Economic and Financial Review

Volume 17 | Number 1 Article 1

6-1-1979

The role of a central bank in an economy

O.O. Vincent

THE ROLE OF A CENTRAL BANK IN AN ECONOMY

O. Ola Vincent
Governor, Central Bank of Nigeria

The lecture seeks to spell out the origin, nature and importance of Central Banking in the market-oriented economies. The lecture is divided into six parts. Part I discusses the concept of central banking including its origin and rationale. Part II is devoted to a brief discussion of the Functions of a central bank. In Part III, monetary policy formulation and implementation, the most important function of a central bank is discussed in some detail. Part IV discusses the relationship between Government and the Central Bank while Part V focusses on the Nigerian situation, especially the relationship between the Central Bank of Nigeria (C.B.N.) and the Government (Treasury). Part VI summarises the paper.

Part I
CONCEPT AND ORIGIN OF CENTRAL BANKING

I like to begin the lecture by asking the grass-root question, "What is a Central Bank?". Briefly and functionally defined, a Central Bank is the national institution that traditionally possesses the monopoly of the issuance of legal tender money in a country; it is entrusted with the custody of the cash reserves of the banking system (i.e. functions as a banker to banks); and acts as lender of last resort. It usually acts as banker and financial adviser to government, and in most cases, it is the custodian and manager of the nation's foreign exchange reserves. A major and perhaps the most important function of a central bank is the formulation and execution of monetary policy which involves the discretionary control of money supply in pursuit of specified national economic goals. Thus, in character, it is central; it is a macro institution whose activities affect the whole national economic life.

Origins of Central Banking

Most central banks in today's developed economies did not start off in the same way as the newer ones in the developing economies did. In many cases, they were privately-owned, joint-stock commercial banks that gradually acquired the sole right of the issuance of legal tender money in the countries in which they operated. Thereafter they took on other functions of central banking and eventually statutorily became known as the Central Bank of the country with or without complete government ownership.

For example, the Bank of England was founded by a group of City of London merchants as a joint-stock bank with limited liability in 1694. Although between 1694 and 1877 it gradually assumed all the functions of a central bank outlined above, it was nationalised only in 1946 from when it could be described as a prototype central bank. Banque de France (the Bank of France or Central Bank of France) was established in 1800 by Napoleon. Since 1848 it has been the sole bank of issue in France and from then on assumed all the other central banking functions although it was nationalised only in 1945.

There are, however, two notable exceptions to this pattern of origin of central banks in the developed countries. These are the Bank of Canada and the Federal Reserve System of the United States. Each of them was set up as a central bank from the start and vested with all the functions and powers of a central bank. The Federal Reserve System of the United States (a system of 12 Federal Reserve Districts each with its own Federal Reserve Bank whose activities are co-ordinated through the Federal Reserve Board in Washington) was set up by the Federal Reserve Act of 1913 as a Federal Central Banking system for the United States. The Bank of Canada was established in 1934 and nationalised in 1938.

In many of the less developed countries, (LDCs) central banks were set up by Governments to perform functions similar to those of the more developed countries (MDCs) as well as engage actively in the promotion of accelerated economic development. Thus, the most common form of central banks in the LDCs is a government-owned institution.

It is evident from the above exposition that modern central banking is a relatively recent economic phenomenon that rarely predates this century. Prior to the establishment of central banks in the developed economies, the concept of the "invisible hand," (enunciated by Adam Smith), a natural law which operates automatically with built-in penalties and rewards and which inevitably pushes and restores the economy to equilibrium was accepted as a sufficient regulatory force in the sphere of economic activities.

Confidence in the invisible hand was undermined in England during the period of many banking and monetary crises especially those of 1825-1837, 1847, 1857 and 1866 which were contained because the Bank of England used its paternal influence and relationship with other British banks to restore order. This firmly established the Bank of England as Great Britain's central bank. Eventually many countries emulated the example of Britain and established central banks in their countries and today the Bank of England enjoys the unique honour of being called the mother of central banks, although the Riksbank of Sweden is chronologically the oldest Central Bank in the world.

These and other central banks both in the MDCs and LDCs were established as alternative to the self-regulatory system of the "invisible hand" which proved inefficient in preventing frequent financial crises. Thus, they were set up and empowered to exercise discretionary control over the financial system in particular and the economy in general. The LDCs were not spared of the menace of financial crisis prior to establishing their own central banks. Nigeria is a case in point. For example, it was after the collapse of the banking boom of the late forties and early fifties in Nigeria that the Banking Ordinance of 1952 was passed. Then followed moves between 1952 and 1958 to establish the Central Bank of Nigeria (CBN) with power to exercise discretionary control over the financial system and consequently influence overall economic activity in the country.

