A review of Soludo's perspective of banking sector reforms in Nigeria

Balogun, Emmanuel Dele
University of Lagos, Nigeria, Department of Economics

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By

Emmanuel Dele Balogun
Department of Economics
University of Lagos
Akoka, Lagos

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By

E. D. Balogun*

This paper focuses specifically on the recent Soludo's banking sector reforms. The study noted that the Soludo's reforms focused on strengthening the financial systems through banking sector consolidation, foreign exchange market stabilization, interest rates restructuring and the pursuit of stabilization as against structural adjustment policies for monetary and inflationary controls. A review of theoretical qualifications to the Soludo's reform show that in thoughts, it is rooted in the Classical traditions of Say's Law, acts monetarist, but expects a Keynesian outcome that money can stimulate expansion in aggregate domestic output. In concluding, the study noted the need to adopt an interest rate operating procedures for monetary policy in addition to moving the economy consciously towards the 'law of one market and one price' for the domestic and foreign money markets.

1. Introduction

The focus of this paper is to review the theoretical underpinning of the banking reforms under the regime of Prof. Charles Soludo, as Governor of Central Bank of Nigeria, June 2004 to date.

As you are aware, banking sector reforms has been an integral part of the economic reforms which began in Nigeria in the mid-1980s with the adoption of the structural adjustment programmes. Four phases of banking sector reforms are easily discernable in Nigeria since 1986. The first is the financial systems reforms which led to deregulation of the banking industry, in addition to credit, interest rate and foreign exchange policy reforms. This culminated to rapid expansion of the banking sector from about 40 commercial and merchant banks with a combined branches network of about 1,655 in 1986 to 121 and about 2,385 branches in 1992 (CBN 1993). The second phase began in the late 1993-1998, with the re-introduction of regulations. During this period, the banking sector suffered deep financial distress which necessitated another round of reforms, designed to manage the distress. The third phase began with the advent of civilian democracy in 1999 which saw the return to liberalization of the financial sectors, accompanied

* Mr. E. D. Balogun is a Lecturer in the Department of Economics, University of Lagos. The views expressed in this paper are strictly those of the author.

with the adoption of distress resolution programmes. While some of the bankrupt banks were liquidated about 89 of them survived and had about 3,382 branches predominantly in the urban centers as at June 2004 (Soludo 2007). By this time also, universal banking had been introduced and the banks could diversify their portfolio to cover all aspect of retail banking. Upon assumption of duty as CBN Governor, Soludo (2007) asserted that the financial system was characterized by structural and operational weaknesses and that their catalytic role in promoting private sector led growth could be further enhanced through a more pragmatic reform. This led to the fourth phase of the financial sector reforms which began since then. This last phase is what I have tagged here the "Soludo Model". For the purpose of this academic discuss, I seek your indulgence to refer to this present phase of the financial sector reforms as a "model", so that by its meaning, we can attempt to deduce or conjecture the theoretical framework which informs the reforms. It will also enable us to situate the theoretical underpinnings of the Nigerian financial systems architecture, its functional relationships and the implications for getting economic incentives right for the promotion of a private sector led growth as envisaged by the proponents.

The objective of this paper therefore is to conjecture the policy approach of the Soludo reforms, characterizing it within known theoretical school of thoughts or foundations. This could enable us to interpret the fall outs and gauge the impact correctly as well as the key theoretical qualifications which belie the alternative perspectives and its implications for new directions of banking sector reforms.

2. The Theoretical Framework and Method of Analysis

Substantial literatures exist which suggest that when economies suffer from severe financial distress, an economic reform is often recommended. The objective usually is to forestall further economic deterioration which results from unsustainable consumption (a situation whereby domestic supply shortages due to stagnating output had to be augmented with unsustainable imports, with adverse consequence of huge external debts overhang). Such economies suffer from stagflation, accompanied with rapid deterioration in social conditions especially the accentuation of poverty. The cause of distress has often been attributed to weak framework for policy design and implementation. At the heart of economic reforms therefore is the need to address a two-fold problem: restructure or get policy incentives right as well as restructure key implementation institutions. Financial sector reforms is that aspect of economic reforms which focus mainly on restructuring financial sector institutions (regulators and operators) via institutional and policy reforms.

Broad Objectives of Banking Sector Reforms

The literature is replete with studies which show that the objectives of financial sector reforms are broadly the same in most countries of Sub-Sahara Africa. Omoruyi (1991), CBN (2004) and several financial sector analysts summarized the objectives to include:

- Less intervention in the market with the view to promote a more efficient resource allocation
- Expanding the savings mobilization base in support of investment and growth through market-based interest rates
- Improving the regulatory framework and procedures so as to forestall distress
- Fostering competition in the provision of banking services
- Laying the basis for minimal inflationary growth or conducive enabling environment

Among the policy instruments often employed to attain these objectives are:

- Foreign exchange markets and interest rates deregulation
- Adoption of market based approach to credit allocation
- Pursuit of sustainable fiscal and monetary policies
- Reforms or restructuring of financial markets via legislative changes
- Active use of prudential regulations and enforcement of capital adequacy requirements

In general the extent of reforms is often guided by the severity of internal economic distortions and the adversity of the disincentives created especially for a private-sector led growth.

The Guiding Principles of Soludo's Reforms

The Soludo,s reforms appeared to be guided by the provision in the NEEDS document {National Planning Commission (NPC), 2004} that the financial sector needed "to play a key role in pricing and trading risks and implementing monetary and fiscal policies" as part of the process of "a shift in emphasis to a private sector led economy". The document further argued that: "there is a strong case for ensuring the efficiency of the financial system and for dealing with the contradiction inherent in the fact that despite high profit levels, the sector does not appear to be playing a catalytic role in the real sector" (NPC 2004). The problematic situation the reforms was intended to address included: the shallow depths of the capital market, dependence of financial sector on public sector and foreign exchange trading as sources of funding; relatively inaccurate returns submitted to the monetary authorities, apparent lack of harmony between fiscal and monetary policies and above all, the poor loans repayments performance as well as bad debts.

