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IMPACT OF MONETARY POLICY INSTRUMENTS ON INFLATION IN NIGERIA

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Abstract

This study examined the impact of monetary policy instruments on inflation in Nigeria from 1990 to 2023. The study employed Auto-Regressive Distributive Lag (ARDL) model to estimate the short-run and long-run relationships. The ARDL estimation revealed meaningful short- and long-run relationships. In the short run, past inflation, money supply, interest rate, and liquidity ratio significantly influenced current inflation levels. Particularly, interest rate had a strong negative effect on inflation, suggesting the potency of interest rate policy as an anti-inflationary tool. In the long run, the same variables maintained their significance, with money supply exerting a positive influence and both interest rate and liquidity ratio exerting a negative impact. The study concludes that monetary policy instruments, particularly interest rate, money supply, and liquidity ratio, significantly impact inflation in Nigeria. Both short-run and long-run estimations revealed that while an increase in money supply leads to higher inflation, effective interest rate management and maintaining an appropriate liquidity ratio can help curb inflationary pressures. The study therefore, recommends that the Central Bank of Nigeria (CBN) should enhance the effectiveness of the interest rate as a policy tool by ensuring that rate changes are promptly and fully transmitted through the financial system to influence inflation outcomes.

Introduction

The formulation of policy on the control of money circulation in the economy is vested with the Central Bank of a country. Monetary policy is the control of money circulating in the economy through the employment of monetary instruments by the monetary authorities. The formulation of policy framework that will ensure price stability has captured scholars and policy makers' attention. Parallel with academic progress and experience in this matter, the understanding of monetary policy has advanced significantly over the last few decades (Adodo, Akindutire and Ogunyemi, 2018).

The relationship between money in circulation and inflationary rate is the main index for measuring a country's performance, prosperity and growth potentials. The control of the volume of money in circulation as well as maintaining price stability has been the main objectives of developing countries including Nigeria. Monetarist economist has argued that there is evidence of relationship between inflation and money supply and uncontrollable increase in the volume of money may have adverse effect inflation (Chaudhry, Ismail, Farooq & Murtaza, 2021).

The foremost goal of monetary policy in Nigeria is price stability. Inflation seems to be a threat to the Nigerian economy despite the numerous monetary regimes introduced by the central bank of Nigeria over the years. In the past, inflationary situations in Nigeria did not allow macroeconomy to grow to desired levels as it significantly reduced the purchasing power of the citizens.

The most recent attempts at stabilizing Inflation rate in Nigeria by the CBN have not achieved the desired result. For example, inflation in Nigeria was mostly in the range of 16.0 - 18.0% with an average of about 16.952 during the year 2021, 18.84% in 2022 and 24.65% in 2023. The 18.72% recorded in March 2021 was due to structural inflationary factors such as shocks in food supply, rise in exchange rates and insecurity which disrupted agricultural activities (CBN, 2022). These values are in stark contrast with the single digit inflation rates that the country had during

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parts of the 2000's. These scenarios highlight the ongoing issue of inflation.

Inflation in the Nigerian economy can be dated back to the c 1960 where cheap money policies were introduced to promote economic activities immediately after independence (Oyakhilomen & Rekwot, 2024). Subsequent to that time, factors such as supply shocks, currency depreciation, and oil revenue volatilities have played crucial roles in driving the Nigerian inflation (Oyakhilomen & Rekwot, 2024). Inflationary shocks felt during COVID-19, with food inflation soaring past the 20% mark is something pretty much unheard of for many decades.

According to Gbadebo and Mohammed (2015), the relationship between inflation and other macroeconomic factors makes it difficult to appreciate the role of monetary policy reforms on inflation targeting within the Nigerian economy. Poverty affects over 40% of the Nigerian people, most of who survive on less than 1 dollar a day, and when inflation is present it simply makes the real income people hold a greater disservice in society since vast amounts of people keep falling into lower brackets increasing inequalities (World Bank, 2023). From the insights of Onwachukwu (2024), inflation has and continues to hamper economic growth and development within the economy, especially during periods of high inflations: 1970s and 1990's for example.

Despite the various tools it has tried to deploy through its monetary policy such as replacing the CBN's interest rates and open market operations, controlling inflation has remained difficult. In early August 2023, it was reported that there was a significant increase in inflation rate which recorded 25.8%, the highest it has been for 20 decades, according to the (NBS, 2023). Such an increase shows that there are factors that exist within the economy that complicate the efforts of the monetary policy to control the price.