There is, however, a major difference between the financial systems of the MDCs and those of the LDCs at the points in time in which they established their Central Banks. In the MDCs developed financial systems were already carrying out sophisticated banking operations. But they tended to misbehave rather frequently and thus plunged these economies into several financial crises. Besides, their performances revealed some gaps and loopholes in the financial arrangements within these economies, the plugging of which called for positive action by their respective governments. Thus, in these countries, central banking was justified by the need for an institution that could control the existing financial systems and promote the goals of national economic development.

In the LDCs, the situation was different. Many of these countries had no financial system worthy of mention. Where a skeletal financial system existed, it was predominantly, if not wholly foreign-owned and controlled. In terms of financial arrangements, whatever existed was between the foreign banks and their head offices overseas and had little or no consideration for the local economies in which they operated. Thus, the need for these economies centred around establishing the necessary indigenous financial institutions and arrangements which could be effectively manipulated to achieve the goals of their respective national economies.

Nationalism was another important factor that accounted for the establishment of central banks in different countries. Nationalism dictated that the national image of each country should be adequately projected in international financial relationships. This could best be done through owning a central bank that would represent the country in international financial forum, hence the call during an international monetary conference in 1922 that every country that had no central bank should establish one. Following this, as many as thirty-nine central banks were established between 1921 and 1935 mainly in the MDCs. Later, the LDCs followed suit. Many of the Central Banks in the latter economies were set up to replace existing currency boards, such as the West African Currency Board that served former British West African Countries as an automatic currency exchange institution that had no monetary management functions, no control of banking operations and were foreign in character and orientation.

Part II
FUNCTIONS OF A CENTRAL BANK

Central Banking functions include the so-called traditional ones and the developmental ones emphasised by the less developed countries. The major traditional functions are, the issuance of legal tender currency, exercising surveillance over the operations of the banking system with a view to ensuring sound banking practice; management of a country's foreign exchange reserves; formulation and implementation of monetary policy; acting as banker to Government and other banks and as financial adviser to Government. The developmental functions embrace the building up of a sound financial structure and the active promotion of capital formation necessary for accelerated economic development.

Issue of Legal Tender Currency

Because of the primary importance of legal tender currency (notes and coins) in the smooth functioning of an economy and in the development of the economy, the issue of legal tender money was the foremost responsibility of all central banks the world over. The names, denominations and forms of such currencies came to be ultimately determined by the government and central bank after the central bank acquired sole right of issue of the currency. The currency of a country is regarded as its national emblem in the economic field. As such its internal and international values have to be jealously safeguarded. To this end, central banks endeavour to prevent over-issue of their country's currencies in order to avoid its depreciation. They also seek to provide it with adequate volumes of foreign exchange backing so as to maintain international respect for it even where it is not a traded currency as is the case with currencies of virtually all developing countries.

Legal tender currency is generally termed base money or high powered money because it forms the basis of commercial banks' money and a credit creation. The issue of legal tender currency originates from the monetization of credit instruments (principally of the government) by the Central Bank as well as from the monetization of foreign exchange surrendered to the central bank by all sectors of the economy.

To service the economy with legal tender currency, the central bank organises not only its production but also its distribution and the periodic replacement of unserviceable ones. It recommends legislations to prevent the production and circulation of counterfeit currency in the economy by unscrupulous elements and thus ensure that the currency is not debased.

Management of External Reserves

In managing the nation's external reserves,[1] the central bank seeks to maintain an adequate volume of external reserves to preserve the value and international respect of its domestic currency.

Thus a major focus of policy in this context is the conservation of reserves. Regulations as to how the release of foreign exchange to economic agents that need them for foreign payments is formulated to guide the central bank in allocating foreign exchange. Rationing of reserves is necessitated by the fact that there is hardly any country which could boast of having adequate foreign reserves that could be freely used by all in the economy for all types of foreign transactions without restrictions. Even the U.S. and U.K. whose national currencies are used as international currencies have to limit the amount of it that could be made available at different points in time. The regulations relating to foreign exchange management involves placing restrictions on remittances both for current and capital transactions.

Another approach to foreign exchange management involves hedging against fluctuations or depreciation in the value of foreign reserves of a country as could be caused by extraneous factors such as devaluation or depreciation of international currencies in which the reserves are held.

