TAKING A SECOND LOOK AT NIGERIA'SECONOMIC STABILISATION POLICIES.

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Abstract

This paper focuses on the expediency of monetary policy and fiscal policy. It draws from a background of arguments of different schools of thought on which of the two approaches is better suited for controlling the economy of nations in order to achieve desirable macroeconomic performance levels in the light of the recent wave of globalisation. Over time, the use of monetary policy and fiscal policy to moderate the workings of the economy of nations has been popular. However, in recent years, there are divergent views on which of these two approaches is better suited for the smooth operation of any economy, due to the different noticeable effects of these policies when applied in some countries in respect of achieving full employment and price stability. The conflict between the desire to achieve full employment and price level stability simultaneously calls for a rethink of stabilisation policy.

Keywords: Monetary policy, Fiscal policy, Fiscal neutrality, Fiscal balance.

Introduction.

The use of fiscal and monetary policies came under scrutiny in the early 70s and over time, the view emerged that fiscal policy has little or no short-run stabilisation role and that though monetary policy could be used for stabilisation, it should give priority to maintaining price stability. Interestingly as stated by Odoko (2007), the Central Bank of Nigeria, as a monetary authority, has the mandate of ensuring price stability.

In recent times, there has been the active interest in the use of discretionary counter-cyclical monetary and fiscal policies in many countries especially in Europe.

Stabilisation policy is used to describe the use of monetary and fiscal policy to smoothen business cycle fluctuations. On its own, monetary policy refers to the combination of measures designed to regulate the value, supply and cost of money in an economy in order to achieve a desirable level of economic activity and macroeconomic performance indicators.

In another sense, monetary policy is that which concerns measures designed to regulate and control the quantity, direction, availability and cost of money and credit in an economy per time with the aim of achieving some macroeconomic objectives. Consequently, the money stock and credit creation can be controlled through the use of quantitative tools like the open market operations, minimum discount rate policy, reserve requirements, stabilisation deposits as well as through qualitative tools such as selective credit guidelines and moral suasion. As posited by Sulaiman (2006), the economic environment that guided monetary policy in Nigeria before 1986 was characterised by the growing importance of the oil sector and the expanding role of government in the economy.

Fiscal policy refers to the use of taxation, public borrowing and public expenditure by the government for purposes of stabilisation or development.

These policies generally encompass both discretionary changes in fiscal and monetary policy resulting from specific policy decisions and automatic stabilisers that occur when taxes and spending respond to changes in economic activity. Automatic fiscal stabilisers could be in the form of tax revenues as personal income tax, employment insurance payments and pension fund contributions.

The view is that monetary and fiscal policy can moderate the business cycles by offsetting changes in aggregate demand by consumers and firms or businesses that would otherwise cause inflationary pressure or weaken economic activity.

In Nigeria, the Central Bank is at the driver's seat of using monetary policies to actualise government intentions. In an attempt to do this till date, the bank has used two major techniques namely:

a. the direct approach or technique
b. the indirect approach or technique

According to Olekah (2007), the direct approach was in use between 1980 and 1993 with reference to the financial system in form of credit ceilings on individual banks, selective credit controls, administered interest and exchange rate as well as specialised deposits by exercising direct control on deposits and lending rates. This approach was not really efficient nor effective and discourages competition among banks.From 1993 to date, the indirect approach is being used in form of Central Bank's interventions in financial markets through the purchase and sale of securities, foreign exchange and foreign reserve management, technical support and incentives to financial operators and most recently regulations of the procedure of operators of financial institutions.

The seeming ineffectiveness of stabilisation policy in some instances and the financial crisis of the 1990s is a pointer to the constraint of stabilisation policy especially from the angle of using fiscal policies. This has given rise to a serious concern for a rethink. The fact that restrictive monetary policy in many cases did not result in lower inflation and the fact that the nature of shocks experienced by economies in the wake of globalisation differs from what obtained in the 1960s make a rethink imperative. Increase in food and energy prices and a slowdown of productivity growth meant that the aggregate supply factors are more important determinants of economic activity.