This research seeks to examine the effectiveness or otherwise of the CBN's monetary policy instruments with regard to the inflation control during the periods under review. Through the investigation of the effectiveness of monetary policy tools during the time period (1990 - 2023).

The decision to use 1990 is strategic, due to the fact that this was the year that marked a turning point for Nigeria in that it was the year that the country commenced major economic transformations aimed at removing government monopolistic practices and minimizing the rate of inflation on the overall economy. These reforms included the Structural Adjustment Program (SAP) as well as the new measures that the CBN started implementing. The year 2023 serves as the endpoint to ensure the inclusion of the most recent data, capturing over three decades of economic trends and providing a comprehensive view of the relationship between monetary policy instruments and inflation. Therefore, the research aims to shed light on the reasons for the persistent inflation patterns and suggest ways of bolstering Nigeria's monetary policies.

This research is structured in five chapters. The first chapter includes an introduction that encompasses the background of the study, statement of the problem, research questions, objectives, hypotheses, significance, scope as well as the organization of the study. The second chapter provides the extensive literature review forming the theoretical as well as the empirical models of the linkage between the monetary policy tools and inflation rate. In the research methods, chapter three defines the research methods, research design, data, analysis techniques and the specified model. The fourth chapter centres on presentation of data results, analysis and interpretation of findings on the effect of monetary instruments on the inflation in Nigeria. The last chapter, that is Chapter five wraps up the study by providing a summary of the findings, conclusions and other findings such as policy options that formulate the study.

Literature Review

Monetary policy refers to the combination of measures designed to regulate the value, supply and cost of money in an economy. It can be described as the art of controlling the direction and movement of credit facilities in pursuance of stable price and economy growth in an economy (Yimka, Ezekiel & Olusegun, 2020). Monetary policy refers to the actions of the Central Bank to regulate the money supply which could be through discretional monetary policy instruments such as the open market operation (OMO), discount rate, reserve requirement, moral suasion, direct control of banking system credit, and direct regulation of interest rate (Ilugbemi, 2020).

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Monetary policy also refers as the specific actions taken by the Central Bank to regulate the value, supply and cost of money in the economy with a view to achieving Government's macroeconomic objectives of economic growth, price stabilization, balance of payment equilibrium, employment generation, etc. (Adesoye, Maku and Atanda 2024).

Inflation is a persistent rise in the general price level of goods and services in an economy over a specific period. It is a crucial macroeconomic indicator as it reflects the purchasing power of money and the cost of living. In Nigeria, inflation has been a recurring challenge, posing a significant threat to economic stability and development. According to the National Bureau of Statistics (NBS), Nigeria's inflation rate surged to 21.91% in February 2023, driven by rising food prices, exchange rate volatility, and supply chain disruptions. This persistent increase in inflation impacts all segments of society, particularly low-income households who spend a significant portion of their income on basic necessities (NBS, 2023).

Inflation can be categorized based on its causes and the rate at which it occurs. In Nigeria inflation can be demand-pull, cost-push and imported inflation. Inflation in Nigeria is driven by a combination of structural, economic, and policy-related factors that includes exchange rate volatility, rising food prices, monetary policy challenges, insecurity particularly in the northern region of Nigeria, which has adversely affected agricultural activities and supply chains. This disruption reduces the availability of food and other essential commodities, further driving inflation (UNDP, 2022). Inflation can also be due to Nigeria's dependence on imported goods that makes it highly susceptible to global economic conditions, such as rising shipping costs, tariffs, and global supply chain disruptions (World Bank, 2020). The removal of fuel subsidies has led to an increase in fuel prices, which indirectly raises the cost of transportation and production, contributing to inflationary pressures (IMF, 2022).

The monetary policy experience in Nigeria could be divided into two broad policy regimes of direct and indirect methods, the direct method lasted from period of independence to 1985 while the indirect methods started in 1986 with the introduction of the structural adjustment programme (SAP).

The direct monetary control method operated passive monetary regime where control of monetary instruments was partially relaxed to focus on developing and maintaining a sound currency with focus on development of adequate supply of credit to the economy with minimal inflationary pressure. It also includes selective credit control policy, interest rate and exchange rate to stabilise the system.