The NEEDS document further identified the policy thrust of the financial sector reforms as: "to build and foster a competitive and healthy financial system to support development and to avoid systemic distress". This is to be achieved by deepening the financial system in terms of asset volume and instrument diversity; drastic reduction and ultimate elimination of financing of government deficits by the financial system in order to free up resources for lending to the private sector; a review of the capitalization of financial institutions and through the development of a structure of financial sector incentives that would support real sector financing. Among the strategies enunciated for achieving these include: embarking on a comprehensive reform process aimed at substantially improving the financial infrastructure; restructuring, strengthening and rationalizing the regulatory and supervisory framework in the financial sector; addressing the issue of low capitalization of financial institutions; developing a structured financing for cheap credit to the real sector and above all foster financial deepening and accommodations for small and rural financial markets.

Method of Analysis

In order to give an objective assessment of the outcomes of the banking sector reforms, there is the need to specify evaluating criteria. Given the fact that the time span since the commencement of the reforms is short, I have proposed to use descriptive statistics to test the hypothesis that recapitalization has contributed significantly to improved banking services to the economy as whole. The assumption is that the post reforms values of these measures differ significantly from the pre-reforms value. Among these measures are: branch networks, increased supply and improved access to credit, increased returns to investors in the banking sectors, reduced distress ratios, and above all increased profit earnings, as well as increased ability to compete within the global economy. It should however be noted that several factors exist besides the reforms measures that could explain the trend in these indicators.

In order to ascertain the relative efficiency of the reforms, we posit that increases in asset base should lead to increase in lending to the real sector at lower interest rates. Interest rates reforms should lead to the convergence, and or narrowing down of the premium between the savings and prime lending rates. Foreign exchange market reforms should foster relative stability of the exchange rate of the naira vis-à-vis world trading currencies, in addition to eliminating divergence inherent in the current multiple exchange rates system.

3. *The Overview and Outcomes of Reforms*

The nature of the Soludo's banking sector reforms and their outcomes can be categorized into the following: (i) Banking sector consolidation; (ii) foreign exchange market stabilization; (iii) interest rates restructuring; (iv) the pursuit of stabilization as against structural adjustment policies for monetary and inflation controls and (iv) currency restructuring

The Nature and Assessment of Banking Sector Consolidation

The most visible element of the Soludo's reform is the banking sector consolidation and the proposed currency reforms. Upon assumption of duty in 2004 as Governor, the Central Bank of Nigeria indicated that the current commercial banks should recapitalize from a minimum capital base of N2 billion to N25 billion. As at the period, 89 banks were in operation made up of about 5-10 banks, whose capital base were already above the N25 billion marks, another group of 11-30 banks, within the N10 to N20 billion mark, while the remaining 50 to 60 banks were quite below the N10 billion mark. A period of about 12 months was given to these banks to recapitalize through new issues, mergers and acquisitions. Failure to do so would mean the liquidation of such banks by the monetary authority. Appropriate legislative backing was obtained for this, and at the end of the exercise, about 25 banks emerged. A total of 18 banks failed to meet the recapitalization criteria and had their licenses revoked.

A preliminary assessment of the impact of the banking sector consolidation can be deduced from a recent presentation by Soludo (2007) which noted that significant progress has been achieved in the area of financial and payment systems reforms which began in 2005. Among these achievements which he identified with regard to banking sector consolidation are as shown in Table 1 below. As can be seen from the table while there was a reduction in the number of banks from 89 to 25, the total asset base rose by 104% post consolidation. Equally, their capital and reserves rose by 192%, while their capital adequacy ratio which stood at 15.18 per cent took a quantum leap to 21.6% in 2006, far above the 10% requirement pre- and post-Soludo's reforms. Among the qualitative achievements identified by Soludo (2007) were that the CAMEL parameters rating of the banks as at September 30, 2006 showed there was no UNSOUND bank while the ratio of non-performing credit to total credit was 9.5 per cent compared to 19.8 per cent in June 2004. Also,

Table 1: Basic Indicators of Banking Sector Consolidation Results

	2004	2006	% Grt.
No. of Banks	89	25	-71.9
No. of Bank Branches	3382	4500	33.1
Total Assets Base of Banks (₦'Billion)	3209	6555	104.3
Capital and Reserves (N'Billion)	327	957	192.7
Industry Capital Adequacy Ratio (%)	15.2	21.6	42.6
Ratio of non-performing credit to total(%)	19.5	9.5	-51.3

Source: Central Bank of Nigeria, Abuja

he observed that the surviving 25 banks are strong and reliable and now the size of first and second largest banks in South Africa in contrast to combined 89 banks in 2003 that were the size of 4th largest bank in South Africa. He also noted that the banking sector has become the dominant sector in the Nigerian Stock Exchange and indeed the key driver of the recent phenomenal growth of the Exchange.

A cursory look at the above score cards would suggest that the banking sector faired well. However, when judged against the stated objectives which informed the reforms, this may not be quite true. While it can be argued that recapitalization may have helped to build and foster a competitive and healthy financial system, it is debatable if the structure of their portfolio investments has the capacity to support the desired economic development aspiration of the proponents. For instance, available data show that despite the rapid increase in lending to the economy, the share of production sectors of the economy especially agriculture and mining remained low and indeed declined proportionately over time suggesting that the new monies may have been channelled into miscellaneous activities. Yet agriculture is known to contribute a major share to the GDP, even under conditions that it is not getting new funds. A significant proportion of the production loans go to manufacturing, probably to finance imports of raw materials, machineries and component assembly activities.

