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# ALIGNING MONETARY AND FISCAL POLICIES TOWARDS ACHIEVING A ROBUST FINANCIAL SYSTEM

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**ABSTRACT**
*The study sought to ascertain the strategic framework and specific policy actions required to align Nigeria's monetary and fiscal policies to achieve a robust, shock-resilient, and efficient financial system. Aligning monetary (Central Bank) and fiscal (Government) policies creates a stable economic environment, crucial for a robust financial system by preventing inflation, reducing uncertainty, and encouraging investment; this involves coordination on debt, spending, taxes, and prioritizing long-term stability over short-term fixes, with strong central bank independence and clear rules ensuring consistent, data-driven decisions that build confidence and support crucial reforms like bank recapitalization for sustainable growth and resilience against shocks. Both monetary and fiscal policies are essential tools for steering the economy towards growth, stability, and full employment. While monetary policy focuses on adjusting money supply and interest rates, fiscal policy involves government spending and taxation to achieve macroeconomic goals. Monetary and fiscal policies are considered crucial for establishing a robust financial system; hence the need to align them, especially in Nigeria.*

**KEYWORDS:** *Aligning, Monetary, Fiscal, Policies, Achieving, Robust, Financial, System*

## INTRODUCTION

Monetary policy and fiscal policy are both tools used by governments to influence economic direction. While monetary policy involves adjusting the money supply and interest rates, fiscal policy involves controlling government spending and taxation. Both aim to achieve macroeconomic goals such as growth, stability, and full employment. Monetary policy refers to the activity that a government deliberately undertakes to manage the amount of money in a market or economy. This is done by primarily controlling interest rates and the supply of money. Raising interest rates encourages corporates and individuals to save more and borrow less as rates are relatively high. Lowering interest rates has the opposite effect and will encourage more spending in the economy. In addition, governments may undertake quantitative easing, which is the buying back of bonds to help bring down long term interest rates. Monetary policy is usually decided by a committee operating on behalf of the central bank.

Fiscal policy focuses on government's revenue and expenditure as a way of managing economic growth. Increased government spending on projects such as healthcare, new developments or subsidies can be used to drive economic growth. If an economy is deemed to be expanding too rapidly, this spending can be curbed and taxes raised to slow the growth down. Raising taxes is an effective way to slow growth as companies and consumers will have less earnings to spend. Fiscal policy can be used to decrease unemployment as it stimulates the job market.

A robust financial system is one that is resilient to domestic and external shocks, efficiently intermediates resources, protects consumer deposits, maintains market integrity, and provides the necessary capital for economic growth. This involves managing and eliminating systemic risks created by the historical tension between the Central Bank (CBN) and the Ministry of Finance (MoF). Experts believe that when these two major macroeconomic levers work in harmony, they create a stable, predictable economic environment that allows financial institutions to perform their core function of intermediation effectively, while minimising systemic risk. To this end, the Central Bank of Nigeria (CBN) recently invited stakeholders to map out ways to effectively align both policies in its recent seminar for finance correspondents and business editors. Monetary Policy, managed by the CBN, uses tools like interest rate changes and open market operations to control money supply and maintain price stability.

By adjusting interest rates, the CBN can influence borrowing, spending and investment decisions, impacting overall economic growth and inflation levels. Fiscal policy, on the other hand, refers to the use of government spending and tax policies to influence economic activity. Managed by the government, fiscal policy focuses on increasing public spending, reducing taxes or a combination of both to stimulate the economy during a downturn. Fiscal policy may also involve reducing spending or increasing taxes to cool down an overheating economy. While fiscal policy primarily targets aggregate demand through changes in taxation and government spending, monetary policy influences money supply, borrowing costs, and credit availability. Experts say these two policies, working in tandem, can help achieve macroeconomic stability and avoid situations like hyperinflation or recession. They say coordination between fiscal and monetary policy becomes crucial when aiming for overall economic stability. It is their contention that without coordination, fiscal expansion by the Federal Government could lead to excessive inflation if not accompanied by monetary tightening. The experts also say that restrictive fiscal policies might need to be offset by accommodative monetary measures to ensure that growth is not compromised. They posit that the primary benefit of the alignment is that it prevents conflicting signals and policy pushback, which can introduce volatility and uncertainty into financial markets.

