Assessment of the Impact of Monetary Policy on Inflation in Nigeria

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Structured Abstract:

Purpose: The purpose of this study is to assess the relationship between inflation and monetary policy in Nigeria.

Methodology: A model which is based on both monetary theory and Keynesian theory has been used. The model expressed inflation as a function of interest rate, money supply; cash reserve ratio and liquidity ratio. Multiple regression analysis was used to estimate the model and descriptive statistics were used to examine the trend of inflation in Nigeria.

Findings: The study revealed that inflation trend has been relatively unstable in Nigeria. The result of the multiple regressions indicated that both interest rate and liquidity ratio have inverse and direct significant relationship with inflation respectively. Though money supply and cash reserve ratio have direct and inverse relationship with inflation but they were not significant.

Implications / Limitations: The implication of the study is that inflation in Nigeria can be attributed more too excess liquidity than money supply. The study further affirmed that interest rate as an important monetary policy tool in controlling the rising trend of inflation in Nigeria.

Originality / Value: The findings of the present study have contributed to the existing literature in a unique manner by distinguishing clearly the influence of liquidity and money supply on inflation in Nigeria.

Keywords: Inflation, Monetary Policy, Relationship, Money Supply.

Paper Type: Original Research Article.

Introduction

Inflation has become a significant problem for Africa and Nigeria in particular during the past twenty years. Since the first oil shock in the mid-1970s, African inflation rates have averaged more than 15 percent a year. For Sub-Saharan Africa, the average inflation rate has been closer to 20 percent a year. A few Sub-Saharan countries have even experienced inflation

rates of 50 or even 100 percent a year. The emergence of substantial inflation in Africa has led to widespread debate about its causes. Many economists that favour traditional adjustment strategies contend that monetary growth, arising particularly from the domestic bank financing of large budget deficits, is the major source of inflationary pressures. By contrast, some critics of the traditional approach, such as the United Nations' Economic Commission on Africa (UNECA) in its "African Alternative Framework for Structural Adjustment Programmes" (UNECA, 1989), have identified exchange rate depreciations as a major factor.

With reference to the establishment of the Central Bank of Nigeria (CBN) in July 1957, the stage was set for a new era in which monetary policy could be used as instrument of economic management. Prior to 1964, it has been argued, that no conscious monetary policies were implemented in Nigeria as operations of the CBN did not start until July 1959. In March 1962 following the launching of the country's Second National Development Plan (1962-1968), the CBN was brought into the limelight of development financing. Monetary issues of concern (since the country was using the currency of the West African Currency Board) were the establishment of a strong financial base and the promotion of domestic financial infrastructures such as the money and capital markets institutions and instruments. Notable actions taken during this period included the issuance of the Nigerian currency, introduction of the first Nigerian money market instrument – the Treasury Bill, establishment of the Nigerian Stock etc.

The most active policy instrument during this period was the interest rate. For instance, between April, 1960 and December 1960, the discount rate and treasury rate were individually raised 10 and 13 times respectively. The aim of the Treasury bill was to encourage commercial banks to repatriate short-term funds from London. Between the periods of 1962 and 1975 there came the amendment act of 1962 that strengthened the Central Bank for effective monetary policy promotion and the adoption of cheap monetary policy aimed at enabling the government to borrow as cheaply as possible for purposes of financing the Second National Development Plan. During the period 1964-1966, monetary policy was targeted at defending the balance of payments, given the rapid credit expansion experienced in this period, which encouraged increased demand for imports and subsequent drain on foreign reserves.

Monetary policy instruments used during this period included fixing the exchange rate and interest rate, control of discount rate moral suasion to reverse the credit expansion.Owing to the civil war in 1970, the Nigerian economy experienced an inflationary spree. Other factors that fuelled inflation were the unrealistic wage increase awarded by the Adebo and Udoji Commissions in 1971 and 1974 respectively. Consequently, inflation became the most serious problem in Nigeria. The Central Bank to this effect embarked on some direct control measures. This included encouragement of commercial banks to channel a greater and increasing percentage of their credit allocation to productive sectors of the economy. Other measures were targeted at reducing the liquidity of commercial banks and issuance of 'stabilization securities'. Under this scheme, the CBN was given powers to sell or allocate these securities to, or repurchase from any banking institution. During the period of 1975 to 1992 which was known as the direct control era in which the major objective of monetary policy during this period was to promote rapid and sustainable economic growth.

