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IS MONETARY POLICY THE BEST INSTRUMENT FOR INFLATION TARGETING IN THE NIGERIAN ECONOMY?

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ABSTRACT

Since the debasement of money emerged, particularly during the 17th and 18th centuries when precious metals were still being used as coins in continental Europe & North America, whereby governments and monarchs often combined gold coins with other metals such as silver, copper or lead and reissue them at the same nominal value, the intrinsic value attached to each metallic coin declined. Consumers who used them had to pay higher prices (more coins) for the same quantity of goods and services than was the case in the past. Price inflation was therefore, a fall-out of monetary inflation. It is in this context that price inflation is essentially considered as a monetary phenomenon. But, does it mean that inflation can only be controlled through monetary policy? This paper, answer in the negative. Reviewing literature on conceptual and empirical issues on monetary policy, inflation, and fiscal policy; this paper posits that inflation in Nigeria though a monetary phenomena is essentially supply oriented in nature and can best be controlled by fiscal policy measures. It therefore suggests that government should put in place the necessary infrastructures that would lower the cost of production (supply side-economics) in the economy and enhance output thereby achieving its inflation targeting regime.

Keywords: Price Inflation, Monetary Inflation, Monetary Policy, Fiscal Policy, Inflation, Inflation Targeting, Economy, Nigeria, Supply Side-Economics.

INTRODUCTION

Inflation refers to the persistent and sustained rise in the general level of prices of goods and services in an economy, manifesting visibly in the decline in the value of money. The effects of high inflation on the economy are generally considered to be predominantly harmful. That is why the achievement of price stability has always been one of the fundamental objectives of macroeconomic policy in both developed and less developed countries (Orubu, 2009).

In Nigeria, inflationary pressures reflecting in persistently rising prices have been an issue of concern to the authorities since the late 1960s.Thus,through the 1970s and well into the first quinquennium of the 1980s,anti-inflation policy became a regular feature of governments' overall economic policy agenda. Inflationary pressures heightened substantially after the adoption of the Structural Adjustment Programme(SAP) in 1986,with the inflation rate rising as high as 38% and 49% in 1988 and 1989 respectively. Despite a mild respite in 1990 with a single digit rate of 7.5%, the inflation rate climbed up steadily to about 44.9% in 1992, and up as high as about 72.8% in 1995.In its effort to stem the problem of inflation in Nigeria, the policy authorities have over the years used a combination of several measures, ranging from wage freezes, price controls, direct involvement of government in the procurement and distribution of essential commodities, to fiscal and monetary strategies. Since the late 1990s

the Central Bank of Nigeria (CBN), has however focused more on monetary strategies to combat inflation (Orubu, 2009). A new monetary policy strategy "Inflation Targeting", pioneered in New Zealand in 1990 is however now gaining popularity in both developed and developing countries. Inflation targeting is an operational framework for monetary policy in which the attainment of price stability becomes the overriding concern of the central bank (Oluba, 2008). The Central Bank of Nigeria (CBN) commenced the implementation of Inflation Targeting (IT) regime as one of its core Monetary Policy strategy, using the Monetary Policy Rate (MPR) as the main tool of stabilization in 2009.There are various causes of inflation and the appropriate measures that can be taken to control or curb it depends on the peculiarities of the individual economy concerned. The crucial issues are: Is the Nigerian inflation phenomena demand oriented as to always warrant using monetary tools? Or is it supply oriented? Which is best handled with a combination of fiscal tools and supply-side economics; (an appropriate instrument for developing economies with shallow financial markets) considering the enormous role that government incomes and expenditures has in such economies? Is monetary policy as an instrument of economic stabilization well entrenched within the Nigerian economy as to always ensure its effective utilization as a policy for inflation targeting? This paper attempts to answer these questions, and is organized into five sections. Following the introductory section is section two, which provides an overview of conceptual issues in monetary policy and inflation. Inflation targeting: concepts and applications are reviewed in section three. The desirability of fiscal policy/supply side economics as long term means of controlling inflation targets are thoroughly discussed in section four. While section five, is concluding remarks.