Before now, many developing countries including Nigeria were blindly sacrificing their long-run growth potential for the sake of absolute fiscal discipline but this has not helped much. Consequently, there is a departure from the traditional stabilisation policies to the use of parameters that positively affect growth and economic efficiency. Hence, policymakers are now giving priority to restoring price stability and fiscal balance. The expediency or otherwise of stabilisation policy as it is being scrutinised now is to see the relationship between short-run stabilisation policy and longer-run objectives of price stability and fiscal balance in a changing world.

The question is does the active use of stabilisation policy potentially compromise or short-change the achievement of price stability and fiscal balance? The popular view now is that though there is still a place for the short-run stabilisation policy, its scope is limited by the need to maintain price stability and fiscal balance over the longer time. It is common knowledge that the quantity theory of money postulates that an increase in money supply, other things being, equal will lead to a rise in the general price level. Specifically, if output potential, Y, remains fixed and the velocity of circulation of money, V, is stable, then an increase in money supply, M, translates directly into an increase in the general price level, P.

What one is saying is that, it is not just enough to increase the volume of money in the economy nor to take steps to cause the money in circulation to shrink but, what steps being taken to increase productivity within an economy. So in Nigeria, what ought we to do considering the peculiar shocks that our economy is exposed to in respect of shocks arising from oil price volatility, political instability and human activities like fraud and capital flight that impact negatively on the economy? The question then is: do we have the institutional framework for formal commitments to price stability and fiscal balance?

However it is important to state that a formal commitment to price stability and fiscal balance might not absolutely erode the place and role of stabilisation policy. Setting a formal inflation targeting framework can take root in the use of appropriate monetary policies against the background of asset price movements to the extent that inflation targets are viewed.

Stabilisation Policy and Nigeria's Economic Environment: Views from Scholars

There exists the Classical, Keynessian and Modern views on monetary policy with each stating their convictions. The classicists are of the view that money is neutral in its effects on an economy and that it only affects the price level and nothing more. Hence, any increase in money supply will result in an increase in the price level but the real income, rate of interest and the level of economic activity will remain

the same.

The classicists believe that the main function of money is to act as a medium of exchange and the relationship between money and price level is explained in terms of the quantity theory of money. The classical quantity theory of money states that the price level is a function of the supply of money. This is represented algebraically as MV=PT where M, V, P and T are the supply of money, velocity of money, price level and volume of transactions or real total output. This equation shows that the total money supply MV equals the total value of output PT in the economy. Thus, assuming V (the velocity of money) and T (total output) to be constant, a change in the supply of money (M) causes a proportional change in the price level (P).

The classicists believe there is always full employment in the economy by the interplay of money supply, rise in price level and reduction in real wage.

The Keynessian view is contrary to the classical view. Keynes posited that the supply of money does not influence the price level directly neither does the economy stay at full employment always. Keynes contended that a change in the supply of money can permanently change variables such as the rate of interest, aggregate demand and the level of employment, output and income. He also believed in the existence of unemployment equilibrium meaning that any increase in money supply can result in a permanent increase in the level of output.

The final effect of money supply on the price level thus depends on its influence on aggregate demand and the elasticity of aggregate output. The weakness of the Keynessian view is the possibility of a liquidity trap when the demand for money curve is flat. Thus, given an interest inelastic investment function, monetary policy will not be effective in the Keynessian analysis.

The modern view adopted by Central Banks around the world is contrary to Keynes view that the link between the supply of money and output is the rate of interest, depending on bonds and speculative cash balances. The modern view of monetary policy is based on portfolio adjustment process and more workable. When a Central Bank purchases securities in the open market, it sets in motion substitution and wealth effects, which will increase aggregate money demand and expand output.

It is important to state that the successful use of stabilisation policy requires a knowledge of the structure of the economy as well as an understanding of the nature of shocks assailing the economy so that changes in the economy can be incorporated into models used by policy makers including variables associated with the unrest in the Niger- Delta region of Nigeria.

