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# EVOLUTION AND FUNCTIONS OF CENTRAL BANKS

By

S. Ibi Ajayi\*

## I. INTRODUCTION

Today's lecture takes us far into history: that of the Evolution of Central Banks, as well as the functions of central banks. The central bank of a country is regarded as the apex regulatory institution of the financial system of that country. Accordingly, "a central bank is an institution charged with the responsibility of regulating the supply, availability and the cost of money in the interest of social welfare", (Ajayi, 1995). It has regulatory authority over all other financial institutions in promoting financial stability and a sound financial system. The importance and relevance of a central bank in any society can not be overemphasized. There is hardly any country today without a central bank. In Africa, having a central bank was considered the "sine qua non" of political independence. As noted by the then President of Ghana, Kwame Nkrumah (1961), "our political independence will be worthless unless we use it to obtain economic and financial self-government and independence." Consequently, central banks in Africa are state-owned and have powerful roles in macro-economic policy making.

All over the world, governments have taken necessary measures to ensure the integration of central banking more closely into the machinery for carrying out macro-economic policy and for many countries, a central bank plays a key role in a country's growth and development process. The traditional role of the central bank is the regulation of the stock of money in such a way as to promote the social welfare. As we shall see in the course of this paper, the roles of a central bank in an economy are necessarily influenced by a host of factors such as the features of the monetary system, the organisation of financial markets, the political and sometimes ideological environment, and the stage of economic development (Ajayi, 1995). Given the complexities of monetary management and the complexities of the structures of the economy in an increasingly globalised world, the issue of financial system soundness has shifted to the centre stage in the last two decades and more so recently in the period since the Asian crisis. In fact, the world of central banking is one of a variety of structures, functions and powers which are in themselves by-products of the economic, political and other realities prevailing in that society. The powers, constellation of functions, broad orientation and techniques of central

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banks differ from country to country. The functions of central banks from one country to the other are not time invariant.

The aim of this paper is to provide a background for much of the details that is going to be presented in other sections of this policy seminar. There will definitely be overlaps. The organisation of the rest of this paper is as follows. Section II discusses the evolution of central banks in a number of countries around the world including a discussion of central banking in Nigeria. In section III we discuss the functions of central banks in general and with specific reference to that of the Central Bank of Nigeria. The relationship between Government and central banks and the issue of independence is the theme of section IV. We discuss the issues of independence with specific reference to the Central Bank of Nigeria. We end up with a discussion of some of the problems and prospects for central banking in section V.

## II. EVOLUTION OF CENTRAL BANKS<sup>1</sup>

### The Bank of England

The history of central banks dates back to the time the Bank of England was established. It is known to be one of the oldest central banks in the world. The conception of central banking in the modern sense started with the creation of the Central Bank of England. It, however, took mainly the complex financial problems that wars and economic crises produced to accord it the distinctive roles that should be given to it both in practice and theory of finance (Ajayi, 1995). The various economic, political and social changes which occurred between the two world wars gave it the principles and operations which brought it into the centre stage. The older central banks (including those of England), Sweden and France had their origin as a rule in their ability to serve their respective government financially. When the Bank of England was incorporated in 1694, it granted a loan of 1.2 million pounds, the amount of the bank's entire capital, to the government of William III to finance the war of the Grand Alliance against France (1689–97). In exchange for the generous offer, government permitted the Bank of England to carry on general banking business including the right to buy and sell coin and bullion, to deal in bills of exchange, to issue its own notes and to make loans. The subsequent extensions of the Bank's charter coincided with additional loans to the government. Thus, the Bank of England has from the beginning served as the government's banker. Commercial banks soon found it convenient to keep deposits with the Bank of England since the latter was the principal issuer of notes. Supplies of notes by these commercial banks and joint stock companies could be obtained in times of need by drawing on their deposits.

By the middle of the nineteenth century, the Bank of England had become a bankers' bank. The legislation passed in 1833 granted its notes legal power while that prerogative

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1. This section has benefited immensely from Boreham et al (1968).

was denied to other banks. The Bank Act of 1844 (Peel's Act) provided that no new bank in the United Kingdom could issue notes and placed restrictions on existing note-issuing banks with the result that the Bank of England became eventually the only note issuing bank in England and Wales.

