

# Policy Reversals and Economic Development: A View from the Financial Sector

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**Abstract** - Developing countries have a variety of market instruments that monetary authorities target to influence the direction of growth of the economy. This paper studies the reversals and manipulations of the market variables of interest rate and exchange rate in the desired direction in which the country should advance. The study employs Granger VAR to estimate the data sourced from WDI and Central Bank of Nigeria. The endpoints targets of Credit to the Private Sector (CPS), Capital Formation and Gross Domestic Product were adopted for the study. The results show that interest rate is more significant in both differenced and non-differenced results. The impact of exchange rate is more evident in capital formation than in the others. Though all the endpoints show a high-level of significance at the overall level, interest rate is more highly significant than exchange rate, and RGDP is the most important for the entire variables as an endpoint. The paper recommends the active management of interest rate first to encourage investment rather than the current practice and for a reduction in the rate. Since the current management of the exchange rate is not sustainable, literature supports the management of the variables within control of the monetary authority while the external variable should be less actively managed.

**Keywords:** Policy reversal; interest Rate; Exchange Rate; Capital formation; Credit to the private sector; Gross domestic Product

## I. INTRODUCTION

Financial market main instruments of prices are interest and exchange rates which enable the prices of credits and currency to be set respectively. These are within the ambit of the monetary authorities to manipulate and influence for the betterment and good direction of the macro economy. Depending on the objectives to be achieved either in the short, medium or long term the monetary authorities deploy these instruments to good advantage and the betterment of the economy. The Monetary Policy Committee (MPC) sets the bench mark interest rate in Nigeria as well as influences the price of foreign currency by the sale of the foreign currency.

With the recent change in the monetary policy rate of the Central Bank of Nigeria, policy analysts were aghast at to what direction the CBN was leading the country economically. At a recent monetary policy Committee meeting of the Central Bank of Nigeria, the announcement of an increase in the rate of interest to be 12.00 was made to the perplexed public who believed the interest rates in economy was one of the highest in any financial market. The country has had double digit interest rate differential for so long. The MPR, being a fulcrum rate around which all other rates gravitate, the central bank just increased the rates up to 12% and that without explanation to the public as it does not owe them one in particular. Lending rates have hovered between 18% (prime lending rate) and 36% in some cases for commercial banks, while the deposit rates remain abysmally low at between 1.5% and 3%. Time deposits commanded between 5% and 8% for very large sums for fairly long period. With the reduction in the MPR some five months before, the public expected the rates to come down, but the lending rates had remained high while the deposit rates had crashed. A one sided effect was thus noticed in the market. Perhaps one of the unexplained reasons is the need to reduce liquidity filtering into the foreign exchange market which is seen to be pulling down the value of the Naira. Thus from the point of lending rate loans had remained constrained while net savings were of short duration within the banks. Thus credit to the economic sectors that require fairly long term lending was also constrained.

This situation is compounded with the export sector's unimpressive performance where the main export of the country dwindled leading to the short supply of main counterpart currency for exchange for imports and for making payments. The situation had driven the price of the dollar through the roof such that in less than one year the Naira lost 28.4 % of its value at the official market and more than 67.5% premium exist between the official and parallel market rates of the currency. Against the backdrop of the scenario is the adroit stand of the government not to devalue the currency and allow the price affect to hold. Within all these information is the fact that more than \$20 billion is held in currency domiciliary accounts with the banks in the country. Simple macroeconomics of exchange rate commends the currency to market depreciation and an official devaluation from the standpoint of the monetary authority. This was not allowed

and the high differential continued with the CBN now selling the foreign currency to banks on a selective basis with emphasis on need, having banned a total number of 49 items from its platform. This means that the end-users of foreign currency at this level must seek to purchase at the unpredictable parallel market. Arguments as to what the matter that was amiss was with particular reference to the export performance and other fundamentals. There was thus argument if the monetary–fiscal mix of the country’s economy was sound as outlined in Flood and Garber (1984). While the market eagerly awaits devaluation, the CBN has continued to hold on. All this coming from a political terrain that was new. Much with the government posture, it has become difficult for the Central Bank to play the market normally and adjust to the environment.

The main objective of this paper is to study the sudden reversals of the market rates policy of the government to a more rigidly managed regime. The paper intends to study the management of the market rates: the interest and the exchange rates under a managed and fairly fixed structure to uncover which is more important. The paper is structured as follows: Following after this introduction is the literature review on exchange and interest rates reversals in a new governmental structure on both concepts and the Nigerian experience. Next is the methodology and empirical analysis which is followed by the discussions on results and expectations. The fifth section recommends on extant issues and concludes the paper.

