IT Readiness Nigeria: the role of Financial Markets in the Operational Framework

MD Ayogu
University of Cape Town
19 January 2008
Transmission Channels

A. Effects on AD

- Interest rate Effects
  - Investment: cost of capital
  - Consumption: saving –interest rate(?)
- Wealth Effects
  - Consumption: life-cycle modes
  - Investment: q models
- Exchange rate Effects

B. Effects on AS

- Working capital Effects

ERE & WE ➤ Asset Pricing

- Unexpected movt in asset prices can impact on bank’s inflation forecast
- Asset prices can carry information that improves forecast
  a) Expectations about future economic activity
  b) Inflation
  c) Monetary policy
Consider following rate scenario

- 90-day N 18% APR
- 90-day €£ 15% APR
- Spot rate €£ N200
- 90-day swap N0.0560

Action

- Borrow €£ @ 15% APR
- Swap @ N0.0560 = 0.112% APR
- Generate N @ 15.112% APR
- Place N @ 18% APR
- Profit = 2.888% APR
- Equilibrium 90-day swap rate for €£ = N1.5000
Interrogates DFA

- CIP:
  \[ F_t - S_t = i_t - i^*_t \]

- UIP:
  \[ S^e_{t+1} - S_t = i_t - i^*_t \]

- CIP & UIP \( \Rightarrow \)
  \[ S^e_{t+1} \approx F_t \]

Message

- Treasury operations tell us that Fwd rate is a predictor of future spot rate
- Interest differential as a predictor of exchange rate changes
- What does the market say?
  \[ S_{t+1} = S^e_{t+1} + \varepsilon_{t+1} \]
Wealth Effects (premises)

• Standard life-cycle models
  1) Age of family members, family lifetime wealth
  2) Interest rate
  3) Composition of wealth should not matter
  4) Wealth defined measured as future labor income, pension, home equity, individual retirement, social sec

Thaler (1990)

• Life-cycle with mental accounts
  1) Composition of wealth matters; MPC coded differently across mental accounts—asset a/c, current income, future income
  2) Size of gain and source of change in wealth matter
  3) Do all wealth changes produce similar change in current consumption? Hall & Mishkin (1982)
Angeletos, Laibson, Repetto, Tobacman, Weinberg (2001)

• Life-cycle and psychological models of self control
  – If the representative Nigerian consumer is a hyperbolic but
  – Lacks both liquid wealth and access to revolving credit
  – Thus smoothens consumption by habituation?

The (market) devil is in the details
1. % household with high level of liquid wealth?
2. % household/popul with access to formal credit?
3. Why does PAN not have an acceptances corporation yet?
4. UAC, UTC for that matter?
5. Limited supply of direct participation instruments; why?
6. What about securitization?

Further related Qs
1. What is driving quality of intermediation?
   a) Nature of maturity transformation?
   b) Menu of contracts on offer (range of instruments/products)?
2. Quality/profile of customers or
3. Quality of institutions that underpin credit flow? i.e. bad photographer or ugly subject?
4. Rules of bankruptcy and contract enforcement (transaction costs)?
Facts

- Unlike Europe and the US, wealth in housing not liquid
- High transaction costs in liquidating collaterals
- Quantum of asset backed lending thin
- Severe constraints on borrowing against future labor income; ditto credit cards
- Large informal economy relative to formal employment

Investment: q models

- Market efficiency: how well do prices reflect fundamentals?
- Stock market crash, real estate booms and bursts, IPO underpricing
- 419, Ponzi schemes in evidence and historically; O’Connel and Zelda (1992)
- So what?
Yes...

- Insignificance of equities in household financial wealth but
- Increasing volatility of stock prices, exchange rate
- Insider dealings that are not vigorously checked
- And yes South Sea Company “purchased the King and Parliament”

But

- Nigerian assets markets not yet robust
- High level of illiteracy compared to Zimbabwe
- Generally low level of market participation
- Market striving to attract investors and deepen
Besides Zim

• For SA
• Total annual premiums (group life, individual life, annuity) as a prop of national income rated highest in the world
• Followed by UK, US, Canada (Vittas, 2003)
• Eliminating double counting, total assets of institutional investors including unit trusts in 2001 = 164% of GDP or ZAR1.56 trillion (US$0.2230 t)

Nigeria

• Cannot afford a complacency that comes from the cold comfort that other countries have managed IT with wacky financial markets and all sorts of Milken, Boesky, Keaton, Drexel, Bonfire of Vanities-type-shenanigans
• Strengthening DFAs is a priority