During the nineteenth century, however, the Bank was beset by one crisis after another. Excessive lending by banks brought on the crises of 1825 and 1837, when many banks failed. It was not until 1837, that the Bank of England started to show concern by acting as a lender of last resort. The banking crises led to a demand for parliamentary intervention to regulate banking and more particularly to control the issue of notes. The crisis generated a debate among two popular schools of thought (i.e. the Currency vs. the Banking Schools). The Currency School viewed that the only way to prevent an over-issue of notes was to insist that the note issue be fully backed by gold, or at least by fiduciary issue. The Banking School, however, believed that the note issue should not be rigidly restricted, but that it should be made variable to suit the particular needs of business at the time. The Currency School tended to over-emphasize the dangers attendant on an excessive issue of notes, while the opposing school was inclined to minimise them.

In the later part of the nineteenth century, the Bank of England began to develop as a true central bank, and it was during this period that it learnt how to use the bank rate as an instrument of monetary policy. The Bank of England fully accepted the responsibilities of a central bank and became used to exercising its powers of control over the commercial banks. It is apparent from the above discussion that the Bank of England developed slowly and only by a kind of evolutionary process did it come to occupy a pivotal position in the national monetary and banking system in England.

### **The Bank of France and the Bank of Germany**

Both the Bank of France and Reichsbank of Germany are of great historical significance. The Bank of France was founded by Napoleon Bonaparte in 1800 mainly for the purposes of providing through note issue a uniform and stable currency. Although privately managed, it had close relationship with government from the beginning. The existing commercial banks were merged with the Bank of France by government edict, which explains the genesis of the duality of the bank as central bank and a commercial bank. The bank was nationalised in 1945.

In 1765, Frederick the Great founded the Koenigliche bank as a purely state institution. It had no stockholders, issued no bank notes and had no chequing accounts, but it discounted bills, and made loans against commodities and real estate. Soon after the German empire was founded, it was made in 1875 into a central bank called Reichsbank and steps were taken to give it a monopoly of bank-note issue. After some experimentation with interim central banking patterned after the American system, a single bank called Deutsche Bundesbank was established in 1957. Even though both France and Germany

also had central banks in the nineteenth century, none of them had the same powers and influences over the other banks as had the Bank of England.

### **The Riksbank of Sweden**

The Riksbank of Sweden was founded in 1656 to serve the banking needs of the Swedish Merchant guild, but was reorganised under government auspices two years later. While it enjoyed in its earlier years the monopoly in the issue of notes, the joint-stock banks which came into prominence after 1830 assumed the note issue prerogative. Government however systematically eliminated the note issue privilege of other banks through legislation and greatly extended other powers of the Riksbank, and gave it a status which is comparable to those of other countries central banks.

### **United States of America: The Evolution of the Federal Reserve System**

Prior to the twentieth century, the United States of America did not have a full-fledged Central Bank. The rise of the banking system paralleled the development of the monetary system. In order to facilitate the financing of the revolutionary war, the first modern bank in the United States, the Bank of North America was incorporated in Philadelphia in 1782. This was followed by similar institutions in Massachusetts and New York. Congress in 1791 chartered the First Bank of the United States. The majority of the stock of the bank was owned privately. It performed some central banking functions by providing fiscal agency services for the infant federal government; and performing some monetary discipline relating to the redemption of state bank note issues. The conservative policy of the bank drew attack from agrarian-frontier group. The charter of the bank lapsed in 1811 and the issue of state bank notes continued unabated. The mounting abuses were called into some kind of order in 1816 when the Second Bank of the United States was federally chartered. It faced the same stiff opposition as its predecessor. Its central banking function especially its control over currency issues by state banks were incompatible with both its private ownership and its commercial banking business. Persistent opposition to the bank supported by President Andrew Jackson led to the refusal of Congress to extend the bank's charter in 1836.

Following the demise of the Second Bank of United States, what is called the era of "wildcat" banking came into existence. With the great vacuum created by the absence of a nationally recognised central bank, state banks in existence offered varied paper currency. The absence of a central bank and the multiplicity of bank notes of various forms and quality were detrimental to the take-off stage of the new economy. Frequent banking and financial panics, and periods of severe credit shortages attested to the defects of the existing system. The damage done to the economic system led to the appointment of a National Monetary Commission which in studying the nation's banking and monetary system provided essential information and recommendations leading to the legislation

establishing a central banking system for the United States in the form of the Federal Reserve System. The new central banking system was established under the administration of Woodrow Wilson through the Federal Reserve Act of 1913. Unlike the European countries each of which has a single central bank, the United States has a system of Federal Reserve Banks, one for each of the 12 Federal Reserve districts. Each Federal Reserve Bank is named for the city in which it is located hence the Federal Reserve Bank of New York, the Federal Reserve Bank of Chicago and so on. For some of the functions of central banking, the regional character of the system is important.