## II. LITERATURE REVIEW

Policy changes have been recurring events in most economies around the world and have been the way to shift from one method of public management to the other and a way to move the market in a desired direction by the government. Thus the world has witnessed changes from one form of market to the other: from classical regulation to deregulation and in some countries guided deregulation, socialism to market determined prices, Keynesian to monetarism, public enterprises to privatisations, pure expansionist economies to cutbacks in expenditure and from progressive tax income structures to flatter taxes [1]. With the political environment, policy changes come from the gaps observed in the economy. At the political front, Cuikerman and Tomassi [2] define policy reversal as a situation in which the unlikely party implements certain unusual policies. Using a Downsian political signalling model, Moen and Riis [3] show that policy reversal can exist to set an equilibrium phenomenon and voters are likely accept to such reversals as a warranted reaction rather than political extremism.

Policy somersaults or reversals are the sudden change of direction or a complete somersault of a stated direction for which business and other organisations have relied to subsist, by the government or a major regulator in the economy. Policies are in themselves the plan of action to direct sectors of the economy in a manner in which the direction of development is stated. Policy reversals have been undertaken

in the matured financial markets that have taken economists and the analysts by surprise and sometimes to the astonishment of the market. Policy reversals, or somersaults or as economically referred to as ‘shifts in preferences’ in a democracy may imply three things. According to Dur and Swank [4], voters’ preferences may induce a change, which may raise costs or lower benefits upon intervention, and may mean that insufficient information was the basis of the earlier decision. For instance, if an untested policy was hijacked by a few people who are profiting at the expense of the majority, then a reversal in the interest of the people is imminent. Sudden policy changes in democracy can and should occur. Dur and Swank [4] offer explanations for policy reversals and conclude that most voters and government are by majority rule and who have incomplete information about the aggregate consequences of bundles of public projects (choices) though not all parts of policies are welcome by the voters. A model presented by the study reveals that the winners and losers of policy actions are progressive in the support or withdrawal of support for policies. Winners among uncertain supporters are thus more enthusiastic and vice versa. Thus uncertain voters among the people may initially oppose a project though they may end up winners eventually.

Policy reversals can be deliberately undertaken to smoothen the effects of a policy that where stabilisation policies cannot be optimal with the differences observable in pollution and product economies [5]. Saxonhouse and Stern [6] introduce the many effects of policy reversals on the Japanese economy where economic fortune of the country has since gone down since 1989 such that the real capital growth rate has gone down from about 4% to 1.05% affecting the economy from the foreign and external trade to central banking as well as financial intermediation within the country. All caused by various policies’ somersaults from the fiscal to the monetary authorities.

Coming from the above argument, countries may face serious economic instability when the political environments change, though it is still in practise of democracy. The changes that happen in the political arena may have substantial changes on the economic direction such that the system is affected to seriously impact on the total output of goods and services and even productivity in the system. With the Nigerian type of economy (rent seeking, trading in primary commodities, etc.) plans to shift focus from raw material production to manufactured goods have not been fulfilled and the continuance on the afore-mentioned type of economic management has been more pronounced than any form of change. Barro [7, 8] reports the early experiences that a transiting economy may face found variously that the impact of political freedom may produce uncertain outcomes. The increase in political freedom with accompanying choices of available investment may result in limitation on governmental power. In military regimes where questions are hardly allowed and freedom of speech curtailed the experience of business environment may depend so much on the level executive thinking and intelligence.

Gurgul and Lach [9] extensively study the post-communist European countries and reports that political instability (implying a change in governmental arrangement) hampered the rate of economic growth with major changes hindering economic prosperity and growth of the countries studied, implying that changes in the political sphere is accepted but expected to changes to the expectations of the people on the economy with time. Aisen and Veiga [10] show empirically by adopting the total factor productivity (TFP) that political instability is particularly harmful for growth by discouraging human and capital accumulation, but with the highly unstable and fragmented countries need to address the root causes of their problems before growth can be expected.

Policy changes are exemplified in the case of South Africa when the apartheid policy changed as from 1994. Faulkner and Loewald [11] examined various sectors of the South African economy and conclude the role of institutions was important in the growth while greater knowledge, higher level of competition and flows of information were major channels. Literature on policy instability and with government changes are not within reach but the Nigeria situation would provide some insights.

