REVIEW AND HARMONISATION OF FRAMEWORK OF FISCAL AND MONETARY POLICIES FOR EFFECTIVE ECONOMIC MANAGEMENT IN NIGERIA

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1. INTRODUCTION

Monetary policy generally refers to the combination of measures designed to regulate the value, the supply and cost of money in an economy in consonance with the expected level of the economic activity. Excessive growth in money supply leads to high rates of spending on domestic and foreign goods. Given that domestic supply is essentially inflexible in the short run, excessive growth in money supply is likely to result in substantial inflationary pressures in the economy. To the extent that spending pressures are directed towards foreign goods (or assets) balance of payments pressure will ensue. The objective or task of monetary policy is to ensure that the expansion in domestic liquidity is consistent with government's objectives of growth, inflation and the balance of payments.

Fiscal policy may be defined as the deliberate change of levels of government expenditures, taxes and borrowing in order to achieve such national economic goals as full employment, price stability, growth in the GDP and balance of payments equilibrium. The main instruments of fiscal Policy, are government taxes, expenditure and borrowing. Borrowing is a supplementary instrument of fiscal policy when fiscal operations result in a deficit. Thus deficit financing implies that the taxes that are generated compulsorily from the citizens are not sufficient to meet the expenditure programme of the government.

Considering that fiscal and monetary policies have the same objective and are designed within the same broad national economic policy framework, the harmonisation of both policies for effective economic management seems quite natural, logical and simple. However, experience in the past two decades have shown that the Nigerian economy has been mismanaged. (See Ojo M O. 1995 p2). Particularly, the poor performance of monetary

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policy has been attributed to the lack of co-ordination or harmonization with fiscal policy. The objective of this paper, therefore, is to review the framework of monetary and fiscal policies with a view to forging a framework for harmonising them for effective economic management. The rest of the paper is divided into six parts. Part 2 is a theoretical overview of some fiscal policy concepts, especially those related to fiscal deficit size and financing. Part 3 examines the macroeconomic policy framework which forms the common basis for the design of fiscal and monetary policies. Parts 4 and 5 analyse in greater details the framework for fiscal policy and monetary policy, respectively. Part 6 is a critical review of the lack of fiscal and monetary policy harmonisation in Nigeria. Part 7 is a harmonised framework of fiscal and monetary policies for effective economic management in Nigeria.

2. THEORETICAL OVERVIEW OF SOME FISCAL POLICY CONCEPTS

In the context of harmonisation of fiscal and monetary policies in Nigeria, particular importance attaches to size of the budget deficit, the relationships between budget deficits and the external current account balance and those between the methods of financing deficits and other stabilisation objectives.

Size of Budget Deficit.

Consideration of the appropriateness of the fiscal policy stance often focuses on the size of budget deficits. Such deficits provide a measure of the excess of government spending over its revenue, and as such an indication of budgetary addition to domestic demand. When fiscal deficit is large and interest rates are positive, the share of public expenditure devoted to financing debt will also increase. In other words, fiscal deficit will in time, feed upon itself through the interest rate component of public expenditure. For this reason, it is considered prudent to pursue the parallel objective of removal of financial repression and reduction in the size of the deficit. Fiscal deficit can be reduced by cutting expenditure or by raising revenue.

The Budget and External Balance

Some linkages exist between the budget deficit and the external sector as indicated below.

1. $CA = Y - A$ ..... (1)
2. $\Delta NFA = CA + \Delta FI$..... (2)

Where:

Y	=	Gross National Income
A	=	Domestic Absorption or Total Domestic Demand
CA	=	Current Account Balance
Δ NFA	=	Change in Net Foreign Asset
ΔFI	=	Net Capital Flows

- Equation (1) says that the gap between production and absorption is equal to the current account balance while Y-A = Export-Import indicating that an improvement in the current account balance requires either an increase in output or a reduction expenditure.
- Equation (2) is the balance of payment identity. Any excess of absorption over income as reflected in the current account deficit, must be financed either by capital inflow or a draw — down on reserves.

Sources Of Deficit Financing

The way in which a fiscal deficit is financed determines to a large extent the impact that it will have on the economy. For analytical purpose, the financing of the deficit can be distinguished in different ways, all important, but emphasizing different aspect. One can distinguish between domestic and foreign, inflationary and non-inflationary, and voluntary and compulsory financing.

Foreign Financing

If a country can finance its fiscal deficit through foreign grants (or through concessionary loans with a long maturity period, then the deficit may not have detrimental implication for the economy. Especially if the deficit is associated with productive uses of resources, it will bring substantial benefits to the economy.