A renowned Economist, Prof. Ken Ife, described a robust financial system as one that is resilient to domestic and external shocks. Ife, the Chief Economic Strategist, ECOWAS Commission, said that such a system should be able to efficiently intermediate resources, protect consumer deposits, maintain market integrity and provide the necessary capital for economic growth. “This involves managing and eliminating systemic risks created by the historical tension between the CBN and the Ministry of Finance.” He said that the major threat to the stability of the Nigerian financial system and fiscal stability was fiscal dominance. According to him, fiscal dominance occurs when the fiscal authority’s large, chronic borrowing needs (budget deficits) constrain the independence and effectiveness of monetary policy.

Ife said that the role of the CBN was to ensure price stability and oversee the soundness of the financial system. He said that its tools must be used consistently and predictably to inspire and maintain investor confidence in the financial system. The economist urged the apex bank to prioritise its legal mandate of price stability. “Achieving sustained disinflation is the most critical contribution to financial system health, as high inflation distorts pricing, creates negative real interest rate, discourages savings and undermines long-term investments. “Monetary policy decisions must be made solely based on economic data, free from political pressure of short-term fiscal needs,” (Ife, 2025). The CBN Governor, Mr Olayemi Cardoso, said that it had become clear to the monetary and fiscal authorities that the most efficient and effective way to achieve their objectives is through partnership and collaboration.

## CONCEPTUAL FRAMEWORK

The primary and major threat to the stability of Nigeria's financial system and price stability is Fiscal Dominance. This occurs when the fiscal authority’s large, chronic borrowing needs (budget deficits) constrain the independence and effectiveness of monetary policy. *Monetary* policy operational frameworks (in short, operational frameworks) are critical for central banks. They encapsulate the mechanisms and tools used to steer the central bank's operational target in line with the desired policy stance and to provide liquidity to the financial sector.

### Monetization of Deficits

The CBN is often compelled to finance government deficits (via "Ways and Means" advances). This injects massive, non-sterilized liquidity into the economy, directly leading to high inflation and making the CBN the primary cause of the instability it is mandated to control. CBN Act, BOFI Act 2020 and ECOWAS Macro-economic Convergence Criteria wants lending to Government of no more than 10% of its revenue of the previous year, and repayable in the same financial year. Interests charged are high and usually 2% to 3% above the Monetary Policy Rate (MPR).

### Fiscal Efficiency & Debt Sustainability

Unreasonable FSP benchmarks; Poor MTEP Budgeting and Unlawful Deficits; Debt eligibility criteria, Cost/Benefit Analysis and Lack of Enforcement Powers of Non-compliance.

Fiscal efficiency and debt sustainability are about a government's ability to manage its finances long-term, ensuring revenue covers spending (fiscal sustainability) without excessive borrowing that threatens solvency. High debt burdens, like Nigeria's 60% revenue to debt servicing, signal inefficiency, necessitating economic diversification,

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better tax collection (like VAT), spending cuts, and growth-boosting policies to reduce debt-to-GDP and meet future obligations, preventing economic crises.

**Crowding Out Effect of Private Sector Investment**

Government over-reliance on domestic borrowing, which attracts sovereign guarantee, raises market interest rates, effectively crowding out the private sector, which is then unable to access affordable credit for productive investment. This in turn forces CBN to embark on Domestic Finance intervention of the real sector. Policy alignment is crucial to remove these conflicting signals, restore confidence, and ensure that the financial sector can perform its core function of intermediation effectively. While government spending aims to boost the economy, the crowding-out theory suggests that increased public spending can inadvertently stifle private sector activity, counteracting some of its intended positive effects, especially in economies with limited capita



Why Alignment Matters is to avoid conflict. Prevents central bank actions (like rate hikes) from clashing with government spending, which can fuel inflation or destabilize markets**.** Coordinated policies attract investment by assuring stability, crucial for financial institutions to intermediate effectively. Enhances stability, reduces volatility in inflation, exchange rates, and interest rates, creating a predictable environment for all economic actors.