Within the Nigerian environment, evidence from [12] studying the period between 1983 and 1999, indicates that the economic projects that were instituted by the military did not bring salutary developments to the economic sphere of the country. The paper discusses extensively on the programmes rather than projects undertaken. Determinants of success of military governments in Nigeria were adduced to the role of the traditional rulers and to the social institutions that promote the direction of the minds of the people. George, Shadare and Oluyemi [13] give the military some credits with the identification of the ills of the society at take-over of government but did not address those problems sufficiently. Literature has been less charitable to and has not given much credit to the military in governments in Nigeria. The environment should witness spontaneous growth at the available political freedom and choice that come with democratic government, but Igwe [14] and Ademu [16] believe that not much has been witnessed in terms of developments in the country, though these studies do not completely agree.

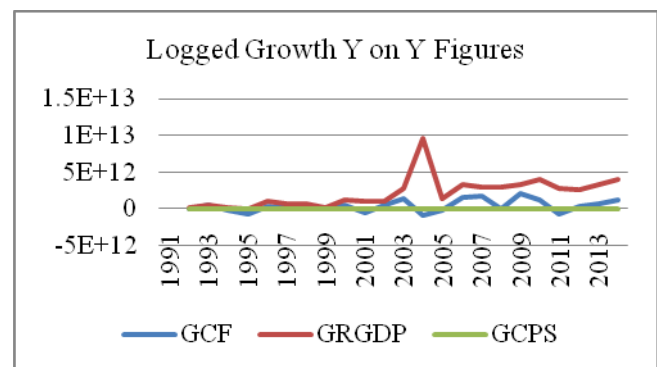
Apart from lags in policy formulation which hamper development and growth, policy implementation has been cited as one of the major changes governance faces in Nigeria. Ozumba [16] observes the widening gap between intentions and results of government of polices. A number of the problems were identified and brings out lack of continuity and inability to own projects of early administration. The paper recommends good leadership and governance and elimination of corruption as major issues to be addressed before policies can yield expected results in Nigeria.

Policy reversals are precipitated rather by actions in the economy within which such policy is formulated. The most

common reversal not often within control is the capital flows. With regard to the reversal of flows of capital into the economy Bello [17] confirms the fear that sudden reversals of capital can have negative effect on the Gross Domestic Product, though FDI is seen to be more reliable than portfolio flows, which tends to be more fluid. Amos, Ajike and Akinlabi [18] indicate in their study that policy reversals bring inconsistency to government and makes planning difficult with result of the study using the manufacturing sector as case study. The study finds exchange rate and interest rate most culpable for the dismal performance of the manufacturing sector which has affected the economic growth. The inconsistency in policies makes the business environment more unpredictable and thus long-term planning becomes difficult which comes with enormous costs for the market to transfer to the weak party to bear. Rodrik [19] had earlier concluded that this is a major challenge for most developing economies as a result of the unstable political environment [20]. Conway [20] focuses more on private investment in developing countries with key price in the economy such as interest rate to measure the level impact of instability on manufacturing. The study found out that interest was highly significant and import prices insignificant. The other significant variable was export prices and that the most affected sub-sector is the manufacturing.

Developing countries attempt to grow through the passage of financial market liberalisation by the lifting of every form of repression that may be stifling the market thus allowing easy flow of credit from the surplus sectors to the deficit sectors (these include flows from abroad).

Figure 1 Three Final Development Outcomes (Year on Year per cent change)



Source: Data from the World Development Indicators

Aggregation into the national economy passes through soft targets like the credit to the private sector into the Gross domestic product and into third targets such as capital formation which tends to the accumulation of capital stock for the economy.

### III. METHODOLOGY AND EMPIRICAL ANALYSIS

The paper adopts two key market variables heavily influenced by the monetary authorities: the key interest rates and the foreign exchange rate. The two being prices influence the market transactions for the three different economic units: the government, firm and the household units. The variables adopted for the study also include the primary developmental variables: capital formation (CF), Real Gross domestic product (RGDP) and credit to the private sector (CPS). The market variables adopted are the variants of the (a) interest rates: the interest rate premium is adopted for the analysis and is defined as:  $LR - GTR$  where L is lending and GT represents Government treasury rates (b) PPPER as purchasing power parity exchange rate between the domestic and counterpart currencies for consumption goods. The complete available years of the data is truncated to 24 years from 1991 to 2014. Data have been varied over the years and this has affected the length of the series of some of the data especially the RGDP and the CF. comparable data for exchange rate differences that can be accounted for Official and Market exchange rate is taken care of by the Purchasing power parity factor. The data is sourced mainly from the World Development Indicators (WDI) and complemented with the Statistical Bulletin of the Central Bank of Nigeria (CBN).