To this end, the CBN imposed quantitative interest rate and credit ceilings on the money deposit of banks and sustained the sectoral credit allocation policy to preferred sectors (agriculture, manufacturing, and residential housing) as against the less preferred sectors like imports and general commerce. This classification enabled the monetary authorities to direct financial resources at concessionary rates to sectors considered as priority areas. These rates were typically below the CBN–determined minimum rediscount rate (MRR). The CBN also compelled banks to deposit with it (special deposit) any shortfall in the allocation of credit to the designated preferred sectors. However, this policy of direct control in the allocation of credit to the priority sectors did not meet the prescribed targets and failed to impact positively on investment, output and domestic prices.

It was further observed, banks' aggregate loans to the productive sector between 1972 and 1985 averaged 40.7 per cent to total credit, about 8.7 percentage points lower than the stipulated target of 49.4 percent. One major factor often cited was lack of instrument autonomy of the Central Bank as the Ministry of Finance influenced by short-term political considerations largely dictated monetary policy. In 1987 the monetary and credit policy measures adopted were designed to facilitate the achievement of the goals of the Structural Adjustment Programme (SAP). The adoption of SAP was as a result of harsh and severe economic difficulties in 1985. The SAP programme was aimed at reforming and dismantling the control regime and enhancement, promotion and use of indirect instruments of monetary

controls. And from the year 1993 till date brought about the use of indirect monetary policy which began with selective removal of credit ceilings for banks beginning in September 1993 followed by the promulgation of the CBN Decree 24 and the Banks and Other Financial Institutions Decree (BOFID) 25 of 1991.Given the number of years since the Central Bank of Nigeria was established and the substantial financial resources and endowment available in the country, coupled with the existing institutions one will expect that the economy at large would have been well-established (Folawewo, etal, 2006). But one can claim that the entire spectrum of the economy has not been sufficiently active especially when compared with the economy of other developing countries.

Some of the problems that are identified for this include:-

1. Political problems in the country: the inconsistency in peaceful political transition as a result of change of government from a past administration to a new one can bring about poor growth of the economy.

2. Poor implementation of past policies: this can be as a result of ineffective and poor execution of the past government capital project and lack of control and maintenance of such problem and also poor implementation of schemes to help guide through the activation of this project.

3. Insufficiency of database: this can be as result of inappropriate method and means through which the population census determination is computed which will bring about how to determine an effective labour force for economy improvement.

4. The ethical problem: the lack of uniformity of the various ethnical or tribal groups for aggregate effective productivity can bring about poor economic development.

The main thrust of this study shall be to evaluate the effectiveness of the CBN's monetary policy in controlling inflation over the years. This would go along way in assessing the extent to which the monetary policies can be used to reduce inflation rate in Nigeria.

Review of Literature

Monetary policy is a major economy stabilization weapon which involves measures, designed to regulate and control the volume, cost, availability and direction of money and credit in an economy to achieve some specified macro economy policy objectives. That is, it is a

deliberate effort by the money authorities (or central bank) to control the money supply and credit conditions for the purpose of achieving certain broad economy objectives. Basically, monetary policy is defined as a set of goals to attain certain objectives oriented towards the growth and stability of the economy. These goals may include stable prices and low unemployment.

Monetary policy according to Nwankwo (1999:4) can be defined as measure or combination of measures designed to influence or regulates the volume, price and direction of money and credit. He contended that money comprises of six different policies dealing with the volume of money and credit, its price or the rate of interest and its allocation. In Nigeria, monetary policy is designed to attain price stability, balance of payment equilibrium and high rate of economy growth. The central bank of Nigeria (CBN) ensures that nation attain price stability, balance of payment equilibrium, and high rate of economy growth by manipulating interest rate and total credit. Salvin (1999:273) defined monetary policy as the use of open market operations changes in discount rates, changes reserve requirement and other measures available to the monetary authorities to control the rate of growth of money supply. He further notes that the goals of monetary policy are price stability, relative full employment and satisfactory rate of economy growth.