**Key Areas for Coordination**

Government debt must remain on a sustainable path, preventing the central bank from being forced to finance deficits (e.g., via 'Ways and Means'), which injects excess liquidity and causes inflation. The central bank needs operational independence to set monetary policy based on economic data, free from political pressure, focusing on price stability. Clear dialogue between the Ministry of Finance and the Central Bank is essential to understand impacts and avoid contradictory signals.

**How Alignment Builds a Robust System**

Supports major initiatives, like increasing bank capital requirements, to build stronger institutions capable of funding national development goals. Improves policy transmission. Ensures that monetary tools work effectively to influence the economy without being undermined by fiscal actions. A harmonized approach helps the economy withstand shocks, from global crises to unexpected domestic challenges. Implement powerful fiscal councils and clear rules to guide government borrowing and spending. Monetary policy should focus on low inflation, as it is the bedrock for financial system health. Use fiscal policy to invest in infrastructure, human capital, and correct market failures, complementing monetary stability.



Aligning Nigeria's monetary (CBN) and fiscal (Ministry of Finance) policies requires strong coordination, data sharing, and clear mandates, focusing on credible inflation targeting, prudent debt management linked to a sustainable

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fiscal framework, fostering financial inclusion via innovation, and building banking sector resilience (like recapitalization) to create a stable, shock-resistant system, as seen in recent CBN reforms under Governor Cardoso.

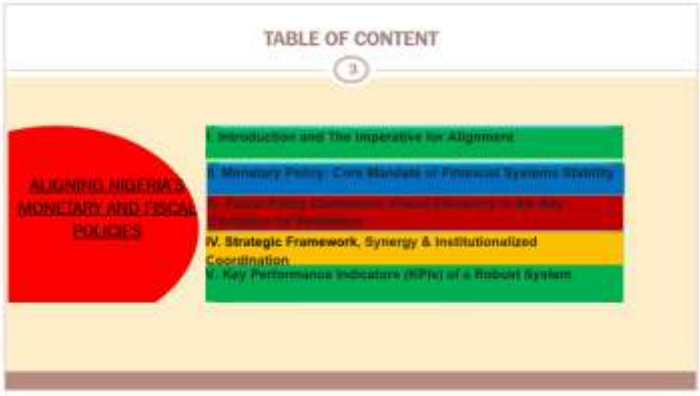
**Strategic Framework**

Rebuild trust through consistent policy, making credibility the core currency for confidence and capital flows. Adopt a clear framework to anchor expectations and guide monetary adjustments. Ensure debt management aligns with a sustainable macroeconomic framework to avoid shocks. Establish shared platforms for timely data to inform joint policy decisions. Promote innovation and inclusion to build a robust, widespread financial system.

**Monetary Policy (CBN)**

Inflation Targeting Framework: Implement explicit inflation targets to guide interest rate decisions. Exchange Rate Management: Move towards a unified, market-driven FX window (like "willing buyer-willing seller") to enhance transparency. Financial Inclusion: Leverage digital innovation (like the Non-Resident BVN) and agent networks to bring more Nigerians into the formal system. Bank Recapitalization: Continue efforts to boost bank capital adequacy (already rising) to strengthen systemic resilience.

**Aligning Nigeria's Monetary and Fiscal Policies**




**Monetary Policy & Financial Systems Stability**

CBN's role is to ensure price stability and oversee the soundness of the financial system. Its tools must be used consistently and predictably to inspire & maintain investor confidence in our financial systems.

