MONETARY STABILITY AND ECONOMIC GROWTH IN NIGERIA*

By

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Mr. Chairman,
Fellow Bankers,
Distinguished Ladies and Gentlemen.

1. I wish to express my delight and appreciation to the Nigerian Institute of Bankers for the honour of inviting me to speak on the occasion of this year's Annual Dinner of your prestigious Institute. The topic I have chosen for tonight's speech is, "Monetary Stability and Economic Growth in Nigeria". Given our mutual concern over recent developments in the banking system and the macroeconomic considerations that make the current restrictive monetary policies necessary, I consider it worthwhile at this time, to reflect on the issue of monetary stability and its place in the country's efforts towards rapid development.

2. The challenge of maintaining stable monetary growth has been a difficult one the world over, due, among other things, to the often uneasy trade-offs involved. In our case, as indeed a large number of developing countries, the task has been made complex by institutional weaknesses in the financial system, the volatility of the external sector, and the perennial and relatively large fiscal deficits of the Government. Due mainly to these factors, efforts to control the money stock in Nigeria over the years, has met with limited success. More often than not, the growth of money supply significantly exceeded policy targets and contributed to destabilising movements in aggregate demand. Excessive monetary expansion, as expected, has been closely associated with rising domestic prices and external sector imbalances.

3. As you know, the relationship between money, output and prices continue to be a matter for sharp division among economists. Nevertheless, there is a fair amount of agreement on a number of broad issues relevant for policy. It is generally agreed that changes in the money stock impact on nominal and real interest rates as well as output and prices in the short-run. Excessive monetary growth, in line with this framework, is expected to stimulate aggregate spending and consequently output expansion, provided there are idle resources. However, if output is relatively inelastic, due to technological limitations, foreign exchange constraints or low productivity (which is the rule rather than the exception in the Nigerian situation), monetary stimulus would tend to generate inflationary pressures as well. Furthermore, an increase in aggregate spending; by stimulating imports, also puts pressure on the external sector. Conversely, if monetary expansion fails to keep pace with the growth in output, this slack would exert a recessionary impact on output growth. The analysis does not necessarily imply that excessive demand pressures alone are to blame for inflation. Inflation can also be due to non-monetary factors on the supply side. The demand-centered analysis merely emphasises the potential role of money in the inflationary process.

4. A second important policy issue arising from the foregoing is the link between inflation on the one hand and market interest rate and the exchange rate on the other. Persistent inflation generates expectations about the course of future prices and puts an upward bias on market interest rate as lenders seek to protect the real value of their funds. On the other hand, rising domestic inflation relative to those of trading partners puts downward pressure on the value of the domestic currency in terms of foreign currency.

5. It is important to point out that the long-term effect of money stock changes on output is generally considered to be tenuous. The main long-term effect of excessive money stock growth appears to be a sustained rise in the price level. Long-term growth is generally considered to depend on real factors such as resource endowments, technology, high productivity and inter-temporal choices between present and future consumption. It therefore follows that an appropriate target for monetary expansion forms an essential part of any package of macroeconomic policy measures. It is broadly this awareness of the importance of monetary growth and short-term economic activity which informs the Central Bank's annual monetary and credit targets.

6. The Nigerian experience confirms the earlier suggestion that inflation can originate from monetary as well as non-monetary causes. For example, the drought that affected agricultural production in the early 1970s and to some extent in 1987 were important contributory factors in the acceleration of prices in the periods. Besides, various other exogenous factors such as cost increases have also contributed to inflation. Nevertheless, the association between monetary growth and inflation has been remarkable in the 1970s and 1980s. By contrast however, the same strong relationship does not seem to exist between monetary growth and economic growth as measured by the Gross Domestic Product (GDP).

7. In the period since 1970, the highest average rates of growth in the money stock were recorded in the period 1974 – 1977 and 1977 – 1983. These two periods have also recorded the highest average rates of inflation. The growth of the money stock averaged 55 per cent in the period 1974 – 1977 and 30.3 per cent during 1987 – 1988 while the inflation rate averaged 21.0 per cent in the earlier and 24.3 per cent in the more recent sub-period. In

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the period before the oil boom, (1970 1973), the average rate of monetary growth and inflation were both lower at 18.8 and 9.5 per cent, respectively Similarly, the slow-down in the average rates of growth of money stock in the period (1978-1980) to 25.7 per cent was accompanied by a de-celeration in the average inflation rate to 12.8 per cent. The most stable period in terms of money supply growth was the period 1981 - 1986 when monetary growth averaged 5.5 per cent. Inflation was at historically low levels during three years of this period but high in 1981, 1983, and especially in 1984 due in the latter two years to acute shortages in supply as indicated by the declines in GDP. In the most recent sub-period, 1987 - 1988, the sharp rise in the average rate of increase in money stock has been accompanied by a significant rise in the average inflation rate to 24.3 per cent.

8. The growth performance of the economy since the 1970s revealed two distinct trends. There was a period of impressive growth from 1973/74 to 1977 due mainly to the boost in crude oil production and prices.. This was followed by a period of stagnation spanning 1978 to 1986. The GDP in fact recorded declines of 4.1 and 6.7 per cent in 1983 and 1984 while its level in 1986 was about the same as five years earlier. The factors responsible for this stagnation in real GDP in the 1980s, as everyone now appreciates, include not only the decline in oil production and prices but the failure of the development strategies followed in the period before SAP. In fact, the inflationary spiral generated largely by rapid monetary growth distorted relative prices — including in particular, the country's exchange rate.

