

Overview of Monetary Policy in Nigeria

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I. Introduction

Monetary policy can be defined as the instruments at the disposal of the monetary authorities to influence the availability and cost of credit/money with the ultimate objective of achieving price stability. Depending on the mandate of the monetary authorities, the objectives of monetary policy may well go beyond price stability. More often than not, monetary authorities particularly in developing countries are saddled with a dual mandate - price stability and sustainable growth. In such a situation, monetary policy is used to achieve both objectives.

Monetary policy influences the level of money stock and/or interest rate, i. e. availability, value and cost of credit in consonance with the level of economic activity. Macroeconomic aggregates such as output, employment and prices are, in turn, affected by the stance of monetary policy through a number of ways including interest rate or money; credit; wealth or portfolio; and exchange rate channels (Akhtar, 1997; CBN, 1995). The monetary authorities apply discretionary power to influence the money stock and interest rate to make money either more expensive or cheaper depending on the prevailing economic conditions and policy stance, in order to achieve price stability. This is why Wrightsman (1976), concludes that monetary policy is nothing but a deliberate attempt to control the money supply and credit conditions for the purpose of achieving certain broad economic objectives. In general, most monetary authorities or central banks have been saddled with controlling inflation, maintaining a healthy balance of payments position to safeguard the external value of the domestic currency and promoting economic growth.

In Nigeria, the Central Bank of Nigeria (CBN) is the sole monetary authority. Its core

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mandate is to promote monetary and price stability and evolve an efficient and reliable financial system through the application of appropriate monetary policy instruments and systemic surveillance. The 1958 Act establishing the Central Bank of Nigeria gave it the following specific functions (which have endured in the 2007 CBN Act):

- issuance of legal tender currency notes and coins in Nigeria;
- maintenance of Nigeria's external reserves;
- safeguarding the international value of the currency;
- promotion and maintenance of monetary stability and a sound and efficient financial system in Nigeria; and
- Acting as banker and financial adviser to the Federal Government.

Embedded in these objectives are two separate but highly related roles: A developmental role and financial surveillance (stability) role. The roles demand, among others, that the CBN focuses on both price stability and growth. In order to ensure the realization of the goals of price stability and economic growth, the CBN deploys its monetary policy instruments in such a way as to ensure optimality in inflation and growth outcomes.

It follows, therefore, that the efficient conduct of monetary policy is a major responsibility of the Central Bank of Nigeria. This is also true of most central banks. Monetary policy complements other economic policies to achieve government's overall macroeconomic objectives of internal balance and external viability. Monetary policy is usually confronted with the problem of managing excess liquidity, rapid expansion in credit as well as excess foreign exchange and capital inflows, particularly in resource endowed economies. In some other economies, mostly industrialized economies, monetary policy may be applied to tackle the problem of liquidity shortage and its uneven distribution as well as inflationary pressures arising from overheating of the economy.

The conduct of monetary policy in Nigeria has undergone several phases. Three of the phases are easily identified - the era of application of direct controls; the era of application of market instruments (or indirect controls), and the era of intense reform of strategy and institutions. The major objectives of policy has, however, remained unchanged, that is, price stability and sustainable growth of the economy.

II. Monetary Policy Process

The monetary policy process is a fairly complex process involving objectives and targets setting, monetary programming, choice of nominal anchor, policy instruments and the institutional framework for monetary policy implementation as well as communication and evaluation of outcomes. Some of the key activities are briefly discussed in this section.

i. Objectives and Targets

In Nigeria, the major objectives of policy are the attainment of price stability and sustainable economic growth. Associated objectives are those of full employment and stable long-term interest and real exchange rates. In pursuing these objectives, the CBN recognises the existence of conflicts of objectives necessitating at some point, some sort of trade-offs. The targets of monetary policy are in the case of the CBN the operational target, the intermediate target and the ultimate target. The Bank manipulates the operating target (reserve money) over which it has substantial direct control to influence the intermediate target, broad money supply, (M_2) which in turn impacts on the ultimate or final objective of monetary policy, i.e., inflation and output. The broad money supply (M_2) comprises narrow money (M_1) and quasi money while the operating target, reserve money is made up of currency in circulation and bank deposits with the central bank.

ii. Nominal Anchor

A nominal anchor for monetary policy is a single variable or device which the central bank uses to pin down expectations of private agents about the nominal price level or its path or about what the Bank might do with respect to achieving that path (Krugman, 2003). Generally, there are two kinds of nominal anchor; quantity-based nominal anchor and price-based nominal anchor. The quantity based nominal anchor targets money while the price-based nominal anchor targets exchange rate or interest rate. In the past, the CBN used broad money supply (M_2) as the nominal anchor for monetary policy. It is important to note that exchange rate targeting may not produce the desired effect if the interest rate is also subject to control at the same time. Some rules are necessary for effective monetary policy. In this case, prices such as exchange rate and interest rate may not be controlled or pegged at the same time. If interest rate is controlled, the exchange rate should be allowed to move freely for the necessary adjustment to materialise so that price stability could be attained.