The second most attractive foreign source of financing deficit is provided by loans with long maturity (say over 10 years) tied to project(s) that pass a relevant cost-benefit criterion.

Foreign borrowing may raise the level of gross foreign exchange reserves, but it will tend to deplete net of owned reserves. That is, foreign borrowing will, in the short-run, have positive effect on the overall balance of payments performance, but not necessarily on the current account. Moreover, external financing of fiscal deficits has implication for

the longer-term external performance of the country by increasing external indebtedness and, therefore, by raising the burden of future debt service.

Non-Inflationary Domestic Financing

Non-inflationary financing is normally associated with the sale of bonds to the public. The extent to which this source of financing is possible depends on two considerations.

(i) The size and sophistication of the country's capital market.

(ii) The interest rate policy being pursued; the possibility of financing substantial share of its fiscal deficit through domestic sale of bonds is not compatible with policies of financial repression, regardless of the size and financial sophistication of the market. In such a situation savers will buy goods or will try to invest their financial assets abroad, thus reducing the capacity of government to finance its fiscal deficit, while at the same time aggravating the BOP problem (see Tanzi and Bleger 1982).

Other non-inflationary ways in which the government can finance its deficit include some compulsory means of which two would be mentioned.

(i) Sales of bonds to social security institutions and other pension funds. Often these institutions are required by law to buy public bonds at negative interest rates. To the extent that the rates are negative amounts to a tax on the institution. If the institution runs deficits that must be financed by Government budget - what government gains on the one hand it losses on the other.

(ii) The second compulsory non-inflationary financing is the building up of arrears i.e. government purchases of goods and services are not paid for on time. When the arrears are created against the private sector, no money creation takes place - it is as if the private sector had bought government bonds at zero interest rate for the period until payment is made. The practice encourages the inflation of contract prices etc. If an arrears is accumulated against a public enterprise, it will run deficits or higher deficits linked either directly or indirectly by government and create inflationary pressures. A well co-ordinated fiscal policy would therefore guard against the accumulation of arrears. Thus accumulation of arrears are considered a particularly unfortunate means of budgetary finance. Such arrears have similar macroeconomic consequences as other forms of public borrowing, as well as jeopardising future financing integrity of the budgetary system

Inflationary Finance: Deficit And Money Creation

The fiscal deficit acquires particular importance when it increases the money supply. The major connection between the fiscal deficit, inflation and the balance of payments comes from the effect that the deficit is likely to have on money creation. The connection between financing of the deficit and monetary expansion (normally referred to as inflationary finance) comes about when the Government sells bonds directly to the Central Bank. Reliance on commercial banks' finance may be expected to have similar effects if banks are not forced to constrain credit to other borrowers.

The most negative effect on the BOP, as measured by the impact on the level of international reserves, is likely to arise from fiscal expansion financed by direct borrowing from the Central bank. Since this mechanism implies, in general, an increase in the money supply, it tends to create excess liquidity in the hands of the public. Such excess liquidity will tend to increase demand for domestic and foreign goods, as well as for alternative financial assets, including foreign assets, and will therefore tend to put pressure on prices and on the BOP.

This is the well known mechanism of adjustment postulated by the monetary approach to the balance of payments and implies that the excess supply of money created by the monetization of the deficit would only be eliminated as foreign exchange reserves have been depleted enough to restore equilibrium in the money market. In addition the pressure put by excess liquidity on the level of prices has an additional equilibrating effect by reducing the real value of the outstanding stock of money.

In an economy operating under a fixed exchange rate system, the more open is the economy (the higher the share of traded goods in total expenditure) the larger will be the role of the balance of payments, adjustment in the equilibrium process, and, therefore, the larger the losses of reserves and the less the impact of monetised deficits on domestic prices. If the exchange rate is allowed to adjust, the monetization of fiscal deficits will put upward pressure on the exchange rate, reducing the losses of reserves and increasing the inflationary impact. In the limit, with a fully flexible exchange rate operating through changes in the price level, the level of international reserves will clearly be affected much less in this case.

The monetary impact of central bank expansion of domestic credit to finance public sector deficit can be reduced by adoption of sterilisation measure and other types of contractionary monetary policies.

Equivalent contraction in credit to the private sector through changes in reserve requirements or through the imposition of other restrictions on the ability of the banking system to expand lending.

If interest rates are market determined, it will tend to push up the levels of interest rates and will lead to the well known "crowding out effect". The stronger the crowding out effect, the lesser will be the balance of payments impart of Central Bank financing of public sector deficit. Thus, in financing larger deficits through the Central Bank, the authorities are confronted with the trade-off between compromising the achievement of monetary target, with the consequent BOP and inflationary results, and constraining the financing of the private sector, with the ensuring effects on economic activity and investment.

