The Proposed Naira Redesign, the Ensuing Cash Crunch, and Their Implications on the Nigerian Economy – Evidence from Q1 2023

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Abstract

Many articles had been published online regarding the proposed naira redesign and its possible consequences on the Nigerian economy ex-ante. This article however focuses on the naira redesign and its implications on the Nigerian economy ex-post, particularly in Q1 2023, when the policy took effect. To achieve this, the article highlights some facts about Nigeria's economy, as well as the implications of the policy on economic activities, using trend analysis on a host of economic variables, with reference to the real GDP, PMI, and inflation. The trend analysis results showed that indeed, the cash-crunch policy affected economic growth and productive activities as real GDP and the PMI shrank. On the other hand, the article dismisses the notion that the inability to account for the high currency outside banks to currency in circulation ratio was the main cause of rising consumer inflation in Nigeria. Rather, the article revealed that the growth in money supply was induced by quasi-money activities which may have led to the rise in consumer prices.

What you should know

i. **The central bank announced a policy to redesign the currency.**
ii. **The timing of the implementation of the policy was very short, disrupting economic activities, further worsened by the preparations for the 2023 general elections.**
iii. **The ensuing cash crunch affected productive activities as many small businesses were forced to close shop. However, the purported claim by the authorities that 85% of the currency outside banks is the main cause of rising inflation was much ado about nothing.**

Background

On October 26, 2022, the Central Bank of Nigeria (CBN) announced a move to redesign the currency (₦200, ₦500, and ₦1000 notes) and introduce new notes into circulation to replace the old ones. The purpose of the policy was to ‘help check counterfeit notes, strengthen the economy, reduce the expenditure on cash management, promote financial inclusion, and enhance the CBN's visibility of the money supply’. According to the CBN, 85% of currency in circulation is outside the confines of banks and most of these funds were either used for illicit activities or were kept underground. This was why they intended to take stock of the currency outside banks and bring them back into the financial system so that they may be able to keep proper track of the money in circulation and as well use it as an avenue to control inflation since it has been tending upwards over the past couple of months.

However, several analysts have noted that the timing of redesigning the currency was a bad one, especially since Nigeria approached elections in February 2023, and the timeframe was too short to implement such a nationwide policy without witnessing hiccups in the process. The CBN announced a deadline of 31st January 2023 for the use of the old notes but later postponed it to February 10 due to pressure from banks, politicians, and corporate organizations who made it known that the deadline was not feasible due to large amounts of cash still in circulation and outside the banks. Between the period of January and March, the cash crunch affected economic activities severely as the economy almost came to a halt, due to the inability to access cash for daily economic activities. Demand for money rose. Some individuals, particularly point-of-sale (POS) agents went as far as selling the currency at a premium for their personal gain, while some banks were seen to have hoarded the new notes, further worsening the impact of the policy.

