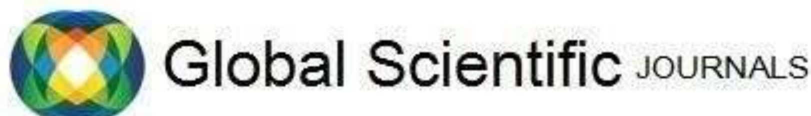

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MONETARY POLICY AND ITS EFFECTIVENESS ON ECONOMIC GROWTH IN NIGERIA

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ABSTRACT

Monetary policy play special roles in any developing country and one of special roles is to control the supply of money with the purpose of promoting economic growth and price stability. This study empirically reassessed the effectiveness of monetary policy on economic growth of Nigeria adopting the error correlation model approach. It utilized time series secondary data spanning between 1982 and 2013. The result showed that a unit increase in Cash Reserve Ratio (CRR) led to approximately seven units increase in economic growth in Nigeria. The result was in consonance with economic literature as monetary policy among other objectives is geared towards achieving the macroeconomic objectives of sustained economic growth and price stability. Therefore, the study recommends that monetary authorities should give priority attention to CRR monetary policy tool as it will produce a more desired result in terms of economic stabilization. And also some combination of fiscal policy measures are needed to attain the complementary balance required driving an economy towards to desired goals.

KEYWORDS: Monetary Policy, GDP, Economic Stability, Economic Growth, Interest Rate, Cash Reserve Ratio, Monetary Policy Rate.

INTRODUCTION

Background of the study

Nigeria’s potential for growth and poverty reduction is yet to be realized. A key constraint has been the conduct of macro-economics, particularly fiscal and monetary policies. This has led to

rising inflation and decline in real incomes. There has been little transparency and accountability in the management of public resources. An objective indicator of the traumatic experience of the Nigerian economy which at the inception of the present administration was the persistent weak GDP growth and declining productivity. This was a manifestation of a demoralized workforce coupled with corruption that characterized government business. Lack of transparency and accountability in the execution of public sector activities was very pronounced in all tiers of government. Equality glaring is the poor socio-economic condition of the people. Poverty rate remained very high, with about 70 percent of the population estimated to be living below the $1 per day consumption (Obafemi,2013).

National economy management became a Herculean task, as the economy has to contend with volatility off revenue and expenditure. The widespread lack of fiscal discipline was further exacerbated by poor co-ordination of fiscal policy among the three tiers of government. Also, there is weak revenue arising from high marginal tax rate with very narrow tax base, resulting in low tax compliance. These have curbed with the introduction of a new integrated tax system.

Other gray areas of the national economy include poor infrastructure, weak public service delivery and a generally weak environment for private sector development. All of these called for the recent exercise embarked upon by government for the privatization of different sectors of the economy. The launching of Transnational Corporation of Nigeria (Transcorp) Plc. By President Olusegun Obasanjo which is chaired by the NSE Director General, Dr. (Mrs.) Ndidi Okereke-Onyuike; the directive of the Governor of Central Bank of Nigeria Prof. Charles Soludo on the current Banking sector consolidation drive are other examples of government influence in public policy formulation at touching the wide of the Nigeria public. Thus, the issue is not only of improving economic management but also on of improving overall governance.

The Nigerian people aspire to and desire to move out poverty within the framework of stable and rapidly growing economy. This is certainly feasible if adequate policies are put in place and sustained. Partially and poorly implemented reforms will not serve to reserve current trend. Thus, the government is at crossroads.