The indirect control method was to restructure and diversify the productive base of the economy by establishing a realistic and sustainable exchange rate for the naira through trade and payment liberalization, through the use of Open Market Operation (OMO), Treasury Bills (NTBs), minimum rediscount Rate (MRR), discount window operations and unification of the official and inter-bank exchange rate in 1999 (Uchendu, 2009).

Theoretical Review

This study is anchored on the quantity theory of money first developed by Irving fisher in the inter-war years, and is a basic theoretical explanation for the link between money and the general price level (Geoff, 2012). Fisher (1932), in his quantity theory of money, opine that like other classical writers the short-run monetary control was dictated by interest rates which were sticky but in the long-run the demand of influence was real cash balance. Fisher further assumed that the rise in commodity prices would precedes the increased in interest rate which was regarded as main channel of the firms' operation cost (Jelilov, 2016). The quantity theory of money gives the relation between money, prices, and output:

$$MV = PY \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots (1)$$

Equation (1) is the quantity equation, linking the price level and the level of output to the money stock. The quantity equation transformed to classical quantity theory of money when it was argued that both V, the income velocity of money, and Y, the level of output, were fixed. Real output was taken to be fixed because the economy was at full employment, and changes in velocity were assumed to be negligible. If both V and Y are fixed, it follows that the price level is proportional to the money stock. Thus, the classical quantity theory was the theory of inflation. The classical quantity theory is the proposition that the price level is proportional to the money stock. It can be viewed as a

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theory of price determination suggesting that the equilibrium price level is strictly proportional to the quantity of money.

Empirical Review

Ayenajeyi, Musa, Emmanuel and Diemsan, (2024) examined the effect of monetary policy instruments on inflation in Nigeria; the study used annual time series data covering the period of 1990 to 2022 and the study used time series data majorly sourced from CBN Statistical bulletin and National Bureau of Statistical; The Auto-Regressive Distributed Lag (ARDL) model was adopted for the study, and it was discovered that money supply, monetary policy rate, and cash reserve ratio are the major instruments that influence inflation, while liquidity ratio had a positive relationship with inflation but statistically insignificant. The study therefore recommended that; the government through CBN should resort to cashless economy in order to reduce the circulation of money in the country.

Lawrence, (2023) examined the impact of monetary policy on disaggregate inflation in Nigeria over the period January 2002 – June 2020. The paper also investigated the impact of oil price shocks on macroeconomic variables in Nigeria. Using a linear Structural VAR approach, we found evidence that a decline of the monetary policy rate does not reduce inflation. In addition, exchange rate seems to have a significant impact on core inflation. That is, a shock to exchange rate decreases core inflation in the long-run, although there is no impact in the short-run. However, in the case of food inflation, an exchange rate shock increases food inflation in the long-run, likely due to the impact on food import. The study further establishes that oil price shock is key in explaining fluctuations in macroeconomic variables in Nigeria.

Charles, Gilbert and Emerenini (2022) examined the determinants of inflation in Nigeria using annual time series data covering the period of 1981 to 2017. The study applied Auto–Regressive Distributed Lag (ARDL) methodology based on the outcome of the ADF unit root test which revealed that the variables are integrated of I (1) and I (0). The ARDL bounds test result provided evidence of a stronghold long-run relationship among the variables. This necessitated the estimation of ARDL short-run and long-run results. The study concludes that both demand–pull and cost–push factors are responsible for inflation in Nigeria and also provide the social infrastructure that would encourage private investment.

Ifurueze, (2022) examine the effect of monetary policy instruments on financial sector performance in Nigeria. The researcher conducted preliminary test including Augmented Dickey Fuller for Unit Roots while the Autoregressive Distributive Lag (ARDL) was used for the data analysis. The study therefore concludes that monetary policy instruments have positive and significant short run policy effect but no significant long run effects on financial sector performance in Nigeria. In line with the findings of the study, we recommend that the relevant regulatory agencies in the capital market should formulate policies that would enhance the efficiency and transparency of the market in order to improve investors' confidence which will in turn enhance effective social economic and political institutions activities in the Nigerian environment.