Table 2: Commercial Banks Loans & Advances in Nigeria, 2000-2006

	2000	2001	2002	2003	2004	2005	2006
CBs Loans and Advances (N'm	1795768.3	2796112.2	3606229.1	4339443.0	5686669.2	7392670.0	9684397.7
Annual Growth Rate (%)	41.8	55.7	29.0	20.3	31.0	30.0	31.0
Sectoral Distribution (% of total)							
PRODUCTION	44.5	40.8	39.1	36.2	36.7	32.8	28.1
Agriculture, Forestry and Fishin	8.2	7.2	6.3	5.6	4.6	3.8	3.2
Manufacturing	28.9	25.7	24.6	23.0	23.0	19.9	16.9
Mining and Quarrying	7.4	7.9	8.2	7.6	9.1	9.1	8.0
Exports	5.5	4.1	3.1	3.2	2.2	1.7	1.3
Miscellaneous	50.1	55.1	57.8	60.7	61.1	65.5	70.6
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: National Bureau of Statistics 2006

In order to test empirically the likely effects of increases in total assets, capital and reserves of banking sector on credit to the production and/or real sector of the economy, a pair wise correlation matrix was computed using Eviews Econometric estimation software and the result is as shown in Table 3. This table is derived from quarterly data which span the period 1999:1 to 2006:4 for the selected variables. The table shows that in line with

Table 3: Pairwise Correlation Coefficients of Commercial

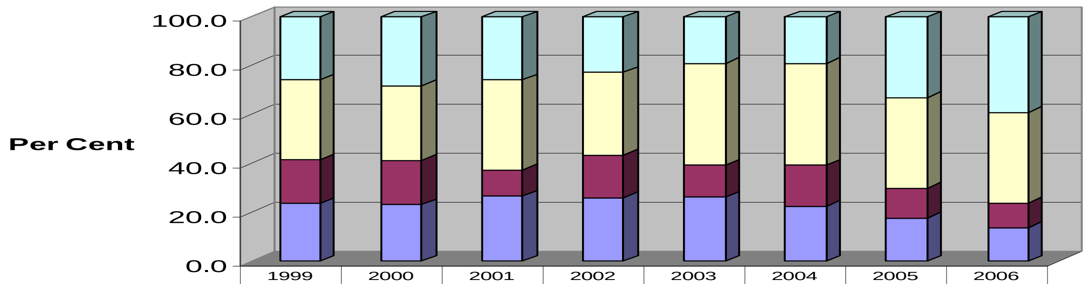
Variable	TCR	PCR	CAPBR	TAREV	PCR/TCR
TCR	1.0000	0.9984	0.9818	0.9977	-0.7537
PCR	0.9984	1.0000	0.9739	0.9985	-0.7262
CAPBR	0.9818	0.9739	1.0000	0.9744	-0.8057
TAREV	0.9977	0.9985	0.9744	1.0000	-0.7292
PCR/TCR	-0.7537	-0.7262	-0.8057	-0.7292	1.0000

TCR= Total Credit; PCR= Credit to Production Sector;
CAPBR= Capital & Reserves; TAREV= Total assets
Source: Derived from data from CBN

theoretical expectation, there is significant and positive correlation between banking sector total assets, capital and reserves and total credit as well as production credit granted by the banks during the period. However, when compared to the relative share of production in total credit, there is a strong but negative correlation between this variable and that of total assets, capital and reserves. This suggest that rather than stimulating increases in credit to production activities, increases in capital base has been associated with relatively less credit to the real sector. This tended to confirm the fear that the current recapitalization exercise may have tended to fuel speculative activities.

Perhaps, the structure of assets holdings of the commercial banks pre- and post-

Figure 1: Structure of Banking Sector Assets



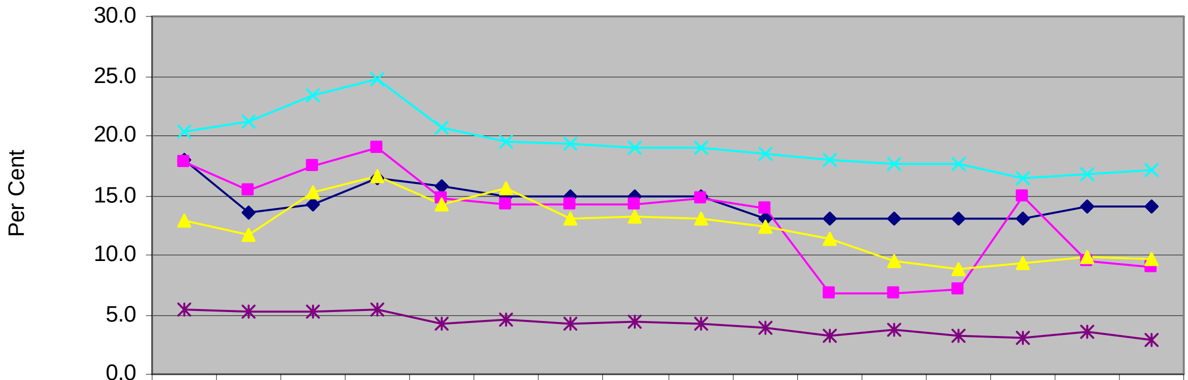
	1999	2000	2001	2002	2003	2004	2005	2006
Unclassified Assets	25.7	28.1	25.8	22.8	18.9	19.0	33.0	39.1
Pr. Sect. Claims	32.8	30.6	37.0	33.7	41.8	41.6	37.1	37.1
Gov. Claims.	17.8	18.2	10.6	17.5	13.1	16.9	12.1	10.0
Bank & Foreign Reserves	23.7	23.1	26.6	26.0	26.2	22.5	17.8	13.8

consolidation may give us a pointer to the investment portfolio items that constitute miscellaneous advances. Figure 1 show that the proportionate claims of the banking sector on government and private sectors exhibited decline post reforms, while that of unclassified assets rose dramatically. This further tends to confirm that banks have found alternative portfolio investments more lucrative than lending to the private or government sector.

