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THE CENTRAL BANK OF NIGERIA, THE LIQUIDITY AND THE SECTORAL CREDIT ALLOCATION

BY

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Mrs. O. O. Akanji

1.0 INTRODUCTION

The current liquidity issue and the inadequate lending to the real sector, that could result to economic growth has generated considerable discussions, while the Central Bank of Nigeria (CBN) has risen up to these challenges by ensuring that liquidity in the banking system is adequate and that sectoral credit allocation to the sensitive sectors of the economy (Agriculture, Power, Aviation and SMEs) that will impact on the real sector for growth are handled with all the attention required.

Moreover, it has been widely reported that the Central Bank of Nigeria played a major role in supplying liquidity to financial markets during distressed period. This article describes the ways in which the CBN has supplied liquidity since 2009. The first is traditional: The CBN supplies liquidity by providing credit through Open Market Operations (OMO) and by lending to depository institutions at the so called discount window. The second is by enhancing the liquidity of the banks through the Standing Lending Facility (SLF) window. This window is securitized by holding their securities against the liquidity supplied to the banks. The Central Bank of Nigeria has used the second approach since late 2006. This article notes that the CBN since after banking consolidation exercise in 2005 has departed from its long standing

tradition of minimizing its effect on the allocation of credit by supplying liquidity to institutions that it believed to be most in need; at the same time; it neutralized the effects of these actions on the total supply of liquidity in the financial market. This article also discusses the CBN's reasons for reallocating credit to the sector that will most impact the real sector of the economy for growth and employment this time rather than simply increasing the total supply of financial market liquidity. This is because monetary policies have price effects and their output effect cannot be established in a direct firm manner if CBN do not reach out with credit allocation to the sectors that give fillip to growth. This article is divided into 5 sections: Section 1 being the introduction, while section 2 discusses "What is Liquidity" concept and definitions. Section 3 will look at the CBN as a supplier of market liquidity and how CBN has allocated credit to the sectors that impact on the real sector. Section 4 will compare the conventional monetary policy versus unconventional monetary policy while section 5 concludes the article.

2.0 WHAT IS LIQUIDITY

The Word "liquidity" is often used to describe very different things. Liquidity is mostly used in the financial market to describe the characteristics of an asset. It is the "degree of ease and certainty of value with which an asset or security can be converted to cash". Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold, are known as liquid assets, while the ability to convert an asset to cash quickly is known as "market ability" Cash is pure liquidity. Every other asset has a degree of liquidity that is determined by (i) how quickly it can be converted to cash and (ii) how much the price of the asset must be reduced to do so. The second requirement originates from the fact that virtually any asset can be

converted to cash quickly if the price is sufficiently attractive.

The word "liquidity" is also used to describe the availability of credit in the financial market. For example, market analysts or policy makers could assess the financial market and indicate that there is a shortage of liquidity or that the financial market is "frozen up". This means that it is difficult or expensive to obtain a loan or get credit. Like the liquidity of an asset, this concept of market liquidity is relative. Even in the most liquid of financial markets, some individuals or firms will be unable to obtain a loan or, if they do, they will be charged a relatively high interest rate. Likewise, many individuals or institutions obtain credit in markets described as "illiquid". No absolute measure of the liquidity of the financial market exists. There is also the concept of "liquidity trap". This is a Keynesian idea. It is when expected returns from investments in securities or real plant and equipment are low, investment falls, a recession begins, and cash holdings in banks rise. People and businesses then continue to hold cash because they expect spending and investment to be low. This is a self-fulfilling trap.

An important distinction separates the concept of market liquidity from the concept of asset liquidity. By the latter definition, cash is the quintessence of liquidity however, "a shortage of liquidity" in the financial market does not mean a shortage of cash because there can never be a shortage of cash.

The CBN has currency management function to ensure that the quantity of cash automatically increases to meet the currency demand through the process of currency indentation which is prepared annually in line with the absorptive capacity and inflation level in the economy. Consequently, there can never be a shortage of cash. When market analysts and policy makers say that the market has become less liquid or is illiquid, they mean that it is more difficult to get a loan than before; they do not mean there is a shortage of cash.

3.0 CENTRAL BANK OF NIGERIA AS A SUPPLIER OF MARKET LIQUIDITY AND HOW IT ALLOCATES CREDIT

Fundamentally, domestic credit has three major sources: private saving (individuals and firms), government saving (surpluses of federal, state and local governments), and changes in the monetary base the sum of cash held by the public and Central Bank of Nigeria. The CBN supplies the market with credit through Open Market Operations (OMO) and to a much lesser extent historically, through loans to depository institutions at the discount window. These actions increase the total supply of credit in the financial market. The effect of an open market purchase of securities on the total supply of credit is exactly the same as an equal amount of lending at the discount window. In this case, the CBN acquires a security in exchange for funds deposit balances at the CBN.

Historically, the CBN has conducted OMO in government and CBN securities; however, OMO can be carried out in any asset prescribed by the CBN Act. When the CBN purchase Treasury securities from the public, it is indirectly making the loan to the Treasury rather than the public. Hence, the supply of credit available to the public increases. Then, if the CBN sells some of its securities, the supply of credit available to the public declines. All things being equal, the supply of credit in the financial market increases or decreases, regardless of whether the change in the monetary base is due to CBN lending or Open Market Operations (OMO).

3.1 The CBN And The Allocation Of Credit

Although lending by the CBN has exactly the same effect on the monetary base as an equivalent Open Market Operation, the effect of these actions on the allocation of credit is different. When the CBN makes a loan to a depository institution, it directly allocates credit to that institution. The effect on the allocation of credit is mitigated by the fact that the total supply of credit increases the borrowing institutions

obtains credit and no one loses credit. The effect of CBN lending on the allocation of credit is intensified when the CBN offsets the effect of its lending activity on the total supply of credit through Open Market Operations. In this case, borrowing institution obtains credit but the total supply of credit is unchanged. In effect, the borrowing institution is getting credit at the expense of some other individual or institution. The total supply of credit is reallocated.

Historically, the CBN has offset the effect of discount window lending on the total supply of credit through Open Market Operations. However, in the wave of financial crisis during 2007 to date, the CBN has encouraged standing lending facility through the discount window and all loans to depository institutions are guaranteed at the CBN Discount Window. The practice of offsetting the effect of discount window lending on this monetary base means that discount window lending reallocated credit to the borrowing institution. The effect of discount window lending on credit allocation has not been an issue for two reasons. First, the initial effect of an Open Market Operation is on depository institutions. Consequently, a discount window loan to a depository institution that is offset through Open Market Operations has the effect of reallocating credit among depository institutions.

Second, and more important, discount window lending has been small historically, before 2007 when the financial crisis created liquidity crunch on the depository institutions. This was because CBN has discouraged depository institutions from borrowing at the discount window by charging penal rate. Depository institutions were expected to come to the window only when they had exhausted the relevant alternative sources of funds. But what happened was that the depository institutions refused to lend to each other because of the perceived depth of problems of these institutions. Moreover those institutions that borrowed from the CBN window were perceived as "troubles". These problems were confirmed when in 2009, the CBN had to do stress tests for the 24 banks and

isolated five depository institutions as very distressed. These five depository institutions had frequented the discount window. The CBN then gave a life line of about =N=600 billion to sustain the depository institutions as a going concern.

3.2 The CBN New Lending Facilities and the Allocation of Credit

In response to the distress in financial markets associated with the international financial crisis and the CBN stress test that showed the depth of illiquidity in the financial system; the depository institutions had not been able to lend to their customers especially customers in the real sector. The CBN initiated a series of new lending program that supported the quantitative easing policy. The lending programs were implemented to ensure "that liquidity would be distributed to those sectors that needed it most"; and that operators in the real sector of the economy access funds at cheap rates.

The first among these programs was the =N=200 billion Commercial Agricultural Credit Scheme (CACS) disbursed through the participating banks. As at April, 2010, four banks, namely Guaranty Trust Bank Plc; First Bank of Nigeria Plc; Skye Bank Plc; and United Bank for Africa Plc participated under the scheme. The second program was the =N=200 billion long tenor fund to boost growth of the Small and Medium Enterprises (SMEs). The third program was the Power Sector =N=500 billion long tenor fund to support the power sector improvement. The fourth was the Aviation sector program of =N=500 billion with each airline to access =N=1 billion to upgrade their services. In all these programs, the lending goes through the depository institution which abinitio has no access to long term funds for the real sector. The CBN funding is a long tenor fund which brings the fund to the depository institution's customers at the Monetary Policy rate.

All other things being equal, these loans are expected to increase the monetary base. But the monetary base was still lower as at end of the

first half of 2010 from the 2010 second quarter indicative benchmark of ₦1,872.00 billion by ₦356.25 billion or 19.02 per cent¹. This is because these loans have no potential to increase monetary base as they are essentially an exchange for less liquid assets of the depository institution that will on lend to the sector so specified. What the loans does to the participating banks was that it only increase their balance sheet without increasing the liquidity of the financial market generally. By doing, these programs had a significant effect on the allocation of credit by the CBN. At the 2010 Institute of International Finance (IIF) Spring Membership meeting held during June 9-11, 2010 at Vienna, Austria, Mr. George Soros canvassed this approach that regulatory authorities must conduct sectoral allocation as this helps to remove bubbles and push growth.

1.0 THE CONVENTIONAL VERSUS UNCONVENTIONAL MONETARY POLICY

The CBN's response to liquidity concerns is a clear departure from the conventional tools of monetary policy. This current development raises two interesting questions. Why did the CBN address the liquidity problem by creating a new array of lending programs rather than relying on conventional open market operations and the discount window? And why did the CBN decide to reallocate the total supply of credit rather than increase the total supply of liquidity in the financial market.

From the literature, it was obvious that the lending apathy exhibited by the Nigerian depository institution could ground economic growth. As indicated by Cechetti (2008), "only depository institutions have direct access to the discount window, and Open Market Operations are conducted with just a small set of primary dealers against a narrow range of highly liquid collateral. In contrast, in jurisdiction with universal banking as we have in Nigeria, the distinction between depository institutions and other types of financial institutions is much less relevant in defining access to central bank liquidity".

Consequently, the CBN has had to use methods it does not usually employ to address liquidity pressures across a number of markets and institutions. In effect, the CBN has had to innovate in large part to achieve what other Central Banks have been able to effect through existing tools.

In Nigeria and because of the underlying problems of the distress in the depository institutions, traditional framework for liquidity provision was not up to addressing the depth of liquidity needs of the real sector of the economy. The CBN was unable to direct the liquidity to the sector in need using Open Market Operations. However, the CBN Act (as amended) does not prevent the CBN from purchasing asset backed securities, commercial paper, and a wide range of other securities, such as those taken as collateral against loans under the new lending programs.

1.1 The Efficacy of the New Approach

Beside the question of 'why' the CBN chose this unconventional approach to monetary policy is the question of 'how' effective it is. Many macroeconomists believe that changes in the composition of the CBN assets that are not accompanied by a change in the monetary base are ineffective. This belief is due, in part, to experience. In the early 1960s the Federal Reserve Bank of USA attempted to reduce long term interest rates while maintaining relatively high short-term interest rates using a procedure called "Operation Twist". Specifically, the Federal Reserve Bank bought long-term securities, while simultaneously selling short-term securities, so that the net effect of these transactions on the monetary base was nil. The rationale was that by increasing the demand for long-term securities and reducing the demand for short-term securities, the Federal Reserve Bank could "twist" the yield curve long-term rates would fall relative to short-term rates. Most analysts concluded that the Federal Reserve Bank had little or no effect on the shape of the yield curve.

Operation Twist's failure is consistent with alternative theories of the term

structure. For example, the expectations hypothesis asserts that long-term rates are determined by the market's expectation of the future short-term rate. If short-term rates are not expected to fall, then long-term rates will not fall either. The failure of operation Twist is also consistent with the risk-premium hypothesis, which suggests that rates on long-term securities are generally higher than rates on short-term securities because investors demand a risk premium for investing in longer-term securities because they have a higher degree of market risk. The risk premium is determined by what economists refer to as "deep structural parameters" that is, the risk aversion of investors. A change in the relative demands for long-term and short-term securities has no effect on the size of the risk premium and, hence, no effect on the shape of the yield curves.

Similar experiences and theoretical arguments apply when attempts to alter the exchange rate through sterilized foreign exchange intervention is undertaken. Sterilized foreign exchange intervention occurs when a central bank purchases securities denominated in one country's currency and simultaneously sells an equal amount of securities denominated in another country's currency; so the effect on the monetary base is nil.

Since December 2009, there has been some evidence that the first level of lending program might have had beneficial effects on financial markets (Financial Markets review January 2010). This was because before December 2009, rate spread had increased as a result of banks' and other creditors' heightened reluctance to lend to banks perceived to have an increased risk of default. Hence, the rise in the term NIBOR rates and other rates that reflect the cost of funds to banks, relative to overnight lending rates, reflects a risk premium that will not be reduced by increasing the liquidity of these banks' portfolios.

2.0 COCNLUSION

In response to the financial crisis and the "Sanusi Tsunami", the CBN instituted a series of new lending to sectors that could impact the real

¹CBN Monetary Policy Department

sector of the economy. The lending increased the liquidity of the participating banks portfolios without simultaneously increasing the total supply of liquidity in the financial market. By so doing, the CBN departed significantly from the historic practice of relying on traditional tools of Open Market Operations and discount window lending to provide liquidity to the real sector of the economy.

Why the CBN chose to enact a series of new lending programs rather than

use its existing tools of Open Market Operations and the discount window is unclear. It seems that the inadequacy of securities for the market made sectoral lending approach much more appealing to the regulatory authority for immediate impact. CBN has chosen to reallocate the credit in the market by providing loans to the real sector through the participating banks, while offsetting the effect of this lending on total credit through Open Market Operations. It seems that CBN desire was not to increase total liquidity in the

economy which could aggravate inflationary pressure but to provide liquidity to real sectors through participating banks to lend for productive purposes and avoid the inefficient liquidation of assets that were temporarily illiquid.

Whatever the reason, it now appears that CBN has injected historically large amounts of credit into the market, which has not impacted the monetary base. This may be due to lag in transmission of the credit to the system.

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BANKING SECTOR CRISIS AND RESOLUTION OPTIONS IN NIGERIA

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1.0 Introduction

Economic development is contingent on productive investment and the financing of such productive activities can be obtained through two channels: via capital markets or banks. In modern economies, these two channels are complementary. But the role of banks is clearly central. Banks are key players in the financing of economies and when their own financial position prevents them from performing this function, economic growth is compromised. As McKinnon and Shaw (1973) observed in their seminal work on the key roles of banks as propellants of growth and development in developing economies, a feeble banking system is repressive, distortionary and disconnects the intermediation process, thereby, precipitating macroeconomic instability. This requires that policy makers, as Nnanna (2005) opines, must articulate robust policies that will deepen the financial system to enable banks to play their roles most efficiently.

Banks play a prominent role in the credit intermediation process in most countries, providing funding to firms beyond the cash flow provided by their normal operations. Banks also typically serve as custodian of a significant portion of household saving. Banks play a key role in channeling credit to firms--particularly those firms that are not able to acquire funding from capital markets or other

sources--and also hold substantial consumer deposits. Specifically, banks perform a maturity transformation function. The banking sector is the agent for financial intermediation, enhances financial intermediation by mobilizing savings (deposits) and channeling them into productive investment in the real sector of the economy (lending). In other words, it performs the function of resource allocation from surplus units to deficit units; increase the allocative efficiency of resources; facilitate risk sharing spreads/ reduces risk faced by economic agents and thereby reducing costs; facilitates generation of wealth in the economy; promotes productivity and economic growth, thereby contributing to poverty alleviation. It also facilitates the exchange of goods and services through the provision of effective and efficient systems of payments, and expands and diversifies opportunities through innovations.

A banking system that is in crisis cannot therefore, carry out its intermediation role effectively as new lending comes to a halt, which is known as a credit crunch. Two mechanisms can act: low capital adequacy ratios of banks and shortfall of liquidity. In the first instance, prudential rules set out the risks that banks can take in relation to their capital requirements. During economic and financial downturns, losses may appear that reduce banks' capital; this effect may be amplified by the accounting rules that require certain assets to be marked to market. In parallel, the risks, often measured on the basis of the credit agencies' ratings that are regularly downgraded during crises, increase and result in higher capital requirements. The shortfall of liquidity results when markets no longer function correctly. Hence, when banks are not sure that they can obtain financing, they stop lending. These two "channels" could

combine and be mutually reinforcing, particularly in the case of build-up of non-performing loans in some institutions that sheds doubt on their solvency. This may lead to bank failures with the associated multiple effects. The whole system then seizes up, and the financing of the economy is jeopardised.

The objective of this paper is to x-ray banking sector crisis and its resolution options in Nigeria. The causes and impacts of banking crisis as well as the way forward for such crisis will also be examined.

The paper has been divided into six main sections. Following this introduction, Section 2 gives the conceptual/jurisdictional experience of banking crisis. Section 3 gives an overview of the structure of the Nigerian banking sector, the causes of banking crisis and its impacts on the economy, while Section 4 highlights the various banking sector resolution options and the Nigerian experience in banking sector crisis resolution. Section 5 highlights the way forward, while Section 6 concludes the paper.

2.0 Conceptual Issues/Country Experience of Banking Crisis

2.1 Conceptual and Definitional Considerations

The term "banking crisis" refers to a situation of major disruptions in a country's banking sector which may not just be minor downturns or disturbances. Banking crisis occurs when the capital of the banking sector has been depleted due to loan losses, resulting in a negative net worth of the banking sector. This implies that the system is insolvent and therefore the value of its realizable assets is less than the total value of its liabilities. A banking crisis can also occur from liquidity point of view. According to Ebhodaghe (1997), a bank is illiquid when it can no longer meet its liabilities as they mature for payment, which is a breach of the contractual obligations. Thus, banking crisis could be insolvent but liquid; illiquid but solvent; and

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| <p>illiquid and insolvent. According to Alashi (2002), a bank is said to be in severe crisis when a bank shows most or all of the following:</p> <ul style="list-style-type: none"> • Gross under-capitalization in relation to the level and character of business; • high level of non-performing loans to total loans; • Illiquidity as reflected in a bank's inability to meet customers' cash withdrawals and/or a persistent overdrawn of position with the Central Bank; • Low earnings resulting in huge operational losses; and • Weak management as reflected by the poor asset quality, insider abuse, inadequate internal controls, fraud, including unethical and unprofessional conduct, squabbles, and a high staff turnover, among others. <p>The crisis could become systemic if a sizeable number of banks in the economy are involved, resulting in runs on banks as depositors lose confidence in the system and attempt to avoid capital losses. In this case, the country is said to be experiencing a banking crisis. More specifically, banking sector systemic crisis occurs when a fairly reasonable proportion of banks in the system are unable to meet their obligations to their customers, owners and the economy as a result of weakness in their financial, operational and managerial conditions which have rendered them either illiquid and/ or insolvent. It can equally be described as those situations where the solvency and/or illiquidity of many or most banks have suffered shocks that have shaken public confidence. Examples include the banking crises in Iceland in 2008, Mexico in 1994, East Asian countries after 1997, in transition economies in the 1990s and many other developed economies in the recent financial crisis. In a systemic crisis, corporate and financial sectors experience a large number of defaults and difficulties repaying contracts on time. As a result, non-performing loans increase sharply. This situation is often accompanied by depressed asset prices (such as equity and real estate prices) on the heels of run-ups</p> | <p>before the crisis, sharp increases in real interest rates, and a slowdown or reversal in capital flows. The CBN and NDIC (2002) joint study recognized a systemic banking crisis as when at least two of the following situations are present:</p> <ul style="list-style-type: none"> • The banks that are critically distressed control 20 per cent of total asset in the industry; • 15 per cent of total deposits are threatened; and • 35 per cent of the banking system's total loans are not performing. <p>2.2 Jurisdictional Experience of Banking Crisis</p> <p>A wave of banking crises has afflicted many countries of the world in the last two or three decades. Banking crises have been protracted and systemic in such countries as Argentina, Chile and Uruguay; in Bolivia, Brazil, Ecuador, Peru and Venezuela, among others. In the USA, the banking crisis of the 1930s had devastating effects on the economy as the American tax payers had to part with about \$160 billion to resolve the resulting savings and loans debacle. Some countries in Europe, Japan and some of the Asian Tigers as well as many other developing countries have tasted the 'bitter pill' of banking crisis.</p> <p>A review by Lingren, Gracia and Saal (1996) revealed that, out of the 186 current member countries of the International Monetary Fund (IMF), 73.5 per cent or 133 have experienced significant banking sector problems at some stages or the other since 1980. Two general classes of problems were identified: crisis (41 instances) and "significant" problems (108 instances). The classification referred to cases where there were runs on banks or other substantial portfolio shifts, collapse of financial firms, or massive government intervention, as crisis. Extensive unsoundness but short of "crisis" status was termed "significant". Evidently, several countries experienced repeated problems of either or both types. Where the problems in banks did not have a significant impact on either the</p> | <p>functioning of the banking sector, or the macro-economy as a whole, as was the case in seven of the countries analyzed, distress was categorized as neither "crisis" nor "significant". The extent or severity of distress was measured by the size of assets or deposits, or the number of banks involved in distress, vis-à-vis the industry.</p> <p>The recent financial crisis that started in 2007 has equally degenerated into banking crisis in many developed economies. The crisis which began as an aftermath of the US sub-prime mortgage led to the fall of many financial institutions in the US including, Indy-Mac Bank; Freddie Mac; Fanny Mae; and UK's fifth largest mortgage lender, Northern Rock. It also led to the insolvency of America's largest securities firms, Merrill Lynch and Lehman Brothers as well as the bankruptcy and eventual collapse of the third largest mortgage lender in the US which caused the collapse of government-backed mortgage. With the crash of structured-products and mortgage market, consumer loans and mortgage market distress led to counter-party risk. The financial contagion that resonated world-wide due to the inter-linkages of the world financial system, led to the tumbling of stocks of all major trading markets across Europe, Asia and other emerging economies. As the financial panic developed, there was a "flight to quality as investors sought safety in US treasury bonds, and currencies such as the US Dollar and the Yen." Equity prices crashed in most Exchanges such that the global stock market gains of previous years were wiped out. Some stock exchanges were closed for days in order to avoid a big plunge. As at end-December 2008, an estimated \$14.0 trillion share values were wiped off world-wide as many stock markets around the globe suffered their worst 12 months of trading.</p> <p>The seriousness of the economic crisis led various governments to initiate unprecedented financial bail-outs coupled with subsequent proposals of massive fiscal stimuli to reverse the trend and bring the world economies out of the doldrums. The policies adopted varied from interest rates cuts, bail-out packages,</p> |
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| <p>nationalization of financial institutions, swaps arrangements, coordinated rates cuts among central banks, etc. In the United States for instance, as at December 24, 2008, the Federal Reserve had used its independent authority to spend US\$1.2 trillion beyond the \$700 billion Troubled Asset Relief Program, (TARP) authorized by Congress from the federal budget on the purchase of various financial assets and extended emergency loans to banks, credit card companies, as well as general businesses. Temporary swaps of treasury bills for mortgage-backed securities and ban on short selling of 799 financial stocks in September 2008 were also adopted. Others included the sale of Bear Stearns, bailouts of American International Group (AIG), Fannie Mae and Freddie Mac, and Citigroup. In addition, investment banks in the US, converted to bank holding companies, a status subject to more regulation, but with readier access to government capital.</p> <p>In the Euro zone, the European Central Bank (ECB) injected about US\$84.0 billion into the economy to ease liquidity problem. It engaged in coordinated rate cuts with six major central banks (the Federal Reserves, Bank of England, Bank of Japan, RBA, Bank of China, and Swiss National Bank). It also used swap lines from the Fed to support its US dollar operations. Other measures in the European Union (EU) were the agreement to increase minimum bank deposit guarantee from 20,000 to 50,000 Euro. In individual EU member countries, initiatives included the German parliament approval of 500 billion Euro (US\$675bn) financial rescue package, while the French government injected 10.5bn Euro (US\$14bn; GBP8.2.bn) into the country's six largest banks. In the United Kingdom, the government directly nationalized parts of the banking system through purchases of equity stakes in certain banks and a GBP300 billion rescue packages was released to banks prompt lending by early 2009. Banks were also subjected to recapitalization. Indonesia in a move adopted by several countries reduced its overnight repo rate, by two percentage points to 10.25 percent. The government introduced safety net</p> | <p>regulations that allowed the government and the central bank to quickly address financial sector weakness. It revised the year's budget to reduce financing needs, pledged to respect the free movement of capital and also set up a task force to manage the crisis. In addition, insurance on bank deposits was revised from US\$10,000.00 to US\$20,000.00.</p> <p>In Nigeria, to avoid being drawn deep into the crisis, the government and regulatory authorities took some proactive measures. These included:</p> <ul style="list-style-type: none"> • Presidential Steering Committee on Economic Crisis • Presidential Advisory team on capital market to deliberate on measures to reverse the declining trend in Nigerian Capital market • Reduction of fees by SEC, NSE and all capital market operators by 50 per cent • Daily price movements harmonized to 5 per cent either way in October 2008 • Guidelines on market makers released by SEC • NSE reviewed trading rules and regulations • NSE de-listed 19 moribund companies • Share buy-back limited to 15 per cent • Strict enforcement of NSE listing requirements • Review of budget to cut financing requirements • Fiscal stimulus through drawdown from oil savings to augment monthly revenue to three tiers of government to mitigate the adverse effect of substantially lower current revenue receipts • Cut in foreign exchange financed expenditure e.g. overseas trips by government officials | <ul style="list-style-type: none"> • The CBN, in line with global experiences, substantially eased monetary policy to mitigate the negative effects of the financial crisis on liquidity in the banking system through a combination of measures: • Monetary policy rate (MPR) reduced gradually from 10.25 percent to the current 8.0 percent • Cash reserve requirement (CRR) reduced gradually from 4.0 percent to current 1.0 percent • Liquidity ratio reduced gradually from 40.0 percent to current 25.0 percent <p>3.0 Overview of the Nigerian Banking Sector and Banking Sector Crisis in Nigeria</p> <p>3.1 Overview of the Structure of the Nigerian Banking Sector</p> <p>The Nigerian financial services industry comprises: banking, insurance, capital markets, pension fund and other financial institutions. The regulators in the sector include the CBN, the Nigerian Deposit Insurance Corporation (NDIC), the Securities and Exchange Commission (SEC), the National Insurance Commission (NAICOM), and the National Pension Commission (PENCOM).</p> <p>As at the end of March 2010, the operators in the industry included 24 deposit money banks (DMBs), 5 discount houses (DHs), 941 microfinance banks (MFBs), 107 finance companies (FCs), 101 primary mortgage institutions (PMIs), 5 development finance institutions (DFIs), 1,621 bureaux-de-change (BDCs), 1 Stock Exchange, 1 Commodity Exchange and 73 insurance companies, about 690 stock brokers, 13 pension fund administrators and 5 pension fund custodians.</p> <p>The banking sector in Nigeria comprises the DMBs with 5,565 branches spread over the country and the DHs.</p> |
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3.2 Causes of Banking Sector Crisis