**Restoring Price Stability (Disinflation) and managing Stagflation**

The CBN must prioritize its legal mandate of price stability. Achieving sustained disinflation (reducing the inflation rate) is the most critical contribution to financial system health, as high inflation distorts pricing, creates negative real interest rate (ECOWAS MCC), discourages savings, and undermines long-term investment. Monetary policy decisions (like setting the Monetary Policy Rate, or MPR) must be made solely based on economic data, free from the political pressure of short-term fiscal needs.(US FED V Trump)

Ensuring steady Forex inflow (thanks to re-routing NNPC revenue through CBN and increased crude production and Dangote export of refined products), to stabilise Forex and increase Foreign Reserves. New Forex Code Enhanced transparency and capacity for managed float, induced Foreign Portfolio Investment, Diaspora Remittance, and export revenue

**Strengthening Regulatory Oversight**

Strict enforcement of capital Aadequacy Ratios (CAR), including the recent bank recapitalization exercise, is vital to ensure that financial institutions can absorb unexpected losses without taxpayer intervention.(AMCON, 2009 US Sub-prime Financial crisis). Higher CAR required for Banks operating overseas. Extend rigorous supervision to the non-bank financial sector (Fintechs, Micro-finance, Shadow banking) to mitigate emerging systemic risks and close regulatory loopholes. Intensify oversight on **cyber security resilience** and enforce strict Anti-Money Laundering (AML) and Counter-Terrorism Financing (CFT) protocols to protect the integrity of digital transactions and the nation's reputation.(Nigeria exit from FATF Grey List/19 Action Points).

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**Enhancing Market Liquidity Management**
Use market instruments (like Treasury Bills and Open Market Operations - OMO) for liquidity management, rather than blunt tools (like arbitrary increases in Cash Reserve Ratios - CRR) that strain bank balance sheets. Develop and deepen secondary markets for fixed-income securities to improve liquidity transmission and create transparent pricing benchmarks for credit risk. Use of Loan to Deposit Ratios to increase liquidity to the private sector. Use of Differentiated Cash Reserve Ratios to also target lending to the Real Sector and Manufacturing sector on single digit and medium term. Statutory Fore-bearance brought in during COVID-19 era to prevent collapse due to wide-spread default. AMCON to finance Banks Balance sheet due to US Sub-prime property crisis




**Fiscal Policy Dominance, Fiscal Efficiency and Resilience**
Fiscal policy actions must support price stability and avoid placing undue pressure on the banking system or the nation's balance sheet.

**Institutional Fiscal Discipline**
**Zero Deficit Monetization:** The Fiscal Authority must enact and strictly adhere to an **absolute** ban on borrowing from the Central Bank (Ways and Means), in accordance with ECOWAS Macro-economic Convergence Criteria. Borrowing must stay within 10% of the previous year's income and repayable in the same financial year. All deficits must be financed through transparent market borrowing (bonds, Eurobonds) or increased revenue.

**Fiscal Responsibility Commission (FRC):** Empower and ensure the independence of FRC, which is the institutional framework set up by the Fiscal Responsibility Act 2007, with Amendment to the Act awaiting the final reading, to provide oversight on public spending, deficit size, and adherence to debt ceilings. It is the relevant Agency to issue or approve Certificate of Compliance on borrowings in accordance with the provisions of FRA2007.

**Debt Sustainability and Transparency**
**Prioritize Revenue:** Aggressively broaden the **non-oil revenue base** (taxation, customs, levies). A strong, diversified revenue stream is the primary tool for reducing the structural deficit and minimizing the need for debt.

**Fiscal Policy Dominance, Fiscal Efficiency and Resilience**
Further prioritize Ad-Valorem Levy of 15% on imported fuel in accordance with Public Service Obligation (PSO) and achievement of import price parity and impose 5% Levy on non-compliance with Domestic Crude Obligation (DCO) which mandates supply to local refining before export.

