Impact of Monetary Policy in Nigeria on Inflation, Exchange Rate and Economic Growth

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Abstract

This paper reviewed the framework for monetary policy decisions and the effectiveness of monetary policy implementation in the Nigerian economy by analysing the impact of the policy on inflation, exchange rate and economic growth. The analysis utilized both primary and secondary information. The review revealed that some Central Bank of Nigeria (CBN) policies have been under criticism because not all monetary policy tools favour all economic agents. Monetary policy involves trade off because of its implication on the whole economy and each economic agent will react to each monetary policy depending on the degree it negatively or positively affects its business or activity. Policy makers, therefore, may decide to grow the economy during stagflation in the short and medium terms before turning to inflation because of the favourable implications of growth on the economy. For the foreign exchange market, monetary policy makers will have to analyse the fundamentals of export and import as well as the country's elasticity to export before taking policy on whether to devaluate or not. However, other challenges such as wide gap between the official market (₦197.00k) and the black market (₦322.00k) which does not favour devaluation within the short run and medium term would require concerted effort. Hence, there is need for policy makers to act in order to reduce round-tripping which is unhealthy to the economy. Also, for effective economic growth and development, it is expedient that monetary policy must be supported by fiscal policy.

Keywords: *Monetary Policy; Inflation; Exchange Rate; Economic Growth.*

1. Introduction

Monetary policy (MP) decision making starts with the identification of global and domestic challenges where issues relating to global growth, commodity prices, capital flows, inflation rate and purchase managers index are examined in relation to the Nigerian economy. This is followed by an analysis of the domestic environment taking into consideration the level of output growth, direction of prices such as inflation, interest and exchange rates and liquidity in the economy. In addition, the financial sector's soundness is assessed by comparing the outcome of the fitness tests conducted by the Banking and Supervision Department of the Central Bank of Nigeria (CBN) on indicators such as Capital Adequacy Ratio (CAR); Non Performing Loans (NPLs); Liquidity Ratio (LR); Return On Equity (ROE); Return On Assets (ROA); Interest Margin to Gross Income and Total Operating Cost to Gross Income; etc against the prudential requirements.

It should be noted that suggestions on the application of appropriate monetary policy, tools or instruments depend not only on the results of the fitness test but also on the effectiveness of previous policy measures implemented by the Monetary Policy

Implementation Committee (MPIC). Views or opinions on the final measures to be adopted are open to vote by the Monetary Policy Committee (MPC) members. However, there are personal statements and/or opinions that individual are free to communicate which may vary from that of the majority. However, opinions contrary to that of the majority are expressed in the individual member's personal statement.

The MPC regularly formulates policies and strategies aimed at ensuring optimal performance of the banking industry and by extension, achieve other macroeconomic objectives. But in the course of implementing these policies, certain conflicting issues and challenges are experienced that has to do with compliance with the rules and regulations set by the CBN on Open Market Operation (OMO), Cash Reserve Ratio (CRR), interest rate, and Liquidity Ratio (LR) which are instruments of Monetary Policy manipulated to achieve growth, price stability, Balance Of Payment (BOP) equilibrium and full-employment.

In the light of this, the major objective of this paper was to review the framework for monetary policy decisions and the effectiveness of monetary policy implementation in the Nigerian economy by analyzing the impact of the policy on inflation, exchange rate and growth. The paper also identified the challenges of monetary policy in Nigeria and tried to proffer answers to the four fundamental questions that most governments and policymakers, at global and domestic levels, are always faced with which are:

i. How can inflation be kept under control?
ii. How can exchange rate be stabilized?
iii. How can unemployment be reduced? and
iv. How can the rate of economic growth be increased and sustained?

It is hoped that this paper will shade more light on how effective monetary policy has been used in managing the Nigerian economy particularly since the adoption of the IMF/WORLD BANK sponsored Structural Adjustment Programme (SAP) in 1986 when financial liberalization and indirect monetary policies were implemented.

2. Concepts / Clarifications

2.1 Monetary Policy

Monetary policy relates to the supply of money and credit allocation, which is controlled via factors such as interest rates and Cash Reserve Requirements (CRR) for banks by the CBN in order to influence outcomes like economic growth, inflation, exchange rates with other currencies and unemployment. Interest rates, reserve requirements; currency peg, discount window, quantitative easing, Open Market Operations; and signaling are some of the tools of monetary policy.

Monetary policy involves changing the interest rate and influencing the money supply. It is a policy used to pursue policies of higher economic growth or controlling inflation. It is usually carried out by the CB/monetary authorities who is charged with the following monetary policy role of maintaining price stability, exchange rate stability, balance of payment equilibrium, maintaining full employment and growth in the economy as highlighted earlier.

2.2 Objectives and Various Instruments of Monetary Policy

The ultimate objective of monetary policy is to control inflation and stabilize domestic prices (viz low interest rates and exchange rate stability). According to Oyejide (2002) macroeconomic instability appears to be intrinsically and directly related to excessive inflation. Therefore, according to the author, the most important contribution that monetary policy can make to be sustenance of macroeconomic stability is to ensure price stability, Balance of Payment (BOP) equilibrium, full-employment or near full-employment, exchange rate stability and financial system stability. Other objectives include development banking by

the Central Bank the world over. According to Fischer (1996), the fundamental task of the Central Bank is to preserve the value of the currency and also promote growth by maintaining a low rate of inflation and ensuring the health of the financial system.
Ogwuma (1994) categorized the objectives of monetary policy pursued by the CBN, which have remained broadly the same since its establishment in 1958, into two broad groups;

i. Promoting monetary policy stabilization, and
ii. Enhancing economic development.