Banks are generally in the business of borrowing short and lending long. In doing so, they provide an essential service (create credit) that allows the real economy to grow and expand. This credit creation service, however, poses an inherent fragility in the banking system. For instance, if depositors are gripped by a collective movement of distrust and decide to withdraw their deposits at the same time, banks would be unable to satisfy these withdrawals as their assets are illiquid thereby leading to liquidity problem. In normal times, when people have confidence in the banks, these crises do not occur. But confidence can quickly evaporate, for example, when one or more banks experience a solvency problem due to non-performing loans. Bank runs are then possible. A liquidity crisis erupts that can also bring down sound banks. The latter become innocent bystanders that are hit in the same way as the insolvent banks by the collective movement of distrust. Sound banks that are hit by deposit withdrawals have to sell assets to confront these withdrawals. The ensuing fire sales lead to declines in asset prices, reducing the value of banks' assets. This in turn erodes the equity base of the banks and leads to a solvency problem. The cycle can start again: the solvency problem of these banks ignites a new liquidity crisis and so on.

All banking crises are different even if they share a number of common characteristics. Generally speaking, they follow a period of significant credit expansion and a sharp rise in stock market and/or property prices in a largely self-sustained mechanism. With the increase in value of assets that may be used as collateral for loans is used to secure new loans, even if the intrinsic economic justification of the new loans is not uncertain. Any external shock that calls into question the value of these assets reveals the poor quality of these loans and the crisis erupts. Losses reduce the banks' capital and the most exposed banks become insolvent. While doubts persist over the extent and the distribution of the losses, the markets become totally illiquid.

Apart from the above scenario, one major cause of banking crisis is macroeconomic instability. Goldstein and Tunrner (1986) noted that macroeconomic volatility can cause banks to be vulnerable if it alters the relationship between the values of bank assets and liabilities. A study by Brownbridge (1998) revealed that periods of high inflation occurred in all the four countries covered in the study. He noted that a high inflation rate was largely responsible for the volatility of business profits because of its unpredictability, coupled with a high degree of variability in the rate of increase of the prices of particular goods and services which constituted the overall price index. This observation underscores factors of adverse selection and poor incentives for borrowers to take risks and inevitably, accounts for the high probability of loan default. In addition, a high inflation rate makes loan appraisals very difficult for banks, especially as the viability of potential borrowers depends on unpredictable developments in inflation, exchange and interest rates.

A dramatic increase in uncertainty in the banking sector, due largely to the failure of a prominent bank or non-financial institution, a recession, political instability, rumors of instability in the sector or a stock market crash, makes it difficult for lenders to separate good from bad risks. The rise in uncertainty therefore is capable of making information in the banking sector even more asymmetric and may worsen the adverse selection problem and these will make lenders unwilling to lend thereby precipitating to a decline in lending, investment and aggregate economic activity. A typical example is that of Northern Rocks. A news flash by the British Broadcasting Corporation indicating that the bank had approached the Bank of England for a facility under the last resort created a run on the bank that eventually led to the failure of that bank.

Poor risk management procedures, ignorance and non-compliance with rules, laws and regulations, technical incompetence, violation of regulations, policies, procedures guidelines, unhealthy competition and weak internal controls and operational procedures lead to

banking crisis. Banks that have proper risk management and internal controls as well as a well focused strategic objective are likely to operate normally even in the face of turbulent situation.

Weak corporate governance, particularly insider abuse and contravention of supervisory regulatory provisions and overbearing directors' interest in loans and advances or any credit facilities are major causes of banking crisis, especially in a developing country like Nigeria. A study conducted by the Research Department of the Bank revealed that in one of the then distressed banks in Nigeria, four of the erstwhile bank's directors abused their privileges and breached their fiduciary duties by engaging in several activities to the detriment of the bank's depositors and other stakeholders. Specifically, they obtained insider loans that constituted about 520 per cent of the bank's total risk assets or about 50.5 per cent of the total loans and advances when the bank was liquidated in 1998.

Overtrading, assets mismatch and excessive risk taking indicating high loan to deposits ratio are significant causes of banking crisis. If a bank's core deposits are short-tenored and it engages in unbridled lending, particularly long-term lending, the tendency for the bank to go into insolvency is there. This is a case of assets mismatch. Overtrading could imply that a bank is giving out loans without taking into consideration of the amount it would be used in settling its daily and future commitments.

Ownership structure of a bank has a direct bearing to its survival. The overbearing influence of a particular director on the board and management of a bank could result in frequent boardroom crisis and the breakdown of internal controls precipitating to banking crisis and may eventually lead to the failure of the bank.

The role of management in the effective performance of a bank is critical. Poor management is one of the principal factors that could precipitate banking crisis. Board squabbles; ineffective board oversight functions; poor leadership

and administrative ability; as well as fraudulent and self-serving practices among board members, management and staff have been attributed as one of the causes of bank failures. Besides, recruitment and placement of fit and proper persons in the management of a bank as well as the integrity and transparency of its management will definitely impact positively on the performance of a bank. On the other hand, a bank with poor quality staff and management and engages in non-publication and non-disclosure of accounts and other performance indices can lead to poor performance and eventual demise of a bank.

Moreover, banks are susceptible to the risk of contagion, owing to their financial inter-relationships through lending and borrowing from each other, holding of deposit balances with each other and through the payments/clearing system. Banking crisis could erupt from bank(s) having exposures with other local banks or its foreign affiliate and correspondent bank(s). Though banks generally need to work in tandem with other local and foreign banks for their smooth functioning, the exposure that such dependence imposes should be limited and secured. This is because the impact of the poor performance of one or more of the banks in the system arising from bank-related distress may negatively affect the operations and activities of other sound banks in the system, leading to systemic problem.

On the foreign front, the excessive dependence of one bank on a foreign bank for its operations poses a significant to the survival of the bank in particular and sector in general. For instance, at the advent of the consolidation exercise in the Nigerian banking sector, many Nigerian banks had correspondent relationships with foreign banks. But when the global financial crisis set in, many of the credits earlier granted to the domestic banks were recalled and most of the local banks recorded some losses as some of the foreign banks were affected negatively.

Gross under-capitalization constitutes another source of banking crisis. Banking sector soundness and its susceptibility to shocks largely

depend on the adequacy of its capitalization. Provisioning for bad loans and other unforeseen losses are absorbed by robust capital, while poor capitalization would lead to the folding up of a bank should the risk of default crystallises.

Financial reforms actually would lead to a more competitive market, but at the same time may lead to an increase in the failure rates of banks and other financial firms. Under stiff competition, banks will normally respond to higher competition and a shrinking customer base by charging lower rates on loans. With increasing competition in the deposit market, banks' funding costs may rise because they have to pay higher rates to attract deposits from competitors. As revenues decrease and costs rise, lending margins shrink as monopoly rents are competed away. Poorly performing institutions will see their economic capital eroded, and they could face the prospect of closure by banking regulators.

3.3 Impact of Banking Sector Crisis on the Economy

As alluded to earlier, a healthy banking system generally contributes to strong economic growth, while banking crisis can present a substantial drag on the real economy as it reduces the amount of financial intermediation undertaken and consequently a decline in investment and aggregate economic activity in the economy. By the nature of their business, banks tend to be highly leveraged and incur a mismatch in the maturity of assets and liabilities, which make them susceptible to deposit runs. Banks' intermediation function entails that they link most sectors of the economy. Hence, on one hand, banking sector difficulties have an effect outside the banking sector, and on the other, shocks to any one sector are reflected in bank performance and can be transmitted through the banking system throughout the economy. For instance, the fall in the price of oil has affected the banks indirectly. Banking crises intensify slowdown in economic activities, prevent loanable funds from being allocated to their most productive uses, reduce the availability and increase the cost of funds to small and medium-size

businesses and seriously constrain the conduct of monetary policy, among others. In developing economies, like Nigeria, banks are the major participants in the financial systems. They operate the payments system, provide liquidity to fledging securities markets and are major purchasers of government securities. Given the major role of banks in these economies, it is easy to conclude that the collapse of the banking system causes serious negative externalities for the rest of the economy. These externalities take various forms.

Bank failures are usually followed by government bailouts. Fiscal costs of banking crises include costs of restructuring the banking system, considering the payments to depositors, bank recapitalization bonds, and asset management schemes. The fiscal gross direct costs are measured as outlays of the government and central bank in terms of bond issuance and disbursements for liquidity support, payout of guarantees on deposits, costs of recapitalization, and purchase of non-performing loans. Net costs to the public sector are estimated as the deduction from gross costs of recoveries from the sale of assets and equity stakes and repayment of debt by recapitalized entities (Hoelscher and Quintyn, IMF 2003). The public money that is needed to recapitalize insolvent banks puts pressure on the budget deficit to increase.

In addition, poorly enforced banking crisis resolution may engender moral hazard on the part of bank borrowers and bank managers. The fiscal burden created through banking crises and any fiscal bail-out of the financial system reduces the resources available for government programs that are of greater intrinsic social value, and can give rise to all sorts of economic, political and social problems when the time arrives to face the costs. The bailout, of course, intensifies the moral hazard problem in the future, due to the fact that future depositors have less incentive to monitor the activity of banks thereby discouraging saving in the domestic banking system, especially where depositors had incurred losses from the failure of banks.

Financial sector crisis has often been

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| <p>associated with reductions in output and other macroeconomic disturbances, as evidenced by the recent global financial crisis. A banking crisis may lead to a fall in output through a sharp contraction in the stock of money (monetary channel), through the decline in credit supply (credit channel) and also by the "idling" of resources that result from bankruptcies, judiciary procedures and seizure of collateral. Furthermore, a breakdown in the payments system would imply severe costs.</p> <p>A banking crisis also influences the conduct of monetary policy. The monetary authorities need to supply the banking system with liquidity during a period of crisis. Banks cannot service their loans and need funds to pay their creditors (depositors). They look at the central bank, as the lender of last resort, to provide them with the needed funds. But, central banks must also be concerned about conducting a monetary policy that provides price stability and promotes growth making the situation a difficult one for the conduct of effective monetary policy.</p> <p>Banking crises pose devastating effects to many of the weakest sectors in the economy that are "credit intensive:" such as housing, agriculture, and small and medium size enterprises. These sectors constitute the highest employer of labour in the economy and so any adverse effect on them will have a multiplier effect on the economy as a whole, particularly in the area of employment. Moreover, the banking system, particularly in a developing economy like Nigeria, the banking sector is the greatest employer of labour aside agricultural sector. A crisis in the sector would translate to more joblessness in the economy.</p> <p>Furthermore, during a banking crisis, the quality of available information worsens, and that intensifies the adverse selection problem and given that several firms experience a decrease in their creditworthiness, due to their inability to pay back their loans, there is a high chance that funds will be directed to inefficient firms because these are the ones that are willing to pay the higher interest rates. As a consequence, the quality</p> | <p>of investment is likely to suffer after a banking crisis has occurred.</p> <p>Also, a banking crisis normally leads to erosion of public confidence in the sector and hence a decline in banking habit. In a country like Nigeria where much effort had been directed to propagate banking habit in the banking public, an erosion of confidence in the banking sector could be a critical one for the nation as it would create distortions in the economy.</p> <p>Banking crises in emerging economies may have significant negative spillover effects on industrial economies and vice versa. The reason is that the importance of emerging economies in the world economy and in international financial markets has grown in recent years. Most developing economies import a lot from the developed world. At the event of financial crisis in the emerging economies, there is bound to be weak demand for imported goods hence a production slowdown. The current financial crisis is a typical case where produced goods in the developed countries are being auctioned at buy 2 and get one free.</p> <p>In the Nigerian context, the effects of the Global financial crisis include lower demand for Nigeria's exports, particularly crude oil, whose price has been on the decline since the crisis. Oil constitutes 25 per cent of our GDP; 99 per cent of exports; and 80 per cent of government revenue. At least 40 per cent of Nigeria's trade is with the US. There is the likelihood of lower commodity prices, for non-oil exports. In addition, there are more job losses, especially in the capital market, while inflationary pressure has resurfaced with the attendant reduced confidence in business environment. All these have resulted in government revenue contraction; de-accumulation of foreign reserves; pressures on exchange rate; limited foreign trade finances for banks as credit lines dry-up for some banks; divestment by foreign investors in the Nigerian capital market with the attendant tightness and possible feedback effects on the balance sheet of banks; and counter-party risks vis-à-vis external reserves, however, the CBN has taken measure to safeguard the reserves.</p> | <p>Long run costs of banking crisis include low savings rates, very limited long term financial relationships, reliance on external financing, high interest rate spreads, dollarization and a heavy public sector debt burden. Under these conditions of "short-termism" and low intermediation, deposit withdrawals translate quickly into credit contractions, which may further worsen the situation as firms are starved of working capital and investment is constrained. Furthermore, the country becomes more dependent on inflows of foreign capital to finance investment or government. Hence, the probability and expected severity of a banking crisis increase, which reinforces the tendency towards low domestic savings.</p> <p>Once a system has experienced a banking crisis, several mechanisms may perpetuate vulnerability. A crisis may not only have reputational effects, but also forces banks to charge high interest spreads to rebuild capital and reserves, or to pay for emergency lending from the central bank and deposit insurance payouts. If there has been a bail-out with public funds, fiscal sustainability may be threatened, and therefore savers and investors will be discouraged by the prospect that a debt crisis will spill over in to the banking system, or be resolved through a new round of hyperinflation or deposit conversion.</p> <p>4.0 Banking Sector Crisis Resolution Options and the Nigerian Experience</p> <p>4.1 Banking Sector Crisis Resolution Options</p> <p>The policy options available in a banking crisis are sensitive to the type and size of shock affecting the financial system, in particular, whether failures are thought systemic. If the situation is non-systemic, the focus of the resolution is on the individual failed bank's balance sheet. In this case the failed bank will either be merged with a healthy bank or liquidated. In a systemic situation, however, the immediate aim of the authorities is usually to restore financial stability of the system as a whole, restore public confidence and</p> |
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avoid bank runs. Here guarantees are likely to be given to liability holders at the failed bank(s), and perhaps to the financial system as a whole to avoid or reduce panic. So the aim is first to stabilise the liabilities of the banking system, before restructuring the assets of the failing banks.

There is a range of options for resolving insolvent banks. At one extreme, a bank can be kept open through an injection of capital. At the other extreme, a bank can be closed with its assets sold and depositors and possibly other creditors paid off. Between these extremes, a bank's licence may be removed but with the bank sold off to another bank, in full or part, to preserve the bank's activities. The extent of involvement of the authorities may also vary. It may be limited to encouraging or organising private sector support, or extended to official financial support, in the limit through government takeover. When a bank is financially distressed there should be a preference, first, to encourage a private sector solution. If an unassisted private sector solution cannot be found, a decision would next be made about whether to liquidate the bank or provide some form of government assistance. In exceptional circumstances, if there were a systemic threat, governments might consider a takeover or guarantee to a failed bank, as an interim measure.

These options are reviewed below in turn.

4.1.1 Unassisted Resolution Options

Bank status unchanged

When a bank supervisor discovers that a bank is at, or close to, the point of insolvency, the first response is to see whether the bank can be rehabilitated without government assistance. There are often several steps here. The bank can be instructed to curtail lending, either in a specific line of business or across the board. A request (demand) for additional capital from existing shareholders or other interested parties is often issued; management changes can be required; and operational changes are almost always undertaken.

Bank status changed private sector merger

If a capital infusion from existing shareholders or other interested parties is not available, an unassisted merger with another healthy financial institution is usually the next course of action. For an unassisted merger to occur, the extent of losses must be transparent to the prospective acquirer. Therefore, supervisors should examine the troubled bank to determine the size of losses to ensure that the acquiring institution has sufficient capital to absorb potential losses in the failing institution.

4.1.2 Liquidation Option

If an unassisted private sector merger is not possible, a decision is often made to liquidate the bank. In liquidation, the bank is declared insolvent, closed, and depositors paid off. The restructuring authority then liquidates all assets. In most cases uninsured depositors and other creditors are only covered if sufficient funds are available after liquidation. Liquidation exerts a strong financial discipline on the various stakeholders. But when liquidation occurs, it may affect other banks through direct exposures or changes in financial market prices. In addition, reimbursing depositor and creditor claims, from the sale of the failed bank's assets, can be a long and disruptive process that locks up people's wealth for months or even years and has knock-on effects throughout the economy.

4.1.3 Assisted Resolutions

If some form of government intervention is considered, various forms are available:

Bank status unchanged

Lender of last resort (LOLR)

Central banks usually only provide emergency liquidity assistance in potentially systemic situations and only for a limited period. Liquidity support to individual institutions can buy time to assess the underlying solvency position and to assess alternative resolution strategies. Although LOLR is intended for illiquid but fundamentally solvent banks, in practice it may be difficult, in the time available, to distinguish between a

liquidity and a solvency problem. Mechanisms should be put in place to ensure that such lending is time-limited and conditional, and that the central bank protects itself from incurring losses, in particular through taking collateral.

Open bank assistance

This occurs when the government provides financial assistance to a distressed bank without taking the bank over or eliminating the current stockholders' position entirely. The assistance can be in the form of the provision of capital or through purchasing non-performing assets from the bank. This allows the operations of the bank to continue uninterrupted. However, there are potential weaknesses with open bank resolutions. Most important, if the bank's management is left in place, and the existing shareholders' investment protected, this will seriously increase moral hazard. Making government support conditional can reduce this problem, for example, through replacing management, eliminating or downgrading existing shareholders' interests, or mandating an infusion of private sector capital. Open bank assistance has often required repeated capital injections before problems have been solved, resulting in large fiscal costs of resolution.

Bank status changed

Assisted Merger or Acquisition

Resolution of a bank failure often involves an assisted merger or acquisition. The transaction can be completed with another bank or, if permitted by law, another type of institution. A merger provides business continuity for both borrowers and depositors. It can be structured in many different ways, depending on the size and complexity of the distressed bank, the funding constraints of the resolution authority, and the amount of time until failure. Banks can also be split up, with the deposits, branches and assets sold off separately.

Assisted mergers are sometimes accomplished using Purchase and Assumption model (P&A). In an assisted P&A, the acquirer purchases the assets and assumes the liabilities,

in whole or part, of the failed bank, with the resolution authority compensating for the difference. Here, existing shareholders lose all of their investments. Uninsured creditors, too, may lose part of their investment if the P&A is only partial.

Bridge Banks

This is a form of temporary government ownership. A number of industrialised countries with systemic crises, such as Finland and Sweden, have assumed temporary ownership of troubled large banks, to permit restructuring and subsequent sale to a private institution. Bridge banks offer a holding period so that a final resolution strategy can be effected. While the government can maintain the business operation of the bank, the set time period forces the resolution authority to focus on cleaning up the bank's balance sheet in preparation for selling it.

Outright Government Ownership

This has typically occurred when a very large bank fails. The government authorities take over the bank by nationalising it, usually eliminating the stockholders' interest but protecting depositors and other creditors. One problem with outright nationalisation, however, is that government managers do not have the same incentives as private bank managers. In market economies, private sector banks are essential for efficiently allocating credit. Evidence suggests that countries with higher shares of state-owned banks tend, on average, to have a higher share of non-performing loans and higher operating costs (Goldstein and Turner (1996)).

4.2 The Nigerian Experience

Two broad types of resolution options have been adopted in Nigeria so far by the regulatory/supervisory authorities:

Outright liquidation (deposit pay-out) and the Purchase and Assumption (P&A) options (assisted mergers and acquisitions). Other resolution options adopted in Nigeria will also be discussed.