Interest Rate Restructuring

There seemed to be very little departure from erstwhile interest rates policies during the Soludo's era, as the reference policy rate, MRR, continued to give distorted signals to operators in the money markets. Thus the reference Minimum Rediscount Rate (MRR) remained at 13 to 15 per cent during the period, in line with pre-Soludo reforms rate. The monetary authority did not consider it appropriate to lower it even when Treasury Bill Rate (TBR), which was higher in pre-reform era, began to fall. Consequently, except between the Second and Forth Quarter 2005, TBR was consistently higher than the 3-month Deposit Rates (DR) and Savings Rate (SR), suggesting that investments in public debt instruments and CBN certificates were more attractive to investors and financial intermediaries, who accordingly shun credit portfolios, capable of stimulating growth. Increasingly also, the MRR which was expected to serve as penalty rate for

Figure 2: Interest Rates Structure in Nigeria, 1999-2006



	99	00	01	02	03	04Q1	04Q2	04Q3	04Q4	05Q1	05Q2	05Q3	05Q4	06Q1	06Q2	06Q3
MRR	18.0	13.5	14.3	16.5	15.8	15.0	15.0	15.0	15.0	13.0	13.0	13.0	13.0	13.0	14.0	14.0
TBR	17.8	15.5	17.5	19.0	14.8	14.2	14.3	14.3	14.7	14.0	6.7	6.8	7.1	15.0	9.4	9.1
DR	12.8	11.7	15.3	16.7	14.2	15.6	13.1	13.2	13.0	12.4	11.4	9.4	8.9	9.3	9.8	9.7
LR	20.3	21.3	23.4	24.8	20.7	19.5	19.4	19.0	18.9	18.5	18.0	17.6	17.6	16.5	16.8	17.1
SR	5.3	5.3	5.3	5.5	4.2	4.5	4.3	4.4	4.2	3.9	3.3	3.7	3.3	3.0	3.5	2.9

patronage of the lender-of-last-resort facility, inadvertently became a docile instrument, but which provide an anchor for rent-seeking on the part of intermediaries, who rather than borrow from the monetary authorities, offload their idle cash balances through the primary window with guaranteed returns.

Towards the end of 2006, there was an apparent realization of this short-coming by the monetary authorities. This led to the introduction of the Monetary Policy Rate as a replacement to the MRR. It is fixed at about 10 percent, but operated within a band of 7 to 13 per cent. It is recommended as the reference interest rates for inter-bank transactions and in the case of recourse to the lender-of-last-resort facilities. It is my view that the starting point of this rate is still very high, given the fact that savings rate, is low, while the majority of funds of the banking sector comes from demand deposits especially from government for which they pay no interest.

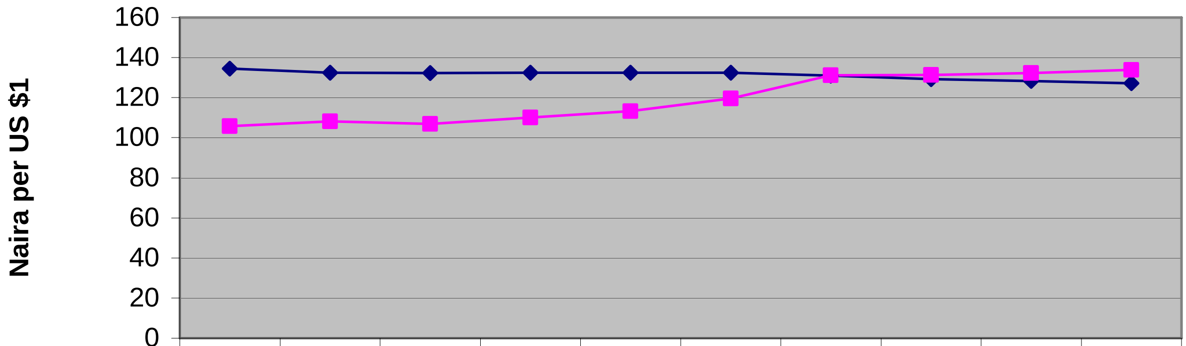
Macroeconomic Stabilization via Monetary Control Policies

Although market reforms appeared to be the major fulcrum of Soludo's approach, it did not depart from erstwhile policy of indirect monetary control via open market operations and quantitative controls of deposit money banks reserves. This task has been made arduous by the fact that in recent years, the fiscal authorities have had no recourse to borrowing from the banking system. This had forced the monetary authorities to bear the full burden of traded treasury bills and CBN certificates, used as major instruments of mopping up liquidity in the banking system. As it seems, the combination of a defective interest rates structure coupled with the demand of monetary management, have led the monetary authorities to mop up the liquidity surfeit in the system, and for which it creates money to meet the debt service obligations upon maturity. Many policy analysts believe that this approach is in itself inflationary, and may not in any form contributes to its abatement.