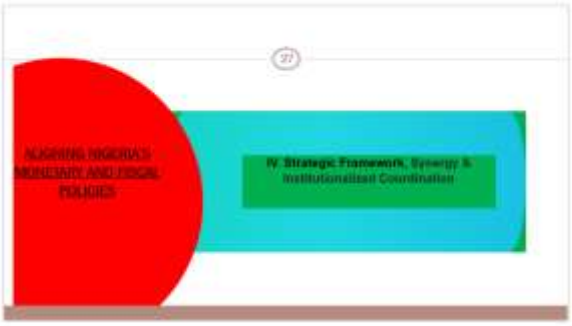
**Debt Profile Management: Rebalance Domestic and Foreign borrowing.** Shift the national debt profile towards longer maturities and more external (concessional) sources where appropriate,(in accordance with FRA 2007) to reduce the domestic interest burden and free up local bank liquidity for private lending.

**Public Financial Management (PFM)**
**TSA Utilization:** Optimize the **Treasury Single Account (TSA)** system to ensure efficient cash management, which reduces unnecessary public borrowing and provides a clearer picture of government cash balances, aiding CBN liquidity forecasting.

**Targeted Spending:** Ensure all capital expenditure is targeted toward high-impact, productive projects that enhance the economy's supply-side capacity, rather than contributing to inflation through unproductive consumption spending.

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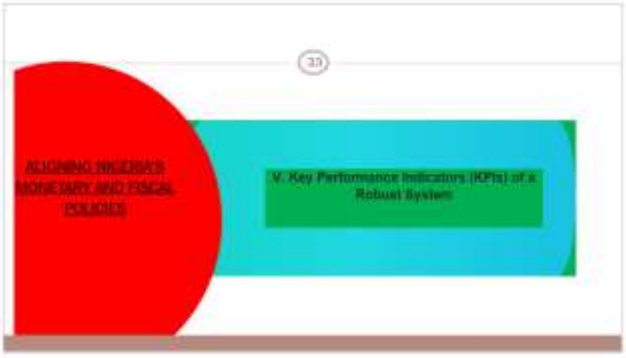
Responsible FSP benchmark, MTEF Budgeting




**Strategic Framework, Synergy & Institutionalized Coordination**
A robust financial system relies on formal, transparent, and continuous coordination between the two authorities.

**The Monetary-Fiscal Policy Compact**
Establish a statutory coordination council with clear mandates, frequent meetings, and transparent reporting. This forum should:
Agree on Macro Targets: Jointly set achievable and consistent targets for inflation, GDP growth, and the fiscal deficit-to-GDP ratio and borrowing profile.

Establish the Debt to GDP ratios, Debt Service to Revenue ratios for Federal, State and Local Government.
Joint Liquidity Forecasting: Share real-time data on expected government revenue/expenditure and foreign exchange flows to enable the CBN to accurately forecast market liquidity and plan its operations.
Contingency Planning: Develop and agree upon pre-defined responses to potential economic shocks (e.g., oil price collapse, global recession) to ensure a unified and swift reaction.
Strengthening the Regulatory Perimeter
The FMoF and CBN must collaborate on legislation that enhances the powers and scope of financial regulation, particularly in managing systemic risk. This includes:
Crisis Resolution: Developing a unified framework for resolving banking or financial sector crises without legislative delay or political interference.
Deposit Protection: Ensure the Nigeria Deposit Insurance Corporation (NDIC) is adequately capitalized and its mandate is harmonized with the CBN's regulatory framework.
Considering establishing CBN-SEC Joint Supervision of Crypto regulation, as it impacts the banking and other financial institutions.




**Key Performance Indicators (KPIs) of a Robust System**
The success of policy alignment can be measured by specific metrics that reflect financial resilience and efficiency:
Inflation Targeting: Achieve a sustained single-digit inflation rate (e.g., below 10%).

Credit to Private Sector (CPS) Growth: Increase the growth rate of credit directed towards the productive private sector (as a percentage of total credit) relative to government borrowing.

Financial Depth: Increase the ratio of M2 (broad money supply) to GDP, indicating the financial system's ability to intermediate and mobilize savings effectively.

Exchange Rate Volatility Index: Maintain a low volatility index for the Naira, demonstrating predictability and reducing speculative activity, including USD dollarisation.