In a CBN (2001) publication, a third dimension, which is the maintenance of a healthy BOPs position in order to uphold the external value of the national currency was added to the above two objectives.

Sanusi (2002) as cited in Oyejide (2002) further expanded the list of Nigeria's monetary policy objectives to include:

i. Achievement of domestic price and exchange rate stability;
ii. Maintenance of healthy BOPs position to support national currency against other Currencies;
iii. Development of a sound financial system; and
iv. Promotion of rapid and sustainable rate of economic growth and development.

2.3 The Instruments of Monetary Policy

The instruments/tools of monetary policy can be divided into two: the Direct and indirect instruments. The direct monetary control tools are the reserve requirement, interest rate policy, sectoral allocation of credit, maximum credit expansion, stabilization of securities and loans to indigenous borrowers. While the indirect monetary policies include Open Market Operation (OMO), discount rate mechanism, liquidity ratio, selective credit control and cash reserve requirement.

2.4 Challenges of Monetary Policy

These include:

i. Monetary policy becomes a problem when there is conflict among the objectives and instruments of monetary policy and other policies as well as the constraints it faces.
ii. The inadequate implementation of various policies as well as inconsistency in such policies.
iii. Improper coordination of fiscal and monetary program.
iv. Fiscal dominance or imbalance has adverse consequences on the monetary base and effective use of indirect tools.
v. Having inaccurate data and improper understanding of the workings of the economy on issues such as unearned income, cross border trade and the informal or underground economic activities.

2.5 Effectiveness and Growing Importance of Monetary Policy

The legacy of the Great Depression in the U.S and other industrialized economies was that monetary policy was "ineffective". This perspective is most famous in Keynes's "General Theory" and in the writings of the "Keynesian economists", in the 1940s through the 1960s. A decade later, this perspective changed and in some circles monetary policy was viewed as equally important as fiscal policy for controlling both inflation and output fluctuations in the economy. According to Oyejide (2002) and Taylor (2004) while it is generally agreed that monetary policy actions are of much importance in influencing macroeconomic variables, there is much less of an agreement or unanimity regarding how to measure and analyze the effects of these actions. According to Oyejide (2002), there are at least two major reasons for this:

i. Transmission mechanism of MP: Monetary policy actions affect the economy primarily through their impact on the money supply. This implies that focusing on controlling money supply and interest rates by the Central Bank will have important effects on the economy.
ii. The ultimate impact of monetary policy actions on aggregate production, income and price may occur over a period of several months or even years, making it analytically difficult to predict the timing and magnitude of the effects of a particular monetary policy action. The reasons for this are;
    a) Economic agents react with a lag to the impact generated by monetary policy action.
    b) Because of the complexity of the interrelations among various sectors of the economy, and
    c) Because of the ripple or pervasive effects of the feedback processes involved.

Consequently, Oyejide (2002) concluded that conducting monetary policy can be a very difficult task and likely to infringe on the effectiveness of monetary policy. Some of the importance of monetary policy includes:

i. Monetary policy changes typically and do not require the approval of both the legislative and executive branches of the government. All that is needed is a vote by the MPC.
ii. Economists view monetary policy as the first line of defense against economic slowdowns because Central Bank can act faster and it is equipped to judge the appropriate timing and magnitude of economic stimulus. Since most contractions in economic activity last for only a few quarters, the timeliness of the policy response is crucial.
iii. Monetary policy has led to big reduction in inflation indicating an increase in price stability. For instance, in the U.S, Europe going back several decades, Africa and other parts of the world.
iv. Improvement in economic performance is not unconnected with improvements in price stability.

2.6 Inflation Rate

Inflation can be defined as the rate at which the general level of prices for goods and services is rising. Inflation means a sustained increase in the aggregate or general price level in an economy. It also means that there is an appreciable increase in the cost of living which implies that nominal income cannot buy as much today as it could yesterday. As a result of inflation the purchasing power of a unit of currency (i.e. the implicit value of money) falls.

Monetarists theorize that inflation is related to the money supply of an economy. However, besides an imbalance in the demand and supply of money, it could also occur due to changes in production and distribution cost or increase in taxes on products. A well known example of the relationship between money supply of an economy and inflation is the hyperinflation (i.e. inflation above 1000 per cent) that struck the German Republic in 1920, when Germany printed paper notes thereby flooding the economy with more and more money and its value plummeted to the level where people would paper their walls with the practically worthless bills. Similar situations occurred in Peru in 1990 and in Zimbabwe in 2007 – 2008.

Consumer Price Index (CPI) is generally used in measuring the inflation rate of an economy. The index, which is adjusted to inflation, tracks the prices of core goods and

services overtime. The final consumers are mostly the worst affected by inflation which makes the cost of living high, making them unable to satisfy even the basic needs of life. Inflation, therefore, erodes the value of money and reduces the purchasing power of consumers. Hence, governments and monetary authorities worldwide try to keep inflation under control through the manipulation of fiscal and monetary policy tools. For example, assuming a 9.0 per cent inflation rate, a loaf of bread that costs N100 in 2010 will cost N109 in 2011 (i.e. after a year) and N153.86k in 2016 (i.e. after 5 years). At the same rate of 9.0 per cent, a savings account that earns no interest on deposits that was worth N1000 in 2004 would be worth N624.03k after 5 years (i.e. in 2010) and only N389.42k after 10 years (i.e. in 2015).

