

THE IMPACT OF MONETARY POLICY ON
BANK PERFORMANCE; 1980 -2006

By

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CERTIFICATION

This is to certify that the research thesis was carried out by NDUKWE OKPAN CHUKWU of Financial Management Technology, Federal University of Technology, Owerri; under the careful supervision of Dr A.B.C Akujuobi and is hereby admitted as having partially satisfied the requirements for the award of degree of Master of Business Administration (MBA) in Financial Management.

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In loving memory of my first teacher and friend, ugoeze
Chinyere Cordelia Chukwu (13 April 1931-08 June 2007)

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ABSTRACT

The study investigated the impact of monetary policy on bank performance, covering the period, 1980-2006. While bank performance was measured through the total external assets of all commercial banks in Nigeria, the cash reserve ratio, liquidity ratio, interest rate, minimum rediscount rate and treasury bills rate, represented instruments of monetary policy. Adopting the multiple regression model, the study confirmed the existence of a significant relationship between monetary policy instruments and bank external assets. Also revealed, is the existence of a significant impact of two monetary policy instruments (cash reserve, ratio and minimum rediscount rate) on net external assets of commercial banks while treasury bills rate, liquidity ratio and interest rate , all failed to contribute significantly to the external" assets of banks. On the strength of these findings, some of the major recommendations are that me monetary authorities need to pay more attention to the use of, especially the cash reserve ratio and minimum rediscount rate .as measures towards helping both the banks and the economy to grow. Similarly, treasury bill rate, liquidity ratio and the interest rate, all need special attention of the CBN for L bank performance to improve.

KEYWORDS: *Monetary Policy, Bank Performance , Cash Reserve Ratio, Minimum Rediscount Rate, Interest Rate , Treasury Bills Rate , Liquidity Ratio , Total Foreign Assets , Monetary Authorities, Economic Development.*

CHAPTER ONE

1.1 BACKGROUND OF THE STUDY

There are a number of factors, both exogenous and endogenous, that can predict instability in the banking system. The exogenous factors, which include macroeconomic shocks emanate from negative effects of financial liberalization, globalization and rapid technological changes. Also, found within the exogenous ambit, are poorly formulated monetary policies that immediately transmit into the banking system which most often result in colossal negative consequences. On the other hand, internal factors may include inappropriate corporate governance, inadequate regulatory and supervisory capacity, internal checks and balances just to mention but a few (Onoh, 2007).

As noted by Tobin and Buiter (1976) and Crookett (1979), it is a known fact that the macroeconomic environment represents a combination of factors that impact on the banking system, which could be either favourable or adverse to the system. When the impact is adverse, banks in order to survive, tend to embark on protective strategies, which may not augur well for both the banking system and the economy, at least, in the long run.

For instance, an economy experiencing sluggish growth or recession, poses formidable changes to all economic

agents, causing business opportunities to shrink. Under such circumstances, it is crucial that banks take actions, which will not affect the health of the banking system adversely or further destabilize the economy. Generally, it is easier to achieve a sound banking system under a stable macroeconomic environment than an unsound banking system could trigger off macroeconomic instability. Hence, the symbiotic relationship between the banking system and macroeconomic environment which monetary policy is at the centre (Busari, 2004; Anoruo, 2002; Onoh, 2002; Ojo, 2000).

There is that need therefore, to determine the effect of the Central Bank of Nigeria monetary policy on the performance of commercial banks in Nigeria.

1.2 STATEMENT OF THE PROBLEM

In all cases, banking crises have resulted, at a minimum, in large losses of wealth and disruptions in supply of credit for investment and commerce (Uchendu, 1995). Therefore, in order to deal with market failures effectively and achieve financial sector stability, effective surveillance of the banking system is essential. The Regular surveillance of banking institutions by the Central Bank of Nigeria, is to ensure strict compliance with prudential and monetary policy guidelines as stipulated by the authorities.

In this context a framework for financial institutions' behaviour is established to foster the maintenance of a safe and sound financial system coupled with a fair and efficient delivery of financial services in the economy. Implied in the foregoing is the fact that commercial banks, as the main vehicle for implementing monetary policies could either be adversely affected or their performance improved upon, all depending on their ability to cope with the regulations on ground.

Past studies in the area of monetary policy effect on commercial banks have often concentrated on the impact of monetary policy on bank credit and profitability (Onyirinde, 2008 and Osuji, 2006). Also, some others considered the influence of bank capital on bank performance employing profitability and asset base as measures of performance (Iwuala, 2008 and Kamalu, 2005).

However, for the influence of monetary policy on bank performance, some of these studies failed to include some key measures which are considered very vital in the study of monetary policy effects on the economy. Jhingan (2006) has

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

This chapter undertakes the review of literature in our field of study, the objective is to keep track of the research outcome of previous researchers, in terms of their methodology, findings and recommendations in the Central Bank's monetary and credit guidelines as well as their impact on commercial banks operations. This will enable us to know the state of the art in our field of study and to sharpen our focus. We shall also try to examine the relevance of the findings of previous researchers in the Nigerian economy.

Therefore having given a brief introduction of the subject matter in chapter one, this chapter of the study will be devoted to the theoretical basis of the study, this is to enable us appreciate the views of experts on this subject matter and for us to have a more lucid appreciation of the research.

2.2 HISTORICAL BACKGROUND

The subject matter of this study can be found under a branch of economics called monetary economics; it is essentially concerned with the role of money in

Economic activity. It concentrates on the development of monetary theory and policy and its use in influencing the level of economic activity. Indeed money and monetary policy affect all facets of the economy like inflation, employment, interest rate movements and so on. Monetary economics also studies the behavior of the financial institutions that are significant in determining the pace of growth and development in the economy. Monetary economics acknowledges that money, financial institutions and monetary condition affect government objectives and the methods of achieving them, it studies the general way in which governments operate especially in the area of public finance. We can only talk of monetary policy in a monetized economy in a subsistent economy there is no exchange not to talk of a medium for exchange. In the barter system goods are directly exchanged for good and this was in operation before its shortcomings led to the introduction of money as a means of exchange, several commodities served as money, some of them are: cattle, sheep, tobacco, elephant tusk, cowries, cigarette, gold and silver to mention a few later on currency came in to use that is Banknotes and coins, today Demand deposits and some marketable securities can be called money (quasi money).

Money became very important in the economy to the extent that individuals, firms, and government could not operate without it, investments could not be carried out

without it, investment depends on interest rate while interest rate is determined by the demand for and supply of money.

Therefore, money plays a pivotal role in the economy; it would therefore be a veritable instrument for controlling the economy. According to Nnamocha (1999) "the thrust of monetary policy is money" and since money is very important in the economy and too much of it is very dangerous like too little would be, it is only rational that we find a way to control it if we really want to keep the economy under control then monetary policy is the appropriate apparatus for this.

2.3 RELEVANT MODELS OR THEORIES TO THE STUDY

This section of the chapter will be devoted to the theoretical basis of monetary policy and bank performance which would be relevant to our study.

2.3.1. MONETARY POLICY:

There are money definitions of monetary policy Anyanwu (1993) defines it as measures designed to regulate and control the volume cost, availability and direction of money and credit in an economy in order to achieve some specified macroeconomic policy objectives. Obioma (1998) defined it as "a measure designed to influence the

availability cost and direction of money and credit in pursuit of specified economic goals". It therefore basically deals with the control of the money stock in order to influence microeconomic variables such as domestic prices, employment, balance of payment equilibrium and sustainable economic growth (Ogwuma,1996). A framework will be helpful for a proper exposition on monetary policy, it will constitute; its legislation, its objectives, its coordination with other policies, its formulation, its implementation and its instruments.

2.3.2 Legal basis of Monetary Policy: The authority to formulate and implement monetary policy is vested in the Central Bank of Nigeria (CBN) as outlined in the CBN, Act of 1958 and subsequently amended in CBN degree No. 74 of 1991. These Laws enjoin the CBN to promote monetary stability and a sound financial system in Nigeria under the overall guidance of the federal government. The CBN is required to make proposals to the head of state through ministry of finance, the head of state has the power to accept or amend the proposal, once he approves it the CBN is obligation to accept it through the ministry of finance and implement it (1997 Federal Budget Provisions).

2.3.3 OBJECTIVES OF MONETARY POLICY: According to Ogwuma (1996) some objectives of monetary policy

are: prompting price stability, reducing pressures on the external sector, stabilizing the Naira exchange rate and stimulating economic growth. This is not exhaustive of the objectives of monetary policy some others are: to moderate inflation rate, inducing increased financial savings, inducing investment and promoting employment.

2.3.4 MONETARY POLICY FORMULATION: In formulating monetary policy, the CBN relies on the technique called financial programming. Its starting point is comprehensive review of the past current and anticipated economic problems, then projections are made, on money supply GDP growth, inflation rates and balance of payment position. For money

Supply for example, the economy's absorptive capacity for domestic credits derived, the permissible aggregate domestic credit is then allocated between the public and private sectors.

2.3.5 MONETARY POLICY INSTRUMENTS/TOOLS: These are variables that are under the control of the monetary authorities and have effect on the proximate targets. According to Jimoh (1944) the proximate targets are: interest rate, narrow money supply, (M1), broad money supply (M2), Domestic credit and high powered money or monetary base. Monetary policy tools could be

direct or indirect. The direct tools include: special deposits, aggregate, credit ceilings, deposit ceilings exchange controls, restriction on the placement of public deposits and stabilization securities. On the other hand, indirect tools include open market operations, cash reserve requirement, liquidity ratio, minimum rediscount rate party charges and selective credit policies.

2.4 A REVIEW OF CURRENT MONETARY AND CREDIT POLICY

Since the introduction of the Structural Adjustment Programme (SAP) in July 1986, efforts have been made on a continuing basis to shift line with the policy on deregulation. These include deregulation of interest rate and sectoral allocation of credits and the adoption of indirect approach to monetary control in the management of liquidity. According to Ibeabuchi (1992:27) the ultimate objective of these measures is the promotion of a free market-oriented economy in which available resources would be efficiently utilized for greater economy performance.

Following the period of Structural Adjustment Programme (1986-1988) Nigeria's economic policies have been characterized with series of changes, inconsistencies and reversals. These changes induced largely by the severity of the economic situation and political factors. According

to Ojo (1996:18) the economy's performance declined progressively between 1990 and 1994 as a result of the policy actions and picked up in 1995 and has the prospects to do better in this democratic environment.

Under the SAP, interest rate was allowed to be market determined -But in 1993 banks were to observe a maximum spread of five percentage points between their average cost of funds and their (ending rate, CBN circular No27 (1993:7) In 1995, fixing of interest rates which was reintroduced in the 1994 budget with a view to reversing the persistent increase in the rates and boosting

Domestic investment was implemented in 1995 due to administrative bottlenecks. CBN circular No.29 (1995:7) identified some of the causes of the high interest rates, which prevailed in 1993 and these include:

-(i) The banking system's financing of the huge fiscal deficit resulting in the crowding out" of the private sector in credit allocation (ii) High rate of domestic inflation requiring compensating high normal interest rate, (iii) Technical insolvency of some banks resulting in distress borrowing and pervasive default in the money market and, (iv) Excessive borrowing for speculative purchases of foreign exchange.

However in 1999 interest rate policy as deregulated and the use of market based techniques of monetary management was introduced. Stabilization securities were

introduced in August 1990 and actively used until March 1993 for stabilizing the excess reserves in the banking system. The issuance of, stabilization securities discontinued on the introduction of open market operation (OMO) on 30th June, 1993 while the stock outstanding was retained mainly to serve as a fail back position for liquidity

Control. However in "January 1995 new issues were allocated as a pre-eruptive measure preparatory to take of the Autonomous Foreign Exchange Market (AFEM) consistent with the transition to the use of market based instruments of monetary policy, the use of stabilization securities was phased out in 1996. Open market operation is still been used as the major instrument for achieving monetary policy objective as well as supporting the attainment of macroeconomic stability including GDP growth and the sustenance of balance of payments viability.

Mandatory sectoral credit allocation was introduced in 1979 to ensure availability of credit to the productive sectors of the economy. During this period agriculture, manufacturing and more recently export and solid minerals were treated preferentially, with the percentage credit allocation to the first two sectors raised progressively. According to CBN circular No 30; (1996: 13) the policy seemed to have made some impact; its prolonged use has engendered distortions and

inefficiencies and is not consistent with the principle of deregulating the financial sector. But still, it has not caused the phasing out of the system.