A technique of analysis that best explain the scenarios is Vector auto regression (VAR) estimation processes which help to understand the interrelationships that exist between variables and the shocks introduced into such relationships. This is complemented with Granger causality process which brings further understanding to how each of the variables affects the others

The above is modelled as follows: a VAR process is

$$Y_t = \alpha + \sum_{k=1}^k A_k Y_{t-k} + \sum_{i=0}^L B_i X_{t-i} + e_t \quad (1)$$

Where  $Y_t$  endogenous variables

- $Y_t$ : a (nx1) endogenous variables (*Intrp*, *ppper*).
- $X_t$ : a (nx1) exogenous variable: *capform*, *CPS*, *RGDP*.
- $e_t$ : a (nx1) residual term.
- $A_k$ : the matrix that measures how endogenous and exogenous variables returns react to their lags.
- $B_i$ : the matrix that measure how *Intrp*, *ppper* react to the exogenous variable.

A  $VAR(p)$  model with  $p$  variables is written as follows

$$y_t = A_1 y_{t-1} + A_2 y_{t-2} + \dots + A_p y_{t-p} + Bx_t + \varepsilon_t \quad (2)$$

#### IV. RESULTS, OUTPUTS AND DISCUSSIONS

The data shows a descriptive of 23 usable observations across which are somehow sufficient for the analysis. Data with large figures are abbreviated and describes as seen below. The standard deviations of that the RGDP and CAPFORM

have the highest variability while the INTRP has the lowest followed by the PPPER. Market variables have the maximum for INTRP at 14.5% and the minimum at 2.47%. Minimum over the period for PPPER is 4.57 while the maximum is 99.40. The table is as below.

Table 1 Descriptive of the Variables

	INTRP	CPS	CAPFM	PPER	RGDP
Mean	7.116	4297.205	4.6E+12	45.22	3.66E+13
Med	6.315	1096.536	2.94E+12	40.098	2.83E+13
Max	14.576	17128.98	1.06E+13	99.399	6.80E+13
Min	2.473	58.12295	1.97E+12	4.5780	1.96E+13
S. D.	2.820	5671.825	2.88E+12	27.940	1.66E+13
Skew	1.191	1.161985	0.841599	0.4209	0.529228
Kurt	4.477	2.853485	2.089596	2.121	1.783336
J-B	7.535	5.196370	3.509411	1.418	2.492241
Prob.	0.023	0.074408	0.172958	0.491	0.287619
Sum	163.6	98835.71	1.07E+14	1040	8.41E+14
SS.D	174.96	7.08E+08	1.83E+26	1717	6.06E+27
Obs	23	23	23	23	23

Source: Data from the World Development Indicators and the Central Bank

The initial VAR table with two lags (as the criterion chosen) indicates very few significant points for each of the endpoints of market intervention rates. The result shows that the RGDP show a more compact F stat and more significant interaction with the other variables than PPPER with a robust F stat and only one significant variable CAPFORM which is just beyond 0.10. The market INTRP indicates more significant interaction with other variables than PPPER. For instance most the significance level is between 0.05 level and 0.01, especially with CPS and RGDP in both lags.

A Granger-VAR output indicates more with explicit outputs that indicates the direction of the results. The INTRP show a highest granger causality with RGDP and CPS being the next both beyond 0.01 levels and finally with PPPER at beyond 0.01 level but insignificant with CAPFORM. The overall output indicates that the causality with the three variables of interest is beyond 0.01 levels. The PPPER shows an output that indicates that it is less significant in the adopted endpoint variables, total causality being beyond 0.10 at 0.0607. It shows a strong impact and causality on CAPFORM only at 0.0413 which is beyond 0.05 level and insignificant with the rest of the variables: CPS, INTRP or GDP. All the endpoint variables show some attachment to other market variables. For instance CAPFORM granger causes INTRP at 0.10 and CPS at 0.05 levels but insignificant with PPPER and RGDP. CPS shows that it is significant with RGDP only beyond 0.10 levels. RGDP is however significant with the market variables: with INTRP at 0.04 and PPPER at 0.004. The strength of this causality is understandable and quite clear as the flows of causality indicates where direction is. It is also significant with the other endpoints variables especially with CAPFORM beyond 0.01 (0.004) and CPS beyond 0.05 (at 0.0423). Overall significant of the RGDP show it is beyond 0.01 levels. This is also the overall result for the other

variables. Other results are as shown in Tables 2 (a – c). It is generally observed the raw data obtained higher level of significant results than the differenced data, though the results do not indicate any significant differences that can bring about a dissimilar outcome.

