OPEN MARKET OPERATION AS AN INSTRUMENT OF MONETARY POLICY IN NIGERIA: ADMINISTRATION, PROBLEMS AND PROSPECTS.

BY

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DECLARATION

I hereby declare that this project, a partial requirement for the ward of the degree of masters in Business Administration (MBA) of the Ahmadu Bello University, Zaria is a project of my findings.

All sources of information for the write up are clearly acknowledged by means of reference from various textbooks, articles, journals, seminars and information from the staff of Central Bank of Nigeria.

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Date: 15 - 3 - 1999

CERTIFICATION

This Project "Open Market Operation as an instrument of monetary policy in Nigeria: Administration, Problems and Prospects," by Mairiga Abdu Shehu meets the regulations governing the ward of the degree of masters in Business Administration of Ahmadu Bello University Zaria, and is approved for ~~in~~ its contribution to Acknowledge and literary presentation.

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ABSTRACT

This study on "Open Market Operations as an instrument of monetary policy in Nigeria: Administration problem and prospects" was undertaken to analyse the objective of monetary policies so far adopted in Nigeria and the close relationship between the monetary aggregates and economic activity and their impact on the economy over the period January 1986 to December 1996. It is aimed at reviewing the administration of Nigeria's market operations with due regard to Nigeria's domestic and external economic circumstances.

The sustenance of market operation stability within a libralised inter bank market in which Central bank of Nigeria had been intervening must be appreciated in order to present a clear picture of the efforts to introduce open market operations as an instrument of monetary policy in Nigeria.

With the current effort to deregulate the financial system, Government introduced Structural Adjustment Programme in 1986, the aims of which was to reduce dependence on the oil sector as the principal earner of foreign exchange, as well as the adoption of appropriate pricing system. The problems currently militating against the immediate success of the use of open market operations in Nigeria include large fiscal deficits financed mainly by the Central Bank of Nigeria and inadequacy of data constraints. The importance of the study is to create a vibrant environment for money instrument and also to suggest how to strengthen the open market institutional arrangement.

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DEFINITION OF TERMS

1.	AFEM	-	AUTONOMOUS FOREIGN EXHANGE MARKET
2.	CBN	-	CENTRAL BANK OF NIGERIA
3.	GDP	-	GROSS DOMESTIC PRODUCT
4.	NDIC	-	NIGERIAN DEPOSIT INSURANCE CORPORATION
5.	NPF	-	NATIONAL PROVIDENT FUND
6.	NSE	-	NIGERIAN STOCK EXCHANGE
7.	OMC	-	OPEN MARKET COMMITTEE
8.	OMO	-	OPEN MARKET OPERATIONS
9.	SAP	-	STRUCTURAL ADJUSTMENT PROGRAMME
10.	SEC	-	SECURITY EXCHANGE COMMISSION

CHAPTER ONE

1.1 INTRODUCTION

Monetary policy has a central role in macro economic management primarily because of the close relationship between monetary aggregates and economic activity. This is true irrespective of whether one is considering the monetary aggregates and economic activity. This is true irrespective of whether one is considering the monetarist or Keynesian framework. The monetary framework of an economy is definitely a scientific device but its application appears to be more of an art.

In practice many factors other than the logic of the theoretical frame work, come into play; one of the key determinants of the type of monetary management is the economic environment.

Although it may be desirable to introduce some monetary instruments, the environment for their effective use may not be suitable. This fact should be borne in mind as I discuss the subject of Open Market Operation as an instrument of monetary policy in Nigeria: Administration, Problems and Prospects. It is the plan of this project to give sufficient background to the evolving monetary policy in Nigeria so as to present a clear picture of the efforts to introduce: OPEN MARKET OPERATIONS AS AN INSTRUMENT OF MONETARY POLICY IN NIGERIA: ADMINISTRATION, PROBLEMS AND PROSPECTS:

With the current effort to deregulate the financial system, government introduced structural Adjustment Programme in 1986, a major objective of which is the deregulation of all the sectors of Nigerian economy as well as the adoption of appropriate and self adjusting pricing system.

In the financial sector, this has led to interest rate deregulation, introduction of auction market for Treasury Bills and certificates, identification of insolvent banks for restructuring, the introduction of more stringent prudential guideline for banks, increases in Banks' minimum capital requirement, upgrading and standardization of accounting procedures. Another important measure include the strengthening of the regulatory framework through the promulgation of the Central Bank Decree 25 of 1991. These efforts are directed at creating a vibrant market environment for money market instruments. Also included is the strengthening of the market institutional arrangement through the establishment of Discount Houses. With effect from September 1992, the authorities also lifted credit ceiling on banks that met some prescribed criteria.

The instruments in which the central bank of Nigeria conduct open market operations comprise treasury bills, treasury certificate and Federal Government Development stocks. Three types of transaction in these securities are possible. The bank may engage in outright sale or purchase of securities, repurchase transaction (Repos) involving purchase or sale of securities with obligation to reserve the transaction, which is simultaneous sale and purchase of securities for delivery at future date. The appropriateness of a particular transaction depends on the bank's perception of the duration of the excess reserves in the system and the banks open market committee which will set the medium term reserve objectives for the transactions. Discount houses and other eligible dealers usually are invited for participation in transaction involving open market operations. The problems currently militating against the immediate commencement of the use of open market operations in Nigeria include large fiscal deficit finance mainly by the Central Bank of Nigeria, inadequacy and data constraints.

1.2 STATEMENT OF THE PROBLEM

Open market operations as instrument of monetary policy in Nigeria currently have problems militating against the success of the policy such as : To what extent the adequate monetary and fiscal policy used to coordinate the operation of money market? How does Central Bank of Nigeria cope with money market inadequacy and data constraints?

How effective and successful is the use of open market operation policy and how effective is the open market operation administration and its prospects.

How is the progress of OMO so far with the present macro economic environment. This project will discuss the subject matter in order to control and regulate the deficit finance, low capacity utilization, growing unemployment, heavy debt burden, accelerated inflation, intensified exchange rate depreciation, as well as high percentage regime of interest rate.

1.3 OBJECTIVES OF THE STUDY

The aims and objective of this research is to suggest how to regulate the financial institution in order to control and regulate the large fiscal deficit since 1986. The fiscal deficit of the Federal Government has been persistently large and growing. Nigerian economy has witness serious macro economic problems characterised by slowdown in economic activities, low capacity utilization, growing unemployment, heavy debt burden, accelerated inflation, intensified exchange rate depreciation as well as high and perverted regime of interest rates. Persistently high and rising government deficit financing has been identified as a major factor in the observed macro-economic problems. The research will be used as a good monetary policy coordination i.e. inadequate co-ordination of monetary and fiscal policies has adversely affected the effectiveness and successful monetary policy which could frustrate development of money and capital markets.

The objective of this research can not be overemphasized for the fact that it will try to guide both the commercial and merchant banks in operation of their credit policy.

As stated earlier, the objectives of the study are:

1. To collate the relevant circulars and guidelines issued by monetary authorities on Open Market Operations with a view to examining the existing policies, test their effectiveness and efficiency in the Nigerian economic environment.

2. To analyze the objective of the monetary policies so far adopted and their impact on the economy and make appropriate recommendations.
3. To assist banks especially the new ones in setting up efficient Open Market Operation department.
4. To assist the Nigerian Bankers in performing their duties in the field of finance efficiently.
5. Appraisal of the various policy guidelines that had been issued by successive governments which came into use in Nigeria, because guidelines are easily misplaced.

1.4 SIGNIFICANCE OF THE STUDY

Due to the paucity of a major scientific research in the area of open market operations with particular reference to Nigeria, it is apparent that there is enough background to warrant a study that will examine the management of cash and marketable securities in the Nigerian economic environment. Since current study in the area of "Working capital management" or "current asset management" has tended to give little emphasis on cash and securities management, the study will some what pioneer a search for it in the Nigerian Banks.

It will be significant in that an efficient management of cash and marketable securities in any economy and in particular a seasoned, deep rooted economic activity that record enormous excess of cash on its weekly operations, can be instrumental to its overall success or at least go a long way in enhancing the efficiency, effectiveness and or creating a vibrant environment for money instruments.

Corporate level managers who are concerned with long range money market plans need to know the particular implications of the administration and prospects of open market operations in over-holding or under-holding cash balance at any given time to the possible out come of business operation.

1.5 SCOPE OF THE STUDY

The research studies the operation and implementation of open market operation as an instrument or tool of monetary policy in Nigeria. The importance of the scope of study is directed towards creating a vibrant environment for money instrument, the administration, problems and prospects. It also studies the strengthening of the market institutional arrangement through the establishment of Discount Houses, the scope of the study also studies the other monetary policies which the Central Bank can operate apart from through open market operations. Open Market Operation comprises the use of treasury bills treasury certificate and Federal Government development stocks and also determines to what extent the use of Open Market Operation controls the large fiscal deficit financed mainly by the Central Bank of Nigeria.