2.5 MONETARY AND CREDIT POLICY MEASURES

After an appreciable economic performance in the early 1970's the Nigerian economy experienced serious economic problems from late 1970's to mid 1980's. The country's balance of payments came under severe pressure and was in persistent deficit during the period. The government current expenditure expanded without an appreciable increase in revenue leading to widening fiscal deficits, which were largely, financed with bank credit with adverse consequences on the general price level. According to Ibeabuchi (1992; 29) the inflation pressure was further aggravated by high demand for imports of both intermediate and consumer goods due to over valuation of the Naira when which made imports relatively cheaper than locally manufactured goods. Furthermore, the government continued involvement in the economy through subsidized interest rate, exchange and price controls seriously distorted and weakened the economy and this reduced the capacity of the economy in responding promptly and positively to external shocks. In addressing the crisis, a number of policy measures were embarked upon by the government. In April 1982, the federal government enacted The Economic

Stabilization Measures, which dealt extensively on import restrictions as well as monetary and credit policies. Efforts were also made in successive years to reduce the public sector deficit through a reduction of recurrent expenditures and increase revenue. Also, existing exchange control measures were reinforced and made increasingly more stringent. From 1984, all imports were placed under specific import licensing. In October 1985, the government declared a fifteen-month economic emergency period during which specified proportion of workers salaries and companies' profits were to be compulsorily deducted and paid to government. However, the effectiveness of the measures were constrained by the continued decline in foreign exchange earnings, the over valuation of the Naira and other distortions and rigidities in the economy.

It was against this bleak and adverse economic background that the (government adopted a comprehensive economic reform programme -the structural Adjustment programme (SAP) in July 1986 to restore domestic and external economic growth.

The banking system therefore has been an integral part of the structural reforms. Thus, over the years, successive monetary policy measures the government of the newly independent Nigeria

Nation, anxious to promote accelerated economic development, viewed the CBN as an instrument or mobilizing development oriented finance. In particular the domestic financial system was expected to generate a substantial part of the funds projected in the development plan launched in the country in 1962 (CBN Research Department, 1976:106).

Another task to which monetary policy addressed itself during this early phase was the maintenance of, and an adequate level of external reserves, which would ensure the soundness, and stability of the Nigerian pound. Again, by the 1958 ordinance, the Central Bank was required to maintain external preserves mainly in gold and self sterling against the national currency. The importance attached to the reserve assets by the government is evidenced by its efforts in 1962 to mobilize and centralize in the bank all of the overseas assets of the country Oluioke (1979: 185).

(A) 1959-1962 PHASE

The most active instruments during this period (1959 - 1963) were Interest rates and moral suasion. The rediscount rate and the treasuring bill rates were revised ten and thirteen times respectively between April 1960 and December 1961. The use of these instruments was aimed at encouraging the commercial banks to repatriate short-term funds from

London and hold them in Nigeria in order to Nigerians the credit base Adekanye, (1984:68). One other task of monetary policy in this early period was the introduction of a new currency to replace the West African currency Board notes and coins that had been in existence up till July 1959. A further step forward came in 1962. The Amendment act that year empowered the central bank to regulate the interest rate structure of the commercial banks by linking it to its own rediscount rate. The essence was to make the transmission of monetary policy through changes in the bank's rediscount rate effective (Olaloku,1979: 185). Monetary policy in the first phase was not only confirmed to consolidating the currency but also to regulating the banking system.

(B) 1962 - 1970 PHASE

this covered the period from the launching of the first national development plan In 1992 to the end of the Civil war in 1970. According to Nwankwo (1979:21), it is called the deficit finance phase because considerations for cheap policy dominated the policy. During this phase, monetary policy becomes more active-.

The flanks regulatory and corrective powers were put to real test in the implementation. The monetary policy measures were directed against a rapid deteriorating domestic inflationary situation were created largely by steady and continuous increase in monetary supply. The

persistent government deficits during this year provide a further momentum to the inflationary pressure. The problem was also compounded by the fact that the rapid rate of increase in money supply and liquid assets was by far out running that of total output of the economy, as most investment expenditures were confined mainly to public infrastructure projects and directly non-productive industries of the private sector, Nwankwo (1979: 21). The period between April 1962 and September 1964 coincided with the launching of the second National Development plan in 1962 the interest rate and variable liquid asset policies aimed to provide "cheap money" for development purposes. During the same period, there were institutional changes leading to the establishment of the call money in July 1962, Adekanye (1984: 69).

This posture of credit era and cheap money inevitable resulted in the rapid expansion of aggregates. The relative stability in the domestic price level for the period notwithstanding, there was a substantial build up of inflationary pressure in the economy to dictate a need for monetary and credit restraint replaced the early regime of cheap money policy. The problem was identified as that of putting a halt to the continued deterioration in the balance of payments and growing inflationary pressures. It was also clear that restoring the balance of payments to a healthy position through governments efforts to restrict imports would

substantially internalized the demand pressures which will then become a threat to domestic monetary stability (CBN, Research Department ,1979; 107),

By October 1966, important Sodo -economic factors began to indicate the need to reverse the stance of policy and in November, the decision to switch to a policy of credit ease was implemented. The direction of monetary policy during the phase was greatly affected by the outbreak of the civil war, which lasted from the middle of 1967 until the beginning of 1970. Monetary policy during this period hinged on the use of interest rates and moral suasion. The credit ceiling was relaxed and the pattern of credit creation was in favour of the productive sectors of the economy. The treasuring certificate was introduced during this period (1968), principally to assist the government finance

Of payments, and a rapid increase of deficit financing. Given these influences it became expedient, at the end of the war to redirect policy towards, among other things, reducing the inflationary pressure, relieving pressure on the balance of payments, increasing government revenue and reducing government reliance on the banking system,(Nwankwo, (1979:21).

During this phrase, the foreign exchange situation though relatively stable, still needed further improvement. Unemployment remained a difficult problem and inflation

had continued unabated. Supply management continued and was intensified as the main strategy to fight against inflation the phase.

(D) 1976-1981 PHASE

The oil boom euphoria was short lived in the first place contrary to expectations and forecasts; inflation was on the increase rather than on the decrease. Secondly, the third National plan was based on the continued increase in crude oil and it was described as a "monument of progress". Thirdly oil revenues were expected to provide 96% of the country's foreign exchange earnings during

The five year period of the plan, but foreign exchange declined instead of increasing, Nwankwo, (1979:22).

In the three fiscal years, covering the period from April 1976 through March 1979, the principle objective of monetary policy remained that of maintaining price stability, but concern for the rapidly depleting external reserves also became the focus of policy in 1978/79 fiscal year: , CBN, Research Dept. (1979:107). The policy during this period was the reduction of excess liquidity of the banks. A combination of instrument were used, direct credit ceiling, cash reserve requirements, stabilization securities exclusion of deposits against letters of credit from eligible liquid assets and interest rate charges, (Adekanya, 1984).

(E) 1982-1985 PHASE

The policy during this period was geared towards conservation of foreign reserves. Measures taken to slow down the amount of foreign exchange disbursements include the re introduction of pre-shipment inspection of raw materials and spare parts, the re-introduction of pre-import sits ranging from 10% to 25%, an outright ban on a variety of commodities and increases in import duties on others and reductions of travel allowances etc.

It was the pre-SAP period, and most of the 1970's monetary policies are initially retained, which include credit ceilings, selective credit control, position of some reserve requirements and maintenance of a lid on interest. The credit expansion ceiling was reduced and Merchant Banks were to ensure that a minimum of 40% of their loans and advances were of medium fid long-term nature. Commercial banks were expected to lend a minimum of the total deposits collected by their rural branches to customers in rural areas. Interest rates and bank deposits were controlled rigidly.

(F) POST 1985

It was seen that monetary policy of the last period failed to stabilize the economy and stem rising inflation. There were noticeable deficiencies in public administration, fiscal

deficits and excessive import bills. There was fiscal indiscipline and lack of transparency in fiscal matters.

Fiscal deficits thus became a feature of governmental budgeting. Also the need arose to correct the distortions in the development planning process, resolve the crises in economic development, restructure the economy generally and remove rigidities in the system of resource allocation and use.

Against the background above, policy measures were needed to improve the efficiency of the public sector, restructure public expenditure, enhance fiscal discipline, remove rigidities in the economy/ reduce resource outflows, increase the non-oil exports and eliminate the accumulation of further external trade arrears. To this end, Nigeria adopted the structural adjustment Programme (SAP) in 1986. The reform package aims at altering and realigning aggregate domestic expenditure and production patterns so as to minimize dependence on exports enhance non-oil exports on the path of steady and balance growth.

The monetary policies under SAP were articulated to stimulate the expansion of output, encourage employment opportunities establish a basis for stable prices and the restoration of Nigeria's internal and external balances. The reforms introduced a market-oriented environment. The

basic instruments for achieving the policies include: (i) The deregulation of the foreign exchange market in order to allow for the adoption of a realistic exchange rate;

(ii) The deregulation of the financial system reforms in

(iii) the Financial markets and the system of monetary management;

(iv) The liberalization of the external trade and payments system;

(v) The commercialization and privatization policies

(vi) The rationalization and restricting removal of subsidies & restricting fax systems etc,

(vi) The adoption of cost- recovery pricing policies and deregulation of interest rates and adoption of a flexible exchange rate system. Most of these measures were couches under the assumption that inflationary measures would be dampened, aggregate output will be increased, exports would increase, capacity utilization will be enhanced while the demand for foreign exchange would be restricted under the evolving market -oriented economy. The monetary policy thrusts adopted were aimed at the reduction of the ability of the banks to create credits, stern excess liquidity and enhance the growth prospects of the economy. The specific measures that were used to reduce inflationary pressures were:

- (a) CBN's order on the banks to deposit in a non - interest bearing deposit account, the naira equivalent of all out-standing external payment arrears,
- (b) The reduction of credit ceilings to the various sectors
- (c) CBN's directive to all parastatals to transfer their account from the commercial bank to the CBN
- (d) The increase use of stabilization securities to mop up excess liquidity in the system.
- (e) The attempt at interest rate deregulation, at various times and the return to pegging at other times liquidity and the use of minimum rediscount rates and legal reserve requirements (Cash and liquidity) as supporting instrument.

The introduction of this system of monetary management entail the creation of appropriate structures necessary for the operation of the instruments and the effective control of monetary aggregates. These structures include the development of the financial markets (secondary market) for trading of securities structures for the emergence of competitive interest rate structures, increase in the efficiency of the financial system, reduce macro-economic instability, reduction of excess liquidity and high fiscal deficits and resolution of the

Problem of distressed banks, which of course is a fall-out of the reforms in the banking system.

An important aspect of monetary policy reform in developing countries is the sustained global movement

towards greater autonomy for Central Bank. This entails providing adequate freedom to carry out monetary management functions on a continuing basis. This general trend of autonomy for the central Bank of Nigeria has not been given any adequate attention by the federal government. The recent amendment to the CBN decree of 1991 reverting the CBN to the control of Federal Ministry of Finance further removed any measure of autonomy the bank has in monetary management.

This autonomy was later restored in 1999 in attempt to enhance the effectiveness of CBN in monetary management. Generally, however, the relative stable monetary aggregate and effective management experienced between 1995 - 1998 point to the fact that indirect controls, based on market forces is more beneficial in terms of superior allocate efficiency of economic resources and the achievement of macro-economic stability.

Deterioration of balance Following (lie increased incidence of excess liquidity in the financial system in 1999 arising from the removal of retail banking from the CBN to the commercial banks, the monetary authorities introduced the Specials Treasury Bills (STB) as an instrument of monetary control The instrument is intended to mop *up* the excess liquidity in the system and thus constrain the ability of banks to expand money supply. The special treasury bills are allocated to banks according to the

volume of foreign exchange demanded by the bank at the Autonomous Foreign Exchange Market (AFEM). The banks are not allowed to rediscount the STBs until after a minimum of three months.

The STBs also seek to assist the monetary authorities reduce pressure on the Naira exchange rates which by the end of the first quarter of 1999 had climaxed at N90.00 to a dollar, from (the former level of N81) to a dollar. This monetary thrust represents an advance measure, which appears like the former direct method of monetary control (stabilization securities). It is also apparent that the use of STB's is a tacit admission by the monetary authorities of the failure of the market mechanism in controlling the large movement in the volume of deposits transferred to the commercial and merchant banks from the Central Bank amid the large volume of oil cash calls released to the Joint Venture Partners by the Federal Government. By the year 2000, the fiscal policy thrust was designed to achieve the following objectives:

- (a) Enhance capacity utilization in agriculture, Manufacturing and mining industries.
- (b) Provide appropriate protection of domestic industries against unfair competition from imports and dumping.
- (c) Encourage diversification of foreign exchange earnings through increased export activities.

