Journal of Economics and Sustainable Development www.iiste.org
ISSN 2222-1700 (Paper) ISSN 2222-2855 (Online)
Vol.6, No.20, 2015

An Analysis of the Effects of Monetary Policy on Nigerian Economy

Nuhu Kabu Maina
Department of Pre-ND Studies, Ramat Polytechnic, Maiduguri, Borno State

Abstract
This study examined the effects of monetary policy in Nigeria economy. The effect of monetary policy is a central issue and has attracted a lot of comments both in and out of the country. The theories of monetary policy became success during 1930's and 1940's. It was believed that the well being of monetary policy in stimulating recovery from depression was severely limited than in controlling a boom and inflation. These views emerged from the experience of Keynes in his theory. Keynes general view holds that during depression, the CBN can increase the reserve of commercial banks through a cheap monetary policy. They can do so by buying securities and reducing the interest rate. As a result of these, the ability of extending credit facilities to borrowers increases. But the great depression tells us that in a serious depression when there is pessimism among economic actors, the success of such a policy is practically zero. In this situation economic actors have no incentives to borrow even at a reduced interest rate. In this case, the question of borrowing for long-term capital needs does not arise in a depression when the business activities are already at a low level.
Key Words: Monetary Policy, Fiscal Policy, Nigerian Economy, Economy

1. Introduction

One of the ways taken by all economy to make the banking sector effective is the use of the monetary policy introduced by the federal government and carried out by the apex bank of the country. Apparently, the existence of an effective banking industry is vital to every economy and it encourages economic growth and development via its role in financial interdiction of funds supplies to deficit economic units .This stimulates international trade, investment economic growth as well employment growth as well as employment.

Monetary policy is one of the steps taken by every economy to make the banking sector effective. Monetary and banking policies are the sole responsibilities of monetary authority, which comprises of The CBN for the initiation, implementation and articulation of monetary system. The CBN carried out these duties on behalf of the federal government according to CBN decree 21 of 1991 and the banks and other financial institution BOFIA A4, of 1991 as amended. The banks proposal on monetary policy is subjective to the federal government.

The policies to be pursued is usually out in form of ''Audience'' to all banks and other financial institutions. The guideline are general in operation within a fiscal year but could be amended on the course of the year. The CBN is equally empowered to direct the activities of the financial institutions in other to carry out certain duties in pursuit of approved monetary policy of which penalties are prescribed for non-compliance with specific provision of the guidelines.

Monetary policy affects financial and economic activities over the year. In other to appreciate the effects of monetary policy on the banking industry, it would be wise to move a review of changing views of monetary influence. Usually when the quantity of money changes in relation to financial activities as viewed by FISHER (1932). Fisher, take other neoclassical writer who held the view that in short run, money influences real cash balances. According to him, when the money stock increases, example;

An increase commodity prices since output and velocity were fixes initially. He assumed that a rise in commodity prices would exceed the increase in interest rate which was regarded as a component of a firms operating cost. In the whole analysis, rise in commodity prices will lead to an increase in a firms profit, demand, money stock and deposit which will eventually lead to a further rise in investment and commodity price. The excess reserved for lending will decline with interest rate, which was stocky earlier.

In the analysis of long-term transmission of monetary influence, Fisher replaced ''Interest-Investment'' channel with ''Real Cash Balance''. He noted that when wealth rises due to rise in money stock, people tend to reduce their cash balances by purchasing goods and service. Since the velocity (v) and output (y) in Fishers equation of exchange (MVPT) is fixed, the risen money stock (M) cannot lead to increased holding of goods and services but will lead to decline in prices level (P). Keynes (1936) accepted the change in money supply relative has both substitution and effect and considered investment to be quite responsive to interest rates.

Keynes recommended price induce wealth effects, (i.e. change in wealth due to change in yields). There are ranging accounts by his interpreters about the extent he integrate them in his general theory. Hence subsequent write to Keynes (i.e. Keynesian or post Keynesian regards the cost of capital (interest rate) as the main process by which changes in money stock influence the economy. Thus the change in volume of money alters the rate of interest. Usually approximated by the long-term government bound rate, which affects investment and consumption. Thus the link between wealth of private sector and real sectors and consumption was analyzed by Piguo (1974) and Patikin (1951) in form of ''real cash balance effect'' According to them changes in quantities of money would affect aggregate demand even if they did not alter interest rate. On the other hand, credit rationing channel of monetary influence explained how financial interdiction, would be controlled by the market forces so as to ration the supply of credit by non-price mechanism.