MONETARY POLICY

Monetary policy is the process by which the government, central bank, or monetary authority of a country controls the supply of money, availability of money and cost of money or rate of interest to attain a set of objectives oriented towards the growth and stability of the economy. There are several monetary policy tools available to achieve these ends: increasing interest rate by fiat; reducing the monetary base; and increasing reserve requirements. All have the effect of contracting the money supply; and if reversed, expand the money supply (Wikipedia, 2009).The primary tool of monetary policy is Open Market Operations(OMO).This entails managing the quantity of money in circulation through the buying and selling of various financial instruments, such as treasury bills, company bonds, or foreign currencies. All of these purchases or sales results in more or less base currency entering or leaving market circulation. Usually, the short term goal of open market operations is to achieve a specific short term interest rate target. In other instances, monetary policy might entail the targeting of a specific exchange rate relative to some foreign currency or to gold. For example, in the case of the USA the Federal Reserve targets the "Federal Funds Rate", the rate at which member banks lend to one another overnight; however, the monetary policy of China is to target the "Exchange Rate" between the Chinese renminbi and a basket of foreign currencies. Other primary means of conducting monetary policy include:

- Discount Window Lending (lender of last resort): discount window lending is where the commercial banks, and other depository institutions, are able to borrow reserves

from the central bank at a discount rate. This rate is usually set below short term market rates(Treasury Bills).This enables the institutions to vary credit conditions(i.e., the amount t of money they have to loan out),thereby affecting the money supply. It is of note that the discount window is the only instrument which the central banks do not have total control over.

- Fractional deposit lending (changes in the reserve requirement); the monetary authority exerts control over banks. Monetary policy can be implemented by changing the proportion of total assets that banks must hold in reserve with the central bank. Banks only maintain a small portion of their assets as cash available for immediate withdrawal; the rest is invested in illiquid assets like mortgages and loans. By changing the proportion of total assets to be held as liquid cash, the Federal Reserve changes the availability of loanable funds. This act as a change in the money supply. Central banks typically do not change the reserve requirement often because it creates very volatile changes in the money supply due to the lending multiplier.
- Moral suasion(cajoling certain market players to achieve specified outcomes):this is a situation where the monetary authority through regular dialogue and consultations with banks and other financial institutions on the platform of Bankers Committee and other channels in order to encourage enhanced efficiency in the financial system.es[specially with respect to interest rate management.
- "Open Mouth Operations"(talking monetary policy with the market)

INFLATION

Given the definition of inflation as the persistent increase in the price level, or a persistent decline in the purchasing power of money, and that this is caused by an increase in available currency and credit beyond the proportion of goods and services, it follows that the core concept was originally that of monetary inflation. Price inflation, which is a common usage of the concept, is therefore as a result of monetary inflation(Mcmahon,2008).Price and output in an economy reflect consumer tastes and production conditions at any point in time. Supposing the conditions which prevail in the current period are such that the supply of certain goods is above the normal level, prices of such goods will have to fall before consumers on the average will be willing to absorb the excess supply. Now, since every economy faces a resource constraint, the production of goods can only occur at the expense of a fall in the output of other goods in the economy. On the relative scale, the prices of other goods whose production falls will tend to rise. But, so long as the stock of money which provides the purchasing power of the economy remains constant, such developments will only lead to a change in relative prices and need not lead to substantial increases in the price level. Indeed, it must be that if production conditions as well as consumer tastes and preferences do not change over time, prices and outputs should eventually return to their original equilibrium levels. On the other hand, it may not necessarily involve the diversion of resources of the economy in order to permanently change the supply of money. For instance, just a mere change in the denomination of the currency will alter the supply of money. With an increase in the supply of money, it becomes less scarce at the existing level of prices. Consumers on the average will thus be willing to part with a higher proportion of their

increased money holdings, which is made effective by demanding for more goods and services. If the supply of output exhibits response inertia, this increase in demand will tend to bid up the level of prices in the economy generally. Thus, monetary inflation will trigger up price inflation only to the extent that the supply of output exhibits inertia in response (Orubu, 2009).

Controlling inflation forms a significant part of the economic activities of a nation. Inflation is important as unrestrained increased of the prices may culminate in hyperinflation, and an excessive fall in the prices may lead to deflation. Both these situations are not healthy and sound for the overall growth and development of a country's economy. In fact, keeping a strong control over inflation has turned out to be one of the primary objectives of the governments of different countries across the globe. To this effect, efficacious economic policies are being formulated, which mainly concentrate on the fundamental causes of inflation in an economy, and try to improvise methods to keep the inflationary conditions under control (EconomyWatch, 2010).On a broad line of classification, two basic theories have been advanced to explain inflation and its dynamics. These are the demand oriented and supply oriented theories respectively.