Non-Performing Loan (NPL) Ratio and Capital Adequacy Ratio: Keep the NPL ratio of the banking sector below the prudential threshold of 5%, and Capital Adequacy Ratio around 15%, reflecting the health of bank balance sheets. This alignment framework moves the Nigerian financial system from a position of chronic vulnerability to one defined by resilience, efficiency, and credibility.

## EMPIRICAL REVIEW

A development economist and lead consultant, ECOWAS Commission Prof. Ken Ife, who spoke on the strategic framework and specific policy actions required to align the country's monetary and fiscal policies towards achieving a robust, shock-resilient, and efficient financial system, said the resort to Ways and Means financing by the CBN was the primary cause of the instability in the financial system it was mandated to control. He said the government over-reliance on domestic borrowing, which attracts sovereign guarantee, raises market interest rate effectively crowd out the private sector, making the sector unable to access affordable credit for productive investment.

The inability of the private sector to access affordable credits, the President, Institute of Professional Economists and Policy Management, said would force the CBN to embark on domestic finance intervention in the real sector. He said policy alignment between fiscal and monetary authorities was crucial to remove the conflicting signals in the economy, restore confidence, and ensure that the financial sector was capable of effectively performing its core function of intermediation. Monetary policy and financial systems stability, he said, requires strengthening regulatory oversights by strictly enforcing capital adequacy ratios to ensure financial institutions could absorb unexpected loses without the intervention of the relevant regulatory agencies.

Other interventions include the ongoing bank capitalisation programme to give the banks a solid capital base; ensuring rigorous non-bank supervision to mitigate emerging systemic risks and closing regulatory loopholes as well as intensifying oversight on cyber security resilience and enforcing anti-money laundry and counter-terrorism financing protocols to protect the integrity of digital transactions and the country's reputation. Prof. Ife emphasised the need to step up the joint risk-based supervision between the CBN and the Nigerian Deposit Insurance Corporation (NDIC), CBN and the Security and Exchange Commission (SEC) to boost crypto supervision, as well as CBN and AFREXIM Bank pan-African payment and settlement system (PAPSS) supervision.

Recent studies, such as Elsayed et al. (2023), examine the interaction between monetary policy and financial stability in the Gulf Cooperation Council (GCC) countries from 2006-Q4 to 2020-Q2. They find that central banks' response to deviation from the inflation target, output gap, or exchange rate movement differs in magnitude and significance across the GCC countries, and the central banks react differently to negative or positive shocks to financial stability. Cairó and Sim (2023) examine the relationship between price stability and financial stability in an economy that experiences endogenous financial crises arising from excessive household debt. They find that the central bank can improve both price stability and financial stability if it adopts an aggressive inflation targeting regime and in the absence of the zero lower bound constraint on nominal interest rates. They also show that if there is a zero lower bound constraint, the aggressive inflation targeting regime will fail to achieve price stability and financial stability.

Bochmann et al. (2023) examine the interaction of monetary policy with financial stability and the real economy in the Euro Area. They observe that the buildup of financial vulnerabilities is accompanied by the reemergence of subdued financial stress, which ultimately harms economic growth. They propose that unconventional monetary policy is more effective in mitigating financial fragility in the Euro Area.

In an African study, Houngbédji and Bassongui (2023) examine the reaction of monetary policy to financial stability by the Central Bank of West African States (BCEAO) from 1970 to 2020. They find that the monetary policy actions of the BCEAO are conditioned on financial stability and the BCEAO reacts to a financial instability risk when emerging risk exceeds a tolerance threshold, and it does so by raising the interest rate. In an Asian study, Nasreen and

Anwar (2023) examine the response of monetary policy to financial stability risks in some South Asian countries. They find that monetary policy reacts to financial stability risks in South Asian countries and central banks tighten monetary policy if the output gap widens and the exchange rate depreciates.

In the empirical literature, Martinez-Miera and Repullo (2019) examine the role of monetary policy and macro prudential policies in addressing financial stability risks using a stylized general equilibrium model in which the key friction in the financial system comes from a moral hazard problem in firms' financing and this friction can be eliminated by bank equity capital. They show that contractionary monetary policy via open market sale of government debt, and tight macro prudential policy via an increase in capital requirements are useful in mitigating financial stability risks, but macro prudential policy has a more potent effect in preserving financial stability.