- (d) Reduce operating costs and inflationary pressures and
- (e) Provide appropriate incentives for investment in manufacturing, agriculture and mining with a view making the economy private sector - led.

There is no doubt that the ad-hoc nature of this monetary control posture has the potential of introducing instability in the banking system, especially since the incidence of distress has not been fully laid to rest.

2.5.1 PRE-SAP REGULATION

There is little doubt that the growth, expansion and changing nature of commercial banking activities in Nigeria within the past

Decade have been a reflection of development within the economy itself. According to Awosika, (1984:12) beginning with the post-civil war reconstruction boom (1970-1974), the oil boom and its essential burst (1975-1977) the attempts by the federal government to take over the "commanding heights" of the economy through a series of indigenization acts enunciated by the Nigerian enterprises promotion decrees (1972, 1977) the Banking Acts (1969, 1979) to the various fiscal and monetary policies pursued in the 1970's, government policies have varying impacts and posed various challenges to the banking sector.

The establishment of the Central Bank of Nigeria in 1958 marked the turning point in government efforts to harness the credit and foreign exchange, the supervision and direction of the system generally. Government control over the activities of commercial banks and the economy was further strengthening by the 1962 Banking Amendment Act which in many ways attempted to remove the ambiguities and loopholes in the original formulation of the previous Banking Acts. It also increased the instruments of monetary control at the disposal of Central Bank. The enactment of the companies act 1968, made

It obligatory on oil commodities operating in Nigeria to incorporate locally, thus, all expatriate banks had to register as Nigeria companies. The companies Decree of 1969, which required banks to render to the Central Bank certain periodical returns, further, tightened the control. As indicated inter-alia, the central Bank of Nigeria Amendment Act of 1968; the Banking act 1969, the Banking Act 1979; the provisions of the Nigeria Enterprises promotion Decrees of 1972, 1977; the monetary circular, the Rural Banking programme, and other government Economic policies to curb inflationary pressures in the 1970s have had far reaching effects on the banking industry in the past decades with varying impacts on the purely indigenous and mixed expatriate banks. As a supplement to the federal Government annual

budget speech, credit guidelines in the form of monetary circular have been issued by the CBN L since 1969 as directives to the banking sector. The declared objectives of the guidelines are:

(a) Promoting accelerated economic developments of the nation by regulating the flow of credit to the favoured sectors;

(b) Promoting orderly growth of the financial markets and;
combating inflation through the regulation of interest rates;

(c) Maintaining a healthy balance of payments and relative price stability through the introduction of exchange control and import restrictions, Awosika (1984:17).

Consequently, provisions of the 1979 credit guidelines for example include placing a ceiling on the aggregate loans and advances, sectoral dependence on crude oil exports and consumers goods imports; enhancing the non-oil export base and achieving sustainable growth. Other aims were to rationalize the role of the public sector and accelerate the growth potential of the private sector.

The main strategies of the program were the deregulation of external trade and payments arrangements, the adoption of a market-determined exchange rate for the Naira, substantial reduction in complex price and

administrative controls and more reliance on market forces as a major determinant of economic activity.

According to Ogwuma (1993:53) the main objectives of the policy since the inception of the SAP were;

- (i) Moderation of inflation,
- (ii) Increase domestic savings and efficient resource allocation,
- (iii) Improved capital inflow,
- (iv) Increased local production and employment,
- (V) Increased earnings from non-oil exports,
- (vi) Enhanced external reserves; and stable Naira exchange rate.

To achieve these broad objectives highlighted above a number of policy instruments or measures were adopted. Credit ceiling, a major instrument of monetary policy prior to the SAP remained important. Under the SAP, to maintain an appropriate monetary growth that would ensure stability in both the domestic and external sectors of the economy, credit ceiling was adjusted to deal with perceived excessive or deficient credit the system as deemed necessary.

In addition to credit control through credit ceiling, indirect measures to reduce the ability of banks to extend new loans included the recall of Naira counter- part of outstanding payment arrears from banks. The Central Bank of Nigeria in 1987, mopping up excess liquidity by the re-introduction and modification of stabilization

securities increase in commercial banks cash ratio in 1989 and 1990 and the introduction of cash ratio for merchant banks in 1990.

Furthermore, within the context of economic liberation the sectoral credit guidelines were reformed to give banks credit operations. In September 1992, indirect methods of credit and monetary control received a boost with the selective lifting of credit ceilings for banks, which had met *the* performance criteria. In June 1993, open market operations (OMO) designed for the credit policy commenced in a modest way.

In affirmative, CBN Briefs series No 97/03 (1997:4) has it that the objectives of monetary policy since 198G have remained as in the earlier period- the stimulation of output and employment and the promotion of domestic and external stability in line with the general philosophy of economic management under SAP. Monetary policy was aimed at inducing the emergence of a market- oriented financial system for effective mobilization of financial savings and efficient resources allocation.

2.6 MONETARY AND CREDIT POLICY FORMULATION

Monetary and credit policy formulation raise very difficult conceptual as well as practical problems. While it is generally agreed that monetary policy may be designed to deal with four broad objectives namely: price stability,

high rate of employment, a desirable or sustainable rate of economic Growth and balance of payment equilibrium. In practice, one finds more often than not that these objectives are conflicting. Monetary and credit policy formulated, relies on the techniques of financial programming which seek to ensure some consistencies among the economic sectors in the process of its formulation. It is of paramount importance to specify the focus of policy; otherwise it will be impossible to evaluate performance, (CBN Research Department ,1979:126). The monetary programme starts with a comprehensive review of recent economic performance, as well as the current and anticipated problems usually the programme attempts to estimate an optimum quantity of money consistent with the assumed targets for Gross Domestic product (GDP) growth, inflation rate and external reserves. Using the computed optimum money supply the economy's absorptive domestic credit is derived thereby permitting targets to be determined for some of the money supply and aggregate domestic credit is allocated between the government and private sectors, Ogwuma, (1996:4). The portion taken up by the government is determined by the size of the budget deficit to be financed by CBN, commercial and merchant banks. In preparing the monetary policy, the process encourages the public, individuals and various interest groups to

Submit proposal. After the policy proposals have been studied, scrutinized, and approved by the board, it is transmitted to the Federal Ministry of Finance. The Ministry usually invites the CBN for discussion of the proposals and submits to the Federal Executive Council.

Monetary policy formulation under the direct control system of monetary policy is different from the policy formulation under the indirect control, under the direct control of money supply, the monetary policy formulation has four stages- definitions of objectives, policy formulation, policy implementation and review/evaluation stages (see fig 2:1). These stages are distinct although closely interrelated. The definition of policy objectives is an important aspect of the formulation process. This assists in proper articulation of the policy focus and the adoption of the correct instrument for the achievement of the goals. The next stage is the formulation of policy thrusts. This entails appraising the recent past and present policy targets as a basis for making projections to the future trends in the absence of policy changes. For example, assuming there is a case of excess liquidity in the system the monetary authority would usually review the past and

Present trends in this regard and thus be able to make projection or the future policy thrusts to contain the situation. The policymakers would then adopt necessary instruments that would assist in containing the situation.

The next stage is the implementation of the policy framework. The implementation is usually affected through the structures provided by the financial intermediaries, especially the banks. There is a conscious attempt to evaluate the results from the implementation stages and the level of effectiveness of the instruments in use. If the objectives are not being achieved, further adjustments are made and tailored to the need of policy framework.

It is important to highlight here that in the implementation of monetary policies, the CBN issues to the banks and other financial intermediaries the broad targets to be achieved and the monetary and banking policies to be achieved. These are in the form of guidelines which prescribed what the banks are expected to do, to ensure sound banking structure. It also prescribes penalties in the event of default. To enhance the level of compliance with the monetary policies, the CBN ensures analysis of regular and occasional returns from banks.

2.7 CBN OBJECTIVES OF CREDIT GUIDE LINES AND TARGETS

In broad terms the objectives of monetary and credit policy guidelines are the same as those of economic policy in general. Although the emphasis of monetary and credit policy guidelines could vary from time to time, its major

objectives have remained generally the same over the years. These include: (i) Promotion of price stability (ii) Reduction of pressure on the external sector (iii) Stabilizing the Naira exchange rate, (iv) Stimulating economic growth.

Since those objectives hardly met simultaneously, some prioritization has to be made. According to Ogwuma (1996; 14), for meaningful achievement of these broad objectives efforts are made to identify the intermediate targets which include determining appropriate level of credit growth or decline rate of inflation and growth of money stock as well as creating a sound financial structure through which monetary control is carried out.

2.8 MONETARY AND CREDIT POLICY INSTRUMENTS, CLASSIFICATION AND IMPLEMENTATION

The monetary policy objectives are achieved through the use of appropriate instruments, which vary between developed and developing economics, monetary policy is a package of actions designed to manage the growth of money supply during a period to its optimal target. When successful, the level of money becomes compatible with the rate of growths of output, inflation, and interest rates. At such a level, money plays the role of an efficient lubricant in the wheel of economic activities. Money will then not constitute a nuisance to the extent that its

supply is too much or frustrate business intentions to the extent that its supply is too little.

The strategy of monetary control used by the Central Bank could be classified into two broad categories: the portfolio constraint (control) technique (Direct Control) and the market intervention mechanisms (indirect control).

In an undeveloped financial environment where the level of monetization of the economy is low, the instruments of monetary policy are limited to direct measures which set monetary and

Credit targets at desired levels as well as guidelines to bank through which the targets are enforced. Indirect instruments as usually employed in market based economics where the quantity of money could be influenced through the relationship between money supply and reserve money as well as the ability of the monetary authorities to influence the creation of reserves. Generally however, for direct control measures, the instruments available to the Central Bank of Nigeria (CBN) for achieving its slated objectives are:

- (a) Special deposits (Stabilization securities).
- (b) Selective credit controls.
- (c) Administered interest rate.
- (d) Liquidity ratio.
- (e) Moral suasion.

(A) SPECIAL DEPOSIT (STABILIZATION SECURITIES) The Central Bank of Nigeria used stabilization securities extensively between 1988-1993 to mop up excess liquidity in the system. This is in form of special deposits used in monetary control on an ad-hoc basis. The issuance of the instrument and its use as a tool of monetary control was suspended on 30 of June 1993 as a deliberate policy thrust to send positive signals to the

Market based system of monetary control and in recognition of the adverse side effects associated with their use as - a policy instrument. What were the adverse effects associated with the use of stabilization securities? First, it reduced the profitability of the banks since they do not earn interest income on the securities it is essential an ad-hoc measure and negates the market mechanism. Special deposits are frozen and do not count as part of a banks liquid asset, In 1996 the monetary authorities consented to an active trading in the out standing balances of these securities held by banks in the inter-bank market in and attempt to improve on hanks liquidity management. According to the Central Bank's guidelines, transactions are to be effected without recourse to the CBN for a rediscounting facility. Secondly, secondary market trading is at an interest rather than a discount thirdly, many banks were not allowed to transact or deal on stabilization securities and these instruments were

made eligible as part of a banks liquid assets for purposes of meeting the liquidity ratio. The outstanding stabilization securities were fully retired by the end of 1998.

(B) SELECTIVE CREDIT CONTROL AND CREDIT GROWTH CEILING

Under the direct method of monetary control, the monetary authorities used two principal methods. The selective credits control and the application of credit growth ceilings. Selective credit controls are direct instruments designed to influence the allocation of credit to specified sectors of the economy. In using this instrument, the various sectors of the economy were divided into two- the preferred and the less preferred sectors. The preferred sectors attracted a minimum percentage of bank credit, usually specified in the monetary policy guideline while the less preferred sectors had a maximum level of bank credit allocated to the sector. The essence is to persuade the banks to grant more credits to the more preferred and productive sectors of the economy while discouraging them from granting credit to the less preferred and less productive sector.

The banks were also classified into groups for purposes of credit expansion depending on their level of deposits. The implication was that bank that had large deposits were allowed to-expand their total credits at a higher level, while the reverse is the case for banks with low deposits.