In Nigeria, the tradition of the Federal Government's expenditure exceeding the available revenue in a particular year denoted as fiscal deficit has compounded Nigeria's problems. For example, fiscal deficit as a percentage of gross domestic product increased significantly from 4% in 1980 to 10.1% in 1982. Although, during the structural adjustment programme years, there was a provision for a fiscal deficit/GDP ratio that will not exceed 3.5% per annum, actual deficit figures often exceed the ceiling. It is on record that in the period between 1991-1994, the deficit was at an average of 10.7% of GDP.

Expectedly, during this period, as a result of federal government spending, domestic inflation increased significantly till 1995. This necessitated some restrictive fiscal and monetary policies, though the problem of budget deficit did not abate even till year 2005 as the deficit/GDP figures below shows.

Budget Deficit Figures as Percentage of GDP

Year	%
1998	4.7
1999	8.4
2000	2.9
2001	4.1
2002	4.8
2003	3.3
2004	7.7
2005	9.9

Source: Central Bank of Nigeria Bulletins (1999-2006)

It is instructive to point out that Nigeria got into problem because the proceeds from oil during the oil boom years between 1975-1980 were mismanaged by embarking on white-elephant projects. The official corruption during those years also became evident in the following years of economic recession when the price of oil fell drastically. The scenario created was such that the economy could not absorb the shocks of the oil price negative volatility.

According to Soludo (1996), a moderate level of fiscal deficit within the limits stipulated in the structural adjustment years might not have constituted a very significant source of macroeconomic instability if oil proceeds in the years of boom were applied to ease constraints and bottlenecks in the productive sector. In the years of recession, extra-budgetary expenditures were on the increase and deficit financing by the Central Bank caused an escalation of the distortion in the pattern of resources allocation in the economy as reported by the World Bank in 1996.

Now that history is almost repeating itself as the price of crude oil is at its highest ever at over $90 per barrel, appropriate stabilisation policies should be put in place to avoid negative economic variables as negative externalities.

It should be noted that traditional stabilisation policy is best suited for dealing with persistent aggregate demand shocks. In contrast, aggregate supply shocks and financial markets shocks are more difficult to handle. For example, a persistent fall in productivity may be difficult to recognise early enough in a country like Nigeria that earns so much money from crude oil. This anomaly can result in an underestimation of the expected inflation figures.

Another shock which might not be easily or readily recognised and addressed by monetary policy steps by policy makers is unexpected asset price bubbles occasioned by political instability. There is generally a consensus that a responsible fiscal policy was necessary for monetary policy to pursue both longer-term price stability and short-run stabilisation objectives with an eye on real stabilisation which is stabilising output or rather the output gap. Looking at this issue with an eye on monetary policy and real stabilisation, maintaining low inflation and price stability has become a major focus of Central Banks around the world and monetary policy is viewed to be better suited than fiscal policy for short-run stabilisation purposes. Real stabilisation entails stabilising output or the output gap. Monetary policy affects the economy in that it affects real and nominal variables through a number of channels referred to as the transmission mechanism of monetary policy.

Traditionally, Central banks normally conduct monetary policy by setting a short nominal interest rate, the Central Bank's instrument rate like the monetary policy rate operational in Nigeria. Normally the lowering of the instrument rate will lower short and longer real interest rates and will affect economic activity by stimulating consumption and investment thereby increasing the aggregate demand and output in the economy since output is essentially demand determined in the short run to medium term. This is what is known as the real interest rate channel to aggregate demand. It is instructive to know that the output gap is the difference between current output and potential output which can be seen as the measure of general excess demand in the economy. Potential output is the assumed or hypothetical output level that would result in the absence of price and wage stickiness. The resulting increase in aggregate demand and the output gap will lead to higher domestic inflation.

It should be noted that if the trend continues, expectation of future inflation and future price level will trigger off the agitation for wage increase and thus form the basis or individual price and wage setting. This is the expectation's channel to domestic inflation. The wisdom by the Central Bank of Nigeria in recently increasing the monetary policy rate (MPR) to 9% is that an increased inflation may be generated by the lowering of the instrument rate herein the MPR and the resulting increase in activity will then add to the negative effects of domestic inflation.