1.6 LIMITATIONS OF THE STUDY

Monetary policy Managers must be constantly aware of the environment and dynamics of the global market place. Further, they must be alive to the reality of geopolitics intruding upon and affecting their endeavours.

The following factors mitigate against having an up-to-date information in conducting this research on open market operations in Nigeria:-

- The Published Central Bank of Nigeria statistics on monetary policies is not up to date.
- The sources of data are not readily available as the Central Bank of Nigeria and other financial organisations are not prepared to release the volumes of their financial and monetary transactions, because they regard this as a trade secret.
- Personal interview conducted with some of the Central Bank of Nigeria staff, the respondent failed to give some detailed information and refuse to disclose some data because of the secret nature of the establishment.
- Some answered questions were not detailed enough because of the time and volume of office responsibility of some staff in sensitive areas. For example cashiers were busy attending to customers depositors.
- Also financial organisations and other banks are not prepared to grant oral interviews for fear of being quoted, as most of these organisations in Nigeria render improper returns to the government agencies.
- Another problem lies with the subject of the study. The research of this nature, involving secondary data and human opinion is bound to have some problems, both natural and artificial.

Bureaucracy is another likely impediment in the way of this research. This is especially so with Central Bank of Nigeria, with a developed organisational line of authority.

1.7 PLAN OF THE STUDY

This projects is divided into five chapters.

Chapter one is the introductory part and chapter two is the Literature review. Chapter three is the Methodology. Chapter four is Data analysis and presentation of the Project while Chapter five is the concluding chapter, which contains Summary, Conclusion and Recommendation.

CHAPTER TWO

LITRATURE REVIEW

2.1 BACKGROUND TO THE ADOPTION OF OPEN MARKET OPERATIONS IN NIGERIA

The technique of Monetary Policy could be divided into two: Direct and Indirect. While the indirect approach has been used very extensively in the more developed Money Market Economies, the direct approach predominates in the less developed economies such as Nigeria. Both techniques aim at influencing the cost and availability of Banking system credit receiving and interest rate by the monetary authorities for compliance by banks, while the indirect technique achieves the same through the financial Markets.

The most potent instrument of the indirect or market based technique is open market operation (OMO). It is therefore pertinent to note that the efforts aimed at introducing Indirect Monetary and Credit 'control anchored on the use of OMO are themselves a part of the broader government policy of restructuring the Nigerian economy since in her effort at seeking lasting solutions to problems of Structural Adjustment Programme (SAP) in September 1986. A major aspect of the programme is the deregulation of economic activities and the adoption of appropriate Pricing Policies in all sectors with greater reliance on market forces and reduction in complex administrative controls. The Central Bank on its part has the responsibility for formulating Monetary Policy to support the government adjustment efforts.

However, prior to the introduction of SAP, the main instruments of monetary policy in Nigeria were direct Controls which comprised the imposition of credit Ceilings on Individual Banks, interest rate regulations and sectoral credit allocation supplemented to varying degrees by cash and liquidity ratio requirements. The prolonged use of these direct controls generated considerable problems and become counter-productive. Some of the negative effects of direct controls include reduced competition in the financial system, leading to inefficiency and misallocation of resources in the banking sector. Credit ceilings generated arbitrary and high lending lending rates, lack of transparency in transaction and the employment of various ploys to circumvent the control by window dressing, the use of off-balance sheet items and the channeling of transactions through uncontrolled institutions, especially finance houses which mushroomed. As more resources as well as supervisory and regulatory efforts of the Central Bank are directed to the enforcement of compliance with direct controls, less attention is devoted to the more important issues of solvency and general health of financial system, with serious long-term consequences.

Although the need to shift to indirect monetary and credit control has been recognised, it has not been possible to implement all the necessary measures and arrangements for the introduction of indirect controls simultaneously. The CBN has therefore, adopted a phased approach and has since 1987 embarked on a comprehensive reform and liberalization of the financial sector with a view to creating a conducive atmosphere for the implementation of indirect approach to monetary control centered on the use of open market operation (OMO). Progress so far made include establishment of a foreign exchange quota system, the deregulation of interest rates, introduction of the auction market for treasury bills and certificates, the issue of these treasury instruments as bearer bills to enhance transferability, identification of insolvent banks for restructuring, the introduction of more stringent Prudential Guidelines for bank, to ensure early recognition of losses and adequate provisioning for the recognized losses, increase in bank's minimum capital requirement, upgrading and standardization of accounting procedures, mopping-up of excess banking liquidity through the issuance of Stabilization Securities and the promulgation of Central Bank Decree No. 24 of 1991 and Banks and other financial Institutions Decree 25 of 1991. The new decrees, among other things strengthened the regulatory and supervisory powers of CBN, streamlined and simplified procedures for licensing banks and established procedure for licensing of Discount Houses and finance companies previously outside CBN's control. Three Discount Houses have since been granted approval in principle and about 500 finance companies have been licensed. In line with the principles of phased approach to the use of indirect control, a series of indirect measures to control the ability of banks in extending new credit were also applied alongside credit ceilings. These measures included the following:

(i) In 1986 and 1987 the Naira counter-part of all external payment outstanding with banks were recalled.

(ii) Commercial Banks cash reserved requirements were increased in 1990.

(iii) In January, 1998, the liquidity ratio of merchant banks was varied from 30% of demand deposits and call money to 20% of total deposits. This was raised to 30% in 1990.

(iv) Between May-June 1989, Public sector accords were transferred from banks to CBN and the banks were prohibited henceforth, from accepting foreign guarantees and/or foreign currency deposits and Collateral's for domestic loans denominated in Naira.

(v) Since October 1990, banks excess liquidity was periodically mopped up through the issuance of stabilization securities.

(vi) In 1991, the base for calculating cash reserve requirement was extended beyond demand deposit to include time and saving deposits.

(vii) Effective first week of September 1996, the Central Bank of Nigeria on selective basis, lifted credit ceiling on individual banks which observed CBN guidelines in respect of Statutory Minimum paid-up capital. However, open market operation (OMO) would continue to be the major instrument of monetary management in 1996 and would be conducted largely in government securities, a large proportion of which is currently held by the CBN. OMO as usual would be co-ordinate with discount window and reserve requirement policies to ensure the attainment of monetary policy objectives and targets.

2.2 HISTORICAL BACKGROUND OF CENTRAL BANK OF NIGERIA

Infact, the Central Bank is the heart turning the wheels of the financial system. The Central Bank is the banker to the Federal and State Governments of Nigeria and the Commercial Banks. It is a Bank that is Central to the Operation of financial systems. Unlike the other types of banks, there is only one Central Bank in each country. It is regarded as a monopoly bank because it is the only owned by the government.

Those who fought for Nigerian Independence learnt early that political independence meant nothing without economic independence. So these nationalists insisted early that the heart of the financial system of the country be instituted. In 1953, an official of the Central Bank of England, Mr. J. I. Fisher, was commissioned to advise the Colonial Government on the desirability and practicability of establishing a Central Bank in Nigeria. Mr. Fisher advised that instead of a Central Bank a currency board should be established.

Fisher's recommendation was not well received and so the pressure continued. In 1955, a team from the World Bank carried out another investigation and came out with the recommendation that a "State Bank of Nigeria" should be established to perform most of the functions of a typical Central Bank apart from issuing currency. Again, this recommendation did not meet the demands of Nigerians. So in April, 1957 a high official of the bank of England Mr. J. H. Lovnes was commissioned to advise on the setting up of a Central Bank. His favourable report was submitted in August, 1957 and the Central Bank was established in 1958. The bank started operation in July, 1959. Since operation commencement by the bank in 1959 it has performed identical function as the other Central Banks in the world perform. These functions can be summarized as follows:

1. The Central Bank acts as the government banker by collecting proceeds from taxation and other revenue due to the federal government.
2. It makes advances of money to the government on monetary matters.
3. It formulates needed banking regulations to be followed by the other banks.
4. It issues and arranges to distribute currency through the commercial banks.
5. It maintains accounts for all the other banks in the country. This is the reason why the central Bank is also called the bankers' bank.
6. It acts as a lender of last resort to the banking system.
7. It is the banker to the Central banks of other countries.
8. It controls the flow of cash in circulation i.e. Inflation and Deflation through its monetary policies.