Outright Liquidation (deposit pay-out):

Under this option, the entire assets and liabilities of the affected bank are placed under the control of the liquidator (NDIC) who would arrange to physically close the bank. NDIC then verifies the assets and liabilities of the bank and exercises control over all its moveable assets. Under Nigeria's deposit insurance scheme, each customer's account is insured up to a maximum N200.0 (two hundred thousand naira). In 1998, 26 banks with 347 branches spread over 32 states and Abuja were closed down and faced liquidation under the NDIC. Some of them were Financial Merchant Bank (FMB), Kapital Merchant Bank (KMB), Alpha Merchant Bank (AMB), United Commercial Bank (UCB), Republic Bank (RBL), CCB, PBN, Mercantile Bank etc

Purchase and Assumption (P&A) Model

The basic characteristics of this option is the purchase of the whole or part (cherry-picking) of the assets of a failed bank by a healthy (assuming) bank and the assumption of the deposit liabilities of the failed bank by the same bank. The P&A Option has featured prominently in the history of bank failure resolution in Nigeria. Following the conclusion of the bank consolidation exercise at end-December 2005, 13 banks that failed to make it were handed over to the NDIC for liquidation. The P&A model has since been adopted by the Corporation for their liquidation. As at end-December 2009, 11 out of the 13 affected banks had been assumed by some healthy banks. These include Allstate, Hallmark (Eco bank); trade, Metropolitan, City Express, African Express, Gulf, Liberty (UBA); Lead, Assurance (Afribank); and Eagle (Zenith). The cases of Triumph and Fortune International banks are still pending in the court.

Other bank resolution options adopted in Nigeria included:

CBN Bail-out Using Guarantees

This option was applied by the CBN during the late 1990s for some of the ailing banks. For instance, at the inauguration of one of the affected bank's new board and management, the CBN gave a commitment that it was fully behind the bank and would

honour all cheques drawn on it. Further guarantees were given to other healthy banks, which enabled those banks to provide life-boat facilities to the affected banks. Unfortunately, this option did not stop the run on these banks.

CBN/NDIC Controlled Restructuring (Open bank assistance)

This option implies taking over the board and management of a bank by the CBN and NDIC in order to restructure the bank and run it profitably. The hope is that the cream of professionals selected jointly by the CBN and NDIC would be able to turn the bank around within a short period of time and return the bank to the owners. This was variously used by the Bank in the late 1990s and recently when about eight (8) banks had problems. In most cases, this option worked out as some of the affected banks were resuscitated, while in other cases the resuscitation efforts proved abortive. In most of the failed cases, the banks had forwarded falsified financial reports to the regulatory authorities to cover up its fraudulent practices which were already beyond redemption.

4.3 The current Banking Sector Crisis Resolution/Pre-emptive Actions by the Regulatory Authorities

The global financial crisis strained the progress made in the sector. The industry experience in the face of the global meltdown is, however, consistent with global trends. Specifically, a section of the banking industry was badly affected and liquidity problem was precipitated following its significant exposure to the capital market in form of margin trading loans. Again, in the wake of the high oil prices, a section of the industry was badly exposed to the oil and gas sector. These excessive exposures resulted in the weaknesses (liquidity problems) exhibited by some of the banks towards the end of 2008.

A joint special examination (CBN/NDIC) of 10 out of the 24 banks as at May 31, 2009 revealed that some of the banks exhibited the following symptoms:

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| <ul style="list-style-type: none"> • Substantial non-performing loan; • Poor corporate governance weaknesses in governance and management; • Weaknesses in capital adequacy; and • illiquidity problem <p>It was against this background that the CBN moved decisively to strengthen the industry, protect depositors and creditors, and restore public confidence and safeguard the integrity of the Nigerian banking industry.</p> <p>In this regard, it replaced the chief executives/executive directors of the banks identified as the source of instability in the industry and injected the sum of N620.0 billion in to the banks in an effort to prevent a systemic banking crisis. The injection of this fund (Tier II capital) into these banks is considered sufficient to resolve and stabilize them to enable them to continue normal business operations. Arrangements have been made to recover non-performing loans from the banks' debtors while guaranteeing all foreign credits and correspondent banking commitments of the five banks.</p> <p>Other Recent Policy Actions to Strengthen the Reform Process The CBN commenced the creation of Asset Management Corporation. The draft Bill for the establishment of Assets Management Corporation of Nigeria (AMCON) has already been passed into law by the National Assembly. The AMCON as a resolution vehicle is expected to soak the toxic assets of the CBN-intervened banks and provide liquidity to them as well as assist in their capitalization.</p> <p>Furthermore, the Bank in collaboration with the fiscal authorities is improving the macroeconomic environment so as to achieve robust monetary and financial policies in particular and, the overall macroeconomic objectives of the government, in general. In this regard, the Bank is collaborating with the Federal Government to raise N500.00 billion for power/infrastructure development. This is expected to provide favorable environment that would encourage operators in the</p> | <p>industry. In addition, N200.00 billion has recently been provided wholly by the CBN for SMEs financing.</p> <p>It is also collaborating with the Securities and Exchange Commission (SEC) and the Nigerian Stock Exchange (NSE) to reduce the cost of transactions, particularly bond issues so as to diversify funding sources away from banks as well as attract more foreign portfolio investors into the sector.</p> <p>Efforts are also being intensified towards strengthening regulatory and supervisory framework and enhancing monitoring of the operations of the Deposit Money Banks (DMBs) to ensure that they remain safe, sound and healthy. In addition, these efforts will also ensure the maintenance of public confidence through the enforcement of appropriate disclosures and reinvigorating the policy of zero tolerance on all unprofessional and unethical banking practice, and greater emphasis on enforcement of Code of Corporate Governance. Standby teams of target examiners are being deployed to any bank at any time to ensure timely regulatory actions, if necessary.</p> <p>To further engender public confidence in the banking system and enhance customer protection, the CBN established the Consumer and Financial Protection Division to provide a platform through which consumers can seek redress. In the first three months of its operation, about 600 consumer complaints were received by the Division which was a manifestation of the absence of an effective resolution mechanism in banks. The CBN has also issued a directive to banks to establish Customer Help Desks at their head offices and branches. In addition, the CBN has commenced a comprehensive review of the Guide to Bank Charges with a view to making the charges realistic and consumer friendly. Furthermore, the Consumer and Financial Protection Division is expected to commence a programme of consumer education and enlightenment and is also collaborating with the Consumer Protection Council on the review of the Consumer Protection Council Act No. 66 of 1992 to regulators to enforce</p> | <p>discipline in the market.</p> <p>The CBN has taken steps to integrate the banking system into the global best practices in financial reporting and disclosure through the adoption of the International Financial Reporting Standards (IFRS) in the Nigerian Banking Sector by end 2010. This is expected to enhance market discipline, and reduce uncertainties which limit the risk of unwarranted contagion. The CBN is also, closely collaborating with other stakeholders like the Nigerian Accounting Standard Board (NASB), Federal Ministry of Finance (FMF), NDIC, SEC, and NAICOM; PENCOM, Federal Inland Revenue Service (FIRS), and Institute of Chartered Accountant of Nigeria (ICAN), among others, towards ensuring a seamless adoption of IFRS in the Nigerian banking sector by 2012. These efforts are being pursued under the aegis of the Roadmap Committee of Stakeholders on the Adoption of IFRS in Nigeria inaugurated by the NASB and facilitated by the World Bank.</p> <p>The universal banking (UB) model adopted in 2001, allowed banks to diversify into non-bank financial businesses. Following the consolidation programme, banks became awash with capital, which was deployed in multiplicity of financial services. In effect, the laudable objectives of the UB Model were abused by operators with banks operating as financial supermarkets to the detriment of core banking practices. To address the observed challenges, the CBN is reviewing the UB Model with a view to directing banks to focus on core banking business. Under the new model, banks would not be allowed to invest in non-bank subsidiaries, while banks with such investments would be required to either divest or spin-off the businesses to holding companies that will be licensed by the CBN as other financial institutions. The three classes of deposit money banks being proposed are: International banks, National banks, and Regional banks.</p> <p>Other measures included: the strengthening of institutional coordination through the Financial Service Regulation Coordinating Committee (FSRCC), adoption of common accounting year end for all</p> |
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banks, aimed at improving data integrity and comparability; conducting own-risk assessments and relying less on classifications by rating agencies; limiting the tenor of Chief Executives of Banks to 10 years;; sound and timely regulation and supervision of the financial sector; stringent demand for transparency in the financial sector; and transparency in structured credit instruments to be improved upon for easy assessment of associated risk.

The Alpha Project Initiatives of the CBN

The Central Bank of Nigeria has articulated a blue print for reforming the Nigerian financial system in general and the banking sector in particular in the next ten years. The blue print is built on 4 pillars of enhancing the quality of banks, establishing financial stability, enabling healthy financial sector evolution and ensuring that financial sector contributes to the real economy. The details are as follows:

- **Enhancing the quality of banks**

The CBN would initiate a five-part programme to enhance the operations and quality of banks in Nigeria, which would consist of industry remedial programmes to fix the key causes of the crisis, implementation of risk based supervision, reforms to regulations and regulatory framework, enhanced provision for consumer protection and internal transformation of the CBN which has commenced.

- **Establishing Financial Stability**

This would centre on strengthening the Financial Stability Committee within the CBN and establishing a hybrid monetary policy and macro-prudential rules. It would also include the development of directional economic policy and counter-cyclical fiscal policies by the government and further development of capital market as alternative to bank funding. Some of the potential levers for the new macro-prudential rules may include limiting capital market lending to a proportion of a bank's balance sheet, prohibiting banks from using depositors' funds for proprietary trading, private equity or venture capital investment, adjusting capital

adequacy and forward looking capital requirement driven by stress tests by the CBN.

- **Enabling healthy Financial Sector Evolution**

The CBN would review the basic one-size-fits-all model of banking in addition to reviewing the universal banking model mandates which would make it possible to have international, national, regional, monoline and specialized banks such as Islamic banks, etc, with different capital requirements, commensurate to the depth of their activities.

- **Ensuring the Financial Sector Contributes to the Real Economy**

This would entail leveraging on the CBN Governor's role as Adviser to the President on Economic Matters to ensure that the financial sector contributes to the real economy. The CBN would take the lead in measuring more accurately the relationship between the real economy and financial sector, as well as cooperating with state governments to run pilot programmes in directing the financial sector's contribution to social and economic development within the states.

Furthermore, the CBN intends to be announcing an advance calendar of its operations for each week so that market expectations are formed in a manner that is conducive to the realization of the objectives of policy. The Bank also proposes to have in place firm consultation procedures with bank executives, prior to and after the policy meetings as a condition for bringing about a more open and transparent monetary policy. The CBN is putting in place a code of conduct for regulators to ensure that regulatory and supervisory staff in the financial services sector live up to the high expectation, thereby reducing various types of risks in both their domestic and international operations.

5.0 The Way Forward

Maintaining a safe and sound banking sector is essential, given the key role that banks play in promoting the health of a country's overall economy. Most countries do this by some form

of banking supervision, generally accepting that the added protection to the banking system in the form of supervision is worth the costs of the regulatory burden. One of the ways that bank supervisors can help promote a healthy banking system is to focus banks on the development of improved risk-management techniques.

Indeed, identifying, assessing, and promoting sound risk-management practices have become central elements of good supervisory practice. Bankers should therefore ensure that their risk-management practices include a focus on less likely outcomes, not just the most common ones, and that the bank is being adequately compensated (provisioning) for the risk it is bearing. The use of exercises such as stress tests and scenario analyses can help bankers identify certain points of vulnerability that may arise during potential downturns.

To arrest banking crisis, there is need to strengthen banks' capital requirements in order to ensure their solvency. This is achieved via the purchasing by public authorities of securities issued by banks or by taking stakes, where necessary, in troubled banks. Banks will thus be able to continue developing their lending activities, by increases in their capital, even if adverse market conditions prevent them from raising funds on financial markets.

Another type of action consists in ensuring the proper provision of liquidity to banks by the monetary authorities so that they can continue to finance the economy in the short- and long-term. Central banks have regularly adjusted their operational frameworks in order to provide the banking systems with all the liquidity that they need: The discount window operations was recently extended in order to give renewed impetus to the money market beyond the very short-term segment. The money market transaction thus was considerably strengthened. The range of eligible counterparties was extended to enable the maximum diffusion of liquidity in the system; the scope of eligible collateral for refinancing was enlarged to provide more flexible access and make larger quantities

available; in the system the refinancing potential of counterparties was thus almost doubled; the refinancing procedures were also radically modified: quantities are no longer limited and are agreed at a fixed rate (instead of a system of variable rates via auctions).

It has been noted that better risk management and stronger financial buffers alone cannot prevent higher-risk activity taking banks from causing systemic crisis. Banks' quest for maximum profit and shareholders' value leads to pressure on the bank management to take excessive risks and should be discouraged through setting of limits of risk-taking. The global financial crisis has demonstrated that banks' excessive risk taking can be catastrophic and that there is no built-in safeguard to constrain such risk taking. It is therefore imperative that regulatory authorities should set percentage-of-capital limits on banks' high-risk activities. The adoption of such limits is the only tangible way to reduce the threat to the financial system.

One of the key board responsibilities is to design compensation programs that reward long-term performance and promote sound risk management. The recent financial crisis revealed that bank compensation practices encouraged excessive risk taking and rewarded short-term profits at the expense of long-term viability. To address this deficiency, regulatory authorities in collaboration with boards of directors of banks should establish and adopt prudent standards for bank compensation programs that require a significant portion of bonuses to be paid in shares that vest over time; link bonuses to performance targets and adherence to prudential principles; and permit bonuses only if supervisors consider a bank's capital ratios sufficient..

Moreover, pursuing sound

macroeconomic policies is another way for policymakers to help prevent banking and financial crises. For instance, it is beneficial to have sound and sustainable monetary and fiscal policy to provide a stable operating environment for entrepreneurs and financial institutions and markets. Many past crises were precipitated either by an external shock affecting an already vulnerable financial sector or by market participants targeting vulnerabilities in certain markets or in certain institutions or governments. Experience has shown that if a condition or policy looks unsustainable, it is most likely that market forces will eventually bring it to an end.

A major cause of distress in most Nigerian banks has been attributed to poor corporate management. In most cases, members of management are often self-serving and indulging in criminally irresponsible behaviour in the administration of their banks. This suggests the need for an appropriate mechanism to be put in place to ensure that erring directors are prosecuted on accelerated basis.

Furthermore, having an open and transparent financial system and economy, accompanied by reliable and accurate accounting standards would generally benefit a country and its market participants. A core principle of economics is that markets are more competitive, and therefore more efficient, when accurate information is available to both consumers and suppliers. Information is thus critical to the effective functioning of financial markets: Timely and accurate financial information about markets, market participants, and governments is important for all actors to be able to make informed decisions. This is of course true during normal times, but perhaps more so during a crisis when market participants and governments are sometimes trying to determine

where problems lie and how severe they might be. Lack of information can present additional problems during a crisis, and incorrect or incomplete information provided by firms, governments, and other institutions can severely undermine their credibility, worsening the problem. Transparency will assist banks to make informed decisions; rescue them from the illusion of high performance; help to build both customer and investor confidence; provides opportunity for re-strategizing; provides a competitive advantage, clear understanding of the risks and challenges facing the bank.

There is need for a forward-looking supervisory regime which would ensure appropriate and sustained capacity building initiatives. Also, bank supervisors should keep abreast of state-of-the art practices and procedures in order to discharge their functions efficiently, effectively and creditably.

6.0 Concluding Remarks

We have tried to explain the concepts involved in banking crisis and jurisdictional experience in financial crisis. The causes and the impact of banking crises on other sector of the economy were also x-rayed. Some policy options for a healthy banking system, including sound macroeconomic policy, sound risk management system and high levels of transparency and disclosure, among others, were recommended.

As a final thought, there is no uniform effects neither is there any single remedy to each crisis, but each brings its own surprises and risks. Clearly, we should not assume that past remedies will fully solve the current and next set of problems or address all future crises. The key is to take lessons from the past and tailor them appropriately to address future situations of potential crisis.

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NATIONAL INCOME POLICY IN A DEREGULATED ECONOMY: THE NIGERIAN PERSPECTIVE

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Abstract

This paper examines the propriety of a national income policy in a deregulated economy. The literature indicates that various interest groups in the country tend to protect their narrow interests when negotiating for higher wages. Consequently, the goals of government to achieve equitable income distribution in the country with a national income policy are often at variance with the private interests. While congenial atmosphere for collective bargaining was deemed desirable for achieving effective income growth, an environment of consistently rising prices was considered an anticlimax to growth and development. Consequently, the paper opined that in a market economy, a national income policy that does not include elements of restraint on prices development was likely to fail. Thus, an income policy must be packaged as a set of comprehensive macroeconomic, monetary and fiscal policies for effective results. As part of the national income policy, an income guidepost with provision for periodic review is advocated.

1.0 Introduction

Wages are an all time major issue of economic policy in all economies, as such, is an integral part of national economic development policy. The major fulcrum of wage policy is the rate of increases, range and structure of wage differentials, the extent of variance between wage groups, degree of desirable or tolerable inequality as well as the adequacy of the wage for the varying differentials of education, skills and length of service.

Given the relevance of income policies to national development, most countries strive to anchor a wage policy that would strike a balance between education, skills and length of service against the demands of minimizing income inequality between the lowest and highest income earning groups in society. However, the composition or range of wages in the public sector is not too central to formulating wage policies in most countries (Tule, 2004). This is because, the methodology for the monetization of the paraphernalia of public office is ill developed, as such; it is often difficult to define what constitutes an appropriate wage when

the public service is involved. In addition, a deliberate public policy designed to stagnate a rise in wages in order to minimize the public debt or contain inflationary pressures is adversative to equity. We are then confronted with answering the question whether the premium between public and private sector wages can reasonably be narrowed by public sector wage policy.

Income policies have been adopted by countries because policy makers are not satisfied with the results of the market mechanism in allocating income equitably. Thus, attempts to reduce unemployment by expanding aggregate demand (using fiscal policy) often lead to intensified cost and price pressures at level of unemployment which are uncomfortably high. Attempts to check these rapid wage increases through price and wage controls or some other policy often leads to higher levels of unemployment.

The cause of this state of affairs is the existence of sufficient concentration of private economic power so that various factor and product markets have substantially become insulated

from the influences of aggregate monetary and fiscal policies. Cost-push inflationary pressures are the most obvious manifestations of this structural deficiency. The existence of these private agitations of economic power is not new. What is new however, is the awareness of the extent to which such power can be utilized in a modern society. Although people do not think in these terms, perhaps, the motivating force behind the continued agitation for higher income encapsulated in an explicit national income policy is the growing dissatisfaction with the existing machinery for equitable distribution of income.

This dissatisfaction has become more apparent in recent years with the recent shift in income positions. Whereas traditional income inequality, endorsed by custom, may have been more readily acceptable as a normal state of affairs, recent quantum leaps in income have made the situation unacceptable, especially to the larger section of society who may not have been beneficiaries of this state of affairs. Consequently, when organized labour see that by concerted efforts they can increase

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| <p>their income levels and when such efforts are bolstered by feelings of inequality, the need for a workable policy becomes imperative.</p> <p>As Tule (2004) found, an efficient public sector wage policy requires a clear understanding of the behavioral relationships in the domestic labour market. Such a policy needs to address the constraints of the market, relevance of labour supply in wage determination, and the conditions under which employees and employers would prefer a certain wage level to another. These issues coalesce into questioning the validity of government wage fixing or minimum wage policy in a deregulated market. In efficient market hypothesis, supply creates its own demand and establishes its own equilibrium. Thus, in a deregulated labour market, government only intervenes to establish the rules and regulate against fraud. Typically, a deregulated labour market is a free market in which individual property rights are protected (including labour rights). It is the opposite of a controlled market where the government regulates the means of production, the usage of goods and services as well as the pricing and distribution of labour and output.</p> <p>In a free market, labour is freely exchanged at a price arranged solely by the mutual consent of sellers and buyers of the services. Thus, buyers and sellers do not coerce each other in the sense that they obtain each other's consent without threat, intimidation or physical force nor are they coerced by a third party (such as government). Thus, participants engage each other because they both believe that what they are getting from each other is worth more than or as much as what they have to offer. Thus, price or wage is the result of buying and selling labour decisions en masse based on the law of demand and supply.</p> <p>A deregulated labour market contrasts with the regulated market in which the government is directly or indirectly involved in regulating the price of labour. This intervention by government makes the market to be less efficient. The price of labour in the market place helps communicate consumer demand to producers and</p> | <p>thus directs the allocation of resources toward consumer and investor satisfaction. Thus, in a deregulated market, the price of labour is a result of a plethora of voluntary transactions, rather than political policy anchored by state might. Thus, through free competition between owners of labour and users, wages are fixed, and tend to rise or fall appropriately as conditions demand.</p> <p>In this paper, we explore the place of a national wage policy in a deregulated economy. The thesis as outlined above is that government wage policy in a market economy should be confined to outlining the conditions for avoiding fraud and in achieving equitable income distribution. To further develop this idea, we structure the paper into five sections. Following this introduction, we outline the major income policy issues in Section 2. In Section 3, we undertake a survey of income policy exercises in Nigeria from the pre-independence era to 1986 when the deregulation of the economy started under the Structural Adjustment Programme (SAP). Section 4 develops conditions in efficient deregulated markets and the possibility of a national income policy within that setup. Section 5 concludes the paper.</p> <p>2.0 Income Policy Issues in a Deregulated Economy</p> <p>Income policy is designed to amongst other things; redistribute income to achieve specific social goals. The perceived goals to be achieved arise from society's unwillingness to accept the adverse adjustment effects that would emerge from the operation of a free market. Thus, it is the unwillingness to allow the market to make the adjustments that government intervenes; ostensibly with a national wage policy to achieve equitable income redistribution. However, while government hopes to minimize to the barest minimum, the economic inefficiency arising from the exercise, it nevertheless, encourages rent seeking and moonlighting activity from labour, especially in the public sector. This sub-optimal behaviour of labour tends to decrease national productivity, while increasing overheads. And as shown by Tule (2004), although wage fixing exercises in Nigeria were targeted at</p> | <p>the public sector, the private sector tended to take a queue from there in fixing their wages.</p> <p>Income policy involves a number of issues some of which include:</p> <ul style="list-style-type: none"> (i) income policy affects all sectors of the economy and regulations such as tax policy affect particularly income distribution amongst the sectors and across income groups (ii) within sectors such as agriculture, discriminatory policies such as between export and food crops affect the relative income positions of the farmers (iii) between the freedom of individual decision makers lies the extent of government involvement in production and marketing decisions (iv) There is the interdependence amongst sectors as a ban on inputs in one sector severely affects income in another sector (v) between domestic policy and foreign policy objectives, higher domestic support prices tend to reduce the volume of foreign trade (vi) between sectoral or microeconomic objectives and macroeconomic objectives, higher product prices versus inflation, subsidy/social policies to reduce unemployment versus the budget deficit. <p>Conditions for Comprehensive Income Policy:</p> <p>Most regulation policies are formulated to meet narrowly construed objectives, and income policy is no exception to this rule. The attendant programs focus on achieving the stated objectives. For income policy in particular, all sectors of the economy must be effectively integrated with the domestic economy.</p> <p>In Nigeria, an income policy that fails to appropriately integrate the agricultural sector into the domestic and export economy would be counterproductive. For instance, increased dependence on foreign imports now transmits substantial instability to the domestic economy.</p> |
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The existing structure of production in the country shows that the food system is disjoint from the domestic economy. Thus, the performance of the domestic economy does not take account of domestic food supply and the agricultural system. The evidence is that:

- Nigerian farmers are still price takers
- The level of industrialization is dwindling instead of growing
- The decreasing proportion of food naira accounted for by non-farm inputs shows the dwindling bases for enhanced income in the country

Income policies may have undesirable or unintended indirect consequences or even direct consequences. The need for equitable income distribution can be a powerful mechanism for motivating greater use of potential influence over wage decisions. For instance, why should a blue collar worker worry that his wage increases are exceeding the growth of his productivity when he believes that the top management is being overpaid, and that white collar workers and stockholders are obtaining too large a share of the proceeds of current income and capital gains, when in fact, they all go to the same market?

