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The Central Bank's capitulation

By Temitope Oshikoya

"The CBN has adopted a number of monetary policy frameworks over the years in response to the changing macroeconomic conditions. Due to monetary policy lags (time of policy initiation, time of policy implementation and the eventual outcome), the CBN has moved from a short-term monetary policy framework to medium-term monetary policy framework." Understanding Monetary Policy Series No. 3, 2011, the CBN.

In response to the realized and expected shocks to the Nigerian economy, the Monetary Policy Committee (MPC), in the Communiqué No.98 of its meeting of 24-25 November, 2014, puts in place drastic measures. It raises Monetary Policy Rate (MPR) from 12 per cent to 13 per cent, increases private sector's Cash Reserve Requirement (CRR) from 15% to 20%; and devalues the official exchange rate of the naira from N155 to N168 per US$1.

Extraordinary measures for extraordinary times. Such times put frameworks under enormous pressures, and could lead to capitulation and adoption of panicky measures. At such times, the test of credibility is not to lose sight of institutional frameworks geared towards achieving medium to long term objectives for the welfare of Nigerians. The measures taken by the MPC of the Central Bank of Nigeria (CBN) are best examined within the context of its institutional monetary policy framework and objectives. In its "Understanding monetary policy," document of 2011, the CBN states that its monetary policy is based on four main pillars: inflation as a monetary phenomenon, inflation targeting to anchor public expectations of future inflation, pro-active rule based monetary policy, and CBN's independence.

Inflation as monetary phenomenon and its anchoring

According to the late Economics Nobel laureate Milton Freedman, "inflation is always and everywhere a monetary phenomenon;" and advocated that the best way of maintaining low inflation and stable output growth is by simply increasing the money supply at a low, stable and constant rate. In October, 2014, aggregate money supply grew by 4.2%, with an annualized low rate of 5% percent against the annual target of 15%, and with the implications that there is a shortage of liquidity in the economy as a whole. With the slow growth of money supply which may have helped in moderating inflationary pressures, and the headline inflation remains within defined targets, hence why the rise in MPR?

The obvious concerns for inflation appear to be supply-side structural factors including food supply shocks and the inflationary impacts of the devaluation, which goes beyond a framework of inflation as simply a monetary phenomenon. It is quite difficult for monetary policy to completely neutralize the conflicting deviations from output gaps and inflation gap arising simultaneously from such supply shocks in the short term. The reaction function of the MPC is then implicitly a choice about the relative volatility of inflation and output; with negative supply and oil price shocks, trying to aggressively maintain its inflation target could restrain output growth and worsen the unemployment situation.

Rather than anchoring inflation on a downward path, the MPC may have inadvertently contributed towards further build up of inflationary pressures. First, it has thrown a life line to governments at all level with the devaluation of the currency, which will generate more revenue in naira terms, estimated to be about by N360 billion, offsetting the impacts of oil price declines by about a quarter. Thus, instead of belt tightening, trust our governments at all levels—executive and legislative branches-- as they maintain recurrent expenditure and fiscal

profligacy. Second, the MPC may have also helped the politicians as they scramble to bring back some of the foreign currencies stashed abroad for conversion at higher naira exchange rates for electoral spending.
Thirdly, devaluation is expenditure switching policy, which is likely to be inflationary. It must achieve real exchange rate depreciation, and not simply nominal exchange rate depreciation for it to work effectively. It must increase the domestic supply of traded goods relative to the domestic demand for traded goods. Three factors must be considered as noted severally in the book on "The Open Economy: tools for policymakers in developing countries." First, there must be increase in the domestic relative price of traded goods reducing demand and increasing supply. Second, a reduction in domestic demand for traded goods at each price, through quantity reduction or fall in domestic income. Third, there should be increase in domestic production of traded goods at each price. With a mono-culture export and heavily import-dependent economy, achieving these conditions will be a tall order in the short-run. Moreover, expect further agitation for increases in wages as market prices of goods double the devaluation rate; all of which will prevent achievements of real exchange rate depreciation.

Pro-active rules-based monetary policy

As previously argued, the managed floating regime provides the CBN with the appropriate ammunition to deal with a variety of complex internal and external shocks. In dealing with the emerging shocks, the CBN needed to be more flexible on the exchange rate as against the previously defined target and band; thus the MPC's decision on this score cannot be faulted given the lack of fiscal buffers to absorb the oil price shocks to the economy. Even then, you have a situation developing of unidirectional asymmetric rules regarding naira exchange rate management. With the different oil boom periods and oil price reaching $147 in 2008, no change was made to the official naira exchange rate, nor was it allowed to appreciate. Yet, monetary policy was tightened to calm inflationary pressures in the most recent oil boom phase. With the oil doom and prices expected to fall as low as $60 or below, the currency is devalued, inflationary pressures are expected to develop and monetary policy tighten further.