Credit ceiling confer on the monetary authorities the power to regulate the demand for credit for specific uses by determining the minimum down payments and regulating the period of time over which the loan is to be repaid. It involves administrative orders whereby the bank using guidelines instructs commercial banks on the cost and volume of credit to specified sectors depending on the degree of priority of each sector (Anyanwu, 1993:145),

(C) ADMINISTERED INTEREST RATES:

Another direct measure for monetary control was the administered interest regime. Interest rates are the price for obtaining loanable funds and a return for forgoing liquidity and are used by the monetary authorities to influence the demand and supply of loanable funds. The central Bank has the power to fix and vary rediscount rates and the structure of all the rates at the money market. The CBN also prescribed the rates for lending and deposits of the major participants in the money market.

Under the administered interest rate regime, first the CBN usually varies the Minimum Rediscount Rates to signal the direction of monetary policy it intends to pursue; secondly, minimum and maximum lending rates were specified for the banks.

Generally, the administered interest rates check inflation, improved resources allocation, encourages domestic non-

bank financial institutions to buy government bonds, to finance development projects and attract foreign investment. Over time, the rate structures introduce various distortions with limited resources allocation, introduced irrationality and thus the intermediation process. This necessitated the interest rate deregulation as a major plank of the monetary policy reforms, (Nzotta, 1991:70).

(D) LIQUIDITY RATIO

The original Act, which gave the CBN, the power prescribes the liquidity ratio for the commercial banks specified a ratio of 5%. The ratio was then designed mainly to safeguard the ability of the banks to meet their obligations to their depositors' cash withdrawals and ensure confidence in the banking system. Later, the legislative amendments gave CBN not only the power to alter the composition of the assets for the computation of the liquidity ratio, but also liquidity ratio itself, which as a result became a tool of monetary control. The liquid assets entering the liquidity ratio include, cash balance and other short-term assets, which easily realizable into cash without much loss of value.

(E) MORAL SUASION:

This involves the use of power of persuasion to influence the lending operations of the commercial banks in the

direction desired by the monetary authorities. The essence of moral suasion is persuasion rather than the forcing of the commercial banks to adapt to whatever advice the Central Bank gives concerning its lending to customers. While commercial banks are under no obligation to follow the banks' advice, they usually do, because to do otherwise might result in their falling out of favour (Olalokun, 1979:195).

For the indirect control measures, the instruments available are:

- (a) Reserve Requirements,
- (b) Rediscount Rate Policy,
- (c) Open Market Operation.

All these confer on the monetary authorities the power to regulate the demand for credit for specific uses by determining the minimum flow payments and regulating the period of time over which the loan is to be repaid. It involves administrative orders whereby the bank using guidelines instructs commercial banks on the cost and volume of credit to specified sectors depending on the degree of priority of each sector Anyanwu; 1993:145).

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(A) CASH RESERVE REQUIREMENT:

The monetary authorities usually employ legal reserve requirements as one of the major tools of monetary policy.

(B) REDISCOUNT RATE POLICY:

This is the interest rate charged by the central Banks. It represent the cost of borrowing by the commercial banks

from the central bank when the former is in need of funds to replenish reserve in order to create deposits by extending loans to customers Olaloku; (1979: 195).

The variable, rediscount rate policy, also called the minimum rediscount rate (MRR) is the rate of interest charged by the Central Bank for rediscounting short-term bills (treasury bill, treasury certificates and eligible development stocks) for banks essentially when they are under pressure for short-term funds. Rediscount is a major function of the central bank as a lender of last resort. The essence is to achieve monetary stability, enhance the liquidity of the banks and foster public confidence in the banks. The rediscount rate is a panel rate and hence banks only resort to it as a last chance of proving their liquidity. Essentially, the importance of the rediscounting rate policy, raising and lowering of the Minimum Rediscount Rate (MRR) signal the intention of the monetary authorities to either contract or expand bank credit. In effect, the MRR produces important announcement effects in the money market, which the operation, especially banks find most useful. When the Central Bank finds that inflationary rates are going up in the economy, it may decide to raise the bank's their lending rate to the borrowing public and thus enable the system to contract the volume of credit created the money supply and inflationary rates.

Conversely, if the CBN wants to reflect the economy following a depression, it may decide to lower the rediscount rate. Borrowing becomes cheap. The banks in the system respond by lowering the lending rates and thus creating more credit since the demand for credit would usually increase especially in an interest sensitive economic system. Investments are increased and same to output, incomes and thus, the movement of prices. The use of the minimum rediscount rate policy conceptually facilitates the operation of open market operations. Changes in the MRR affect the credit creation capabilities of the commercial banks, only if they are rediscounting their bills with the Central Bank. Thus, if banks do not avail themselves of the rediscounting facilities of the Central Bank a rise in the MRR will not affect the creation of the banks hence the money supply. The importance of the discount rate for monetary regulation lies in the fact that it is the peg on which the spectrum of interest rate is structured, (Nzotta, 1999:76).

(C) OPEN MARKET OPERATION (OMO):

Open Market Operations constitute a major instrument of monetary policy under the market-based system of monetary management. Essentially, Open Market Operation (OMO) is used by the monetary authorities to regulate the cost and availability of credit in the banking system and thus influence the level of money supply.

Open Market Operation is based on the discretionary power of the Central Bank to buy and sell government securities or instruments in the money market, to the bank and non bank public and thus achieve stated macro-economic objective. Those eligible instruments include Treasury Bills, Treasury certificates and development stocks of maturity more than 3 years to maturity.

Open Market Operation conceptually, is mainly conducted in the secondary market for government securities; the import is that it needs an efficient secondary market for it to function effectively.

Open Market Operation ensures that altering the reserve base of banks, thereby enhancing or limiting their credit creation capabilities, carries out monetary expansion or contraction. Assuming an expansionary monetary policy is being pursued the Central Bank purchases government securities from the Commercial Banks, thus causing their reserves to rise and hence increasing their credit creation ability. The purchase of securities is a direct injection of liquidity to the banking system.

It is pertinent to mention that a pre-condition for the monetary policy is the existence of well-developed money market. In an economy like Nigeria, where financial market is very narrow and underdeveloped coupled with large amount of excess reserve, usually maintained by

banks and inadequate supply of securities the successful use of OMO is limited (Anyanwu, 1993:140). In Nigeria, the direct monetary control tools are being phased out due to their emerging short comings moreover, the developed economies now operate the indirect monetary systems, according to Ahmed (1991). This process, which started in 1986, is yet to be fully achieved .The authorities have not yet let go of some direct instruments and they have not met all the necessary prerequisites for a proper market based monetary control system, that statement was made in 1991 but it is still applicable today because credit ceilings (on agriculture) and stabilization securities (National savings certificate) are still obtainable in the monetary policy guidelines for 2002/2003 fiscal years. Again, according to Osaka (2001) "the prerequisites for a market based system are deregulated interest rate, deregulation of the market for government debt instruments, well developed institutional framework and the reduction of excess liquidity in the economy" and some of these are not well in place in Nigeria also.

CLASSIFICATION OF MONETARY POLICY INSTRUMENTS:

(Nnamocha, 1999) identified different classification of monetary policy instruments.

(1) Traditional and modern instruments

- (2) Aggregative instruments and selective instruments
- (3) Indirect instrument and direct instruments.

In the first form of classification, the instruments are traditional in the sense that they have been in use for a long time while the other instruments are modern because they were developed only some few years back. Examples of the traditional instruments according to Nnamocha (1999) are "open market operations, discount rate policy, required reserve ratio and moral suasion" and he gave examples of modern tools thus: special deposits and imposition of advanced import deposit. The instruments are classified as general in the sense that they look at the economy as a unit and the instruments is directed at this unit, the general instruments work indirectly to the objectives and they are mostly quantitative. A good example is the interest rate policy. The selective instruments are directed to particular targets, they are discriminating and

Selective, they are usually used to affect particular segments of the economy a good example is the advance import scheme. The third form of classification is most popular among the three. This classification has the same concept with (Nwankwo, 1979)'s classification into quantitative and qualitative instruments. The only difference is in the name. "Direct or quantitative instruments are those instruments which effect control by

placing ceiling on bank credit and interest rate thus limiting bank's freedom to undertake certain activities" (Onyido,1999). The direct approach is features of underdevelopment in financial markets examples of such instruments are credit ceilings, direct regulation of interest rate and Sectoral allocation of credit. Credit ceiling stipulates the limit to which banks are allowed to expand credit so that the price level will be stable.

Sectoral allocation of credit is aimed at the preferred economic sector that is, industry agriculture and housing with the aim of inducing higher levels of output in the economy and thereby restraining inflation. Direct regulation of interest rate specifies the levels of ranges within which both deposit and lending rates are to be maintained as stated earlier. This is used where the financial market is under developed and in addition where capital is scarce and has to be-optimally allocated.

Indirect instruments are generally referred to as market-based instruments as they change the supply of bank reserves through transactions at market related prices and on a voluntary basis. Most indirect instruments are aimed at the balance sheet of the central bank .According to Ahmed (1991), indirect approach to monetary control involves the use of reserve requirements, open market operations and discount rates in the financial markets to control the cost and availability of bank credit. Open market operation enters to the buying and soiling of

securities by the central bank in the money market. This is aimed at reducing or increasing the supply of money by influencing commercial banks liquidity, when the policy is contractionary, the Central Bank sells security in the open market. This action will reduce commercial banks' liquidity and cut short their ability to increase credit. On the other hand, if for expansion, the Central Bank acquires securities and pays for them with money.

This goes to increase the reserve of banking system and constitutes extra liquidity to the banking system in the former, the securities would be purchased by banks and/or their customers from their bank accounts and would result in the transfer of deposit from the commercial banks to the Central Bank and a reduction in the reserve of the commercial banks. The assumption is that when the Central Bank sells its securities in the open market, commercial banks loose reserves, which will compel them to reduce their lending in order to satisfy the reserve requirement. The Central Bank aims to control the reserve of the commercial banks so that they will alter it in the desired direction. Required reserve ratio is made up of cash reserve ratio which is the required proportion of banks' deposit liabilities kept in cash balances with" the Central bank and the liquidity ratio which is the proportion of total deposits kept in liquidity assets, mainly used to safeguard the ability of the banks to meet depositor's cash

withdrawals and ensure confidence in the banking system. This instrument was first adopted in the United States of America (U.S.A.) in 1935 following the suggestion of Keynes in his treatise of money in 1930. It aims as stated above at ensuring that banks have sufficient liquidity to meet daily transactions, it also aims at curbing the credit creating ability of commercial banks and this reduces the money supply when it is raised.

When the central bank raises the reserve ratio of commercial banks, this means that they are required to keep more money with the Central Bank . Consequently, excess reserve with commercial banks are reduced, the net effect will be a reduction in the aggregate money supply by reducing loans and advances, less money is created through the multiplier system.

The effectiveness of reserve requirement is limited and this is because some amount of money is also held outside the banking system • by non-bank commercial institutions (NBF), monetary policy's reserve requirement might actually influence the reserves of merchant and commercial banks but they cannot influence those of non bank financial institutions here, the effectiveness of reserve requirement, would be watered down by the amount of funds these non-bank financial institution accumulate and hold outside the banking system. Reserve

requirement is particularly effective for sterilizing excess liquidity in the banking system but are less efficient over the day-to-day management of bank liquidity, open market operation is more efficient in this regard. "The discount rate mechanism is the interest rate charged by the central bank on its loans to the commercial banks." It is the rate at which the CBN lends money to the banks as a lender of last resort" Onyido (1999), has added, that "the importance of the discount rate is that other rates of interest are linked to it, they fluctuate together with the rise and fall of the discount rate. Discount rate policy is used for influencing borrowings. Required reserve ratio and open market operation refer to how central bank influence availability of credit but discount rate policy acts directly on the cost of credit.

Discounting means that the CBN accepts bills that are not yet mature, at a discounted rate and "keeps them until they are mature. Changes in the discount rate are associated with increase or decrease in central banks credit to the commercial banks. The discount rate is a penal rate; it is imposed and is greater than the market interest rates, a sort of penalty for the banks whose distress position leaves them with no option than to resort to the central bank. The extent to which the central bank can use discount rate as an instrument of policy depends on its role as the lender of last resort. If commercial banks have to borrow at higher interest rates, being

business enterprises, then it is expected that they pass this to customers in higher interest on bank loans therefore, we can conclude that an increase in bank rate will decrease demand for the central banks evaluation of the underlying condition of the economy and of money and credit demands.

