## SMC Working Paper

No. 05/2008

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# Proposed Inflation Targeting or *Mis-targeting* in Nigeria?

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**About the Author**

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**How it Began**

In August 2007, the Central Bank of Nigeria introduced the phase two of the reform of Nigeria's financial system which shall focus on the implementation of a strategic agenda for the Naira. The concluded phase one of the reform package comprised a 13-point agenda designed to restructure, refocus and strengthen the Nigerian banking and financial system. The idea behind phase two is to lend prominence to what is considered the most important responsibilities universally expected of any central bank which are mainly the issuance of legal tender currency and the defence of the currency's value through the pursuit of low inflation as well as appropriate and stable exchange rate regimes. The thinking of the Central bank is that the well-implemented phase-two will fast-track the vision of making the naira the currency of reference in Africa and invariably enable the deepening of the seeming successes of phase one. Supporting this plan is the new mandate to the CBN enshrined in the CBN Act of 2007 which is meant to ensure that the bank places emphasis on the achievement of monetary and price stability in addition to providing acceptable and transparent framework that will lock-in inflationary expectations. This framework is inflation-targeting as the nominal anchor for monetary policy starting from the first day of 2009.

**What is Inflation Targeting?**

It is widely accepted that the pursuit of price stability (defined as maintaining a low and stable rate of inflation) is primary to long-run growth and development and should be the heart of monetary policy. There are many reasons for this: high and variable inflation rate is socially and economically costly because it affects perspective planning, distorts prices, lowers voluntary savings and investment and orchestrates flight to values. Given this scenario therefore when the focus of monetary policy is primarily narrowed to the deliberate pursuit of low inflation – rather than output or unemployment – it is regarded as inflation targeting. It contrasts with alternative monetary policy strategies such as money targeting or exchange rate targeting. Although the latter – money and exchange rate – still seek to achieve low and stable inflation their targets are such intermediate variables, as the growth rate of money aggregates or the levels of the exchange rate of an "anchor" currency (in the case of exchange rate targeting).

Generally, inflation targeting is a policy in which an estimated inflation target is made public and deliberately pursued using the instruments of monetary management such as interest rate to steer actual inflation towards the desired policy target. For instance the bank raises interest rate when actual inflation is getting above the target and vice versa. This monetary policy strategy was pioneered in New Zealand in 1990. By the mid-1990s, seven countries (New Zealand, Canada, the UK, Sweden, Israel, Australia, and Spain) converted to inflation targeting; and Japan announced its intention to adopt this regime[1]. Now it is also in use in Egypt, South Africa, Brazil, South Korea etc. This framework represents the heart of new Keynesian monetary policy. Its main characteristics of the framework include the following: (a) announcement of an official numerical inflation target for a specified period of time (b) designing monetary policy to center on inflation forecast in recognition of the fact that a low and stable inflation rate should be the foremost goals of a central bank as well as (c) perceived transparency and accountability.

Inflation-targeting frameworks have been implemented with a view to bridle the well-known consequences of high inflation uncertainty which generally results in inefficient resource allocation and low productivity growth. The characteristics of the framework tend to strengthen transparency and coherency of monetary policy thereby eliminating uncertainites concerning future inflation rates. Overall it heightens the confidence level among the households and other economic agents that the central bank in fighting inflation and future inflation expectations. Its proponents believe that the flexibility of the framework and the accompanying cautious but discretionary manipulation of monetary policy instruments such as interest rate to tame inflation is an advantage in so far as it presents the central bank in the eyes of the public as fulfilling its statutory goals of price stability. This view is also further supported by the notion that in the absence of long-run (but only a short-run trade-off between variabilities – and not their levels - in inflation and output) tradeoff between inflation and output, it only makes more sense to aim at very low inflation rates. This trade-off between variability of inflation and the variability of output dominates current mainstream thinking in this respect. For instance, it is expected that the impact of an adverse macroeconomic shock such as oil price collapse or inflationary expectations is increase in inflations. Policy action in this instance will depend on how fast inflation is quickly brought back to target. If it is quickly brought back to target, it will be less variable and output will fluctuate around the trend.

1 Inflation Targeting: Lessons from the International Experience Eastern, Economic Journal, Fall 2000 by Dutkowsky, Donald H, http://findarticles.com/p/articles/mi_qa3620/is_200010/ai_n8926740/pg_1 (Browsed on March 28, 2008)

However, if on the contrary the central bank is slow to bring inflation back to target, output will fluctuate less, while inflation will be more variable.