Exchange Rate Stabilization

The Soludo's reforms of the foreign exchange market revolved mainly around strengthening the Dutch Auction Market, and narrowing the premium between the DAS, Bureau De Change and Inter-Bank rates. This was achieved through more frequent intervention of the

Figure 3: Quarterly Nominal and Real Effective Exchange Rates in Nigeria, 2004-2006



	2004Q1	2004Q2	2004Q3	2004Q4	2005Q1	2005Q2	2005Q3	2005Q4	2006Q1	2006Q2
NER	134.44	132.42	132.32	132.37	132.4	132.35	131.05	129.31	128.25	127.19
REER	105.75	108.21	106.95	110.06	113.17	119.58	131.14	131.33	132.21	133.85

Central Bank at the DAS market, in addition to permitting the banks to provide bureau de change services. The result over time was the deliberate appreciation of the exchange rates. Figure 3 shows that exchange rates were stabilized at approximately N132.3 = US $1 between the Second Quarter 2004 to the corresponding quarter in 2005. Thereafter it was appreciated to about N131.05 = US $1.00 in the Third Quarter 2005, a level that coincided with the Real Effective Exchange Rates calculations based on the trends in the relative consumer price indices of Nigeria and the US. However, beyond this period, further deliberate appreciation of the market in the face of diverging inflations suggested that the exchange rates appeared to have become overvalued. This notwithstanding, there appear to be relative stability in exchange rates since the advent of Soludo, buoyed by two main factors: the first is the increased foreign exchange earnings which resulted from high world prices of crude oil (Nigeria's main foreign exchange earner) with a concomitant increase in Nigeria's external reserve holdings; the second is the deliberate intervention of the monetary authorities in the market as a way of establishing a managed float of the national currency.

4. *Theoretical Qualifications to the Soludo's Reforms*

The financial sector reforms and especially the Soludo's are premised on certain assumptions, which may be applicable to market economies, but with limitations when applied to developing economies like Nigeria. For this reason, it is useful to examine the theoretical framework which informed the reforms, its underlying assumptions that seems especially critical to the outcomes and to determine the impact of their absence for alternative direction for reforms.

The Theoretical Qualification of Banking Sector Consolidation

The starting point of our discussion of the theoretical qualifications to the Soludo' is the banking sector consolidation which so far appears to be its main driving force. This perhaps, is a logical response to the argument by the NEEDS document (NPC 2004), that the bane of Nigerian banking sector is low capitalization, and which prevented the country from being a big player in global financial markets. This argument draws its strength from the neo-classical supply-side economics, rooted in Say's Law that "supply creates its own demand" (Jhinghan, 2003). It is my conjecture that proponents of these reforms that anchored it on banking sector recapitalization believe that increased capital base may imply increased availability of loanable funds. This should lead to a fall in interest rate and should be capable of stimulating or eliciting a demand following response as envisaged by Say's Law of Markets. Unfortunately, Say's Law did not relate to the financial markets, but more specifically to the product markets with the belief that "production of commodities creates, and is the one and universal cause which creates a market for the commodities produced". While Say's Law remained silent with regard to the role of money, it however argues that the only reason to have money is to buy goods, and did not envisaged the Keynesian outcome that there could be the precautionary and speculative demand for money (Kates, 1998).

An extension of Say's Law is reflected in an alternative view that all money that is held is done so in financial institutions (markets), so that any increase in the holding of money increases the supply of loanable funds. Then, with full adjustment of interest rates, the increased supply of loanable funds leads to an increase in borrowing and spending. So any negative effects on demand that results from the holding of money is canceled out and Say's Law still applies.

If this is the premise of the Soludo's financial sector recapitalization, it appears consistent with the classical views of monetary policy that the main function of money is to act as a medium of exchange, and its sole importance is to determine aggregate price level. It does appear that by this policy stance, there is great likelihood that there could be rapid monetary expansion which, the monetary authority must have to contend with as part of its role of inflationary control. Here lies the inherent conflict or trade-off in policy objectives with origins from the actions of the monetary authorities itself. Five such conflicts and inconsistencies can be identified:

The first relates to management of the liquidity surfeit which arose there from. Whereas the envisaged source of liquidity surfeit had been thought to originate from fiscal actions, we are here confronted with 'new money' (from the supply-side) that is the creation of the monetary authorities, since during the period, the fiscal authorities have had no recourse to borrowing from the central bank, as it boasted of adequate revenues and foreign reserves. It is my belief that the monetary authorities were compelled to create their own instruments given the dearth of treasury bills to contend with this type of liquidity.

The second is the rapid expansion in the endogenous money supply, informed by the change in economic activity, which affect people's desire to hold currency relative to deposits. The banking sector consolidation via recapitalization is therefore believed to draw into the banking system a significant proportion of currency outside banks which is known to be high in Nigeria. With a quantum jump in reserves of banks, their ability to create credit or deposits is naturally expected to rise accordingly. However, this can only be true in the absence of leakages in the credit creation process. Such leakages could arise, if a significant proportion of the new money is channeled towards meeting mandatory holdings with the central bank, or through the purchase of 'money sterilization instruments' and if alternative investment windows exist such as changes in business activities which affect the behaviour of banks and borrowers. The latter is particularly notable in Nigeria, since such changes made long term real sector investment non-lucrative, thereby resulting in credit apathy by both lenders and borrowers.

The third relates to the "impressive" results that is being paraded that financial strength is synonymous with growth. It does appear that this premise for financial sector reforms tended to depart from the earlier classical perspective towards agreeing with the Keynesians that monetary policy plays a key in affecting economic activity. The Keynesians contend that a change in the supply of money can permanently change such variables as the rate of interest, the aggregate demand, and the level of employment, output and income. If this is viewed from the perspective of the Keynesians, recapitalization amounts to cheap money policy which should indeed leads to lower interest rates and increased investment. The increased investment will raise effective demand through the multiplier effect thereby increasing income, output and employment. However, an important qualification to this assumption in Keynesian analysis is that this is feasible when the economy is known to operate below the full employment level. Given the stage of development, market structures, especially dualism and segmentation, and the claim of widespread liquidity surfeit by the monetary authority, the Nigerian financial markets seemed to operate beyond the full employment level. A Keynesian monetary policy could shift the equilibrium money supply towards intersecting with the demand for money curve at the precautionary and speculative level. With the advent of universal banking, the demand for the new funds, is guided by the precautions that meeting the demand of real sector credit is risky; short term trade financing, especially imports yields quick returns, while opportunities to invest in bonds and treasury bills and other money market instruments offer a lucrative returns. There is therefore very slim chance that the new money would find its way into investment, given the general level of credit apathy on the part of financial markets. The theory that being 'big' and 'strong' connotes 'tremendous increase' in credit creation ability, and by inference, rapid growth, becomes illusionary.