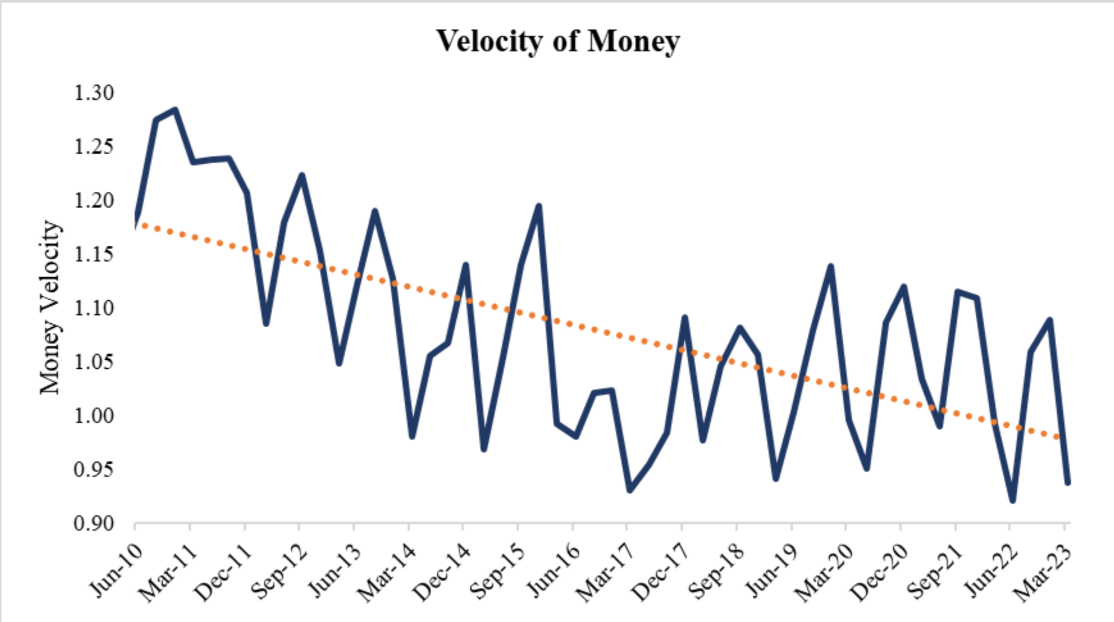
Many articles had been published online regarding the proposed naira redesign and its possible consequences on the Nigerian economy ex-ante. This article however focuses on the naira redesign and its implications on the Nigerian economy ex-post, particularly in Q1 2023 when the policy took effect. To achieve this, the article highlights some facts about Nigeria's economy and some implications of the policy on economic activities, using the real GDP, purchasing manager index (PMI), and inflation as benchmarks. Before deep diving into the policy and its effects, we review some important concepts in economics, which may further solidify our understanding of how monetary policy works.

In today's Economy, Banking Innovations are Key to Determining Money Demand, Money Multiplier, and the Velocity of Money

Monetary policy, which the CBN is tasked with, serves the economy better when financial markets are competitive and well-developed. Until 2009, most financial dealings were conducted either in the form of cash or cheques. As new financial innovations emerged (instruments used to process financial transactions), people's preferences and habits around the storage and use of cash changed over time. These changes influenced the money multiplier and the velocity of money, two of the foundations of Nigeria's existing monetary policy framework.

As Figure 1 has shown, the velocity of money has fluctuated over time, with economic events determining its volatility. Overall, the trend of money velocity was downward sloping, implying that the implementation of alternative means of cash (such as mobile banking payments, web payments, POS, ATMs, and improved cheque infrastructure) may have led to a fall in money velocity over time since these alternatives were available and more convenient than carrying cash around. Furthermore, the recent downward push in the average number of time money changes hands between January and March 2023 was a result of the cash crunch policy that came about due to the announcement of the implementation of the new Naira notes and the withdrawal of the old notes.

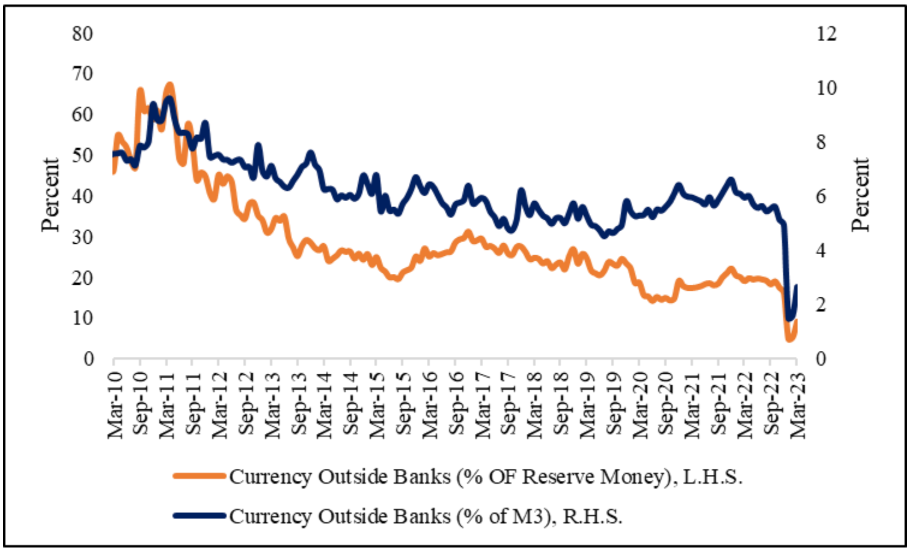
Figure 1: Declining Velocity of Money in Nigeria



Source: CBN Statistical Bulletin, 2022.