3. THE MACROECONOMIC POLICY FRAMEWORK

In Nigeria, as in most market economies, the design of monetary and fiscal policy is done within the context of the overall economic programme of the country. Such a programme typically defines the main objectives in terms of real growth in GDP, inflation rate and balance of payments. To achieve the objectives, the authorities implement a set of fiscal, monetary, economic and structural policies. This comprehensive system of policy formulation relies on the techniques of Financial Programming.

A prerequisite of the Financial Programme is the preparation of major sector accounts; including National Product (GDP), Federal Government Budget, Monetary Sector and the Balance of Payments.

These sectoral accounts would be used for:

i. A review and assessment of recent economic developments;

ii. Determination and quantification of appropriate policy objectives such as the GDP growth rate, inflation rate, Federal Government budget deficit or surplus and the balance of payments;

iii. The determination and quantification of a co-ordinated set of policy instruments to achieve the set targets.

Three of the tables are shown in simplified form on the next page.

The aim of monetary and fiscal policy is to reduce or eliminate disequilibra in the BOP and/or inflation. However inflation and BOP difficulties are often a symptom rather than basic causes of economic disequilibrum. Consequently, policies should be aimed at

eliminating the basic causes of disequilibrum. Often the basic causes of inflation or external imbalance has been **excessive monetary expansion.**

Monetary expansion brings about changes in relative prices, thus encouraging imports, discouraging exports, and inducing unfavourable capital movements. Monetary expansion is itself promoted by other factors and in recent years the culprit in many developing countries including Nigeria, has been **large fiscal deficits.**

Considerable attention is therefore being paid to the size of the fiscal deficit and the mode of financing the deficit. Consequently economic policy framework sets quantitative performance targets related to

(i) The size of the fiscal deficit in nominal terms;

(ii) Aggregate Domestic Bank Credit expansion and,

(iii) Sub-ceiling on bank credit to government

BALANCE OF PAYMENTS BOP	**GOVERNMENT BUDGET**	**MONETARY SURVEY**
Current Account (X,I) +Capital Account =Change in NFA	Revenue - Expenditure =Change in NCG	NFA + NDA = M_2 Or NFA+NDC+OAN = M_2

NFA = Net Foreign Assets
NCG = Net Credit to Government
NDA = Net Domestic Assets
NDC = Net Credit to the Domestic Economy
OAN = Other Assets (Net)
M_2 = Money Supply (Currency outside banks + deposits)
X = Exports
I = Imports

Note that the three tables are closely linked

- The outcome of both the BOP (ΔNFA) and Government Budget (ΔNCG) influence the monetary survey.
- Growth and prices influence the BOP and Government Budget. Similarly, the extent to which investment exceeds saving in the national income account is reflected in an external current account deficit.

- The Monetary Survey is a consolidation of the balance sheet of the Central Bank and the Deposit Money Banks (DMBs).

4. FISCAL PLANNING AND BUDGETARY FRAMEWORK

The Fiscal Planning and Budgeting Cycle: includes important activities such as designing a macroeconomic framework, collating the sectoral budget into a single national budget, monitoring the implementation of the budget and evaluating results. In this light the main agencies involved with planning and budgeting cycle include the Federal Ministry of Finance (F.M.F) office of Accountant General of the Federation (AGF), the National Planning Commission (NPC) the Presidency; the office of the Auditor-General of the Federation (AuGF) and several inter-ministerial committees.

Planning: There are three main levels of planning. The first determines the overall strategies of the Federal Government (FG) with regard to the conduct of macroeconomic policy and the provision of government services. The second function is aimed at how much FGW can afford to spend in total and how that spending should be financed. This aspect of fiscal policy is intimately related to the overall macroeconomic management of the economy. This is accomplished by means of macroeconomic projections. For example, forecasts for oil exports, imports, exchange rates and GDP are excellent guides to expected federally collected revenues - Federally retained revenues plus borrowing less principal and interest due, should equal the resources available for spending. The third planning function is aimed at deciding how much should be spent on each sector, ministry, agency, programme or project. This provides the foundation for the annual budget.

The budget cycle starts in July, when the Federal Government makes an assessment of its current fiscal position and begins the process of formulating future policies. The NPC establishes the overall macroeconomic framework in coordination with the FMF and the CBN. Frequently, however, final policy decisions are not taken until November or December.