The purpose of monetary policy includes macro-economic goals of full employment, economic growth, price stability, wealth distribution, efficient resource allocation, favourable balance of payment and industrial development (Ojo, 2002). A key function of Central Bank of Nigeria is to

promote and maintain stability and sound financial system (CBN Act, 2007). This function has facilitated long term planning, aid infrastructural development, attract foreign investments and engender economic growth (Anyanwu, 1993). In Nigeria the Central Bank is responsible for the promulgation of sound monetary policies in order to aid the attainment of the set objectives. The formulation of fiscal policies, which also affects the achievement of the above objectives, however falls on the wider government, particularly the Ministry of Finance (CBN Act, 2007). Given that both monetary and fiscal policies impact on economic growth and development, it is not surprising that they are entwined (Nangoko 1991). Fiscal policy comprises taxation, public expenditure, reliefs, concessions, and fiscal incentive policies. Government fiscal measures can be categorized into two which include Automatic Stabilizers and Discretionary Fiscal Measures. The Automatic Stabilizers are government spending or tax actions that take place without deliberate government control which tend to affect the business cycle (Okigbo). Whereas, Discretionary Fiscal Policy are government spending and tax actions that are taken to achieve specified macro-economic goals (Johnson, 2009).

Concept of Monetary and Fiscal Policy

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Fiscal Policy Asogu 1998 defined fiscal policy as the use of government expenditure, taxes, borrowing and financial administration to further national economic objectives.According to Central Bank of Nigeria (CBN) (1993) Fiscal Policy refers o the discretionary changes in the level, composition and timing of government expenditure and revenue. Fiscal expenditure is capable of increasing output in the desired direction while fiscal deficits tend to have serious adverse effect on monetary aggregates and inflation. A hand full of literature exists on the relationship between monetary and fiscal policy on commercial banks performance, but above these, various researchers have adopted the following measures; Odufalu (1994) based his study mainly on the effect of monetary policy on banks profitability in Nigeria. He developed a model of bank profitability, which had profit before interest and tax as the dependent variables. while the independent variable include, average interest rate on savings and time deposits, prime lending rate for loans and advances, treasury bills rate, total deposit, liquidity ratio, cash and income. he also used pooled data for only twelve commercial banks from 1986 to 1990 periods and estimate the model using the ordinary least square [OLS]estimation method.

Ogunleye [1995]in his own submission criticized and questioned Ogufalu's use of certain variables in his model, for example, lending rate is one aspect of interest rate and thus, making its inclusion among the explanatory variables questionable.

Nyong [1996] undertook a very outstanding study different from all other precious studies earlier reviewed he used two- ways causality test between profitability and capital investment in banks. It was hypothesized that an increase in lending rate and deposit rate leads to increase in profit.

However, an increase in excess liquidity may or may not lead to increase in bank profitability. An increase in excess reserve may lead to increase in profit in condition of strong demand for loan able funds. it may lead to a fall in profit in a condition of weak demand and hence constrain the ability of bank to make profits. labour costs could increase profit only if matched with productivity in line with the marginal productivity theory because generally increase in labour cost should decrease bank profit as it is a cost to the banking sector. This implies that profit is dependent on capital, investment, which provides the means for adoption of modern technology for improve performance, thus a resultant increase in profit.

To estimate the model, he used a two-stage least square estimator procedure and to different time period, that is, before structural adjustment programme [SAP] [1986 to 1990] and deregulation [1982 to 1985].the result of his findings showed a statically significant and negative effect of managerial efficiency on banks profit performance, which posed contrary to uchendu's findings. knight [1970]studied the effect on federal reserve system policies on the banking sectors and found out that, the variation in free reserve has a pronounced effect on banks' loan and investment expansion ability. Wall [1987] Gondrean and whitehead [1989] used the adjusted net interest margin, return on asset [ROA] and return on equity.[ROE]as a measure of commercial bank performance.