[1] External reserves are generally made up of gold, convertible currencies, foreign bank balances and foreign short-dated government debt instruments.

Developmental Functions

The developmental roles of central banks are more germane to the LDCs than the MDCs. As has been noted earlier, the latter economies have the necessary financial structure and arrangements which give their central banks the scope to exercise their traditional functions. The former economies lack them. Thus in the LDCs, central banks have first to build up the financial structure and nurture the financial arrangements which they have to regulate for the orderly growth of the economy.

Most central banks in developing economies as exemplified by the Central Bank of Nigeria have had to establish money and capital market structures as well as organise their modus operandi. The vital contribution by the Central Bank of Nigeria to the setting up of the Lagos Stock Exchange in 1961, its financial support to the establishment of specialised banks such as the Nigerian Industrial Development Bank, the Nigerian Bank for Commerce and Industry, the Nigerian Agricultural Bank and the Nigerian Mortgage Bank (reconstituted from the Nigerian Building Society) are cases in point. Its introduction and management of various money market instruments such as the Treasury Bills (1961), Treasury Certificates (1968), Certificates of Deposits (CDs) and Bankers' Unit Fund (BUF); (1975) are other examples of its role in fostering the development of a diversified financial structure and instruments. These activities are undertaken for the purpose of finding the funds for economic development and stimulating much needed capital formation. Most developing economies pursue economic development by formulating and implementing economic development plans. Nigeria has launched and operated not less than four such plans since the eve of her political independence. The financing of these plans has been and remains a major concern of the C.B.N. Here lies the explanation for the floatation of numerous government development stocks, the unsubscribed portions of which are generally taken up by the C.B.N.

Other Functions

The central bank renders several other services to the government and the banking system. These include acting as banker to the government as well as acting as its financial adviser. As banker to the government, the central bank keeps accounts for the government (including state governments in a federal system). It manages government's public debt by floating or/and, underwriting such debt instruments receiving the proceeds of such loans and paying the subscribers their interests and capital when these fall due.

To other financial institutions in the economy, the central bank acts as lender of last resort mainly to ensure the stability of the financial system. It keeps part of bank cash reserves as current accounts on which they draw for clearing purposes. It creates and manages money market instruments of various descriptions and organises efficient clearing of cheques among the banks.

In general, central banks manage government debt either entirely on their own as in Nigeria or in conjunction with the Treasury as in U.K. Management of government public debt involves floating government loans of short, medium or long-term maturity. Short-term government loans are raised through the issue of treasury bills or/and certificates while long-term loans are raised using government stocks. Some central banks underwrite these loans to the extent that is not taken up by the banks, non-bank financial institutions and the general public. This is the practice in Nigeria. In other countries such as the U.K., the central bank does not determine what amount can be raised but rather the commercial banks and other financial institutions bid for the take up of government debt instruments by tender either as syndicates or severally. The interest rates payable on the loans are determined by market forces and not given by the central bank as in the case of Nigeria.

Part III
MONETARY POLICY

Objectives of Monetary Policy

The objectives of monetary policy (or management) as part of the traditional functions of central banking include the maintenance of relative price stability, a desired rate of economic growth, low rate of unemployment and a healthy balance of payments position. In the LDCs, the promotion of a sound financial structure and ample financing of a desired pace of economic growth are additional points of focus. The maintenance of relative price stability implies striking a balance between money supply growth rate and real output growth rate. In formulating realistic monetary policy to be pursued in any given period the desired rate of growth of national output must be known. Then a projection of what level of money supply would be appropriate for this projected level of output is made and efforts are subsequently geared towards ensuring that money supply does not exceed or fall short of the desired level.

While the central bank has the task of setting the desired level of money supply, the decision as to the desired level of output growth and employment is more often than not a political one that belongs to the government. Thus the money supply target of the central bank has to be consistent with the stated macro-economic objectives of the government.

It is generally recognised that the surpluses or deficits in a country's balance of payments are somehow connected with its rate of monetary expansion through credit expansion unless the economy is a closed one. In an open economy, excessive credit expansion or deficit financing in both the private and public sectors leads to a draw-down of foreign reserves where such credit is used to finance imports in excess of exports. To prevent unnecessary reserve drain, a central bank might, if considered desirable and beneficial to the economy, try to forge a balance between foreign receipts and payments. If foreign payments are met from bank credit which could not be repaid by foreign earnings of equivalent amount, the credit overflow is plugged using various devices discussed below under instruments of monetary policy. If on the other hand a country experiences balance of payments surpluses the fear that such built-up surpluses could result in excessive domestic money issue and its attendant inflationary pressures would call for a further opening up of the economy for increased importation of goods and services and exportation of capital.