**…Doing the First Things First**

Two issues are of concern with respect to the central bank's decision to adopt the framework in Nigeria come January 2009. The first refers to the thinking behind the framework as well as its overall building blocks. If these foundations are punctuated by lots of logical inconsistencies or theoretical inappropriateness, then its application will obviously result in less than desirable outcomes if not outright negative outcomes. If the first is satisfactory, the second concern is therefore about the country's readiness to implement the framework in the light of the many requirements for achieving its success. Starting from the second concern and holding the first constant as if the condition of logically consistent assumption underlying the framework is fully satisfied, the relevant questions here concerns the various requirements or conditions to be met for Nigeria to effectively attain the much desired success in the implementation of the proposed policy.

Some of the widely accepted prerequisites for the adoption of inflation targeting based on varieties of experience from many countries include true autonomy of the central bank, adequate and reliable data generating capacity, prudent fiscal behaviour and robust modern financial institutions as well as public support and already favourable condition for lower rates of inflation. Others include flexible prices which are not subject to administrative regulation and the existence of financial markets which allows the use of indirect monetary instruments.

The independence of the Nigerian central bank has been called to question during the proposed redenomination of the naira last year. Based on its own understanding and interpretation of the new CBN Act which provides in part that the functions of the CBN shall be to ensure monetary and price stability as well as issue legal tender in Nigeria it has announced a naira redenomination which it withdrew within 24 hours because of the absence of the support of the presidency. In withdrawing that decision cited section 19 of the CBN Act 2007 as the source of Mr. President's approving authority in matters relating to the denomination, forms and design of our national currency. Truly autonomous central bank should have high level of goal independence or institutional autonomy which imbues it with power to formulate monetary policy (ies) independently of political institutions. Can one then conclude that the Nigerian central bank has the final say when it comes to the formulation of monetary policy? For effective inflation targeting, the central bank must not only have full legal autonomy but should be seen and act as one that has it and consequently be free from fiscal and political pressures that have the capacity to trigger objective that are in conflict with the inflation targeting goal. As it is with the redenomination so it is with large fiscal deficits. This has continued to undermine the autonomy of the central bank with respect to monetary management. No matter how fiscal deficits are financed, they always have deleterious inflationary consequences. But this is worse when it is financed by ways and means usually in response to the pressure from the government. Nigeria's fiscal disposition is largely characterized by a tradition of deficit budgeting financed mainly by ways and means particularly during the military era. This happens always particularly when other financing alternatives fail to yield desired amounts to enable government meet its programmes. In these circumstances, the central bank becomes a ready institutional tool in the hands of government to meet its inflationist objectives through the issuance of securities in the financial markets.

Furthermore, unreliability of data is one of the major problems facing econometric modeling and estimation in Nigeria which incidentally is central to price-inflation forecasting for inflation targeting. Even with so many reforms in the central bank and the national bureau of statistics, timely and reliable data availability remains an issue in Nigeria. One expects that officially designated data collection and processing institutions should be able to collect data from reliable sources within the system in a timely manner. This is not particularly the case although one can acknowledge that there have been substantial improvements given what obtained in the past which nevertheless leave substantial room for further improvement. The absence of this desideratum means that we cannot meet the demands for full, timely, and accurate information on key variables such as GDP, financial and trade data etc. over required time periods. Since forecasting is in the heart of inflation targeting such forecasts may not be as robust as should be expected by its advocates since data is necessary to implement them. Although the CBN generates own data, in some cases, particularly in the past there are significant divergences among the data series being published on the same subject by other organizations with data-generating responsibility. These could have a consequence of fundamental disparities in data generating and reporting procedures. The implication is confusion and unreliability of data and results consequently emanating from such.

Another important requirement is a healthy financial system which is fundamental to effective monetary policy transmission. This requirement means that the banking system should be sound and capital markets well developed. There is no gainsaying that the Nigerian banking system today is reasonably sound. Their levels of capitalization which compares favourably with other banks the world over and growing linkages with other foreign financial institutions attest to the ground-breaking improvements which have taken place in that industry. Nigerian banks today are generally considered as 'safe' with minimal probabilities of failure from the standpoint of asset/capital adequacy. Riding on the back of asset inflation orchestrated by the recapitalization of the banking subsector, the stockmarket capitalization also grew very astronomically. The bond market performance has also showed signs of good prospects. Above all this, the capital market is also on the verge of its own recapitalization. These pluses notwithstanding however, it appears there is no conscious plan on the side of the central bank - outside the fact of fast recovering confidence in the system following the consolidation - to tackle the enormous volume of cash circulating outside the regulated system. The fact that our economy is largely cash-based presupposes that CBN should start with efforts to bringing in more of the cash outside the system if the formulation and implementation of monetary policies and subsequent monitoring with available statistics is expected to yield reliable results for implementing the proposed inflation-targeting framework. In the absence of such deliberate plan, the time required for natural adjustment may be longer meaning that the 2009 target date may not be appropriate.