iii. Monetary Programme/Model

In designing monetary policy, the CBN reviews developments in the economy over a period, articulates the major pressure for and risk to price stability and formulates a framework which will guide its monetary policy implementation. The framework which is essentially an approach to monetary management is based on a programme which sets out future trends in macroeconomic aggregates. *The monetary programme* defines the quantitative targets to be attained. The CBN uses the IMF financial programming framework in a medium term framework. This programme is updated from time to time to take account of developments in the course of the 2-year programme period.

iv. Monetary Policy Instruments

Until 1993 when open market operations (OMO) was introduced, the CBN relied almost exclusively on varying combinations of direct instruments of monetary control from time to time. These instruments included: credit ceilings, sectoral credit allocation, interest rate controls, imposition of special deposits, moral suasion, withdrawal of government deposits, stabilisation securities and exchange controls, etc. As the financial markets deepened over time as a consequence of the economy-wide macroeconomic reforms that commenced mid-1980s, the CBN started the process of shifting from the use of direct instruments to market-based instruments. The most significant move in the new direction came in June 1993 when the Bank introduced OMO. The market-based tools include in addition to OMO, reserve requirements which specifies the proportion of a bank's total deposit liabilities that should be kept with the central bank; and discount window operations under which the central bank performs the role of lender of last resort to the deposit money banks. Open market operations may be undertaken through outright transactions or through repurchase transactions. Repurchase transactions are temporary and are usually reversed at the expiration of the contract and involves the purchase of securities with agreement to sell the securities back at a later date with some financial consideration. On the other hand, reverse repo involves the sale of securities to a party with agreement to purchase the securities at a later date with some interest. Currently, OMO is the major instrument of monetary policy at the CBN. Other supporting instruments are discount window operations, moral suasion, foreign exchange sales/swaps and the standing facility introduced in December 2006.

v. Liquidity Management

Liquidity management involves the supply/withdrawal from the market the amount of liquidity consistent with a desired level of short-term interest rates or reserve money. It relies on the daily assessment of the liquidity conditions in the banking system, so as to determine its liquidity needs and, thus, the volume of liquidity to inject or withdraw from the market. The liquidity needs of the banking system are defined by the sum of reserve requirements imposed on banks, excess reserves, i.e. funds held in excess of these requirements, autonomous factors, i.e. a set of items on the central bank balance sheet which have an impact on banks' liquidity needs but are not under the direct control of the central bank (e.g. banknotes in circulation, government deposits or net foreign assets). Liquidity management is supported by daily liquidity forecasting of the central bank balance sheet to guide the Bank's management on the expected level of liquidity in the system over a period of time from the current period so that appropriate measures are taken to prevent undesirable market developments, that may negatively impact on the objective of price stability.

III. The Conduct of Monetary Policy in Nigeria

Theoretical framework

The objectives of public policy typically includes low and stable domestic prices, sustainable real growth of GDP, favourable balance of payments, reduction of unemployment, poverty reduction, etc. The Central Bank's role as an institution of government is to conduct appropriate monetary policy which is consistent with these objectives. In this regard, the central bank determines the amount of money supply that is consistent with the country's macroeconomic objectives and manipulates the monetary instruments at its disposal in order to achieve that amount.

In order to determine the money supply, the Central Bank uses information on the balance of payments, government budget deficit or surplus and other economic indicators, e.g., growth, prices, etc. On the basis of the information, three basic tables are prepared, namely: balance of payments, government budget and monetary survey. The three tables are shown below in simplified form:

BALANCE OF PAYMENTS (BOP)	GOVERNMENT BUDGET (Gov B)	MONETARY SURVEY
Current Account (X,I) + Capital Account = Change in NFA	Revenue - Expenditures = Change in NCG	NFA + NDA = M ₂ or NFA + NDC + OAN = M ₂

Where;

NFA = Net Foreign Assets

NCG = Net Credit to Government

NDA = Net Domestic Assets

NDC = Credit to the Domestic Economy (Net)

OAN = Other Assets (Net)

M₂ = Money Supply (currency in circulation + deposits)

X = Exports

I = Imports

As can be seen from the Table above, the three columns are closely linked. Both the outcome of the balance of payment (Δ NFA) and government budget influence the monetary survey. At the same time, the real growth of the economy and prices influence the balance of payments (growth in exports, demand for imports, etc.) and the government budget (oil revenue, tax collection, expenditures on wages, materials, etc). The monetary survey is the consolidation of the balance sheet of the Central Bank and the deposit money banks, (DMBs).

The monetary survey uses balance sheet identity of the form:

$$M_2 = (M_1 + QM) = NFA + NDC + OAN \quad \dots\dots\dots(1)$$

$$\Delta M_2 = \Delta (M_1 + QM) = \Delta NFA + \Delta NDC + \Delta OAN \quad \dots\dots\dots(2)$$

Where:

M₂ = money supply (broadly defined)

M₁ = money supply (narrowly defined)

QM = Quasi-money or Time + Savings deposit at deposit money banks.