More damaging to monetary and fiscal stabilization policy is the creation of conditions possible for prices to rise when aggregate demand is dwindling. The issue is why powerful citizen groups should be concerned that their demand for specific public benefits and subsidies exceed the current fiscal capacity of government to pay especially when they believe that other income recipients are not working more than them nor paying their fair share of income taxes. Consequently, the notions of fiscal dividends have evaporated as new expenditure initiatives, coupled with high level corruption, have outpaced even the most optimistic estimates of government revenues. These institutional rigidities aggravate social pressures, leading to incessant demand for higher wages and constituting a demonstration effect on other parts of the economy.

It is these kinds of Pareto sub-optimal conditions that have led to aggravated experiments in income policies in most market economies. However, the realization is that restraint, whether compulsory or voluntary, is needed on demand for unbridled growth in income by segments of society. The usual reasons of high inflation used in the demand for higher wages is the result of either anticipations of greater inflation or the familiar cost-push phenomenon, hardly ever due to excess demand. It is pertinent to note that income policies have been introduced because market imperfections have substantially weakened the ability of monetary and fiscal policies to achieve desired levels of economic growth and price stability. In what follows, we shall examine income policies from two perspectives: short and long term.

Short Term Considerations

Although we are contemplating a deregulated market environment, in the short run, we have to accept the continued departure of income policy from the free market model and to use government intervention as a counterbalancing force. Given the drift towards the market in recent years, formal wage fixing and control may not have a place in modern economic calibrations, and ditto, a formal national wage policy that tends to legislate across the board minimum wage for all classes of labour. As long as wage policy does not limit the ability of labour to negotiate a living wage for its services, nor unduly task the capacity of both government and private sector to pay as well as reward declining productivity, a battle line may not seem eminent. However, where the reverse is the case, then, the desirable wage policy would be one that seeks to promote labour and employment dynamism while removing fraud in wage fixing and payments.

A Galbraithian approach of limiting wage policies to larger labour unions and business entities, which seem to be subject to governmental influence and public pressure, may be needed. Once central wage negotiations are to be dismantled, government may need to take the initiative to arrive at some type of national consensus

(guideposts or objectives) with all stake holders to establish an acceptable and enduring framework for collective bargaining on wages and productivity issues. However, the fear of this model as observed by Tobin (1972) is that an arbitrary imitative component in wage settlements exists, which may be influenced by national standards. Hicks (1955) had argued that wages can be influenced by non-economic forces such as customs, or by what the negotiating parties perceive as right.

From the foregoing, there is no unique or once for all institutional structure for achieving national consensus on these purely economic issues of income policy. Any structure adopted is likely to show substantial strains and weaknesses arising from pressures. However, experience of most countries is that as one structure wears out, another contemporary structure is developed. One thing is certain, as individuals or groups find ways to exploit existing structure for personal rather than the national gain, such a structure would persistently break down and need modification. Modification or new policies must take account of the consensus building requirement to ensure acceptability and implementation.

As a cardinal objective of national income policy, the drive to engender an equitable income distribution must weigh higher than the choice of specific numeric targets to be met. In addition, designing an equitable wage policy as much as possible should be people participatory. The degree of voluntarism could vary over time.

An income policy must not convey the impression of an omnibus Father Christmas where it promises apples on mango trees. The fact that income policies tend to breakdown as the economy approaches full employment or even below it shows that income policies have a limited lifespan. Keynes (1946) provides an eclectic approach to what is needed in the short run. According to him, No one can be certain of anything in this age of flux and change. Decaying standards of life at a time when our command over the production of material satisfactions is the greatest ever, and a diminishing scope for individual decision and choice at a

time when more than before we should be able to afford these satisfactions, are sufficient to indicate an underlying contradiction in every department of our economy. No plan will work for certain in such an epoch. But if they palpably fail, then, of course, we and everyone else will try something different.

In the Long Run

Long run considerations of income policy should focus on private economic blocks that have been insulated from the impacts of monetary and fiscal policy. The departures from the effective functioning of the market are often instigated by government involvement/interference. Frequently, government statutes and regulations are constraining and counterproductive to the effective functioning of the markets. Consequently, in the long run, we need to examine in totality, the sum of government legislations, rules, regulations, and guidelines which interfere unduly with the efficiency of the market, raise prices or give the economy an inflationary bias.

Government through the inefficient administration of its social schemes has sheltered numerous groups from market forces, thus creating excessive costs to other sectors of the economy and even on other groups within the sheltered subsidy sector. Consequently, the obstacles to change should not be underestimated. The cost of each option may not be the right criterion to making a choice. What is relevant is: the benefits to some group would certainly outweigh the costs to them and so a powerful group would always exist to oppose the policy once it is at the higher costs end.

Efforts to reduce impediments to free market operation including labour resistance to requirements bothering on productivity increases need to be evenhanded. The effort to identify special protective devices must be broad and comprehensive, covering all stake holders. Such an undertaking would require considerable support from all stakeholders.

Any acceptable national wage policy

would require fundamental changes in the administration of government expenditure programs and the use of public funds which often tend to be sub-optimal, due to social welfare and equity considerations. This would entail an ambitious and extended effort, most likely to set in motion strong political and social counter pressures. The most propitious time for such changes is not during times of high unemployment. A stock of the various sub-optimal social schemes may reveal a huge cost which outweighs the benefits even to the groups directly benefiting. With so many sectors of society attempting to insulate themselves against uncertainties and competition, efforts at evolving a national wage policy under a deregulated economy may remain largely pedestrian and self-defeating. The deadweights of the interferences with the mechanism of economic progress and productivity may reduce the absolute size of the benefits available to the larger sector of society.

3.0 A Survey of Wage and Income Policies in Nigeria

The Federal Government has since colonial times retained the prerogative to establish broad based income policies in Nigeria. In pursuit of this prerogative, the government had carried out this exercise through the use of wage commissions (Anyafu, 1996). Broad based wage and income bargain institutions in Nigeria's public sector dates back to the early 1900s when the country was still under colonial regime. However, the formal institutionalization of these wages and income commissions and committees was done in the 1930s by the colonial administration.

The factors which have influenced the growth in income in the 1920s through the 1950s were expansion in public utilities (water, electricity, housing and a relatively integrated transportation system). In addition, exploration and mining activities increased labour overheads. These activities bred a pool of skilled and semi-skilled artisans, through formal and informal training systems influenced public sector compensation policies in the country (FOS, 1998).

Thus, government established a

number of Wage Commissions to review and define a national wage policy for the country. These include: Bridges Committee (1941), Tudor Davis Commission (1945), Harragin Commission (1946), Miller Committee (1947), Cowan Commission of Enquiry (1948), Gorsuch Committee (1955), Mbanefo and Morgan Commissions (1959), Morgan Commission (1963), Adebo Commission (1970), Udoji Commission (1973).

Continued resistance to labour demands led to prolonged tensions between organized labour and the colonial government. In the end, the colonial administration not wishing to risk its more expanded objective of maximizing economic gains, caved in to the prolonged demand of labour and established internal machinery for bilateral public sector wage negotiation, the Harragin Commission in 1946. However, its recommendations did not evolve a new minimum wage. This failure led to much civil unrest by organized labour and paved the way for the establishment of the Cowan Commission of Enquiry in 1948 to look into the immediate and remote causes of the crises.

The Cowan Commission of Enquiry introduced two Whitley Councils in its report. The one Council was in charge of Clerical Staff and Office employees (the white collar workers) and the other was for industrial and or manual workers. Although the Whitley Councils were ineffective in engendering an acceptable income policy, nevertheless, they were retained as the income policy document till 1964. The inability of the Whitley Councils to effectively provide compensation for labour, minimize income inequality and provide for differentials of education and experience led to the breakdown of collective bargaining between labour and the colonial government. Consequently, the colonial administration in 1963, established the Morgan Wages and Income Commission to examine what constituted appropriate income policy for the differentials of labour.

The Morgan Wages and Income Commission (1963) recommended the establishment of the National

Wages Board. Consequently, in 1964, the National Wages Board was established to establish broad based criteria for increases in wages and income. The National Wages Board did establish the conditions but these proved ineffectual as salaries and wages lingered far behind national income. Consequently, government, succumbing to pressure from organized labour, in 1973, established the Udoji Commission on salaries and wages.

The end of the civil war presented substantial challenges to government to redistribute income across regions in the country. The oil boom provided impetus for implementing the income redistribution to achieve more balanced growth in the country. Consequently, government established the Jerome Udoji Commission to look into the issue of salaries and wages across board. The recommendations of the Udoji Commission led to a displacement of the Wages Board with the National Negotiating Councils I, II and III. The National Negotiating Councils were inaugurated in 1976. The mandate of the National Negotiating Councils was to negotiate salaries, fringe benefits and general conditions of service for the public service, but excluding partial and fully commercialized parastatals, state owned companies and academic and non-academic institutions (Universities, Research Institutes, Teaching Hospitals, etc).

The military governments established a number of salary review commissions in response to prevailing economic conditions which made existing wages untenable. However, by 1986 when SAP was introduced, government deregulated the economy, including wages-requiring labour to negotiate directly with their employees. Hitherto, public sector wage adjustment exercises provided impetus for the private sector to negotiate new wage increases with their employees. Although much has not changed with respect to this, however, the then existing automatic adjustment mechanism between the public to private sector seem to have lost much of its steam such that public sector wage increases no longer translated to automatically meeting similar demands in the private sector. What has emerged from the survey of

the wages commissions is that their recommendations were short-lived, leading to agitations for higher wages once government policy generated any form of inconvenience on labour.

Another feature of wage policy in Nigeria over the years was the absence of a standard framework for wage and income adjustment. Consequently, wages were adjusted based on the strength of labour and its capacity to pressurize government to make an award. Often, arm twisting existed. To enable government sell a hard economic policy, a wage increase was awarded. Wage increases at the Federal level were accompanied by prolonged strike at the state level before such awards could be implemented at that level of government. Consequently, Federal workers were perpetually at advantage when wage increases were contemplated.

Available evidence indicated that wage increases were done on the spur of the moment not having been provided for in the fiscal appropriation for the year in which they became effective. Thus, the implementation of salary and wage increases led to an overshooting of the boundaries of fiscal discipline leading to higher prices, loss of productivity arising from labour unrest and strikes. In the end, the new wage was overtaken by rising prices setting the stage for a new round of higher income demand.

The Status Quo

There currently exist wide range disparities between income groups in the country. While the poor are indeed very poor, attempts at income redistribution have been lopsided, being targeted at the white collar worker with the hope that proceeds would be redistributed to the very poor. Within the white collar group, huge differences are identifiable between Federal and State Civil servants. Within the civil service itself, wide differentials between grades are noticeable.

While disparities may not be completely eliminated in income structure, obvious yawning gaps are counterproductive. While the need to look up to the next grade is appreciated, punitive structural

defects should be eliminated so that officers at the lower grade feel grossly imbalanced mentally when they differential in take home is compared with their next higher level officers. The existence of such disparities at the national level encourages income marginalization across sectors, establishments, different strata of government and the economy generally. The state of affairs does not create room for effective implementation of a national income policy.

While productivity measures may be difficult yardsticks for gauging the need for increased income in the public service, in the private sector, the methodology for measuring such output is advanced. And whereas the public sector may be preoccupied with its social welfare functions, nevertheless, it sets the tone and signposts the directions of economic development in the country including income policy. Thus, a lopsided income structure in the public sector stigmatizes efforts at income redistribution and creates a permanent basis continued labour agitation for equity in income distribution.

4.0 Deregulating the Market

The absence of competition may allow an excessive number of institutions to survive, including inefficient ones that would ordinarily not survive under market conditions, and hence breed low productivity due to the rent seeking behaviour of the employees enjoying subsidy wages (with low productivity) and a moral hazard problem. Although economists may have us believe that the market remains the best stimulus to productivity growth, the theoretical and empirical basis for this has only recently been established.

A wide range of literature exists on the effects of competition on wages and productivity (Nickell, 1996; Vainiomaki and Heden, 2003). Although Symeonidis (2002) has shown that profitability may fall in the short run, it may recover in the longer term following increased competition if there is free entry and free exit and market structures are allowed to adjust, no such simple relationship has been established in the literature

between market structure or profitability and the intensity of competition.

The standard view is that during recession, workers lose jobs from established employment relationships. The prevalent thinking here is that workers lose their jobs because wages are sticky downwards and employers no longer find the relationships profitable after the recession shock. The high level of unemployment persists until the workers can find new jobs. Hall (2005) finds that available evidence supports the contrary. An adverse shock does not affect established employment, especially in deregulated economies where collective bargaining affects few workers outside the public sector. Job relationships end when it is convenient for employer and employee to terminate the relationship. A shock raises the level of unemployment by lowering the profitability of hiring new workers.

On the other hand, unemployment does not rise because of a bulge of layoffs but because workers entering the job market from previous jobs/school/home activities, experience unusual difficulty in finding job placements.

Inflation today has been traced to fairly stable structural aspects of labor and products markets. The effects of this, however, depend on the extent of national resource utilization.

Another important element is the dynamic mechanism through which current perceptions of price and income changes are generated from past events. In addition to these purely economic factors, a plethora of social and political considerations are identifiable. From a structuralist point of view, the inflationary process is essentially the by-product of a struggle over income distribution, occurring in a society where most owners of labour have little bargaining power over the product due to large scale unemployment and fear of losing existing jobs. However, given perfect market conditions, the negotiating power of labour is encapsulated in the trade union, whose power is affected by structural and market factors, the manner in

which the trade union exercises that power is affected by perceptions of what is happening and by political and social attitudes and norms. The trade union therefore, uses market power to negotiate for increased real income and defensively, to protect real income from past and expected increases in production or general price levels. Once the inflation process is initiated, increases in wages and prices become basically defensive-made in an effort not to lag behind. However, every defensive wage secured by labour threatens the real income of other sectors of the economy and spurs an endless chain of new defensive wage increase moves.

This view of inflation-induced wage struggle to protect the erosion of real income substantially provides a more meaningful explanation of wage-price behaviour in a modern deregulated economy. More significantly however, is the fact that the problem it attempts to address has become aggravated in recent times as the social norms regulating group behaviour have for various reasons become more tolerant of an increasingly aggressive use of market power.

Indeed, society is becoming more sensitive to the existence of income inequalities or injustices and is therefore, becoming more readily supportive or tolerant of efforts by underprivileged groups to improve relative income, through political, economic or social action or both. However, when the market price of labour or other products become weapons in the struggle over income shares, the underprivileged that possess little market power is the likely casualty, losing out to the already privileged groups. This is the space for national income policy administration to minimize the frustrations of the underprivileged group in the market and remove the fraud of the privileged groups.

If a national income policy is not designed to address these concerns, then, the economy would remain subject to substantial inflationary pressures. With time, as both the labor and product markets garner considerable market power to outdo each other, the economy would be

worse off. Thus, we submit that inflationary consequences of a struggle over the share of income can only be controlled through the institution of a national income policy.

The national income policy is here conceived as a system of restraints (i.e. more explicit and forceful social norms) which controls unbridled expansion in income with slight rise in prices without commensurate growth in productivity. The pattern of these restraints should be systematically integrated with other measures so as to guide the evolution of income shares in a manner which society judges to be fair and equitable. The implication is that a successful national income policy cannot be pursued independent of price restraint policy.

While compulsory wage controls is not being contemplated here, an examination of wage-price guidepost is advocated. The guideposts are a set of definitions of patterns of wages behaviour which, if generally followed would be consistent with efficient resource allocation, reasonable equity and approximate stability of the overall price level. The strength of this approach is anchored on the fact that in collective bargaining, wage rates are not set by impersonal market forces but human beings using collective decisions. Consequently, the decision makers have room for judgment (or no real decision would exist). Over the relevant time horizon, the decision makers do not usually know what approximate wage or price would maximize net income. Consequently, questions are settled by rule of the thumb, comparison, considerations of equity, policy or public appearance.

Thus, if government's arguments for restraint make sense to any of the participants in the decision process, to the extent that any of them prefer to avoid or minimize public criticism, and to the extent that they believed government's appeals and their decisions were tailored to affect other wage and price decisions, then the guideposts would have been successful. The guideposts therefore, are designed to influence employer's collective bargaining rather than directly affect union attitudes or aggressiveness. An efficient national

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| <p>wage policy must therefore, encapsulate the element of collectivity and consent. For this to be forthcoming, employees must see the system as being fair and equitable to all. Thus, a system which embodies sacrifices on the one side must be seen to be commensurate with the costs to be incurred by the other. Members must also believe that the restrictions its members accept on their freedom to do as they please will achieve something important.</p> <p>A national income policy anchored on purely voluntary participation may have limited results. It might therefore, be otherwise unwise to take a chance at a purely voluntary wage policy compliance system. Also, courting adherence through widespread publicity to violations of a voluntary policy may prove as a self destructive policy. We believe that the envisaged system, which has provision for periodic renegotiation would offer enough flexibility to permit the relative wage changes that are essential for efficient resource allocation.</p> <p>5.0 Conclusion and Policy Considerations</p> <p>The paper surveys the literature on income policy and found that in both controlled and deregulated markets, an income policy is needed to guide the direction of income growth. In addition, such a policy was necessary to avoid exploitation and fraud as well as to the advancement of the narrow interests of members of society. Consequently, the paper advocated the development of guideposts with wide ranging consultations, which</p> | <p>would be used for future income growth in the country. It was observed that such guideposts would need to be periodically reviewed. In addition, a national income policy must be pursued in conjunction with a price restraint policy to avoid unbridled growth in prices.</p> <p>The income policies reviewed were born out of exigencies of the moment. Consequently, the policy consisted essentially in establishing ad-hoc committees/commissions to produce a wage document. After long deliberations with organized labour, government implemented parts of the recommendations, setting the stage for another round of labour agitations for higher wages. It was observed that such a policy was counterproductive and needed a review.</p> <p>The paper also examined existing income structure and the wide ranging disparities across board in the country. The paper observed that such inequalities and divergences between Federal and State wages as well as between grades and across sectors was sufficient to create industrial disharmony within the labour force and encourage corruption, rent seeking and moonlighting activities. Consequently, the paper advocates for a review of the status quo with a view to achieving a more balanced national income distribution.</p> <p>As part of the policy issues, we observe that if the underlying structural rigidities of the economy which hamper the effective transmission of market mechanism</p> | <p>impulses were not addressed, inflationary pressures may exacerbate another need for new wage demands with attendant social pressures. Unless strong actions were taken to reduce the inherent market imperfections, the country may be increasingly resorting to greater direct controls over wages. The choice may actually be between fostering a greater degree of competition in private markets and relying more heavily on government control over private decision making.</p> <p>A more fundamental policy of price control or restraining surges in aggregate demand would involve vigorous and timely coordination of monetary and fiscal policies. Inflation would not abate through a mere application of demand management policies.</p> <p>Another national income policy would involve structural changes to the national manpower policy, designed to make labor supply more easily mobile between employers, industries, occupations and regions. There is also the need to eliminate a host of private practices and government policies, adopted in effort to protect one or another private interest at the expense of the national interest. These policies today create strong structural downward rigidities of particular wages and unnecessary bottlenecks and immobility's at high employment. Some of these provide artificial support for the market power of particular groups, while others directly and unnecessarily raise costs.</p> |
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FISCAL OPERATIONS AND THE EFFICACY OF MONETARY MANAGEMENT IN NIGERIA

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1.0 Introduction

It is incontrovertible that an effective and efficient monetary policy is essential for economic growth and development. This is borne out of the fact that pragmatic monetary management regulates liquidity to an optimal level to ensure macroeconomic stability which is imperative for growth. Monetary management is usually carried out by the central bank using various instruments at its disposal to regulate the availability and cost of money in consonance with the absorptive capacity of the economy. Generally, low and stable inflation has become the core mandate for most central banks for obvious reasons that inflation has costs which are detrimental to economic agents, particularly, as it affects rational decisions and to the economy as a whole. However, most central banks in developing and emerging economies are further entrusted with developmental functions that ultimately impair their core mandate. In these economies, several factors including shallow markets, inadequate data and fiscal dominance inhibits the ability of the central banks to effectively superintend over the monetary management process. Thus, in this group of countries, inefficient markets create distortion for financial intermediation, inadequate data obstruct monetary programming

and unbridled fiscal expansion impairs monetary policy performance.

The Nigerian economy shares somewhat similar characteristics as those identified with most of these economies. In the first instance, in addition to its primary objects, the CBN is also saddled with developmental functions as a result of the need for rapid economic development. Secondly, prior to the banking/financial sector reforms, the financial markets were shallow and banks were structurally oligopolistic. In addition, fiscal policy has over the years hampered monetary management largely due to its expansionary nature, thereby forcing the Bank to continually adjust its monetary programme to counter the adverse effect of fiscal dominance. Specifically, for most of the 1980s and 1990s, sporadic revenue sharing attended by unbridled fiscal expansions at all levels of government exerted intense pressure on monetary policy implementation. Consequently, several efforts were initiated by the monetary authority to solicit for better understanding from the fiscal authorities on the need to complement monetary management initiatives with fiscal prudence in order to engender a low inflationary environment that is critical for growth.

Beginning from 2001, the Federal Government in addressing the predicament of the monetary authority undertook a number of fiscal reforms including oil price budget benchmarking, due process etc which brought some levels of fiscal restraint. However, the ability of the government to sustain its efforts suffered setbacks as fiscal developments shortly afterwards became inimical to monetary processes. Therefore, the challenges to effective monetary management remained issues of fiscal profligacy and the need to properly co-ordinate fiscal and monetary policies for effective performance.

The purpose of this paper is to underscore the need for a predictable fiscal operations at all levels of government as a means of ensuring effective and efficient monetary management in the Nigeria federation. Following this introduction, section two discusses conceptual issues and the review of literature, section three discusses government's fiscal operations and challenges to monetary management, while section four examines fiscal reform and its impact on monetary management. Section five contains suggestion on the way forward and some concluding remarks.

2.0 Conceptual Issues and Review of Literature

2.1 Conceptual Issues on Fiscal Policy

Fiscal policy is the deliberate changes in the levels of government expenditure, taxes and other revenue and borrowing in order to achieve such national goals or objectives as price stability, full employment, economic growth and balance of payments equilibrium Okunroumu (2003). The stance of fiscal policy could be neutral, which implies a balanced budget where government spending is equal to tax revenue; expansionary, where a government raises its spending or reduces taxation, or a combination of the two; or contractionary, when government spending is reduced either through higher taxation or reduced spending (Wikipedia, 2010).

Monetary Policy

According to Mordi (2008), the term monetary policy refers to a blend of measures designed by the central bank to regulate the value, supply and cost of money consistent with the absorptive capacity of the economy or the expected level of economic activity without necessarily generating undue pressure on domestic prices and exchange rates. The objectives of monetary policy can vary from one country to the other, but are generally of two variants. The first focuses on single objective of price stability, while the second perspective has multiple objectives of achieving not only price

stability, but other macroeconomic goals. The need to regulate money supply is based on the general consensus that the quantity of money supply and the general price level are highly related and if not regulated, could result in undesirable effects such as rising inflation. The control of money supply could be done through the use of direct instruments such as interest rates fixing, credit ceilings, directed lending and exchange rate controls or through the use of indirect instruments such as Open Market Operations (OMO), reserve requirements liquidity and cash reserve ratios, discount window operations, including standing deposit and lending facilities, among others.

2.2 Review of Relevant Literature

Monetary and fiscal policies are inextricably tied, suggesting that a sustainable fiscal policy and pragmatic monetary management are important to the realization of the objectives of growth and development of an economy. Both policies are essential components of overall macroeconomic policies and they usually shares similar goal of macroeconomic stability, low inflation and reduced unemployment. All these objectives, however, may not be achievable without trade-offs and also requiring a lot of coordination for policy effectiveness.

