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Monetary policy committee at crossroads

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"With employment so far from its maximum level and with inflation running below the Committee's 2 percent objective, I believe it's appropriate for progress in the labor market to take center stage in the conduct of monetary policy……In current circumstances, forward guidance can lower private sector expectations regarding the future path of short-term rates……leading to more accommodative financial conditions." Janet Yellen, now Chairman of U.S. Federal Reserves, in a speech on Challenges of Monetary Policy, dated March 4, 2013.

Introduction

The Monetary Policy Committee (MPC) of the Central Bank of Nigeria (CBN) is at a crossroads. The Communiqué No. 97 of the meeting of the MPC of September 18-19, 2014 noted that "…the Committee was of the view that the direction for policy in the short-to medium term would be either to retain the current tight stance of monetary policy or further tighten monetary policy… The Committee was split between retaining the current stance of monetary policy and further tightening." The personal statements of the 12 members of the MPC released in the third week of October shed more light on the decisions. Meanwhile, the Chairman of the MPC, Governor Emefiele, in his maiden speech in July, 2014 had already provided forward guidance towards loosening monetary policy over the medium-term, interpreted as commencing after the elections in February, 2015.

The sources of the quandary facing the MPC lie in three areas: the evolving welfare objectives function for the CBN; the need to proper dimension the realized and expected domestic and foreign shocks to the economy; and the policy reaction needed to counter these shocks and minimize deviations from well-defined objectives. Based on these three sources and recognizing the complexity of the challenges that monetary policy makers face, the rationale for retaining the current stance of monetary policy by the MPC is quite understandable. This article, however, argues that forward guidance for short to medium term should aim at loosening rather than further tightening of monetary policy.

CBN's welfare objectives function.

The optimal monetary policy objective function is usually derived from the society's welfare function, aimed at minimizing the inflation gaps and output gaps or unemployment gaps. For the setting of monetary policy, this objective loss function has been calibrated by the Taylor Rule (designed by John Taylor, Professor of Economics at Stanford University), which shows that when inflation rate gap is high, interest rate should go up; while interest rate should go down when the output gap or the reverse unemployment gap is high. The Central Bank's task becomes complicated with stagflation: high inflation co-existing with high unemployment.

In the past three years, the CBN has delivered on price stability, defines as being within the inflation target of below 10% that it sets for itself. Over the same period, the CBN has also equally defended the Naira, albeit at a cost to the foreign exchange reserves, within the exchange rate target that it equally sets. In the past, however, unemployment was not considered a major priority in the discussion of the MPC. But, with Nigeria's unemployment rate of 24 percent and a misery index of 48, it has become difficult for the MPC to ignore developments in the labour market.

Realized and emerging shocks.

The second source of the quandary lies in the confluence of shocks facing the economy. The already realized increases in food prices, pushing food inflation to 10 per cent in August from 9.4 percent in April, 2014, have been driven by internal supply shocks emanating from the security situation impacting the North-East and skirmishes in the North Central regions, which would abate once the security situations and domestic food production improve. An expected domestic demand shock relates to electoral spending over the next four months, which will inject more liquidity and possibly impact, albeit temporarily, core inflation, which has declined consistently from 8.1 percent in June to 6.3 percent in August. Given the transitory nature of electoral spending, it will at best reduce unemployment very marginally.

The real domestic supply and demand shocks are further complemented by realized nominal liquidity trap within the domestic banking system, which has been a permanent feature. In addition to more profound fiscal dominance factors identified in Boyonomics, the liquidity surfeit with large excess reserves of over N300 billion markedly indicates the uncertainty relating to credit extension to the real economy by banks. The expected liquidity injection of nearly N900 billion from AMCON in October further raised concerns. In general, liquidity trap usually occurs at very low or near zero interest rates with the spectre of deflation. Yet, Nigeria's MPR at 12 percent is one of the highest in Africa and among emerging markets globally. In Nigeria, average prime and maximum lending rates, at 16.5 percent and 26 percent respectively, are also relatively high in the global contexts. Nigeria also has one of the highest CRR among emerging markets.

As discussed in my paper on 'Microeconomics of banking, high lending rates," in the Guardian of February, 2014, commercial bank's reluctance to lend reflects several factors including uncertainties, information asymmetry, credit rationing, and preference for financial assets such as treasury bills and bonds, and returns from the foreign exchange market. The incentives to extend credit is the difference between risk-adjusted real earnings from loans or buying other financial assets and returns to holding the money as reserves. Clearly, commercial banks are presently more inclined to hold other financial assets and reserves given the risk-adjusted returns. It is recognized that the CBN has already embarked on some measures to defrost credits for the SMEs and the power sector in particular. The CBN is also already working on the centralised Biometric Verification Number solutions and Collateral Registry Regulations to partly address issues relating to information asymmetry.