Jhingan [2007] adopted return on equity as the major measurement of profitability and examined the effect on interest rate and other monetary component on bank profitability. The primary goal of monetary policy in Nigeria has been the maintenance of domestic price and exchange rate stability since it is critical for the attainment of sustainable economic growth and external sector viability. Adefeso and Mobolaji, (2010) employed Jahansen maximum likelihood co-integration procedure to show that there is a long run relationship between economic growth,

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degree of openness, government expenditure and money supply (M2) in Nigeria. Ajisafe and Folunso, (2002) observed that monetary policy exerts significant impact on economic activity in Nigeria. Kogar (1995) examined the relationship between financial innovations and monetary control and concludes that in a changing financial structure, Central Banks cannot realize efficient monetary policy without setting new procedures and instruments in the long-run, because profit seeking financial institutions change or create new instruments in order to evade regulations or respond to the economic conditions in the economy. Examining the evolution of monetary policy in Nigeria in the past four decades, Nnanna, (2001) observed that though, the Monetary management in Nigeria has been relatively more successful during the period of financial sector reform which is characterized by the use of indirect rather than direct monetary policy tools yet, the effectiveness of monetary policy has been undermined by the effects of fiscal dominance, political interference and the legal environment in which the Central Bank operates. Busari et al. (2002) stated that monetary policy stabilizes the economy better under a flexible exchange rate system than a fixed exchange rate system. It stimulates growth better under a flexible rate regime but is accompanied by severe depreciation, which could destabilize the economy meaning that monetary policy would better stabilize the economy if it is used to target inflation directly than be used to directly stimulate growth. They advised that other policy measures and instruments are needed to complement monetary policy in macroeconomic stabilization. In the same stride, Batini (2004) stress that in the 1980s and 1990s monetary policy was often constrained by fiscal indiscipline. Monetary policies financed large fiscal deficit which averaged 5.6 percent of annual GDP and though the situation moderated in the later part of the 1990s it was short lived as Batini (Ibid), described the monetary policy subsequently as too loose which resulted to poor inflation and exchange rates record.

Folawewo and Osinubi, (2006) investigate how monetary policy objectives of controlling inflation rate and intervention in the financing of fiscal deficits affect the variability of inflation and real exchange rate. The analysis is done using a rational expectation framework that Incorporates the fiscal role of exchange rate. The paper reflects that the effort of the monetary authority to influence the finance of government fiscal deficit through the determination of the inflation-tax rate affects both the rate of inflation and the real exchange rate, thereby causing volatility in their rates. The paper reveals that inflation affects volatility of its own rate as well as the rate of real exchange. The policy implication of the paper is that monetary policy should be

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set in such a way that the objective it is to achieve is well defined. This suggests that the ability of the CBN to pursue an effective monetary policy in a globalised and rapidly integrated financial market environment depends on several factors which include, instituting appropriate legal framework, institutional structure and conducive political environment which allows the bank to operate with reference to exercising its instrument and operational autonomy in decision-making. The degree of coordination between monetary and fiscal policies to ensure consistency and complementarily, the overall macroeconomic environment, including the stage of development, depth and stability of the financial markets as well as the efficiency of the payments and settlement systems, the level and adequacy of information and communication facilities and the availability of consistent, adequate, reliable, high quality and timely information to Central Bank of Nigeria.

METHODLOGY

Model Estimation and Data Issues from the foregoing review; the paper adopts the Error Correction Model to reassess the impact of monetary policy on economic growth of Nigeria. The model is expressed thus:

RGDP = f (IR, CRR, MPR) ………………………………………………….. (1)

Where;

RGDP = Real Gross Domestic Product

IR = Interest Rate

CRR = Cash Reserve Ratio

MPR = Monetary Policy Rate.

In our model, RGDP measures economic growth of Nigeria while IR, CRR, MPR are our monetary policy variables, whose impacts were reassessed in this paper.

From the functional relationship above (1).The econometric model was specified thus below (2). The econometric form represents the actual population representation of the true relationship or the structural or explicit function of the relationship. Thus, our model is structurally specified as:

$RGDP=\psi_0+\psi_1 IR+\psi_2 CRR+\psi_3 MPR+\varepsilon$ ………………… (2)

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Source of Data

The data required for this study are of the secondary nature and were collected mainly from the Central Bank of Nigeria (CBN) Statistical Bulletin, Annual Reports and Statement of Accounts (of various issues). These data were supplemented with data from the National Bureau of Statistics (NBS) as well as the Federal Ministry of Finance.