Table 2 (a) Dependent variable: CPS

Exclud	Chi-sq	Df	Prob	Exclude	Chi-sq	Prob.
D(INT)	2.440	2	0.29	INTRP	0.942	0.62
D(RGDP)	3.558	2	0.1688	CAPFORM	4.507776	0.10
D(CAPF)	4.041	2	0.13	PPPER	0.613	0.73
D(PPP)	0.291	2	0.86	RGDP	5.569	0.06
All	14.42	8	0.07	All	30.40	0.00

Table 2 (b) Dependent variable: CAPF

Exclud	Chi-sq	Df	Prob.	Exclu	Chi-sq	Prob.
D(INT)	10.473	2	0.005	INTR	5.303	0.070
D(CPS)	17.448	2	0.000	CPS	8.441	0.014
D(PPP)	7.355	2	0.025	PPPE	1.947	0.377
D(RG)	2.857	2	0.239	RGD	2.953	0.228
All	28.160	8	0.000	All	40.503	0.00

Table 2 (c) Dependent Variable RGDP

Exclude	Chi-sq	Df	Prob	Exclude	Chi-sq	Prob.
D(INT)	3.33	2	0.18	INTRP	6.327	0.04
D(CPS)	2.07	2	0.35	CPS	7.140	0.02
D(CAPF)	7.82	2	0.02	CAPF	12.517	0.00
D(PPP)	3.52	2	0.17	PPPE	13.142	0.001
All	9.49	8	0.30	All	21.066	0.007

Source: Data from WDI and Output from the System

The discussion on the result centres on the level of significance and direction. While the market variables are used to influence the direction of credit or attention to the other sectors and the endpoints are what the outcomes are, then the result show a fair impact of the manipulation of interest or exchange rates to impact or influence development of the country. For instance from all indication of these result, the interest rate is more important for management of the economy than the exchange rate. The significant level of the INTRP is evident on two of the three endpoints: RGDP and CPS, while RGDP causality is on both the market variables as well as the other endpoints, the CPS shows strong causality with only RGDP. PPPER is significant only with CAPFORM and none other. The implication of this is that exchange CAPFORM is linked with the CPS. The complete results are shown as Table 1.

## V. RECOMMENDATIONS AND CONCLUSIONS

The interest rate is the economy affects more business units than the exchange rate which affect the firms importing intermediate inputs. In fact a significant level of importation for consumption which is drawdown on the nation's foreign exchange reserve. The management of the interest rate now is being used to influence the exchange rate as a result of the

perceived liquidity in the banking system. The constrain of credit to reduce the demand for foreign exchange may not be best option as causality to exchange rate from interest is not highly significant and no causality exist from credit to exchange rate. Interest rate should rather be used under the present dispensation to attract more investible projects that can add to the output and in the process the capital formation in the economy.

Another basic recommendation concerns the premium on interest rate which is the basic price used in this study. The interest rate in the economy is one of the highest in any formal banking system in a developing country. The high rate encourages rent-seeking behaviour from the banks and discourages lending to the productive sectors of the economy. Since the banks can still report profit without much of intermediation to private sector, then a proactive management of interest rate for the purpose of directing credit to the needed sectors of the economy is important.

The exchange rate as presently management is less than optimal as it is not sustainable. The authorities must find a way to reduce currency substitution in the economy which seems to be a reason why the demand is high for foreign exchange. Literature has proved time again that the impossible trinity needs to be controlled from home first before the external relations would find itself in a desirable manner. In this wise it best to manage the interest rate more proactively and manages the exchange rate on a passive basis.

From the foregoing it is quite clear that electoral promises not based on full information might turn out to be disastrous for politicians coming freshly into government. The scenarios in Nigeria follows the Dur and Swank (1997) analyses of sudden policy reversal and somersaults that countries like Nigeria has experienced of recent. The essence of political change is to bring the citizens into a new elixir of life that was not possibly obtainable in the previous administration, which perceivably can be corrected with the new administration that made electoral promises based on incomplete information. Sudden policies reversals of this type might not be easily forgiven by the citizenry.

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