- **Demand-Oriented Theories.** The fundamental argument of the demand-oriented theories is that inflation rises in an economy when aggregate demand is greater than aggregate supply (i.e.AD > AS).This is based on Keynesian analysis, which posits that it is the level of national expenditure that determines the price level. Thus, if for some reason aggregate demand is greater than full employment level of income, an inflationary gap will crop up triggering the prices of goods and services in the economy. Several factors can give rise to excess demand in the economy. They include (but not limited to) increased private and government expenditure; rapid growth of money supply; reduction in indirect and direct taxes; excess demand spilling over from the international economy, increase in wages without productivity improvement, and exchange rate depreciation. Therefore a necessary condition for price inflation to occur when aggregate demand is greater than aggregate supply is that the economy should be operating at, or at least very close to full employment level of output/GNP. Based on this analysis, with the Nigerian economy (Industrial & Agricultural sectors) operating grossly below full capacity, the persistent inflationary trend cannot be said to be demand induced.
- **Supply-Oriented Theories.** The supply oriented theories have to do with cost-push influences, and have to do with drops in aggregate supply due to increasing prices of inputs such as labour, imported inputs, raw materials and higher taxes by government. Here inflation is assumed to be caused by increases in the cost of production that are independent of the state of aggregate demand. If there is sustained increase in the prices of raw materials used in production, producers for whom such raw material are useful will pass on the cost of production to consumers by way of higher prices in order to maintain their profit levels. This analysis is more apt for the Nigerian economy with its massive dilapidated and inadequate

infrastructures, thereby increasing cost of production and fuelling the inflationary trend.

From the above theories, it's obvious that if the primary reason for inflation in an economy is the excessive demand for goods and services, then the economic policy on governmental level should find out the causes of such unnecessary rise and undertake measures to decrease the overall level of aggregate demand. Sometimes, if it is seem that Cost-push inflation is responsible for the rise in the demand for goods and services, then the cost of production must be checked, to handle the inflation related problems.

INFLATION TARGETTING

Given the breakdown of the relationship between monetary aggregates and other variables such as inflation, Central Banks in the 1990's,began adopting formal, public inflation targets with the goal of making the outcomes, if not the process of monetary policy more transparent. In other words, a central bank may have an inflation target of 2% for a given year, and if inflation turns out to be 5%, then the central bank will typically have to submit an explanation. Many countries have thus, adopted Inflation Targeting (IT) as their monetary policy regime. New Zealand was the first country to formally adopt inflation targeting in 1990, with Canada following in 1991, the United Kingdom in 1992, Sweden in 1993, Finland in 1993, Australia in 1994 and Spain in 1994.Isreal and Chile have also adopted a form of inflation targeting. Essentially, inflation targeting may be viewed as a strategy in which the central bank adopts a numerical target for inflation and commits to achieving the target. Meaning that as long as inflation remains within the stated range, the central bank is free and indeed, is expected to stabilize the permissible range, then, the central bank must make the inflation target its overriding objective and work towards containing it to within that range (Uchendu, 2009).Inflation targeting involves several elements:

- Public announcement of medium-term numerical targets for inflation.
- An institutional commitment to price stability as the primary, long run goal of monetary policy and to achievement of the inflation goal.
- An information inclusive strategy, with a reduced role for intermediate targets such as monetary growth.
- Increased transparency of the monetary strategy through communication with the public and the markets about the plans and objectives of monetary policy markets.
- Increased accountability of the central bank for attaining its objectives.

Inflation targeting has several important advantages. It enables monetary policy to focus on domestic considerations and to respond to shocks to the domestic economy. Inflation targeting also has the advantage that velocity shocks are largely irrelevant because the monetary policy strategy no longer relies on a stable money-inflation relationship. Indeed, an inflation target allows the monetary authorities to use available information, and not just one variable, to determine the best settings for monetary policy. A key advantage of inflation targeting is that it can help focus the political debate on what a central bank can do in the long run(that is control inflation),rather than what it cannot do (raise economic growth and the number of jobs permanently through expansionary monetary policy).Thus inflation

targeting has the potential to reduce political pressures on the central bank to pursue inflationary monetary policy and thereby reduce the likelihood of time inconsistent policy making(Miskin,1999).It is in view of the above advantages and improvements in the monetary policy environment achieved in the last few years which led the CBN to transit to inflation targeting, despite the challenges identified above. Perhaps, it needs to be emphasized that it will be unwise and unjustifiable to insist on meeting the "pre-conditions" perfectly before transition. What is important is whether a country has met the conditions sufficiently and not fully (Uchendu, 2009).