The Central Bank thus have a responsibility to keep an eye on the economy because if this is not done the economy may be assailed by a never-ending sequence of shocks and disturbances, inflation and price changes of raw materials as well as shifts in international capital flows.

Monetary policy from the aforementioned is better suited for short run stabilisation as its use for longer than necessary has the capacity of inducing hyper-inflation. This is more so when we understand that, in the long-run, output fluctuates around potential output which is determined by factors other than monetary policy. Thus, there is a clear-cut difference between output targets and inflation targets of monetary policy.

It should be emphasised though that in the longer-term, monetary policy can only control nominal variables such as inflation and nominal exchange rate. It cannot increase the average level or the growth rate of real variables such as the gross domestic product and employment or affect the average level of the real exchange rate.

Stabilisation Policy: Emerging Issues

There is the view that monetary stability is the appropriate criterion for stabilisation policy and as such a fully successful monetary policy requires no fiscal policy (fiscal neutrality), this view is however not

realistic. It should be stated that neither monetary policy nor fiscal policy in isolation is sufficient enough to achieve the desired economic goals. The use of fiscal policy for stabilisation by trying to reduce or expand private spending and investment through increase in tax or tax reduction may have the same effect or end result on the economy but definitely different directional effect.

Consequently, given the different directional effects, the choice between monetary policy and fiscal policy as stabilisation instruments will depend, to some extent, on the importance the society attaches to expanded current consumption. Monetary policy puts off the burden of stabilisation to future periods while fiscal policy causes the burden to be currently shouldered and as such more suitable than monetary policy on ethical grounds. However, the more administrative efficiency of monetary policy makes it readily available for use and might continue to dominate the policy choice for economic stabilisation since it does not require legislative process.**Stabilisation Policy:Taking a stand**

Stabilisation policy is often adopted by governments and agents of governments in order to achieve what is described as a desirable state of economic affairs. This desirable state could be measured in terms of income, employment and prices etc.

Expectedly, different organs of government like the Central Bank in Nigeria and the Federal Ministry of Finance among others often work together through the instrument of the annual budget seeking to achieve this desirable state.

However, taking a second look at stabilisation policy has become imperative in the light of new evidences and deficiencies of earlier approaches. To the ordinary man who is not critical about the interplay of macroeconomic variables, achieving a satisfactory economic state simply requires that national real income should be, as large as possible, consistent and also with a generally acceptable rate of growth and development, However, this does not work just like that. This is because this view assumes that all resources made available for employment at market determined prices would be used and that production will be reasonably efficient. The statement also suggests that the purchasing power of money will be stable.

The major conflict between the desire to achieve full employment and price level stability simultaneously calls for a rethink of stabilisation policy. From experience governments aim at achieving full employment especially of the labour force may induce inflation while government action may not produce full employment . For a country like Nigeria, with high rate of unemployment, what must we do? Government action at reducing inflation through reduction in purchasing power could result in unemployment and government action to increase purchasing power sufficiently to stimulate full employment may result in inflation.

This paper favours the administrative efficiency of monetary policy in that its application does not require any legislative process as required by the use of fiscal policy.

Conclusion

With reference to all the issues discussed above, it is obvious that policy implementers are in a dilemma as to which of the approaches, between monetary and fiscal policy, to lean on. The truth is that the choice of what policy to adopt per time will largely depend on the peculiarities of the economy as at that time. There is no one-size-fits all approach or framework that can work.

However, no matter what approach is to be adopted, it will be necessary to reduce the monopoly power of labour organisations and large business enterprises if the goals of price level stability and full employment is to be reasonably achieved. The most realistic option then is to do away with price level stability in favour of full employment if only a reasonable level of inflation will be experienced.

In addition there is the need to set up institutional frameworks at different levels of government to ensure formal commitments to price stability and fiscal balance. This is what some components of the fiscal responsibility bill should address.

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