Favourable condition for lower rates of inflation is absent. Over the years, the level of unproductive debt expansion measured by the difference in the rates of growth in money supply and the real output growth clearly shows that we are not yet ready to slow down on inflating the system. Monetary expansion, along with some other psychological factors such as the expectations of inflation vis a vis the rate of growth of real output underly inflation particularly when the index used is measured correctly to cover a wider set of prices. If productivity growth is encouraged through a combination of factors such as through commitments to low/no fiscal deficits, strong commitments to the rule of law, as well as private property rights protection which create super incentives for sustainable entrepreneurship, the potential inflationary impacts of monetary expansion will be reduced. Although at present we do not have high levels of inflationary expectations, thanks to CBN's statistics, yet the factors which fuel inflation and consequently future expectations regarding its occurrence fully abound. Recently, the central bank stopped commercial bank's margin finance (credit creation fro stock purchases) activities which terribly fueled stock market asset bubbles. These bubbles were (mis)read as the signs of a rapidly growing market with best global return on investment. On the other hand, the forces which should neutralize its occurrence in a sustainable fashion is glaringly absent. Productivity was not really encouraged as inflation-induced market upsides drew enterprise to speculation in capital market stocks (save the primary market offers) at the secondary markets. To make the point a bit clearer, the Securities and Exchange Commission had recently suspended trading on a few companies' stocks whose stock market value of their shares were rising astronomically while they were operationally otiose. The conclusion based on the foregoing is that there is no favourable commitment to creating the condition germane for low inflation.

From the above, it appears that although the financial system is sound, which in itself is a necessary condition; other supporting and satisfying conditions for the adoption of inflation targeting are absent. What it all means is that there is a potential threat of less than desired results if we go ahead to implement the framework without necessarily addressing these issues. It has been recognized that inflation targeting does not work well in countries that do not meet these set of preconditions which has also made the framework unsuitable for majority of emerging market economies. Nigeria will not be and exception. Therefore going back to our initial premise, even if this framework is without pitfalls as a tool for our monetary management we may still need to go back to do the necessary things before we can possibly take maximum advantage of its supposed benefits. Perhaps this may be why the entire countries of the world – including the United States - have not adopted this framework so that they could tidy the home front first or can it possibly be that this framework does not actually deliver the el-dorado that it promises. Afterall, the United States before now has had macroeconomic performance that was envied globally.

**Cross-Country Evidence Do Not Support Claims**

Ball and Sheridan (2003) in a thought provoking paper has demonstrated from evidence based on data from a group of twenty OECD economies seven of which adopted inflation targeting in the 1990s that it was not responsible for low inflation or its volatility. Their conclusion is that there is no evidence that inflation targeting improves economic performance as measured by the behaviour of inflation, output and interest rates. Many such studies have also shown that the much mouthed beneficial claims do not necessarily derive from the fad of targeting inflation. One of such is Honda (2000) who found no evidence that inflation targeting had an effect on either inflation or any other variable in Canada, New Zealand and the UK. After a detailed and painstaking research by a group of scholars from Cambridge university, they concluded in these words: "We have attempted in this study to gauge empirical evidence for both developed and emerging countries that adopted the new monetary policy strategy that has come to be known as inflation targeting (IT). It may very well be the case that IT countries, developed and emerging, have been successful in taming and controlling inflation. But then there is also evidence that clearly suggests that non-IT central banks have also been successful in achieving and maintaining consistently low inflation rates. Our overall conclusion, then, is that the available evidence we have managed to gauge clearly suggests that a central bank does not need to pursue an IT strategy to achieve and maintain low inflation. Indeed, and as Friedman (2004) suggests that acute focus on the IT strategy may very well lead to 'the atrophication of concerns for real outcomes, especially so in an environment of supply-side shocks of the kind that we are experiencing at this juncture with increasing energy prices"' (Alvarazo;_____)

Anticipating correctly that the warnings of Friedman can haunt, the CBN had reassured that focusing on inflation targeting would not mean that the CBN would not be interested in other broader objectives of macroeconomic policy such as output growth, employment, exchange rate, and balance of payments. Instead, the framework is meant to enable CBN to pursue these objectives in a more disciplined and consistent manner rather than the ad-hoc processes of the past. How credible this supposition may be is really questionable. That takes us to our first concern which is whether the popular pro-side arguments about inflation targeting is also correct and consistent.