One of the characteristics of a good economy is one with a moderate level of inflation rate of 2.0 or 3.0 per cent which is beneficial as it encourages people to buy more and borrow more since the level of interest rate also remains low during lower inflation times. It also encourages investment, both local and foreign. Consequently, low or moderately steady inflation rate is a major macroeconomic objective all governments as well as central banks always strive to achieve as it boosts consumers and producers confidence in the economy. Policy makers since the end of the 20th century have attempted to keep inflation steady at 2.0 per cent per year. Moreover, countries that are experiencing higher rates of growth can absorb higher rates of inflation. For example, India’s target is around 4.0 per cent while Brazil’s 4.5 per cent.

2.7 Foreign Exchange Rates

Foreign exchange is the means of payment for international transaction. It is made up of convertible currencies that are generally for the settlement of international trade and other external obligations. Aside from factors such as interest rate and inflation, the exchange rate is one of the most important determinants of a country’s relative level of economic health; and one of the most watched, analyzed and manipulated economic measures which plays a critical role in a country’s level of trade. A higher currency makes a country’s exports more expensive and imports cheaper in foreign markets; and vice versa. Also, a higher exchange rate can be expected to lower the country’s Balance of Trade (BOT), and vice versa.

Exchange rates express the value of one country’s currency in relation to the value of another country’s currency. The rates play an important role in economics, affecting the Balance of Trade (BOT) between nations and influencing investment strategies. Investors and workers are often wary of investing or taking up jobs in countries whose exchange rates fluctuates often and by large amounts. Hence, the need for a stable rate is of paramount importance.

Stable exchange rate is generally viewed as favorable but there can be drawbacks. An economics principle called the Mundell-Flemmig Trilemman states that countries have three economic goals;

i. Stable exchange rates
ii. Free movement of capital, and
iii. Independent money supply.

The Trilemma states that it is only possible to have two of these goals at the same time. The trend in the post-World War II economic system has been to have (1) and (2) at the expense of (3). However, preoccupation with exchange rate stability can exacerbate other economic problems. In the late 1990s, Argentina had inflation problems that could have been erased the government economy, but had adjusted the money supply. But this strategy was not pursued partly because of concerns about exchange rate stability (Frazier, 2016).

Frazier further added that countries, especially developing ones, pursue stable exchange rates to attract foreign capital. They usually accomplish this by fixing their currencies to that of a more stable country, a practice called pegging. A country's Central Bank may increase or decrease the money supply to maintain this rate. Many countries have their currencies pegged to the U.S dollar, but some (e.g. Nigeria, China and Kuwait) dropped the connection when the dollar lost strength.

For an economy like Nigeria's, with a weak productive base, hampered by infrastructural inadequacies, rising production costs including excessive interest rates, low capacity utilization, it is logical that there would exist a demand gap for goods and services which may only be filled through importation from abroad. Stability of the naira is important for a number of reasons:

i. It provides barometer for measuring the resilience of the economy.
ii. It can be used to measure the confidence of investors.
iii. It allows for certainty and enables investors to make medium and long term investment plans or decisions.
iv. Continuous depreciation of the ₦aira discourages the diversion of investible funds to non-productive activities through currency speculation which unscrupulous individuals would naturally prefer to productive activity.

2.8 Economic Growth

Economic growth can be defined a s an increase in the capacity of a country or an economy to produce goods and services compared from one period of time to another. Although the growth of an economy is thought of not only as an increase in productive capacity but also as an improvement in the quality of life of the people of that economy (Investopedia, 2016).

Economic growth has two meanings:

i. Most common definition, increase in the output that an economy produces over a period of time, the minimum being two consecutive quarters.
ii. An increase in an economy's production using all scarce resources available to it.

Using a Production Possibility Frontier (PPF), an outward shift in the curve means that an economy has increased its capacity to produce all goods and services, and vice versa. Outward shift of the curve can occur due to sufficient investment in new technology (i.e. capital goods), as it enables production of vast quantities of output from relatively few resources. Introduction of new technology to production and manufacturing is among the reasons for China's rapid growth rate in recent times. To achieve long run growth, therefore, allocating scarce funds to capital goods rather than consumer goods is a necessary condition. Standard of living will be reduced in the short run as resources are diverted away from private consumption but can increase in the future by more than it would have been if such short term sacrifice had not been made.

Other factors that can lead to an outward shift of the PPF also include specialization, new production methods such as the computerization of methods, increase in labor force through natural growth or immigration, and discovery of new raw materials which increases the capacity to produce e.g. oil. On the other hand inward shift of the PPF means underutilization, loss or exhaustion of some of an economy's scarce resources. Low human and real capital investment, dearth of infrastructural facilities or its destruction through erosion or conflicts, and natural disasters such as earthquakes, floods, etc are among the reasons for an inward shift in the PPC.