Related to the above, is the contentious monetary authorities stance that the inability to recapitalize, and/or forged a merger and acquisition relationships with others implies institutional weakness. This is in spite of the fact that the NEEDS' document which laid the foundations for the reforms admitted ("….. that despite ***high profit levels***, the sector does not appear to be playing a catalytic role in the real sector") that some of these banks are profitable ventures, but that the monetary authorities grouse with them is that they are not playing a catalytic role in the real sector. The pertinent question is: can small not be beautiful? If at the level of their capitalization they are doing good business, why should they be liquidated on the ground that they needed to be big to make 'bigger profits'? Here lies the contradiction in policy. The financial distress experienced by this group of banks is policy induced as some of them were actually not distressed in the true sense of that word. Ironically, one of the elements of the financial sector reforms is the promotion of small holder and development finance institutions expected to grant concessionary loans to small holder enterprises. Indeed, the monetary authorities agree that small is beautiful, but prefers to kill the 'small' for the 'big'.

The fifth relates to the likely conduct of the emerging 'oligopolies' in the foreign exchange markets. One argument often advanced for liquidity mop up by the monetary authorities is the need to keep a tab on monetary expansion as an instrument to stabilize the foreign exchange market. The operating procedure usually is to limit the capacity of banks to make outrageous bids for foreign exchange, through the control of their money reserves. This task was arduous when the banks were many and have a lower capital base. However, let us for once imagine the monster the monetary authority would have to contend with given the fewer but richer number of banks equipped to manipulate the foreign exchange market to their advantage. The forex market would remain their niche and the likelihood is there that they may become sharper and wiser in that market than in other investment portfolios markets. If anything, the recapitalization has strengthened them further to accentuate their rent seeking behavior, and domestic monetary policy appears inadequate to address this problem.

The Theoretical Qualifications to Foreign Exchange Market Reforms

So far, the foreign exchange market reforms under Soludo, seems to strengthen the Dutch Auctions Market (DAS) with a view to stabilizing the exchange rates and eliminate erstwhile market segmentation. As a major player in that market, the monetary authorities uses periodic supply or injection of foreign exchange into the market for the purpose of achieving a two-fold objective of stabilizing exchange rate at the desired level as well as mopping up excess liquidity in the banking system which is considered for inflationary control.

Two areas of theoretical qualifications that tended to generate conflicts or tradeoffs arising there from are: (i} the implicit belief that a Mundellian adjustment policies is required to foster internal and external macroeconomic balance and (ii) the notion that the market fundamentals of the domestic foreign exchange market is unique, and as such warranted peculiar approach to its formation and promotion.

With regard to the first, the deliberate effort on the part of the monetary authorities to stabilize exchange rates in the face of a BOP surplus tended to suggest that it did not favour further devaluations via expenditure switching policies. This stance is logical, given that as a small country, devaluations would only serve to accentuate domestic inflation. However, to the extent that it had shown concern on how this surplus affect domestic money, also tends to suggest that it belongs to the school of thought that “a balance of payments deficit is always and everywhere a monetary phenomenon” and as such can only be corrected by monetary measures. This school argues that there is a strong link between external and internal balance via the monetary survey equation which relates the supply of money to the demand for money as well as the external sector.

The monetary approach can be expressed in the form of the following relationship between the demand for and supply of money (Jhinghan 2003):

$$M_D = \oint(Y, P, i) \quad \cdots \quad \cdots \quad \cdots \quad \cdots \quad \cdots \quad (1)$$

$$M_S = NDC + NFR \quad \cdots \quad \cdots \quad \cdots \quad \cdots \quad \cdots \quad (2)$$

$$M_D = M_S \quad \cdots \quad \cdots \quad \cdots \quad \cdots \quad \cdots \quad (3)$$

Or $$M_D = NDC + NFR \quad [\because \quad M_S = NDC + NFR] \quad \cdots \quad (4)$$

Whereby M_D is the demand for money which is a stable function of income (Y), prices (P) and rate of interest (i); M_S is the money supply, which is a multiple of monetary base (m) which consists of net domestic money (credit) (NDC) and country's foreign reserves (NFR). A balance of payment deficit or surplus is represented by changes in the country's reserves such that:

$$\Delta NFR = \Delta M_D - \Delta NDC \quad \cdots \quad \cdots \quad \cdots \quad \ldots \quad (5)$$

Or $\quad \Delta NFR = BOP \quad \cdots \quad \cdots \quad \cdots \quad \ldots \quad \cdots \quad \cdots \quad (6)$

Such that: $BOP = \Delta M_D - \Delta NDC \quad \cdots \quad \cdots \quad \cdots \quad \ldots \quad \cdots \quad \cdots \quad (7)$

Where *BOP* is the balance of payment which, is equal to the change in demand for money and change in domestic credit. From equation (5) and (7), a balance of payment deficit means a negative BOP which reduces the NFR and the money supply. On the other hand, a surplus means a positive BOP which increases the NFR and the money supply. When BOP = 0, it means BOP equilibrium or no disequilibrium of BOP.