Furthermore, the implementation of these alternative banking payment channels coincided with the fall in the overall trend of the velocity of money while the average currency outside the banking system (as a ratio of total money and reserve money) also began to decline, (see Figures 1 and 2 respectively). This implies that people retain less and less money outside of banks and prefer less cash in everyday transactions. These trends are reflected in the velocity of money over time (Figure 1) and the huge drop in the currency outside bank ratios (Figure 2). Furthermore, Figure 1 demonstrates that the velocity of money is not constant (due to its fluctuations over time) and the relationship between the velocity of money and the demand for the currency has been unstable over time, necessitating a rethink of the current monetary policy framework adopted by the CBN.

Figure 2: Decline in Cash Outside Banks in Relation to Reserve Money and Broad Money



Source: CBN Money and Credit Statistics, 2023.

Moreover, Figure 3 illustrates that the money multiplier has been declining, lending more credence to the notion that banks' ability to create more money due to the creation of new notes (an increase in the money base) has dwindled over time. Therefore, a thorough understanding of the concepts of money multiplier and velocity of money is a precursor to an understanding of monetary policy and the way money works in an economy.

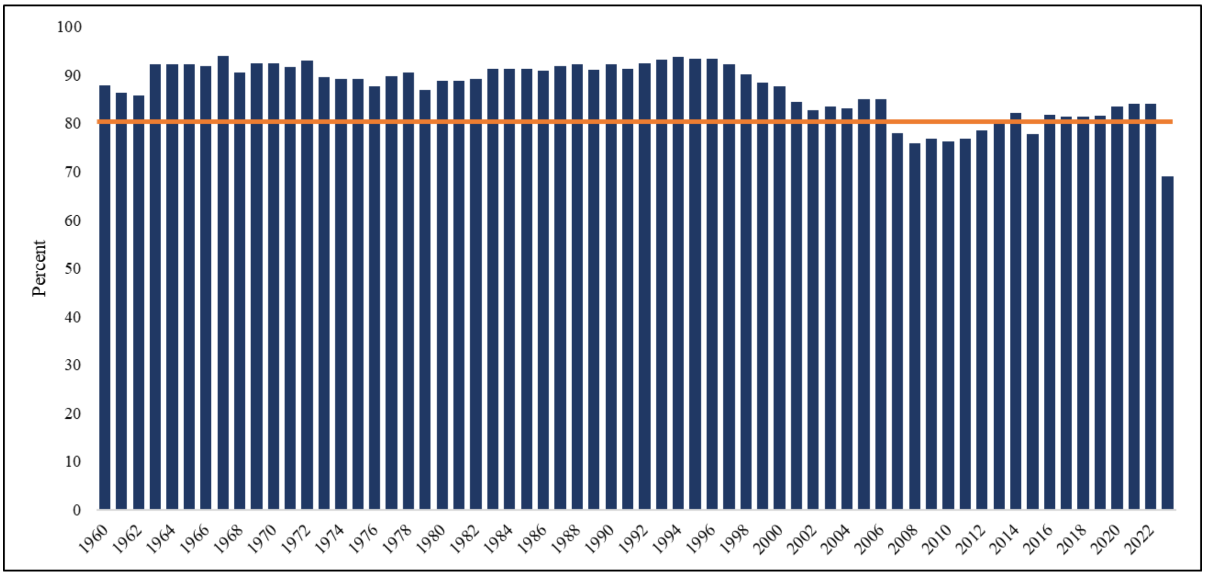
Figure 3: Falling Money Multiplier

Source: CBN Money and Credit Statistics, 2023.

A High Currency Outside Banks - Much Ado About Nothing?