Changes in loan due to higher cost of borrowing and this will also result in reduction in investment spending and vice versa. The general response of the market rate to a change in discount rate will be large when the market view the adjustment as signaling a shift in the central banks evaluation of the underlying condition of the economy. A change in discount rate must be interpreted in the context of surrounding economic and financial conditions and in the light of the way they complement other policy actions. If a change in discount rate is anticipated, it may not make appreciable impact on market rates. This explains why timely actions are required for banks to anticipate effecting changes in discount rates before such change. Selective credit policy is an instrument of monetary policy, which is designed to channel funds to sectors considered imperative to economic development. It stipulates the cost, direction and quantity of money and credit to preferred sectors of the economy. Banks are more disposed to lending to higher return sectors which are most times non productive, examples are the commercial and the services sectors, here therefore lies the need to direct resources to

more productive sectors. As practiced in Nigeria, selective controls come in two forms: Aggregate credit ceilings and sectoral allocation. Aggregate ceiling stipulates the amount of credit to each sector and specifies sectors while sectoral allocation breaks down in percentage, banks credit to all the sectors of the economy,

Monetary Policy Implementation: After the CBN's monetary policy proposals are approved by the president or Member of state, the relevant proposals are outlined in the form of a monetary policy circular for implementation by banks and other financial institutions; the circular contains special guidelines with penalties for malfeasance. The central bank tries to ensure that the monetary policy guidelines are well implemented it does this by carrying out on side and offside examination of the books of the banks.

2.9 EFFECTIVENESS OF MONETARY AND CREDIT POLICY

The effectiveness of monetary and credit policy depends on the following variable;

(A). Stability of Velocity of Money: Usually the velocity of money has a direct relationship with the price levels. Given $MV=PT$, a change in M (Money supply) would require a stable

V (Velocity) to have a strong impact on P (Prices) and T (total goods and service exchanged for money) This V must be constant and independent of changes in money supply (M).

(B). The Nature of Inflationary Trends: The nature of the inflationary trends in the economy goes a long way to determine the effectiveness of monetary policy. Monetary policy is not usually effective in dealing with cost-push inflation but the demand pull type of inflation.

(C) Interest Rate Elasticity of Money Demand for Loanable Funds: Interest rate of elasticity of money demand must *be* inversely related to the degree of effectiveness of monetary policy. This situation demands that the demand for money be inversely related to interest rates. Thus there is the need for interest elasticity for effectiveness of monetary policy thrusts.

(D) Development Financial Market and System: The effectiveness of monetary policies also depends on the level of development and sophistication of the financial markets, especially the money market and money markets operation.

Certain instruments of monetary policy particularly the open market (OMO) depends so much a high level of

sophistication of the money market especially the secondary market segment.

(E). Resolution of the Conflict with Treasury Goals:

For an effective monetary policy thrust, the instrument must be used for more monetary management than as treasury tools.

(F). Macro- Economic Stability: for the effectiveness of monetary policies there must exist stable macro-economic framework. Unstable aggregates will produce distortions and gaps in the economy that make it difficult to implement monetary policy thrusts.

2.10 PROBLEMS AND PROSPECTS OF INDIRECT MONETARY AND CREDIT POLICY CONTROL IN NIGERIA:

It has been seen that the movement to the market oriented system of indirect monetary control will not be easy. It will involve taking considerable preparatory measures to improve the financial environment before the tools are implemented. In reality, it means building a financial system, which will be more responsive to the needs of lenders and borrowers as well as to monetary control purposes. This will require substantial improvements in the macro-economic, legal and regulatory

environments. As a developing economy, which has . been depressed for too long, it will also, require broadening the range and improving the efficiency of the financial institutions and markets. In the main, the preparatory activities necessary for the take-off of indirect monetary control will focus on removing the main obstacles to the new techniques (Oresotu ,1993:171). Specifically, efforts have to be devoted to the restoration of the appropriate transmission mechanism between the monetary market and the real sector of the economy; the design of a competitive market as a medium for mobilizing and channeling financial resources as well as conducting monetary policy for the control of financial variables to their optimal levels to permit the achievement of target rate of growth of output under non-inflationary condition. Under the rigid, administratively- controlled economy prevailing before the 'introduction of the Structural Adjustment programme the identified problems militating against the introduction of the market based regime of monetary management are as stated below.

(a) GOVERNMENT FISCAL DEFICIT FINANCING AND EXCESS LIQUIDITY.

The fiscal deficit constitutes a direct injection to aggregate demand, increasing pressure on the general level of prices and the external balance of payment, Also reliance on the CRN for the financing of the fiscal deficit the Federal

Government leads to increases in the monetary base and swells the level of excess liquidity in the banking system. However, a high level of excess liquidity is inconsistent with the principle of practical reserves system and the effective use reserve requirements and Open Market Operations (OMO). There was therefore the need to rid the system of unwanted liquidity. The most effective instruments at the disposal of the CBN were the stabilization securities and the cash reserve requirements. In addition, arrangements needed to be made for the privatization of the CBN function of understanding issues of government dept instruments as in countries already adopting the new techniques. Also, institutional arrangement that would assist the CBN in a market oriented management of domestic liquidity must be put in place to fill *n* perceived gap in the secondary market for short-term securities.

(b) HARMONIZATION OF FISCAL AND MONETARY POLICIES

Fiscal deficits of the federal government in the recent past have been out of tune with monetary targets largely because of improper coordination of the fiscal "and monetary programme. Fiscal imbalance has adverse consequences on the monetary base and the effective use of indirect tools. Fiscal viability during and after the preparatory period of the monetary programme is thus

very important hence it was necessary to set up a machinery to synchronize fiscal and monetary policies on a continuous basis as well as formulate the general thrust of the open market operation policy.

(c) Insolvent Banks: Following the huge size of bad and doubtful debts in banks portfolio of assets, some banks are currently not solvent enough, for the indirect controls. Insolvency undermines inter-bank confidence of the non-bank public. Confidence in banking is an invaluable asset the lack of which would undermine competition among participating depository institutions during the period of indirect monetary and credit control.

The problems of ailing banks which is already being looked into by a joint committee of the CBN and NDIC will thus be addressed during the preparatory period to ensure that insolvency which affects confidence in the banking system is removed. Non-Bank Financial Institutions: Since the introduction of structural Adjustment programme in 1986 the number and size of non-bank financial institutions have risen tremendously.

These institutions perform some banks like functions but are not currently under the general credit guidelines of the CBN. If these institutions are not adequately monitored in the new era there will be a source of

enormous leakages in the monetary control. For this reason, there will be the need to examine the activities of the non-bank financial institutions. Though this may be accomplished before implementation the effort to assess and monitor the operation of these institutions could still extend into the implementation stage without precluding the introduction of the new method,

(E) INADEQUATE MONEY ACTIVITIES: Activities on the money market are dominated by Federal Government securities which are held mainly by the CBN. The banks control brokerage services in the market wholly while there is still no adequately developed secondary market for treasuring securities. For this reason money market activities have remained narrow even though the volume of securities is very large. Brokerage services need to be extended to a number, of independent brokers beside banks accredited official dealers. The development of the monetary market is important for a successful use of open market operation. Efforts during the preparatory period will be geared towards making the market more active along the lines indicated To this end, non treasury securities could be introduced into the market.

(F) BANKING SUPERVISION.

Effective banking supervision is vital for the success of the new techniques. For this reason the supervisory function

of the CBN will need to be strengthened. Hopefully, the role of NDIC will supplement the supervisory role of the CBN. Banks' reporting formats will need to be standardized in order to make bank reports operational records comparable with one another and easily interpreted by all and sundry.

(G) STATISTICAL DATA

A successful manipulation of reserve requirements and Open Market Operation will require timely and reliable data on the liquidity position of banks and the factors defining the monetary base. These data are presently available on monthly basis with some uncomfortable lags. Under the new technique, data should be readily available on weekly and even on daily basis. To this end, the system of data processing, storage and retrieval in the CBN and the banks must be strengthened in order to make timely intervention of the monetary authorities easy during the implementation stage.

(H) TRAINING.

The personnel to be involved in the implementation of the new policy need to be trained. Already some staff of the CBN has undertaken country studies on the use of indirect monetary control in the Central Bank of Ghana, India, Indonesia and Malaysia, (CBN Research Department, 1991:10) According to CBN Research Dept. (1991:10) the most important problem of the shift to the

indirect approach to monetary management in Nigeria is the persistence of government fiscal deficit, financed by the banking system, especially the Central Bank. The enormity of the problem derives from the magnitude of the deficit, its persistence and the mode of financing. In recent years, deficit financing has constituted the greatest threat to monetary policy deducing the effectiveness of policy instruments. Consequently, inflationary pressures have persisted; exchange rate depreciation in all segments of the foreign exchange market has been rapid while the current account of the balance of payments has recorded unsteady performances, fluctuating between small, surplus and large.

The deficit has also complicated the management of the interest rates, which are vital indicators of performance of policy under the indirect approach to monetary control. Efforts to minimize the growth of the domestic liquidity arising from the monetary effects of the deficits through the issuance of stabilization securities have resulted in an upsurge of inter-bank rates. The rates, which in normal circumstances should be the lowest, are the highest. The insatiable demand of banks for foreign exchange despite the adoption of measures to reduce domestic liquidity has been responsible for the excessive growths in monetary and financial variables, exacerbating the distortions in the system. For instance, aggregate credit, propelled by excessive credit to the Federal Government and State and

threatening explosion in the money stock. It is generally believed that if the problems of fiscal deficit and its current model of financing are removed from the economic problems challenging monetary policy today, the country will witness greater macroeconomic stability reflecting in the resumption of stable growth as well as reduced unemployment and inflation Oresotu (1992:173). The prospect for improved performance of monetary policy under the regime of indirect approach depends inextricably, on the extent of reduction in fiscal deficit. Financing and the avoidance of reliance on the financial resources of the banking system for the financing of the deficit. The probability of reducing the deficit depends on the ability of government to generate additional revenue and rationalize its recurrent expenditures. Efforts to raise revenue through reduction of petrol subsidy have met with political and social constraints.

Government has also introduced the Value Added Tax (VAT) with a view to improving revenue out turn. With regards to expenditures, government has taken steps to privatize some parastatals with a view to eliminate the grants to these agencies. It is hoped that the intensification of these measures and the adoption of credible strategy towards removing the social-political constraints will increase the prospects of viability of government finances and eventually eliminate unsustainable budgeting and financing.

The achievements of the above mentioned improvements will no doubt promote the viability of government, thereby reducing or eliminating government reliance on the banking system's financial resources as it is in many countries adopting indirect approach to monetary and credit control. Such countries have either learnt from the adverse experiences of others or they have witnessed the danger in this method of macroeconomic management.

2.11 FACTOR INFLUENCING MONETARY CREDIT POLICY EFFECTIVENESS IN NIGERIA.

The observed monetary and credit policy influence on the banking sector, notwithstanding, it is generally known that monetary policy measures are not as effective as they should be in Nigeria, Since monetary policy is bank-based, the enhancement of bank performance through monetary policy is not fully realized. This coupled with other problems (internal and external to the banking industry), has exacerbated distress in the system, which in turn affects monetary management adversely. Thus, according to Ojo (1992:23), one of the problems, which constrain monetary policy in Nigeria, is the banking industry itself. Others are conflicts of policy objectives and instruments, budget deficit financing by the system, undeveloped financial infrastructure, poor banking habits, leakages in the demand and supply of money, the structure of production, policy harmonization and implementation

constraints, political instability, world recession, inadequate data bank, poor policy formulation and the exchange rate,

(1) UNDERDEVELOPMENT BANKING SYSTEM

It is generally accepted that where as monetary policy is required to improve the performance and efficiency of the banking industry, the banks in turn are expected to assist in achieving monetary management. One important feature of the banking industry recently is the high level of distress in the system, which manifested in liquidity and capital adequacy problems, management inefficiency and poor earnings potentials of the banking system. Although monetary policy somersaults contributed to the distress in the system, this has obvious implications for the effectiveness of monetary policy. This is because the presence of weak and terminally distressed banks leads to the disintermediation process and affects the ability of CBN to implement monetary policy.

Apart from the above, the banking system is also largely undeveloped with low level of technology, provision of inefficient service and poorly equipped and motivated personnel, thus, the general efficiency of the system is constrained, especially ability to assist in implementation of monetary policy thrusts of the government.