Now let us examine this theory against the backdrop of the fact that the Nigerian economy is starting from a position of a BOP surplus. What should be the direction of a monetary approach to its adjustment, especially so if the monetary authorities have stabilized the exchange rates to a near fixed position? A surplus would suggest that expansion in money supply would have its origin from equation (4), such that:

$$\cdots \quad [\because \; M_S = NDC + NFR] \quad \cdots \qquad (4) \, .$$

This can be interpreted to mean that, although domestic money supply may exceed the demand for money, the excess money is not from domestic borrowing but from draw-down on reserves which in itself serves to mop up liquidity. To the extent that such liquidity does not swell the reserves of deposit money banks but that of the central bank, the ability of such funds to compromise monetary policy pursuits depends on the timing of the releases, especially so since the government have limited their use of ways and means advances. If the monetary authority therefore chooses to forestall wholesale releases, it has two alternative instruments: (i) increase the reserve requirements, which is a quantitative controls measure, or (i) create its own certificates to mop up the liquidity (which is a market based instrument). The experience so far, is that the Nigerian monetary authority chose the latter approach, implying that it would create 'new' or 'high-powered' money to meet the contractual obligations associated with such instruments upon maturity. Although the monetary authority has often argued that it is a desirable pre-emptive action, such a precautionary reaction to this 'insipid' liquidity may in fact be the root cause of inflation of a monetary origin. It does appear that the monetary authority has chosen to stab itself in the foot by helping the fiscal authorities to monetize reserves which it has to periodically struggle to control, even when such money is not reflected in domestic credit. It therefore means that monetization of foreign reserves could indeed make available larger cash balances which could be deployed to increase their purchases to buy more foreign goods and securities, and it could raise their prices and increase imports of goods and foreign assets, but not financed from borrowing.

The second major qualifications relates to the conflict inherent in the operation of DAS Foreign Exchange Market. DAS can be described as the Nigerian version of the spot market for foreign exchange. Unlike all other spot markets dominated by financial institutions and individuals, the principal actors in this market are the Central Bank of Nigeria and Commercial Banks. Also, contrary to being a traditional spot market where wholesale and retail transactions take place concurrently daily inter bank, the Nigerian DAS is solely a wholesale auction markets which is dominated by the central bank as a monopoly supplier while the financial institutions are a buying cartel purportedly on behalf of their clients. Although it is often being argued that it is a wholesale market in which reciprocal patronage is expected from all players in the market, unfortunately, this has not been so. Instead, the financial institutions retail foreign exchange to individuals and corporations through a second window - the inter bank market - which operates more like the spot market. Thus, in practice, the Nigerian spot market is segmented into: DAS, the wholesale segment which is monopolistic in supply and oligopolistic in demand, and the second: inter bank, which is olipolistic in supply to ultimate users of foreign exchange.

The major dilemma or conflict arising from the segmentation of the spot market is the tendency of participating financial institutions in the DAS to convert purchases from the wholesale market to speculative operations at the inter bank market as well as in their retailing activities with individuals and corporations for arbitrage gains. This is often reflected in ever increasing and widening market premium which the proponents of the reforms seemed to be worried about. Although the monetary authority has often thought that what is needed to rectify this anomaly is increased funding of the wholesale market through very frequent interventions such that the speculative activities of the inter bank is minimized. Unfortunately, speculations given the Nigerian experience are far beyond the ambit of the two regular markets, but extend to what is commonly known as black or parallel market operations which is completely illicit or illegal.

Given this operational background, what should be the focus of forex market reform? It is my view that reforms should mean a movement away from frequent interventions and ultimate reliance on the ability of the market to allocate foreign exchange resources efficiently. However, the operational mechanism of DAS show that instead there has been a resurgence of interventions, and this would perhaps explain the persistence of rent-seeking behaviour by operators. This again leaves us with another dilemma as to whether the supply base can be broadened such that central banks intervention is eliminated while the perfect competitive outlook of the spot market is improved. In my view this is feasible if the central bank concede their role as major supplier to the commercial banks. This can be done via fiscal reforms which would enable all the tiers of government to negotiate their realized foreign exchange through spot market operators instead of the wholesale market. By this act, the wholesale auction market would be eliminated and the window for speculation and arbitrage permanently foreclosed. It also means a conscious move towards the law of one market. In particular, this should mean that domestic interest rate should converge with the Eurodollar market rates. That way speculations based on inter-country differences will be eliminated.

Over all Qualifications to the Theoretical Underpinning of the Soludo's Reform

From the analysis so far, it could be inferred that in thoughts, the Soludo's approach to reforms is Classical with deep foundations in Say's Law. However, it is obvious that he adopts the Monetarist view for fostering internal and external macroeconomic balance but expects Keynesian results. It is his monetarist perception of the role of money that motivated the monetary authorities to conclude that excess 'insipid' liquidity could be injurious to the economy by way of rising inflationary pressures, and must be mopped up using its own instruments of high-powered money. Rather than tame inflation, it seems to be the driving force behind domestic inflation of monetary origin. However, to the extent that he favoured interventions both in the foreign and domestic money markets, he acts Keynesian, believing that the unseen hand of the state is capable of moving the economy in the desired direction. Perhaps, it is this ambivalence that is the root cause of the conflicts and tradeoffs which the Soludo's reforms elicited. It is obvious therefore that what is needed to bolster the Soludo's reform might be the adoption of a neo-classical supply-side economics stance, in which it would reconcile, monetary with fiscal policies for the purpose of achieving the set goals. Such reconciliation would mean that the monetary authority should be less concern with expansionary fiscal stance, for as long as its origin is not through domestic borrowing. Under such a scenario, it should rely mostly on interest rate operating procedures for macroeconomic management with the sole objective of moving towards the 'law of one market' in both the domestic and international money markets.