On the external front, there are concerns about reversal by foreign portfolio investors (FPI) in Nigeria, due to expected increase of the U.S. Federal Reserves' policy rate. Falling crude oil price, down by a quarter to $83 per barrel since July, is already a realized phenomenon, and more is expected. The jury is still out on whether this shock is going to be temporary or permanent. But the outlook is not favourable when combined with production losses due to oil theft. Basic macroeconomics suggests that with negative oil shock affecting government revenue, fiscal policy should take centre stage. However, it is clear that the Minister of Finance and Coordinating Minister for the Economy has been caught napping with the proposed 2015 budget. As Dele Sobowale, the veteran Vanguard columnist wrote in “Unrealistic crude benchmark, exchange rate,” the underlying assumptions of $78 for crude oil price and N160 per dollar for the 2015 national budget “exhibits the triumph of hope and self-delusion over reality and the verdicts of economic history and experience. Neither one of the two key foundations of our budget can, by any stretch of imagination, be considered reasonable—given global current situation and trends into 2015.”

The reaction function of MPC

The tasks of central bankers in respect of crafting and executing monetary policy have never been easy. Monetary policy makers have to try to measure the magnitude, size, sources, timing, and speed of shocks leading to deviations in targeted objectives; as well as lags of policy reaction function, including recognition of shocks and deviations, actions and effects of policies. Due to lags, monetary policy can take 6 to 12 months or more before having its full impacts on the economy. Although judgment calls are still important, quantitative economic models based on different economic theories or a combination of theories do help in clarifying some of these issues.

The third main source of MPC’s quandary is, therefore, the individual members’ policy reaction functions based on different schools of thought. In this context, it is essential to avoid what Paul krugman, an economics Nobel laureate will call “Derp,” which is a determined believe in some economic doctrine that is completely unmovable by evidence, experience and global practices. Thus, the Monetarist versus Keynesian approaches alluded to in the statement of the MPC deserve some clarifications and elaborations. First, both economic schools of thought agree that monetary policy affects nominal monetary variables such as price levels and interest rates. But there is disagreement on the influence of monetary policy on the real economic variables such as output or unemployment in the short term.

Second, the late economics Nobel laureate Milton Freedman, the father of Monetarism believed that “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 the 1980s, there was a shift from this approach due to unstable relationship between monetary aggregates and other macroeconomic variables. Monetarism was revived under the New Classical Economics, championed by Robert Lucas, also a Nobel laureate and others, emphasizing that both rational expectations of private economic agents and market clearing with instantaneous adjustment will render policies ineffective.

Third, the New Keynesian School also using rational expectations assumptions agrees that money supply is neutral in the long run. However, due to market failures, imperfect competition, information asymmetry, and sticky prices, the economy will not attain potential output and full employment in the short run. Thus, monetary and fiscal policies can be effective in the short term, when the economy is hit by some unexpected external shocks. In the case of monetary policy, an increase in the money supply or reduction in interest rates can increase output and lower unemployment in the short run. New Keynesian School is associated with economists including John Taylor and Stanley Fischer, former IMF’s deputy managing director and now vice chairman of U.S. Federal Reserves, and Joseph Stiglitz, a Nobel laureate and former chief economist of the World Bank.

The monetary policy framework of the CBN in the past few years has been informed by the monetary school. 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. The CBN has delivered on its defined inflation targets. Further, in August 2014, aggregate money supply grew by 3 percent, with an annualized low rate of 4.4 percent against the annual target of 15.5 percent, and with the implications that there is a shortage of liquidity in the economy as a whole.

The CBN, however, cannot be more pro-monetarism in its approach to economic management than the IMF--the ivory tower of monetary approach to balance of payments. Yet, in its Nigeria’s Article 4 Consultation document of April 2014, the IMF noted that “the current policy stance poses a concern about longer-term inclusive growth: while inflation has come down from 12 1/2 percent at the beginning for 2012 to 8 percent at end-2013, lending rates remained unchanged reflecting no changes in the monetary policy rate established by the CBN, so that the maximum real cost of borrowing has increased from 10 percent to 17 percent, amplifying barriers to growth of SMEs that have no access to the equity market.” Further, Kenneth Rogoff, a former Chief Economist of the IMF and one of the early proponents of inflation targeting in the 1980s recently noted that excessive emphasis on low inflation targets can be counterproductive in the aftermath of severe shocks (“Inflation is still the lesser Evil”; and “The Federal Reserves in a time for Doves” by Kenneth Rogoff, June and August 2013).