Over the decades, the Federal Reserve structure has become more centralised. The making of macro-economic policy has become centralised in Washington in two policymaking bodies: the Board of Governors of the Federal Reserve, and the Federal Open Market Committee. The former is made up of seven members (called governors) appointed by the President of the United States with the advice and consent of senate for a term of 14 years. One of the members of board is appointed by the President as chairman. The Open Market Committee which has the responsibility for open market operations has 12 voting members made up of the 7 members of the Board of Governors and 5 of the presidents of the regional Federal Banks. The presidents of the regional banks serve on a rotational basis with the notable exception of the president of the New York Bank (the bank charged with carrying out open market operations) who is always a voting member of the Open Market Committee. No doubt the system has undergone fundamental changes as a result of the experiences gained from the great depression and subsequent experimentation with the system. Just as the banking system of the United States developed in stages, the structure as well as the operations of the Federal Reserve System has evolved gradually in response to the complexity and changing needs of the United States economy.

### **Evolution of other Central Banks**

Apart from the Federal Reserve System of the United States, other central banks were established mostly in the first and second half of the present century. These include the South African Reserve Bank, 1921; Commonwealth Bank of Australia, 1924; the Central Bank of China, 1928; the Bank of Canada, 1934; the Reserve Bank of India, and the State Bank of Pakistan, 1935. A phenomenal growth in the number of Central Banks in Africa took place in the 1950s. These include the Bank of Ghana, 1957; the Central Bank of Tunisia, 1958; Bank of Morocco, 1959; and the Central Bank of Nigeria, 1959. Central banks founded in the 1960s in Africa include the Bank of Sudan, the Bank of the Republic of Guinea, and the Somali National Bank, 1960; the Central Bank of Algeria, 1963; in 1964, the following were founded: the National Bank of Rwanda, the Bank of the Republic of Burundi, the Reserve Bank of Malawi and the Bank of Zambia.

One innovation after the world war II had been the establishment of central banks to serve a group of countries. One of these is the *Banque Centrale des Etats de l'Afrique de l'Ouest* (termed the West African Central Bank).



## **Nigeria: The Evolution of the Central Bank of Nigeria (CBN)**

The development of the Central Bank of Nigeria was an outgrowth of the characteristics and deficiencies of the period preceding its existence. The first institution in existence was the West African Currency Board which was established in 1912 and was the currency issuing authority. Consequent upon the criticisms of the system, Mr. Loynes was appointed to make recommendations on the establishment of a Nigerian Central Bank, the introduction of a Nigerian currency and other associated matters. In the 1940s and 1950s, Nigeria's financial sector witnessed a turbulent period culminating in the collapses of many indigenous owned private and state banks. Banking business during this time was dominated by foreign banks, while only few Nigerians were involved and trained in the art of banking. The enactment of the Nigerian Banking Ordinance in 1952 introduced some regulation into the banking sector and curtailed to some extent the bank failures of no-regulation era. The condition of the economy between 1952 and 1958, and the minimal regulation of the banking industry by the 1952 Ordinance, gave impetus to the establishment of many indigenous banks, all of which failed. The general collapse was the resultant effects of several factors including poor management, undercapitalisation and high degree of indiscipline. The regulatory void created led to the establishment of an institution that would not only oversee and regulate the behaviour of the institutions in the financial sector, but also carry out stabilisation policy generally.

The era of proper banking regulation began with the enactment of the Central Bank of Nigeria Act of 1958. The Act was necessitated by the need to eliminate the deficiencies in the financial sector, promote and integrate the Nigerian financial sector, stem the tide of bank failures and promote the growth of the domestic money and capital markets among others. The Bank commenced business in July 1959. At different times, the powers of the Central Bank of Nigeria were enhanced. The promulgation of the CBN Decree 24 of 1991 and the Banking and Other Financial Institutions Decree (BOFID) No. 25 of 1991 was another milestone in central banking history because of the powers conferred on the Bank to perform the modern primary functions of a central bank. Together with BOFID, the CBN Decree confers larger powers on the Bank in the areas of banking supervision and examination, monetary management and promotion of safety measures and soundness of the financial system. While these changes are welcome developments, some have argued that the CBN has not achieved much in the area of independent selection of suitable instruments to achieve its objectives. Similarly, not much has been done by the recent amendments on the issue of central bank autonomy.<sup>+</sup>

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<sup>+</sup> Editor's Note: Prof. Ajayi wrote this paper before the CBN was granted instrument autonomy by the government

