Interest and Exchange Rates Management in Nigeria: A Macroeconomic Implications

By

Tony Elumelu

Economic theory is replete with definitions and types of interest rates. It is however, not the intention of this paper to dwell on this. What is important here is that interest rates, like other prices, perform a rationing function by allocating limited supply of credit among the many competing demands on it. Thus, it is an important instrument for monetary management.

Meaning of Interest Rate Management

Interest rate management refers to the totality of steps and processes designed and used by the monetary authorities (the CBN) to determine, sustain or support the level of interest rates in an economy in ways that engender the achievement of the stated macroeconomic goals of price and exchange rate stability, rapid and sustainable employment, and generating growth.

Interest rate management also entails anticipating the financial markets and developing appropriate policy measures to impact the markets using known monetary tools.

It needs to also ensure that rates do not fall to levels where the liquidity trap ensnares the economy. (Liquidity trap - the level of interest rate below' which further reductions will not impact on the level of economic activities/national income).

Interest Rate Management Techniques

(a) Administrative Fiat

_ Government employed the use of administrative fiat. Nigeria practiced this in pre -SAP era.

_ The regulatory authorities relied exclusively on the use of direct controls to regulate the economy.

_ The apex bank fixed interest and other banking charges.

_ Monetary aggregates were fixed by a combination of both direct and indirect measures. The regulatory authorities set the maximum rate by which credit could be expanded. Allocation to the different sectors was also fixed by the body. Credit expansion was strictly controlled by the monetary authorities and sect oral allocation of credit was prescribed to favor the preferred economic sectors.

Effects of Administrative Fiat

Merit:

Promotes stability since the rates are seldom changed while the monetary authorities' resolve to defend the monetary aggregates creates a high level of credibility.

Defects:

_ Inefficient use of capital input, due to the artificially low cost of commercial credit resulting in:

_ Inappropriate pricing of credit and deposits:

Acute scarcity of loan able funds in the system, because banks would prefer to invest their funds in T/Bills than lend below their average cost of funds.

_ Low level of capital formation for economic development

(b) Free Market Determination

this involves the deregulation of interest rates and abolition of sect oral allocation. Nigeria is currently using this technique. Under this technique, the regulators only set the rules and allow the operators to play according to their dictates within the rules. Another important element of this technique is the licensing of more banks so as to increase the depth and intensity of competition in the industry.

Yet another important element of deregulation is that the pricing of deposit and credits is left for the banks and their customers. Borrowers will not pay an interest higher than the MPC - Marginal Productivity of capital.

Depositors demand an interest rate high enough to compensate them for postponing their consumption and cover risks of value associated with inflation.

CURRENT INTEREST RATE MANAGEMENT TECHNIQUES IN NIGERIA

Regular Open Market Operations.

Allowing the Naira to Depreciate CBN Saving Certificates

Introduced in the face of perceived' liquidity overhang in the economy to mop up excess liquidity from the system. Having tenors of 180 and 360 days. The minimum amount required to invest in the instrument is N250, 000.00, which is lower than the requirement for some banking products that do not attract interest rates that compare favorably with the offering from the apex bank. Currently, the rate on funds for 360 days stands at 21.5% up from 20%. The products come regularly to the market and have been attracting a sizeable portion of investors' funds.

Adjustment of Key Ratios Banks

Cash Reserve Ratio:

Rose from 11 % to 12.5% in April 2001 to curtail credit creation by banks in the face of 'perceived' persisting liquidity overhang in the economy.

Liquidity ratio:
Increased from 35% to 40% in April 2001 as part of a contractionary monetary policy outlook to stem expansion in the money supply through the lending activities of banks.

Rediscount Rate:
Minimum Rediscount Rate increased to 16.5% per annum from 1 5 % .The effect of this is to increase the cost of funds.

How does Banks React to a Contractionary Interest Rate Policy move?

When the CBN increases its rates, banks respond as follows:

_ Banks reduce credit to the marginal customers, usually the SMEs.

_ Consumer finance is drastically reduced.

_ Banks concentrate their lending activities to the short term.

_ they intensify deposit mobilization with higher rates and incentives.

It is relevant to mention here that the policy has not achieved the

desired result because rates are still skyrocketing daily.

The CBN's Interest Rate Management Policy has not been Very Effective as a result of the following

monetary policy pronouncements by CBN tend to be more reactionary to developments in the Nigerian economy. The policy pronouncements are also anchored on Demand Management Techniques.

Policy Divergence between CBN and Ministry of Finance: whereas CBN employs restrictive monetary policy tools, the Federal Ministry of Finance is embarking upon fiscal expansion.

Structural rigidities/bottlenecks in the Nigerian economy: Individuals, organizations and institutions cannot efficiently adjust their goals and resources to changing constraints and opportunities. This has weakened the effectiveness of monetary policy initiatives.

Due to poor banking habit of the citizenry, more funds lie outside the banking system while high and rising cost of commercial funds has sent more corporations to the capital market.

The mop up effects of OMO has made rates to skyrocket to about 45%, thus creating an illusion of FX rate stability because of liquidity squeeze. However, this is at the expense of interest rate stability and economic growth.

Exchange Rate Management in Nigeria

Introduction

Economic theory, in the quest for simplicity, assumes that the exchange rate is any other price and that it is determined by the forces of demand and supply in a perfectly competitive market and in a world where free international exchange is the rule.

An extension of this theory is that such factors as net foreign exchange earning [exports - imports], current account balances, productivity and its growth among others, determine the exchange rate of a currency.

Role of Exchange Rate
it helps in ensuring international exchange of goods and services as well as achieving and maintaining international competitiveness and hence ensures viable Balance of Payment position.lt serves as an anchor for domestic prices and contributes to internal balance in price stability.