Zoli (2005) posited that fiscal policy could affect monetary policy through the impact of budget constraint, and also through the effect on a number of monetary variables such as interest and exchange rates. Sargent and Wallace (1981), submitted that excessive fiscal expansion (fiscal dominance) weakens monetary authority's ability to control inflation and also creates distortions for interest and exchange rates.

On the coordination of fiscal and monetary policy, Blinder (1983) stated that the lack of coordination usually stems largely from the following: the fiscal and monetary authorities having different objectives (the two authorities might have different opinions about the likely effects of fiscal and/or monetary policy actions on the economy) and; the two

authorities making different projections on the likely state of the economy. Melitz (2002), estimated the reaction functions of the monetary and fiscal authorities on a pool of 19 OECD countries over the period 1960 1995 and found that monetary and fiscal policies have tended to move in opposite direction, which underscores the need for greater understanding of their interactions for effective policy development.

Sokoler (2002) in his study on the interaction between fiscal and monetary policy in Israel observed that the financial system showed remarkable resilience as evident in a stable foreign exchange market and inflation expectations which were within 1 3 per cent range. He noted that these impressive results were possible because both the fiscal and monetary policy were properly coordinated as they focused on reducing the deficit/government debt and maintaining price stability. Mutoti, (2005) noted that to reduce the conflict between monetary and fiscal policies necessitated the institution of the following: independence of the central bank; limiting central bank credit to the government; fiscal discipline, and; establishing developed financial markets.

3.0 Fiscal Operations and Challenges to Monetary Management

3.1 Fiscal and Monetary Policy Formulation

The main instrument of fiscal policy in Nigeria is the budget and is usually prepared by government ministries/departments/agencies (MDAs) of the federal government under the supervision and guidance of the Ministry of Finance (MoF), through the Budget Office of the Federation (BOF). Hitherto, the time horizon for the budget had been one fiscal year, until recently, when the medium term fiscal framework was introduced.

Under the current democratic dispensation, the budget estimates are collated and fine tuned by the MoF with due consultation with the Presidency and thereafter presented to the Federal Executive Council (FEC) for consideration. After its adoption by the FEC, the budget

proposal (Appropriation Bill) is presented by the President to the joint session of the National Assembly. The Bill is deliberated upon in both chambers (House of Representatives and Senate) of the National Assembly, while the MDAs are frequently invited to defend their entries. After due consideration that may necessitate some amendments, approval is granted by the National Assembly and the Bill forwarded for consent of the President in order to become an Appropriation Act. Under the erstwhile military regimes, budgeting was exclusively the responsibility of the Supreme Military Council under the chairmanship of the military Heads of State. Under the military administrations, therefore, budget process was less tedious as decisions were made by the nucleus of the central command structure of the Nigerian Army and fewer persons were involved in the process. Over the past years to date, however, the main thrusts of the Federal Government fiscal policy (ies), irrespective of the regimes (military or civil), largely remains the pursuit of the primary goal of economic growth, employment generation and provision of infrastructure.

The authority to carry out monetary policy is vested in the CBN through the CBN Act 2007. This law, which repealed previous legislations on the matter, enjoins the Bank under Section 2 to ensure monetary and price stability, among others. In designing monetary policy, Ezema (2007) noted that the CBN reviews developments in the economy over a period, articulates the major pressures for and risk to price stability and formulates a framework which is essentially based on a monetary programme which sets out future trends in macroeconomic aggregates to guide its monetary policy implementation. The monetary programme is reviewed on the basis of the performance of macroeconomic aggregates against the projections. He also observed that monetary management generally focused on price stability through assiduous tracking of liquidity.

The role of the CBN in budgetary process is indirectly derived from its object under Section 2 (e) of the CBN Act 2007 as banker and

financial/economic adviser to the Federal Government. Although the role of the Bank in the formulation of fiscal policy is essentially that of adviser, it is nevertheless assigned the major role of financing the fiscal deficits through the granting of temporary advances to the Federal Government as provided under Section 38 (1), subject to the limitation imposed by Section 38 (2) and (3a) of the Act.

In the context of the objectives of both the fiscal and monetary policies as enunciated, it is apparent that conflict will often arise between the CBN whose primary goal is to maintain monetary and price stability and the

Federal Government whose primary pursuits are infrastructure provision, employment generation and economic growth. Therefore, proper coordination of monetary and fiscal policies is a key factor in achieving effective monetary management and is imperative in ensuring a stable macroeconomic environment.

3.2 Trend in Government Fiscal Spending

In over four decades, the fiscal operations of the government both at the national and sub-national levels have essentially been characterized by continuing growth in expenditure and have persistently followed the

booms and burst pattern of earnings from the oil sector. The developments in crude-oil earnings have heightened the pro-cyclical nature of fiscal thrusts such that increase in revenue was most of the time followed by more than proportionate expansion in government expenditure. A cursory look at government outlay indicated that aggregate expenditure of the Federal Government grew at an annual average of about 40.5 per cent between 1990 and 1999, while those of the sub-national governments increased at an annual average of about 31.9 per cent over the same period.

Similarly, between 2000 and 2008, the expenditure of the federal and the sub-national governments grew at an annual average of about 16.5 and 41.9 per cent, respectively (Appendix 1). The fiscal expansion of the three tiers of government and the concomitant large fiscal deficits of the three tiers of in the 1990s militated against the efficacy of monetary policy. Thus, huge fiscal operations at all levels and the inflationary financing of large budgetary deficits of the Federal Government vitiated monetary management, particularly, as the CBN had to take-up an annual average of 36.7 per cent of the Federal Government's fiscal deficits with the issuance of high powered money (Appendix 2).

This condition subsequently created distortions in the financial markets as interest and exchange rates were misaligned throughout the period. The burgeoning of government fiscal operations continued unabated from 2000 through 2008, however, there was moderation of fiscal expansion at the federal level owing to the introduction of fiscal reforms in 2003, while the rapid fiscal expansion persisted at the sub-national levels. Consequently, unbridled fiscal spending with the attendant fiscal deficits by all the tiers of government, over the years, engendered rapid monetary growth, accentuated inflationary pressure and vitiated the effectiveness of monetary management as monetary targets were missed by wide margins for most periods (Appendix 3).

Figure 1: Growth rate of public expenditures for Federal and Sub-national governments

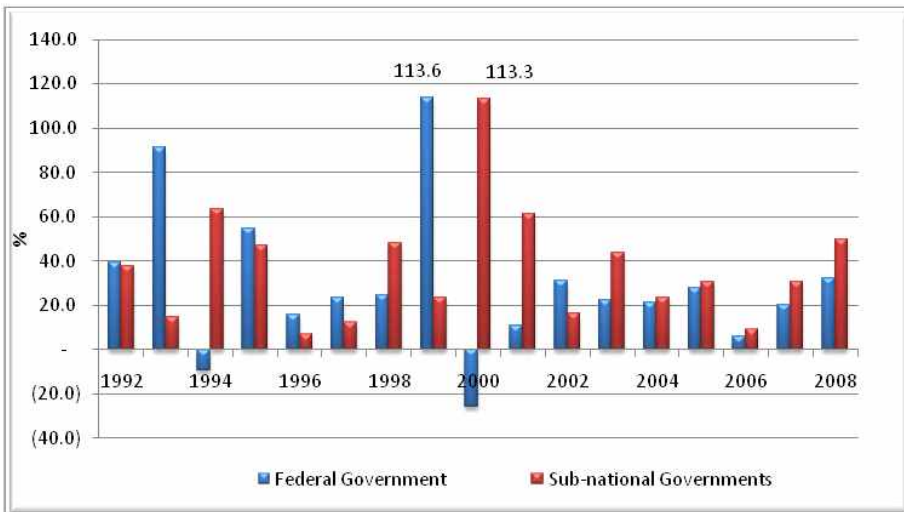


Figure 2: Percentage of CBN Take-Up of Federal Government Fiscal Deficit Financing

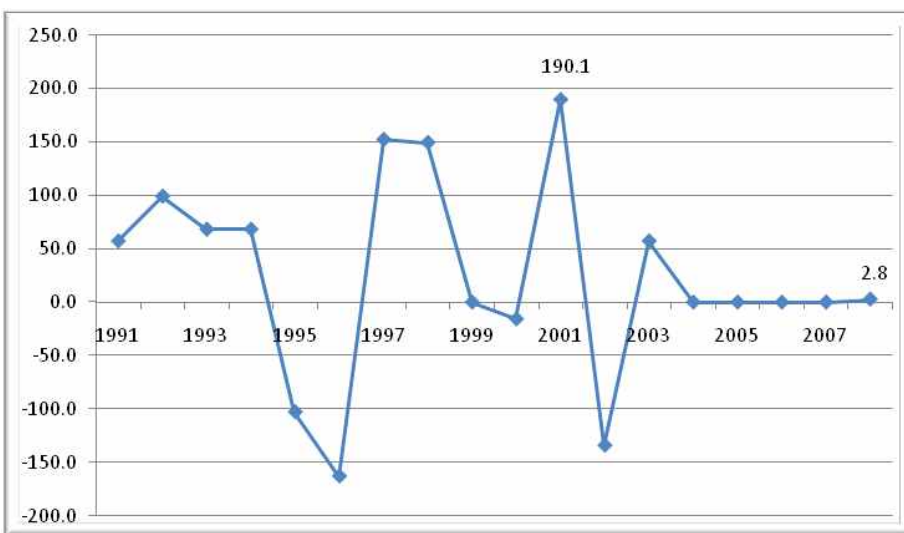
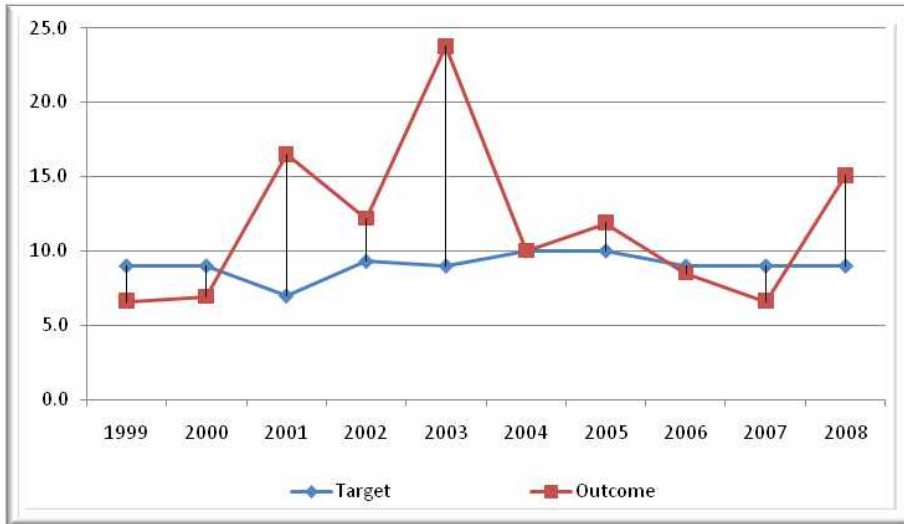


Figure 3: Inflation targets and outcomes



3.3 Challenges to Monetary Management

Several fiscal factors have overtime hampered the efficiency and effectiveness of monetary management by the CBN. These factors included the following:

- ◆ The financing of large fiscal deficits of the Federal Government mainly by the CBN through the “ways and means advances” particularly in the 1980's and substantial part of 1990's.
- ◆ Excessive fiscal spending by the three tiers of government due to the sustained increase in revenue flows from the Federation Account, occasioned by rising price of crude oil at the international market.
- ◆ Banking system borrowing by the sub-national governments to finance unplanned and inefficient extra budgetary activities.
- ◆ Unbridled fiscal expansion due to un-coordinated budgetary operations of the three tiers of government.
- ◆ The rapid monetization of crude oil earnings and other un-budgeted receipts.
- ◆ The provisions of Sections 162 (1-5) of the Constitution of the Federal Republic of Nigeria which stipulates outright sharing of all revenue that accrues to the Federation Account among the three tiers of government, making it impossible for effective prediction of fiscal injections into the

economy.

- Persistent drawdown of the excess crude saving by the three tiers of government at unpredictable intervals raises their spending patterns

Given the resolute commitment to the mandate of ensuring monetary and price stability at all times, the CBN in the past three decades deployed several monetary instruments including the un-conventional ones to contain the problem of liquidity surfeit and rein-in inflation. Consequently, for most of the 1990s, the Bank deployed un-conventional instruments including stabilization securities, CBN certificates, special treasury bills, special deposits, withdrawal of public sector deposits from deposit money banks, in addition to the conventional instruments of open market operations (OMO), rediscount rate, reserve requirements, cash/liquidity ratios to achieve its objectives. With continuing threats to monetary management emanating largely from fiscal shocks, the Bank introduced other complementary monetary management tools including repos, open buy-back (OBB), reverse repos, swaps, special OMO auctions, occasional foreign exchange swaps, special wholesale Dutch Auction System (wDAS) and standing deposits and lending facilities, among others, in the last half-decade, to liquidate intermittent liquidity upsurges. In 2006, the Bank re-engineered its policy framework by replacing the Minimum Rediscount Rate (MRR) which hitherto served as

the nominal anchor for interest rates in the economy with the Monetary Policy Rate (MPR) in order to be more proactive in monetary management.

It is pertinent to emphasize that monetary management remained confronted with the problems of the non-committal to the Bank's ultimate target of inflation by successive governments. This posture always create difficulty for the pursuit of a low and stable inflation by the CBN, as the short term objectives of government is inconsistent with medium to long run objective of price and monetary stability.

4.0 Fiscal Reforms and the Efficacy of Monetary Management

Realizing that fiscal prudence is a pivot in achieving low inflation and stable macroeconomic environment, the Federal Government embarked upon a number of fiscal reforms beginning from fiscal year 2001 to ensure efficient use of resources. These included:

Fiscal Rule Oil price based fiscal rule by applying specific oil price benchmark for budgeting and the establishment of a savings fund known as the excess crude revenue account to warehouse excess revenue from crude oil sales above a predetermined oil price benchmark. This policy is aimed at ensuring that public expenditure is smoothed over time.

- ◆ Monetization of the benefits of public servants to stem the ever rising recurrent expenditure of the Federal Government, thus reducing waste and releasing more resources for the provision of social and economic infrastructure.
- ◆ Pension Reform Enactment of the Pension Act 2004 to free public resource from the burden of pension payments and institute fiscal affordability in public finance nationwide.
- ◆ Public Sector Procurement Reform The establishment of the Budget Monitoring and Price Intelligence Unit (BMPIU) 'Due Process' to ensure that procurement procedures are in line with best practices, guarantee value for money

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| <p>and maintain budget discipline.</p> <ul style="list-style-type: none"> ◆ Introduction of policy based budgeting to ensure transparency and accountability and adherence to budget processes by law. • Commencement of the medium term fiscal framework Medium Term Fiscal Framework (MTFF) embodying Medium Term Expenditure (MTEF), Medium Term Revenue Framework (MTRF) and Fiscal Policy Strategy (FPS) to drive budgetary processes. • Enactment of the Fiscal Responsibility Act (FRA) 2007 to ensure prudent management of the nation's resources and engender long term macroeconomic stability. <p>Other complementary measures directed at ensuring fiscal discipline and support the efficacy of monetary management included:</p> <ul style="list-style-type: none"> ◆ Entrenchment of a provision limiting the granting of advances to the Federal Government for budget support. Section 38, 1-3 of the Central Bank Act 2007 provided for the granting of temporary advances of not more than five per cent of the previous year's actual revenue of the Federal government and such shall be repayable at the end of the financial year in which it is granted. Furthermore, the Bank's power to grant such advances in any subsequent year is not exercisable unless previous advances have been paid. ◆ The West African Monetary Zone (WAMZ) primary convergence criteria requirement limiting government budget deficit/GDP ratio to 4.0 per cent and central bank financing of such deficit to 10.0 per cent of previous year's revenue has been helpful in containing fiscal extravagance. <p>The implementation and institutions of these reforms have so far yielded positive results particularly with regards to engendering macroeconomic stability and creating the enabling environment for monetary management to thrive. Specifically, the fiscal reforms had</p> | <p>brought some element of prudent fiscal management particularly with respect to the size of fiscal deficits/GDP ratio which declined asymptotically from 1.5 per cent in 2004 to 0.6 per cent in 2007. Similarly, with regard to financing of fiscal deficits, the CBN zero tolerance for 'ways and means advances' was respected by the Federal Government as the Bank's deficit take-up was nil, except in 2008 when its took-up 2.8 per cent of the deficit (Appendix 2).</p> <p>Notwithstanding these developments, the coordination of fiscal and monetary policy calls for constant re-examination of issues with respect to the overall liquidity in the economy. Given the high degree of vulnerability of the federation revenue to the vagaries of oil prices in the international market, a sustained downward swing in prices for instance could constitute a serious threat to the fiscal operations of all levels of government and may induce governments, particularly, the Federal Government, recourse to the CBN for financing of huge fiscal deficits. This may reverse the gains of the fiscal reforms and put monetary management at risk.</p> <p>In the light of this, monetary authority should at all time not loose sight of the inherent danger posed by revenue volatility to government fiscal operations and ultimately, the effectiveness of monetary management.</p> <p>5.0 Way Forward and Conclusion</p> <p>The paper has examined the various ways in which government fiscal operations has constrained monetary management in Nigeria. It established the fact that huge public spending by the three tiers of government, over the years, had hampered monetary management resulting in the missing of monetary targets by wide margins, while induced serious pressure on the general price level. The paper also discussed the various fiscal reforms and examined the aftermath of the reform initiatives.</p> <p>To further strengthen and improve the efficacy of monetary management, the following suggestions are instructive.</p> | <ul style="list-style-type: none"> ✓ The current efforts at strengthening transparency and accountability in fiscal management should be sustained to prevent undue constraints to monetary management. In this respect, strict adherence to the fiscal responsibility laws (FRA 2007) would continue to stimulate fiscal discipline and good public expenditure management. ✓ The continued observance of the Medium -Term Fiscal Framework (MTFF) and the newly introduced performance budgeting initiatives should be pursued with vigor to improve allocation and operational efficiency of government spending. ✓ Internal auditing of MDAs should be strengthened to inculcate financial discipline and promote efficiency in public expenditure management. ✓ The savings in the excess crude account should be strictly channeled to provision of socio-economic infrastructure including building transport infrastructure such as roads and rail, energy particularly power, health services to enhance human capital and support adaptable technological research so as to lay the foundation for industrialization and economic advancement. ✓ The government should initiate and pursue policies/reforms that would truly diversify Nigeria's revenue base to promote predictable earnings and engender a macroeconomic environment in which resources are efficiently utilized to ensure sustainable public finance at all levels of government. ✓ Sub-national governments should be encouraged to adapt and enact the relevant provisions of the FRA 2007. This would promote efficient public expenditure management, assist budgetary operations and ultimately foster the fiscal policy coordination nationwide. ✓ There is need to ensure that the fiscal operations of government do not result in excess liquidity beyond the absorptive capacity of |
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the economy. In this respect, it is important to pursue consistent monetary-fiscal policy mix to achieve the desired macroeconomic objectives. Thus, arrangements for the sharing vital information to support the execution of both policies for effective monetary management should be fashion out and implemented.

- ✓ High powered committee

involving public and private sector practitioners should be constituted to ensure the effective fiscal and monetary coordination and make recommendation to the Federal Executive Council (FEC).

Finally, the intention to rehabilitate the nation's dilapidated social and physical infrastructure by the Federal Government would require huge budgetary outlays and inevitably substantial injection of liquidity with

serious implications for monetary management. Thus, fiscal authorities must ensure judicious use of resources in order to foreclose inefficient expenditure that could frustrate monetary authority's efforts at ensuring monetary and price stability. In addition, an enduring fiscal and monetary coordination should be instituted by both authorities through reconciliation of common objectives and the pursuit of complementary actions to realize them.

APPENDIX 1

Public Expenditure (N' Billion)

| Pub Exp/Yr | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|------------|------|-------|-------|-------|-------|-------|-------|-------|--------|
| Fed. Govt. | 66.6 | 92.8 | 177.3 | 160.9 | 248.8 | 288.1 | 356.3 | 443.6 | 947.7 |
| Sub-Nat | 27.0 | 37.1 | 42.5 | 69.4 | 102.0 | 108.9 | 122.2 | 181.2 | 223.5 |
| Total | 93.6 | 129.9 | 219.8 | 230.3 | 350.8 | 397.0 | 478.5 | 624.8 | 1171.2 |

Source: CBN Statistical Bulletin

Public Expenditure (N Billion)

| Pub Exp/Yr | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Fed. Govt. | 701.1 | 1018.0 | 1018.2 | 1242.8 | 1504.2 | 1919.7 | 2038.0 | 2450.9 | 3240.8 |
| Sub-Nat | 476.7 | 768.3 | 894.3 | 1282.9 | 1586.2 | 2066.6 | 2252.6 | 2943.5 | 4403.6 |
| Total | 1177.8 | 1786.3 | 1912.5 | 2525.7 | 3090.4 | 3986.3 | 4290.6 | 5394.4 | 7644.4 |

Source: CBN Statistical Bulletin

APPENDIX 2

Fiscal Indicators

| Pub Exp/Yr | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 |
|-----------------|--------|--------|--------|--------|--------|--------|-------|--------|--------|
| FG Deficit | -35.76 | -39.53 | -65.16 | -70.27 | 1.0 | 32.05 | -5.0 | -133.4 | -285.1 |
| CBN Take-Up (%) | 57.4 | 99.4 | 68.4 | 68.5 | -103.0 | -163.2 | 152.7 | 149.8 | 0.0 |

Source: CBN Statistical Bulletin

Fiscal Indicators

| Pub Exp/Yr | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|-----------------|---------|---------|---------|---------|---------|---------|---------|---------|--------|
| FG Deficit | -103.78 | -221.05 | -301.40 | -202.72 | -172.60 | -161.41 | -101.40 | -117.24 | -47.38 |
| CBN Take-Up (%) | -15.7 | 190.1 | -134.3 | 57.4 | 0.0 | 0.0 | 0.0 | 0.0 | 2.8 |

Source: CBN Statistical Bulletin

APPENDIX 3**Key Monetary Management Variables (%)**

| Particulars | 1991 | | 1992 | | 1993 | | 1994 | | 1995 | | 1996 | |
|-------------|------|-------|------|-------|------|-------|------|-------|------|-------|------|-------|
| | Tgt. | Outc. | Tgt | Outc. | Tgt | Outc. | Tgt | Outc. | Tgt | Outc. | Tgt | Outc. |
| M1 | 14.6 | 32.6 | 24.3 | 52.8 | 20.0 | 57.5 | 21.4 | 46.7 | 9.4 | 15.4 | 14.5 | 18.0 |
| M2 | 14.6 | 32.7 | 26.8 | 49.8 | 18.0 | 53.8 | 14.8 | 34.5 | 10.1 | 19.4 | 16.8 | 16.2 |
| Inflation | n.a | 13.0 | n.a | 44.5 | n.a | 57.2 | n.a | 57.0 | n.a | 72.8 | n.a | 29.3 |
| RM | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a |

Source: CBN Annual Reports

Key Monetary Management Variables (%)

| Particulars | 1997 | | 1998 | | 1999 | | 2000 | | 2001 | | 2002 | |
|-------------|------|-------|------|-------|------|-------|------|-------|------|-------|------|-------|
| | Tgt. | Outc. | Tgt | Outc. | Tgt | Outc. | Tgt | Outc. | Tgt | Outc. | Tgt | Outc. |
| M1 | 13.5 | 10.6 | 10.2 | 17.2 | 4.1 | 19.9 | 9.8 | 62.2 | 4.3 | 28.1 | 12.4 | 15.9 |
| M2 | 15.0 | 16.0 | 15.6 | 22.3 | 10.0 | 31.4 | 14.6 | 48.1 | 12.2 | 27.0 | 15.3 | 21.6 |
| Inflation | n.a | 8.5 | n.a | 10.0 | 9.0 | 6.6 | 9.0 | 6.9 | 7.0 | 16.5 | 9.3 | 12.2 |
| RM | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a | n.a | 14.0 |

Source: CBN Annual Reports

Key Monetary Management Variables (%)

| Particulars | 2003 | | 2004 | | 2005 | | 2006 | | 2007 | | 2008 | |
|-------------|------|-------|------|-------|------|-------|------|-------|------|-------|------|-------|
| | Tgt. | Outc. | Tgt | Outc. | Tgt | Outc. | Tgt | Outc. | Tgt | Outc. | Tgt | Outc. |
| M1 | 13.8 | 29.5 | 10.8 | 8.6 | 11.4 | 29.7 | 13.3 | 32.2 | | 36.6 | | 55.9 |
| M2 | 15.0 | 24.1 | 15.0 | 12.3 | 15.0 | 24.4 | 13.3 | 43.1 | | 44.2 | | 57.8 |
| Inflation | 9.0 | 23.8 | 10.0 | 10.0 | 10.0 | 11.9 | 9.0 | 8.5 | 9.0 | 6.6 | 9.0 | 15.1 |
| RM | n.a | 19.8 | 12.8 | 5.2 | 6.5 | 4.2 | 7.5 | 27.6 | 3.3 | 48.6 | 26.0 | 29.6 |

Source: CBN Annual Reports.

