THE CENTRAL BANK OF NIGERIA, THE LIQUIDITY AND THE SECTORAL CREDIT ALLOCATION

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1.0 INTRODUCTION

The current liquidity issue and the inadequate lending to the real sector, that could result to economic growth has generated considerable discussions, while the Central Bank of Nigeria (CBN) has risen up to these challenges by ensuring that liquidity in the banking system is adequate and that sectoral credit allocation to the sensitive sectors of the economy (Agriculture, Power, Aviation and SMEs) that will impact on the real sector for growth are handled with all the attention required.

Moreover, it has been widely reported that the Central Bank of Nigeria played a major role in supplying liquidity to financial markets during distressed period. This article describes the ways in which the CBN has supplied liquidity since 2009. The first is traditional: The CBN supplies liquidity by providing credit through Open Market Operations (OMO) and by lending to depository institutions at the so called discount window. The second is by enhancing the liquidity of the banks through the Standing Lending Facility (SLF) window. This window is securitized by holding their securities against the liquidity supplied to the banks. The Central Bank of Nigeria has used the second approach since late 2006. This article notes that the CBN since after banking consolidation exercise in 2005 has departed from its long standing tradition of minimizing its effect on the allocation of credit by supplying liquidity to institutions that it believed to be most in need; at the same time; it neutralized the effects of these actions on the total supply of liquidity in the financial market. This article also discusses the CBN's reasons for reallocating credit to the sector that will most impact the real sector of the economy for growth and employment this time rather than simply increasing the total supply of financial market liquidity. This is because monetary policies have price effects and their output effect cannot be established in a direct firm manner if CBN do not reach out with credit allocation to the sectors that give fillip to growth. This article is divided into 5 sections: Section 1 being the introduction, while section 2 discusses "What is Liquidity" concept and definitions. Section 3 will look at the CBN as a supplier of market liquidity and how CBN has allocated credit to the sectors that impact on the real sector. Section 4 will compare the conventional monetary policy versus unconventional monetary policy while section 5 concludes the article.

2.0 WHAT IS LIQUIDITY

The Word "liquidity" is often used to describe very different things. Liquidity is mostly used in the financial market to describe the characteristics of an asset. It is the "degree of ease and certainty of value with which an asset or security can be converted to cash". Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold, are known as liquid assets, while the ability to convert an asset to cash quickly is known as "market ability" Cash is pure liquidity. Every other asset has a degree of liquidity that is determined by (i) how quickly it can be converted to cash and (ii) how much the price of the asset must be reduced to do so. The second requirement originates from the fact that virtually any asset can be converted to cash quickly if the price is sufficiently attractive.

The word "liquidity" is also used to describe the availability of credit in the financial market. For example, market analysts or policy makers could assess the financial market and indicate that there is a shortage of liquidity or that the financial market is "frozen up". This means that it is difficult or expensive to obtain a loan or get credit. Like the liquidity of an asset, this concept of market liquidity is relative. Even in the most liquid of financial markets, some individuals or firms will be unable to obtain a loan or, if they do, they will be charged a relatively high interest rate. Likewise, many individuals or institutions obtain credit in markets described as "illiquid". No absolute measure of the liquidity of the financial market exists. There is also the concept of "liquidity trap". This is a Keynesian idea. It is when expected returns from investments in securities or real plant and equipment are low, investment falls, a recession begins, and cash holdings in banks rise. People and businesses then continue to hold cash because they expect spending and investment to be low. This is a self-fulfilling trap.
An important distinction separates the concept of market liquidity from the concept of asset liquidity. By the latter definition, cash is the quintessence of liquidity however, "a shortage of liquidity" in the financial market does not mean a shortage of cash because there can never be a shortage of cash.

The CBN has currency management function to ensure that the quantity of cash automatically increases to meet the currency demand through the process of currency indentation which is prepared annually in line with the absorptive capacity and inflation level in the economy. Consequently, there can never be a shortage of cash. When market analysts and policy makers say that the market has become less liquid or is illiquid, they mean that it is more difficult to get a loan than before; they do not mean there is a shortage of cash.

3.0 CENTRAL BANK OF NIGERIA AS A SUPPLIER OF MARKET LIQUIDITY AND HOW IT ALLOCATES CREDIT

Fundamentally, domestic credit has three major sources: private saving (individuals and firms), government saving (surpluses of federal, state and local governments), and changes in the monetary base the sum of cash held by the public and Central Bank of Nigeria. The CBN supplies the market with credit through Open Market Operations (OMO) and to a much lesser extent historically, through loans to depository institutions at the discount window. These actions increase the total supply of credit in the financial market. The effect of an open market purchase of securities on the total supply of credit is exactly the same as an equal amount of lending at the discount window. In this case, the CBN acquires a security in exchange for funds deposit balances at the CBN.