The FMF and the NPC send out call circulars in August to each ministry soliciting their detailed requests for funding in the next year. These circulars also offers general guidance on expenditure priorities and policies. The negotiations between the ministries, the FMF and the NPC take place in October to determine the preliminary recurrent and capital allocations for the next year. The final proposals are vetted through the Ministerial

Budget Committee which includes Director Generals (DGs) the FMF Budget Department, the AGF, the NPC, the CBN and the Presidency.

The final budget allocation proposals are presented to the Cabinet and then to the Armed Forces Ruling Council for review along with a macroeconomic framework from the NPC and proposals on foreign exchange and Monetary policy from the CBN. The entire package is then brought to the office of the President for approval in November or December. The results are announced in the form of a budget speech, usually in early January. The final expenditure vote allocations are then used as the basis for system of quarterly warrants authorised by the Minister of Finance which provide the authority to incur expenditure (AIE) by budget head or sub-head. The line ministry officers for each sub-head authorise expenditures while the tender boards approve contracts.

Under Parliamentary Democratic government, the Executive President (towards the end of the year, e.g. November 1999) submits to the National Assembly an Appropriation Bill indicating the revenue projection and expenditure proposal for the next year (2000). The National Assembly in turn scrutinizes the proposals through the various Committees, and after a thorough debate, the Appropriation Bill is passed into Law as an Act, It is only after the law is passed that the government can incur expenditure.

When the approved budget or the Appropriation Act is received at the FMF, Budget Department, AIEs or Warrants are issued to Ministries, authorising them to incur expenditure.

The approved budget is divided into three parts:

(i) Revenues arranged by type

(ii) Recurrent allocations arranged by ministry

(iii) Capital expenditure arranged by sector.

The annual national rolling plan, first published in 1990, provides detailed descriptions of the broad policies of the FG on a macroeconomic and on a sector by sector basis. It also contains a rolling three-year capital investment plan on a project by project basis within each sector. Ideally, the total allocations within the rolling plan should match those of the budget.

The implementation of the budget is monitored on a monthly basis within the ministries by the Finance and Supplies (F&S) Departments which keep monthly transcripts of all receipts and expenditures. The F&S departments also reconcile these transcripts with their monthly bank balances and then forward the result to the AGF. The AGF staff monitor

the data for breaches of authority to incur expenditure, provide reports to the FMF Budget Office, the AuGF, the NPC, and the Presidency. The AGF also sends the final report for the entire year to the AuGF. The AuGF then further reviews the data and prepares an annual report on the final accounts of the FG. The Public Accounts Committee reviews the annual reports of the AuGF as well as any case of financial or physical losses that may be brought by the AuGF. Many of these monitoring and control mechanisms have broken-down under the military and need to be re-established.

5. FRAMEWORK FOR MONETARY POLICY

Within the macroeconomic policy framework already described, the role of the Central Bank is to conduct appropriate monetary policy which is consistent with the national objectives of real growth in GDP, inflation rate and the BOP. In his regard, the Central Bank determines the demand for money consistent with the country's macroeconomic objectives and manipulates the monetary policy instruments at its disposal in order to equate money supply with demand. The ensuing money growth rate and other relevant parameters become the monetary aggregate targets for the relevant period.

The Supply of Money

The use of policy instruments to affect monetary aggregates requires analysis (understanding) of the money supply process. This analysis is facilitated by the use of the accounting framework on page 12.

The Accounting Framework

The accounting framework is basically an analysis of the components of the money supply which are on the liabilities side of the accounts and the factors affecting changes (growth or reduction) in the money supply on the assets side.

- **The Central Bank or Monetary Authority Accounts:** The liabilities of the Central Bank include currency held outside banks and bank reserves which together constitute Base **Money or Reserve Money.** Currency outside the banks is a direct component of money supply, while the availability of bank reserves affects the ability of deposit money banks to create deposits. Analysis of the assets side of the balance sheet indicates the foreign (or external) and domestic factors affecting the growth of money and reserve money.

- **Deposit Money Banks (DMBs):** The DMB's account is a summary of the activities of financial institutions whose liabilities represent the deposit component of money supply. Assets of the DMBs include their reserves and their extension of domestic credit.
- The Monetary Survey: This is a combination or consolidation of the two other accounts just considered. The liabilities of the monetary survey constitute Money and Quasi money . The assets side consists of foreign and domestic assets which are the factors affecting growth in the money supply.