**The Downsides of Inflation Targeting**

The biggest plus to the central bank of targeting inflation is the seeming assurance it communicates to the economy that percentage changes in the selected basket of consumer goods (CPI) will not be higher than desired. In that way it builds some confidence in economic agents, which apparently douses expectations of future inflation: a key determinant of actual inflation. But the CPI only captures a narrow range of prices of selected consumer goods to the neglect of much more items in an average Nigerian's basket. This neglect includes asset prices which has exhibited serious inflationary consequences. On average, it could compound the negligence of asset-bubble-ballooning central bank. A testimony was the much-touted performance of the Nigerian capital market which was primarily driven by a conscious asset-inflation-creating credit by the central bank through consolidation. The inflation in these assets are not captured and is not expected to be part of the overall target. Given this scenario, one can conclude that having a target limited to the CPI is a serious problem. The effectiveness of monetary policy as a nominal anchor depends on what is targeted and how. A better target should incorporate asset prices, directly or indirectly, rather than only consumer prices. One of the fundamental problems arising from this framework is therefore the absence of a valid price index. The so-called representative basket of goods in Nigeria is very obsolete and unrealistic as it does not take adequate account of our complex and diverse economy. Every person has his own basket of goods and services which changes with time.

Another problem is the ease of response of the central bank to a financial crisis or changing economic conditions if the inflation targeting framework is adopted. Strict focus on prices of consumer goods and inflation may lead to the neglect of other variables that equally impact on overall macroeconomic performance in magnitudes that are not fully known. For instance, one thing that is clear is that rapid (non-inflationary) productivity growth will curb inflation. Basic economics couches inflation in terms of too much money pursuing few goods. Thus if the volume of goods can increase/expand in a non-deliberately inflationary manner, it will necessarily douse inflation. This perspective in providing solutions to potential macroeconomic instability will ordinarily be ignored. As earlier pointed out, inflation target can turn the central bank into an inflation nutter such that the attention be largely concentrated on the inflation target to the detriment of stable growth and employment.

Contrary to popular view, inflation targeting is also not a market-based policy. By regulation, the central bank controls the monetary base (currency and bank reserves) and since the broad money supply is geared to the monetary base through the money multiplier, the monetary authorities of their own chosen volition manipulate or determine the rates of growth of money. This action recognized thus by theory has little to do with the market. To achieve target inflation rates within the framework of inflation targeting, what the Central Bank does is equally to manipulate/adjust the monetary base and consequently the broad money aggregates to sustain the path of the targeted price level. This justifies the endogeneity of money within this line of thinking and confirms that the market did not chose the inflation target. Discretionary monetary policy of this nature is very dangerous. Generally in discretionary policy, economic policy-makers who cannot commit to a rule in advance often will conduct a policy that confers sub-optimal results, despite their avowed intention of achieving the best possible outcome. Rather than allow the market forces to be in operation, inflation targeting can only approximate a fight against market forces. Inflation targeting offers excessive discretion over how and when to bring inflation back to target because targets can be changed.

Furthermore for a long time, the minimum rediscount rate (MRR) was the dominant instrument for the central bank's monetary management before the adoption of the monetary policy rate (MPR). The shift to MPR was based on the conclusion that MRR is no longer relevant as it only influenced the setting of commercial bank loan rates and does not seem to have any linkage with other interest rates, either interbank rates, or yields available on government securities. This independence or unclear relationship constrained the ability of the central bank to influence economic variables through the conduct of monetary policy. The application of MRR for many years could also not eliminate the macroeconomic imbalances typified by the same-directional response of both interest rates and inflation rates. What this signifies is that (a) either that the central bank does not fully understand the relationship between the MRR and other macroeconomic aggregates or (b) it chose to undermine the performance of the macroeconomy in order to serve the holders of state apparatus. This has led to several bouts of policy inconsistencies (and reversals). But even with a shift to MPR has there been any clear relationship such that the conduct of monetary policy is effective? There still seems to be a disconnect. Liquidity management has not been very successful even with the upwards adjustments in the MPR. The downward adjustments have also not considerably reduced interest rates as much as would be expected. May be because these reductions were not based on a clear understanding of the relationship between the monetary policy instrument and monetary or macroeconomic aggregates. It was always fixed based on the discretion of the central bank and sometimes policy advice from members of the private sector. It may also be because the Nigeria Bonds issuance is outside the direct oversight of the CBN such that there exists a disconnect between net issuance and the policy goals which means also that bond yields may not always react to CBN's monetary policy stance. Given the absence of constant quantitative interdependencies among economic parameters the central bank is therefore helpless because there will not be any credible standard with which to calibrate their monetary policy measures. The workings of monetary transmission mechanism is only known retrospectively meaning that statistical models attempting its forecast may only be chasing after shadows.