NFA = foreign assets (net)

NDC = aggregate domestic credit (net)

OAN = other assets (net)

Δ = change.

Thus, given the projected growth in output, inflation and accretion to external reserves (NFA), the Central Bank determines the level of money supply and bank credit consistent with the above macroeconomic framework using an appropriate form of the demand for money function such as:

$$\ln (M_2/P_t) = a_0 + a_1 \ln \pi + a_2 \ln Y + a_3 (M_2/P_{t-1}) + a_4 \ln (i) \dots\dots\dots (3)$$

Where,

(M_2/P_t) = real money supply (broadly defined deflated by the price level)

P_t = general price level at time t

π = inflation rate

Y = real gross domestic product

(M_2/P_{t-1}) = the dependent variable (real money supply) lagged one period

i = interest rate.

Given the computed values of broad 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 (NDC), consistent with growth in real GDP, inflation rate and the balance of payments target follows from equation (2), such that:

$$NDC = M_2 - NFA - OAN \dots\dots\dots(4)$$

$$\Delta NDC = \Delta M_2 - \Delta NFA - \Delta OAN \dots\dots\dots(5)$$

The ensuing addition to aggregate domestic credit is then decomposed into credit to Government (ΔNCG) 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:

$$\Delta DCP = \Delta NDC - \Delta NCG \dots\dots\dots(6)$$

The ΔDCP so derived becomes the maximum amount of increase in credit to be extended to the private sector. The framework just described formed the basis of the credit ceilings imposed on individual banks until they were dispensed in September 1992.

Under the indirect approach, the level of monetary aggregates consistent with the achievement of macroeconomic objectives continued to be determined by the CBN

as explained above, but the achievement of the target was through the control of base money (B). 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 control can be achieved by controlling base money.

Concepts of Monetary Base or Base Money

Monetary base (B) is composed largely of:

- (i) Currency with non-bank public (Cp);
- (ii) Cash reserves of banks (R) comprising vault cash and balances held at the central bank;

The main sources of base money (B) comprise:

- (i) Net Central Bank Claims on Government (NCBCG)
- (ii) Net Foreign Assets of the Central Bank (NFACB); and
- (iii) Other Assets (net) of the Central Bank (OACB)

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

$$\text{NCBCG} + \text{NFACB} + \text{OACB} = \text{Cp} + \text{R} = \text{B} \quad \text{.....(7)}$$

The Concept of Money Multiplier

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

$$M_2 = m.B \quad \text{.....(8)}$$

Where Money Supply (M₂) is broadly defined

m = Money Multiplier; and
B = Base Money.

From (8), the multiplier may be derived as:

$$m = M_2/B = (C_p + D)/(C_p + R) = (C_p/D + D/D)/(C_p/D + R/D) \quad \dots\dots\dots(9)$$

Or

$$M = 1+c/c+r \quad \dots\dots\dots(10)$$

Where

D = deposits held by banks;

c = ratio of currency to deposits;

r = ratio of bank reserves to deposits;

And all other variables are as previously defined. Following from equation (10), equation (8) may be re-written as follows:

$$M_2 = \{(1+c)/(c+r)\}(R+C_p) \quad \dots\dots\dots(11)$$

Equation (11) can be used to estimate the level of money supply arising from a given level of base money (B) and the multiplier. Consequently, the Central Bank can control the money supply (M_2) through changes in bank reserves (R) and currency outside bank (C_p) which, as shown above, comprises its known liabilities.

The Central Bank can also influence the multiplier (m) in the desired direction. The currency-to-deposits ratio (c) is a function of the preference of economic agent for holding money either in the form of currency or demand deposits. While this ratio is generally thought to be outside the control of the Central Bank, it may be sensitive to interest rate movements. Bank reserves to deposits ratio (r) may be influenced by monetary policy instruments such as interest rate and open market operations (OMO). More importantly, (r) can be directly influenced by the Central Bank through the use of reserve requirements.

Institutional framework

The institutional set up of the monetary policy process affects the efficacy of monetary policy. In Nigeria, the Monetary Policy Department of the CBN articulates the monetary policy framework and produces draft monetary programme which is considered by the Monetary Policy Committee (MPC). The MPC also considers draft reports on the economy and assessment made by the staff of the Bank on which monetary policy deliberations and subsequent decisions are based.

The MPC deliberates on the monetary policy instruments which are subsequently implemented by the operational departments. The MPC meets every other month and has a calendar of meetings. It is the highest authority on monetary policy issues at the CBN. In line with the new CBN Act, the Committee must sit at least four (4) times in a year. Because the CBN has instruments independence, its monetary policy decisions are not vetted by any higher authority. The Committee comprises the Governor and four (4) of his deputies, two (2) external Board members, the Permanent Secretary, Ministry of Finance and a secretary, usually the Head of Monetary Policy Department. Following the enactment of the new CBN law, the membership of the Committee is expected to be expanded to include some appointees of the President and the Governor of the CBN.