Objectives of Exchange Rate Management
_ the general objectives of foreign exchange policy in Nigeria are basically the same as those of economic policy. The specific short and medium-term identifiable objectives include:

_ to narrow the gap between the official and parallel markets and prevent disequilibrium in the foreign exchange market.

_ Ensuring stability and sustainability of the exchange rate.

_ Maintaining a favorable external reserve position and ensuring external balance without compromising the need for internal balance, while keeping in view the overall goal of sustainable output, growth and employment.

_ Reduction of dependence on imports and oil exports.

_ Diversification of the export base.

_ Elimination or reduction of incidence of capital flight

_ correcting the sky rocketing Naira exchange rate.

Types of Exchange Rate Management Methods

In our world, the perfect situation described in economic theory does not exist and so we have four major mechanisms for managing/ determining the exchange rate.

_ monetary unification - integration with other nations e.g., the EU. The power to issue currency is surrendered to the supernatural body and member countries are usually made to align their economies to meet the set conditions, i.e., convergence test.

_ Fixed Exchange Rate system: In a fixed rate regime, the government sets the rate at which the currency will exchange for other currencies. The currency is supported by the government and is usually protected with Exchange Controls. Nigeria practiced this in the 1 980s.

The assumption here is that market failure exists and the forces of demand and supply cannot be trusted to effectively allocate resources in ways that best promote the stated economic objectives. FX is also scarce and must be carefully utilized.

_ Freely floating rate system: Here the external value of the national currency is left to be determined exclusively by the forces of demand and supply.If demand for the country's currency (represented by the demand for its exports by other nationals) is high, its price - exchange rate -must be high. The reverse holds if the supply of the national currency (which is mirrored by demand for imports the residents of the importing country) is relatively high, the currency will be cheap. Floating Exchange Rate system within set limits or boundaries (dirty float). Here, the government sets the exchange rate with upper and lower limits.

Under this situation, the government sets the exchange rate, but allows some degree of flexibility for rate adjustment. Therefore, the dirty float system tries to combine the features of both fixed and floating exchange rate regimes.

Exchange Rate Management: The Nigerian Experience

Before the introduction of the Structural Adjustment Programme (SAP) in 1986, the country operated a fixed exchange rate regime based on trade and exchange controls, which was anchored through import license controls regime. Between 1986 and 1995, different exchange rate management regimes were introduced by the various governments in power at the time, including a dual exchange rate regime in 1 988, the Interbank Foreign Exchange Market [IFEM] in 1989 and the reintroduction of a dual exchange rate system in 1995. Over this period, the demand for foreign exchange outstripped supply progressively.

The existence of different foreign exchange markets in Nigeria is primarily borne out of the inadequate supply of foreign exchange.

In order to crowd out some requests for foreign exchange, the monetary authorities scrutinize requests to differentiate between productive [genuine) and frivolous demands. Unmet demands are met at the parallel market.

The pressure on the daily Inter-Bank Foreign Exchange Market has continued to be on the increase and this has resulted in the instability of the Naira exchange rate, while the gap between the official and the parallel markets continues to widen.

Problems with the Nigerian Exchange Rate System

_ a critical requirement for a freely floating exchange rate regime is the absence of any form of economic rigidity. The Nigerian economy is characterized by structural rigidities and bottlenecks. Most of our exports and imports are characterized by inelasticity either on the demand or supply side or both.

_ Restraint on the free flow of goods and services by our trading partners. The guidelines of the CBN on the purchase of foreign currency are often cumbersome, causing some frustrated potential foreign exchange users to patronize the parallel market. There is always a gap between supply and demand for foreign exchange.

The Nigerian economy is import dependent. Thus, pressure on fore demand will inevitably create the alternative market, hence different rates. On-oil export is under-reported and proceeds are hardly repatriated into the country, thus compounding the supply rigidity.

Macroeconomic Implications of Nigeria's Interest and Exchange Rate Management Experiences for the Real sector of the Economy

the real sector is here defined as consisting of the following sectors - Agriculture, Manufacturing, Building & Construction, and Mining & Quarrying.

A review of financial statistics from the World Bank and the Economist reveal that the real sector of Nigeria's economy has been the worse for it. Between 1993 and 1999, the manufacturing sector contributed less than 8% of GDP at 1984 constant factor cost. Interest rates on 2 years' government bonds, corporate bonds and 90 days' money market instruments is at least 4 times higher in Nigeria than in most developed countries of the world [inching the G-8 countries]. On the other hand, GNP in absolute terms and per capita is lower in Nigeria than in some third world countries such as India, Malaysia, Egypt, Indonesia, South Africa and Israel, to name a few. Even against some African countries, Nigeria's GNP Per Capita is one of the lowest, despite a relatively high GNP. With a GNP per head of US$292, the average Nigerian falls below the international poverty line of US$300 as approved by UNDP. This corroborates the World Bank position that Nigeria's per capital income is currently below the threshold of the Highly Indebted Poor Countries [HIPC]. In general, the macroeconomic indicators reveal that between 1995 and 1999, GDP growth rate was below 4%, industrial capacity utilization was below 40% and change in the exchange rate was as high as 92.8% in 1999. In the external sector, insufficient supply of foreign exchange continues to mount pressures on Nigeria's exchange rate. The stringent documentation requirements in the official market crowds out some fore demands that are ultimately met in the parallel or black market. Thriving malpractices in the parallel market and the documentation requirements of the official market have both contrived to make patronage of the former increasingly attractive and profitable, further discouraging domestic production and worsening Nigeria's balance of payment position. The statistics are damning.

It is clear that Nigeria is in dire need of rapid and sustainable rate of economic growth and development, if we are to reduce the level of human miseries pervading the country.

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