(II) CONFLICTS BETWEEN MONETARY POLICY INSTRUMENTS AND OBJECTIVES:

Apart from the inadequacy of the banking industry itself the "multi- target" characteristic of monetary policy assumes possible conflicts: of objectives, which are not achievable simultaneously, the instruments are used continuously in order to achieve the desired combination of objective. An example is the implementation of the policy of withdrawal of public sector deposits in bank in 1989 as a means of stemming excess liquidity in the banking system. This exposed the nature of poorly developed banking infrastructure and is at the cause of the distress of most of the banks. Assuming also that the government intends to increase productively and decides to increase the credit creating capacity of the banks through the purchase of its securities in the open market operation, the net effect is that this would lead to monetary expansion and thus inflation. The monetary authorities would thus prefer to us less vigorous in the focusing of those instruments to reduce the obvious conflicts.

(III) FISCAL DEFICITS:

The financing of a large fiscal deficit of the government by the banking system over the years also constrains monetary policy implementation. The problem rises

because such financing of government deficits by the central bank increases monetary base and swell the level of excess liquidity of the banking system. It is noteworthy that between 1990 and 1993 the level of federal deficits increased tremendously and this resulted in a high level of growth in resulted in a high level of growth in monetary aggregates. This put excessive pressure on money supply. The monetary authorities thus were constrained in controlling the general level of prices through the use monetary policy instruments.

(IV) UNDERDEVELOPED FINANCIAL INFRASTRUCTURE:

In Nigeria, the financial infrastructure (money and capital markets) is largely undeveloped. This constrains the effectiveness of monetary policy since this situation sustains the low level of magnetization of the economy. This situation also constrains the ability of monetary aggregates to influence the aggregates in the real sector of the economy and thus the achievement of macro-economic objectives,

(V) POOR BANKING HABITS:

There is the presence of poorly developed banking habits. Banking habits reflects on the perception and ability of the public to use banking services. Poor banking habits results in a largely non-monetized financial structure which hinders the effectiveness of monetary policy. One central

concerned here is that a lightly non-monetized sector results in a high tendency to hold currency, which are not subject to monetary policy influences. The use of cheques is low, especially with a high level of distress in the banking system and the high level of moral decadence in the society

(VI) LEAKAGES IN THE DEMAND AND SUPPLY OF MONEY

In Nigeria, there is a high level of preferences for transactions balances by the public, especially the petty traders and small businesses. There are also obvious leakages that arise from deliberate destruction of currency due principally to religious and cultural factors and various other social norms.

The most fundamental constraint to the effectiveness of monetary policy is the obvious conflicts with the fiscal policy goals of the government. In a developing country like Nigeria, government has paramount need for developmental finance to sustain the.

development potentials and growth prospects of the economy, the high level of external debt servicing and the large public sector. Government also has the basic need to enhance finances due to the receding revenues it obtains from its traditional source such as taxes, development assistance and petroleum resources.

Moreover, in Nigeria there is a high level of tax evasion, poor performance in revenue generation, lack of transparency in fiscal relations and fiscal indiscipline. Thus, the government usually resorts to deficit financing as a viable option for sustaining its financing needs. Their monetary policy instruments are used more as treasury goals.

As noted by Ezeuduji (1994:275) budget harmonization processes end approving huge government expenditure without adequate revenue base, while the banking sector is made to provide the required financing even when monetary management would be compromised.

(VIII) POLITICAL INSTABILITY:

Another factor that affects monetary policy effectiveness relates to political instability, policy instability results to political instability in the micro-economy, increased risks in holding domestic financial assets, high levels of capital flight and mostly policy summersaults/Frequent coups, violent change in government, dictatorship and the low level of participatory democracy sustain the ineffective regulatory environment for the financial system especially with regards to its ability to perform its intermediation roles. In addition to the above, other factors emerge occasionally to constrain effectiveness of monetary policy. For example large net

inflows of foreign Change, which constitute invaluable assets in itself, could pose a problem for monetary policy management. If it is monetized beyond the need for monetary stability other sources of adverse influences on monetary policy management include: -

- a. World recession or external shocks;
- b. Inadequate bank regulatory arrangement;
- c. Uncomplimentary banking laws;
- d. Poor policy formulation;
- e. The structure of production and
- f. Activities of non- bank financial institution and the informal sector.

Far from being traceable to any fundamental mistakes in policy formulation, the specific problems facing monetary policy in Nigeria are largely attributable to exogenous factors. First, is the inability to use the conventional techniques of monetary policy because of the lack of financial market of the required breadth and depth.

For instance, open market operation (OMO) cannot be applied because the volume of eligible securities in the market is inadequate. In addition, transactions in government I securities which represent the bulk of money market securities are not fully exposed to money market forces since the CBN is required to guaranty their repurchase at par. Thus, as long as this guarantee is operative, effective open market operations, which *require* market sensitive interest rates, are precluded.

According to Ogwuma (1993:155) rapid growth in liquidity has impacted adversely on the Naira exchange rate and domestic price fever. Although excess Liquidity during the period is linked immediately with the monetization of foreign exchange and rapid growth in aggregate in liquidity has impacted adversely on are those factors, which influence these monetary aggregates. The greatest problem in this respect is the financing of large government deficit by the CBN.

The fast hut not the least factor is the shortcoming of the most popular instrument of monetary regulation in Nigeria credit guidelines. Apart from the fact that commercial banks failed on a number of occasions to attain full compliance with the various Central Banks guidelines the problem of "Window dressing" the figures of their credit operations cannot be ignored. Most importantly there is the problem of loan diversion; the inability to control the ultimate use into which a borrowed fund may be put. The more prescription of a sectoral distribution of credit .may not ensure that funds borrowed for production cannot be applied for consumption CBN Research Department ,1979:98).

2.12 PERFORMANCE EVALUATION OF MONETARY AND CREDIT GUIDELINES

The Commercial Banking Industry is involved in the business of providing financial services to the Nigeria economy. In playing this intermediation role, the sector acts as the main channel for the transmission of monetary and credit policies in the¹ economy and at the same time earns income for its shareholders. According to Uchendu (1995:115) the commercial banking profit function for the industry is influenced mainly by interest and exchange rate policies, credit availability, labour cost and policy stance on provisioning for non-performing loans. Other factors affecting the performance Of banking firms are size and structure of the industry.

Monetary and credit policies though with its constraints, have contributed significantly to creating the enabling environment for commercial banks to discharge their primary responsibilities to the economy. These responsibilities include;

- i) Mobilizing financial resources through interest rate measure;
- ii) Stimulating investment, employment and growth;
- iii) Promoting international trade and payments by domestic monetary and financial

management;

- iv) Contributing to economic stability by using stabilization securities, cash and liquidity ratio;
- v) Simplifying resource allocation through interest rates liberalization, creating appropriate environment for indirect monetary management and generally, stimulating competition in the system (Ezeuduji, 1994:251). Therefore, CBN'S credit and monetary guidelines have been able to curtail excesses, but also promote or help in the performance and profitability at the commercial banks.

2.13 CURRENT STUDIES

Several authors have investigated the monetary policy commercial bank performance relationship and the results of these studies have generated a lot of controversies in banking literature. According to Ojeiabi (1994), the controversies have divided economists into two areas of view. One school of thought according to him, holds that for effective monetary policies, both formal and informal markets need to be controlled. This school maintains that monetary objectives cannot be achieved if the quantitative monetary control is restricted only to the banking sector. The other school of thoughts believes that financial dualism is of no significance in monetary management the Radcliff committee in Britain studied the growth of

financial intermediaries since world war 11, and came to the conclusion that they adversely affect the power of the central bank of England to control credit Ithingan (1986) also agreeing with the Radcliff view described the process whereby a restrictive monetary policy is rendered ineffective by reducing the velocity of money.

Gurley and Shaw (1960) in their writing in support of a more comprehensive approach to monetary policy pointed out that non-control of non-monetary financial institutions can lead to a crease in the assets of commercial banks, increase total credit to inflationary tendencies as both institutions are capable of creating their one unique debt and could both fuel Inflation. They contend that monetary control limits the supply of other financial assets. Money therefore, as a successor of monetary control would regulate the creation of financial assets in all forms that are competitive with direct securities in spending units' portfolio.

The Radcliff committee however rejected the idea of controlling the intermediaries because it was not politically possible in England as such a prospect will not be welcome except as a last resort. This is not only because of its administrative burden but because the further growth of new financial institutions would allow the situation to continually slip from under the grip of the authorities. As noted by the United States commission on money and credit, "the evidence from either the cyclical or the secular periods does not support n case for an extension of the direct monetary control over non-bank financial intermediaries; their

contribution to cyclical changes in velocity appears to be too small to warrant such an extension. This is in consonance with the other school of thought which believes that control over a non-bank financial institution is pointless, they do not render monetary policies ineffective, Johnson (1969) in supporting this view observed that there seems to be no empirical case for empowering the Central Bank to extend its control over financial intermediaries similar to those exercised over commercial banks, according to him, the position of the central banks is not significantly weakened by the presence of non-bank financial institutions more so, when the public will not easily switch from bank deposit to indirect securities of non-bank financial institutions.

Both schools of thought agree that monetary policies affect economic and financial performance but disagree on the ability of non-bank financial institutions to mitigate this impact. Some other authors have studied this issue of monetary influence on the economy. Among the early efforts to explain how money affects economic and financial activities was the one made by Fisher (1932). He, like other neoclassical writers held the view that in the short run, monetary influence was dictated by interest rates that were sticky initially though rising subsequently but in the long run the channel of influence was real cash balance. Thus, money stock increases following, for example, an increase in gold stock and rise in reserves. The short-run effect according to Fisher, would be to

increase commodity prices since he assumed that output and velocity were fixed initially. Fisher assumed also that the rise in commodity prices would precede the increase in interest rates, which was regarded as a component of the firms operating costs. Consequently, the rise in commodity prices would lead to an increase in the firm's profit followed by increases in business investment, loan demand, demand deposits, and money stock, these would also lead to further increase in commodity prices and investment.

In his analysis of long-run transmission of monetary influences, Fisher replaced the "interest-investment" channel with real cash balance" thus, when wealth increased following a rise in money stock, people would try to reduce their cash balances by purchasing goods and services. Since velocity (v) and output (T) in fishers equation of exchange ($MV=PT$) is fixed, a doubling of money stock (M) cannot lead to increased holding of goods and services but rather would lead to the doubling of the price level

(P). Fishers however did not provide adequate explanation for the substitution and wealth effects expected from a change in quantity of money, thereby making his position ambiguous.

Like Fishers analysis, Keynes view on monetary transmission mechanism was not clear -cut, this caused subsequent writers to interpret him differently.

Subsequent writers to Keynes, the Keynesians or post - Keynesians, regard the cost of capital (or interest rates) as the main process by which change in money stock influence the real economy. Thus the change in the volume of money alters the rate of interest usually approximated by the long-term government bond rate, which affects investment and possibly, consumption. The rate of interest therefore was seen as the link between real and financial sectors. Other major channels of monetary influence recognized by the most Keynesians were the wealth effect on consumption expenditure and credit rationing linkage between financial and real sectors.

Thus, the link between net wealth of the private sector and consumption was analyzed by Pigon (1947) and Pinkin (1951) in the form of "real cash balance effect" which implied that changes in the real quality of money could affect real aggregate demand even if they did not alter the rate of interest. While the debate on the proper link between real and financial sector continues, there appears to be a consensus among n group of economists called non-monetarists or neo-Keynesians, which monetary policy operates through changes in market price

of equities which represent claims on existing real assets. The work of Tobin and Brainard (1908) regards the equity rate as the major link between money and the level of another group of non-monetarists often called neo-Keynesians, argue that changes in the . quantity of money have direct impact on short term interest rates, equity yields and possibly other rates of return on real assets, this suggests that the full effect of monetary policy is subject to long lag since it takes time for monetary policy to be reflected in long interest rates, equity yields and components o aggregate demand.

Finally, while non-monetarists' arguments generally imply that monetary policy is not as effective as fiscal policy in determining total spending in the economy, the monetarists led by Friedman (1970) and (1971) hold views which can be summarized thus-monetary policy influences banking performance directly, as well as indirectly through feed back effects from the economy.

Hancock (1989) examined the impact of directly policy vis-a-vis deregulation. She examined the effect of interest rates and other components of monetary policy on bank profitability and the production of financial services in a deregulated environment. She developed and explicit model of financial production which include assets and liability holdings and the demand and supply by commercial banks of financial services. The data period

ranged between 1979 and 1984 for a sample size of two hundred and twenty three banks (223), According to Hancock, in the period prior to deregulation of the American financial services industry, profits were relatively more responsive to rates on time deposits and borrowed money than on loans, after deregulation, the reverse was the case. Excess reserve holding behaviour changed significantly in the regulation era. Increase in interest rates, which leave the spread between borrowing and lending costs unchanged, decrease variable profit prior to deregulation and increased profitability after deregulation.