The Central Bank of Nigeria (CBN) has reported that 85% of all banknotes printed and currently in circulation and outside the banks 'is a disturbing trend that must not be allowed to continue'. There are several ways to assess this statement. However, one thing to bear in mind is that the whole idea of banknotes is for the notes to be kept outside of banks for all the functions that traditional money serves. Also, this statement may be found to be on the extreme because when data on the currency outside banks as a ratio of currency in circulation was curated, it revealed that this has not been a recent trend. Looking through Figure 4, it can be established that the percentage of currency outside banks from the currency in circulation has always been above 80% since 1960, except for the period spanning 2007 to 2012 (during which the global financial crisis affected the balance sheet of Nigeria's banking system). Therefore, the narrative that currency outside banks was the main cause of rising consumer prices and inflation in Nigeria may be much ado about nothing.

Figure 4: Currency Outside Banks (% of Currency in Circulation)



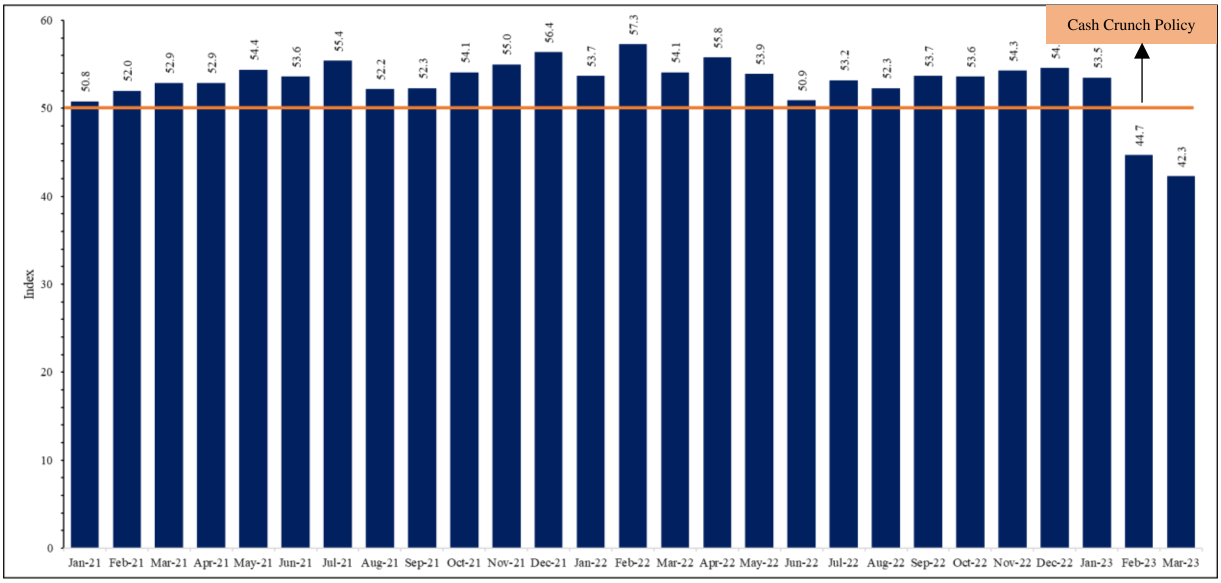
Source: CBN Money and Credit Statistics, 2023.

Implications of the Cash Crunch on the Economy

The Implications of the Cash Crunch on the Purchasing Managers Index (PMI)

One of the several ways of assessing the effect of a policy on economic activities is through PMI readings. This index comes in handy since it provides a monthly direction of economic activities unlike GDP which is calculated on a quarterly and yearly basis. Any readings below 50% indicate a fall in economic activities over that period, while PMI readings above 50% imply that economic activities have expanded. Therefore, the PMI may be used as an alternative to predict the direction of economic activities pending the release of GDP figures. From Figure 5, the Stanbic IBTC Bank PMI data show that private sector productivity in Nigeria took a hit due to the country's recent cash crunch, falling to 42.3 points in March 2023, the most significant decline since the survey's inception in January 2014, except during the outbreak of the COVID-19 pandemic in 2020. In February 2023, the index fell to 44.7 points, likewise reflecting a sharp drop-in corporate and business activities. Analysts have noted that the CBN Naira redesign policy was the main reason for the steep drop in both months, resulting in a cash constraint that badly affected numerous businesses.