2.3 MONETARY DEVELOPMENTS IN NIGERIA

The major force behind monetary development in Nigeria as in many other developing countries is the need to finance the government is fiscal operations aimed at accelerated economic development and growth. For instance, the first nationally integrated economic development plan 1962 – 1968, envisaged a public sector capital expenditure of N1,586 million out of a planned total of N2,366 million. The budgetary gap that developed during the implementation of the plan was financed largely by the Central Bank of Nigeria, especially when the foreign aid component of the plan was not realized. As a result, narrow money supply (M1) grew by 29.7 percent between 1960 and 1964, while broad money supply (M2) grew by 44.0 percent in the same period. In order to check the ensuing inflationary pressure, money supply narrowly declined and contracted from 15.9 percent in 1964 to 3.9 percent in 1965. Between October 1966 and January 1970, money supply rebounded rapidly for the purpose of financing government budgetary deficits due to fall in revenue and increased expenditure on civil disturbance in the country. This development led to the growth of M1 (Money Supply) from 8.9 percent in 1966 to 30.0 percent in 1969. By 1975 M1 grew by 73.5 percent due to monetization of increased foreign exchange earnings from oil to finance infrastructural development and government establishments. For most of the 1970s to the 1990s monetary developments were dictated by increased credit to the domestic economy. Narrow money grew from

1.2 percent in 1992. A large portion of the money supply was used to finance government deficits incurred during these years.

2.4 CAPITAL MARKET DEVELOPMENT IN NIGERIA.

The capital market of Nigeria comprises a primary market for the issue of new securities and secondary market where existing share are traded. Trading in these is organised by and managed by the Nigerian Stock Exchange (N.S.E.) which evolved from the Lagos stock exchange in 1977. Presently six branches exist in Enugu, Ibadan, Onitsha, Kaduna, Kano and Port Harcourt. The Securities and Exchange Commission (ESC) established in 1988 is apex regulatory body for the Nigeria Capital Market. However, the CBN Monitors activities in the Market as it are a part of the financial system in which the bank has statutory authority.

Recent developments in Nigeria Capital Market include, the release of pricing guidelines to issuing houses by SEC, steps taken towards the establishment of an over – the – counter (OTC) market for trading in non-quoted companies, shortening the delivery/settlement period and internalization of the market.

Table 1 gives summary of some recent statistics from the capital market between 1989 to 1992. Total Market capitalisation increased from ₦12.0 billion in 1989 to ₦32.5 billion in 1992, while the NSE all shares index rose steadily from 325.3, 513.8, 784.0 in 1989, 1990 and 1991 to an all time high of 1106 in 1992. During the same period, the number of listed securities increased from 198 in 1989 to 251 in 1992, also the number of stock brokering firms and listed companies increased substantially from 61 and 111 in 1989 to 140 and 153 respectively in 1992.

The main sources of debt instruments for the debt market were:

(1) Corporate Companies who took advantage of cheaper money in the capital market to raise funds for business expansion and working capital in an atmosphere of high interest rates, inflation and depreciating Naira.

(2) Government over a time was gradually phasing out its development stocks, insurance companies, pension and trust funds, the National Provident Fund (NPF) and banks were the major purchasers of capital market debt instruments. However, the changing macro economic environment made debt instrument unattractive to its traditional holders, except to the extent they have to satisfy statutory requirements on the amount of debt they have to hold in their portfolio. In the equity market both publicly quoted issues and private placement in the primary market grew phenomenally due mainly to the privatisation of government shares in some companies and the requirement that bank increase their capital base from ₦30 million naira to ₦50 million for Commercial Banks and from N20 million to ₦40 million for merchant banks. Small investors, Individual and banks participated actively in the equity market. Pricing of shares recently became the responsibility of issuing houses.

2.5 INSTITUTIONAL ARRANGEMENT FOR FORMULATION AND IMPLEMENTATION OF OPEN MARKET OPERATION.

The process of policy formulation is reviewed by the Central Bank of Nigeria and the procedure for setting medium to long term policy targets and the translation of such targets into short term reserve targets for the day-to-day implementation of open market operation. As is the practice in many other countries, Open Market Committee of the Central Bank of Nigeria will be responsible for setting medium to long term targets and for translating them into short term reserve objectives for the day to day operation of the Trading Desk. The process of policy formulation will begin with preparatory work by the staff of the relevant policy priorities and prepare introduction for carrying them out. At two such meetings at half yearly intervals, open market committee members exhaustively discuss real gross national product, inflation, balance of payments and employment. At the other more frequent meetings, the longer run money and credit targets would be translated to short term targets for day to day operations. At all of its meetings, the open market committee will develop policy specifications to guide the open market operations of the Trading Desk.

The open market committee will discuss the outlook for economic activity in the productive sectors, employment and price movements, the monetary aggregates, financial market conditions, government fiscal operations, the external sector and exchange rate. It will then weigh information from a variety of sources and consider the likely consequence of alternative policy prescriptions. Similarly, the OMC will note developments that might lead it to review its earlier target ranges for the aggregates in the current year. This is particularly so when changing percent of a major variable such as Inflation. Exchange rate, etc., seem to be altering the previous relationships.

At the end of wide – ranging discussion and debate about economic and financial trends and the future outlook, the OMC should arrived at some consensus on an outline of the specifications for monetary growth and reserve conditions for the near term. Thereafter, the OMC would address the working of the directive that will guide the open market operations trading desk of the CBN until the next meeting. Open market committee has a vital role in operating day to day trading desk.

2.6 THE CONCEPT OF OPEN MARKET OPERATION AS MONETARY INSTRUMENT

It is necessary to define three concepts at the beginning and these are:

(a) The country's monetary system

(b) The objectives of monetary management

(c) The types of monetary management.

The Nigerian Monetary Systems is part of the wider financial sector and its major operators are the monetary authorities, the banks (Commercial & Merchant) as well as discount houses recently permitted to operate within the system. The monetary authorities design and implement monetary policy and consist of the presidency, the Central Bank of the Nigeria and the Federal Ministry of Finance, of these, the Central Bank of Nigeria is the agency which is primarily responsible for designing monetary policy proposals for presidential approval and ensuring the implementation of the monetary policy measures accepted by the Federal Government. The goals of monetary policy remain broadly the same irrespective of the package of instruments in use. Concisely, monetary policy attempts to maintain a balance, as much as is feasible, between the supply of and demand for the monetary assets of the economy in order to achieve adequate and stable economic growth. This broad purpose may be translated into several specific objectives such as price stability, high level of employment or an acceptable rate of unemployment, a sustainable growth rate of real Gross Domestic Product (GDP) as well as balance of payment equilibrium. However, two important points should be noted: - Policy objectives vary depending on the importance attached to them at specific periods and owing to potential conflicts, trade-off are a common feature in the design of monetary policy. Also, monetary policy is part of the National Economic Development strategy, which also requires financial and sectoral policies to operationalise it. Thus, these other policies must work in harmony with monetary policy to prevent distortions and instability. There are basically two types of monetary management: - In a predominantly Market-based economy, there is heavy reliance on Indirect Instruments of Monetary Control which are applied to take advantage of the relationship between the money supply and the monetary base and the ability of monetary authorities to induce appropriate changes in the monetary base. Bank reserves constitute an important component of the monetary base usually targeted by the monetary authorities to control the money supply through the conduct of the open market operations as well as the manipulation of the discount rate and the reserve ratio in support of open market operations. On the other hand, in under-developed financial markets the most common monetary tools are the direct instruments or quantitative controls which set the monetary targets at desired levels. The common example is interest rate regulations, credit ceilings and sectoral allocation of credit. In Nigerian context, the application of credit ceiling was designed to ensure that domestic credit expansion and the monetary implications of the balance of payment matched the expected increase in total demand for liquidity in the economy. In the application of these instruments (Direct and Indirect), a monetary control framework begins by establishing a link between them and the ultimate targets for output growth, inflation and the balance of payments. However, since a direct relationship is not strictly possible, an intermediate target such as the growth in money supply or bank credit is set. In this setting, the appropriate level of money supply is determined by the public demand for money. For indirect monetary control, the intermediate targets are fixed after the money demand function has been estimated and the monetary survey undertaken. In a regime of indirect monetary control the operating variables in a predictable way are controlled.

CHAPTER THREE

RESEARCH METHODOLOGY

3.0 INTRODUCTION

The major aim of this research is to evaluate the open market operations as an instrument of monetary policy and also to study the administration, achievement problems and prospect of OMO in Nigeria. The main purpose of this chapter is to describe the procedures and approach adopted in conducting this research. It will clearly bring out the sources of data and methods used. Efforts have also been made to discuss the techniques applied in the analysis of the data obtained.

3.1 RESEARCH METHODS

There are three major types of research methods. The Historical, descriptive and experimental research methods.