### III. FUNCTIONS OF CENTRAL BANKS

In the course of discussing the evolution of central banks, we found that the various functions performed by the modern central banks developed gradually and according to changing circumstances. Many of the earlier central banks in Western Europe, for example, evolved in their various functions. The monetary problems at the time of establishment of the relevant central banks and the need to eliminate deficiencies in the financial system and economy resulted in the many responsibilities of the modern central banks. In a general context, the functions of central banks all over the world as listed in traditional texts on central banking consist of the following:

- (i) regulating the issue of currency and controlling the quantity of money and credit for monetary policy purposes. This is the same as saying that it is the function of the Central Bank to issue currency in adequate quantity for the smooth running of the economy.
- (ii) acting as banker to the government or acting as the fiscal agent of government.
- (iii) acting as banker to the commercial banks — including the lender of last resort function.
- (iv) managing the country's international reserves as well as its exchange rate.

In carrying out these functions, central banks are usually given some powers under the act establishing them. The type of powers and each central bank's style of carrying out its functions inevitably varies between one country and the other. The type of techniques used by central banks to adequately mop excess liquidity through open market operations, for example, depends crucially on the stage of development of the money market.

In addition to the functions mentioned above, central banks have additional functions especially in developing countries. Such functions include first, the regulatory and supervisory role in order to ensure the efficient running of the financial system. The second is the promotional role of the central bank. Central banks are expected to foster the development of financial infrastructures such as the development of money and capital markets, the instruments of the market and the development of specialised financial institutions.

It is not my intention to bore this honourable listeners given their excellent academic background with the details of these various functions. You all have them at the tip of your fingers. Indeed these functions have been described in an earlier paper presented to the research department in a seminar some years ago (See Ajayi, 1995). At this juncture, it will suffice to point out the distinction in the role of central banking in a well developed economy and that of a developing economy like ours. In this regard, I like to point out first that the specific role of any central bank is affected by many variables among which are the nature and type of government, the courage and professionalism of the man at the helms of affairs at the central bank, the stage of economic development and the structure



of financial markets. Second, central banking in developing countries faces many limitations. These include the fact that the economy outside the realms of money may be very large. Many names such as the "informal sector", the "underground economy" have been given to this phenomenon. The point is that to the extent that the size of the informal sector is large, it may have serious effects on the role of the central banks and its effectiveness in performing its functions. Third, in many African countries, for example, cash is the main mode of payments as opposed to checking accounts. The personal disadvantages of carrying cash in our country and the deleterious effects on the growth of financial deepening are enormous. Fourth, the money and capital markets are not developed. There is shallowness in its depth and breadth. This inevitably affects the choice of policy instruments. Fifth, in many developing countries, short run changes in the volume of money reflects the fiscal action of government and the balance of payments. In the case of the former the central bank may have little or no control and in the case of the latter, sterilization possibilities may be limited.

There are a number of subtle differences between central banks around the world. We can draw examples from that of the Federal Reserve System (referred to as the FED) of the United States and the Bank of England. The Bank of England also performs most of the functions as the Fed, although, there are some differences and exceptions. The American banking system is a little more complex than the British system, partly on account of the size of US economy and the state and federal laws governing banking. In organisational structure, both the Bank of England and the Federal Reserve System are different, consequently, the processes of achieving the same results may be dissimilar. There are a number of Federal Reserves (FEDs) as against one central bank in Great Britain. When short of cash, American member banks borrow from their central bank, whereas British commercial banks never do this directly, but instead call in some of their loans to the money market, thereby compelling bill brokers and discount houses to borrow from the Bank of England. Thus, the higher rate charged by the Bank of England serves to check lending to the money market. The FED do not have the same check, for the fear that the banks may be regarded by their customers and general public as unhealthy or distressed. Monetary policy is a matter to be decided jointly by the Treasury and the Bank of England whereas in the US the FED working through the open market committee is independent.

For all central banks, it is becoming increasingly clear that the maintenance of monetary stability is the key to economic policy. Thus the maintenance of a non-inflationary environment is seen as the major task of central banks. Several conclusions emerge from the existing literature on this issue (IMF, 1996). First, the evidence is strongly indicative of a negative relationship between inflation and long-term growth even at moderate rates of inflation of 10–30 per cent. High rates of inflation are definitively harmful to growth. Second, growth falls steeply as inflation exceeds 30–40 per cent and tends strongly to become negative at very high rates of inflation. Third, reduction of high inflation has been a precondition for the revival of growth. Annual inflation has to be

reduced to less than 50 per cent for growth to resume. The implications of these findings for Nigeria is clear.