Empirical Results

By the rule of thumb and assuming every other thing remains equal/constant we employed the Ordinary Least Square (OLS) and other time series estimation techniques to test the hypotheses in this paper. The tables below show our various results.

Stationary Test Results (Unit Root)

Variables	ADF Statistics	Critical Values	Order of Integration
RGDP	-5.823025	1% = 3.6661* 5% =-2.9627 10%=-2.6200	I(1) Stationary at first difference
IR	-6.414077	1%= -3.6661* 5% = -2.9627 10%= -2.6200	I(1) Stationary at first difference
CRR	-2.980288	1%= -3.6661* 5% = -2.9627 10%= -2.6200	I (1) Stationary at first difference
MPR	-5.833626	1%= -3.6661* 5% = -2.9627 10% = -2.6200	I (1) Stationary at first difference

Source: Authors' Computation 2017

Source: Authors' Computation, 2015

From the table above, the Mackinnon critical value for rejection of unit root hypotheses indicates as follows:

RGDP, IR, CRR, MPR are stationary after first differencing and as such they are integrated at order one I (1).

COINTEGRATION TEST

Johansen Cointegrating Test

Eigen Values	Likelihood ratio	5% Critical value	1% Critical value	Hypothesized no of CE(s)
0.619867	60.52391	47.21	54.46	None**
0.424298	30.53969	29.68	35.65	At most 1*
0.239480	13.42259	15.41	20.04	At most 2
0.147203	4.936247	3.76	6.65	At most 3*

Source: Authors' Computation 2017

Source: Authors' Computation, 2015

*(**) denotes rejection of hypothesis at 5% (1%) significant level

Likelihood ratio test indicates two cointegrating equations at 5% level of significance. Therefore, this suggests that there will be long run relationship among the variables.

Error Correction Model Result and Discussion

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-4.208992	8.455188	-0.497800	0.6228
D(D(IR))	-1.946261	1.344124	-1.447977	0.1596
D(D(CRR))	6.971632	3.377270	2.064280	0.0491
D(D(MPR))	-0.653380	1.977099	-0.330474	0.7437

ECM(-1)	-0.066450	0.483509	-4.273861	0.0002

R-squared	0.448543	Mean dependent var.	8.253710
Adjusted R-squared	0.363704	S.D. dependent var.	55.53862
S.E. of regression	44.30215	Akaike info criterion	10.56663
Sum squared resid	51029.69	Schwarz criterion	10.79792
Log likelihood	-158.7828	F-statistic	5.286959
Durbin-Watson stat	1.277534	Prob(F-statistic)	0.002979

Source: Authors' Computation, 2015

Source: Authors' Computation 2017

From the results estimated above, Cash reserve ratio was statistically significant while Interest rate, monetary policy rate were statistically insignificant. The results therefore, showed that a unit increase in Cash reserve ratio led to approximately 7 units increase in economic growth in Nigeria.

SUMMARY, CONCLUSION AND RECOMMENDATIONS

The results arising from this study showed that the most effective monetary policy tool among the tools reassessed was cash reserve ratio as a unit increase in cash reserve ratio resulted to improvement in economic growth by 7 units without increasing the inflationary pressure in the Nigerian economy.

Therefore, the study recommendations that monetary authorities in stabilizing the Nigerian economy should give priority attention to cash reserve ratio as it will produce a more desired result in term of economic stabilization.

In the light of the above, the issue of broad monetary policy instrument should be critically looked into by the monetary authorities especially in Nigeria because it can be sometimes dangerous for the economy; rather efforts should be put in place in ensuring that commercial bank (Deposit Money Bank) follow Central Bank's guideline for financial intermediation.

Moreover, the Central Bank's policy of cashless society should be genuinely pursued with vigor as it will help in minimizing inappropriate moves by commercial banks to meet their customers' demand at the expense of macroeconomic policy objectives. Also helpful fiscal policy measures should be undertaken alongside monetary policy, as both are re-enforcing and complementary.

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