Historical research deals with determination, evaluation and explanation of past events essentially for the purpose of gathering a better and clear understanding of the present and making more reliable prediction of the future.

Descriptive research is concerned with collection of data for the purpose of describing and interpreting existing conditions. The three ways of presenting descriptive research consist of general description analysis and classification. There are five types of descriptive research namely:

(a) Case study;

(b) Sample Survey Study;

(c) Correlation Study;

(d) Cross Sectional study;

(e) Longitudinal Study.

Case study is the detailed descriptive analysis of everything that is in the history or development of single person, communication, event or institution for the purpose of understanding the life cycle of each or particular units.

Sample survey involves large number of persons and the description of population, characteristics through the selection of unbiased sample.

Correlation study is concerned with measuring the degree of relationship between two or more variables for the purpose of making prediction about variables.

Cross-sectional study is concerned with gathering of facts/data about different sub-group: at one point in time.

Longitudinal study is concerned with gathering data on the same person or group at different point in time.

The third method of research is the experimental research. This is a systematic and logical procedure of identifying and evaluating the relationship between variables that create a particular state of affairs under controlled conditions.

This study, therefore, is basically a descriptive research, because it is concerned with the collection of data for the purpose of describing and interpreting open market operation as an instrument of monetary policy in Nigeria. The study is conducted in such a manner as to obtain necessary information or data essential for arriving at meaningful conclusions as regard open market operation with reference to what role Central Bank of Nigeria played in the operation through open market committee (OMC).

3.2 SOURCES AND METHOD OF DATA COLLECTION

The sources and collection of data was approached from different angles. Sources involves both primary and secondary data, and involves the use of Interview, Questionnaire, Documentation, economic and financial review of CBN and the Nigeria Trade Journal, such as published books journal, articles, Magazine and Newspapers containing relevant information on the problem under study.

3.3 METHODS USED IN ANALYSING THE DATA

The information and data gathered are presented in numerical figure and arranged in a tabular form. The tables are numbered and different sections were selected for the analysis and also numbered to correspond with that of the tables.

3.4 SUMMARY

The chapter three of this project discusses the research methods and sources of the methods of collecting data which includes primary and secondary source and the justification of the methods used in gathering the data.

CHAPTER FOUR

DATA PRESENTATION AND ANALYSIS

4.0 INTRODUCTION

Open market operation (OMO) refers to a monetary management technique widely used by the monetary authorities to control the growth of liquidity in an economy. In Nigeria, the CBN began to apply OMO from 30th June, 1993 as part of the final phase of the shift to the market based method of monetary management. Since then, OMO has remained the main instrument of monetary policy, complemented by cash reserve requirement and discount window operations. OMO is conducted on weekly basis during which government securities are traded by authorised dealers through the discount houses. OMO is a market-based tool of monetary management. It involves the central bank's discretionary powers to purchase and/or sell securities in the financial market with the view to influence liquidity conditions and movements in interest rates. Its effectiveness and attractiveness depend on the maturity yield of the traded instruments in relation to other money market instruments as well as prevailing investment incentives. The liquidity control function of OMO is achieved by varying the level of money stock through trading instruments such as Treasury Bills, Treasury Certificates and other Instruments, which the Central Bank may deem appropriate.

For instance, when monetary authority want to reduce liquidity in an economy, it sells securities to authorised dealers. This leads initially to contraction in Commercial and Merchant banks reserves. As long as the Central Bank keeps such reserves in its vault and the bank have no access to new money from abroad, the ability to create new money is eventually reduced. On the other hand, when the Central bank wants to inject money into an economy to make it liquid, it purchases securities, thereby increasing the stock of bank reserves and banks ability to create and increase the quantity of money in circulation.

OMO transactions may consist of outright sales/purchases. This technique is expected to have a permanent effect on the level of liquidity in the economy. Repurchase and reverse repo arrangements enable central bank to effect temporary liquidity management. In some cases, agreements are reached in the current period, while the actual transfers are carried out in the future. This technique is called forward sales/purchases and effects future liquidity levels.

4.1 OPEN MARKET OPERATIONS SINCE 1993 UP TO 1995

The Central Bank continued to emphasize open market operations as the primary tool of monetary policy. The market operations appeared to have been constrained by the depressed interest rate regime and the contractionary impact of the CBN interventions in the AFEM. The market remained depressed as transaction fell further below the level in the previous year. Aggregate bids and sales fell persistently in the first five months of the year, before the modest recovery observed in June, bringing the total value of bids and sales in the first half of 1995 to 108,795 and 95,296 million. Overall, the bank conducted 50 weekly sessions of open market sales of treasury bills during the year, compared with 51 in 1994. Aggregates bids and sales amounted to ₦178,768 and ₦158,190 million, respectively, compared with ₦289,016 and ₦223,681 million in the previous year (See Table 4.1). In contrast to the encouraging response to CBN's open market sales of treasury securities in 1993 and 1994, Commercial and Merchant banks substantially reduced their treasury bills holding in the review year. Consequently, CBN's holding of such bills increased sharply by ₦11.350.9 million or 37.1 percent to ₦41,984.1 million from ₦30,633.2 million in 1994. That represented a reversal of the trend in 1994 and 1993 when CBN holdings fell by ₦13,315.3 and ₦37,203.6 million respectively. The fall in aggregate bank holdings in 1995 reflected largely the impact of Central Bank Interventions in the Autonomous Foreign Exchange Market (AFEM) which required authorized dealers to provide 100 percent Naira cover for their foreign exchange demand. The banks consequently rediscounted a large proportion of their treasury bills holding in order to back up their demand for foreign exchange at the AFEM with naira deposits. Besides, the banks initial subscription to new issues declined leaving the CBN with sizable amount of Treasury bill investments. Although open market operations appeared to be weak during the year, the gross monetary base showed considerable moderation, reflecting largely the contractionary impact of the CBN's interventions in the AFEM at rate determined by market forces.

OPEN MARKET OPERATIONS AT WEEKLY OMO SESSION (₦ MILLION)

Table 1

DATE	AMOUNT OFFERED (N) MILLION (1)	TOTAL BIDS (N) MILLION (2)	AMOUNT SOLD (N) MILLION (3)	AVERAGE TEN OR 1 DAY (4)
1993				
JUNE	250	452	250	57
JULY	1,300	3,135	1300	50
AUGUST	1,700	2,575	2,020	27
SEPTEMBER	4,700	9,505	7,608	34
OCTOBER	10,000	13,393	9,853	41
NOVEMBER	10,000	14,804	11,709	46
DECEMBER	17,000	17,826	16,525	47
TOTAL	44,950	61,690	49,265	-

Source: Central Bank of Nigeria

Table 2

1994				
JANUARY	14,000	14,594	12,100	54
FEBRUARY	13,500	10,777	9,200	57
MARCH	10,000	14,684	12,224	31
APRIL	11,000	21,525	11,000	29
MAY	21,000	26,509	20,447	50
JUNE	13,000	11,646	9,351	39
JULY	9,500	14,758	8,553	33
AUGUST	8,000	19,627	9,230	33
SEPTEMBER	21,000	37,100	26,385	55
OCTOBER	-	35,391	33,206	45
NOVEMBER	-	46,945	39,265	36
DECEMBER	-	36,460	32,720	32
TOTAL	-	290016	223,681	-

Source: Central Bank of Nigeria

Table 3

1995			
JANUARY	28,280	23,330	30
FEBRUARY	22,792	19,983	70
MARCH	18,462	15,762	40
APRIL	12,238	10,563	51
MAY	8,9840	8,194	51
JUNE	18,229	17,464	49
JULY	10,305	8,980	46
AUGUST	12,144	10,779	53
SEPTEMBER	18,139	14,260	29
OCTOBER	14,405	13,305	59
NOVEMBER	4,600	5,425	35
DECEMBER	10,200	10,145	31
TOTAL	178,778	158,190	-

Source: Central Bank of Nigeria

4.2 THE PROGRESS OF OPEN MARKET OPERATION SO FAR IN NIGERIA.

A review of the meaning, purpose and characteristics of open market operations is necessary in order to assess the progress made so far in its use in Nigeria. When the necessary conditions are available, Central banks all over the world engage in open market operation in order to regulate the cost and availability of credit and thereby influencing the banking system's credit to the economy so as to achieve the desired level of money supply. As all of us know, OMO is based on the discretionary power of Central Banks to buy and sell –eligible securities in the money market from and to the private sector, depending on the objectives of the policy.