9. The major factors responsible for increases in the money stock over the years have been inflow of foreign exchange especially from crude oil export and increases in bank credit to both the government and the private sectors. Government expenditure in particular tended to rise persistently, resulting in rapid monetisation of crude oil earnings in periods of buoyancy and relatively large budget deficits financed by the banking system when oil revenues are low. Consequently, most of the years which recorded the highest and most destabilising increases in the money supply were those in which relatively large increases occurred in both aggregate bank credit and government monetisation of crude oil earnings. From the foregoing, it seems clear that the country's experience in the last two decades or so has lent support to the Central Bank's approach to monetary and credit regulation. Let me now turn attention to the current monetary measures which I believe can best be understood against the background of the main developments since 1987.

10. The 1987 package of fiscal and monetary policy measures in line with the objectives of the Structural Adjustment Programme (SAP) achieved a measure of success as regards external, and to some extent, domestic stability. However, economic activity became sluggish in the face of stagnant disposable incomes and reduced agricultural output following the drought which affected most parts of the country. Furthermore, there was concern about the acute unemployment situation. It was against this background that the Government adopted the re-flationary budget of 1988. Both fiscal and monetary policies, you may recall, were significantly eased, and with the lifting of the wage freeze substantial wage increases were granted in many sectors of the economy.

11. At the end of 1988, the results of the reflationary policies were mixed. While aggregate output as measured by GDP rose by an impressive 4.1 per cent, the inflation rate had climbed from 10.1 per cent at the end of 1987 to 38.3 per cent. The balance of payments, moreover, had recorded a deficit of ₦2.3 billion in contrast to the earlier year's surplus of ₦159.2 million. Furthermore, the naira exchange rate which remained under pressnre all year round, recorded a depreciation of 22.7 per cent against the United States dollar. The extent of the stimulus to aggregate spending was indicated by the dramatic increase of 43.9 per cent in the money stock — against the t rget rate of increase of 15 per cent.

12. These developments clearly underscored the need to strengthen demand management measures in 1989 as part of the efforts to restore domestic and external stability. The stance of monetary policy for the year was therefore one of moderate restraint aimed at: moderating inflation; reducing pressure on the balance of payments; stabilising the naira exchange rate; building-up the country's depleted external reserves; and stimulating output and employment.

13. In line with the policy of restraint, the ceiling on commercial and merchant banks' loans and advances was lowered from 12.5 to 10 per cent while commercial banks' cash ratios were raised by one percentage point. The Central Bank's Minimum Rediscount Rate was in addition, raised by 0.5 percentage point to 13.25. Contrary to expectations, monetary and credit aggregates maintained their sharp upward trend while inflation continued to accelerate throughout the first quarter of 1989. Furthermore, the naira continued to slide even after the sharp downward adjustment that occurred following the merger of the FEM and the autonomous markets. By the end of the first quarter of the year, therefore, it became apparent that the measures already put in place would be inadequate to contain the domestic inflationary pressures and the pressures on the naira exchange rate.

14. Against this background, additional restrictions were introduced since April. These, you will recall, included the upward review of cash and liquidity ratios, the prohibition of foreign-guaranteed loans and the order to recall such loans outstanding and the increase in the capital adequacy ratios of banks. The climax to the squeeze or liquidity came with the Government order on the transfer of the deposits of public sector and parastatal organisations from commercial and merchant banks to the Central Bank. As we are all more than familiar, banks' compliance with this directive was accompanied by significant liquidity pressures on a number of banks, some of which sought for, and obtained lender-of-last resort support from the Central Bank. The money market remained inactive for a while as the situation unfolded, until the return of confidence especially to the interbank fund market.

15. It is gratifying to note that with the exception of the problem of inflation, it was evident that the objectives of 1989 monetary policy were being achieved, especially from the second quarter. Having said that, allow me to say that the way banks have so far adjusted to the reduced level of liquidity, has become a source of concern to all of us. Lending rates have been pushed to a height that threatens the life of the non-bank corporate sector and ultimately the financial sector as well. This has happened even though banks have paid relatively low rates on saving deposits. The situation suggests strongly that the liquid banks are employing some collective masket power to their immediate advantage. This we all know does not augur well for the future of the economy in general and the banking sector in particular. There is an urgent need for banks to narrow the wide gap between their rates on savings deposits and their effective lending rates.

16. I wish to reiterate that an important aspect of SAP is the liberalisation of the exchanve and trade system ana the gradual decontrol of the financial system. My view of the future is that the process of de-control would be intensified. This view is grounded on the belief that a deregulated system is more efficient than a system of rigid controls. However, the financial system cannot be left completely without some control. Nevertheless, it is my view that the CBN would increasingly remove the existing direct controls and rely more on indirect controls. Indirect controls, by their nature, are non-discriminatory and do not interfere with competition. Consequently, they are in the long-term interest of the banking system.

17. I wish to emphasise, however, that the achievement of monetary stability through the use of indirect controls is predicated on the acceptance of greater responsibility by banks in ensuring that the game is played according to the rules. It is my hope that banks would not inadvertently operate in ways that would give credence to the scepticism expressed in some quarters about the ability of a free market system to determine, for example, a stable exchange rate and an equitable interest rate structure, consistent with price stability and growth objectives.

18. It is my hope, indeed our hope, that the industry will review the situation in the light of the social responsibilities that devolve on us as bankers. The banks cannot be blamed for all the problems of the economy but they are expected to play a constructive role to assure not only the success of the programme of economic transformation which the country has embarked upon, but also to pave the way for the greater liberalisation of the financial system.

19. Once again, thank you for honouring me. I wish you all a happy evening.

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