  Thus the monetary survey using the balance sheet identity is of the form:

  $M_2 = (M_1 + QM) = NFA+NDC +OAN$.....(3)

  $\Delta M_2 = (\Delta M_1 + QM) = \Delta NFA + \Delta NDC + \Delta OAN$.....(4)

Where M_2 = money supply (broadly defined)
M_1 = money supply (narrowly defined)
QM = quasi-money or Time + Savings deposit at DMBS
NFA = foreign assets (net)
NDC = aggregate domestic credit (net)
OAN = other assets (net)
Δ = change

- **Demand For Money**

Given the projected growth in output, inflation rate and balance of payment i.e. accretion to external reserves (ΔNFA) in the relevant future period. the Central Bank determines the demand for money and bank credit consistent with policy objectives.

A variety of the estimating techniques may be used depending on the availability of data and the stability of the relationship between the relevant variables e.g.

- Sophisticated econometric models
- Regression Analysis of the form:

THE ACCOUNTING FRAMEWORK FOR MONETARY ANALYSIS

The Central Bank

Assets	Liabilities
Foreign Assets	Base Money
Claims on Central Government	- Currency Outside Banks
Claims on DMBs	- Bank Reserves
Other Assets	Central Government Deposits
	Other Liabilities

Deposit Money Banks (DMBs)

Assets	Liabilities
Reserves	Demand Deposits
-Vaults Cash	Savings Deposits
-Balances with Central Bank	Time Deposits
Claims on Central Government	Foreign Currency Deposits
Claims on Private Sector	Central Government Deposits
Other Assets	Credit From Central Bank
	Other Liabilities

Monetary Survey

Assets	Liabilities
Foreign Assets (net) (NFA)	Money (M_1)
Domestic Credit (net) (NDC)	-Currency Outside Banks (Cp)
-Claims on Govt. (net) (NCG)	-Demand Deposits
Claims on Private Sector (DCP)	Quasi Money (QM)
Other Assets Net (OAN)	- Savings Deposits
	-Time Deposits
	-Foreign Currency Deposits
	(M_1) + (QM) = M_2

$$\text{Ln}\ \frac{M_2}{P} = a_0 + a_1 \text{Ln}\prod + a_2\ \text{LnY} + a_3\ \text{Ln}\ \frac{M_2}{P_{t-1}} \quad \text{.....(5)}$$

Where[t]

$\frac{M}{P}^2$ = money supply (broadly defined M_2) deflated by the price level(P)

$\prod$ = inflation rate or the opportunity cost of holding money e.g. interest rate.

Y = real gross domestic product.

- A more judgemental approach would be to assess the demand for money on the likely movement of the ratio of money to nominal GDP or the velocity of money which is the inverse of this ratio

Determination of Money Supply and Credit Targets

Given the computed values of money M_2, foreign assets (net) NFA and other assets net OAN, the credit absorptive capacity of the economy, i.e., the change in aggregate domestic credit (ΔNDC), consistent with growth in real GDP, inflation rate and balance of payments target (0rΔNFA) follows .from equation (2) such that:-

NDC = M_2-NFA-OAN.....(6)

ΔNDC = ΔM_2— ΔNFA- ΔOAN (7)

The ensuing addition to aggregate domestic credit is then decomposed into change in credit to Government (ΔDCG) and change in credit to the private sector (ΔDCP). Having determined the level of government deficit to be financed by the banking system, credit to the private sector is derived as a residual:-

ΔDCP = ΔNDC - ΔDCG.....(8)

Thus, the ΔDCP derived becomes the maximum amount of increase in credit to be extended to the private sector during the relevant period, and the ΔDCG becomes the public sector borrowing requirement (PSBR) on the banking system.

The Framework For Indirect Control

Since June 1993 when Open Market Operations (OMO) was introduced, the framework for monetary control has been based largely but not solely on the relationship between the money supply and the base money (monetary base or high-powered money). The feasibility of controlling bank credit and hence money supply in this way hinges on the principle that banks maintain a stable relationship between their reserves (vault cash and

deposit with Central Bank) and the amount of credit they extend, such that the credit control can be achieved by controlling base money.

The Concept of Base Money

Base Money (B) is composed largely of:

(i) Currency with non bank public (Cp); and

(ii) Cash Reserves of Banks (R) comprising vault cash and balances held with central bank:

The main sources of base money (B) comprise

(i) Net Central Bank Claims on Government (NCGCB)

(ii) Net Foreign Assets of the Central Bank (NFACB); and

(iii) Other Assets (net) of the Central Bank (OACB)

Thus, the balance sheet identity of the Central Bank can be written as:

$$NCGCB + NFACB + OACB = C_p + R = B \quad \ldots\ldots(9)$$

The Concept of Money multiplier (in)