Ezeanyeji, Obi, Imoagwu and Ejefobihi, (2021) focused on the impact of monetary policy on inflation control in Nigeria. The study is based on time series data from 1980 to 2019. The variables include – exchange rate, inflation rate, money supply (% GDP), Treasury bill rate and monetary policy rate. The research findings showed that monetary policy has no significant impact on inflation control in Nigeria both in the short – run and long – run. Money supply has negative and insignificant impact on inflation control in Nigeria both in the short – run and long – run. Again, exchange rate has negative and insignificant effect on inflation control in Nigeria both in the short – run and long – run. The Treasury bill rate has negative but significant effect on inflation control in Nigeria in the short – run, while in the long – run it has positive but insignificant effect on inflation control in Nigeria.

Dakasku, Jelilov, Isik and Akyuz, (2020) explored the impact of monetary policy instruments on economic growth in Nigeria from the period 1986 to 2018. Autoregressive distributed lag model (ARDL) was employed for the long run and short run dynamic relationship between each of the policy variables; Money supply, Interest rate and Exchange rate, and the target variable; Gross domestic product. The study concludes that monetary policy instruments are significant in explaining economic growth in Nigeria. Also, it

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is recommended that necessary measures should be taken by the monetary authority to ensure proper use of the instruments by maintaining favourable interest rate, exchange rate and money supply in to attain the desired level of growth in the economy.

Inim, Samuel and Prince (2020) examined other determinants of inflation in Nigeria using the autoregressive distributed lag (ARDL) method on quarterly data from January 1999-December 2018. Findings show that poor infrastructural development, exchange rate, political instability, corruption, and double taxation significantly stimulate inflation rather than just money supply. The results show a causal relationship between other determining factors and inflation. The ARDL result shows a significant long-short run relationship. The study recommends that non-monetary factors of instigating inflation should be controlled and security expenditure should be reviewing along with-related mechanisms to achieve low inflation at single digits at most and economic growth and development.

Okotori, (2019) evaluated the dynamics of monetary policy and inflation in Nigeria. Monthly data from 2009-2017 were used to estimate the model derived. The findings revealed that money supply, exchange rate, monetary policy rate, treasury bills rate, reserve requirement and liquidity ratio have significant and effective impact on the inflation rate. Based on the foregoing, it is recommended that the CBN stay focused on its current foreign exchange rate policy as well as making an unrestricted use of the monetary policy tools in its attempt to arrive and remain at the 6-9% inflation threshold for Nigeria.

Ankarara and Azebi, (2018) investigated the effectiveness of selected monetary policy tools in the control of inflation in Nigeria. Result of the ADF showed that all the variables are integrated of order I(1), except for the Error Correction Term (ECT) which is stationary of order I(0). The Johansen cointegration test result revealed the presence of a long-run relationship between inflation rate and the selected monetary policy variables. The ECM result revealed that the estimated model has a self-equilibrating mechanism of 12%. The paper concludes that Treasury Bill Rate (TBR) is an effective tool in controlling inflation both in the short and long run. While Exchange Rate (EXR) and Money Supply (MS) are very effective monetary policy tools in the control of inflation in the short run. Monetary Policy Rate (MPR)is effective in the long run.

Methodology

Model Specification

The model specified in this study was adopted from Amaning & Seidu, (2020). The dependent variable for this study is Inflation Rate (INF) while Money Supply (Ms), Interest rate (INT), and Liquidity Ratio (LQR) are the independent variables. Hence, the model is explained thus;

INF = f (Ms, INT, LQR) ---------- (1)

Where: INF = Consumer price index as annual percentage change; Ms = The total amount of monetary assets available in Nigeria commonly used as M2 (Broad money supply) in N'million; INT = Monetary policy rate in %; LQR = Liquidity rate measured as % of liquid assets to total deposits; F= functional relationship,

From the equation above, the explicit econometric model is detailed as

$INF = \beta_0 + \beta_1 Ms + \beta_2 INT + \beta_3 LQR + \mu$ ----------(2)

Where: μ = Error term; β_0 is the constant; β_1, β_2, β_3 are the slope/Regression Coefficients

Where by β_0, β_1, β_2, β_3 are positive parameters which are greater than zero, t = 1, 2… is the time index for the time from 1990 to 2023 yearly basis and μ is the error term. Given our specific variables, the linear relationship between Monetary policy and macroeconomic performance can be stated thus.

The a prior expectation is that there is a positive significant relationship between monetary policy instruments and inflation in Nigeria from 1990 to 2023.

