transmission like the traditional interest rate channel or credit channel where lending is a key component (Mishkin, 1996). A well functioning financial system serves as the medium for conveying monetary policy decisions to firms, households and, thus, to every sector of the economy. The reactions of economic agents to monetary policy decisions with respect to consumption, savings and investment in productive activities determine the outcomes of policy objectives.

However, for the financial sector to serve as the vehicle for transmitting monetary policy decisions successfully, it must be well-developed, sound and possess basic qualities which will effectively deliver monetary policy decisions. These include financial sector deepening, reflecting the volume of liquidity; availability of credit and efficient intermediation mechanism.

V.1 Monetary Policy Implementation and Financial Sector Development.

The Monetary Policy Committee (MPC) is the highest decision-making body on monetary policy issues at the CBN. Once monetary policy decisions have been made by the MPC, the implementation departments (Monetary Policy, Banking Operations, Banking Supervision, Trade and Exchange Departments, etc) transmit the decisions to the financial sector which in turn serves as the main conveyor belt (the intermediary) that conveys same decisions to economic agents in the real, external and fiscal sectors of the economy through the intermediation mechanism. The responses of these economic agents to monetary impulses determine the levels of consumption, savings and investment decisions that ultimately lead to the production of goods and services, ensure internal and external stability as well as generate employment opportunities. These processes which establish the nexus (relationship) between monetary policy implementation and financial sector development is known as the transmission mechanism. The foregoing analysis, therefore, establishes the crucial role and importance of financial sector development to monetary policy implementation.

A number of channels of monetary policy transmission mechanism have been identified in the economic literature, namely interest rate, liquidity, credit, exchange rate and assets price channels. These are the basic channels; however, with inflation targeting phenomenon, inflation expectation channel has also being identified in the economic literature. Suffice here to illustrate monetary policy implementation and financial sector development nexus with interest rate channel. If the rate of inflation is above the single digit target set by the CBN, the MPC may decide to use the interest rate rather than the liquidity channel, and increase interest rate say by 100 basis points, i.e. from 10. 0 per cent to 11.0 per cent. This is transmitted by the financial sector to the economy with implications for cashflow and income. Interest rates adjustments by banks and other financial institutions to reflect the high new policy rate will constrain the cashflow of economic agents and, thus, reduce their spending capacity. At the same time, those who depend on interest income will earn higher interest returns. In effect the curtailment of consumption spending will reduce the inflationary spiral to achieve macroeconomic stability. However, if the financial sector is not sufficiently developed and lacks financial depth marred by inadequate liquidity, fragmented financial system and structure with many interest rates that are not integrated, the financial sector may be insensitive to the magnitude of the change in policy rate. Consequently, it will transmit highly disproportionate and unsynchronized interest rates to maintain a wide spread between deposits and lending rates, The resultant effects are that consumers, savers and investors alike are collectively penalized, thus making interest rate channel ineffective. This further illustrates the criticality of the role of the financial sector to monetary policy implementation.

In other words, if the financial sector lacks depth, in terms of liquidity and products diversification, poor credit delivery and weak intermediation, monetary policy implementation will be ineffective, thus, resulting in undesirable outcomes. In addition, the financial sector must not only be developed, but should be integrated to eliminate structural rigidities. The existence of financial dualism where the informal sector is looming large over and above the formal sector creates structural rigidities which limit the effectiveness of monetary policy.

As indicated in section 4, one of the quantitative weaknesses of Nigeria's financial sector development is the wide interest rates spread between deposits and lending rates which were between 9.3 and 15.4 per cent in the period 2006-2007. The monetary policy rate (MPR) in the same period ranged between 8 and 10.5 per cent. Apart from the interbank market which the MPR tracks, variation in the MPR between 50 and 100 basis points does not have meaningful impact on the rates applicable to the other sectors of the economy because of the wide interest rates spread. In other words, whether an increase or a decrease between 50 and 100 basis points, the banks are adequately accommodated by the wide spread. In the circumstance, the unresolved question has been; is the MPR actually driving interest rates and, thus, the economy?

VI. Policy Recommendations and Concluding Remarks

Following the analysis above, the main policy recommendations are:

(i) The wide spread between deposits and lending rates should be addressed in other to make the MPR an effective instrument of monetary policy as is the experience in the United States (US), United Kingdom (UK), Japan and other European countries.

(ii) There is also the need to investigate the multiplicity of interest rates and a variety of banks' charges that have compounded the interest rates which banks charge their customers.

(iii) The derivative for hedging and risk management should be developed to further deepen the financial market and increase product variety.

(iv) To eliminate the existence of financial dualism, efforts should be made to integrate the informal financial sub-sector to the mainstream through the effective coordination of the activities of community/microfinance banks.

The paper examined the implementation of monetary policy in recent years following the successes recorded in the banking sector reforms and noted the achievement of most of the objectives of monetary policy. In addition, in terms of financial sector development, Nigeria has achieved greater institutional and regulatory capacity as well as products varieties that have improved development in the financial sector. The quantitative assessment of the financial sector indicates a healthy state of the banking industry.

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