The concept of money multiplier derives from the idea that banks can and do expand money supply by a multiple of reserves available to them. This is exhibited in the relation:

$$M_2 = m.B \quad \ldots\ldots(10)$$

From the monetary survey we saw that

$$M_2 = C_p + D \quad \ldots\ldots(11) \text{ and from (9)}$$

$$B = C_p + R \quad \ldots\ldots(12)$$

From (10), the multiplier may be derived as

$$m = \frac{M_2}{B} \quad \ldots\ldots(13)$$

Substituting the right hand side of (11) and (12) in (13) and dividing by D the money multiplier can be defined in terms of ratios of currency and reserves to deposits:

$$m = M_2/B = (C_p + D)/(C_p + R) = (C_p/D + D/D)/(C_p/D + R/D) \quad \ldots\ldots(14)$$

$$\text{or } m = \frac{1 + c}{c + r} \quad \ldots\ldots(15)$$

Where D = deposit held by banks;

c = ratio of currency to deposits:

r = ratio of bank reserves to deposits:

And all other variables are as previously defined.

Controlling the Money Supply

- Calculate the level of Base money (B) consistent with the target for M2 in the financial programme: $B = \frac{M_2}{m}$
- Take into account factors affecting (B) outside Central Bank control.
- The Central Bank can then estimate increases or decreases in the sources of B that it does control so as to hit the target by the use of OMO.
- The multiplier (m) can be influenced through changes in reserve requirements and interest rates.
- If interest rates increase ratio (c) in equation (15) declines and (m) Increases.
- If reserve requirements increase, (r) increases and (m) declines
- The implication of this is that the Central Bank's control over reserve money is incomplete. For example, changes in NFA, which are a reflection of the balance of payments outcome cannot generally be considered to be a policy-controlled variable.
- In countries where there is policy co-ordination or harmonisation between the Central Bank and the Ministry of Finance, control can be effectively exercised over net claims on Government but the experience in Nigeria has been that the CBN adjusts passively to government's budgetary position.

6. EXPERIENCE WITH MONETARY POLICY IN NIGERIA

We summarize below the experience of Nigeria with OMO to illustrate the absence of harmonisation of fiscal and monetary policies. The 1990 decade in Nigeria was characterized by severe economic instability. The major problems to which macroeconomic policy measures were directed albeit unsuccessfully included internal imbalance reflected in high and accelerating rate of domestic inflation accompanied by falling private investment, low output growth, reduction in industrial capacity utilization, external imbalances reflected in depreciating exchange rate, current account deficits, capital flight and high level of external indebtedness.

A restrictive monetary policy stance was adopted and aimed at reducing the inflation rate and contributing to exchange rate stability. Credit to the private sector was programmed to expand moderately while credit to government was expected to drop substantially. Since June 1993 the main technique for achieving the objectives of monetary policy has been the use of OMO, reinforced by changes in cash reserve requirements and discount window operations.

Contrary to the restrictive stance of monetary policy since 1991, monetary aggregates have grown phenomenally as a result of the larger than anticipated growth in CBN credit to Government and CBN's passive adjustment to government's budgetary position.

The rate of inflation as measured by the CPI rose persistently from 44.6 percent in 1992 to a peak of 72.8 percent in 1995 declining to 29.3 percent in 1996 and 8.5 percent in 1997 and edging up to 10.2 percent in 1998. In tandem with high rates of inflation, the exchange rate depreciated from N9.9095 to the US$1.0 to about N80 to N85 per US$ between 1996 and 1998 and then to about N100 to the dollar in 1999. In spite of increased liquidity, nominal interest rates rose phenomenally in line with inflation, but real rates remained largely negative. Although external assets grew since 1996, reaching over US$7 billion in 1997 and 1998, the balance of payments pressure which resumed in 1992 persisted throughout the 1990 decade.

The general reduction in the tempo of economic activity continued to be reflected in lower and declining trend in capacity utilization. The real GDP virtually stagnated or grew at very low rates. Unemployment remained high. Social services, especially the health, electricity, telecommunications, etc, came under intense pressure. Apart from the huge cost of providing these services, there are wide-spread disruption in service delivery.

The situation was worsened by acute fuel shortages since 1997. The nutrition status of the people is adjudged to have suffered declines as a result of food price increases. Thus in spite of monetary policy measures, economic instability persisted.

Why Did Monetary Policy Fail?

- The failure to sell the weekly primary auction at true market rates is the most important factor in the failure of OMO to achieve monetary policy targets. This was the result of arbitrary government intervention from January 1994 to September 1998 when Treasury bills rate was administratively set at 12 to 12.5 percent.