At the CBN, there are other supporting institutional arrangements. These include the Monetary Policy Technical Committee (MPTC) and the Monetary Policy Implementation Committee (MPIC), Fiscal Liquidity Assessment Committee (FLAC) and Liquidity Forecasting Committee (LFC). These Committees perform different but complementary roles in the formulation and implementation of monetary policy at the CBN. The MPTC meets monthly to review economic and financial developments, on the basis of which it advises the MPC on the appropriate course of action. The Committee which comprises all the policy departments and some operational departments is anchored by the Monetary Policy Department. The MPIC meets weekly to review liquidity situation and take actions aimed at ensuring that the Bank's operational target, base money remains at the prescribed level. The committee is chaired by the Deputy Governor, Economic Policy. The FLAC is an inter-agency committee comprising representatives of the Debt Management Office, the Budget Office of the Federal Ministry of Finance and the Office of the Accountant General, and the CBN represented by staff of the MPD and other key departments. The Committee is hosted on behalf of the CBN by the MPD.

Monetary Policy Implementation Framework

Prior to the banking sector consolidation exercise that was concluded in December 2005, the framework for monetary policy in Nigeria had witnessed some transformation. This included the shift from the use of direct monetary policy control to indirect (market-based) monetary management, and the switch 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 aggregates remained the intermediate target for achieving the ultimate objective of inflation during this period, there were some fundamental changes in the

strategies and instruments employed in the conduct of monetary policy in order to cope with the evolving financial environment. These changes are discussed below.

Era of Direct Control (Pre-SAP Period)

As has already been pointed out, prior to the introduction of the Structural Adjustment Programme (SAP) in mid 1980s, the monetary policy framework placed emphasis on direct monetary control. This was essentially due to the relatively underdeveloped nature of money and capital markets in the country then. The framework 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. During this period the set monetary targets were hardly realized. Instead, the strategy created a lot of distortions and bottlenecks in resource allocation, resulting in wide spread inefficiencies in resource allocation and utilization.

Period of Indirect or Market Approach (Post-SAP Era)

In line with the economic deregulation embodied in 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.

Regime of Short-Term Monetary Policy Framework (1986-2001)

Consistent with the broad objectives of monetary policy, a number of monetary targets and instruments were adopted during the short-term (one-year) monetary policy framework (1986-2001). OMO, conducted wholly using the Nigerian Treasury Bills (NTBs), continued to be the primary instrument of monetary policy. This was complemented by the cash reserve requirement (CRR) and the liquidity ratio (LR). Other policy instruments employed included the discount window operations, mandatory sales of special NTBs to banks and a requirement of 200 per cent treasury instrument to cover for banks' foreign exchange demand at the Autonomous Foreign Exchange Market (AFEM). Interest rate policy was deregulated through the proactive adjustment of minimum rediscount rate (MRR) to

signal policy direction consistent with liquidity conditions. Surveillance activities of the CBN focused mainly on ensuring sound management and maintenance of a healthy balance sheet position on the part of deposit money banks (DMBs). On the external front, the official and inter-bank exchange rates were unified in 1999.

In spite of the reforms in the articulation and execution of monetary policy during this period, most of the monetary and financial targets were substantially missed. The actual growth rates in broad measure of money supply (M2) and aggregate bank credit for the years, 1999-2001, were higher than the targets by wide margins, (Table 1). Although, inflation performed better in two of the three years, aggregate output was sluggish during the period. The outcomes could be attributed to the expansionary fiscal operations of the three-tiers of government and the resultant liquidity overhang, as well as lack of coordination of monetary and fiscal policy implementation.

Table 1: Key Policy Variables (% except otherwise stated)

	1999		2000		2001	
	Targets	Outcomes	Targets	Outcomes	Targets	Outcomes
M ₂	10.0	31.4	14.6	48.1	12.2	27.0
M ₁	4.1	19.9	9.8	62.2	4.3	28.1
Agg. Credit to the						
Economy	18.3	35.5	27.8	(23.1)	15.8	74.8
Net Credit to Govt.	10.2	57.1	37.8	(162.3)	2.6	(94.6)
Net Credit to Private						
Sector	19.9	27.3	21.9	30.9	22.8	43.5
Inflation	9.0	6.6	9.0	6.9	7.0	16.5
Real GDP Growth	3.0	2.7	3.0	3.8	5.0	4.6

Regime of Medium-Term Monetary Policy Framework (2002-2005)

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 framework, monetary policy guidelines are open to half-yearly review in the light of developments in monetary and financial market in order to achieve medium- to long-term goals.