Figure 5: The Cash Crunch Resulted in Falling Economic Activities in Q1 2023

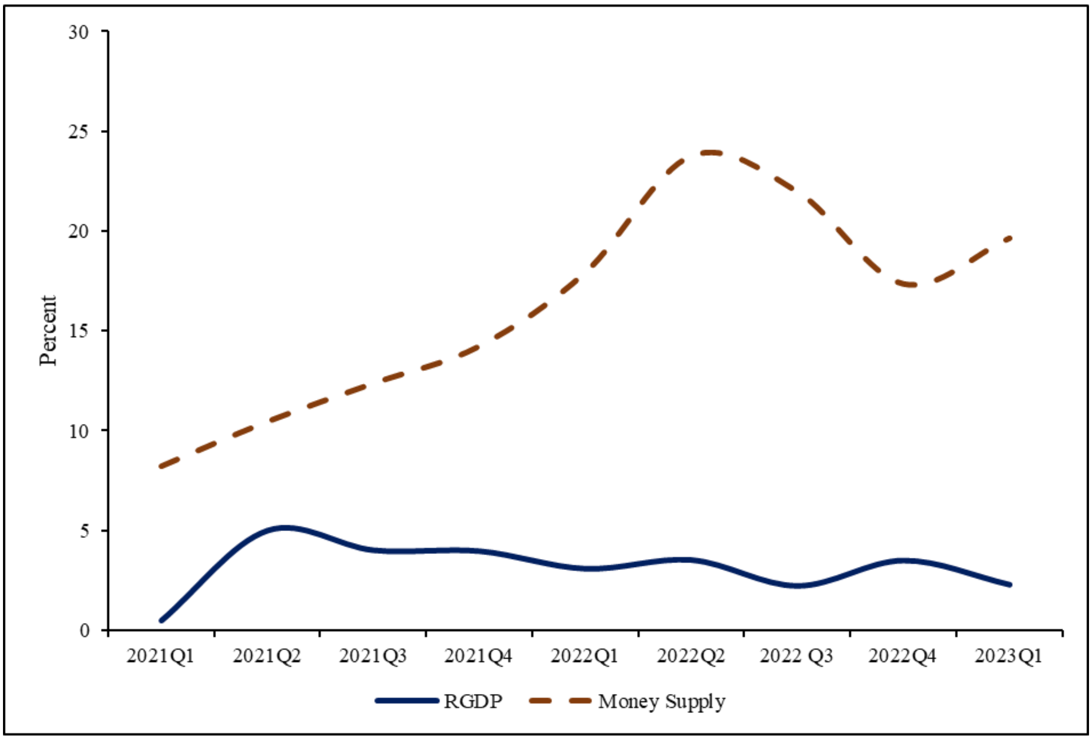


Source: Stanbic IBTC Bank Purchasing Managers' Index (PMI)

The Implications on Real GDP

According to the most recent data from the National Bureau of Statistics (NBS), the shortage of Naira in the first quarter of 2023 had a significant impact on economic activities. As a result, Figure 6 revealed that real GDP growth for Q1 2023 grew by 2.3%, a drop from its previous year's growth of 3.1% (Q1 2022) and the previous quarter's growth of 3.5% (Q4 2022). While the CBN appears to be making efforts to increase the volume of currency in circulation, many small firms closed shop during this time, and the negative effects of such affected productive activities, which may continue to be felt for some time to come. Finally, the charts in Figure 6 on money supply growth and real GDP growth demonstrate the amount of money supply growth that induces economic activities. It revealed that while the money supply is growing at double digits, real GDP is growing at single digits, implying that the influx of cash in circulation has not transpired in the same level of productive activities in the economy. This is because much of the money supply growth has been directed towards quasi-money activities, rather than driving economic output.