John (2002) in his book titled "money and banking. An introduction to analysis and policy", defines monetary policy as the deliberate management of money supply for the explicit purpose of attaining specific objective or set of objectives, in the sense that monetary policy involves the conscious planned manipulation of volume of money in circulation to achieve specific objective of employment, growth and price stability. The monetarist whose leader is Milton Freidman argue that money supply should be controlled and not interest rate because they felt, the level of or direction of movement of interest rate is not an appropriate guild for policy. In their view a high or raising interest rate may well be a reflection of expansionary rather than contractionary policy. Olumechere (1988:27) sees monetary policy measures as a deliberate actions adopted by the government to regulate and control the supply of money so as to promote the achievement of national objectives. According to umole (1985:19) monetary policy is the control of supply of money as an instrument in achieving the objective of a general economic policy. He goes further to state that, it is a policy which deals with the discretionary control of money supply by monetary authorities in order to achieve sated or desired economic goals. Ezeugo (1987:15) shares the view with Olumechere and Umole

(1985:19). He pointed out that monetary policy involves measures which the government adopted using specific instruments to stimulate, structure or restructure of the economy so as to attain the desired objective which may include increase output in the industry, agriculture or other sector of the economy. Employment generation, control of inflation, adjust the balance of payments and mobilization of savings.

Anyanwu(1997:71) monetary policy is a government policy about money. It is a deliberate manipulation of cost, availability of money and credit by one government as a means of achieving the desired level of prices, employment, output and other economy objectives. The government of each country embarks upon policies that increase or decrease the supply of money because of knowledge that money and the cost of money affect every aspect of the economy by affecting aggregate demand, money supply affect the level of consumption and the rate of economic growth, an increase or decrease in the cost money, interest rate affects all the variables too.

Ayubu (2013) assessed monetary policy and inflation dynamics in Tazannian economy. He made use of both Structural Vector auto-regression SVAR and Vector auto-regression model VECM. The study fouind out that inflation trends in the country was more of output phenomenon than monetary phenomenon. The study called for a parallel coordination of the monetary policy and focus on direct intervention in promoting the growth of the economy.

.Onyeiwu (2012) examined the impact of monetary policy on inflation and growth of the Nigerian economy using the Ordinary Least Squares method with data from 1981 to 2008. The results of the analysis showed that monetary policy represented by money supply exhibits a positive impact on GDP growth and balance of payment but a negative impact on inflation.

Objectives of the Study

The major objective of the study is to examine the impact of monetary policy on inflation in Nigeria. Other sub-objectives include, examining the trend of inflation in Nigeria and identifying influence of core monetary policy instruments on inflation.

Hypotheses

H_0: Monetary policy does not have significant impact on inflation in Nigeria.

H_1: Monetary policy has significant impact on inflation in Nigeria.

Limitation of the Study

Though there are several macroeconomic policies designed to control inflation but the focus of this study is on monetary policy being one the most used policy in various economies in achieving macroeconomic objectives. Also the study covers the period 1980 to 2013 to pave way for long period examination of the trend of inflation in Nigeria

Methodology

Following both monetarist and Keynesian theories of inflation the model to be adopted will specifically be based on the following functional relationship:

$$inf = f(int, lr, crr, ms) \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots..(1)$$

Equation 1 reads that inflation rate is a function of interest rate, liquidity ratio and cash reserve requirement. However, to hold firm the influence of the random variable, the equation is explicitly transformed into the following:

$$inf = \alpha_0 + \alpha_1 int + \alpha_2 lr + \alpha_3 crr + \alpha_4 ms + \mu_i \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots(2)$$

Where:

INF = inflation rate

INT = interest rate

LR = liquidity rate

CRR = cash reserve requirement

Ms = money supply M2

The parameter estimates are $\alpha1$, $\alpha2$, $\alpha3$, $\alpha4$, while $\alpha0$ is the parameter constant.

μ= error term.

Method of Evaluation

The economic apriori expectation (Table 1) will evaluate the parameters to find out if they meet the standard economic theory expectation both in signs and sizes.

The method adopted for evaluation of the model is the multiple linear regression method of ordinary least square (OLS). The techniques to be used in the analysis are:

i. Signs and magnitude of parameters: this is suggestion about the sign of the parameters and possibility of their sizes mentioned above.