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FUNDED CONTRIBUTORY PENSION SCHEME, FINANCIAL DEEPENING AND ECONOMIC GROWTH: WHAT DOES THE EVIDENCE SAY SO FAR ABOUT THE NIGERIAN ECONOMY?

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1.0 INTRODUCTION

The Pension Reform Act (the Act) of June, 2004 was enacted to replace the old fiscally unsustainable Pay-As-You-Go (PAYG) defined benefit pension system with a fully funded defined contributory benefit system. Although the underlying reason responsible for the systemic change to the new scheme was for ensuring that the retirees under the new scheme are provided with the requisite liquidity to mitigate old-age poverty, another positive externality derivable from a contributory scheme is its potential to engender increased savings which can lead to financial deepening and capital market development, thereby fostering economic growth and economic development. This is important because ample empirical evidence has shown that financial depth in the developing economies of the world, especially in sub-Saharan Africa is very shallow (Ndebbio, 2000). Many of these countries have instituted reforms of their financial sectors.

In Nigeria, as part of the Structural Adjustment Programme (SAP), both the financial and the foreign sectors of the economy were deregulated. One of the purposes of deregulating the financial sector was to increase the real rate of interest sufficiently so that

domestic savings can be mobilised. Also, an increased real rate of interest may encourage portfolio variant of capital inflow. It is therefore conceivable that the defined contributory pension scheme which was introduced at a later date could then serve as a shot in the arm towards the realisation of the goals of savings mobilisation, domestic financial instruments acquisition and portfolio investment inflow (financial deepening).

Since the inception of the funded contributory pension scheme, one wonders if the depth of Nigeria's financial system has appreciably improved. It is therefore the objective of this paper to globally survey if indeed there can be a nexus between funded defined contributory pension schemes, savings mobilisation and financial market deepening which may culminate into economic growth. Data collected in this regard on the Nigerian economy are descriptively analysed.

Abstract

The fully funded defined contributory benefit pension system was introduced in Nigeria in July, 2004 to replace the old fiscally unsustainable defined benefit (Pay-As-You-Go) pension system. The new pension scheme, coming at the heels of earlier reforms in Nigeria's financial sector, could be deemed to serve as a further boost towards savings mobilisation, increased financial instruments acquisition and economic growth. After a survey of relevant literature was conducted, secondary data on relevant macroeconomic indices in the Nigerian economy were collected. The data were descriptively analysed. The results showed that TDS (total domestic savings) increased during the post-pension reform period and the increased TDS was not GDP growth induced. Some measures of financial deepening such as DCP/GDP (domestic credit to the private sector as a share of GDP), TBD/GDP (total bank deposits divided by GDP) and CIM (contract intensive money) did not improve appreciably during this period which hints at poor intermediation in Nigeria's banking sector. However, the DCP/GDP + SMC/GDP (the domestic credit to the private sector as a share of GDP plus stock market capitalisation as a share of GDP) measure showed a remarkable improvement during this period due largely to the performance of the SMC/GDP measure. This suggests that the Nigerian capital market achieved some measure of deepening during the post-pension reform period. It is therefore the recommendations of this paper that despite the increased TDS which may have been contributory pension funds derived, efforts must still be intensified to increase the participation rate of the scheme by including states' employees and the informal sector workers in the scheme. The poor performances of DCP/GDP, TBD/GDP and CIM measures must be reversed through a rigorous enforcement of banking regulations and the Nigerian judiciary must be truly reformed such that it can be enabled to enforce contract laws and protect private property rights. In order to further deepen the Nigerian capital market, PenCom must be made to relax the stringent portfolio diversification guidelines that the PFAs are required to comply with. This must be quickly followed by the internationalisation of the Nigerian capital market.

Keywords: Funded Contributory Pension Scheme, Total Domestic Savings, Financial Deepening Measures, Economic Growth, Nigeria.

Based on the findings from the analyses, it would be possible to discern if increased savings due to the new scheme has contributed to financial deepening and economic growth in Nigeria. The paper concludes by making recommendations.

2.0 LITERATURE REVIEW

The literature review section is divided into two sub-sections, namely: the theoretical framework sub-section and the history of pension systems in Nigeria sub-section.

2.1 Theoretical Framework

What is financial deepening? And how can a funded contributory pension system foster financial deepening and possibly economic growth? In the view of Ndebbio (2000), financial deepening means an increase in the supply of financial assets in the economy and therefore the sum of all the measures of financial assets gives us the approximate size of financial deepening. From this, it is suggested that the financial sector is the conduit through which financial deepening is manifested. The Department for International Development (DFID) (2004) defined the financial sector of an economy as the wholesale, retail, formal and informal institutions in an economy offering financial services to consumers, businesses and other financial institutions. It therefore broadly includes everything from banks, stock exchanges, insurers, credit unions, microfinance institutions and money lenders.

DFID (2004) further outlined the ways in which the financial sector can be adjudged to be developed or to have deepened and these include improvement in the efficiency and competitiveness of the sector, the range of financial services that are available may increase, the diversity of institutions which operate in the financial sector may increase, the amount of money that is intermediated through the financial sector may increase, the extent to which capital is allocated by private sector financial institutions to private sector enterprises responding to market signals (rather than government directed lending by state owned banks) may increase, the regulation and stability of the financial

sector may improve and more of the population may gain access to financial services.

Through its contributory feature, the funded scheme has the inherent potential to boost savings. OECD (2005) has observed that institutional investors, in particular pension funds, mutual funds and insurance have enhanced their role as collectors of savings over the past few decades. It went on to conclude that this trend is likely to continue as retirement saving grows and the increased pension saving will augment the size of capital markets. The large pool of savings which constitutes pension funds must be channeled into portfolios for reasonable returns so that old-age liquidity of the retirees (former affiliates) and hence their old-age consumption (welfare) can be assured. This requires a high degree of financial intermediation in the financial sector. Such a come-together of the deficit and surplus spending units is likely to result in more deepening of the financial system (Goldsmith, 1969; Ghani, 1992; Greenwood and Jovanovic, 1990).

Put differently, there will be more investment in the economy through the financial system. While a plethora of literature exists to support the relationship between increased savings and financial deepening, some literature also exist which are less sanguine about this relationship. For instance, in a reaction to some observers' claim that the Chilean reforms in 1981 may have, among other things, increased savings and deepened the financial markets in that country, Rocanda (2000, p.30) submitted that while the second outcome may be generally accepted, some developments in the macro-economy like reforms in the banking system and privatisation may have given this outcome a shot in the arm. Furthermore, she also queried the crediting of the first outcome to the reforms carried out in the country's social security system by painting a slew of possible fiscal scenarios that the government may have conceivably pursued to achieve the same outcome.

Some observers have emphasised the role that institutions may play in

the deepening of the financial markets. They have hinged their contributions mainly on three theories: the power theory of credit, the information theories of credit and legal origin theory. The power theory of credit posits that financial institutions would be more willing to extend credit if in case of default; they could easily enforce contracts by forcing repayment or seizing collateral. The amount of credit in a country would therefore depend to some extent on the existence of legislation that protects creditors' rights and on the quality of procedures that lead to repayment (McDonald and Schumacher, 2007; and Tressel and Detragiache, 2008).

Information theory of credit in its own case stresses the role of information disclosure. It submits that the amount of credit to firms and individuals would be larger if financial institutions could better predict the probability of repayment by their potential customers. It follows then that the more banks know about the credit history of prospective borrowers, the deeper credit markets would be. For this reason, public or private credit registries that collect and provide broad information to financial institutions on the repayment history of potential clients is crucial for deepening credit markets (Djankov et al, 2005 and McDonald and Schumacher, 2007).

As for legal origin theory, Beck et al (2002) have identified a political and adaptability channel through which legal origin affects credit markets. The political channel depends on the balance between state power and private property rights. For example, civil law that promotes institutions that favour state power over private property rights would tend to have adverse implications for the growth of credit markets. The adaptability channel recognises that legal traditions differ in their ability to evolve with changing conditions.

The argument has been that common law traditions evolve efficiently because judges respond case by case to changing conditions. The implication of this is that countries whose law is French must have on average substantially slower financial development than British common

law countries (La Porta et al, 1998). Empirical evidence available tends to support this institutional approach. Djankov, McLiesh and Shleifer (2005) have found from data on 149 countries that after controlling for macroeconomic factors like GDP growth, inflation and fiscal imbalances, legal institutions have made a clear contribution to the development of financial markets. Similar findings were reported by Galindo, and Micco (2001) in cross-sectional regressions of Latin American countries. Singh et al (2009) using panel data for a sample of 40 SSA countries from 1992-2006, have essentially arrived at a similar conclusion with the foregoing contributors and have strongly stressed that the legal history of most SSA countries in the CFA Franc zone is responsible for the financial shallowness of the countries in this zone.

What are the measures of financial deepening? Kiyotaki and Moore (2005) in their models of financial deepening used the degree of trust in the economy and the ease of conversion of illiquid paper (after an initial acquisition) into a liquid paper as measures of financial depth. The latter they called "securitisation or financial intermediation" and according to them, if the level of trust is high, and the costs of converting to liquid paper are low, then a measure of financial deepening may be deemed to have been achieved. Khan (2002) in his study of inflation, financial deepening and economic growth utilised three measures of financial depth; namely, domestic credit to the private sector as a share of GDP, domestic credit to the private sector as a share of GDP plus stock market capitalisation as a share of GDP, stock market capitalisation as a share of GDP.

Ardic and Damar (2006) in their study of financial sector deepening and economic growth in Turkey captured financial depth as total bank deposits divided by GDP. De Jesus Emidio (2007) utilised the ratio of bank deposit liabilities to nominal GDP to capture information on the extent of financial intermediation and the savings level in the economy of Mozambique. McDonald and Schumacher (2007) in their study of financial deepening in sub-Saharan

Africa saw financial depth as the ratio of GDP of bank credit to the private sector.

Hasan et al (2007) in their study of institutional development, financial deepening and economic growth in China, used two measures of financial deepening. One measure was based on banks alone; which was the ratio of total bank loans to GDP and the other was the non-bank sources; which was the ratio of equity and non-financial corporate debt (long-term and short-term corporate bonds) issuance to GDP. In essence, issuance of equity and corporate bonds represents the activities of the capital markets.

Rousseau and Wachtel (2008) in their study of the impact of financial deepening on economic growth used three measures of financial development, namely: the ratios to GDP of liquid liabilities (M3), liquid liabilities less narrow money (M3 less M1) and credit allocated to the private sector. Lastly, Singh et al (2009) in their study of financial deepening in CFA Franc Zone captured financial depth as credit to the private sector in terms of GDP.

Can financial deepening really lead to economic growth? There exists a burgeoning empirical evidence to support the position that increased financial deepening can indeed foster economic growth. About four decades ago, Goldsmith (1969), Shaw (1973) and McKinnon (1973) began to draw attention to the benefits of financial structure development and financial liberalisation. The main policy implication of the McKinnon-Shaw school is that government restrictions on the banking system such as interest rate ceilings, high reserve requirements and directed credit programme, hinder financial development and ultimately reduce growth.

The seminal empirical work that established the growth finance nexus was King and Levine (1993a) which extended the cross-country framework introduced in Barro (1991) by adding financial variables such as the ratios of liquid liabilities or claims on the private sector to gross domestic product (GDP) to the standard growth regression. They found a robust, positive and

statistically significant relationship between initial financial conditions and subsequent growth in real per capita income for a cross-section of about 80 countries.

Similar conclusions have been reached by subsequent papers on endogenous growth theory in which services provided by financial intermediaries such as information collection and analysis, risk sharing and liquidity provision were explicitly modeled. These papers showed convincingly that long-run economic growth depends on financial deepening (see for instance, Greenwood and Jovanovic, 1990; Bencivenga and Smith, 1991; Roubini and Salai-i- Martin, 1992; and Greenwood and Smith, 1997).

Reasoning along the same line, Levine (2005) identified some functions traditionally performed by financial intermediaries such as diversification and management of risks (including liquidity risk), mobilisation and pooling of savings and concluded that to the extent that these functions may influence savings and investment decisions, they can also influence economic growth.

Lately, however, a growing body of literature seems to be circumspect about the foregoing. These studies have for instance, pointed out that most of these studies have used cross-country data sets from 1960-1989. Since legal structures, cultural and economic histories differ between countries; the possibility of omitted variable bias has often been raised when discussing the results of cross-country studies.

Although more recent studies such as Levine et al (2000) have used methods that are less prone to biases caused by simultaneity, omitted variables and unobserved country-specific effects, the debate has continued. In order to reduce unobserved heterogeneity at the cross-sectional level, Ardic and Damar (2006) used provincial level data to investigate the link between financial sector development and economic growth in Turkey during the period 1996-2001. The results of the study revealed a strongly negative relationship between financial deepening and growth in real GDP per

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| <p>capita in Turkish provinces. They ascribed the reason for this to the inefficient banking sector during this period when the Turkish banking sector channeled deposits into the Treasury.</p> <p>Using a similar approach to side-step the problems of omitted variables and unobserved country-specific effects and arriving at different results, Hasan et al (2007) used panel data for the Chinese provinces to study the role of legal institutions, financial deepening and political pluralism on growth rates. Their regression results showed that the development of financial markets, legal environment, awareness of property rights and political pluralism are associated with stronger growth.</p> <p>In trying to look into the debate on the direction of causality (simultaneity) between financial liberalisation and economic growth in Mozambique, de Jesus Emidio (2007) utilised the co-integration test and the Granger-causality test to determine the economic growth financial deepening relationship and the direction of causality between economic development and financial deepening, respectively. The co-integration test suggested that there is a long-run relationship between economic growth and financial deepening and weak exogeneity tests and Granger-causality tests indicated that economic development is causally dependent on financial deepening in Mozambique.</p> <p>2.2 The Overview of Pension Systems in Nigeria</p> <p>The history of Nigeria's pension system dates back to the year 1951 when the first pension scheme was inaugurated in the country. According to Balogun (2006), Nigeria's first ever legislative instrument on pension matters was the Pension Ordinance of 1951 which had a retroactive effect from 1st January, 1946. The law provided public servants with both pension and gratuity. The National Provident Fund (NPF) which was established in 1961, was the first legislation enacted to address pension matters of private organisations. Pensions Decrees 102 and 103 (for the military) of 1979 were enacted with retroactive effect</p> | <p>from April, 1974 (Ahmad, 2006).</p> <p>The police and other Government Agencies' Pension Scheme were enacted under Pension Act No. 75 of 1987. This was followed by the Local Government Pension Edict which culminated into the establishment of the Local Government Staff Pension Board of 1987. In 1993, the National Social Insurance Trust Fund (NSITF) scheme was established by decree No. 73 of 1993 to replace the defunct NPF scheme with effect from 1st July, 1994 to cater for employees in the private sector of the economy against loss of employment income in old age, invalidity or death.</p> <p>Before 2004, most public organisations operated a Defined Benefit (Pay-As-You-Go) scheme and final entitlements were based on length of service and terminal emoluments. The defined benefit pension scheme in Nigeria was plagued by many problems among which were poor funding due to inadequate budgetary allocations [for instance shortage of budgetary releases relative to benefits resulted into unprecedented and unsustainable outstanding pension deficit estimated at over N2 trillion before 2004 (Balogun, 2006)], weak, inefficient and non-transparent administration. There was no authenticated list/data base on pensioners and about 14 documents were required to file for pension claims. Restrictive and sharp practices in the investment and management of pension funds exacerbated the problem of pension liabilities and over 300 parastatals' schemes were bankrupt before the defined benefit scheme was finally jettisoned and replaced with the funded contributory benefit scheme in July, 2004.</p> <p>The new pension scheme was established for all employees of the Federal Public Service, Federal Capital Territory and the private sectors (including informal sector employees) in Nigeria. The major operators under the scheme are the National Pension Commission (PenCom), Pension Fund Administrators (PFAs), Closed Pension Fund Administrators (CPFAs) and Pension Fund Custodians (PFCs). Being a</p> | <p>contributory scheme, employees are to contribute minimum of 7.5 percent of basic salary, housing and transport allowances and employers are to also contribute a matching fund. So the total minimum monthly contribution of a typical employee contributor under the scheme is 15 percent of basic salary, housing and transport allowances.</p> <p>PenCom was established to regulate, supervise and ensure an effective administration of pension matters. In this regard, the commission is mandated under the Act to, inter alia, establish standard rules for the management of pension funds, approve, license and regulate PFAs, PFCs and CPFAs, manage national data bank on pension, impose sanctions or fines on erring employers, PFAs, PFCs and CPFAs and ensure that payment and remittance of contributions are made and beneficiaries of retirement savings accounts (RSAs) are paid as and when due. In order to avoid the illiquidity and unsustainability that plagued the erstwhile defined benefit (PAYG) system, the Act and subject to enforcement by PenCom, specifically spelt out the investment of pension assets.</p> <p>According to Balogun (2006), Peterside (2006) and Dalang (2006), pension funds should be invested in ordinary shares of companies quoted on Securities and Exchange Commission (SEC), regulated securities exchange and money market investments which must be made on a money market electronic platform approved by the Central Bank of Nigeria (CBN) or the Money Market Association of Nigeria. To ensure that investments made by PFA are of the highest quality, the guidelines require that investment instruments and companies invested in must have at least "BBB" rating from at least two rating agencies. Banks whose instruments are being invested in must have a minimum "A" rating from at least two agencies and securities issued via Initial Public Offering (IPO) must be listed on a recognised Stock Exchange and must also have "AAA" ratings from at least two rating agencies.</p> <p>As for money market and fixed income securities, PFAs are only</p> |
|--|--|--|

allowed to invest in Federal and State Government Bonds, Nigerian Treasury Bills, corporate bonds and preference shares, as well as bank deposits. Capital market investments allowed are ordinary shares of listed companies with 3 out of 5 preceding years' profitability and dividend payment, units of open-ended unit trusts, units of closed unit trust Mortgage-backed Securities (MBS), Real Estate Investment Trusts (REITs) and asset backed securities.

In order to effectively manage investment risks across the various assets, [Balogun (2006); Peterside (2006); Dalang (2006)] all submitted that the Act stipulated and subject to PenCom supervision and enforcement, the following diversification guidelines i.e. the maximum investment in portfolios of pension fund assets; Federal Government Securities 100 per cent; State Government Securities 20.0 per cent; Corporate Bonds/Debt including Real Estate Investment Trusts and Mortgage-backed Securities 30.0 per cent; Money Market Instruments 25.0 per cent; Ordinary Shares 25.0 per cent and Open-ended and Closed Funds 5.0 per cent.

The PFAs are basically private limited liability companies licensed to manage pension funds under the Act. All investment decisions of pension funds are made by the PFAs. Some private organisations or public agencies run self-funded and well-managed pension schemes. Such organisations or agencies who wish to continue running such schemes are licensed under the Act to perform functions essentially similar to the PFAs. These organisations or agencies are called the CPFAs. PFCs are banks licensed to hold the pension fund assets on behalf of the PFAs. They do not make decisions as to how funds entrusted in their care should be invested.

3.0 METHODOLOGY

Secondary data on some key macroeconomic indices relevant to the paper in the Nigerian economy were collected from the period 2001 to 2007. These indices are the nominal GDP, domestic credit to the private

sector (DCP), stock-market capitalisation (SMC), total bank deposit liabilities (TBD), currency in circulation (C), broad money (M2), total domestic savings (TDS), and the inflation rates. The sources of these data are CBN Annual Reports and Statement of Accounts (2001-2007) and CBN Statistical Bulletin (2001, 2007).

Some of these data were transformed into measures of financial deepening including degree of trust in the economy and real gross domestic product (RGDP). As regards measures of financial deepening, the following computational approaches were adopted: domestic credit to the private sector as a share of GDP $\left[\frac{DCP}{GDP}\right]$

as in Khan (2002), McDonald and Schumacher (2007), Hasan et al (2007) and Singh et al (2007); domestic credit to the private sector as a share of GDP plus stock market capitalisation as a share of GDP $\left[\frac{DCP + SMC}{GDP + SMC}\right]$ as in Khan (2002); total bank deposits divided by GDP- $\left[\frac{TBD}{GDP}\right]$

as in Ardic and Damar (2006), de Jesus Emidio (2007) and Hasan et al (2007). In order to capture the degree of enforcement of contracts and the protection of property rights (quality of institutions) and therefore the level of trust in the economy as mentioned in Kiyotaki and Moore (2005), the contract intensive money (CIM) was utilised as in Clague et al (1999). The CIM is very objective because it avoids the problem of ordinality inherent in the use of other indexes of institutional quality.

The CIM is derived thus:

$$CIM = M_2 - C/M_2$$

Where:

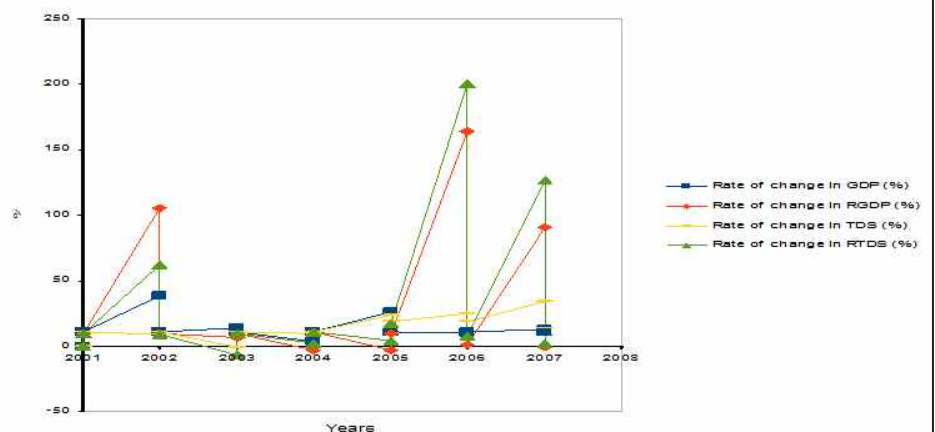
- CIM = Contract Intensive Money
- C = Currency in Circulation
- M₂ = Broad Money

Contract intensive money of one (1) indicates a high degree of trust in the economy while contract intensive money of zero (0) shows an absolute lack of trust in the economy. The CPI data were used to generate inflation series. RGDP data were derived by using the CPI data to deflate the nominal GDP figures. Likewise, the CPI figures were used to deflate the nominal TDS figures to get the RTDS figures.