Sources of Data

In this study, data are annual time series data from 1990 to 2023 representing a period of 34 years, the data used is gotten from a secondary source collected from the database of the World Development Indicator (WDI) published by the World Bank and Central bank of Nigeria data base (CBN).

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Estimation Technique

The method of estimation adopted or method of estimation to be adopted in this study is Autoregressive Distributive Lags (ARDL), developed by Pesaran et al (2001). This methodology estimates the impacts and applies the bounds testing in order to determine whether long-run relationship exists between the variables in the model. One of the advantages of the ARDL approach is that it can be used to model mixture of both I(0) and I(1) in the same specification, which is not acceptable using traditional approaches, such as ordinary least square (OLS) technique.

Also, ARDL bounds testing approach is more suitable and provides better results for small sample size. Using this approach, the dynamics of both the short-run and long-run parameters including the speed of adjustment when there is shock are estimated simultaneously within the same framework. Moreover, it subverts the problem of over-parameterization, as robust lag lengths are crucial to this approach. However, the shortcoming of ARDL approach is its inability to incorporate I(2) variables in its analysis.

Discussion of Findings

The findings from the trend analysis revealed dynamic patterns across the study variables over the period under review. Inflation fluctuated significantly, reflecting Nigeria's macroeconomic instability influenced by policy shifts, global oil price movements, and exchange rate volatility. Broad money supply showed an upward trend with periodic policy-induced fluctuations, while interest rates remained relatively volatile due to changes in monetary policy direction. Liquidity ratio showed a more stable trend, reflecting regulatory efforts to maintain banking sector health. These observed patterns are consistent with Nigeria's economic history and help contextualise the statistical results that followed.

Descriptive statistics highlighted that inflation had the highest mean and variability among all variables, indicating its unstable nature in the Nigerian economy. Money supply and interest rates also exhibited notable dispersion, signalling irregular monetary conditions over the years.

The correlation analysis showed that interest rate and liquidity ratio were negatively correlated with inflation, while money supply had a positive correlation, aligning with theoretical expectations.

The unit root test confirmed that the variables were of mixed integration some stationary at level (I(0)), and others at first or second difference (I(1) and I(2)). This mix of integration justified the use of the ARDL (Auto-Regressive Distributed Lag) model, which is best suited for such data structure.

The ARDL estimation revealed meaningful short- and long-run relationships. In the short run, past inflation, money supply, interest rate, and liquidity ratio significantly influenced current inflation levels. Particularly, interest rate had a strong negative effect on inflation, suggesting the potency of interest rate policy as an anti-inflationary tool. In the long run, the same variables maintained their significance, with money supply exerting a positive influence and both interest rate and liquidity ratio exerting a negative impact.

The residual diagnostics affirmed that the model is well-specified the tests showed no evidence of heteroskedasticity, autocorrelation, or multicollinearity, and confirmed that the residuals are normally distributed. Altogether, the findings support the theoretical assertion that monetary policy instruments significantly affect inflation and highlight the importance of prudent monetary management in Nigeria.

Conclusion and Recommendations

This study concludes that monetary policy instruments, particularly interest rate, money supply, and liquidity ratio significantly impact inflation in Nigeria. Both short-run and long-run estimations revealed that while an increase in money supply leads to higher inflation, effective interest rate management and maintaining an appropriate liquidity ratio can help curb inflationary pressures.

Recommendations

The Central Bank of Nigeria (CBN) should enhance the effectiveness of the interest rate as a policy tool by ensuring that rate changes are promptly and fully transmitted through the financial system to influence inflation outcomes; Authorities should monitor and regulate the expansion of money supply, especially during political cycles or crises, to

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avoid fuelling inflation. Monetary expansion should be linked strictly to real sector growth; The CBN should continue to maintain an optimal liquidity ratio within the banking system. Ensuring that banks do not hold excess idle funds will limit speculative behaviours and improve overall price stability.

Suggestion for Further Study

Future research could extend this study by incorporating more variables such as exchange rate, fiscal deficit, crude oil prices, and external reserves. Researchers may also adopt a comparative analysis of Nigeria and other developing economies to identify common policy lessons. Additionally, applying more advanced econometric techniques like Structural Vector Auto-Regression (SVAR) or Generalized Method of Moments (GMM) could provide deeper causal insights.

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