While there was a need to deal with the current exchange rate volatility with the managed floating exchange rate regime, the MPC did not provide solid justifications for the increase in the MPR. For a start, using a monetary growth framework, money supply remains subdued at 5%; using its inflation target framework, core and headline inflation rates remain within targets; and using the Taylor rule, there was no need for raising the MPR. Output and unemployment gaps are still very large and celebrating 6 to 7% GDP growth rates as a ceiling, compared to potential growth rate of 10-12%, is a no brainer. As Stephen Roach outlines in China's Monetary-Policy Surprise, the central bank of China considers 7% GDP growth rate as the floor; hence its recent easing of monetary policy to spur further growth. Further tightening has also made a mockery of the maiden speech of Governor Emefiele, which provided forward guidance to a loosening cycle for monetary policy over the medium term.

More importantly, it appears the MPC has focused more on nominal policy rates and not real policy rates. Yet, as in the case with devaluation, where real exchange rate depreciation is what is important, real policy rates are what bring about real impacts on the economy. Real policy rate at 5% is higher in Nigeria relative to its main comparators. Among the BRIC---the policy rates are 4.6%, 1.2%, 2.5%, and 4% for Brazil, Russia, India, and China respectively. Among the MINT, an acronym also developed by Jim O'Neil, the real policy rates are currently -1.3%, 2.9%, 5%, and -0.7% for Mexico, Indonesia, Nigeria, and Turkey. Among the SANE countries, developed by this author, the real policy rates are -0.25%, 0%, 5%, -2.6% for South Africa, Algeria, Nigeria, and Egypt. Among the Middle-East oil producing countries, the real policy rates are -0.6%, -0.3%, -5%, -1% for Saudi Arabia, Iran, Iraq, and Kuwait respectively. The real policy rates are -2.6%, -16%, and 1% for Angola, Sudan, and Libya respectively. Nigeria's high real policy rate sits comfortably with the five countries with very highest misery index: Venezuela, Iran, Nigeria, Serbia, and Argentina (VINSA). With the increase in the MPR, and reduction in output growth, Nigeria's misery index just inched up towards 50, but still the third highest among 90 countries.

CBN's Independence

The MPC appears to assert its independence against fiscal dominance. **O**ver a period of five years of oil boom, the fiscal framework, especially the Excess Crude Account designed to ensure counter-cyclical policies in period of oil doom, lost its credibility at the most pressing time that it was needed. As a result of fiscal indiscipline, the burden of adjustment weighs heavily on monetary policy frameworks. In this context, the MPC's message was essentially that the CBN has had enough of the constraints—fiscal leakages and indiscipline with ECA's depletion—that the fiscal authorities have been posing on its ability to do its job effectively; thereby putting it at the mercy of foreign portfolio investors (FPI) to sustain foreign reserves and defend the naira exchange rate. It indicts the fiscal policy managers with its message that the cosmetic fiscal measures are not enough and the benchmarks are not realistic---$73 oil price versus $55-70; and exchange rate of $168 versus $162.

While the CBN asserted its operational independence against fiscal dominance, it capitulated to financial markets dominance. What is even more disturbing is the statement that "*The Committee was, therefore, of the view that if it failed in taking the right policy actions now, the market would force the Bank to take more drastic actions in the future with far less foreign exchange reserves.*" Although designed to appease the political authorities on devaluation before the elections, the statement is a very unfortunate approach to communication on monetary policy by the CBN as it lowers its reputation and credibility as an independent agency and suggests that its policies are directed by powerful financial interests operating via the financial markets. The financial markets now lead the MPC, and will lead it towards N200 or more to US$1 very soon and possibly 16% MPR. The insatiable appetite of the markets and FPI for higher MPR and further exchange rate depreciation will be difficult not to satisfy and meet. The MPC threw itself under the bus to be crushed by the financial markets going forward. It is against this financial dominance that the Bank for International Settlement (BIS)—the central bank to central banks has consistently raised an alarm as monetary policies become subordinated to short-term financial markets dictates propagated by vested financial interests and analysts.

While the MPC rebuked fiscal dominance, but bowed to financial dominance, the only stakeholders left in the lurch are poor Nigerians, whose welfare will be further impoverished by the inflationary pressures of the devaluation and the rising borrowing costs along with the fiscal austerity measures that will negatively impact inclusive growth and shared prosperity.

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