THE SUITABILITY OF FISCAL POLICY IN ACHIEVING INFLATION TARGETS

Globally, inflation control has become the most critical objective of macroeconomic policy in many countries. The ability of the policy adopted to control inflation however depends on whether the underlying causes of inflation have been properly identified. If inflation is demand-based, the best strategy would be to reduce aggregate demand. But if inflation is cost or supply-oriented, then the focus should be on how to reduce the cost of production which is best achieved through fiscal stimulus (Orubu, 2009). Fiscal policy is the means by which a government adjusts its levels of expenditure in order to monitor and influence a nation's economy. It is the sister strategy to monetary policy with which a central bank influences a nation's money supply. These two policies are used in various combinations in an effort to direct a country's economic goals. Before the Great Depression in the United States, the government's approach to the economy was laissez faire. But following the Second World War, it was determined that the government had to take a proactive role in the economy to regulate unemployment, business cycles, inflation and the cost of money. By using a combination mixture of both monetary and fiscal policies (depending on the political orientations and the philosophies of those in power at a particular time, one policy may dominate over another), governments are able to control economic phenomena. Fiscal policy is based on the theories of John Maynard Keynes. Also known as Keynesian economics, this theory basically states that government can influence macroeconomic productivity levels by increasing or decreasing tax levels and public spending. This influence in turn, curbs inflation (generally considered to be healthy when at a level between 2-3%), increase employment and maintains a healthy value of money (Heakal, 2009). The purposes of fiscal policy are:

- Reduce the rate of inflation.
- Stimulate economic growth in a period of recession.
- Basically, fiscal policy aims to stabilize economic growth, avoiding the boom and bust economic cycle.

The three possible instances of fiscal policy are neutral, expansionary and contractionary.

- A neutral stance of fiscal policy implies a balanced economy. Government spending is fully funded by tax revenue and overall the budget outcome has a neutral effect on the level of economic activity.
- An expansionary stance of fiscal policy involves government spending exceeding tax revenue i.e
    I. This involves increasing AD

II. Therefore the government will increase spending (G) and cut taxes. Lower taxes will increase consumer spending because they have more disposable income(c).
III. This will worsen the government budget deficit.

- A contractionary fiscal policy occurs when government spending is lower than tax revenue.
  I. This involves decreasing AD
  II. Therefore the government will cut spending (G).
  III. And or increase taxes. Higher taxes will reduce consumer spending(c).This will lead to an improvement in the government budget deficit.

Keynesian economics suggests that increasing government spending and decreasing tax rates are the best ways to stimulate aggregate demand. This can be used in times of recession or low economic activity as an essential tool for building the framework for strong economic growth and working towards full employment, while the resulting deficits would be paid for by an expanded economy during the boom that would follow. Thus, fiscal stimulus does not cause inflation when it uses resources that would have otherwise been idle. For instance, if a fiscal stimulus employs a worker who otherwise would have been unemployed, there is no inflationary effect; it is when the stimulus employs a worker who otherwise would have had a job, that it increases labour demand while supply remains fixed, leading to wage inflation and therefore price inflation(Sullivan & Sheffrin,2003).The Nigerian inflationary phenomena is cost/supply oriented in nature(considering the high cost of production and low capacity utilization within the agricultural and industrial sectors, see table below),due to lack of basic infrastructures and an excess of idle human and capital resources, Nigeria's inflation is currently 10.5%,a figure that is still too high considering the country's desire to have a single digit inflation figure. Throughout last year, the CBN adjusted its MPC rate from 6.5% to its current 12% all with the aim of curbing inflation without the desired result.

Nigeria's Production Capacity Utilization & Inflation Rate 1980-2010.