But economic growth is not without its adverse effects, the prominent being environmental degradation. In addition, with increased growth the world is slowly being depleted of its non-renewable resources and raw materials used in wealth creation. This trend is a cause for concern both for economists and others.

3. Literature Review

3.1 Inflation Rate

Table 1: RGDP Growth, Inflation and Exchange Rates (2009 – 2014)

Year	RGDP (%)	Inflation (%)	Exchange Rate (N/$)
2009	6.96	13.9	148.9
2010	7.87	11.8	150.3
2011	7.69	10.3	153.86
2012	6.61	12	157.33
2013	6.77	8	157.31
2014	6.23	7.9	158.55
2015	3.8	9	168

Source: CBN, 2016.

From 9.0 per cent in January, 2013 Nigeria's inflation rose by 0.5 per cent the following month. In March of the same period, the rate slowed to 8.6 per cent, the lowest rate since April 2008. And in April, it inched toward double digit at 9.1 per cent. The inflation rate slowed for three straight months of August, September and October, 2013 at 8.2 per cent, 8.0 per cent and 7.8 per cent, respectively before edging up to 7.9 per cent in the following month of November. In 2014, all major prices were relatively unchanged at single digit average of 8.1 per cent from January through to December, but slight fluctuations.

In 2015, the annual inflation rate experienced accelerating trend from 8.2 per cent in January to 9.4 per cent in September 2015, the highest value since February 2013, mainly as a result of falling naira value. In October 2015 the rate fell slightly to 9.3 per cent and later increased to a three year high of 9.6 per cent in December (see Table 1 Figure 2).

The rate remained the same at 9.6 per cent in January 2016 but jumped to double digit 11.4 per cent in February, representing the highest rate since December of 2012. This was largely due to declining value of the naira that keeps pushing up import prices, and also a fuel shortage. The rate jumped by 1.4 per cent to 12.8 per cent in March 2016, way above the market expectation of a 10.0 per cent rise. On a monthly basis, this means that consumer prices increased by 2.3 per cent, the fastest pace since June 2010. Upward pressures came from housing, water, electricity and gas, clothing and footwear, transport, furnishings and household equipment, education, health, miscellaneous goods and services, hotels, cafes and restaurants, alcoholic beverages, tobacco and kola (CBN, 2016).

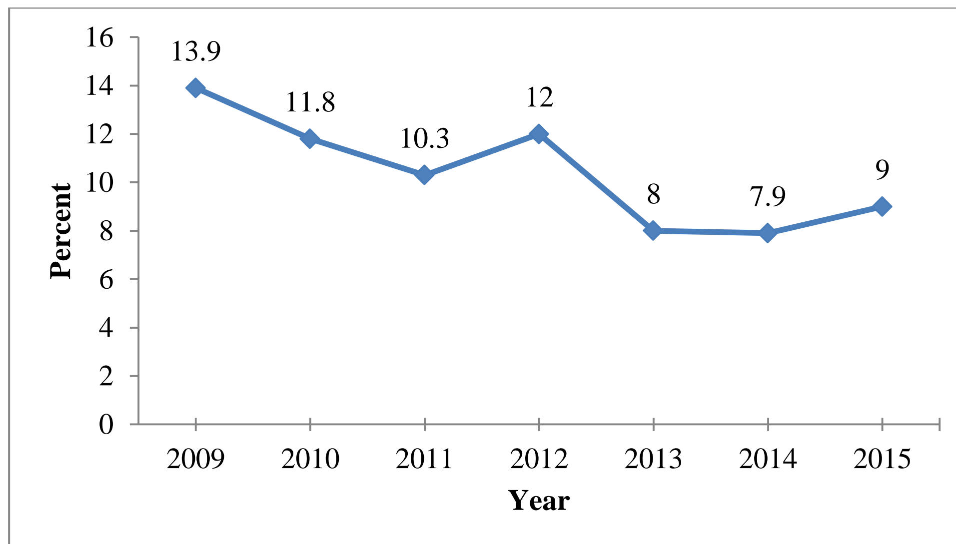

Figure 1: Inflation Rate (2009-2015)
Source: Authors' Design, 2016.

3.2 Exchange Rate

Official records sourced from the CBN indicate that when the Structural Adjustment Program (SAP) was introduced in 1986, the local currency unit (i.e. Naira) was N1.75 to a U.S dollar. The value steadily depreciated to N157.31 in 2013. As at April 2015 the rate was N198.75 to a U.S dollar, and in the course of one year depreciated slightly to N197.0 in March 2016. Historically, The Nigerian naira reached an all time high of N204 in February 2015, and a record low of N0.53 in September of 1980. However, in the black market the exchange stood at N322.00 to the dollar in April, 2016 (see Table 1 Figure 2).