Ogunleye , (1996) pointed out that in Nigeria, only two major studies have attempted some detailed study on the impact of monetary policies on the performance of commercial banks, these are Odufalu (1994) and Uchendu (1995) although, he also acknowledged Ezeuduji (1994) who highlighted the channels through which monetary policy affects the performance of licensed banks . He opined that Ezeuduji (1994) failed to discuss the impact of these policies nor their measurement.

Odufalu's study was mainly on monetary policy variables determinants of banks profitability in Nigeria. He developed a structural model of bank profitability in which the reduced form had profit before interest and tax as the

dependent variable, the explanatory variables the employed include average Interest rate on savings and time deposits, prime lending rate for loans and advances, treasury bills rate, time deposits, liquidity ratio, cash ratio and income. Using pooled data for only twelve commercial banks for 1986 - 1990 period, the estimated the model by the method of ordinary least square (OLS). From this results, total deposits, treasury rate and lending rate had positive significant impact on banks profitability, both liquidity ratio and income were not significant the study also indicated that only 39% of bank's profit are due to influences of monetary policy instruments, the small R^2 shows that there are other significant determinants of bank performance not factored into monetary variables, Qgunfeye observed that the use of lending rate and savings rate was questionable, from his point of view using these two in the same analysis was not right because according to him the difference between the two is what is important for profitability, he also opined that Odufaly should have excluded deposits form his anal/sis because they are liabilities of the banking system and to monetary policy variables.

Uchendu (1995) was the second work that solely used Nigerian data for his empirical analysis. He used data covering 1970 to 1993 and a total of sixty commercial banks as sample size. He employed three different measures of profitability: interest earnings, rate of return

on assets and rate of return on capital and these were the dependent variables. His profit function had six explanatory variables and these include interest earnings, rate of return on assets and rate of return on capital and these were the dependent variables. His profit function had six explanatory variables and these include: interest rates, exchange rate, commercial banking system reserves, concentration ratio, a variable measuring efficiency and unit labour costs. To measure the effect of size, the sample size was divided into three groups, viz: all banks, six banks in operation since 1970 and the three big commercial banks which have also been in operation since 1970.

From his analysis, the equations degenerated from an adjusted R-square value of 0.9223 for the interest earnings to 0.6579 for the rate of return on capital and the explanatory powers of the equations deteriorated from all banks; six banks to three banks categories. He found that interest rate as an explanatory variable had a positive and significant relationship with all measures of profit, on the other hand, he found that exchange rate reduced banks profit though he added that this inference might be wrong. The impact of reserves on profit was positive and significant for the interest earnings and rate of return on capital but not significant when return on assets was employed as the dependent variable. Other factors that had positive effect on commercial bank profitability

included the oligopolistic market power of the three big commercial banks in Nigeria and staff remuneration. In conclusion, Uchendu's study found considerable link between commercial bank performance and monetary policy, it should be noted however, that just like Odufalu (1994), quite a number of important monetary policy variable were missing from the explanatory variables. Like Odufalu (1994), Uchenedu only identified and estimated a number of banks' profitability determinants but failed to explicitly exploit what changes in profitability resulted from changes in monetary policy variables.

Finally, majority of these previous works have viewed bank performance in too much of a parochial sense, sometimes profitability appears to be the only indicator of bank performance. This is not true, just as the total external assets of commercial banks could be employed as a possible measure of bank performance (CBN, 2005). This study, therefore, aims to correct some of these short comings. Consequently , this study investigates the impact of monetary policy on bank performance, measured through total external assets .

CHAPTER THREE

RESEARCH DESIGN AND METHODOLOGY

3.1 INTRODUCTION

This chapter treats the methodology adopted to carry out the test on hypotheses.

Therefore, this chapter is concerned with how the study was designed, the procedure adopted in gathering data, the research methodology and the source of data collection, the instrument of data collection and data analysis including the techniques adopted in testing the hypotheses.

3.2 RESEARCH DESIGN AND SOURCE OF DATA

The study covers the period, 1980-2005, while adopting ordinary least square multiple regression model as the main statistical tool of analysis. Here, the total commercial bank external assets ($TFASSET_t$ as the dependent variable) is regressed on the corresponding figures for the monetary policy instruments namely Minimum Rediscount Rate (MRR), Interest Rate ($INTRES_t$), Treasury Bills Rate ($TRBL_t$), Cash Reserve Ratio, (CRR_t), and Liquidity (LR_t), as explanatory variables. The study employed only secondary data from the Central Bank of Nigeria (Annual Statistical Bulletin etc) and the Nigerian National Bureau for statistics. The test statistics include therefore, Coefficient of Correlation (R), Coefficient of

Determination (R^2), the analysis of variance (ANOVA/F-ratio) and the t-distribution (t-test). While the ANOVA/F-test establishes the significance or otherwise, of the model as a whole, the coefficient of correlation seeks to test the strength or magnitude of the relationship between the monetary policy instruments and any of the dependent variable, Commercial Bank Total Net External Assets. T-test seeks to test the extent of contribution or level of significance of the monetary policy instruments to the dependent variable net external assets of commercial banks.

3.3 SPECIFICATION OF THE MODEL

Data were sourced from both the Central Bank of Nigeria (CBN)

and the National Bureau for Statistics (NBS) publications, covering

the period 1980 - 2005. Specifically, we have;

$TFASSET_t$ = Level of Total External Assets of

commercial Banks, in year t.

MRR_t = Level of Minimum Rate in year t

$INTRES_t$ - Level of Interest Rate in year t

$TRBL_t$ = Level of Treasury Bill Rate in year t

CRR_t = Level of Cash Reserve Ratio in year t

LR_t = Level of Liquidity in year J

For hypotheses II for example, we have the regression equations as;

$$TFASSET_t = f(MRR_t, INTRES_t, TRBL_t, CRR_t, LR_t) \dots\dots\dots (1)$$

3.4 TEST OF HYPOTHESES

The following hypothesis is tested;

HOI: $p^2 = 0$ (i.e., the regressor, level of Total External

Assets Of Commercial Banks in a given year has no

significant relationship with the actual independent variables for that year).

HA_t $p^2 > 0$ (i.e., there is a significant relationship between the dependent variable (TFASSET_t) and actual independent variables ;

$$(MRR_t, INTRES_t, TRBL_t, CRR_t, LR_t) \dots\dots\dots (1)$$

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3.4.1 DECISION RULE

Under both the F-test and student t-test, the Ho is rejected once the calculated F-ratio or F-ratio is greater than the theoretical or critical values at the specified degree of freedom.

CHAPTER FOUR

DATA PRESENTATION AND ANALYSIS

4.1 INTRODUCTION

Recall that in chapter three, the model for the study was clearly defined. However, in this chapter, we shall focus on the presentation and analysis of the data. Invariably, these involve estimation of model, analysis, interpretation of the results and testing of the hypotheses of the study in order to arrive at policy measures.

4.2 DATA PRESENTATION

Under this section of the report, we present the data set employed in estimating the model as already outlined in chapter three. It is instructive to note that only secondary data were employed, which were sourced from two main sources.

1. The Central Bank of Nigeria (CBN) statistical bulletin and
2. The National Bureau for Statistics (NBS).

THESE DATA ARE AS PRESENTED IN TABLE 4.1

TABLE 4.1: THE NIGERIA MONETARY POLICY INSTRUMENTS -CASH RESERVE RATIO, LIQUIDITY RATIO, INTEREST RATE, MINIMUM REDISCOUNT RATE, TREASURY BILLS RATE AND

**MONEY SUPPLY AND COMMERCIAL BANKS TOTAL
FOREIGN ASSETS, FOR THE PERIOD, 1980 -2006**

	YEAR	TFASSET	MRR _t	INTREST t	TRBL _t	CRR _t	LR _t
1.	1980	250.20	47.60	9.50	6.00	r's.00	161.90
2.	1981	259.20	38.50	10.00	6.00	5.00	143.20
3.	1982	246.40	40.50	11.75	8.00	7.00	15.30
4.	1983	343.50	54.70	11.50	8.00	7.00	81.00
5.	1984	412.50	65.10	13.00	10.00	8.50	319.40
6	1985	414.59]	65.00	11.75	10.00	8.50	153.10
7	1986, ;	1740.40	10.00	12.00	8.50	1.70	36.40
8	1987	2991.30	12.75	19.20	11.75	1.40	46.50
9	1988	4807.20	12.75	17.60	11.75	2.10	45.00
10	1989	7461.50	18.50	24.60	17.50	2.90	40.30
11	1990	6550.20	18.50	27.70	17.50	2.90	44.30
-12	1991	10369.70	14.50	20.80	15.00	2.90	38.60
13	1992	19386.00	17.50	31.20	21.00	4.40	29.10
14	1993	24892.60	26.00	18.32	26.90	6.00	42.20
15.	1994	17864.70	13.50	21.00	12.50	5.70	48.50
16.	1995	57257.80	13.50	20.79"	12.50	5.80	33.10
17	1996	47605.00	13.50	23.32	12.00	7.50	43.10

18.	1997	53334.50	13.50	21.34	12.19	7.80	40,20
19.	1998	75141.50	14.31	21.34	12.95	8.30	46.80
20.	1999	135223.2	18.00	27.19	17.00	11.70	61.00
21.	2000	194585.4	13.50	21.55	12.00	9.80	64.10

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22.	2001	305028. 5	14.31	21.34	12.95	10.80	52.90
23.	2002	398210. 0	19.00	23.90	18.90	10.50	52.50
24.	2003	437658. 6	15.75	20.48	15.02	10.00	50.90
25.	2004	481295. 5	15.00	20.62	14.21	8.60	50.20
26.	2005	468457. 5	13.00	19.47	7.00	9.70	50.20
27.	2006	644838. 1	11.50	18.40	8.80	4.20	57.90

Source: CBN Statistical Bulletin, 2006.

4.3 TESTING OF HYPOTHESES

4.3.1 THE INFLUENCE OF MONETARY POLICY ON COMMERCIAL BANKS TOTALS FOREIGN ASSETS,

This involves the use of a multiple regression model to determine the extent of influence of monetary policy instruments on commercial banks total assets. This test of model significance is carried out in two ways –ANOVA and coefficient of determination approaches.

The Hypothesis states thus:

Ho 1: There is no significant relationship between changes in minimum rediscount rate and bank performance.

Ho2: There is no significant relationship between changes in interest rate and bank performance.

Ho3: There is no significant relationship between changes in treasury bill and bank performance.

Ho4: There is no significant relationship between changes in Cash reserve ratio and bank performance.

Ho5: There is no significant relationship between changes in liquidity ratio and bank performance.

Table 4.2 presents the regression result/output which shows the influence of monetary policy instruments on commercial banks total foreign assets.

TABLE 4.2: HYPOTHESIS RESULT/OUTPUT

0.660 R
 0.435 R²
 160236.603 Standard Error of Estimate
 .27 Observations
 5 Predictor Variables
 Y Dependent Variable

variable	Coefficients		Std error	t(df =13)	significance
Intercept Xi = MRR _t	b ₀ bi	210107.7 - 7996.952	189088.7 3602.823	-2.220	***0.038
X ₂ = INTRESt	b ₂	-5997.137	10490.51 0	-0.572	0.574
X ₃ = TRBLt	b ₃	-3279.824	9621.158	-0.341	0.737
X ₄ - CRR _t	b ₄	34804.731	11045.25 1	3.151	***0.005
X ₅ = LR _t	b ₅	483.567	819.308	0.590	0.561
ANOVA Table					
Source	SS	df	MS	F=3.235^	***0.003
Regression	r^2E+oTT~	5	8.306E+0 1		
Residual	5.4E+011	21	0		
Total	9.5E+011	26	2.568E+0 1 0		

Source:

SPSS 15.0

NB: **** = Significant at 0%; *** = significant at 1%; ** - Significant at 5%; * NS = Not significant. F-tabulated df (5,21), 1% - 4.04; 5% = 2.68; t-tabulated (df=21); 1% = 2.831; 5% - 2.080.

4.3.1.1 TEST OF MODEL SIGNIFICANCE - ANOVA APPROACH

Calculation of the total sum of square, TSS; n_A

$$\sum_{t=1}^T (TFASSET_t - TF_t)^2$$

from the ANOVA as shown in table 4.2, yields the hypothesis stated in this form;

$$H_0: \beta_1 = \beta_2 = \dots = \beta_k = 0, \text{ for } k=1, \dots, 6 \dots 4.1$$

This is to say that all the coefficients of the explanatory variables in the regression are zero) or the explanatory variables have no significant effect on the actual variation in total foreign assets of commercial banks for the period under investigation, 1980-2006.