- Secondly, the CBN's practice of underwriting government securities sales to the public at targeted interest rates deprives the CBN of control over its portfolio of government securities and hence over its credit to Government (net). OMO is intended to overcome this loss of control, but as long as OMO is limited by the same interest rate constraints, the CBN will not be able to control credit to Government and hence Base money.
- The inability of the CBN to control money supply was aggravated by government's disregard for the limits on ways and means advances as well as the conditions for repayment.
- Persistently larger than anticipated government deficit was complicated by extra budgetary expenditures, and the operation of extra-legal accounts with implication for transparency and accountability.
- Prolonged unstable political and economic environment feeding back on each other.
- The deterioration in the general condition of the financial system as gauged by capital adequacy, asset quality, earnings and quality of management.
  - For example at the expiration of the deadline of December 1998 for banks to raise their minimum capital to N500 million, only 64 (41 out of 51 Commercial Banks, and 23 out of 38 Merchant Banks) had fully complied.
  - Over 40 percent of total loans and advances of banks insured by NDIC are classified as bad and doubtful.
  - Pervasive distress in the financial sector has impaired the systems responsiveness to monetary policy changes. The number of distressed banks increased from 7 in 1989 to 50 in 1997. In spite of the liquidation of 14 Commercial and 16 Merchant Banks in 1998, there were still as many as 22 distressed banks in the system at the end of 1998 (CBN Annual Report 1998).

7. FRAMEWORK FOR THE HARMONISATION OF FISCAL AND MONETARY POLICY FOR EFFECTIVE ECONOMIC MANAGEMENT

The Nigerian fiscal and monetary policy framework suffers not so much from a lack of technical design or expertise as from a general lack of commitment to good governance. From what we have seen above of the experience of Nigeria with fiscal and

monetary policy, the two most important issues at the core of harmonisation are:

-The size of the budget deficit

-The sources of deficit finance.

Therefore, the most important element in the framework is federal government commitment to good governance and the observance of agreed monetary targets in the macro framework.

- Aggregate credit target
- Sub-ceilings on credit to government
- This would imply reduction in the size of the budget either by reducing expenditure or raising revenue
- Federal Government should avoid inflationary financing that is the budget deficit should not be financed by the banking system, especially the Central Bank
- The corollary to this is that the preference should be for private sector financing. Compulsory financing should be avoided by paying market rates.

- The main framework for fiscal and monetary policy harmonisation should continue to be the Monetary Survey where M_2 = NDA + NFA
  M_2 = NCG + NCP + OAN + NFA
- Monetary data are usually more reliable and more timely than fiscal data. Monetary expansion is often the basic problem, rather than the deficit itself. The behaviour of the fiscal deficit is monitored through the amount of credit expansion to the government. This credit expansion is broadly an indication of the monetary expansion for which the public sector is responsible.

Nevertheless the macroeconomic policy framework can make do with some improvements.

- The overall macroeconomic and sectoral planning efforts require better information. Up-to-date, accurate and comprehensive information on recent performance as well as projections should be provided to FMF, NPC, CBN and the Line Ministries. Projections need to be more realistic and internally consistent
- Explicit spending limits should be indicated in the call circulars sent to the different ministries soliciting their detailed expenditure for the next year.
- There is need for better monitoring. Sectoral budgets should set measurable targets in terms of the level and quality of services to be provided. The choice of individual projects to include or eliminate from the budget should be informed not only by

concern for affordability but also by the strategic role of government.

- The FMF should increase the frequency of its reviews from once a year to at least four times a year.
- The office of the Auditor General should audit all accounts. Each ministry should make public their goals and progress made in meeting these goals.
- Expenditure controls require a firm commitment to adhere to the approved budget. Without this commitment from top to bottom, no system can be effective. The existing system of financial regulation is adequate if properly implemented. Authority to incur expenditure by a political appointee, authorization of expenditure by the Presidency and all off-budget accounts should be eliminated. New or stringent penalties should be imposed on over-spending budgetary votes.
- The Federal Governments financial regulations and audit functions are meant to ensure internal accountability. The system has been weakened over the years. There is need for determined effort to improve on transparency and accountability.

There are some institutional issues which should be resolved to improve the overall framework for the harmonisation of fiscal and monetary policy for the effective management of the economy. In particular, the issue of de-facto independence/autonomy to the CBN.

Central Bank Autonomy And Improved Economic Performance

The concept of Central Bank Independence (CBI) recognizes that the government has ultimate responsibility for general economic policy - including monetary policy. Hence CBI does not mean that the Central Bank be completely divorced from government, but that it be "independent within government".

Arguments for Central Bank Independence

(i) There is need to separate the currency issue arid lending functions of the Central Bank from the financing and borrowing functions of government. Lack of CBI may jeopardise the monetary policy function of the Central Bank.

(ii) To insulate Central Bank monetary policy function from political pressure.