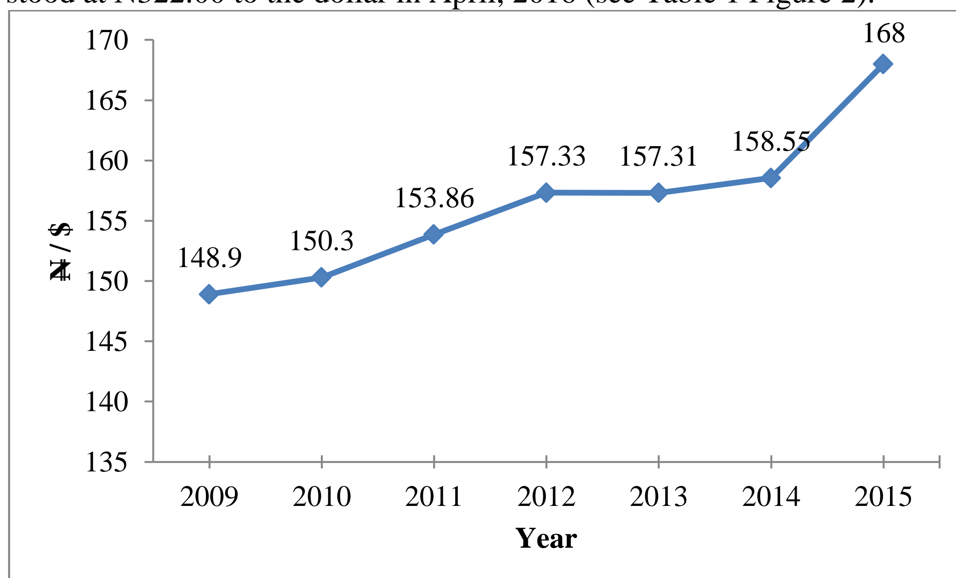

Figure 2: Exchange Rate (2009-2015)
Source: Authors' Design, 2016.

3.2.1 Exchange Rate Regimes

Numerous regimes have been considered in the literature, ranging from the extreme such as the fixed exchange rates (currency boards and unions), to intermediate regions (adjustable or crawling peg and target zones/crawling bands), to completely free floating.

Several Scholars [Mundell, 1968 and McKinnon, 1971] regard exchange rate policy as a facet of monetary policy.

According to Nnana (2002), despite the plethora of theoretical and empirical works and views on exchange rate, a general consensus on the "right" policy or regime is yet to emerge. Is a country better off or otherwise under a fixed or flexible rate arrangement? Sanusi (2002) opined that empirical evidence has shown that neither the fixed nor flexible exchange rate regime ranks above the other, but the best is the one that stabilizes macroeconomic performance in terms of minimizing fluctuations in output, consumption, domestic price level and some other key macroeconomic variables. A flexible exchange rate regime provides greater room for monetary policy to maneuver, as long as it is duly supported with complementary fiscal and structural policies, Sanusi (2002) pointed out.

3.2.2 Fixed Exchange Rate

A pegged exchange rate is the same thing as fixed exchange rate. When currencies are pegged, their values rise and fall in sync with one another. To help foster economic growth, increase trade, promote economic stability and attract foreign investors, most developing nations or economies peg their currency against a more economically stable countries currency, or the currencies of their largest trading partner countries in order to simplify their trade processes. As a result, the Central Bank of the pegging country must hold large amounts of the currency to which it is pegged in a reserve account (Sue-Lynn, 2016).

Most empirical works in the literature suggest small open economies are better off under a fixed exchange rate regime. Similarly, it has been argued that the less diversified a country's export and production structure and the more geographically concentrated its trade, the stronger the case for the country to adopt a fixed exchange rate regime [World Economic Outlook, (1997) and Flood et al (1989) in Nnana, (2002)]. The general consensus in the literature prefers a greater degree of fixity, if the source of macroeconomic instability (e.g inflation) is predominantly endogenous; otherwise it undermines policy flexibility which can have serious, implications for internal and external balance.

The instrument of monetary policy of the Central Bank of Nigeria during its first decade or existence was the exchange rate which was fixed at par with the British Pound. This was very convenient, as fixing the exchange rate provided a more effective mechanism for the maintenance of BOP, viability and controlling inflation in the Nigerian economy. This system of fixed parity lasted until 1967 when the British pound was pegged to the U.S dollar.

The Naira had to undergo defacto devaluation in sympathy with the dollar when the economic fundamentals dictated otherwise in 1973 and 1975, respectively. With these developments, the severe drawbacks in pegging the Naira to a single currency became obvious. It was against this backdrop that the need to manage the exchange rate of the Naira was firmly established. Hence, in 1978 Nigeria pegged her currency to a basket of 12 currencies of her major trading partners. This experiment led to a considerable stability in the Naira exchange rate, but there was ample evidence, following the economic crisis in 1981 that the exchange rate was overvalued against the U.S dollar. With respect to macroeconomic outcome, historical data showed that changes in monetary aggregates and prices were fairly stable, while growth in output and budget deficits was very significant.

3.2.3 Flexible Exchange Rate Regime

While in theory, either fixed or flexible exchange rates can work, in practice, fixed exchange rates or exchange rate targets have been counter-productive. This, according to Makin (1999) is because fixed exchange rate regimes tend to impose the same monetary policy on different economies whose differing needs may require different monetary policies.

The author gave some specific global examples of difficulties over the last 30 year to reinforce this point.

The struggle, Makin (1999) illustrated, to preserve the Bretton Woods System of fixed exchange rates in the late 1960s until August of 1971 highlighted the problems with pegged currencies for advanced industrial countries. The period of flexible exchange rate regime began with the final collapse of the Bretton Woods System in August of 1971 and can attempt to return to the pegged regime in December 1971 under the Smithsonian Agreement, failed. The pegged regime was finally abandoned in February of 1973, just in time to avoid currency chaos in financial markets had the fixed rates been in place when oil crisis happened in late 1973.