H_A : At least one $\beta_j \neq 0$, for $j = 1, \dots, K \dots 4.2$, meaning that at least one

of the explanatory variables has a significant effect on the actual variation in total foreign assets of commercial banks for the period under investigation, 1980-2006.

DECISION RULE

Once the calculated f-ratio is greater than the f-ratio tabulated (read from the f-ratio table), at the specified degrees of freedom and alpha levels of significance, we reject H_0 and accept the H_A . Here, again, the degrees of freedom remain (5,21) and alpha levels; 1% = 4.04; 5% = 2.68 But, with the calculated f-ratio of 3.235 (see ANOVA table 4.2), we therefore reject H_0 and accept H_A

to conclude that the model is in fact statistically significant at 5% level of significance.

4.3.1.2 MODEL SIGNIFICANCE - THE COEFFICIENT OF DETERMINATION APPROACH (R^2)

As stated in chapter three of this report, one other way of testing the model significance is through the coefficient of determination, R^2 . Hence, R^2 is calculated from the formula;

$$F_{cal} = \frac{(1-R^2)/(N-K)}{\dots\dots\dots} \quad 4.3$$

Where;

$$F_{cal} = \frac{(0.435) / (6-1)}{(1-0.435) / (27-6)}$$

F-ratio calculated = 220.699 But, f-ratio tabulated, (5,21); 1% - 4.04; 5% = 2.68

Since f-ratio calculate (3.235) is greater than f-ratio tabulated (5% = 2.68), we therefore reject H_0 and accept H_A to conclude that the model is statistically significant and the resulting regression equation is given thus;

$$TFASSET_t = 160236.603 - 7996.952MRR_t - 5997.137INTRES_t - 3279.824TRBL_t + 34804.731CRR_t + 483.567LR_t \dots \quad 4.4$$

4.3.1.3 TEST OF THE INFLUENCE OF EXPLANATORY VARIABLES ON COMMERCIAL BANKS FOREIGN ASSETS -T-TEST

4.3.1.4 The hypotheses tested here are as follows: Hoi; Changes in minimum rediscount rate have no significant effect on bank performance.

Ho2: Changes in interest rate have no significant effect on bank performance.

Ho3: Changes in treasury bills rate have no significant effect on bank performance. Ho4: Changes in cash reserve ratio have no significant effect on bank performance.

Ho5: Changes in liquidity ratio have no significant effect on bank performance.

To test the specific strength of the explanatory variables in contributing to the variations in commercial banks total foreign assets, we resort to the strident t-test as found in the regression result /output of Table 4.2. Here, the result shows that whereas minimum rediscount rate and cash reserve ratio proved significant at least, at 5% alpha level, treasury bills rate ,interest rate and liquidity ratio proved to be non- significant contributors to the level of foreign assets of commercial banks in Nigeria for the period under review ,(i.e. t -calculated; 2.220 and 3.151 > t -tabulated, 2.080). Furthermore, the order of importance is shown as:

$CRR_t > MRR_t > LR_t > INTRES_t > TRBL_t$ [3151]
 [2.220] [0.590] [0.572] [0.341] Obviously, cash
 reserve ratio exerts the greatest influence while the least
 contribution is from treasury bill rate. Others are
 minimum rediscount rate, liquidity ratio and interest rate
 in that order.

4.4 DISCUSSION OF RESULTS

From the results of the hypotheses, it is striking to note
 that monetary policy contributes significantly to bank
 performance as proxied by total foreign asset investment
 of commercial banks. Added to this, the model shows
 about 66% level of relationship between the explanatory
 variables taken together and the bank performance (see
 the ANOVA Table 4.2 and appendix 1).

However, in terms of the signs of the individual
 coefficients, while the minimum rediscount rate, treasury
 bill rate and interest rate, each bears a negative sign,
 meaning that they all exert negative contributions to the
 level of commercial banks total foreign assets, the cash
 reserve ratio and liquidity ratio with their positive
 coefficients, each makes a positive contribution to total
 foreign assets of commercial banks in Nigeria.

CHAPTER FIVE

SUMMARY, RECOMMENDATIONS

5.1 SUMMARY

The study examined the influence of monetary policy measures on the performance of commercial banks in Nigeria, covering a period of twenty six years from 1980 to 2005. The hypotheses formulated had the following objectives:

The main objective of this study is to empirically determine the impact, of monetary policy on the Nigerian commercial banks. The specific objectives, however, include the following:

1. To determine the influence of cash reserve ratio on bank performance.
2. To determine the influence of liquidity ratio on bank performance.
3. To find out if interest rate has significantly affected commercial bank performance.
4. To ascertain the influence of minimum rediscount rate on bank performance.
5. To determine whether a significant relationship exists between treasury bill rate and bank performance coefficients, each makes a positive contribution to total foreign assets of commercial banks in Nigeria.

6. To determine whether the level of money bank supply has significantly affected bank performance.
7. Finally, to offer suggestions on how to improve bank performance through the application of monetary policies.
8. The results reveal that even at 0% alpha level, a significant relationship exists between all the monetary policy instruments namely cash reserve ratio, liquidity ratio, interest rate, minimum rediscount rate, treasury bills rate, money supply and commercial banks total net foreign assets for the period under investigation.
9. Whereas the level of money supply, treasury bills rate and minimum rediscount rate, each exerts a significant effect on the level of bank performance, the cash reserve ratio, liquidity ratio and interest rate do not contribute significantly to the level of commercial bank performance.

5.2 CONCLUSION

On the basis of the findings, some conclusions were reached which include in the following.

1. Monetary policy instruments can be employed to influence bank performance and liquidity ratio with their positive influences on the level of bank performance in Nigeria.

2. The greatest influence can be achieved when Cash reserve ratio is employed, followed by, minimum rediscount rate, liquidity ratio, interest rate, and treasury bills rate in that order.
3. While the Cash reserve ratio, and liquidity ratio exert positive influence on the level of bank. performance, the treasury bills rate, interest rate and minimum rediscount rate, each exerts ' , a negative influence on bank performance.

5.3 RECOMMENDATIONS

The study having made the afore-mentioned findings and conclusions, therefore offers the following recommendations.

1. That monetary authorities should pay more attention to the use of such instruments Cash reserve ratio and minimum rediscount rate in order to influence the level of bank performance.
2. Similarly, since the desire is always to ensure high performance of the banking sector, more attention equally needs to be given to the other monetary instruments as their correct manipulation no doubt, would bring about the desired results.
- 3 The negative contributions of both the treasury bill, interest rate and the minimum rediscount rate, invariably, calls for a closer look at the way such policies are implemented in Nigeria, with a view to

improving banking performance while ensuring economic growth.

Regression

[DataSet] C:\Program Files\SPSS Evaluation\NDUKWE CHUKWU.sav

Descriptive Statistics

	Mean	Std. Deviation	N
TFASSETt	125800.94	191604.02444	27
MRRt	23.3433	16.65602	27
INTRESt	19.2289	5.61956	27
TRBLt	12.8141	4.81669	27
CRRt	6.5111	3.02189	27
LRt	68.4444	61.77182	27

Correlations

		TFASSETt	MRRt	INTRESt	TRBLt	CKRt	¹ c* i_rU /
Pearson Correlation	TFASSEit	1.000	-.357	.203	-.013	<i>AKf-t</i> <i>:~t-JIS</i>	-17^
	MRRt	-.357	1.000	-.651	-.324	.140	.771
	SNTRESt	.203	-.651	1.000	.695	.115	-.508
	TRBLt	-.013	-.324	.695	1.000	.038	-.349
	CRRt	.453	.140	.115	.038	1.000	.161
	LRt	-.174	.771	-.508	-.349	.161	1.000
Sig. (1-tailed)	TFASSETt		.034	.155	.474	.009	.193
	MRRt	.034		.000	.050	.243	.000
	INTRESt	.155	.000		.000	.284	.003
	TRBLt	.474	.050	.000		.426	.037
	CRRt	.009	.243	.284	.426		.212
	LRt	.193	.000	.003	.037	.212	
N	TFASSETt	27	27	27	27	27	27
	MRRt	27	27	27	27	27	27
	INTRESt	27	27	27	27	27	27
	TRBLt	27	27	27	27	27	27
	CRRt	27	27	27	27	27	27

Lrt	27	27	27	27	27	27
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Variables Entered/Removed¹¹

Model	Variables Entered	Variables Removed	Method
1	Lrt, CRRt, TRBLt, INTRESTt, MRRt		Enter

a. All requested variables entered. b. Dependent Variable: TFASSETt

Model Summary^{1*}

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Change Statistics					Durbin-Watson
					R Square Change	F Change	df1	df2	Sig. F Change	
1	.660 ^a	.435	.301	160236.6030	.435	3.235	5	21	.025	.509

a. Predictors: (Constant), Lrt, CRRt, TRBLt, INTRESTt, MRRt b. Dependent Variable: TFASSETt

ANOVA^b

Model	Sum of Squares	df	Mean Square	F	Sig.
1	4.2E+011	5	83064701821	3.235	.025 ^a
Regression	5.4E+011	21	25675768933		
Residual	9.5E+011	26			
Total					

a. Predictors: (Constant), Lrt, CRRt, TRBLt, INTRESTt, MRRt b.

Dependent Variable: TFASSETt

Coefficients³

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95% Confidence Interval for B		Correlations		
	B	Std. Error				Beta	Lower Bound	Upper Bound	Zero-order	Partial
1 (Constant) MRRt	210107.71 -7996.952	189088.75 3602.823	-.695	1.111 - 2.220	.279 .038	-183123.870 - 15489.433	603339,283 - 504,471	-.357	-.436	-.364
INTRESt	-5997.137	10490.510	-.176	-.572	.574	-27813.346	15819.072	.203	-.124	-.094
TRBLt	-3279.824	9621.158	-.082	-.341	.737	-23288.118	16728.470	-.013	-.074	-.056
CRRt	34804.731	11045.251	.549	3.151	.005	11834.873	57774.588	.453	.567	.517
LRt	483.567	819.308	.156	.590	.561	-1220.278	2187.412	-.174	.128	.097

Coefficients³

Model	Collinearity Statistics	
	Tolerance	VI F
1 (Constant)		
MRRt	.274	3.647
INTRESt	.284	3.519
TRBLt	.460	2.175
CRRt	.886	1.128
LRt	.386	2.594

a. Dependent Variable: TFASSETt

Coefficient Correlations³

Model		LRt	CRRt	TRBLt	INTRESt	MRRt	
1	Correlations	LRt	1.000	-.064	.202	-.111	-.666
		CRRt	-.064	1.000	.119	-.282	-.187
		TRBLt	.202	.119	1.000	-.683	-.327
		INTRESt	-.111	-.282	-.683	1.000	.563
		MRRt	-.666	-.187	-.327	.563	1.000
	Covariances	LRt	671266.13	-580105.8	1590694.7	-954632.0	-1965646
		CRRt	-580105.8	1.2E+008	12659895	-3E+007	-7425989
		TRBLt	1590694,7	12659895	92566684	-7E+007	-1E+007
		INTRESt	-954632.0	-3E+007	-7E+007	1.1E+008	21272127
		MRRt	-1965646	-7425989	-1E+007	21272127	12980335

a. Dependent Variable: TFASSETt

Col linearity Diagnostics¹

Model Dimension	Eigenvalue	Condition Index	Variance Proportions					
			(Constant)	MRRt	INTRESt	TRBLt	CRRt	LRt
1	5.059	1.000	.00	.00	.00	.00	.01	.00
2	.657	2.775	.00	.04	.01	.01	.00	.10
3	.138	6.064	.00	.01	.00	.06	.87	.01
4	.091	7.452	.00	.50	.01	.00	.00	.82
5	.043	10.816	.27	.00	.03	.59	.09	.03
6	.012	20.433	.73	.45	.95	.33	.03	.03

a. Dependent Variable: TFASSETt

Residuals Statistics³

	Minimum	Maximum	Mean	Std. Deviation	N
Predicted Value	.43084.46	328305.25	125800.94	126388.21590	27
Residual	-171143.0	491726.72	.00000	144007.36461	27
Std. Predicted Value	-1.336	1.602	.000	1.000	27
Std. Residual	-1.068	3.069	.000	.899	27

a. Dependent Variable: TFASSETt

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