The major objectives of monetary policy since 2002/2003 have been to subdue inflation to a single-digit level and maintain a stable exchange rate of the naira. 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 injection/withdrawal of public sector deposits in and out of the DMBs. The CBN has also continued to ensure banking soundness and financial sector stability, not only to ensure the effective transmission of monetary policy actions 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 key point of which was the ₦25 billion minimum capital base for DMBs). The 2004/2005 monetary policy and credit guidelines were fine-tuned in 2005 in the light of changing environment. New policy measures introduced included maintenance of a tight exchange rate band of plus/minus 3 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 improved fiscal discipline at the federal government level, impacted positively on the monetary aggregates in 2004 and 2005, resulting in the achievement of set targets during the period. The growth rate of real GDP also increased substantially, exceeding set targets in 2003-2005.

Table 2: Key Policy Variables (% except otherwise stated)

	2002		2003		2004		2005	
	Targets	Outcomes	Targets	Outcomes	Targets	Outcomes	Targets	Outcomes
M ₂	15.30	21.55	15.00	24.11	15.00	12.26	15.0	34.61
M ₁	12.40	15.90	13.80	29.50	10.80	8.60	11.4	29.7
Agg. Credit to the Economy	57.90	56.59	25.70	58.44	24.50	12.0	22.5	14.5
Net Credit to Govt.	96.60	(6,316.31)	(150.30)	26.80	29.90	(17.95)	14.5	(37.0)
Net Credit to Private Sector	34.90	11.79	32.30	24.11	30.00	26.61	25.24	30.8
Inflation	9.30	12.20	9.00	23.80	10.00	10.00	10.0	11.90
Real GDP Growth	5.00	3.48	5.00	10.24	5.00	6.10	6.0	6.23

The CBN was able to achieve the targets owing to the pro-active implementation of sound monetary policies, including zero tolerance on government borrowing from the CBN. From monetary policy point of view the reform of the financial system, a key component of which was bank consolidation, was intended to minimize macroeconomic instability arising from banking systemic distress; deepen the capital market; finance productive activities in the private sector, particularly non-oil sectors; minimize the counterfactual shocks of creating distortions in the money markets and the financial system; encourage investment inflows through effective participation of the industry in the global financial system, among others. As a direct consequence of the exercise, the capital base of Nigerian banks (combined) increased from about US\$2.5 billion in June 2004 to about US\$5.8 billion at end-December 2005. This has been accompanied by rising inflow of foreign investment into the sector till date. Virtually all the banks have been listed in the Nigerian Stock Exchange (NSE) with the capital market becoming more liquid and more capitalized. The banks now have the potential to finance big investment transactions as their single obligor limits have increased, while regulation and supervision have become more effective given that ownership has been diluted with more regulators having the legal authority to oversee them. The CBN can now focus on a fewer number of banks for effective supervision and zero tolerance towards infractions, and improved

corporate governance: greater transparency is being enforced and deployment of IT infrastructure (eFASS and RTGS) has significantly helped the process.

Monetary Policy Implementation Post-Consolidation (2006-2007)

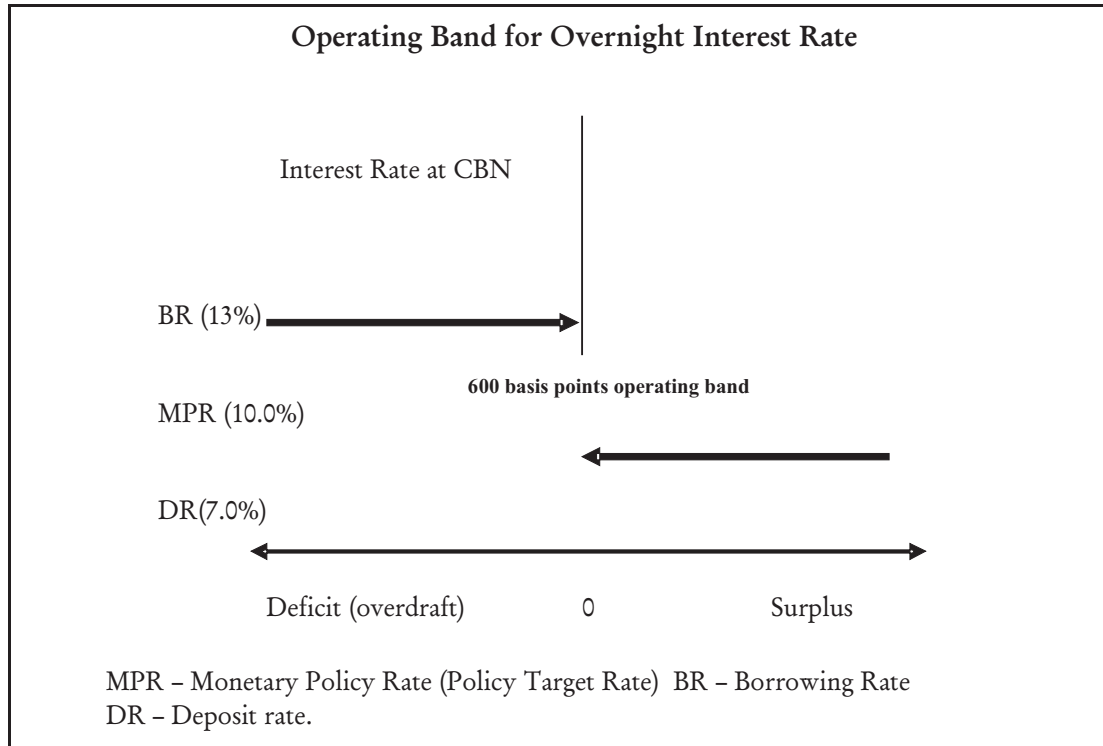
The key feature of the monetary conditions during the period, 2006/07 included: persistence of excess liquidity despite reversal of historic conditions, for example, ways and means and emergence of a new but very important source of excess liquidity-increased private inflows. The objectives of monetary policy during the period remained unchanged. The monetary policy strategy during the period 2006-7 included:

- Zero tolerance on ways and means advances;
- Gradual run-down of CBN holding of TBs;
- Aggressive liquidity mop-up operations-frequent OMO sales supported by discount window operations;
- Unremunerated reserve requirements;
- Increased coordination between the Bank and the fiscal authorities;
- Restructuring of debt instruments into longer tenor debts;
- Increased deregulation of forex market; and
- Occasional forex swap.

These strategies were complemented by the underlying reforms of monetary policy and the financial system in general.

Standing Lending and Deposit Facility

Interest rates behaviours and monetary policy response: A stable deposit base as opposed to volatile, short-term funds has started to impact positively on interest rates stability. In order to fast track interest rates stability, the CBN introduced a new framework for the implementation of monetary policy in December 2006. As part of the new framework, the Bank established a Standing deposit and lending facility rate and replaced the MRR with the MPR which was set at 10.0 per cent. The framework was designed as a corridor with the lending facility as the upper band of the corridor while the deposit facility rate served as the lower band. The corridor had a width of 600 basis points with the MPR at the centre.



The MPC on the recommendations of the MPTC reviewed the MPR. Following the adoption of the new framework, the erstwhile volatility in the inter-bank rate moderated significantly.

Other monetary policy outcomes: Relative to the past, the conduct of monetary policy during the period could be said to be fairly effective. Inflation and growth outcomes were closest to their targets during the period 2006-2007 compared to previous periods (Table 3).