Sanusi (2002) pointed out that since the adoption of Structural Adjustment Programme (SAP) in 1986, Nigeria shifted to flexible exchange rate regime. Also, in line with international practices, Nigeria shifted from direct monetary control to indirect approach (or market-based techniques) since 1993, thereby avoiding the weakness of direct controls; because as the economy develops and financial market expand, direct controls tend to become less effective and such controls are eventually circumvented, especially in a global world economy.

In a speech on Exchange rate stability and international Finance delivered before the U.S Congressional Committee on Banking and Financial Services, Makin (1999) stated that in 1992 the fixed exchange rates within European Currency System proved unworkable to maintain. The British pound, the Italian lira and the Spanish peseta were allowed to float down after Germany was forced to follow tighter MPs to avoid the inflation associated with currency union between East and West Germany.

Makin (1999) supported his argument of the danger of pegged exchange rates with illustrations of the Asian Crisis that emerged in the spring of 1997 when Asian market like Thailand, South Korea, and Indonesia that pegged their currencies to the U.S dollar borrowed heavily in dollar-denominated loans. Too much borrowing and too much investment led to excess capacity and heavy dollar borrowing proved a fatal combination for emerging markets. As a result, Makin (1999) concludes that the Asian crisis was far more intense and prolonged than many had expected.

Pegging currencies in an environment of excess capacity and deflationary pressure adds to that deflationary pressure. Makin (1999) pointed out that the IMF's initial approach to the currency crisis in Emerging Asia (tighter Monetary and Fiscal policy) proved disastrous since it exacerbated the conditions of excess capacity. Also, Rubin (1999), acknowledged that these tighter policies by the IMF are counter-productive, adding that currencies should either be allowed to float freely or irrevocably pegged through the use of a currency board.

In conclusion, Ray and Chatterjee (2001) cited countries like Asia, Russia, Latin America and emerging markets where currency pegs have given way to floating currency system. The author illustrated the experiences of Mexico and Australia. Mexico which has maintained a flexible currency policy since 1995 and Australia with its floating currency, have suffered less from the problems of excess capacity encountered by emerging market economies in 1997.

3.2.4 The Nigerian Foreign Exchange Market

IFEM was introduced in October, 1999 in order to deepen the market by enhancing foreign exchange inflow from autonomous sources and moderating the Naira exchange rate. In respect to this, Ekaette (2002) observed that there is a wide gap between the official and parallel market exchange rate and the inability to bridge the gap have often been blamed for the instability in the economy. The author gave two reasons why the parallel market thrives;

i. Banks are suspected to use the parallel market as an avenue where they can off-load the dollars they procure from official market, which also contributes to depreciation of the Naira and instability in the economy.
ii. The Naira has been depreciated also mainly because the economy which it supports has weak productive base and consequently the demand gap for consumer goods and services which cannot be met by local producers has to be fitted by imports.

On the substantial exchange rate depreciation, particularly in the BDC and parallel market, Sanusi (2002) stated that the causes are varied and include;

i. Expansionary fiscal and monetary policies.
ii. Import dependence for production and consumption.
iii. Evasion and avoidance of import duty payment (facilitated by increased activities in the parallel market).
iv. A high rate of inflation.
v. Speculative demand.
vi. Malpractice and unethical behavior by some banks (i.e duplication) which involves “round-tripping” and the use of “free funds” which impacted negatively on the economy, particularly by facilitating capital flight and the instability of exchange rate.
vii. Unethical behavior on the part of some authorized dealers.

The author concluded that monetary policy alone cannot guarantee the desired stable and orderly exchange rate system without;

i. Effective coordination of other economic policies, particularly fiscal policy;
ii. Dedication and cooperation of all stakeholders;
iii. Social and political stability, especially during a pre-election and an election year;
iv. Provision of an enabling environment in terms of effective and efficient infrastructure that will support production for domestic consumption and exports;
v. Reducing over-dependence on imports by manufacturers and producers for inputs;
vi. Reducing the monetization of government deficits and excess earnings from crude oil export to a level that is consistent with the absorptive capacity of the economy;
vii. Surveillance over the activities of the banking institutions by the Central Bank, because it is recognized that the way exchange rate policy affects the economy depends, among other things, on the health of the banking system;
viii. Banks rededication to financial intermediation and playing according to the rules of the game.