Historically, the CBN has conducted OMO in government and CBN securities; however, OMO can be carried out in any asset prescribed by the CBN Act. When the CBN purchase Treasury securities from the public, it is indirectly making the loan to the Treasury rather than the public. Hence, the supply of credit available to the public increases. Then, if the CBN sells some of its securities, the supply of credit available to the public declines. All things being equal, the supply of credit in the financial market increases or decreases, regardless of whether the change in the monetary base is due to CBN lending or Open Market Operations (OMO).

3.1 The CBN And The Allocation Of Credit

Although lending by the CBN has exactly the same effect on the monetary base as an equivalent Open Market Operation, the effect of these actions on the allocation of credit is different. When the CBN makes a loan to a depository institution, it directly allocates credit to that institution. The effect on the allocation of credit is mitigated by the fact that the total supply of credit increases the borrowing institutions obtains credit and no one loses credit. The effect of CBN lending on the allocation of credit is intensified when the CBN offsets the effect of its lending activity on the total supply of credit through Open Market Operations. In this case, borrowing institution obtains credit but the total supply of credit is unchanged. In effect, the borrowing institution is getting credit at the expense of some other individual or institution. The total supply of credit is reallocated.

Historically, the CBN has offset the effect of discount window lending on the total supply of credit through Open Market Operations. However, in the wave of financial crisis during 2007 to date, the CBN has encouraged standing lending facility through the discount window and all loans to depository institutions are guaranteed at the CBN Discount Window. The practice of offsetting the effect of discount window lending on this monetary base means that discount window lending reallocated credit to the borrowing institution. The effect of discount window lending on credit allocation has not been an issue for two reasons. First, the initial effect of an Open Market Operation is on depository institutions. Consequently, a discount window loan to a depository institution that is offset through Open Market Operations has the effect of reallocating credit among depository institutions.

Second, and more important, discount window lending has been small historically, before 2007 when the financial crisis created liquidity crunch on the depository institutions. This was because CBN has discouraged depository institutions from borrowing at the discount window by charging penal rate. Depository institutions were expected to come to the window only when they had exhausted the relevant alternative sources of funds. But what happened was that the depository institutions refused to lend to each other because of the perceived depth of problems of these institutions. Moreover those institutions that borrowed from the CBN window were perceived as “troubles”, These problems were confirmed when in 2009, the CBN had to do stress tests for the 24 banks and isolated five depository institutions as very distressed. These five depository institutions had frequented the discount window. The CBN then gave a life line of about =N=600 billion to sustain the depository institutions as a going concern.

3.2 The CBN New Lending Facilities and the Allocation of Credit

In response to the distress in financial markets associated with the international financial crisis and the CBN stress test that showed the depth of illiquidity in the financial system; the depository institutions had not been able to lend to their customers especially customers in the real sector. The CBN initiated a series of new lending program that supported the quantitative easing policy. The lending programs were implemented to ensure “that liquidity would be distributed to those sectors that needed it most”; and that operators in the real sector of the economy access funds at cheap rates.

The first among these programs was the =N=200 billion Commercial Agricultural Credit Scheme (CACS) disbursed through the participating banks. As at April, 2010, four banks, namely Guaranty Trust Bank Plc; First Bank of Nigeria Plc; Skye Bank Plc; and United Bank for Africa Plc participated under the scheme. The second program was the =N=200 billion long tenor fund to boost growth of the Small and Medium Enterprises (SMEs). The third program was the Power Sector =N=500 billion long tenor fund to support the power sector improvement. The fourth was the Aviation sector program of =N=500 billion with each airline to access =N=1 billion to upgrade their services. In all these programs, the lending goes through the depository institution which abinitio has no access to long term funds for the real sector. The CBN funding is a long tenor fund which brings the fund to the depository institution's customers at the Monetary Policy rate.

All other things being equal, these loans are expected to increase the monetary base. But the monetary base was still lower as at end of the

first half of 2010 from the 2010 second quarter indicative benchmark of =N=1,872.00 billion by =N=356.25 billion or 19.02 per cent[1]. This is because these loans have no potential to increase monetary base as they are essentially an exchange for less liquid assets of the depository institution that will on lend to the sector so specified. What the loans does to the participating banks was that it only increase their balance sheet without increasing the liquidity of the financial market generally. By doing, these programs had a significant effect on the allocation of credit by the CBN.
At the 2010 Institute of International Finance (IIF) Spring Membership meeting held during June 9-11, 2010 at Vienna, Austria, Mr. George Soros canvassed this approach that regulatory authorities must conduct sectoral allocation as this helps to remove bubbles and push growth.

1.0 THE CONVENTIONAL VERSUS UNCONVENTIONAL MONETARY POLICY

The CBN's response to liquidity concerns is a clear departure from the conventional tools of monetary policy. This current development raises two interesting questions. Why did the CBN address the liquidity problem by creating a new array of lending programs rather than relying on conventional open market operations and the discount window? And why did the CBN decide to reallocate the total supply of credit rather than increase the total supply of liquidity in the financial market.