The parameter α_1 mentioned above is expected to have a positive sign. The parameter α related to interest rate, is expected to appear with a negative sign since interest rate and inflation are negatively related. The parameter α_3 of the variable liquidity ratio is expected to have a positive sign with inflation rate.The cash reserve requirement related to the parameter α_4 is expected to have a negative sign as mention above. T

ii. Coefficient of multiple determinations (R^2) and adjusted (R^2) will be used to test for the goodness of fit. The value of (R^2)lies between 0 and 1. The closer the (R^2) is to 1, the better the goodness of fit whereas the closer the (R^2) is to 0, the worse the goodness of fit.

iii. t – test: this is used to find out the statistical significance of the individual regression coefficients. In this case, we use a two- tailed test to conduct it at a 5% level of significance. When this is done the computed t-ratio (t-cal) is compared with the theoretical t (t-tab) with n-k degree of freedom.

iv. F- test: this is a tool of the overall significance of the entire regression plane. It will be used to find out whether the joint impact of the explanatory variables actually have a significant influence on the dependent variable.

Sources of Data

In order to ensure an adequate and comprehensive research, secondary data of minimum rediscount ratio, interest rate, liquidity ratio, and reserve requirement and inflation rate were collected from 1980 to 2013.

Data to be used in this study are sourced from the central bank of Nigeria (CBN) statistical bulletin.

Discussions

This section of the study presents that empirical result and interpretation of the results are also made. However, basic inferences are also drawn from the findings. As one of the objectives of the study, assessment of the pattern of inflation in Nigeria during the year under review is carried out through descriptive statistics.

Descriptive Statistics

The descriptive analysis employed in this study comprises of line trend graph and correlation matrix. The line trend graph is only for inflation rate which is the dependent variable and the variable of interest. The correlation matrix involves other monetary policy variables. Figure 1 shows the trend of inflation during the period under consideration.

Figure 1 indicates that the trend of inflation during the period under review is relatively unstable. The graph shows that there is not unique upward or downward movement of the inflation trend during the period. Inflation reached its peak between 1990 and 2000 precisely around 1995. This can be attributed to the period under the military regime and prior to the civilian regime when the government expenditure was at its peak with little impact on the economy. Corruption and impunity in governance worsens the situation of the Nigerian economy at this period.

According to Adebiyi (2006) issuing of fiat money was the order of the day during the last military regime in Nigeria. These were done without recourse to domestic output or the nations gold reserve. All these accounted for the unprecedented rise in inflation trend during this period.

The trend also shows that from the start of the democracy in 2000, the inflation trend nose dives and fell drastically. This trend has been maintained from year 2000 till date.

To further explore the pattern of the distribution of the variables the study considers the correlation matrix the result is presented in Table 2

Table 2 shows the correlation and covariance nature of the variables used in our model. On the whole there appears to be divers correlations between inflation and the monetary policy variables. For instance, CRR and INF exhibits negative relationship. The same relationship is found between inflation and interest rate. However, the relationship between money supply,

liquidity and inflation appears to be positive. To know how significant these relationships are there is the need to estimate the regression equation using the data on the variables. The regression analysis is as follows.

The Regression Results

Table 3 shows the result of the regression for the first model. It explains the empirical relationship between inflation INF and other independent variables such as cash reserve requirement CRR, liquidity ratio LR, money supply MS and interest rate INTR. It should be noted that the independent variables are the monetary policy indicators.

From the table, the relationship between inflation and cash reserve ratio is inverse that is negative relationship. This conforms to the apriori expectation. The implication is that a rise in cash reserve requirement will reduce inflation. Notwithstanding the effect on inflation is not statistically significant. This is because the variable fails to pass the test of statistical significance at 5%. The next among the monetary indicator is the liquidity ratio. The result shows that liquidity ratio exhibits a positive or direct relationship with inflation. The implication is that a rise in the level of liquidity in the economy will lead to rise in inflation rate. However, the relationship is statistically significant. Thus, indicating that liquidity ratio has significant impact on level of inflation in Nigeria.

The next is the first monetary policy instrument used in the model which is the money supply. Though money supply exhibit a positive and direct relationship with inflation but the relationship appears not to be significant. The sign conforms to apriori expectation but the effect on inflation is not significant.