There is also the problem associated with the use of formulaic principles derived from and which have application relevance to abstract sciences in forecasting the behaviour of human-related operations. Inflation targeting is same – technically speaking – as inflation-forecast targeting. Thus the challenge of policy makers is to adjust interest rates in response to forecast deviations from the objective. This demands accurate forecasts and corresponding quantitative estimates of the impacts of potential changes on these forecasts estimates. Developing a model that will deliver such accuracy is not only tough but practically impossible. Human activities are different from the precise mechanical relations upon which the fundamentals of the formulas is derived. Which means that they cannot be applied without error which level of bias may not be known. Such econometric models have been of little help in policy making activities. The end point of all this is central banks develop models and mechanically adjust policy in response to them. The result of every econometric research is a piece of historical document. They do not provide any certainty concerning future transmission mechanism. The resulting impact of base money on the broad money may differ from the way it was in the past based on the monetary multiplier and other factors such the velocity of circulation.

Another important point of concern is about the assumption of instantaneity of money-inflation relationship meaning that we can successfully manipulate monetary aggregates and expect to have the full result of the action within a given short period. Although it is not clear how long it takes for the full effect of change in money supply to affect inflation, some studies have shown that it varies with countries and for Nigeria is not less than eighteen months. This means that the impact of money supply adjustments on inflation is not of one-time strike on inflation. Therefore when the MPR is adjusted in order to influence other rates which invariably affects the spending decisions of economic actors it neither affects the economy nor inflation in a manner that is readily predictable. The transmission mechanism of monetary policy has long and variable lags because the economy takes time to adjust to changes in monetary conditions. Inflation targeting however does not seem to operate within this frame of reasoning which suggests that the actual inflation can be adjusted to hit the target inflation within a short period if a deviation is observed. This belief is just deceptive. What happens is merely the suppression of the truth about prevailing condition of inflation.

**Without Money there is no Inflation**

The thread of this discourse points to the following: (a) CBN and by extension, Nigeria is not yet ready for the implementation of the inflation targeting framework. This is because the stringent conditions required – based on the experiences of countries who have adopted it – are not yet met. (b) Evidence from many countries show that inflation targeting is not that effective as a monetary policy framework for the achievement of macroeconomic stability. (c) the framework itself is laddened with many pitfalls which makes it inappropriate for the pursuit of sustainable growth and development of the Nigerian economy.

Commonsense tells us that if you discover the cause of a problem and uproot it, that problem is almost solved. Though resolving the consequences may linger a little while, but that will fizzle out. The primary cause of inflation is excessive monetary growth which also triggers inflationary expectations that sustains inflation over a longtime path. Many central banks – including Nigeria – has become more obsessed with price stability with little attention paid to factor underlying it: the movements in money. A lose monetary policy through its impact on interest rate reduction although temporarily raises demand, output will ultimately raise inflation. This classical theory of inflation has not changed. There is a veritably traceable connect between money and prices. Although this link is known to many central banks, emphasis has remained much more faddishly or in herd-style response on other variables as targets rather than money supply itself._It is expected that the focus of monetary policy should be on the management of the primary source of inflation which in itself is unrestricted fiscal, monetary and credit expansion by the government using the instrumentality of the bank, the thinking is a policy that merely suppresses the effects of its own actions. What this means is that the central bank should first of all manage the money creation process which is at the heart of inflation arising primarily from both the financing of government's fiscal deficits as well as the growing penchant for loosening banks credit creation capacity. The creation of money out of thin air can only generate inflation. Once this is resolved within the context of the rule of law, efficient justice system for the protection of private property rights, and eradication (or serious reduction) of public sector corruption, inflation will naturally drop to very low minimums and the economy will grow very strongly.

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