### Functions of the Central Bank of Nigeria (CBN)

We have discussed in a paintbrush version the overall functions of central banks throughout the world. We need to come home to Nigeria for some specifics even though generally speaking the functions the Central Bank of Nigeria (CBN) are not different from those enumerated above. In a way too, the functions of the CBN can be said to evolve over time. The functions of the CBN are defined in the objectives of the Bank as defined in section 4 of the 1958 Ordinance:

- (1) to issue legal tender currency in Nigeria;
- (2) to maintain external reserves in order to safeguard the international value of the currency;
- (3) to promote monetary stability and a sound financial structure in Nigeria; and
- (4) to act as banker and financial adviser to the Federal Government.

Over time, the functions of the Central Bank of Nigeria has been broadened, so also have the instruments of monetary control. Since inception, the Bank broadly interprets the objectives of its monetary policy function to include (Oke, 1995):

- (i) the achievement of relative stability of domestic prices;
- (ii) the maintenance of a healthy balance of payments position and a stable exchange rate;
- (iii) the promotion of a rapid and sustainable rate of economic growth and development; and
- (iv) the development of a sound financial system.

Some of the functions of the Central Bank of Nigeria are summarised below<sup>2</sup>.

- (i) **Banker and Adviser to the Government:** The 1958 CBN Act and CBN Decree of 1991 provide that one of the key functions of the CBN shall be to act as banker and financial adviser to the Federal Government. The CBN maintains federal government's account and undertakes most government's banking business. Local and State government, public enterprises and agencies also maintain accounts with the CBN. In this regard, the CBN has the sole responsibility of receiving and accounting for the revenues of the federation. The Federal Government in May 1989 directed all its parastatals and agencies to withdraw their account from commercial banks and lodge them with the CBN.<sup>+</sup>

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<sup>+</sup> *Editor's Note: This policy has been reversed. Government Ministries/Agencies no longer maintain accounts with the CBN, since end - March, 1999. They now patronise the Commercial/Merchant Banks of their choice.*

2. For detailed discussion, see Ajayi (1995).

A banker to the federal government, the CBN not only maintains accounts for the government, it also accepts responsibility for the financing of its expenditure gaps. Paragraph 35 of the CBN Ordinance 1958, provides that “the Bank shall be entrusted with the issue and management of Federal Government loans publicly issued in Nigeria, upon such terms and conditions as may be agreed between the Federal Government and the Bank”. In this regard, the CBN grants financial accommodation through the granting of Ways and Means Advances facility. The CBN mobilizes funds for the Federal Government through the issuance of government securities, such as treasury bills and certificates, development bonds, treasury bonds, etc. In this manner, the CBN manages government’s domestic and external debt in conjunction with the Federal Ministry of Finance.

- (ii) **Banker to other Banks:** The CBN Act of 1958 and CBN Decree No. 24 of 1991 (section 37 and 38) clearly specify that the CBN as the apex financial institution must promote confidence in the financial system through its activities as banker to other banks and may seek the cooperation of other banks in pursuit of this objective. The CBN must formulate policies for the introduction of appropriate payments instruments and supportive of the efficient functioning of the payments system. In this regard, it facilitates the clearing of cheques and credit instruments through its clearing houses distributed nationwide. The CBN issues directives on cash reserve and liquidity ratios, prudential requirements, sectoral credit allocation and on other activities of banks. This is achieved through its Monetary Policy Guidelines. The CBN is expected to promote a sound financial system through banking supervision and examination. This enables the CBN to monitor the activities and performance of financial institutions on a periodic basis.
- (iii) **Currency Issue and Distribution:** This is one of the oldest functions of the CBN. The CBN, by law, is the only bank authorised to issue currency. It does not only issue currency, but the CBN is also involved in its distribution, safe custody of stocks and management of orders. Without the regular and timely distribution of currency, economic activities would be disrupted.
- (iv) **Stable Monetary and Macroeconomic Environment:** The CBN Decree of 1991 (No. 24 and 25) states that the Bank’s principal objective “shall be to issue legal tender currency in Nigeria, to maintain external reserves, to safeguard the international value of the currency, to promote monetary stability and a sound financial structure in Nigeria”. Price stability which is achieved through effective monetary policy is indispensable for money to perform its role in an economy. The CBN also sets the growth rate of money supply to be compatible with overall macroeconomic policy goals. The CBN is expected to monitor and allocate foreign exchange resources such that foreign exchange allocation and usage are compatible with macroeconomic objective of government.