(iii) To improve policy transparency and credibility and hence achieve longer-run price stability.

(iv) Corollary to (iii) above — acceptance of CBI by government backed by a mandate for maintaining price stability is a demonstration of the strength of government's

commitment to policy harmonisation and more effective economic management.

(v) CBI can enhance the quality of both monetary and general government policy formulation and harmonisation.

Major features of Central Bank Independence

(I) Statutory Objective: Independent Central Banks generally have narrow and clearly defined mandate or objective of price stability set for them by statute.

(II) Conflict Resolution: In the event of conflict between stated objective(s) and other government or its own policy objectives, more independent Central Banks have greater freedom to determine priority.

(III) Monetary Policy Independence: Refers to the freedom to formulate and implement monetary policy, especially to use policy instruments to achieve stated inflation goal or target (instrument independence). A key component of this measure of CBI is the degree of freedom to change official interest rates, to select exchange rate under a floating system, and select the mix of policy instruments and techniques it uses to undertake OMO.

(IV) Limitation on Financing Government Deficit: More independent Central Banks are either precluded from financing government deficits or have strict limits imposed on their ability to do so.

(V) Appointment and Dismissal of Principal Officers: Appointment to independent Central Banks may include non-government appointees or nominees:

- Terms of appointments are fairly long and scattered;
- Dismissal is made difficult or precluded.

(VI) Budgetary Independence: Independent Central Banks have budgetary independence. An internally self-financing central bank is considered more independent. Less independent central banks have budgetary allocations or have to present annual budgets to government for approval.

We are aware that the degree of independence among Central Banks covers a wide spectrum. Legislation may not cover every conceivable relationship between Central Bank and government. The voids are filled by tradition at best and power politics at worst. Therefore, actual independence may vary from legal independence because of personalities of key individuals in the bank and in the rest of government; the respect for the law with

regards to observance of legislation; the quality of the banks' advice as well as formal and informal arrangements between the bank and other arms of government.

Evidence from both theory and practice leaves little doubt that the implementation of market friendly monetary policy and policy co-ordination have little or no chance of success without a substantial measure of central bank independence: in particular; the ability to use its policy instruments freely, and the specification of a price stability goal or an inflation target. It is no wonder, therefore, that a number of countries with poor records of inflation e.g. Chile, Mexico, New Zealand and Venezuela, among others, have had the legal independence of their central banks enhanced. Similarly, several countries in Eastern Europe have recently made or are considering significant changes to their central bank's legislation for the same purpose. More recently, the major industrial countries of the European Economic Community are on the move towards more independent central banks. In particular, the Maastrich treaty requires national banks participating in the European System of Central Banks to meet a prescribed standard of independence.

- Therefore, the government should be responsible for determining and setting monetary policy goals.
- The goal(s) should be clearly defined to include the achievement and maintenance of price stability (this should be understood to mean 1 to 3 percent average inflation rate or a long-term target of say 2 percent).
- Conflicting goals should be avoided e.g. price stability may conflict with objectives of full employment, economic growth, balance of payments etc.
- In turn the central bank should be granted instrument independence i.e. ability to design and implement monetary policy freely and using all the instruments at its disposal to achieve the goal or target set for it.
- The central bank should be accountable by being held responsible for meeting its goals or target.

In this regard, the Central Bank should publicly announce its immediate policy goals e.g. inflation rate for the next three years after consultation with appropriate arms of government, such as those responsible for Finance, planning and Economic Development.

The Governor should be required to explain and justify the bank's policy in meeting its pronounced goal in public, preferably to a selected group of well informed elected officials. The testimony should be accompanied by the publication of a report. This is

similar to the Humphery Hawkins hearing at which the Chairman of the Federal Reserve Board testifies twice a year before the United States Senate.

The function and responsibility of the Board of Directors and the Executive Board should be clearly stated to show that monetary policy is their primary responsibility. Such Directors and Board members should be selected from persons of recognized standing, and professional experience in monetary, financial and economic matters. Board member should be appointed for a lengthy term, more than 5 years, say 8-10 years. The terms of appointment should be staggered to make for continuity.

The central bank should not be required to finance the government deficit and should not manage the public debt.

The functions of the central bank should be defined to include the promotion of a stable financial system through the traditional roles of lender of last resort, banking licensing, prudential supervision and regulation etc. Even where some of these functions (e.g. supervision and regulations) are delegated to other agencies, the central bank should either have concurrent authority or considerable input. The central bank should not have responsibility or deposit insurance.

Finally, the central bank should enjoy budgetary independence, and its annual budget should not be subject to government or ministerial approval.

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