Schnabl and Sonnenberg (2020) analyze the impact of conventional and unconventional monetary policies on financial crises by comparing the financial market stabilization measures of the Federal Reserve System and the European System of Central Banks in response to the US subprime crisis and the European financial and debt crisis. They show that the Federal Reserve System's measures were more directed toward stabilizing the banking system, whereas the European Central Bank's measures were more directed toward ensuring the debt sustainability of Euro Area crisis countries

Dr Afangideh Johnson, Assistant Director, Monetary Policy Department at the CBN, said that Nigeria's macroeconomic landscape required coordinated responses to address structural weaknesses. Johnson said that aligning government borrowing with CBN liquidity forecasts would enhance monetary policy transmission and prevent crowding out private-sector lending. He recommended formalising the Fiscal-Monetary Policy Coordination Committee and establishing a multi-agency council to harmonise fintech, digital payment and data-protection regulations. Most of the stakeholders agreed that alignment of monetary and fiscal policies required certain mechanisms for effective coordination. They urged policymakers to establish clear frameworks and operational arrangements, adding that the CBN must maintain its independence and strictly adhere to its primary mandate of price stability.

## CONCLUSION

Fiscal and monetary policies are both essential tools used to influence a nation's economic direction. While fiscal policy involves government spending and taxation, monetary policy involves adjusting the money supply and interest rates. When these policies are coordinated effectively, they can complement each other to achieve macroeconomic stability, growth and full employment goals. Often the policy used will depend on the economic climate and how much clarity the central bank and government have on the cause or main issue within the economy. When looking to drive growth in an economy, monetary policy can be immediately implemented to lower interest rates if they are at high levels already. This alignment framework moves the Nigerian financial system from a position of chronic vulnerability to one defined by resilience, efficiency, and credibility. Fiscal Policy plays a stabilizing role by managing growth dynamics, tackling unemployment, and keeping inflation in check. Government spending priorities can channel resources to essential sectors like healthcare, education, or infrastructure. It can assist in the redistribution of income through fiscal measures can strive for a more equitable society. It can strategically support certain industries or innovations, laying the groundwork for long-term economic growth.

## RECOMMENDATIONS FOR A ROBUST FINANCIAL SYSTEM

Establish comprehensive legal and regulatory frameworks to oversee all financial institutions and markets effectively. Ensure that regulatory bodies are independent, well-resourced, and proactive in monitoring compliance and identifying emerging risks (known as "Regtech" when leveraging technology). Put in place clear frameworks for the orderly resolution of failing institutions to minimize disruption to the broader economy and reduce the need for government bailouts. Mandate transparent and consistent reporting standards to ensure that all market participants have access to sound information, which helps in making informed decisions and imposing market discipline. Encourage a diversity of financial institutions (e.g., commercial banks, microfinance, credit cooperatives) to promote competition and serve distinct customer segments. Broaden access to finance for underserved populations through initiatives like digital banking, mobile payments, and simplified account requirements, which can enhance stability in the long term. Ensure the smooth, secure, and resilient functioning of payment, clearing, and settlement systems, which are the "arteries" of the financial system.

Facilitate the use of innovative technologies (fintech) to lower transaction costs and improve efficiency, while also addressing new risks, such as cybersecurity threats. Invest in data collection and research to support sound, evidence-based policies and allow for robust risk analysis. Enhance coordination and information-sharing among national and international authorities (such as the IMF and World Bank) to manage global financial risks and ensure consistent implementation of standards. Ensure that financial institutions embed comprehensive risk management practices (covering credit, market, operational, and liquidity risks) into their core business strategies. Delineate clear roles and responsibilities for all participants, from government authorities to individual institutions, to ensure accountability. Promote strong corporate governance and ethical behavior to build and maintain public trust and confidence in the financial system

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