Thus an expansionary monetary policy would raise the force of equity (i.e. reduce the yield on equities). The margin between the market evaluation and cost of reproducing the existing capital goods will stimulate new investment over those goods. The non-monetarist argued that monetary policy is as effective as fiscal policy as to determine total spending in the economy in spite of their differences. It holds the following views:

1. Movement in quantity of money is the most reliable measure of monetary value.
2. Monetary authority can detect the movement in the stock of money over time and business cycle.
3. Changes in stock of money are the primary determination of total spending as emphasized on omen's economic stabilization program.
4. Monetary impulse are transmitted to real economy through an active price process or profit adjustment process which affect many financial and real antes.

2 Statement of Problem

Despite the establishment of Central Bank of Nigeria (CBN) in 1958, banking industry remained both poor, inadequate in terms of number, quality and variety of service rendered. The establishment of CBN paved way for adoption of monetary management by the banking industry. Just in case any analyst is waiting in the wings to strike CBN for its poor monetary policy performance. Ogwuma (1994:362) offers a defense which says "A less than objective appraisal of the CBN role in the Nigerian economy could interpret the adverse macro-economic trend as evidence of failure on the part of CBN.

3 Objectives of the Study

The following issues are the main aims and objectives of carrying out this study;

a. To identify the basic effects of monetary policy in order to Achieve a sound financial system.
b. To examine CBN monetary policy strategies
c. To identify the best policy measure for economic stability.

4. Conceptual Framework and Theoretical Framework

The concept and definition of monetary policy in the previous year has no universal acceptability but however, the term monetary policy according to CBN release on monetary policy concept (2006) was defined as "Any policy measure designed by the Federal Government through the CBN to control cost availability and supply of credit. It also referred to as the regulation of monetary supply and interest rate by the CBN in order to control inflation and to stabilize the currency flow in an economy. However, in the CBN Briefs (Series No 97/03 June 1997).Monetary policy was defined as follows; The combination of measures designed to regulate the value, supply and cost of money on an economy in consonance with the expected levels of the economic activities These imply that the excess supply of money would result in excess demand for goods and services, which would in turn cause a rise in price and determination of balance of payment position. Monetary policy is one of the available tools of macroeconomic objectives. The primary goals of macroeconomic policy are price stability, external stability and a satisfactory rate of output growth.

The effect of monetary policy is a central issue and has attracted a lot of comments both in and out of the country. The theories of monetary policy became success during 1930's and 1940's. It was believed that the well being of monetary policy in stimulating recovery from depression was severely limited than in controlling a boom and inflation. These views emerged from the experience of Keynes in his theory. Keynes general view holds that during depression, the CBN can increase the reserve of commercial banks through a cheap monetary policy. They can do so by buying securities and reducing the interest rate. As a result of these, the ability of extending credit facilities to borrowers increases. But the great depression tells us that in a serious depression when there is pessimism among economic actors, the success of such a policy is practically zero. In this situation economic actors have no incentives to borrow even at a reduced interest rate. In this case, the question of borrowing for long-term capital needs does not arise in a depression when the business activities are already at a low level.

The classical view of monetary policy is based on the quantity theory of money. According to this theory, an increase in the quantity of money leads to a proportional increase in price level. The quantity theory of money

is usually discussed in terms of ''Equation Of Exchange'' which is given by the expression. P, denotes price level and Y denotes the level of current real GDP. Hence, PY represents current;
''NORMINAL GDP'' M denotes the supply of money over which the fed has some control and v denotes the **"Velocity Circulation**'' which is the average number of time a naira is spent on final goods and services over the cause of the year. The equation of exchange is an identity which states that the current market value of all final goods and services… nominal GDP must equal the supply of money multiplied by the average number.

Monetarist view of monetary policy dates back in 1950's, a new view of monetary policy called monetarism, has emerged that disputes the Keynesian view that monetary policy is relatively ineffective. Adherent of monetary argue that the demand for money is stable and not sensible to change the interest rates.

Types of Monetary Policy

There are basically two kinds of monetary policy, they are:

a. Expansionary Monetary Policy

An expansionary monetary policy is used to overcome depression, recession and deflationary gap. When there is fall in consumer goods and services, and in business investment goods, a deflationary gap emerges. The Central Banks starts an expansionary policy that eases the credit market conditions and leads to an upward shift in aggregate demand. For this the CBN purchases the government securities in the open market, lowers the reserve requirements of member banks, lowers the discount rate and encourages consumer and business credit through selective credit measures.

b. **Restrictive Monetary Policy**

This is the kind of monetary policy designed to reduce aggregate demand (AD) and inflationary gap. Inflationary pressure takes place as a result of risen consumer demand for goods and services and there is also boom in business investment. The CBN introduces the restrictive policy in order to lower aggregate consumption and investment by increasing the cost availability of bank credit.