Thus, if there is need to reduce bank credit and hence money stock in an inflationary economy, the appropriate response of the central bank is to sell traded securities, hoping that the private sector (banks and public) would purchase them. When purchases are made by banks or on behalf of customers the banking system's cash reserve position is reduced while the system's ability to embark on credit expansion is constrained. If direct purchases by public is made by withdrawal of funds from the banking system, money stock is still constrained through reduction in the system's reserve and hence ability to expand credit. However, if the purpose of securities by the private sector is financed through currency outside the banking system the constraining effect of money supply is direct. The Central Bank sometimes some times changes strategy by buying securities in the market. In the process, the reserve of the banking system is expanded. This enables the bank to expand credit, which influences money stock. Where funds realized from the sale of securities by public are kept outside the banking system, OMO expands money supply directly.

Apart from the exceptional case where OMO affects money supply directly, the normal channel of influence of OMO on money stock is through the reduction or expansion in bank reserves and there by bank credit. Although the effect of OMO on bank reserves and liquidity are basically the same, a reserve requirements, OMO is seen as more flexible and better suited for the day-to-day adjustment of the reserves in the desired direction.

Having explained the meaning, purpose and mechanism of OMO, it remains to review its general characteristics, particularly its instrument techniques of operation, participation, conditions for success and relevance.

The type of securities used for OMO varies from country to country but generally they consist of both government and non-government instrument with issues ranging from very short term to long term maturities. The essential consideration is that the securities should be those which the central bank can use easily to influence the level of reserves, credit and money stock and there by to induce favourable changes in other relevant variables for economic growth.

The techniques of OMO operations also vary among economies, depending on the sophistication of financial environment; the operations vary from outright sales and purchases to temporary trading in securities. Temporary transactions could be repos in which securities are sold with an agreement to be purchased in future before maturity; or reverse - repos in which securities are purchased with an agreement to resell later before maturity. Other refinements in OMO trading include forward sales and purchases as well as swaps. Recruitment of participants to OMO operations depends largely on the structure of the financial system. Where there are discount houses, it is common for the central bank to channel transaction primarily through these discount houses.

In their absence the central bank relies on selected financial institutions especially banks, as dealers for OMO operations. In any case, the primary consideration in the choice of dealing institutions is the effectiveness of the institution achieving the objectives of OMO, as highlighted earlier. In the final analysis the success of OMO depends on the response of the private sector to the prompting of the central bank.

This means the private sector should be prepared to buy sufficient amount of eligible securities when the central bank wants to sell and sell enough securities when the bank seeks to buy them. To get appropriate response from the private sector, there is need for well-developed financial system with interest-sensitive financial market. Thus, the more attractive the interest rates offered by the central bank, the more likely the bank would find buyers for securities it wants to sell. On the other hand, the ability of the central bank to buy adequate securities to enhance reserves in the period of monetary case would require interest rate acceptable to it and the sellers. Thus, a deregulated interest rate structure is crucial to success of OMO operations. From the foregoing review, it is clear that OMO relies on trade in securities in order to adjust the level of bank reserves so as to influence bank credit with a view to influencing monetary growth.

However, the expansion or contraction in money stock is not desired for its own sake but rather to achieve monetary growth that is consistent with the short to long term objectives of the economy, especially with respect to exchange rates, interest rates, investment and low or non-inflationary growth in goods and services. These considerations have stimulated the interest of OMO in Nigeria.

4.3 THE COMMENCEMENT AND PREPARATION OF OPEN MARKET OPERATION IN NIGERIA.

The commencement of OMO in Nigeria at the end of June 1993 was preceded by years of preparation because the enabling environment for the success of this scheme was non-existent. Even at its commencement all the necessary conditions have not been met. Nevertheless, OMO scheme had started in a modest way, while efforts were being made to improve further the necessary environment. This section set out to examine how the OMO scheme works in Nigeria but it would be necessary to review first of all the preparations designed to overcome the constraints to its commencement.

Preparation for OMO: Between 1987 and the first half of 1993, a number of measures were taken to create a conducive environment for indirect monetary management, including the use of OMO.

These measures could be grouped broadly into six categories as reviewed below.

(i) DEREGULATIONS OF FINANCIAL SYSTEM

The financial environment was deregulated following the overall economic policies, which have favoured reliance on market forces since 1986. Thus, interest rates were deregulated in 1987. The controls placed on some rates in 1991 were removed in 1992. To improve the efficiency of public debt management and conduct of monetary policy and in particular pave the way for OMO, an auction-based system of issuing treasury bills and certificates was introduced in 1989. These instruments were made Bearer Bills to enhance transferability. The improvements in the issue of treasury securities were designed to encourage private sector investment, interest and participation in the holding of these securities in order to enhance indirect monetary management (including the use of OMO).

In line with the deregulatory stance of the policy, the prescription of credit ceilings was removed in 1992 for banks, which met the stipulated performance criteria.

(ii) ENHANCEMENT OF INSTITUTIONAL FRAMEWORK:

The procedure for licensing new banks was created to stimulate competition in the money market. This led to rapid growth in the number of banks. Furthermore three discount houses were given approval in principle to facilitate among other things, the issue and sale of short-term government securities by tender.

By the end of the first half of 1993, one of the discount houses had started operation with the objectives, which include the promotion of OMO in Nigeria.

(iii) PROMOTION OF FINANCIAL SECTOR SUPERVISION:

The need to strengthen the financial sector through banking supervision was realized. Initially efforts were directed to only banks, subsequently non-bank financial institutions started to receive attention. In 1990, presidential guidelines were introduced. These were designed, among other things, to compel banks to make provisions for bad and doubtful debts underlying the ailing banks with a view to resolving he ailment which had started to create problems for the financial markets.

One of the steps taken to strengthen the banking sector was the increase in the minimum paid-up capital of banks to N50 million for commercial banks and N40 million for merchant banks. By the end of the first half of 1993, the management of six banks were already taken over by the CBN for restructuring while a number of other ailing banks were undergoing self-restructuring under the special supervision of the central bank of Nigeria Deposit Insurance Corporation (NDIC).

Through the CBN and banks and other financial institutions Decrees of 1991, the CBN acquired higher degree of autonomy in the conduct of monetary management and increased regulatory and supervisory power over commercial and merchant banks and other financial institutions, such as discount houses and finance companies.

These new powers have enhanced efforts of CBN in tackling the constraints to effective conduct of monetary management (including the use of OMO).

(iv) <u>MOPPING-UP OF EXCESS LIQUIDITY:</u>

Realising the destabilizing influence of excess liquidity on monetary management, the CBN embarked on mopping up of this excess through issuance of stabilization securities since August 1990. These measures have not been vary effective due largely to the fueling of excess liquidity, through the mandatory financing, by the banking system of large fiscal deficit.

(v) <u>DEVELOPMENT OF DATA BASE:</u>

The importance of timely data for the issuance of indirect monetary management, especially through OMO, was realised by the CBN at the time the scheme was conceived. Consequently, efforts have been made to improve the quality and timeliness of financial data. For example, remarkable progress has been made in the computerization efforts of the CBN and banks, thereby creating a more conducive environment for quick processing of relevant data.

(vi) TRAINING AND DIALOGUE AMONG OPERATORS AND POLICY MAKERS:

The need to impart relevant skills on both the technicians and operators of OMO, has led to the training of a number of officers of the CBN, approved discount houses and some banks on OMO. Already, some staff of the CBN have undertaken in other countries, studies on discount houses and the use of indirect monetary control in the Central banks of Ghana, India, Indonesia, United States of America, United Kingdom, Philippines and Zimbabwe.

Similar studies and attachment programmes have been carried out by the approved discount houses and some banks, while there are plans to continue in that direction. Furthermore, the role of the various participants in the OMO scheme has been demonstrated to policy makers and operators in seminar and workshops.

Despite the preparations highlighted above, the financial environment is still far from I deal. Nevertheless, OMO commenced operations at the end of June 1993 with the hope that required conditions for its effective operations would improve overtime.

4.4 TECHNICAL AND CURRENT OPERATIONAL, MODALITIES FOR OMO IN NIGERIA.

When the level of reserves in the system is determined, a decision is taken on whether these excesses or deficiencies would be mopped up by or replenished with OMO, cash and liquidity ratios or a combination of the three. When OMO is the chosen target instrument and the amount of excess or deficiency to be adjusted is determined, the CBN invites the public to buy and sell securities as may be necessary and in accordance with the published operational procedures which would be reviewed in the light of experience.

The current operational procedures could be categorized into five places as follows:

(i) OMO INSTRUMENT, TECHNIQUES, PARTICIPANT AND MEETINGS:

Eligible instruments are treasury bills, treasury certificates and eligible development stocks. Other money market instruments would be made eligible when necessary. Two techniques will suffice for the present. They comprise outright (or permanent) sale/purchase of eligible instruments and temporary transactions. Sophisticated techniques such as forward sales and purchase are left out in the meantime to allow market participant to master the fundamentals first. At present, the bank conducts OMO through the discount house system while the weekly auctions at the primary market remain open to all auctions and authorised dealers – discount houses, commercial and merchant banks. The CBN and the discount houses are scheduled to meet regularly.