Since the data are of time series in nature and based on the survey of literature, the appropriate method of analysis should be regression analysis. But since the observations on the indices are inadequate, any regression performed would suffer from many econometric problems among which is serial correlation; so the appropriate method of analysis of the bi-annual data, in this instance, is descriptive analysis.

In order to evaluate the performance of domestic savings, nominal GDP, real GDP, measures of financial deepening including contract intensive money, the study period was broken into two sub-periods, viz: 2001 to 2004 (pre-pension reform period) and 2004 to 2007 (post-reform period). In essence then, this paper is a country-specific, inter-temporal comparative one.

Figure 1: Trends in the Rate of Growth of Nigeria's GDP, RGDP, TDS and RTDS (2001-2007)



2.0 DISCUSSION

Figure 1 shows that the rate of growth of nominal domestic savings (TDS) from the first half of the first year (2001) of the pre-pension reform period was about 11.11 percent. This index decreased to about 9.46 percent at the end of this period. At the start of the post-pension reform period in the first half of 2004, the growth rate of TDS was about 11.11 percent and at the end of the period, it increased to about 14.01 percent. The average rate of growth of TDS during the pre-pension reform period was about 7.38 percent, while the average rate of growth of TDS during the post-pension reform period was about 21.81 percent (see Table 3, Appendix III). In real terms, Figure 1 also shows that the rate of growth of real domestic savings (RTDS) from the first half of the first year of the pre-pension reform period was about 10.02 percent. This index decreased to about 2.63 percent at the end of this period. At the start of the post-pension reform period in the first half of 2004, the growth rate of RTDS was about 11.15 percent and at the end of the period, it decreased to about 2.20 percent. However, the average rate of growth of RTDS during the pre-pension reform period was about 12.42 percent while the average rate of growth of RTDS during the post-pension reform period was about 52.94 percent (see Table 3, Appendix III). What this implies is that after the defined contributory pension scheme was introduced, total domestic savings increased somewhat both in nominal and real terms.

Figure 1 also shows that at the start of the pre-pension reform period in

2001, the rate of growth of nominal GDP was about 11.11 percent and at the end of this period, the growth rate of nominal GDP decreased to about 3.65 percent. At the start of the post-pension reform period in the first half of 2004, the growth rate of nominal GDP increased to about 11.11 percent and at the end of this period in 2007 it remained at that level. The average rate of growth of nominal GDP during the pre-pension reform period was about 12.82 percent while the average growth rate of the nominal GDP during the post-pension reform period was about 13.39 percent.

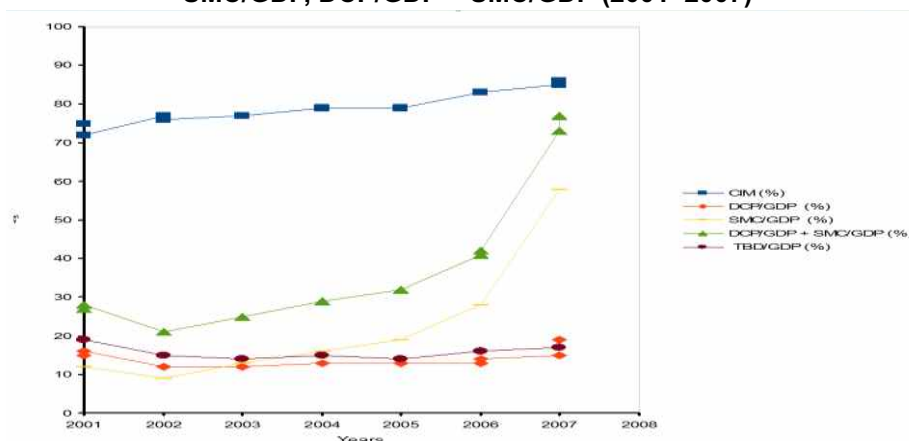
A marginal increase in real terms, at the start of the pre-pension reform period in 2001, the rate of growth of RGDP was about 10.02% and it decreased to a negative value of about -2.83 percent. At the start of the pre-pension reform period in 2004, the rate of growth of RGDP was about 11.11 percent and at the end of the period in 2004, it decreased to a negative value of about -0.38 percent. The average growth rate of RGDP during the pre-pension reform period was about 23.10 percent while the average growth rate of RGDP during the post-pension reform period was about 39.09 percent (see Table 3, Appendix III). When the growth rates in the two periods are compared, it can be seen that those growth rates are comparable. So the appreciable increase in nominal and real domestic savings cannot be said to have its origin in the growth of nominal and real Gross Domestic Product. But did the increase in savings lead to increased intermediation and financial deepening?

Figure 2 shows that the DCP/GDP measure of financial deepening was about 15 percent at the start of the pre-pension reform period. It closed the period by decreasing to 13 percent. At the start of the post-pension reform period, it remained at 13 percent and at the close of the period it increased to about 19 percent - a marginal increase in its performance during the post-pension reform period.

Also, figure 2 shows that the TBD/GDP measure of financial market deepening was about 19 percent at the start of the pre-pension reform in 2001. It decreased to about 15 percent at the end of this period. At the start of the post-pension reform period in 2004, it stood at the 15 percent mark and increased to about 17 percent at the end of the post-pension reform period. It should be noted that the performance of this measure at the close of the post-pension reform period was far less than the value of this measure at the start of the pre-pension reform period. So the TBD/GDP measure returned a very poor performance during the reform period. When the behaviour of the DCP/GDP and TBD/GDP measures are considered, it can be said that intermediation during the post-pension reform was poor and quite understandably so as one measure feeds the other measure i.e. the TBD/GDP feeds DCP/GDP in this instance.

The SMC/GDP measure of financial deepening at the start of the pre-pension reform period was about 12 percent and at the end of the period, it increased to about 16 percent. At the start of the post-pension reform, it remained at about 16 percent. At the end of this period, this measure increased appreciably to 58 percent. When the DCP/GDP and SMC/GDP measures were combined, a better performance was realised. At the start of the pre-pension reform period in 2001, DCP/GDP + SMC/GDP measure of financial deepening was about 27 percent and at the end of the period it increased quite marginally to about 29 percent. At the start of the post-pension reform period, the measure still stood at about 29 percent. At the end of the period, it had increased substantially to about 77 percent. It must really be

Figure 2: Trends in Nigeria's CIM, DCP/GDP, SMC/GDP, DCP/GDP + SMC/GDP (2001-2007)



emphasised though that this improvement in performance was largely due to the performance of the SMC/GDP and not the performance of the DCP/GDP measure.

Figure 2 also shows that the CIM as a measure of financial deepening at the start of the pre-pension reform period was about 75 percent. At the end of this period in the first half of 2004, it marginally increased to 79 percent. At the start of the post-pension reform period in the second half of 2004, it still stood at 79 percent. At the close of the period in 2007, it marginally increased to 86 percent.

As it has been shown, the measures of financial deepening like the DCP/GDP, TBD/GDP and CIM have not performed spectacularly well as they have all turned in less than impressive performances. But can it now be said that the better performance of the DCP/GDP + SMC/GDP and the SMC/GDP measures translated into increased nominal GDP and RGDP? As it has been discussed earlier, the increases in the nominal GDP and RGDP during the post-pension reform period when compared with pre-pension reform period were quite minimal and as such it cannot be said that these measures contributed to their growths.

5.0 RECOMMENDATIONS AND CONCLUSION

5.1 Recommendations

The following are recommended: although the TDS may have increased probably due to pension funds, there is indeed room for improvements in this area. Presently, the only group participating in Nigeria's defined contributory pension scheme is the Federal Government's employees. The perennial high unemployment rate and the high excess capacity rates in Nigeria's industries, if not reversed may lead to low participation rate which in the future may erode the base of the scheme causing the number of retirees to outstrip the number of the workers in the labour force who should be supporting the system. This outcome is not the same but similar in consequence to the problem presently confronted by pension systems in the industrial economies of North America, Europe and Asia where as a result of longevity

and low fertility rates, the bases of these systems may be thinning out (lower replacement rates) which if not reversed may cause the retirees, in the case of Nigeria, represented by their PFAs to offload huge amounts of equities into the market in an attempt to make the pensioners maintain their old living standards. The outcome of this would be lower returns on these assets and lower living standards of the retirees.

The other arms of governments at the states and local governments' levels must emulate the federal government in making the participation of their employees in the new scheme compulsory and this must be inserted as a clause in their conditions of service. Nigerian governments at all levels must also face squarely the problem of perennial unemployment and excess capacities plaguing the Nigerian economy by instituting employment-boosting policies like for instance, retraining employees who as a result of the changing structure of the domestic and foreign economies become unemployable. This can be done by governments sending these unemployed and unemployable agents to government approved but privately-run retraining centres.

Another way by which governments can increase employment and hence improve participation rate is for governments to commit more resources to the education sector. One crucial positive externality can be derived from this. Improved funding for education implies that more research in the area of technology would be carried out in Nigerian institutions. This may cause innovations to be discovered. The industries in Nigeria, which are presently operating at excess capacities, and whose manufactured exports are low, may partner with these institutions and tap into the innovations and incorporate them into their production processes. This, coupled with the fact that increased funding for education would produce a pool of well disciplined and more productive workforce would enable the Nigerian industries to produce more qualitative and quantitative goods that would compete favourably in the international markets. The ensuing better-terms-of-trade for Nigerian manufactured goods would

generate employment and income.

The workers in the informal sector (artisans and traders), can be encouraged to join the new pension scheme by governments embarking on media sensitisation campaign to educate this group on the positive aspects of the scheme.

In order to reverse the poor performances of DCP/GDP, TBD/GDP and CIM measures of financial deepening, the banking regulations as outlined in the banking sector reforms must be seriously enforced by the appropriate regulatory agencies so as to improve intermediation. That may be achieved because of customers' confidence that their deposits would not be lost due to insolvencies of banks. And in the event of insolvencies, the judicial system would wade in appropriately in cases where some banks try to prove difficult and ensure that customers are paid back their deposits promptly so that hidden losses would not be incurred by depositors through an erosion of the purchasing power of the naira that may be caused by ravaging inflation. This would happen if Nigeria's judicial system is truly reformed such that the practitioners in the system are enabled to readily enforce contract laws and protect property rights.

Although the DCP/GDP + SMC/GDP measure of financial deepening has improved due to the SMC/GDP component, there is also room for improvements. Nigeria's capital market and the pension funds management guidelines as outlined by PenCom are plagued by what is referred to as "home bias". This term means that portfolios are concentrated in the domestic market of investors (Oxera, 2007). The Nigerian capital market must be internationalised such that domestic institutional investors can invest in foreign-based instruments and likewise, foreign institutional investors can invest in Nigerian-based instruments. Granted that PenCom relaxes its guidelines, this objective is achievable only if the Nigerian stock exchange is ICT compliant through the acquisition and use of the state-of-the-art ICT hardware and software such that Nigerian-based instruments are listed on the exchanges in New York, London, Paris, Singapore and

| | | |
|---|---|---|
| <p>Johannesburg and vice versa.</p> <p>Internationalisation of the market may as a result of foreign investors' demand for new investment instruments, compel the Nigerian capital market operators to float such new and innovative instruments. This may further deepen Nigeria's capital market. Some other advantages of internationalisation are the reduction of risk and higher average returns. In this regard, Jorion and Goetzmann (1999) have submitted that greater international diversification results in higher average returns and/or lower risk compared with a domestic investment strategy.</p> <p>5.2 Conclusion</p> <p>From the results in section (4.0), the</p> | <p>following can be concluded: First, TDS increased both nominally and in real terms during the post-pension reform period. Second, the increase in TDS cannot be said to have its origin in GDP growth as the GDP only increased marginally in both nominal and real terms during the post-pension reform period. So the increase in TDS must have been derived from a different source other than from the GDP which may be from pension funds. Third, the DCP/GDP, TBD/GDP and CIM measures of financial deepening did not improve appreciably during the post-pension reform period. This indicates the possibility that there was poor intermediation in the banking industry as the TBD/GDP feeds the DCP/GDP. The low CIM also points at the</p> | <p>possibility that the level of trust in the Nigerian economy is low due largely to poor enforcement of contract laws and lack of protection of property rights. So the Nigerian economic agent is still reluctant to put his money in naira denominated instruments. Fourth, the measures of financial deepening that showed remarkable improvement was the DCP/GDP + SMC/GDP and this was due largely to the good performance of the SMC/GDP component. This buttress the fact that the Nigerian capital market had achieved some measure of deepening. But this has not translated into nominal GDP or RGDP growth.</p> |
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APPENDIX I

Table 1: Nigeria's Currency in circulation (C), Broad Money (M2), Inflation rates, CPI, Nominal GDP, RGDP, TDS, DCP, SMC, TBD (2001 - 2007).

| (i) Year | (ii) Currency in Circulation (C) (₦ bln) | (iii) Broad Money (M2) (₦ bln) | (iv) Inflation Rates (%) | (v) CPI | (vi) Normal GDP (₦ bln) | (vii) RGDP (₦ bln) |
|--------------------------|---|--|-----------------------------------|--------------------------|----------------------------------|--------------------------|
| 2001 | | | | | | |
| 1 | 323.72 | 1302.72 | 18.70 | 100 | 4669.11 | 46.69 |
| 2 | 357.28 | 1315.87 | 18.90 | 101 | 5187.90 | 51.37 |
| 2002 | | | | | | |
| 1 | 370.09 | 1583.51 | 12.80 | 68 | 7185.96 | 105.68 |
| 2 | 390.21 | 1599.50 | 12.90 | 69 | 7984.40 | 115.72 |
| 2003 | | | | | | |
| 1 | 446.50 | 1965.35 | 13.90 | 74 | 9122.76 | 123.28 |
| 2 | 451.32 | 1985.20 | 14.00 | 75 | 10136.40 | 135.15 |
| 2004 | | | | | | |
| 1 | 467.38 | 2240.96 | 14.90 | 80 | 10506.24 | 131.33 |
| 2 | 478.90 | 2263.59 | 15.00 | 80 | 11673.60 | 145.92 |
| 2005 | | | | | | |
| 1 | 557.61 | 2600.20 | 17.70 | 95 | 13405.05 | 141.11 |
| 2 | 563.24 | 2626.46 | 17.90 | 96 | 14894.50 | 155.15 |
| 2006 | | | | | | |
| 1 | 587.02 | 3395.86 | 7.38 | 40 | 16400.52 | 410.01 |
| 2 | 651.57 | 3735.45 | 8.20 | 44 | 18222.80 | 414.15 |
| 2007 | | | | | | |
| 1 | 726.83 | 4889.70 | 4.86 | 26 | 20564.01 | 790.92 |
| 2 | 776.77 | 5378.67 | 5.40 | 29 | 22848.90 | 787.89 |
| (viii) DCP (₦ bln) | (ix) SMC (₦ bln) | (x) TBD (₦ bln) | (xi) Nominal TDS (₦ bln) | (xii) RTDS (₦ bln) | | |
| 709.66 | 583.61 | 877.98 | 439.30 | 4.39 | | |
| 820.26 | 648.45 | 975.53 | 488.05 | 4.83 | | |
| 897.07 | 672.84 | 1088.77 | 532.89 | 7.84 | | |
| 964.01 | 747.60 | 1209.75 | 592.10 | 8.58 | | |
| 1112.46 | 1192.41 | 1275.35 | 590.17 | 7.98 | | |
| 1231.18 | 1324.90 | 1417.06 | 655.74 | 8.74 | | |
| 1340.06 | 1733.35 | 1600.84 | 717.77 | 8.97 | | |
| 1503.26 | 1925.94 | 1778.71 | 797.52 | 9.97 | | |
| 1708.39 | 2610.05 | 1832.48 | 985.02 | 10.37 | | |
| 1968.39 | 2900.03 | 2036.09 | 1171.64 | 12.20 | | |
| 2107.18 | 4608.85 | 2634.79 | 1466.75 | 36.67 | | |
| 2547.14 | 5120.94 | 2976.35 | 1741.60 | 39.58 | | |
| 3078.10 | 11965.12 | 3443.63 | 2336.54 | 89.87 | | |
| 4335.26 | 13294.58 | 3958.98 | 2663.78 | 91.85 | | |

Sources: (i) CBN Annual Report and Statement of Accounts (2001 - 2007)

(ii) CBN Statistical Bulletin (2001, 2007).

APPENDIX IITable 2: Nigeria's CIM , $\frac{DCP}{GDP}$, $\frac{SMC}{GDP}$, $\left[\frac{DCP}{GDP} + \frac{SMC}{GDP}\right]$, $\frac{TBD}{GDP}$ (2001 – 2007)

| (i) Year | (ii) CIM | (iii) CIM (%) | (iv) $\frac{DCP}{GDP}$ | (v) $\frac{DCP}{GDP}$ (%) | (vi) $\frac{SMC}{GDP}$ | (vii) $\frac{SMC}{GDP}$ (%) | (viii) $\left[\frac{DCP}{GDP} + \frac{SMC}{GDP}\right]$ | (ix) $\left[\frac{DCP}{GDP} + \frac{SMC}{GDP}\right]$ (%) | (x) $\frac{TBD}{GDP}$ | (xi) $\frac{TBD}{GDP}$ (%) |
|-------------|-------------|---------------------|---------------------------|------------------------------|---------------------------|--------------------------------|--|--|--------------------------|-------------------------------|
| 2001 | | | | | | | | | | |
| 1 | 0.75 | 75 | 0.15 | 15 | 0.12 | 12 | 0.27 | 27 | 0.19 | 19 |
| 2 | 0.72 | 72 | 0.16 | 16 | 0.12 | 12 | 0.28 | 28 | 0.19 | 19 |
| 2002 | | | | | | | | | | |
| 1 | 0.77 | 77 | 0.12 | 12 | 0.09 | 9 | 0.21 | 21 | 0.15 | 15 |
| 2 | 0.76 | 76 | 0.12 | 12 | 0.09 | 9 | 0.21 | 21 | 0.15 | 15 |
| 2003 | | | | | | | | | | |
| 1 | 0.77 | 77 | 0.12 | 12 | 0.13 | 13 | 0.25 | 25 | 0.14 | 14 |
| 2 | 0.77 | 77 | 0.12 | 12 | 0.13 | 13 | 0.25 | 25 | 0.14 | 14 |
| 2004 | | | | | | | | | | |
| 1 | 0.79 | 79 | 0.13 | 13 | 0.16 | 16 | 0.29 | 29 | 0.15 | 15 |
| 2 | 0.79 | 79 | 0.13 | 13 | 0.16 | 16 | 0.29 | 29 | 0.15 | 15 |
| 2005 | | | | | | | | | | |
| 1 | 0.79 | 79 | 0.13 | 13 | 0.19 | 19 | 0.32 | 32 | 0.14 | 14 |
| 2 | 0.79 | 79 | 0.13 | 13 | 0.19 | 19 | 0.32 | 32 | 0.14 | 14 |
| 2006 | | | | | | | | | | |
| 1 | 0.83 | 83 | 0.13 | 13 | 0.28 | 28 | 0.41 | 41 | 0.16 | 16 |
| 2 | 0.83 | 83 | 0.14 | 14 | 0.28 | 28 | 0.42 | 42 | 0.16 | 16 |
| 2007 | | | | | | | | | | |
| 1 | 0.85 | 85 | 0.15 | 15 | 0.58 | 58 | 0.73 | 73 | 0.17 | 17 |
| 2 | 0.86 | 86 | 0.19 | 19 | 0.58 | 58 | 0.77 | 77 | 0.17 | 17 |

Source: Author's Computation.

APPENDIX III

Table 3: Rate of change in GDP, RGDP and TDS in the Nigerian Economy (2001 – 2007)

| (i) Year | (ii) Rate of change in GDP (%) | (iii) Rate of change in RGDP (%) | (iv) Rate of change in TDS (%) | (v) Rate of change in RTDS (%) |
|-------------|---|--|---|---|
| 2001 | | | | |
| 1 | - | - | - | - |
| 2 | 11.11 | 10.02 | 11.10 | 10.02 |
| 2002 | | | | |
| 1 | 38.51 | 105.73 | 9.19 | 62.32 |
| 2 | 11.11 | 9.50 | 11.13 | 9.44 |
| 2003 | | | | |
| 1 | 14.26 | 6.53 | -0.33 | -6.99 |
| 2 | 11.11 | 9.63 | 11.11 | 9.52 |
| 2004 | | | | |
| 1 | 3.65 | -2.83 | 9.46 | 2.63 |
| 2 | 11.11 | 11.11 | 11.11 | 11.15 |
| 2005 | | | | |
| 1 | 26.32 | -3.30 | 23.51 | 4.01 |
| 2 | 11.11 | 9.95 | 18.95 | 17.65 |
| 2006 | | | | |
| 1 | 10.11 | 164.27 | 25.19 | 200.57 |
| 2 | 11.11 | 1.01 | 18.73 | 7.94 |
| 2007 | | | | |
| 1 | 12.85 | 90.97 | 34.16 | 127.06 |
| 2 | 11.11 | -0.38 | 14.01 | 2.20 |

Source: Author's Computation.

THE CHALLENGES OF POWER SUPPLY IN ENHANCING INTEGRATION PROCESSES IN ECOWAS MEMBER COUNTRIES

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1.0 INTRODUCTION

The most significant challenge facing the West Africa today is access to adequate power supply. Energy is a significant part of the total infrastructure that allows rural and urban poor to grow beyond subsistence activity, to generate individual savings and increase their demand for modern energy services. It must be stated upfront that the region is more than adequate to meet its short and medium-term requirements, taking into account the numerous resources in terms of human and material resources, especially water which can be harnessed into hydroelectricity. For example, the bandama river in Cote d'Ivoire, Cavally river that span through Liberia and Cote d'Ivoire, River Niger which passes Mali, Guinea, Niger and Nigeria, Volta River which cut across Ghana and Burkina-Faso to mention just a few which if adequately harnessed are the drivers for growth and economic development.

Generally, infrastructures are facilities and amenities which a population needs for its welfare, some of which are basic necessities of life that every primitive society needs to be able to survive. The quality of life in a society

Abstract

The birth of the Economic Community of West African States (ECOWAS) in 1975 as an instrument for fostering regional development and unity was also due to the limited economic coherence within the sub-region. This prompted their leaders to embrace regional integration as a central element of their development strategy. There has been increased awareness among these countries that progressive integration holds great potential for minimizing the costs of market fragmentation and thus, represents a precondition for integrating the region into the global economy. Cooperation and integration is also necessary to improve West Africa's competitiveness and position it to maximize the benefits of globalization. Enhancing the region's access to global markets will inevitably dovetail into sustaining economic and social growth. Power and energy are indispensable for sustainable development. Reliable power supply is an absolute prerequisite to economic growth; jobs creation; enhancement of value-added economic activities and support of income-earning activities not only in the urban but especially in rural areas, thus improving living standards. Integration is one of the most promising and cost-effective options for the Economic Community of West African States (ECOWAS) to further the development of its energy sector, in order to gain the environmental, social and economic benefits accruing from a more efficient use of resources. It was in realization of the above that ECOWAS leaders in November 1999 conceived the idea of West African Power Pool (WAPP) and the West African Gas Pipeline (WAGP) aimed at integrating power and energy supply to the region. However, as sound and well conceived this line of reasoning might be, the region still suffers from inadequate power.

is to a large extent determined by the quality and quantity of infrastructural facilities and services available to it at any given point in time. The importance of these especially the energy supply cannot be overemphasized.