The second monetary policy instrument used in the model is the interest rate. The interest rate expectedly shows a negative or inverse relationship with inflation. The implication is that a rise interest rate would lead to a fall in the level of inflation in the economy. From the table the coefficient of interest rate is -0.6839525. The implication of this is that a unit rise in interest rate will definitely lead to about 0.6 unit fall in inflation rate in Nigeria. Unlike money supply the relationship between interest rate and inflation is significant. This is because the coefficient of interest rate passed the test of statistical significance at 5% level.

The R square is relatively impressive. The value of R square of 0.51 is an indication that about 51% variation in inflation is explained by the independent variables that is the

monetary policy indicators. The explanatory power of the independent variables is relatively very high. Following this, the test of overall statistical significance that is F test shows that the model is statistically significant at 1%. The result has corroborated the high R square value obtained in the empirical result.

Basic Inferences from the Findings

Firstly, findings from the result have shown that the legal reserve ratio or the cash reserve ratio might not be an important tool for controlling inflation in Nigeria. The results are an indication that despite the expected negative relationship, the relationship is not significant. The non-significance might be in connection with the position of Ojo (2003) that some financial institutions have enough cash deposits that will render the effect of CRR useless in controlling inflation in the Nigerian economy.

Secondly, the extent of liquidity in the economy appears to have significant impact on inflation in Nigeria. The liquidity ratio indicates the level of cash in the economy. This variable has been shown by the result to have a significant impact on inflation. This conforms to the reports of CBN 2005 that there reports have been consistently link the cause of inflation in Nigeria to volume of cash in circulation. This has been the reason behind the mopping up exercise of excess cash in the public often by the CBN.

Ironically, money supply as monetary policy instrument appears not to have significant impact on inflation in Nigeria. But interest rate which is the other monetary policy instrument used appears to have significant impact on inflation. The implication of the result is that the rate of liquidity in the Nigerian economy might be as a result of the effect of interest rate (see CBN 2004, 2007 and 2010).

Again, the relationship between inflation and inetrst rate in Nigeria conforms to the famous Taylors principle where a rise in interest rate is expected to lead to a fall in the level of inflation in any economy. According to Taylor (1993, 1999), with inflation and the output gaps at zero, the central bank is expected to keep the current and expected future real interest rates at zero. On the other hand if the economy shows a positive output gap and inflation, the Taylor rule has it that the central bank raises nominal interest rates. The feedback exceeds unity, which means that nominal interest rates rise more than one-for-one with inflation. Consequently, this ensures that the central bank raises real interest rates sufficiently to contract demand (i.e., by stimulating a positive sequence of real interest rate gaps).

Conversely, as the economy weakens and inflation falls, the [1]Taylor rule suggests that the central bank makes arrangements within its policy framework to sufficiently provide demand stimulus (see Jordi and Mark, 2007).

Conclusion

The study has shown that the pattern of inflation in Nigeria during the period under review has been mostly unstable. This confirms the position of some scholars that inflation in Nigeria has been volatile. The implication of this result is that the efforts by the monetary authority to tackle inflation using monetary policy is well justified since the nature has been shown to be unstable.

It can be concluded form the study that liquidity ratio and money supply both will have direct relationship with inflation while, interest rate and cash reserve ratio will have inverse relationship with inflation. All these results conform to apriori expectation.

Again, cash reserve ratio and money supply do not have significant impact on inflation. While, liquidity ratio and interest rate both have significant impact on inflation. The implication of the result is that both liquidity ratio and interest rate are veritable tools for controlling inflation in Nigeria and the amount of liquidity in the economy might not be all as a result of money supply.

Lastly, it can be concluded that the level of liquidity in the economy can be linked to interest rate since both of them have significant impact on inflation. Again, the study has shown that monetary policy is effective in controlling inflation in Nigeria. This is shown through the R square value which attributes 50% systemic variation in inflation to monetary policy and this is also significant at 5% level.

Recommendations

Considering the findings of the research works following recommendations are made:

(i) **Reducing price instability:** Since the study used consumer price index inflation to proxy inflation rate in Nigeria and this has been shown to relatively unstable. This compounds the severity on inflation in Nigeria. Therefore efforts should be made by the monetary authorities to reduce price fluctuations.

(ii) Embarking on contractionary monetary policy: Interest rate has been shown to have significant inverse relationship with inflation. The implication is that increase in interest rate can reduce inflation significantly. Consequently, monetary authorities are advised to categorize interest rate as an important tool for controlling inflation in Nigeria.