Unemployment, stupid!

While the mantra of monetarism has helped with price stability as defined by the CBN, the hawks within the MPC still do not believe that high unemployment rate is the number one economic evil today. With the high rate of unemployment and jobless growth, it is safe to state that the economy is already below its potential output; and added to it are the potential recessionary gaps from realized and emerging shocks. In this context, the marginal social benefits of reducing unemployment from a high of 24 percent outweigh the marginal social cost of inflation, which is still below defined target. Thus, the above-quoted observation of the Chairman of the U.S. Federal Reserves, “I believe it’s appropriate for progress in the labor market to take center stage in the conduct of monetary policy,” becomes pertinent today for the MPC and the CBN. Governor Emefiele acknowledged in his maiden speech that the MPC will formally consider unemployment in its deliberations. There have been arguments that unemployment figures are not readily available. However, the CBN can indeed assist the National Bureau of Statistics (NBS) in improving on the readiness and accuracy of unemployment figures, much as it has provided support for the inflation data from the NBS.

As discussed in Macroeconomics in Emerging Markets by Peter Montiel, there are some other guiding principles for understanding policy reactions to shocks. One guiding principle relates to exchange rate regime. With a nominal liquidity shock emanating from domestic money markets, fixed exchange rate is better. With demand shocks emanating from domestic goods market, a flexible exchange rate is better. However, neither fixed nor flexible exchange rates can provide full protection for changes in supply shocks or changes in world interest rates or foreign financial shocks.

Thus, the managed floating regime, essentially in-between fixed and flexible regimes, provides the CBN the appropriate ammunition to deal with a variety of complex internal and external shocks. However, over the past three years, the CBN appears to have staked its credibility on the stability of the exchange rate for the naira. Although with relatively stable exchange rate and within the uncovered interest parity framework, interest rate is still high in Nigeria relative to other emerging markets, financial dominance by FPI is prodding the CBN not only to maintain the current MPC stance, but to adopt further tightening that would protect the returns on their investment.

The other principle relates to aggregate demand management. Negative demand shocks that lower aggregate demand tend to move inflation and output in the same direction, both inflation and output would go down; and vice versa with positive shocks shifting them up. Increased credits and electoral spending would, ceteris paribus, increase both output and inflation. With a tightening monetary policy reaction, the CBN can offset these demand shocks. But we already argue that electoral spending shock is likely to be temporary and annualized credits growth remains at half the target of 16%, and much lower in August at 5.4 percent.

On the other hand, short-term supply shocks that lower aggregate supply move inflation and output in opposite directions. The slowdown in agriculture output and increase in food prices reflect this phenomenon. However, 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. Jeffery Frankel in “The Death of Inflation Targeting” has noted that rigid inflation targeting would lead to perverse response to supply and terms of trade shock; while with nominal GDP targeting, an adverse supply shock is automatically divided between inflation and real GDP, hence unemployment. However, nominal GDP targeting could also generate persistent deviations of inflation from target.

Thus, for the MPC, there is a need for flexible inflation targeting that recognizes the importance of financial stability, unemployment reduction along with inflation targets. There is no need for elevated policy action in the short term. Shifting to a further tightening cycle, with an already elevated and tight monetary policy at this point in time, is neither supported by the country’s economic data, the proper dimension of the emerging domestic and foreign shocks to the economy, nor by proponents of economic theories from the two mainstreams of macroeconomics.

In concluding, reputation is an important element in the conduct of monetary policy. However, reputation depends not only on past performance of policy action, but also on credible announcements needed to form expectations by private economic agents. Further tightening will make a mockery of the maiden speech of Governor Emefiele, which has already provided forward guidance to a loosening cycle for monetary policy over the medium term. Reading the policy stance and future guidance of some MPC members at the July and September 2014 meetings, and the shift between both meetings, suggest an ad-hoc monetary policy reaction function, which should not replace a medium-term strategy for monetary policy based on solid economics analytical rigor. More importantly, this will, suggest, going forward, that the CBN’s own policy reaction function that incorporates the welfare objectives of unemployment with inflation targets has still not been fully and properly institutionalized.

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