Figure 6: GDP Growth vs Money Supply Growth

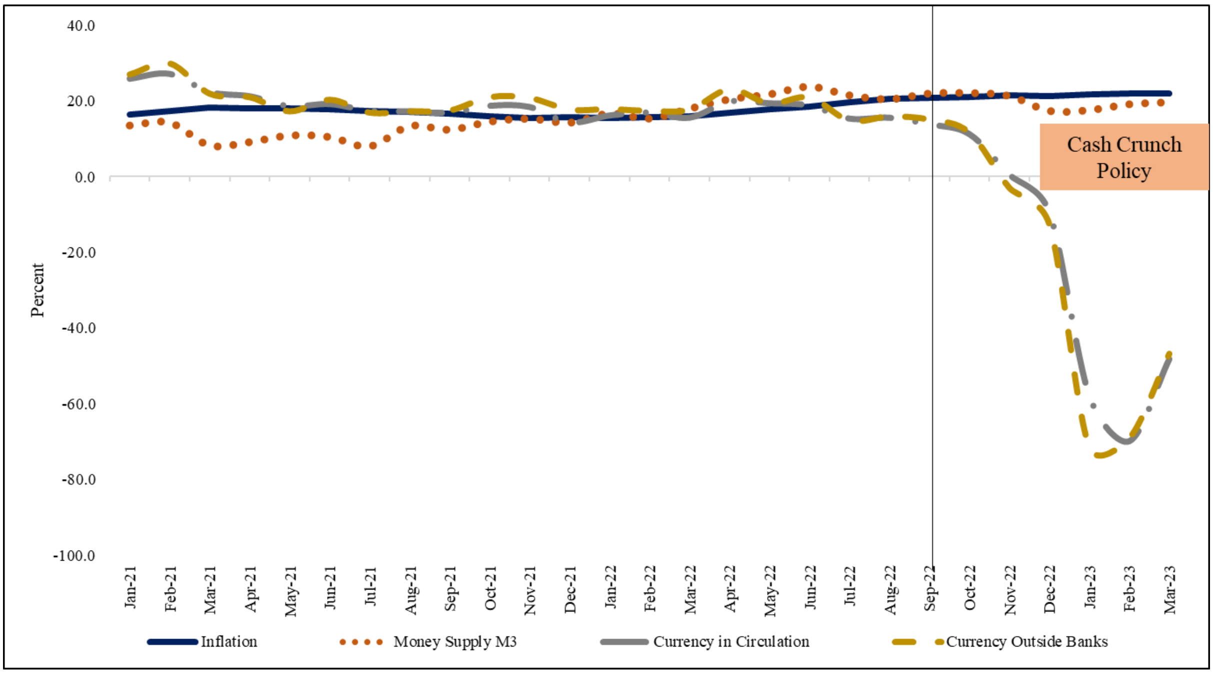


Source: CBN Statistical Bulletin, 2023

Implications of The Cash Crunch on Inflation

Despite the claim by the CBN that the significant hoarding of naira notes outside the banking system is the reason for the inflation spiral, and by reducing the amount of cash in circulation, inflation will fall. Unfortunately, inflation did not abate in Q1 2023 as evidenced by the inflation figures from the NBS (2023). As Figure 7 has shown, despite the fall in the growth rates of currency outside banks and currency in circulation to negative figures due to the CBN policy, inflation remained elevated, driving to new highs in Q1 2023, while money supply growth remained positive and higher than its corresponding previous year growth. The uptick in inflation despite a fall in the growth rates of currency outside banks and currency in circulation lends more credence to knock off the purported claim that 85% of currency outside banks is the main reason for rising consumer prices in Nigeria.

Figure 7: Growth in Currency Outside Banks and Currency in Circulation are not the Drivers of Inflation in Nigeria



Source: National Bureau of Statistics, 2023; CBN Money and Credit Statistics, 2023.

For anyone willing to know, inflation in Nigeria is mostly supply-driven, affected by global supply chain disruptions, pressures in import prices, and continued exchange rate depreciation at the black market. If the CBN wants to control inflation from the demand side, then it needs to look no further than its ‘ways and means’ lending to the government. Injecting an extra ₦22.7 trillion into the system would no doubt be inflationary since the injection of liquidity through quasi-money activities undermines the credibility of the CBN’s price stability mandate and exacerbates the tendency for fiscal deficit monetization. Therefore, quasi-money activities need to be winded as much as possible to curtail the excess money supply growth and tackle inflation head-on in Nigeria. In essence, 85% of currency outside the banking system is not a problem. What matters is to have a good account of how much of total currency is in the economy, how much of these is driving economic activities and for the rescindment of the extra injection of liquidity through quasi-money activities beyond the required threshold.

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