3.3 Growth Rate

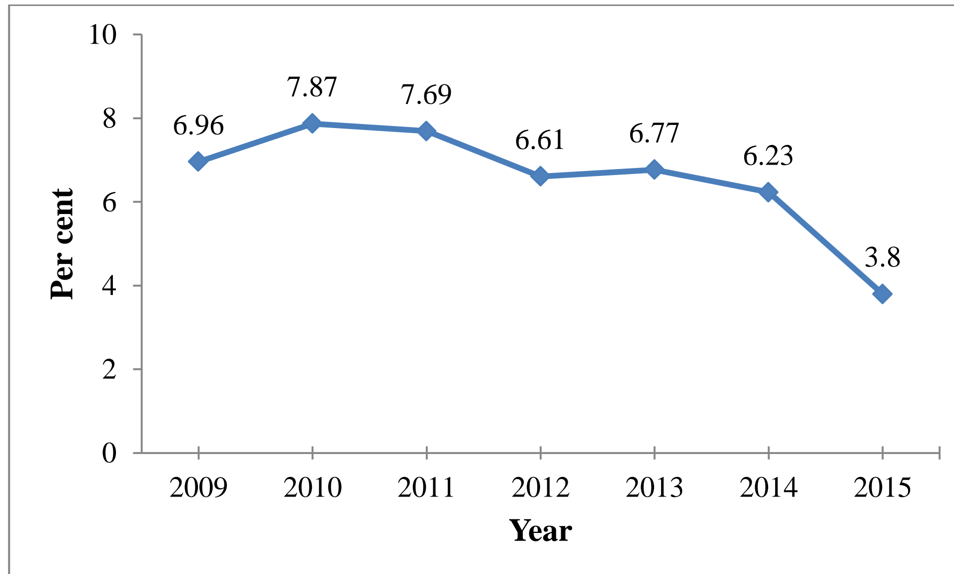

Figure 3: GDP Growth Rate (2009-2015)
Source: Authors' Design, 2016.

The Nigerian economy sustained a growth rate of around 7.0 per cent Real Gross Domestic Product (RGDP) for almost a decade. This favorable level of growth slowed slightly to 6.3 per cent in 2014 due largely to macroeconomic challenges, particularly exchange rate variability, vulnerability to slow global economic recovery and global financial developments as well as falling global oil prices that led to sharp drop in fiscal revenues (Balami *et al.* 2016a). It slowed further in the last quarter of the same year, though negligibly to 5.94 per cent.

The first three months of 2015 witnessed the lowest growth rate since the last quarter of 2012 of 3.96% attributed to lower oil prices and supply constraints that pulled the oil sector down. The economy slowed by 2.11per cent in fourth quarter of 2015 from a 2.35 per cent and 2.84% per cent expansion respectively in the second and third quarters. Oil production stood at 2.16 mbd in the last three months of 2015, lower than 2.19 mbd in the third quarter of the year. But during fall of 2015, the economy expanded by 2.79 per cent which is much lower than the 6.22 per cent recorded in 2014. Services sector drove the expansion up by 4.78 per cent, followed by agriculture up by 3.72 per cent while industrial output fell 2.24 per cent (see Table 1 and Figure 4).

3.4 Policy Decision Making Processes

In the Literature, exchange rate targeting, monetary targeting, inflation targeting and monetary policy with GDP targeting are the different types of MPC frameworks used in managing the economy. The monetary policy framework of the CBN has passed through two phases. Exchange rate targeting (1959-1973) of the CBN has passed through two phases. Under monetary targeting direct control investment of monetary policy used has opened direct monetary control utilized in the past. Figure 4 presents the methodological and institutional basis around which various monetary policy decisions are formulated, implemented and evaluated.

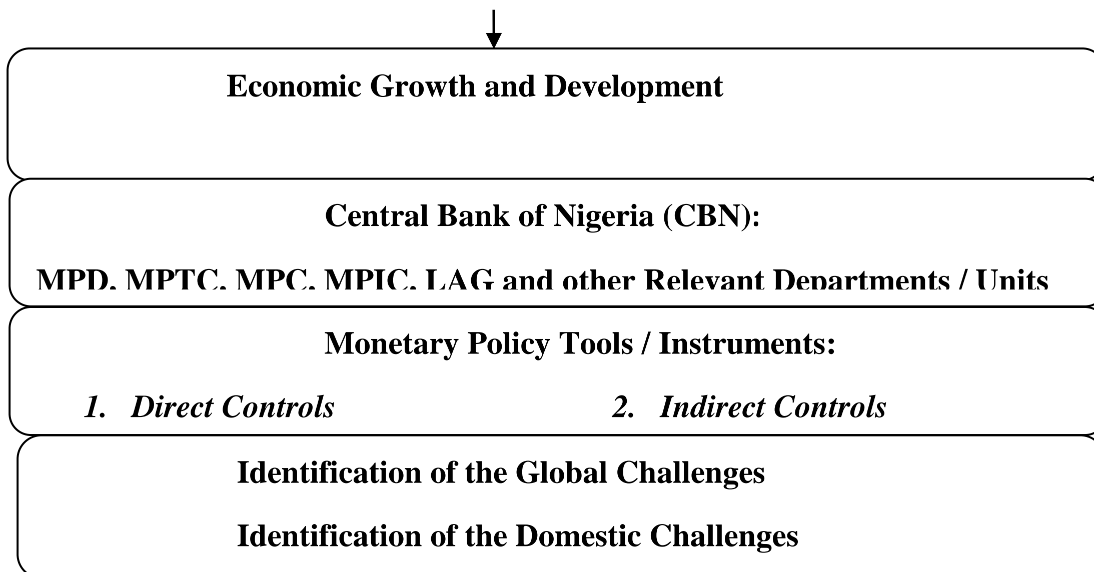

Figure 4: Monetary Policy Decision Making Process in Nigeria
Source: Authors' design, 2016.

The institutional arrangements include the CBN Act 2007 (Amended) authorizing the bank to fully focus on monetary and price stability through the conduct of monetary policy. This was achieved through bi-monthly meeting of MPC. This included revising challenges at the international and domestic level for the team running of the economy. In the carrying out the monetary policy decision, the institutions took into consideration the dual nature of the Nigeria's financial system along rural/urban, formal/informal, unreliable forecast on revenue and expenditure profits and state payment system infrastructure which tends to be inadequate. The degree of independence of the bank was also taken into consideration for example the issue of devaluation. It is important that there is need to collaborate with financial institutions.