- (v) **Lender of Last Resort:** The CBN grants temporary facilities to banks and discount houses when they are in liquidity crisis. This assist to give confidence to the financial system and enhances the banking system's ability to withstand economic shocks.
- (vi) **Developmental Functions:** The developmental activities of the CBN include: the promotion of the growth of the money and capital markets; promotion of banking habit; establishment of special schemes and funds, for example, the Agricultural Credit Guarantee Scheme (ACGS), the National Economic Reconstruction Fund (NERFUND); promotion of and support for specialised institutions, for instance, the Nigerian Export Import Bank (NEXIM), Nigerian Deposit Insurance Corporation (NDIC), etc.

For the purposes of achieving its objectives, in particular that of monetary stability, an array of tools are available to the bank for monetary control. These include the following (Falegan, 1995):

- (a) variable discount rate, interest rate structure and bank charges
- (b) open market operations
- (c) variable liquid assets and liquidity ratio
- (d) moral suasion
- (e) selective credit control
- (f) cash reserve requirement
- (g) special deposits
- (h) stabilisation securities.

The 1968 amendments provided additional instruments of monetary control. The 1991 decree provided additional functions for the Central Bank of Nigeria (CBN).

#### **IV. CENTRAL BANK'S RELATIONSHIP WITH GOVERNMENT AND THE ISSUE OF INDEPENDENCE**

Over time, there has been discussions about the relationship of the central bank with Government. The independence of the central bank is often discussed within the context of the functions it performs. What is the relationship that the central bank should have within government? Should the central bank be an independent agency established to conduct the task of administering monetary policy without interference from the executive branch? Should the central bank be independent from government or be independent within government?. These are delicate and difficult questions to answer. We attempt here to address the issue of the independence of central banks. We discuss in what follows the theoretical issues of central bank independence, the extent of independence and the lack of it in a number of industrialised countries, the experiences of Nigeria's Central Bank, and the empirical evidences on central bank independence and macroeconomic performance.

The arguments for central bank independence centres on a number of grounds each of which has its own merit and demerits. We mention four popular arguments. First, the control of a nation's monetary system is not only important but too delicate a matter to be left in the hands of politicians. Given the special nature of the management of money, it requires the skill and finesse in both financial manipulation and market operation that only the most skilled experts possess. Second, it is argued that politicians lack the political courage and the sense of long run responsibility which are necessary to protect the currency of the nation from abuse and debasement. In a regime of paper money, the nation's currency is especially vulnerable to maladministration since political control can lead to inflation. Third, given that a central bank protects the general interest, there may be situations when government interests, for example, may be in conflict with societal welfare. This may happen when a central bank is interested for policy purposes in increasing the rate of interest and government is reluctant because it wants to be able to borrow cheaply. Fourth, there is need for an independent person outside the government circle to speak publicly on economic matters.

A number of central banks in the industrial world enjoy independence. This independence relates to the power to design and implement monetary policy without the interference of the executive branch. In the United States, for example, the Federal Reserve undertakes monetary policy formulation and implementation without seeking ratification from the President or any appointee of the executive branch. The Federal Reserve is expected by law to report to congress about twice a year.

In Western Germany, the Deutsche Bundesbank has the overall responsibility for monetary policy. Although the Federal Government owns all the capital of the Bundesbank from which it receives profit, it does not derive any other privilege from the Bank. The Bank is not formally accountable to any arm of government but to the General public and submits an annual report to the government.

The Swiss National Bank is required by regulation to regulate the country's money in circulation and to facilitate payment transactions. This, the banks understand as facilitating monetary stability. While there is consultation on policy matters between the Bank and the Government, approval from Government before implementation of policy is unnecessary and not required.

At the other end of the continuum of central banks policy and independence are the Bank of England and the Bank of France. In the United Kingdom, the Treasury and not the Bank of England has the responsibility for monetary policy. In practice, it is the Treasury that has the responsibility for monetary policy while the Bank is the agent that implements monetary policy after close consultation with the Treasury. In France, it is the Ministry of the Economy that decides on the stance of monetary policy. Thus in the legislation of the Bank of France, responsibility for monetary policy and independence is denied it.