(ii) TRADING ON SECURITIES:

Currently, OMO is conducted through notice to dealers. When sufficient number of discount houses commence operations and the CBN dealing room is fully equipped, trading in securities will be carried out largely through the telecommunications network. Notice by the CBN to sell securities in order to retrieve the surplus in the market is given to dealers in writing, well ahead of the conduct of operations, stating the amount, the instruments, and maturities. The CBN conducts OMO through tender but unlike in the primary market, dealers are required to submit open bids to a discount house which in turn makes bids to the CBN.

The Dutch auction system is adopted by both the CBN and the discount houses to determine successful bidders. Usually, the CBN accepts those bids with lowest discount while the discount houses allocate bids accepted by the CBN to bank bidders at each bank's bid rate, when the CBN wants to buy securities to replenish shortage of funds, a notice is given, inviting dealers to offer eligible securities for outright sale.

Like the invitation for sale by the CBN, the notice specifies the instrument, amount and maturities. When invited, dealers make open offers to a discount house, showing the discount rate at which the bills are being offered. Although the CBN has the discretion as to which offer to accept, it usually accepts those offers with the highest discount rates up to the amount on offer.

(iii) SETTLEMENT PROCEDURE

The method of payment to effect the transfer usually is done by executing a two authorised signatories of the transferee or only (discount house or Bank). Each transferees issues a letter of transfer of funds in favour of the transferor and submits same to the discount office of the CBN for processing.

(iv) THE CBN SECURITIES DEALING ROOM:

When the CBN dealing room for OMO becomes operational, telephone and fax machine would be used for communicating with market operators. Through these media, the CBN requests, on daily basis, the rates, from the discount houses and informs them of its intention to sell or buy securities.

The discount houses, in turn call the CBN to give proposition on the securities for trading while the CBN responds later.

(v) RESULTS OF OPERATION:

In the meantime, the result of each conduct of OMO is announced to dealers and the public. The result normally shows, among other things, the amount on tender or offer, amount allocated or accepted, ranges of bids and offer rates and the applicable marginal or stop rates.

4.5 CENTRAL BANK OF NIGERIA: EXPERIENCE WITH DIRECT MONETARY INSTRUMENTS

There must be cogent reasons why the monetary authorities in Nigeria have decided to move away from direct to indirect monetary instruments. It is therefore necessary to briefly review CBN's experience with the application of the direct instruments in the past. Before the Structural Adjustment Programme (SAP) was adopted in 1986, the CBN relied solely on the direct instruments to control money supply growth. The empirical evidence is that the CBN was not pleased with the outcome of applying such instruments, although there were no alternatives, given the constraints of the financial sector. With the example of credit ceilings and sectorial credit rationing, the CBN found it increasingly difficult to achieve the stated monetary targets; particularly with regard to credit to government and the private sector and ultimately the intermediate monetary variable, the narrow money supplies (MI).

The credit ceilings were initially effective, but as the banking sector and the economy expanded some problems began to set in. For instance, in order to satisfy certain needs, many items of credit were excluded from the credit ceilings. These only served to erode the effectiveness of the ceilings as some operators used such avenues to hide credit transactions. Enforcement was made difficult by the lags in obtaining and processing monetary data. This had a perennial problem on the Nigerian economy.

Above all, the credit ceilings encouraged inefficiency in the banking system. Permitting banks, irrespective of their efficiency, to grow by the same ration as stated in the guidelines tended to restrict competition in the system. The policy protected the weaker banks, while limiting the growth of the efficient ones. The practice also favoured the larger banks with large turnover which permitted them to accommodate new borrowers. Under the circumstances, dynamic banks that aggressively mobilized savings were penalized. There used to be incessant allegations of banks trying to circumvent the ceilings by acting as brokers between owners and borrowers of funds.

Sectoral credit controls have been an important direct monetary tool in Nigeria. These controls are aimed at giving easier credit access to the productive sectors. The most popular in Nigeria have been the sectoral allocation of Bank's loans and advances within the overall credit limit, and specified ratios of loans to rural areas and small scale enterprises.

The experiences of the CBN with the selective credit control has been a mixed one. In cases where penalties for non-compliance have been stiff and enforceable, some reasonable compliance have been observed. However, skepticism about the effectiveness of such controls has increased over the years. The possibility of leakage could not be ruled out particularly when it has been difficult to monitor the end use of the allocated credit.

Under the general framework of the SAP, the Nigerian Monetary System has undergone significant changes with the ultimate aim of inducing the emergence of a market based system of monetary control. Some of the important action favourable to the attainment of that goal were the numerous institutional adjustments, especially the promulgation of both the CBN Decree and the banks and other financial institutions Decree of 1991, substantial improvements in the macro economic, legal and regulatory environment, the deregulation of interest rates, the attempts to rid the economy of excess liquidity, as well as the simplification and selective lifting of credit ceilings. The financial sectors reforms were undertaken to induce the emergence of an indirect or market based system of monetary control.

4.6 CONCEPT AND RELEVANCE OF INDIRECT MONETARY CONTROL

The technique of indirect monetary control basically involves the control of the money stock through a manipulation of the sources of the monetary base.

The monetary base is defined as the sum of total bank reserves (vault cash and balances with CBN) and currency in the hands of the non bank public. The sources of the monetary base are not the foreign assets of the CBN (NFACB), net domestic claims on commercial banks (CCB) and other assets (Net) of the CBN (OACB). The base is used up as reserves by the banks [R] and currency outside banks (CP).

These variables as they appear in the CBN's balance sheet form the following identity:

NFACB + NDCGCB + CCB + OACB = R + CP = H

Where H is defined as the monetary base. The process of money creation in this framework follows from the relationship which makes changes in the money supply dependent on changes in the money base, that is, M = MH. If the money multiplier (M) is stable overtime, the money supply can be controlled by inducing changes in the monetary base (H). To control the money supply, the monetary authorities apply the market based instruments (Open Market Operations, discount rate and reserve requirements). In practical terms, the monetary authorities estimate the desired money supply for the future period projecting the likely growth in the monetary base and hence the money supply assuming that all things remains equal. The difference between the desired and likely levels of money stock will then result in the determination of some gap in the monetary base which will indicate the type of action to be taken by the monetary authorities.

4.7 OTHER INSTRUMENTS OF MONETARY CONTROL IN NIGEIRA.

Other tools of indirect control would be used along with open market operations. The most likely candidates are outlined as follows:

(i) CASH RESERVE REQUIREMENTS

It is envisaged that reserve requirements will continue to be used to supplement OMO.

Reserve requirements are particularly effective for sterilizing existing excess liquidity in the banking system. They are also easily monitored on day to day basis because they are held by the central bank. However, the lag in bank returns would need to be reduced so that each bank's deposit liabilities can be determined on more current basis. If banks would be made to maintain reserve balances, it would not only promote a more active management of reserve balances, but will also obtain the wide fluctuations in short term rates that would occur if banks, for example, aggressively acquire funds only close to the end of the month, when the adequacy of their reserve positions is to be determined.

(ii) DISCOUNT WINDOW OPERATIONS.

Central Bank discount window operations would be an important supplement to OMO, and fulfilling essentially the central bank's function of lender of last resort to meet individual institutions unforeseen or unexpected funding needs to adjust their positions.

The main goal of discount window operation would be to provide overnight accommodation that could not be obtained on reasonable terms at the discount house(s) and / or in the inter-bank market.

(iii) PLACEMENT OF GOVERNMENT DEPOSIT.

The movement of government deposits between the central bank on the one hand, and commercial and merchant banks on the other, has proved to be a potent tool for controlling reserves of the banking system. The federal reserve system in the United States of America (USA) employs a variant of such instrument to minimize the impact of treasury's cash management on bank reserves, while the Malaysian central bank employs another form of it for regulating bank reserves. This instrument effectively reduced excess liquidity in the Nigerian banking system in 1989. Conversely, it can also be used to inject additional, reserves into the system when there is need to do so. In such circumstances, government deposit would be transferred back to banks in order to increase funds available to other money market operations that are temporarily short of funds.

(iv) MORAL SUASION

Moral suasion has a useful role to play in all systems of monetary management as a supplementary tool and will be more vigorously used. The experience of other Central banks illustrates the importance of close and constant interactions between market operators and the central bank.

Such interactions promote understanding and engender mutual confidence between the central banks and the players in the financial markets.