From the literature, it was obvious that the lending apathy exhibited by the Nigerian depository institution could ground economic growth. As indicated by Cechetti (2008), “only depository institutions have direct access to the discount window, and Open Market Operations are conducted with just a small set of primary dealers against a narrow range of highly liquid collateral. In contrast, in jurisdiction with universal banking as we have in Nigeria, the distinction between depository institutions and other types of financial institutions is much less relevant in defining access to central bank liquidity”.

Consequently, the CBN has had to use methods it does not usually employ to address liquidity pressures across a number of markets and institutions. In effect, the CBN has had to innovate in large part to achieve what other Central Banks have been able to effect through existing tools.

In Nigeria and because of the underlying problems of the distress in the depository institutions, traditional framework for liquidity provision was not up to addressing the depth of liquidity needs of the real sector of the economy. The CBN was unable to direct the liquidity to the sector in need using Open Market Operations. However, the CBN Act (as amended) does not prevent the CBN from purchasing asset backed securities, commercial paper, and a wide range of other securities, such as those taken as collateral against loans under the new lending programs.

1.1 The Efficacy of the New Approach

Beside the question of 'why' the CBN chose this unconventional approach to monetary policy is the question of 'how' effective it is. Many macroeconomists believe that changes in the composition of the CBN assets that are not accompanied by a change in the monetary base are ineffective. This belief is due, in part, to experience. In the early 1960s the Federal Reserve Bank of USA attempted to reduce long term interest rates while maintaining relatively high short-term interest rates using a procedure called “Operation Twist”. Specifically, the Federal Reserve Bank bought long-term securities, while simultaneously selling short-term securities, so that the net effect of these transactions on the monetary base was nil. The rationale was that by increasing the demand for long-term securities and reducing the demand for short-term securities, the Federal Reserve Bank could “twist” the yield curve long-term rates would fall relative to short-term rates. Most analysts concluded that the Federal Reserve Bank had little or no effect on the shape of the yield curve.

Operation Twist's failure is consistent with alternative theories of the term structure. For example, the expectations hypothesis asserts that long-term rates are determined by the market's expectation of the future short-term rate. If short-term rates are not expected to fall, then long-term rates will not fall either. The failure of operation Twist is also consistent with the risk-premium hypothesis, which suggests that rates on long-term securities are generally higher than rates on short-term securities because investors demand a risk premium for investing in longer-term securities because they have a higher degree of market risk. The risk premium is determined by what economists refer to as “deep structural parameters” that is, the risk aversion of investors. A change in the relative demands for long-term and short-term securities has no effect on the size of the risk premium and, hence, no effect on the shape of the yield curves.

Similar experiences and theoretical arguments apply when attempts to alter the exchange rate through sterilized foreign exchange intervention is undertaken. Sterilized foreign exchange intervention occurs when a central bank purchases securities denominated in one country's currency and simultaneously sells an equal amount of securities denominated in another country's currency; so the effect on the monetary base is nil.

Since December 2009, there has been some evidence that the first level of lending program might have had beneficial effects on financial markets (Financial Markets review January 2010). This was because before December 2009, rate spread had increased as a result of banks' and other creditors' heightened reluctance to lend to banks perceived to have an increased risk of default. Hence, the rise in the term NIBOR rates and other rates that reflect the cost of funds to banks, relative to overnight lending rates, reflects a risk premium that will not be reduced by increasing the liquidity of these banks' portfolios.

2.0 COCNLUSION

In response to the financial crisis and the “Sanusi Tsunami”, the CBN instituted a series of new lending to sectors that could impact the real

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sector of the economy. The lending increased the liquidity of the participating banks portfolios without simultaneously increasing the total supply of liquidity in the financial market. By so doing, the CBN departed significantly from the historic practice of relying on traditional tools of Open Market Operations and discount window lending to provide liquidity to the real sector of the economy.

Why the CBN chose to enact a series of new lending programs rather than use its existing tools of Open Market Operations and the discount window is unclear. It seems that the inadequacy of securities for the market made sectoral lending approach much more appealing to the regulatory authority for immediate impact. CBN has chosen to reallocate the credit in the market by providing loans to the real sector through the participating banks, while offsetting the effect of this lending on total credit through Open Market Operations. It seems that CBN desire was not to increase total liquidity in the economy which could aggravate inflationary pressure but to provide liquidity to real sectors through participating banks to lend for productive purposes and avoid the inefficient liquidation of assets that were temporarily illiquid.

Whatever the reason, it now appears that CBN has injected historically large amounts of credit into the market, which has not impacted the monetary base. This may be due to lag in transmission of the credit to the system.

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