Year	Capacity Utilization% (Manufacturing)	Inflation Rate %	Year	Capacity Utilization% (Manufacturing)	Inflation Rate %
1980	70.10	9.90	1995	29.30	72.80
1981	73.30	20.90	1996	32.50	29.30
1982	63.60	7.70	1997	30.40	8.50
1983	49.70	23.20	1998	32.40	10.00
1984	43.00	39.60	1999	35.90	6.60
1985	38.30	5.50	2000	36.10	6.90
1986	38.30	5.40	2001	39.60	18.90
1987	40.40	10.20	2002	44.30	12.90
1988	42.40	38.30	2003	46.20	14.00
1989	43.80	48.90	2004	55.70	15.0
1990	40.30	7.50	2005	54.80	15.80
1991	42.00	13.00	2006	53.30	8.50
1992	38.10	44.50	2007	53.30	6.60

1993	37.20	57.20	2008	52.60	15.10
1994	30.40	57.00	2009	na	12.0
			2010	na	12.8

Source: CBN, Nigeria; Major Economic, Financial & Banking Indicators 2004 and Other Issues

Judging by the three major criteria (capacity utilization, growth rate, employment rate) for assessing the performance of the Nigerian manufacturing sector over the past years, it's obvious that the performance is woeful. With rising inflation, low demand, massive depreciation of the Naira (N157 to $1.0) costs of production are already hitting the roof. The implication is that manufacturers would not be able to replace their ageing machineries, capacity utilization would further worsen, and there would be cut back in employment and poverty level would get worst (Banjoko, 2009).Unarguably, Central Bank actions are the most important government policies affecting economic activity from quarter to quarter or year to year. But, monetary policies are demand-side macroeconomic policies. They work by stimulating or discouraging spending on goods and services. Economy-wide recessions and booms reflect fluctuations in aggregate demand rather than in the country's productive capacity. Monetary policy tries to damp, perhaps even eliminate, those fluctuation. It is not a supply side instrument. Central banks have no handle on productivity and real economic growth (Tobin, 2008).

The manufacturing sector must be recognized as a major tool for sustainable growth and development and be accorded due regard and priority in the scheme of things. Infrastructural constraints that obstruct the realization of the full potentials of the manufacturing sector must be removed. There is need for massive investment in upgrading our state of infrastructure especially power, rail, port etc. The case of electricity supply is very pathetic. Inadequate supply of power has driven many companies underground. There should be reduction in tariff on major raw materials as a way of reducing the high cost of production. Fiscal policy is an important tool for managing the economy because of its ability to affect the total amount of output produced-that is, gross domestic product. The first impact of a fiscal expansion is to raise the demand for goods and services; this greater demand leads to increases in both output and prices. The degree to which higher demand increases output and prices depends, in turn, on the state of the business cycle. If the economy is in recession, with unused productive capacity and unemployed workers, then increases in demand will lead mostly to more output without changing the price level (If the economy is at full employment, by contrast, fiscal expansion will have more effect on prices and less impact on total output).This ability of fiscal policy to affect output by affecting aggregate demand makes it a potential tool for economic stabilization. In a recession, the government can run an expansionary fiscal policy, thus helping to restore output to its normal level and to put unemployed workers back to work. During a boom, when inflation is perceived to be a greater problem than unemployment, the government can run a budget surplus, helping to slow down the economy. Such a countercyclical policy would lead to a budget that was balanced on the average.

CONCLUSION

Since the last two decades or more, monetary policy measures have become more critical in addressing the problems of inflation in Nigeria. This has been based on the fundamental premise that the key to controlling inflationary pressures in the long-run is for the policy authorities to control aggregate demand through the use of monetary policy instruments, while at the same time seeking to achieve significant improvements in the ability of the economy to produce more goods and services, thereby establishing rightward shifts in the economy's aggregate supply curve .This approach has not yielded the expected results most of the time, largely due to the fact that the transmission mechanism(financial markets) through which monetary policies are expected to exert its influence on the targeted goals/objectives is grossly under-developed with few major players and instruments for its activities to have any meaningful and corrective impact, also it cannot enhance any appreciated growth in output & employment generation because its not a supply side instrument. Monetary policy is an awesome macroeconomic instrument of stabilization. But, its efficiency is best suited for developed economies with advanced financial markets that are highly sensitive to changes in interest rates and money supply, and having high rates of industrial capacity utilization. For developing economies like Nigeria, with shallow financial markets where government finances are usually the only alternative for accelerated economic activities, monetary policy hardly seems the best option.

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