3.5 Global and Domestic Challenges

At the global level, the key parameters that drive monetary policy in 2016 include the following:

i. Fall in oil and other commodity prices;
ii. Stronger dollar and the normalization of the U.S economy;
iii. Slow growth in China including falling imports and exports;
iv. Shading away stocks in China;
v. Divergence in monetary policy between U.S and the Euro zone and other developing nations;
vi. Problem of low inflation trap in the Europe zone etc;
vii. Insecurity/crisis in the middle east (such as Libya, Syria, Iraq), Ukraine and Russia; and
viii. Problem of immigration and Greece debt (CBN, 2016).

At the domestic level, the outlook for the Nigerian economy includes the following;

i. Falling crude oil prices;
ii. Insecurity in the North-east and Niger Delta areas;
iii. Problem of Post Boko Haram era;

iv. Corruption;
v. Loan concentration particularly in oil and gas and the power sector;
vi. Rising level of NPLs;
vii. Infrastructural deficit: Power supply, road and, communication network etc;
viii. Declining level of the quality of assets and Return on Equity (ROE);
ix. Problems of high level of liquidity in the economy;
x. The wide gap between official (N197) and Bureau De Change (N322) exchange rates to the U.S dollar (April, 2016);
xi. Problem of high interest rate for borrowers and low interest rate for savers; and
xii. Fuel Scarcity (CBN, 2016).

4. Discussions on the Relationship between Variables

4.1.1 Monetary Policy and Inflation Rate

Over the period 2009 to 2014 various monetary policies have been formulated and implemented. This include rising CRR and MPL which led to moderation of inflation in Nigeria. However, the tight monetary policy stance adopted assisted in turning SLF and IBR positive in real terms between 2009 and 2012, while figure 3 shows the variation in the level of inflation from a high of 13.9 per cent to a low of 7.9 per cent in 2014. However, inflation has escalated two digits of 12.4 per cent in April 2016 from 9.0 per cent in December 2015due to a number of factors.

4.1.2 Monetary Policy and Exchange Rate

Although, the monetary authority has doled out policies to support the naira from year 2009 to date but the naira has been sliding downward against the dollar and indeed other world currencies from N148.90 / USD in 2009 to a high of N168 USD in 2016. However, at the black market the naira has depreciated to N322 to the dollar. Figure 2 shows the exchange rate of the naira to the dollar. In order to save the naira the CBN has adopted a number of demand management policies. The poor performance of the naira is not unconnected with the fall in crude oil price in the international market and demand for imported goods since Nigeria is import dependent economy.

4.1.3 Monetary Policy and Economic Growth

The Nigerian economy has been affected by the “Dutch disease” where discovery of a natural resource (oil) has led to neglect of the real sectors of the economy such as agriculture and industrial development. The economy is currently import-dependent. The economy depends on crude oil as the source of government budgetary revenue and the main source of foreign exchange earnings due to non diversification of the economy. The external reserve has been under pressure due to low level of accretion from our main export commodity. There is also rising level of debt and market concentration in the financial sector. The Nigerian economy is clearly an economy that has mismanaged abundance and now trying to pursue the optimal path of growth (Balami *et al*. 2016b).

5. Conclusions

The review showed that monetary policy decision making process is complex and difficult. It requires inputs from a number of units of the CBN. This includes data and information on the global and domestic environment as well as the result of stress test for Domestic Money Banks (DMBs) which include CAR, LR, NPLs, ROE, and ROA etc. For effective financial system stability:

i. The application of monetary tools/instruments requires trade off among the variables and it depends on the environmental challenges facing the economy e.g. trade-offs between the stability of the exchange rate and maintenance of adequate foreign exchange rate.
ii. Monetary policy instruments can be divided into two broad categories as direct and indirect tools.
iii. The major actors in monetary policy making decision include the CBN, MPD, MPTC, MPC, and MPIC and other departments like Statistics and Research. This requires high quality human resource.
iv. The problem of the foreign exchange market is partly due to unearned income, lack of transparency of operation of the DMBs operations such as opening of account, the letter of credit and bills for collection, e.g. the DMBs do not sell dollar at N200.00 but N322.00 per dollar.
v. The Nigerian economy is a mono-product earning and there is greater pressure on the demand side rather than the supply side because Nigeria is import driven economy.

6. Recommendations

i. The Nigerian economy need to be diversified in order to open up the productive and growth drivers of the economy such as Agriculture, solid minerals, industry and the educational sector for growth, foreign exchange earnings and higher revenue for the economy. This would enhance the growth of the economy and benefit associate.
ii. In the medium term, the supply side of the foreign exchange earning section be grown and expanded e.g palm oil, tomatoes, rice etc through targeted growth of sound sectors of the economy where Nigeria has comparative advantage.
iii. The number of retreats need to be increased to enhance the quality guiding policy of monetary policy decision for better qualify and attention. This can be achieved through organizing quarterly retreats in addition to bi-monthly MPC meeting.
iv. CBN needs to improve the quality of human resources, research and innovation so as to remain as close as possible to ever shifting frontiers of knowledge and the changing dynamics of modern economy.

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