(iii) Monitoring of cash in circulation: The level of liquidity has been shown to have rising effect on inflation. This implies that the effort of the CBN to consistently mop up excess cash in the public should be sustained. This has been shown to have a significant reducing impact on inflation.

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Table 1

Apriori Expectations

Variable	Expected signs
Inflation rate	
Interest rate	Negative (-)
Liquidity ratio	Positive (+)
Cash reserve requirement	Negative (-)
Money supply	Positive (+)

Table 2

Correlation Matrix of the Distribution

	Crr	Lr	ms	Intr	Inf
Crr	1.0000				
Lr	0.1201	1.0000			
Ms	-0.3098	0.4651	1.0000		
Intr	-0.0688	0.3498	0.4169	1.0000	
Inf	-0.0517	0.4530	0.2785	-0.5852	1.0000

Source: Authors Computation

Table 3

Regression Equation for Inflation Rate

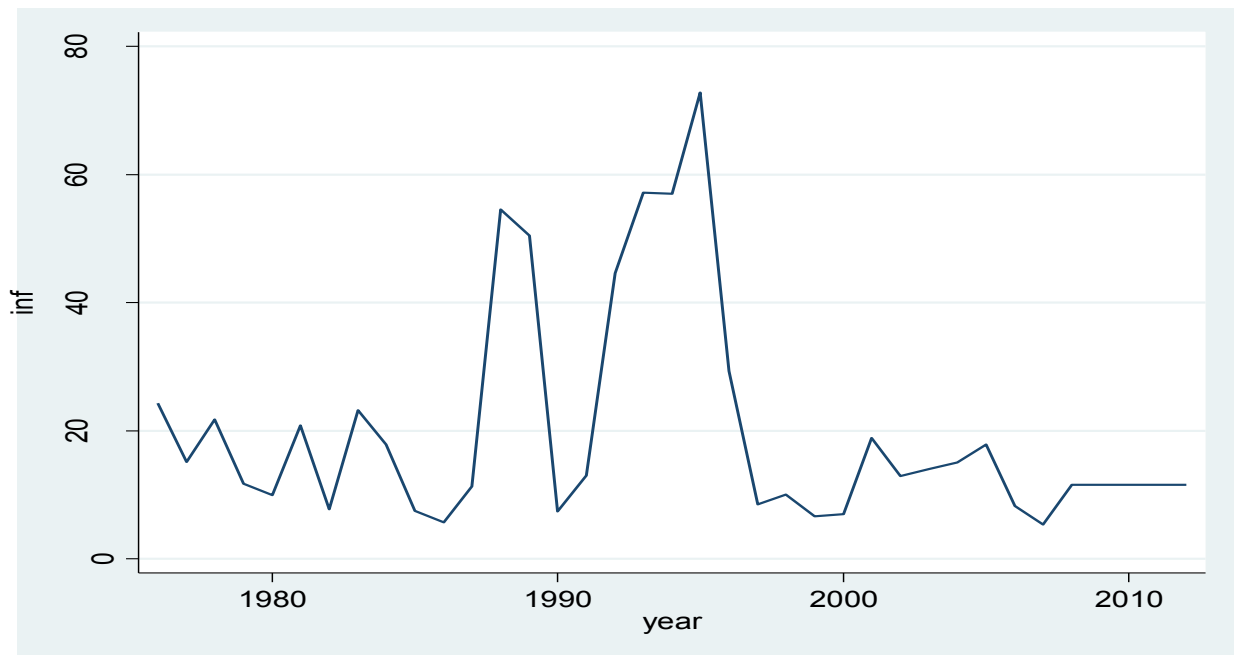| Variables	Coefficient	Standard Error
CRR	-.0936515	.4577029
LR	.5601054**	.3034366
MS	3.82e-13	1.04e-12
INTR	-.6839525***	.2033779
Constant	47.26853	13.95606

$R^2 = 0.5178$ F(4, 32) = 5.74***, Prob> F = 0.0013

*** *Statistical significance at 1%,* ** *Statistical significance at 5%,*

Source: Authors Computation

Figure 1

Inflation Trend in Nigeria

Source: Authors Computation