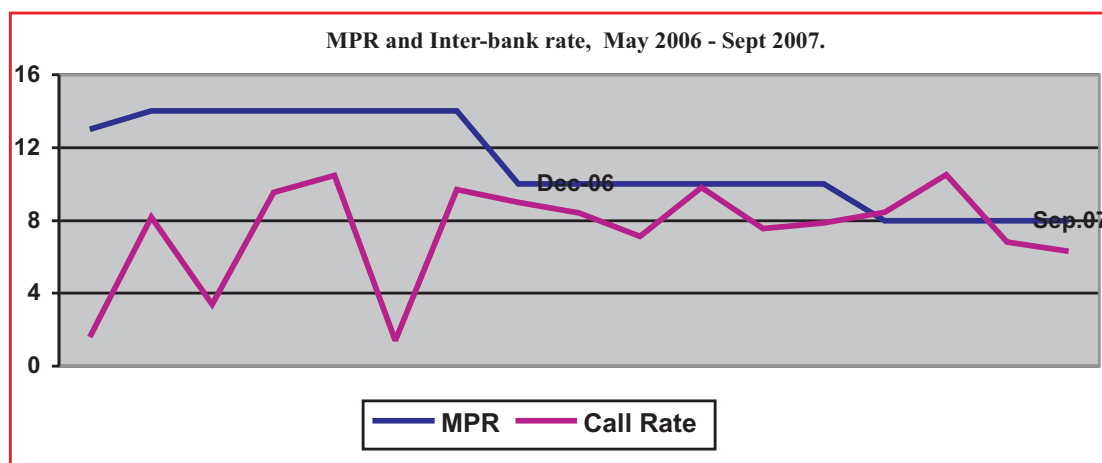
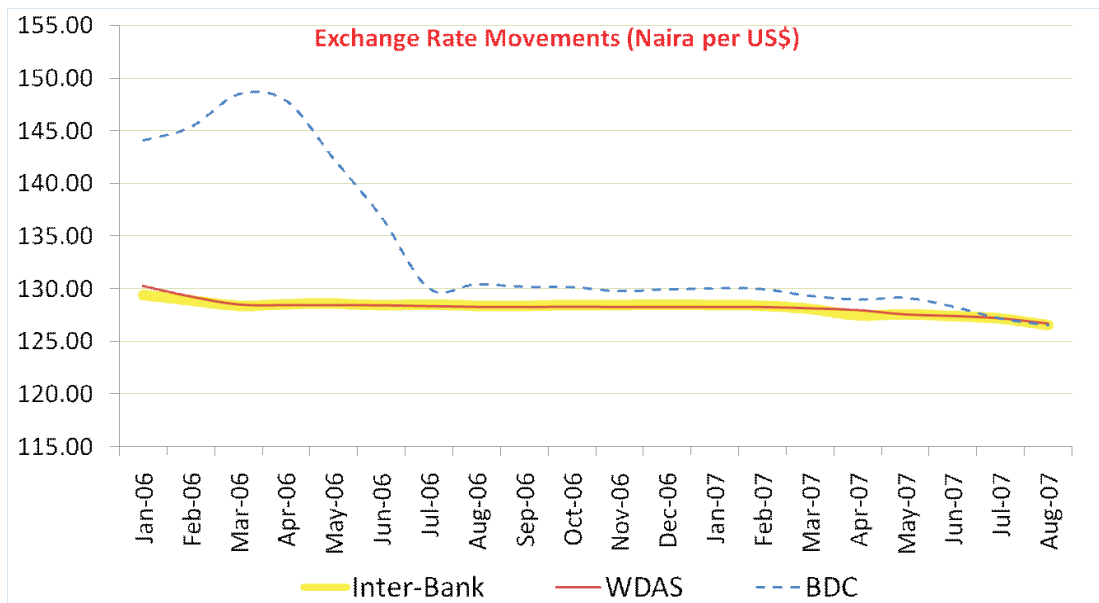
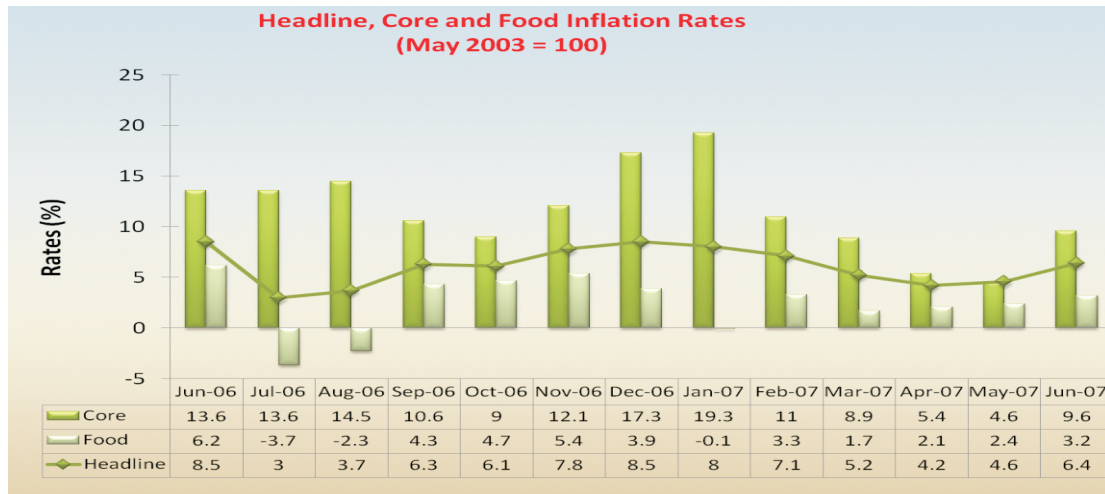
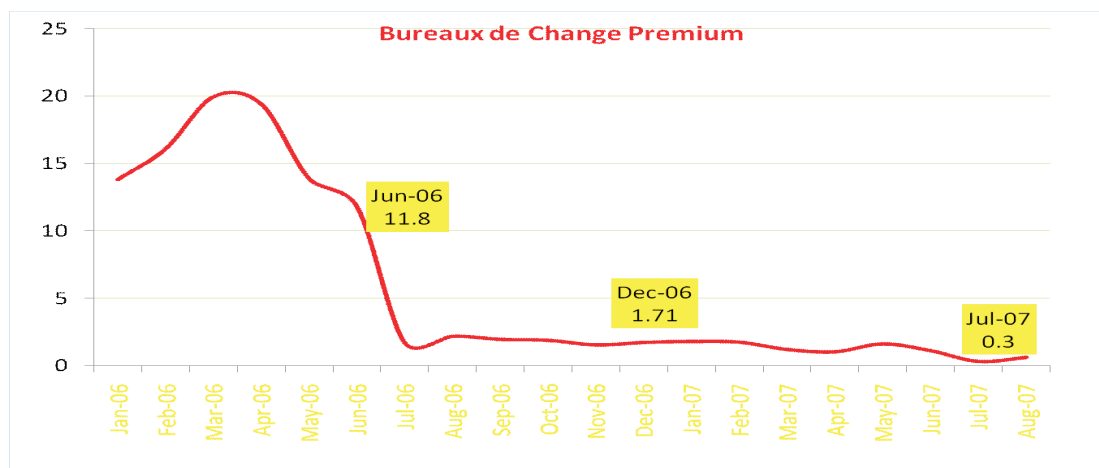


Table 3: Key Policy Variables (% except otherwise stated)