At the beginning of central banking in Nigeria, the independence of central bank from government interference was guaranteed. There was not to be interference from

Government since the administration of its affairs and business are the responsibility of the Bank's Board of Directors. All that the act requires is for the Bank to keep the Minister informed of the monetary and banking policy being pursued; and has no power to delay, stop or prevent the Bank from carrying out the policy. Theoretically, from the Act therefore the Central Bank of Nigeria is independent. According to Nwankwo (1980 p. 13), "it can be argued that, statutorily, the CBN is one of the most independent of central banks in the world". However, this was in theory. In practice however, the position, dominance and prestige of the Minister of Finance has always been very important. In this regard, when the first minister of Finance was alive, he made clear who was the boss. It has been pointed out by C.V. Brown (1966) that most of us were under the impression at least from the budget speeches before 1966, that the Bank operated under the instruction of the Minister of Finance! He also suggested that if there "were a conflict, the ordinance suggests the Central Bank should win, but in reality this can by no means be certain" (Brown, 1966 p. 144). It was known from the public speeches of the Prime Minister however that the Bank was independent within Government. No open confrontation of course ever occurred at that period between the Minister of Finance and the Governor of the Central Bank.

When the development plan was launched in 1962, divergence of opinion occurred between the Government and the Central Bank. It was clear that the policy of deficit financing which government was pursuing was at variance with the Bank's primary objective of monetary stability. In addition, the Bank called for a general review of tax incentives and other forms of financial subsidy granted to business as a way of buoying up Government revenue. There were evidences of struggles between the bank and the Government in the middle 1960s. The Bank called for a review of the situation and the result was the CBN Act Amendment Decree No. 3 1968 which gave the last say in policy matters to the Federal Executive Council. This act is an important watershed on issues relating to the CBN independence. The relationship between the Ministry of Finance and the central bank took a new turn with the following provisions (Ajayi, 1978):

1. The Board (of Directors of the Bank) shall keep the Commissioner of Finance informed of the monetary and the banking policy pursued or intended to be pursued by the Central Bank.
2. The Commissioner shall from time to time if he disagrees with the Board on the monetary and banking policy pursued so inform the Board of his disagreement and thereto, and the Minister may submit his representation and that of the Bank to the Federal Executive Council.
3. The Federal Executive Council may, in writing, after considering the representation direct the Central Bank as to the monetary and banking policy pursued or intended to be pursued and the directive shall be binding on the Board which shall forthwith take all necessary step expedient to give effect thereto.



In the act, the Commissioner (Minister) of Finance becomes the spokesman in the Federal Executive Council on issues of monetary policy. The Governor of the Central Bank cannot reach the Federal Executive Council except through an intermediary, the Minister of Finance. A situation where the principal adviser to the Government on financial and monetary affairs cannot reach the Government directly except through an intermediary (who may hold divergent or opposing views) cannot be regarded as satisfactory (Nwankwo, 1980). Subsequent happenings have tended to make the central bank not autonomous in the performance of its duties. Under Decree 24 of 1991, the CBN got its freedom from the Ministry of Finance and came under the presidency: (1) the CBN Governor shall keep the President informed of the monetary and banking policy pursued by the Bank (2) The President after due consideration may in writing direct the Bank as to the monetary and banking policy pursued or intended to be pursued and the directive shall be binding on the Board which shall forthwith take all necessary steps or expedient to give effect thereto. By 1995, the CBN was back under the Ministry of Finance.

In summary, over the years since its inception, the CBN has lost most of its independent powers to the Ministry of Finance. The Bank has had little or no discretionary powers in formulating and executing monetary policy. Government fiscal policy overrides monetary policy (Falegan, 1995). Government excessive spending has limited the success of the Bank in controlling aggregate credit and monetary aggregates, and hence inflation. In 1994 for example, 65 per cent of the economy's total credit went to government. Of the amount that went to government, about 80 per cent came from the Central Bank! Anecdotal evidences of the behaviour of the central bank under the last regime shows very clearly its vulnerability and puts to question its leadership role as far as the economy is concerned.

Does the status of central banks (whether they are independent of government) matter to the outcome of stabilization policies embarked upon the central banks? There are some empirical evidences on the relationship between central bank independence and macroeconomic performance. One in which there is abundant evidence is that between independence of central banks and price stability. The analyses in general tend to show the existence of a statistically significant relationship between central bank independence and reduced inflation. When central banks are independent, it is easier to maintain monetary stability. The results also show that in general, monetary policy was less accommodative of government deficit financing in countries with more independent central banks.