4.8 THE CENTRAL BANK OF NIGERIA DISCOUNT WINDOW UNDER OPEN MARKET OPERATION (OMO)

In discussing this we have to understand the words "discount" and "window" in the line of open market operation. Discount is defined as "the amount of reduction which is allowed for immediate payment of a debt which is not yet due". This is the general business understanding. However, from a banker's point of view, the usual way to regard a discount is to look upon it practically as interest charged for a loan of the amount until the bill is due. Thus, a banker's discount is different from a true discount. A bankers discount is not really interest upon the actual amount advanced, but an interest upon the amount that is to be prepaid. Expressed in another way "Discount" in our context is used as a verb and means to subtract from a loan, when it is first made, the amount of interest which will be due when the loan has to be repaid.

The word discount window was defined according to Marcia Stignum as "Facility provided by the federal, enabling member banks to borrow reserves against collateral in the form of government or other acceptable paper".

However, one of the principal objects of Central Bank of Nigeria as provided in the CBN decree 1991, section 2 (C) is that it shall promote monetary stability and a sound financial system in Nigeria. Pursuant to this, the bank acts as a lender of last resort through rediscounting of securities and granting of advances for fixed duration. Since the inception of the Bank, its discounting operations have always been conducted in government securities and self liquidating bills arising from sales of agricultural commodities. Export produce bills drawn to finance such exports as timber and groundnut oil were rediscountable at the CBN. In 1960, monthly rediscounts in respect of produce bills averaged less than ₦1 million in 1973, it average little over ₦194 million at its peak.

There was rapid decline in 1974, reflecting the high liquidity in the system at that time until 1977 when the value of rediscounts rose again to ₦28 million.

Applicable rediscount rates were sometimes below the CBN MRR, in an effort to promote agriculture. Treasury Bills rediscounted by the CBN rose from ₦102 million in 1970 to ₦4.4 billion in 1989. The volume of treasury certificate rediscounted were negligible, at highest peak of ₦160 million in 1987.

The rediscounted rate were usually based on the MRR which was fixed at maximum of 1% above the NTB issue rate. There was liquidity crisis in the banking system during the second half of 1989 which was attributed to the withdrawal of public sector deposit from the banking system. There were remote causes, ranging from asset/liability mismatch, misappropriation, taking of volatile inter bank funds and over reliance on government deposits to structural defects in many of the banks that got into financial distress. To avoid systematic distress, the CBN embarked on a financial support through which banks which had treasury bills and certificates virtually off loaded them on the CBN. The Bank also debited these defaulting banks for proven inter bank placements which they could not meet. Further more, the discount window was expanded to accommodate the following instruments: NDICA accommodation bills, negotiable certificate of deposit and state government promissory notes. The value of the accommodated bills discounted was ₦2,310 million while the NCDS and notes amounted to ₦618 million. Although the window was primarily expanded to allow for the injection of liquidity into the system, it had to be contracted as soon as liquidity returned to the market.

The importance of this action is to stress that the CBN is always ready to discharge its role as lender of last resort at any appropriate occasion.

Prior to 1989, the yields on treasury securities were fixed each year by the bank through the monetary policy circular. Then came SAP in 1986 and deregulation of interest rate in August 1987. On 21st November, 1989 the pricing of treasury bills and certificate through auction was introduced. For the investors, the impact was positive and significant, the NTB issue rate at the maiden auction rose from a discount of 12.25% per annum (p.a.) consequently the MRR was adjusted upwards from 13.25% to 18.50% p.a.. Since the primary auction was by tender and therefore market determined, the weekly issue rates were no longer fixed. Under the auction based system, the market in treasury securities became more dynamic. Gross rediscounts of NTB during 1990 rose to N32.26 billion during 1991. However, the foregoing represents a historical analysis and could at best assist us in fashioning our envisaged direction. I should like to say that not all the views of this paper represent the official position of the bank.

We shall know if banks were to obtain accommodation from the Central Bank without any limit or impediment, the Bank would have no control whatsoever over money supply. Indeed, access to CBN credit, being high-powered money, must be restricted to that level that the bank perceives as right for the economy.

I would say that while the bank would not abdicate its responsibility to act as a lender of last resort, the emergence of discount houses in the banking scene would significantly alter the relationship between the Central Bank and the Banks.

(A) ELIGIBLE INSTRUMENT

It has already been stipulated in the monetary and credit policy guidelines for 1993 that the bank will conduct OMO in the following eligible instruments. Treasury bills, Treasury certificates, Development stocks by implication, these instrument are eligible for the discount window support.

In Practice, the NTB would remain the dominant instrument. The NTC has become unpopular, by reason of the short-termism prevailing in the economy. For development stocks, the fact that they are quoted securities inhibit smooth dealings in thus.

(B) Government securities may for sometime continue to be the only eligible instruments at the window. However, with increased market development, couple with confidence and transparency among market players, consideration for eligibility may be given to state government promissory notes, negotiable certificates of deposits banker's acceptances and commercial papers.

There is no doubt that we recognize the expediency of an optional portfolio mix, especially in the composition of assets of discount houses.

This is necessary for the purpose of meeting extreme liquidity exigencies against a dominant treasury bill asset profile which may of necessity be dumped on the bank. Nonetheless, our experience dictates that caution is required.

(i) DISCOUNT RATE

At the inception of OMO, in order to stimulate the market, our current spread of 20% on bills rediscounting which was recently reduced from 5% may be further reviewed downwards. The banks buying rates, apart from serving as an essential instrument of controlling money supply and as a means of influencing the levels and structure of interest rate, should be seen to be market related, and indeed that there exist a structure that indicates the stance of Monetary policy. The MRR (Currency 26%) which has begun to move in tandem with the market – determined NTB rate would be expected to play a more patent role in monetary management.

(ii) ELIGIBILITY TO BORROW

The lender of last resort facility is expected to be primarily available to discount houses.

This would enable the monetary authorities to control and gauge the liquidity in the system. Banks requiring overnight funds would be expected to exhaust the available facilities at both inter – bank market and discount houses. In any event, any direct accommodation to such banks by the central bank shall be discriminatory rate.

The "mandate facility" currently managed by the discount office through which banks treasury bill holdings are automatically rediscounted would be reviewed. In view of the continued performance of this secondary market function by CBN it is believed that this would certainly impair the relevance of discount houses as vehicles for funds intermediation.

(iii) REPURCHASE AGREEMENT

To tidy overnight or short term liquidity requirements, the bank shall be prepared to enter into repurchase agreement with discount houses. These will be at the Bank's discretionary rates, but with fine specials. However, such bills shall not mature before the repurchase dates.

(iv) ADVERSE CLEARING BALANCES

Commercial banks incur advances by reason of temporary debit balances that may result from their daily clearing operations. Under the new dispensation, such adverse positions need to be promptly covered by the affected banks or collaterized under approved facilities. Furthermore, such advances would attract penal overdraft charges and such rates would not in any event be lower than prevailing inter bank market rate.

In conclusion, the CBN discount window under open market operation would acquire a more dynamic posture, consistent with prevailing monetary policy trust. It will be wholly market driven but responsive to the peculiar imperative of our money management. The window under an OMO regime should create a playing field conducive for the viability and sustenance of discount houses as agents of financial resource pooling, smoothening and intermediation, as shown by the table below.

Table 4

YEAR	AMOUNT (N MILLION)	AS RATIO OF GDPC (PER CENT)
1986	3,660	5.0
1987	4,328	4.0
1988	12,200	8.5
1989	15,300	7.9
1990	23,500	10.9
1991	35,300	12.4
1992	43,800	9.8
1993	28,552	7.3

Source: Central Bank of Nigeria and NDIC market survey

N. B.: Budget deficit is to be reduced to an average of 5.3 percent in the period of 1993 – 1995

These large budget deficits were financed largely through borrowing from the banking system, especially the Central Bank. Such Central Bank finance constitutes the major sources of excess reserves in the banking system. Should the trend continue, the excess reserve would be required to be mopped up through the use of OMO and may prove unsustainable and unrealistic.

(v) DATA CONSTRAINTS:

The modest progress in data generation and transmission not withstanding, the variety and timeliness of monthly and other relevant data would require increased efforts at computerization by all the institutions in the financial sector. Although the Central Bank and other financial institutions have computerized much of their activities, a lot need to be done.

For example, returns to the CBN are still made on paper forms instead of diskettes and few institutions have been able to link their computers in various parts of the country.