Aims and Objectives Of Monetary Policy

There appear to be a general consensus that the single most important objectives of monetary policy are the pursuit of price stability. These recognition is perhaps derived from the increasing rate at which many central banks around the world are been given the exclusive power to control inflation and stabilize domestic prices. The perspective which recognizes a focus on inflation as the right approach to macroeconomic stability receives a strong support from the analytical research summarized in Fisher (1996) The study concludes that the fundamental task of the currency and the following;

a. Achievement of domestic price and exchange rate stability
b. To control inflation
c. Maintenance of healthy balance of payment position
d. Promotion of rapid and sustainable rate of economic growth and development
e. Maintenance of macroeconomic stability
f. Development of a sound financial system
g. To stabilize the naira exchange rate
h. To maintain a high level of employment

Instruments of Monetary Policy

The policy instruments are of two kinds, they are;

i. Indirect Quantitative or General
ii. Direct Quantitative or Selective

These affect the levels of aggregate demand and through the supply of money cost and availability of credit. The first category includes the bank rate variations, open market operation and changing reserve requirement. They are meant to regulate the overall level of credit in the economy through commercial banks. The selective credit control aims at controlling specific kinds of credit.
They are discussed under the following;

a. **Bank rate policy**:

The bank rate is the minimum lending rate of the Central Bank at which it rediscounts first class bill of exchange and government securities held by the commercial bank. When they notice an inflationary pressure in the economy, it raises the bank rate. In this period, borrowing from the CBN becomes difficult and the commercial banks borrow less from it. Also the commercial banks borrowers such as the individual and industries borrow less from it due to an increase in its lending rate.

On the contrary when prices are depressed, the central bank lowers their bank rate making it cheaper to borrow from them. The commercial banks also lower its lending rate making it easy for businessmen to borrow money. In this case, investment, output, employment, income and demand starts rising.

b. Changes in Reserve Ratio:

This system was first adopted in USA as suggestion by the Keynes ''Treatise on Money'' as a monetary devise. In every organized financial economy, certain percentage of its total deposit is kept in form of reserve fund its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio. Bank is required by law to keep more to the central bank. They lend less when their reserve is reduced and they lend less. The volume of investment, output and employment are adversely affected.

On the contrary when the reserve ratio is lowered, the commercial banks reserves rises, thereby lending more and the economic activities are favored.

c. Open Market Operation:

This refers to the sell and purchase of securities by the central bank in the money market. When prices are rising and there is a need of controlling them, the central banks sell securities. The reserves of commercial banks are reduced and they are not in a position to lend money to individual and corporations. Further investments discouraged and the rise in price are checked. On the contrary, when recessionary forces starts in an economy, the central bank by securities from business communities and commercial banks, their by increasing their reserve. Investment, output, income and aggregate demand rises.

d. Credit Controls:

Credit control is used to control specific types of credit for particular Purposes. They usually take the form of changing margin to control speculative activities in the economy or in particular sectors in certain commodities and prices will start rising. The central bank raises the margin requirement on them. The result is that the borrowers are given less money is loans against specified securities.

Fiscal Policy

Fiscal policy which is national in scope, is a government policy related to taxation and policy, which is concerned with money supply, are the two most important components of a government overall economic growth.

Keynesians considered fiscal policy the steeling wheel for aggregate economy. They said classical economists with their Laissez-Faire policy were trying to drive an economy without any steering wheel. Fiscal policy can be either expansionary, concretionary. It is expansionary or loose when taxation is reduced or public spending is increased with the aim of stimulating total spending in the economy known as aggregate demand. On the other hand, fiscal policy is contraction or tight when taxation is increased or public spending is reduced in order to restrict demand and slow down the economy.

In Nigeria, the major fiscal policy instrument includes changes in tax rate (on personal income, company income, petroleum profits, capital gain, import duties as well as mining rents, royalties etc) and government expenditure (recurrent and capital).

Differences between Monetary and Fiscal Policy

Monetary and fiscal policy is both instrument of macroeconomic stability but they have the following difference;

a. Monetary policy is typically implemented by a central bank, while fiscal policy decision are set by the national government
b. Both monetary and fiscal policy may be used to influence the performance of the economy in the short run
c. Monetary policy uses instruments such as open market Operation, Reserve ratio and moral Suasion etc for economic stability while Fiscal policy uses taxation as the instrument of economic stability.
d. Fiscal policy decisions undergo stages before a [approval in the house while monetary policy decisions are approved by the decisions of the CBN.

Empirical Literature

The effects of monetary policy is a central issue in macroeconomics, it has attracted comments from different scholars both in developed and developing countries.

Ojo (1999) regards monetary policy during much of the 90's as generally restrictive, yet money supply (in this case M2) increased persistently and well beyond the established growth rate target. Sanusi (2001) goes further back to a period (1959-1969) when Nigeria's monetary policy was deliberately expansionary during this period. As the Treasury bill rate was reduced from 5% in 1960 to 3, 5% in 1964, M2 rose at an annual rate of 44% between 1960 1994 and to 84% during 1968-1970.