Power is very important in the quest for economic and industrial development of any nation. With steady power supply, the simulation of indigenous technological development as well as creation of job for teaming graduates becomes inevitable. More importantly the cost of doing business in West Africa is bound to reduce with better returns to investors, and it could also lead to the opening up of new areas of manufacturing that once seemed unattractive for investors as a result of new reliance on uninterrupted power supply. The achievement of

increasing returns coupled with increased output made possible by increased investment in the electricity sector would impact positively on other sectors of the economy and ultimately on economic growth.

The objective of the paper is to examine the benefits and the challenges that would accrue to ECOWAS countries by harnessing the potentials of their energy through integration for development. This is because, integration holds great potential for minimizing the costs of market fragmentation and thus, represents a precondition for integrating the region into the global economy. Cooperation and integration is also necessary to improve West Africa's competitiveness and position it to maximize the benefits of globalization. Enhancing the region access to global

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markets will inevitably dovetail into sustaining economic and social growth. Power and energy are indispensable for sustainable development.

This paper is structured into six parts. The introduction forms part one while part two reviews the literature. Part three is devoted to advantages that would accrue to the region through integration while part IV deals with the appraisal of policies with special reference to energy (electricity) for sustainable integration and development in West Africa. Part five and six concludes the paper with some recommendations.

2.0 REVIEW OF LITERATURE

Comparative economic history has shown that sustainable social development will remain a mirage in any developing country if the energy sector is neglected. The importance of energy in the economic development process particularly of developing countries is well known and documented in the literature (ADB, 1996; Iwayemi, 1983, 1993, 1998; Karekezi and Ranja, 1997; Orubu, 2004). This is because energy demand, supply and pricing impact positively on the socio-economic development, the living standards and the overall quality of life of the people (Iwayemi, 1998). The extensive use of energy and energy based inputs in the production process of nations cannot thus be overemphasised.

Historically, increases in power sector had been the traditional path to industrialization and economic development. The long-term economic and social development of any country particularly in ensuring rapid industrial production not only in the big industrial set up of West Africa but also the Small and Medium Scale Enterprises (SME) requires the effective delivery and management and use of its energy resources especially electricity. The causality between energy consumption and economic growth especially in enhancing integration was first brought to light by the seminal paper of Kraft and Kraft (1978). They averred that while the level of economic activity may influence energy consumption and enhance

integration, the level of gross energy consumption has no causal influence on economic activity. The implication being that energy conservation policies can be intimated without aggravating the side effects of economic growth.

Other studies that have found unidirectional relationship running from regional growth to energy consumption are Soyatas and Sari (2004) for Italy and Korea; Fatai, Oxley and Scrimgeour (2004) in New Zealand; Ghosh (2002) for India (using inter-country electricity consumption), for Taiwan (using coal consumption); Cheng and Lai (1997) in Taiwan Province of China; Ageel and Butt (2001) for Pakistan among others.

Soyatas and Sari (2002) and Lee (2004) for Taiwan are some other studies that have also found unidirectional relationship from energy consumption to economic growth and not in the reverse unlike the earlier examples. Similar studies have also established bidirectional causality between economic growth and energy consumption. Examples are Glausure and Lee (1977) for South Korea and Singapore.

Ebohon (1996) investigated the causality between energy consumption and economic growth for Nigeria. He noted that power is life, consequently its quality, quantity, availability, accessibility and reliability for life sustenance in particular in boosting industrial production cannot be overemphasized. Access to electricity remains an urgent human need in many ECOWAS countries. Despite the fact that budgetary provisions were made for power, actual provision have not met the expectations of the generality of the people.

Adequate policies in the energy sector supported by adequate legal and institutional framework are essential tools for sustainable development. Indeed, throughout the world those countries that industrialized rapidly had already built up strong energy sector. Today, globalization is usually discussed as if it is only concerned with the advancement of information technology and the development of a

vibrant and productive manufacturing sector. The importance of power sector for sustainable development in a globalizing economy has become critical. West Africa, like many other regional blocs, have over the past four decades stated and pursued the objective of accelerating the pace of development of the economy in the bid to transform into the group of developed or industrialised region.

3.0 REGIONAL INTEGRATION IN ECOWAS COUNTRIES THROUGH POWER SUPPLY

The delineation of West Africa into many countries with limited economic, political or geographical coherence, following political independence, led ECOWAS leaders to embrace regional integration as a central element of their development strategies. Except some few, the small size of the economy provided the rationale for pursuing mutually beneficial economic cooperation and regional integration. There is a growing realization among the regional leaders that progressive integration holds a greater potential for minimizing the cost of market fragmentation and thus, represents a precondition for integrating the countries into the global economy. Specifically, regional cooperation and integration are also necessary to increase ECOWAS countries access to global markets. Thus, the vision and commitment of West African leaders to the objective and principles of political and economic cooperation, led them to create the Economic Community of West African States (ECOWAS) in 1975 as an instrument for fostering regional development and unity.

3.1 Advantages of Regional Integration

Regional economic integration has an important role to play in accelerating economic growth and sustainable development in West Africa and in the following ways:

- Regional energy cooperation and integration offer one of the most promising and cost-efficient options for developing countries, especially in West Africa to further develop the power and energy sectors, in order to gain

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| <p>the environmental, social and economic benefits from a more efficient use of resources.</p> <ul style="list-style-type: none"> Regional energy integration has been playing an important role in securing provision of energy services to millions of people in West Africa. Market expansion, which will promote greater specialization and faster industrialization through economies of scale and will help mitigate the problems associated with smaller market size in the region. The growth in domestic and foreign direct investment and the increasing competitiveness of the region in the world economy. Rapid and extensive improvement in economic efficiency through enhanced competition among the participating countries and increased incentives for the deployment of new technologies and methods of production alongside rapid innovation. Economic efficiency is one of the three pillars of sustainable development. Energy helps economic development at the local level by raising productivity and enabling local income generation. The availability of jobs, productivity increases or better economic opportunities are all severely limited without access to modern energy. Greater regional co-operation in infrastructure projects such as energy, will reduce transaction costs; facilitate market integration; promote economic integration and growth in Africa, and increase the incentives for investment, particularly by the private sector. Improved energy trade coupled with energy integration programmes will contribute to accelerated economic growth; the achievement of Millennium Development Goal (MDG): the eradication of extreme poverty and hunger; through economic growth and increased availability of electricity for social purposes. | <ul style="list-style-type: none"> Opportunities of buying lower cost energy through integration would be possible. The Republics of Togo and Benin, through their electricity interconnections with Ghana have sustained their economies and guaranteed a minimum quantity of electricity supplied from Ghana for a 25 year period. In addition, there have been opportunities of buying lower cost energy from Ghana compared with local resources. Access to electricity and other modern energy sources is crucial for economic and social development. Modern energy services are vital to the quality of life. The eradication of poverty requires, among other things, clean water, adequate sanitation and health services, a good education system and a communication network. None of these can be achieved without energy. Power interconnections and regional trade have gained importance as a mechanism for improving the economic efficiency of power system. The value of the power interconnection derived from the ability to achieve economies of scale as individual smaller power systems can be operated and expanded as part of a larger regional system. <p>3.2 Enhancing ECOWAS Integration through West Africa Power Pool (WAPP)</p> <p>and West Africa Gas Pipeline (WAGP) At its 3rd meeting held in Accra, Ghana on 5 April 2002, the West African Power Pool (WAPP) Steering Committee adopted Resolution No.1 relating to the objectives of the West African Power Pool. One of these objectives is to increase the overall level of electrification within the region. The WAPP is expected to fast-track the development of the region in this respect.</p> <p>Briefly, a power pool is traditionally referred to as an arrangement between two or more interconnected electric systems, which are planned and operated to supply power in the most reliable and economical manner</p> | <p>for their combined load requirements. Pooling total production capacity from all the power plants facilitates the dispatching of excess capacity from one system to another. Accordingly, centrally dispatched power pools are expected to achieve increased efficiencies by selecting the least-cost mix of generating and transmission capacity, by coordinating maintenance of units and sharing operating reserve requirements.</p> <p>A World Bank study in 2006 has indicated that an estimated saving of US\$1.6 billion over 10 years could be realized through the optimal use of the regional electricity resources and installations. Such quantifiable benefits are driving other regions to diversify their energy supply base. The West Africa Gas Pipeline (WAGP) is also expected to achieve this laudable integration initiative. The study noted further that Benin, Togo and Ghana were estimated to have saved nearly US\$500 million in energy costs over a 20-year period, when the WAGP-supplied gas replaces more expensive fuels in power generation. Ghana estimates that it will save between 15,000-20,000 barrels of crude oil per day by using gas from the WAGP to run its power plants. Nigeria benefits by monetizing previously flared gas and exploiting its comparative advantage to meet the energy demand of its neighbours, whilst delivering clear environmental benefits.</p> <p>There is a greater awareness of energy's role for socio-economic development and also in the area of increased productivity. No country has been able to raise per capita income from low levels without increasing its use of commercial energy. The West African Power Pool project, which brings together 14 countries, is now modeling the trading of electricity across borders, in order to optimize investment response to forecast electricity demand and population growth. West Africa's huge hydropower potential could be developed for the benefit of the vast majority of regions population, in particular as regional integration projects.</p> <p>While some countries have excess generation capacity, others are experiencing shortage, with serious</p> |
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consequences for their economic and social development. Although it is technically feasible for each country to develop sufficient energy resources to meet their needs in the medium to longer-term, however, following this path may make the achievement of economic and environmental efficiencies through regional co-operation difficult. Such cooperation would allow under-supplied regions, or countries over-dependent on hydroelectricity, where supply can vary during drought seasons, to have immediate access to a pool of electricity, and to contribute to such a pool when water levels are high. This would facilitate uninterrupted power supply throughout the region. It is expected that sustainability of these two projects would inevitably enhance the regional integration in due course.

The table below outlined the proposed West African Power Pool for the sixteen ECOWAS countries spanning 2004-2014.

The development of the West African Power Pool (WAPP) and the West African Gas Pipeline (WAGP) are expected to enhance the generation of electricity in any part of the region and to be consumed in any part of the

region. In fact, the efforts to integrate the power sector for the overall development of region fits well into the thinking that energy access has been identified as a universal priority of the New Partnership for Africa's Development (NEPAD). In this regard, NEPAD specifically states that 'energy plays a critical role in the development process, first as a domestic necessity but also as a factor of production whose cost directly affects prices of other goods and services and the competitiveness of enterprises'.

4.0 APPRAISAL OF THE POWER SECTOR POLICIES AND CHALLENGES IN SOME ECOWAS COUNTRIES

ECOWAS countries persistent energy crisis has weakened the industrialization process, and significantly undermined the effort to achieve sustained economic growth, increased competitiveness of domestic industries in domestic, regional and global markets and employment generation. Against this background, four countries would briefly be examined.

Nigeria like some other developing

countries is an energy intensive growing economy. The electricity (power) sub-sector operates below its estimated capacity with frequent power outages. To compensate for the power deficit, the domestic, commercial and industrial sectors persistently use private operational generators. Despite the huge recourses and the reforms that the government had embarked upon so as to remedy the problems in the power sector, the situation had remained unchanged.

Towards the end of his second term in office (2006), President Olusegun Obasanjo deregulated the electricity industry through the enactment of Electric Power Reform Act 2005. In line with this reform, the defunct National Electric Power Authority (NEPA) is now named Power Holding Company of Nigeria (PHCN). The law paved way for the unbundling of NEPA into the 18 companies, 6 generating companies, 1 transmission company and 11 distributing companies. The bulk of infrastructural investment in Nigeria has always come from the government in spite of the much-talked-about policy of public-private-partnership (PPP) in infrastructural provision especially in the last ten years. As overall government investment fluctuates according to the ups and downs in the main sector/driver (oil production) of the economy, the increased investment in electricity has not had any positive impact on the economic development as most industries rely on generating sets for their industrial and domestic use and this has impacted negatively on the output and total performance of industries in the economy. Since the investment in this sector does not correspond with the expected returns, there were allegations of mismanagement in the electricity sub-sector. Sequel to his swearing-in as the President of the Federal Republic of Nigeria, President Umaru Musa Yar Adua highlighted a 'Seven-Point Agenda' for his administration. In particular, he declared a state of emergency in the power sector and the National Assembly instituted several probes into what transpired in the power sector of Nigeria. Knowing the importance of power toward nation building, the President in April, 2009, made a promise to Nigerians

WAPP Expansion for 2004-2014 with fully Integrated Regional Planning for ECOWAS

| Country | Existing Thermal | Combined Cycle | Gas Turbine | Existing Hydro | New Hydro | TOTAL MW |
|---------------|------------------|----------------|-------------|----------------|-----------|----------|
| Benin | | | | | | |
| Burkina Faso | | | | | | |
| Gambia | | | | | | |
| Ghana | | 330 | | | | |
| Guinea | 20 | | | | 852 | 872 |
| Guinea Bissau | 15 | | | | | 15 |
| Cote D'ivoire | | 1352 | | | 360 | 1712 |
| Liberia | 49 | | | | 69 | 118 |
| Mali | | | | | 95 | 95 |
| Niger | | | | | 70 | 70 |
| Nigeria | 1129 | 2500 | 1337 | 212 | 1005 | 6183 |
| Senegal | 1 | | | | 37 | 38 |
| Sierra-Leone | 28 | | | | | 28 |
| Togo | | 100 | | | 19 | 119 |
| TOTAL | 1195 | 4382 | 1337 | 212 | 2676 | |

Source: WAPP Electricity Trade Quantity and Prices with Regional Planning, January 2004.

that he would deliver 6,000MW of electricity before the end of December year.

In Ghana, it was a success story as it was on record that the country celebrated one year of uninterrupted power supply in 2007. Prior to this time, the government realized that the development of the various sectors of the economy depend heavily on reliable, adequate and economically prized power supply. Thus, the power sector was accorded top priority in economic growth. This can be clearly seen through the articulated vision of country's energy sector which succinctly states: "To provide adequate and reliable energy supplies to all sectors of the economy to support socio-economic development, poverty reduction and also for export. Besides, the government of Ghana has committed itself to increasing the current installed power generation capacity of about 2,000MW to 5,000MW in the medium-term by 2015. This is to make electrical energy available for industrial as well as domestic use. The government also constructed some power plants, notable among which was the Bui Hydroelectric Power Project that seeks to add 400MW capacity to the existing power generation in the country. Government, indeed realized that the challenge of adding 3,000MW generation capacity over a period of five years would require huge investment which government alone could not provide, thus, the Ghanaian government encouraged the participation of Independent Power Producers into the power generation business.

Senegal relies heavily on petroleum products as fuel for electricity generation. A major portion of the country's revenues deriving from exports are used for buying imported petroleum products. In the face of the global market oil prices that are fluctuating, if the oil prices remain the same or worsen, it will continue to constrain Senegal's power sector. More than 60 per cent of Societé National d'Electricité du Senegal (Senelec) plants are old and past their normal efficient operating life. The grid has many small unreliable plants and lacks a large base-load plant to provide stability resulting in frequent

power surges and blackouts. To ensure sustainable long term development of the electricity sector and recognizing the challenges of fluctuating supply levels and prices of oil, the Government of Senegal has decided to diversify their energy sources from dependence on imported petroleum products through the development of coal-based technologies and introduction of new and renewable energy sources, namely coal, domestic gas, hydro, wind, biomass and solar. Against this background, the Board of Directors of the African Development Bank (AfDB) approved a senior loan of up to Euros 55 million in 2008 to finance the Sendou Power Project in Senegal which is meant for the designing, development, procurement, construction, operation and maintenance of a 125 MW coal-fired power plant on a 29 ha site located 35 km from Dakar in Sendou, Bargny, and will produce 925 GWh of electricity annually. By adding a net capacity of 125MW and being the largest plant in Senegal, Sendou Power will stabilize the Senegalese grid and secure its base load. This grid stabilization will contribute to the local economy and support private sector development, and specifically to large industries consuming high voltage electricity.

For many years in The Gambia, NAWEC has been finding it difficult to achieve financial sustainability for its normal operations due to rising fuel prices, distribution and transmission losses and non-payment of large bill arrears particularly by large commercial and industrial consumers. As a result, the system is not robust enough to meet the growing demand and requires significant investment to operate efficiently. Thus, in 2006, the Electricity Law was passed and this opened up the generation component of the electricity sector to private investors and an Independent Power Project (IPP) of 23MW capacity which was expected to begin power generation that year.

4.1 Challenges of Power and Energy towards Integration in ECOWAS countries

The reasons for these dismal performances can be viewed from the

following stand point.

- Uncertainty in continuity of energy policies, politicizing of the energy and power sector, lack of local contents coupled with weak indigenous private sector participations.
- Inadequate budget provision to finance the sector of the economies in the ECOWAS sub-region on a sustainable growth path.
- There is an enormous potential for hydropower development in Africa, and yet to date majority of that potential has not been harnessed. At present, the majority of the poor in Africa spends a significant proportion of their income on energy and relies mainly on generators. Since most of Africa's poor live in remote rural communities, there are no clear economic incentives for grid-extensions or for supplying modern power supply.
- Lack of local technical and managerial capacity. Capacity building for the power sector is an important task. However, most governments in West Africa are unable to mobilize the level of investment and commitment needed to develop and retain the wide array of skills needed by the power sector. This partly explains many of the difficulties faced by the region's power sector. Without a sufficient mass of trained and skilled professionals, infrastructure projects including power interconnections cannot be planned, implemented and maintained. Policies and strategies to promote capacity building are needed to ensure sustainability of cross-border electricity interconnections. These include; enhancement of investment in the social sectors, remuneration, support for information and communication technology, effective utilization of existing capacity and the creation of a favourable environment for the attraction and retention of professionals.
- Weak domestic capital markets that are unable to provide long-term financing that have long 'pay

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| <p>back' times and earn little or no foreign currency. On the other hand, to realize the potential for regional power integration, high-level and yet flexible institutions, capable of gaining confidence of international and regional investors in the energy sector are required. However, in ECOWAS countries, the state-owned, vertically integrated electricity monopolies failed to adequately manage the electricity business, and the diverse technical and financial problems became endemic in the sector.</p> <ul style="list-style-type: none"> • Electricity consumption in most West African countries is very low and demand is mostly confined to the energy-intensive industries, commercial enterprises and load centers in urban locations. The electricity sector is often characterized by high technical losses, managerial weaknesses, illegal electricity connections and political interference. • Poor policies and inadequate regulations, which increase risks to private investors and increase business cost. The governments participating in the WAGP (Nigeria, Benin, Togo and Ghana) have played critical roles in supporting the pipeline project. The project is also listed in the short-term priority list of the NEPAD, initially decided upon by the African leaders. Regional integration through energy is increasingly being seen as a way for individual countries facing structural and economic weaknesses to join the global economy. Today, intra-West African trade remains low and the lack of macro-economic policy convergence and insufficient infrastructure negatively affect cooperation and integration. • One of the major causes of insecurity regarding infrastructure is political instability. Civil wars, social unrest and political instability make it very difficult to attract much needed investment for the development of infrastructure. For example, Liberia and Sierra-Leone has enormous potential for the generation of hydroelectricity | <p>(through the MANO River Authority), but the lack of political stability within the countries for many years was a disincentive to investments in the energy infrastructure.</p> <ul style="list-style-type: none"> • Closely related to the above, regional economic integration is hampered by the effects of conflicts and political instability. Foreign Direct Investment (FDI) including foreign aids inflows to West Africa have been hindered due to decades of political unrest. Investors are reluctant to invest in areas of high risks. • Poverty and customers' inability to pay an economic and appropriate electricity tariff is very prevalent in West Africa. Youth restiveness, compensation extortion, and vandalism of gas pipelines, restricted primary energy sources and insufficient transmission line capabilities are several challenges militating energy development in the sub-region. <p>5.0 CONCLUSION</p> <p>From the exploration undertaken so far, it is evident that power is critical to rapid economic development through regional integration. Given our low level of infrastructural facilities, there is no doubt that the ECOWAS countries require adequate social and economic infrastructures to enhance growth and development.</p> <p>The technical and economic characteristics of power make it imperative for government to play an essential role in its provision. The private sector can also be made to contribute to the development of power, particularly through the provision of an enabling environment.</p> <p>Above all, West African leaders must institute a stable and democratic system of governance that guarantees economic prosperity within a culture of the rule of law. This will impart positively on all the regional sectors development thereby enhancing rapid growth of the region.</p> <p>6.0 RECOMMENDATIONS</p> <p>From the foregoing, energy is a significant part of the total</p> | <p>infrastructure that allows rural and urban poor to grow beyond subsistence activity, to generate individual savings and increase their demand for modern energy services. Thus, the following are recommended to ensure regional energy integration for sustainable development.</p> <ul style="list-style-type: none"> • The absence of political disputes and social unrest is an important prerequisite to regional energy integration. Interruption of energy supply, on the other hand, can cause serious financial, economic and social losses. To support the goals of sustainable development, energy must be available at all times, in sufficient quantities and at affordable prices and the role of stable government in facilitating this cannot be over-emphasised. • Nations should develop energy policies, which clearly set out rational objectives regarding the development of all power generation options, including hydropower, other renewable sources, and conservation and efficiency measures. • Stakeholders should establish an equitable, credible and effective environmental assessment process, which considers the interest of the people and the environment within a predictable and realistic schedule. The process should focus on achieving the highest quality of decisions in a given period of time. • Project developers should include environmental and social assessment criteria when comparing project alternatives, to eliminate unacceptable alternatives early in the planning process. • Project design and operation should be optimized, by ensuring the proper management of environmental and social issues throughout the project cycle. • Political commitment and government support have proved to be a successful factor in West Africa's regional energy |
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| <p>integration experience. Although the role of governments is changing due to energy sector reforms, they are instrumental in setting up the institutional and regulatory frameworks that will create an enabling environment to attract private capital and develop energy markets.</p> <ul style="list-style-type: none"> • Sustainability of policies and establishment of focal points. ECOWAS members are encouraged to create NEPAD focal points, and form an ad-hoc inter-ministerial committee to oversee the implementation of the NEPAD programme. • Establishment of Common External Tariff (CET) that would fast track regional power supply and uniform prices. Cross-border gas pipelines require a framework for transactions to take place, harmonized arrangements for operations, a system of tariffs for use of the pipeline, gas pricing, and agreed principles and procedures for dispute resolution. | <p>In the case of WAGP, the pipeline will be extended to new markets with almost no past experience in the gas industry.</p> <ul style="list-style-type: none"> • West Africa's unfavorable investment climate has led to high transaction costs, expensive financing terms, weak domestic capital markets, low sovereign credit ratings, and a lack of local technical and managerial capacity. Successful integration of energy systems requires a framework for transactions to take place, harmonized arrangements for systems operations, a system of tariffs, and agreed principles and procedures for dispute resolution. Different legal, regulatory and licensing system existing in different countries need to be harmonized to ensure smooth transactions, and minimize the likelihood of future disputes. • Harmonization of the statutes of the national regulatory bodies, when they exist, would facilitate | <p>cross-border trade. The role of regional institutions cannot be dismissed, in addition to securing political support; these institutions could also coordinate capacity building, information and experience sharing among regulators, if their institutional and human capacity is reinforced. The difficulty in coordinating international investments can be eased when multilateral development agencies participate. These institutions can mobilize more financial resources, help reduce transaction costs and ease the enforcement of contracts. The absence of these institutions may be a cause of the inability to secure investments towards regional energy infrastructural development.</p> |
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