The weaknesses highlighted above are some of the remaining constraints to effective OMO in Nigeria. Their removal or reduction will involve continued development of the money market by discouraging its oligolistic structure in the control of funds, among other things: tackling problems of ailing banks: harmonizing monetary and fiscal policies; relieving the CBN of its role of under writing treasury securities and upgrading the computer capacity of the various financial institutions as well as establishing an integrated electronic communication system so as to generate and transmit accurate and timely data.

(vi) POLICY CO-ORDINATION:

Inadequate co-ordination of monetary and fiscal policies has adversely affected the effectiveness of monetary policy tools and could frustrate the effectiveness of OMO.

(vi) INADEQUACIES OF MONEY MARKET:

The current state of the money market in certain respects is to a degree for the use of OMO. Some of the problems which may inhibit the success of OMO includes:

(a) Oligopolistic Market Structure and Inefficiencies of fund intermediation.

(b) Historically high, volatile interest rates. (The yield curve is currently inverted)

(c) The existence of a large and growing number of technically insolvent banks with concomitant erosion of confidence.

(d) Inadequate expertise in government securities trading.

(e) The absence of an active secondary market in securities and

(f) Lack of institutional private sector organization such as discount houses to under write government securities

(vii) COMMUNICATION:

The success of OMO will also depend on efficient communication system as trading activities will eventually require modern communication gadgets such as hot line automatic telephone connections between the central banks and principal dealers including discount houses. The present level of communication link is grossly inadequate and need to be improved.

(viii) REVIEW OF EXPECTATIONS:

Getting market players to revise their expectations may prove a great challenge to the new techniques of monetary policy.

People and institutions benefiting from the present arrangement may resist change. Others that stand to benefit in the long run may be hurt in the short turn and many avoid the sacrifices demanded today for gain in the future and instead they may seek undue privileges for the prospect of immediate gains.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATION

This chapter being the concluding one, will attempt to give a summary of all the preceding chapters, after which a conclusion would be drawn. Based on the conclusion suggestion and recommendation would be provided for improvement of open market operations practice in the country as well as suggesting of areas for further research.

5.1 SUMMARY

Chapter one of this work gave an overview of open market operations, which was used to determine or identify problems that initiated the research. It was also in this chapter that objective, rationale and significance of the study was stated.

Chapter two was where literature on open market operations was appraised. It is the chapter where respect was given to whom it is due. The major discovery in this chapter was the existence of various techniques for money market management. These techniques are numerous, such as cash budget, control of cash flows, investment of idle cash in securities and method of selecting an optimum portfolio of securities. Not only the existence of such techniques but their capacity of solving problem was found by earlier research.

Chapter three is the traditional research methodology chapter. Thus it explored the methods, techniques and instruments used by the researcher in his data collection exercise. The chapter also revealed problems faced by the researcher in data collection. One of the problems worth mentioning here was the uncooperative attitude of the staff of CBN and the other institutions approached by the researcher. Where audience was granted the data and answers gives were unsatisfactory and scanty.

Chapter four presents data collected, its treatment and what was found out of it. One of the major discoveries in this chapter was absence of efficient open market operations in the Nigerian economic operations. As found by the result of the Questions asked, only 12.5 per cent of our banks reported having a standing cash management policy. Most of the banks investigated showed that they spend money as they come, without a prior plan for its flows. That is to say a large portion of the sample related that they don't have a strict policy that is followed at all times in their cash management practice.

From the above, it is evident that the policy measures and institutional reforms introduced since 1986 under the Structural Adjustment Programme (SAP) have achieved a large measures of success, For instance, significant growth of domestic output has been recorded over the years.

Financial savings have increased in response to the deregulation of interest rate, financial services have improved as a result of continuing deregulation of the financial sector, while a relatively more congenial economic environment has been evolving in the country, apart from the achievement made in creating a more favourable condition for open market operations in Nigeria.

5.2 CONCLUSION

I would like to conclude by reminding members of the banking industry here that as the main participants in the money market they owe it a duty to ensure that the use of OMO succeeds in Nigeria.

It is clear from the foregoing that the motivation for the use of OMO is the desire to enhance efficiently in the financial intermediation to the benefit of the financial sector. And, I hasten to add that the realization of this laudable objectives depends on an in-valuable co-operation. The authorities required continued support in the implementation of all aspect of monetary policy, trusting that any measure introduced is designed to bring about desired improvements in the financial system. There are many ways members of the banking community could demonstrate their support to the course of policy especially now that credit ceilings have been removed and OMO is about to be implemented.

The active involvement of banks in the government securities trading is one such way. As a result of banks' poor response to investment in treasury instruments the CBN has been saddled with large holdings of the securities. A situation which is incompatible with monetary stability.

Banks are therefore enjoined to be more active in government securities trading both in the primary and secondary markets in order to enhance the success of OMO.

Another important area where banks cooperation is most needed relates to compliance with prudential guidelines.

The purpose of the guidelines is to restore confidence to the financial system, to the benefit of the economy in general and the banking system in particular. An important aspect of prudent banking is to ensure that incidence of fraud and sharp practices are minimized if not eliminated.

Similarly bank should realise that their continued survival under the regime of indirect approach to monetary control depends on adequate provisioning for bad and doubtful debts. Provisions out of profit for this purpose can only be reduced to tolerable levels if banks adopt pure economic criteria in the granting of loans and advances. Departure from such standard may generate bad and doubtful debts, erosions of capital base and ultimately insolvency. The importance of bank data to the successful implementation of OMO has been discussed above.

I only need to emphasize here that banks should co-operate with the authorities and ensure hitch free implementation of OMO by rendering returns promptly and intensify the computerization of their operations in order to drive the advantages of quick and accurate data compilation.

Another major problem that could hinder implementation of OMO is the current inverted interest rates of some big banks. Some big and liquid banks do not pay more than 14 to 16 percent on term deposits and their prime lending rates range between 22 to 26 percent. However, they charge between 60 – 80 percent on over-night loans in the inter-bank market. With this type of inverted yield curve, it is impossible to borrow from the inter bank market to finance securities trading even if the current treasury bill issue rate of 20 percent were trebled.

It need hardly be emphasised therefore that banks should infuse some sanity into the inter-bank markets.

Finally, I would like to sat that the slow reaction of problem banks to the agreed programme on self-restructuring by the concerned and banks, delay in restructuring can only worse the problem of such banks and there can be no resemblance of stability and orderliness in the money market for the effective use of OMO if the market continues to be polluted by insolvent institutions.

5.3 RECOMMENDATION AND FUTURE PROSPECTS:

Given the level of preparatory activities already undertaken; given the advantages associated with the use of OMO as against the disadvantages of credit ceilings and interest rate regulations and given other favourable conditions which by far the adverse ones; the prospects of OMO as a viable monetary policy instrument in Nigeria are bright, provided there is full commitment by all concerned towards the realisation of the objectives.

I will strongly recommend that the following steps should be taking in order to continue with effective open market operation in Nigeria.

- A condition for efficient open market transaction is that, there should be the presence of a sufficiently large amount of high quality paper that is regularly to be traded.

  It is therefore, recommended also that the Federal Government of Nigeria relax the exchange control restrictions to permit outward direct investment to Open Market Operations financing.

- Also recommended is the re-introduction of foreign guarantee loan as this would boost the source of financing imports/exports from overseas creditors. This is a swift way to implement and meet the needs of changing circumstances, and its effect will be immediate.

- *In order to assist the* Administration *of the* Open Market Operations, the Central Bank of Nigeria should grant certain delegated powers to various financial institutions.

- The Federal Government will have to intensify the use of moral suasion by holding more regular dialogues with banks, other financial institutions and agencies, on monetary policy measures and development in order to enhance performance.

- As part of the broader policy measures aimed at promoting finance of Open Market Operations in Nigeria, the Central Bank window should be reactivated and streamlined strictly in line with the lender-of-last-resort function of the Bank. In this regard, intervention shall be geared towards the facilitation of Open

Market Operation, and in the form of short-term, largely overnight loans, collateralised by borrowing institution holdings of government debt instruments and other first class instruments.

- At present, there is a large stock of government securities outstanding and the bulk is held by the CBN. In spite of the shallowness of the Nigerian money market, transactions with similar effects as those of Open Market Operation can be conducted.
- This could be achieved by using open market operations i.e. using the primary issuing process as the mechanism for selling bills at the market price (Carl-Johan Linel, 1990). Already treasury bills are issued by tender which is a step close to market based activities. The volume of treasury securities outstanding and the part held in the CBN's portfolio to influence the level of interest rates and credit in the system.

Major characteristics of OMO which enhance its prospect of success and which commends it to all market participants include the followings:

(i) Open market operations are much more flexible in their use than direct control.

(ii) Open market operations do not interfere with competition between banks.

(iii) The institutional arrangements required for the operation of OMO lead to efficiency in the use of funds.

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