Monetary Policy Strategy in Nigeria

Monetary policy strategy refers to how the central bank carries out monetary policy actions (Mish kin, 2001). A central feature of the difference forms of monetary policy strategy is the choice of the numerical anchor. Thus each of the three basic types of monetary policy strategy uses a different nominal anchor. Monetary targeting involves the use of information conveyed by the monetary aggregate to conduct monetary policy. Monetary targeting occurs in at least two forms, first is the rigid Friedman-type in which the chosen monetary aggregate is kept on a constant growth rate path as the forces of monetary policy. Second is the flexibility variety, which may involve a set of monetary aggregate, each of which is allowed to grow at different rate.

According to ''Odozi'' the conduct of monetary policy goes on three inter-related stages, namely:

a. Policy Formulation Stage
b. Implementation Stage
c. Review Stage

The frame work of this exercise is usually provided by law as follows;

1. The relationship between the central bank and the federal Government
2. Which arm of the government has the financial authority on the policies initiated by the central bank?

5. Conclusion and Recommendation

This study has been concerned with finding the effects of monetary and banking policies on the economic growth. It is necessitated by the fact that since the financial liberalization, Nigeria has come to rely heavily on the use of monetary and banking policy for stabilization of the economy. The empirical result revealed that an effective monetary policy is necessary for macro-economic stability for attainment of economic growth and development. The following policy idea is necessary: Stabilizing the Naira Exchange Rate**:** Considering the failure of various market oriented measure aimed at stabilizing the naira exchange rate since the introduction of SFEMFEM there is need for another approach as well as modification of the easily manipulated method of foreign exchange allocation. In addition there is the need for Effective Monetary Policy in order to take adequate measures in streamlining macroeconomic instability and order economic impediment that jeopardizes growth and development. Furthermore, there is the need for restrictive monetary policy to overcome inflationary gap. Restrictive monetary policy is one designed to curtail aggregate demand: The economy experiences inflationary presume due to rising consumer demand for goods and services. The government and institutions charged with economic development strategies and policy function should evolvement to impact move on GDP by conceptuality on the use of exchange rate, interest rate in order to raise the level of investment.

6. Reference

Akatu, O.(1963). *Reflection on Macroeconomic:* Otta: Papers and Proceedings Press.
Anyanwakoro, M. (1999). *Theory and Policies of Money and Banking.* Uwani Enug:Hosanna Publication.
Attamah, N. (1999). *Basic Principles of Economics.* Coal Camp Enugu: Marydan Publishers.
Campbel, (1982). *Nigerian Economic Policy and Performance.* Oxford:OxfordUniversity Press.
Ezeduji, F.O. (1994). *Conduct of Monetary Management In Nigeria.* Onitsha: Wema Publishers.
Friedman, (1963). *The Role of Monetary Policy.* Binmighan: Wiglass Publishers Inc.
Jhinghan, M.C. (1970). *Advanced Economic Theory.* Mayan Vinan Phase 1 Delhi: Vindu Publication.
Julius, A.A. (2004). *Facing New Challenges In Banking.* Akume: Jobies Press.
Keynes, J.M. (1936).*The General Theory of Employment Interest and Money.* New York: Harcourt Brace Company.
Nwagbara, C.P. (2004). *An Introduction Approach to Statistics.* Ogui Road Enugu: J.F.C and Company Publication.
Ogikhonon H. and Dimowo F.A. (1997). *The Structure of the Nigerian Economy* (1960-1997). Awka: Joanne Educational Publishers Ltd.
Pandey, I.M. (1992). *Monetary Policy Effects.* London: MC Graw Hill Companies Inc.
Uchendu O.A. (1996). *The Transmission of Monetary Policy in Nigeria.* Central Bank of Nigeria Economic and Financial Review, Vol. 34. No 2, p. 608.
Udeabah, S.I. (2002). *Economic Development and Planning* Ogui New Layout Enugu: Lincon Press Nig.
Ezeudoji, F.U. (1994). The effects Monetary Policy on the Performance of Banking Industry In Nigeria. *CBN Economic and Financial Review.* Vol. 32, Pp 3-10.
Million, F.C. (1971). A Monetary Theory of Income. *Journal of Political Economy.* Vol. 2, PP3-8.
Odozi, V.A. (1997). The Management of Monetary and Banking Politics. *CBN Billion.* Vol. 21, PP 2-13.
Ojo,M.O. (1999*). A review and Appraisal of the Monetary and other financials sector policy measures in the Federal Government budget for 1999.*CBN Bullion. Vol.24,pp2-8