	2004		2005		2006		2007	
	Targets	Outcomes	Targets	Outcomes	Targets	Outcomes	Targets	June Outcomes
M ₂	15.00	12.26	15.0	34.61	15.00	30.55	19.0	36.4
M ₁	10.80	8.60	11.4	29.7	13.30	12.15	n.a	11.01
Agg. Credit to the Economy	24.50	12.0	22.5	14.5	22.50	-67.4	-29.96	
Net Credit to Govt.	29.90	(17.95)	14.5	(37.0)	(57.2)	(692.1)	(54.94)	
Net Credit to Private Sector	30.00	26.61	25.24	30.8	30.00	27.82	30.0	
Inflation	10.00	10.00	10.0	11.90	9.0	8.5	9.0	6.4
Real GDP Growth	5.00	6.10	6.0	6.23	7-10	6.03	7.0	5.69

Exchange rate was also relatively stable. The Bank's favoured measure of inflation, the year-on-year headline inflation has remained at single digit in the post bank consolidation period, while the exchange rate of the naira has been fairly stable.





Future Direction of Monetary Policy

The current monetary policy framework is based on the targeting of base money as operating target with monetary aggregates as intermediate target. The ultimate objective is to influence the general level of prices - inflation. Monetary targeting implied by the current practice was considered adequate as a result of the level of development of the financial system. In most industrialized economies, monetary framework is predicated on short term interest rate, set by the central bank to influence financial conditions and ultimately, aggregate demand. On the other hand, where financial markets are not well developed, reserve requirements are applied along with controls on interest rate and credit allocation (Fry; 2000: 4). The CBN's monetary policy framework and the instruments for monetary management have been fine-tuned over the years for more robust outcomes. The Bank has kept the conditions in the financial markets under constant surveillance and has applied measures considered appropriate to stem undesired effects.

Given the improvements in the monetary policy environment in the last few years and also the need to consolidate the gains of improved inflation performance, the CBN may well be on its way to a new monetary policy framework, inflation targeting. The major argument for inflation targeting is that it is a better anchor for inflation expectations. Also, the fact that monetary aggregates targeting suffers

from a number of limitations, which include the instability of the money multiplier and velocity of circulation of money as well as the transmission path of monetary policy, makes it less likely to produce desired outcomes on a sustainable basis.

The major area of concern, however, is the commitment of the fiscal authorities to adhere in the future to prudent fiscal operations which will rule out financing by the banking system, especially the CBN. Current efforts aimed at ensuring sustained fiscal prudence are encouraging and when institutionalized through the passage of the Fiscal Responsibility Bill, an enabling environment would have been created for a more robust monetary policy. An inflation targeting monetary policy regime will enthrone more transparency in monetary policy. It will make monetary policy more credible and help to anchor inflation expectations. Once it is understood that the CBN is committed to a particular level of inflation, the banks and non-public will act in concert to ensure its attainment. However, if they do not believe the CBN, the anchoring of inflation expectations may be difficult. The CBN has demonstrated seriousness of purpose and credibility with the banking consolidation and the reform of the foreign exchange market.

Concluding Remarks

This paper presents an overview of monetary policy in Nigeria. It has attempted to review developments in the past as well current and future concerns. In spite of the successes of monetary policy in recent times, it is recognized that challenges still exist. These include:

Liquidity Surfeit. This has been one of the major challenges of monetary policy in Nigeria, especially given the cash-based nature of the economy. More so, the expansionary profile of fiscal policy has continued to constrain the impact of monetary policy.

Sustenance of Current Monetary Policy Initiatives. Recent monetary policy initiatives like transparency requirements on DMBs, stoppage of payment of interest on DMBs overnight deposits, etc may require firmness on the part of the Bank in view of the anticipated pressures from the DMBs for an early review.

Narrowing the Spread between Savings and Lending Rates:

Narrowing the spread between savings and lending rates remains a challenge for monetary policy. There has been some improvements following recent reforms, but there is still room for improvement, and this should be a key concern of policy in the years ahead.

Financing Real Sector Investments. Given the dual mandate of the CBN, monetary policy must be tailored to promote real sector lending. With the large capital base now at banks' disposal, it is envisaged that the required capacity would be available to finance long-term investments in the real sector in such areas as power plant; telecommunication; oil and gas; railway, etc. Monetary policy must, however, be such that enables this to happen. The recent move by the MPC to stop paying interest on banks overnight deposits is in part aimed at this, i.e. deepening the credit market.

Fiscal Dominance. Another serious challenge to the conduct of monetary policy is the continued fiscal dominance occasioned by expansionary fiscal operations of the three tiers of government. Effective coordination between monetary and fiscal policies which is now in place deserves to be sustained and strengthened.

Data Problem. The absence of reliable data on current basis, especially from the DMBs, makes timely intervention in the money market difficult. The CBN recently deployed new IT solutions which are intended to improve banking system IT network connections. This, we hope, would improve the timeliness of data rendition by banks to the CBN for the conduct of monetary policy.

Banking System Surveillance. With the completion of the first phase of the banking sector consolidation exercise and the emergence of bigger and stronger banks, the next challenge is greater monitoring and supervision, in order to stem future occurrence of banking distress in the country. This explains the monetary authorities' shift to risk-based and rule-focused supervisory approach.

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