5. Policy Options and Concluding Remarks

It is apparent that the Soludo's reforms has been spurred by the decision to promote investments in both domestic and international financial markets in the face of rising reserves following the recent oil export booms. At the domestic market levels, it is presumed that deepening the loanable funds supply base holds the key to the realization of this objective, while the focus at the international financial market levels is on the placement of idle reserves in the Eurodollar markets to generate more returns for the country. In general, the policy actions taken are premised on the need to minimize risks that can adversely affect the rate of return on domestic and international financial investments in the country. The two sources of risk often identified in the literature are exchange rates and interest rates risks which affect the investment decision (Appleyard & Field, 1998). Thus, financial markets reforms so far are targeted at the management and control of these risks in such a way to create the right incentives for the inflow of foreign investment in addition to rapid expansion in domestic investment. This means that we needed to get prices right so as to reduce the conflicts in the twin objective of attaining internal and external balance. What is required therefore is the need to urgently fine-tune the Soludo's approach to the domestic money and foreign exchange market reforms. The fine-tuning approach should be based on the 'law of one market', i.e. the deliberate adoption of policies that would ensure convergence of domestic and international rates of return on financial markets investment. This would require:

Getting Domestic Interest Rates Right

On the domestic scene, there is the need to narrow the gap in interest rates structures of alternative financial markets investment portfolios. In particular, there is the critical need to determine the appropriate benchmark for interest rates policies. Although the newly introduced monetary policy rate is targeted at this, the extent of adjustment is inadequate. A situation whereby the interest rate premium between the MPR and the Savings Rate is so wide suggest that arbitrage activities informed by this development would continue to issue distorted signals for the viability of credit portfolios and real sector investments on the one hand, and alternative investments in securities and money market instruments on the other hand. Although a market based supply side policies was expected to attain this, the monetary authority would need to be less concern with the perceived adverse trade off implicit in their current approach. Indeed contemporary experiences of similar economies lend support to this approach. Thus, countries with best practices like the United States, United Kingdom keep their monetary policy rates close to their deposit rates especially savings rate. Also countries within Africa which belong to a monetary zone maintained the same tradition as it is evident from the data on Senegal and South Africa. However, Botswana and Nigeria are classic examples of undesirable interest rates structures, induced by the failure of the monetary authorities to prescribe an appropriate reference rate in line with best practices (see Table 4).

Table 4: Interest rates Structure in Selected Countries 2004-2006													
	Botswana		Senegal		South Africa		United States		United Kingdom		Nigeria		
DESCRIPT	SAVINGS	BOB LEND	DISCOUNT	DEPOSIT	DEPOSIT	DISCOUNT	DISCOUNT	FEDERAL	3-MONTH	TBR	MRR/MPR	3-M DR	Sav. Rate
2004Q1	7.8	14.3	4.0	3.5	6.7	8.0	2.0	1.0	4.2	4.0	15.0	15.6	4.4
2004Q2	7.6	14.3	4.0	3.5	6.9	8.0	2.0	1.0	4.6	4.4	15.0	13.1	4.4
2004Q3	7.6	14.3	4.0	3.5	6.5	7.5	2.6	1.4	4.9	4.7	15.0	13.2	4.4
2004Q4	7.7	14.3	4.0	3.5	6.0	7.5	3.2	2.0	4.9	4.7	15.0	13.0	4.4
2005Q1	8.5	14.3	4.0	3.5	6.1	7.5	3.6	2.5	4.9	4.7	13.0	12.4	4.0
2005Q2	8.4	14.0	4.0	3.5	6.0	7.0	4.0	2.9	4.9	4.7	13.0	11.4	3.3
2005Q3	8.1	14.3	4.0	3.5	5.9	7.0	4.6	3.5	4.6	4.4	13.0	9.4	3.7
2005Q4	7.2	14.5	4.0	3.5	6.2	7.0	5.2	4.0	4.6	4.4	13.0	8.9	3.3
2006Q1	6.7	15.0	4.0	3.5	6.6	7.0	5.5	4.5	4.6	4.4	13.0	9.3	3.0
2006Q2	6.6	15.0	4.0	3.5	6.6	7.5	6.0	4.9	4.7	4.5	14.0	9.8	3.5
2006Q3	6.2	15.0	4.3	3.5	7.3	8.0	6.3	5.3	4.9	4.7	14.0	9.7	2.9
Source: IMF International Financial Statistics													

Getting External Investment Opportunities Right

On the international scene, it is critical to foster the emergence of a rate of return on foreign investments especially in the Euro-Dollar markets based on real changes in financial assets in question and not gains from nominal exchange rates adjustments. Luckily enough, the stabilization of exchange rates so far is a good omen, but the monetary authority should also compliment this with the adjustment of domestic interest rates to coincide with Euro Dollar interest rates so as to put paid to this speculations arising there from. This would require actions not only to synthesize the segmented domestic foreign exchange market, but also to ensure synergy between the foreign exchange market and the domestic money market. One way to achieve this will be to look at the market fundamental of the Nigerian forex market, especially the DAS vis-à-vis the inter bank, with a view to permanently merging the two markets.

Concluding Remarks

Overall, the major challenge to the Nigerian financial sector reforms is how to engender healthy competition in addition to enhancing investments. This demands the need to evolve an investment friendly interest rate regime that is supportive of the growth objective of the government. The only way this can happen given the recapitalization schemes, is to allow increases in money supplies to be reflected in the costs of borrowing. The lower costs of borrowing would induce the desired credit expansion, which would give fillip to investment activities. Although this may be inflationary in the short run, it is still more beneficial since its origin is not from high powered money.

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