## **V. PROBLEMS AND PROSPECTS OF CENTRAL BANKING**

In this section, I like to point out some of the problems of the Central Bank of Nigeria and the challenges that it faces in the year 2000 and beyond. The challenges are more not only because of the new wind of change under the present political dispensation but particularly within the context of changes pervading the world's global village of which Nigeria is a part. We will need to rectify some of the age-long pitfalls in policy formulation and execution, transparency and accountability. We need more than ever before pro-active

thinking in terms of developmental process and necessary action. In the earlier years, the CBN could be said to have performed creditably well in a number of its functions when we take a look in particular at its promotional roles. There are a number of problems confronting the financial system today. The economy has no doubt gotten more complicated in recent years and in particular since the adoption of the structural adjustment programme. As a result of reliance on the market mechanism, competition among financial institutions increased. The number of operators increased but also there was a lot of risk-taking culminating in excessive non-performing loans. The incidence of fraud and forgeries also increased. No doubt the Central Bank of Nigeria has gone through turbulent periods the last few years and in particular in the periods from 1993–98. There are anecdotal evidences of inability to stand up to the guiding principles of central banking. In the process of its uncanny accommodation the Central Bank threw into the wind its professionalism and monetary responsibilities. The maintenance of monetary stability requires the ability of the Central Bank to put in check the fascination of government with excessive borrowing from Central Bank.

The Nigerian economy is still a cash-and-carry society. While a number of banks in some parts of Africa have advanced into the stage of electronic banking system, we are still where we were some several years back. This is due to lack of trust in the payment mechanism and underdevelopment of necessary infrastructural facilities. The central bank should improve the functioning of the payments system through planning and co-ordination of all activities relating to the payments system. This way, more trust and confidence in the payment system, coupled with an efficient and smooth functioning of the payments system can be ensured.

The banking sector witnessed large scale distress since the early 1990s. The distress is an outgrowth of a number of factors including government's regulatory measures, management incompetence on the part of banks, government interference in some banks. It has not been possible to discover the early warning signals of possible distress because of the poor monitoring system in place. The problems hindering the effective performance of the supervisory institution include lack of autonomy, ineffective supervision/examination of financial institutions and possible confusion of roles between CBN and NDIC. Inadequate banking supervision and coordination by the central bank and other regulatory agencies have contributed to the high incidence of distress of financial institutions. The financial conditions of banks in Nigeria indicate substantial deterioration. Financial institutions require supervision from cradle to grave. Improving the financial condition of banks through constant monitoring and examination, improving bankruptcy law, timely prosecution of delinquent borrowers and fraud activists, and reduction in cost of financial services will enhance the efficiency of the system. Better regulation and supervision are key to prevention. The regulation includes not only the licensing but also the imposition of prudential standards. The financial crisis are not only costly to the economy but also reduce the effectiveness of monetary policy (Fischer, 1997). They are costly because the volume

and efficiency of financial intermediation are reduced when banks are distressed and being closed on a large scale or they are struggling to strengthen their portfolios. The effectiveness of monetary policy is impaired because banks which are in trouble do not respond appropriately to interest rate changes. Additionally, the central bank has to exercise caution in using monetary policy for fear of damaging fragile banks.

One of the greatest challenges facing the central bank in its future monetary policy in this economy is to bring inflation under control, stimulate output and employment, and foster financial deepening. These are no mean tasks and yet very desirable for the economy.

This brings me now again to the issue of the relationship between the Federal Ministry of Finance and the Governor of the Central Bank. It is possible for the central bank to be independent within the government and carry out the design and its monetary policy execution with a high degree of professionalism as in other central banks around the world. For the central bank to maintain monetary stability, it must be in a position to put a "stop" to government's insatiable appetite for excessive credit.

Before concluding, let me mention two very important developments which are likely to test the will and ability of the Central Bank of Nigeria in the future. The first relates to the issue of financing development in Africa. The traditional sources of finance for development, official development assistance, has been drying up. The need to look for alternative and sustainable sources of finance has become imperative. Some of the sources that are being discussed include foreign direct investment flows, and capital flight reversal. Both of these flows have implication for macroeconomic stability and have to be managed properly. Second, the Asian financial crisis informs us that weak financial structure can at best compound the problem of economic management. There is need therefore to modernise the financial sector to catch up with the rapid expansion of private capital. It also informs us of the need to look critically at the applicability of the liberalisation of capital account in an environment of volatile international capital flows<sup>3</sup>.

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3. For details on this and other issues see S. Ibi Ajayi, *The Challenges of Financing Development in Africa*, United Nations Economic Commission for Africa Discussion paper series ESPD/DPS/99/2, see also paper of the same title presented for the Joint Conference of African Ministers of Finance and Ministers of Economic Planning, Addis Ababa, Ethiopia, April, 1999.

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