Instruments of Monetary Policy

The instruments of monetary policy in both the developed and developing countries today include: open market operations; the rediscount or bank rate; moral suasion, various forms of reserve requirements including cash and liquidity ratios, special deposits and stabilization securities; selective credit control; and direct regulation of interest rates.

Open Market Operations involve discretionary sale or purchase of government debt instruments in the money market by the central bank. The sales are carried out to reduce the liquidity or cash holding of the banks and the public while the purchase is to increase it. Its application necessitates the variation of the rediscount rate and other interest rates, that are linked to it—raising the rates at a time of sale and lowering them at a time of purchase. For open market operations to be effective, there have to be a developed and interest-sensitive money and capital markets in which dealers are financially literate and alert enough to read and understand the indicators and to utilise the given opportunities. In this context it is clear that only the MDCs with developed money and capital markets can effectively use this instrument to achieve the desired objectives of policy.

Moral Suasion—an injuncton to banks to exercise caution in credit expansion, or lend more to selected sectors of the economy or observe certain banking procedures—is an age-long instrument. It is always in use even where specific measures are stipulated along with sanctions for non-compliance, because the successful implementation of monetary policy requires the co-operation of all financial institutions concerned with the given directives.

Reserve Requirements

Cash reserve requirements and liquidity ratio stipulations have to do with ensuring that banks maintain safe ratios between their deposit liabilities and the cash or liquid assets they hold. It can be used to limit banks' credit expansion as well as to ensure that they are always in a position to meet their customers' demand for cash. The cash and liquidity ratios are expressed as the ratios between their deposit liabilities and their cash holding and selected liquid assets, respectively. Different countries stipulate different reserve ratios. In Nigeria the cash ratio was not emphasised for regulatory purposes until recently. Emphasis was placed on the liquidity ratio which has, nevertheless, remained at 25 per cent since it was first stipulated although the composition of qualified liquid assets has been varied over time. In some MDCs such as the United States of America, the cash ratio is an important monetary policy instrument.

Special deposits are supplementary reserves used to scale down the volume of banks' liquidity when it is feared that excessive bank cash balances may induce excessive credit and monetary expansion. The deposits are made by commercial banks in the central bank and are not allowed to be used as base for credit expansion in that they do not count as liquid assets. Generally these deposits earn no interest. Nigeria called for these deposits in the civil war years in connection with local currency pre-payment for import and currently for the same reason and as a penalty to recalcitrant banks for short-falls in stipulated loans and advances to agriculture and residential building construction. Stabilization securities which also belong to the same class of instruments are issued by the central bank to commercial banks at given interest rates and serve the same purpose as special deposits in terms of squeezing banks' excess cash holdings and restricting their credit expansion. The securities are issued at the discretion of the central bank based on the level of excess cash holdings of the banks as judged by the central banks. The issue of these securities could be intermittent depending on the circumstances. For example, the Central Bank of Nigeria has in the current fiscal year discontinued the issue of these securities because the banks' cash and liquidity ratios have decreased significantly from the levels of the past two previous fiscal years.

Direct credit control is the stipulation of permissible rates of banks' credit expansion over a given period. It could take the form of an overall ceiling on aggregate credit expansion or sectoral allocation of permissible increase to different sectors of the economy or both. In Nigeria, both variants of selective credit control have been applied in various years from 1969/70 to date. Other countries apply one form of credit control or the other as their economic circumstances dictate.

Another instrument of monetary policy that deserves mention here is *exchange control*, which is the control exercised by central banks over the release of foreign exchange to economic agents that need them for foreign payments. Few countries permit the unrestricted use of their foreign reserves for foreign payments. This is because the volume of foreign reserves in any economy frequently fall short of the demand. Even the United States of America and the United Kingdon whose national currencies are internationally traded impose limits on the amount that could be used for any foreign transactions. Such restrictions are aimed at ensuring that at any point in time, the central bank should be able to meet very pressing demands for foreign reserve backing that are necessary to accord the national currency a respectable and safe status in international financial markets. This is the reason behind the adoption of exchange control by the Central Bank of Nigeria from the late sixties to date, even during 1974-76 when our foreign reserve level was very high.

Limitations of Monetary Policy

The problems of monetary policy formulation and implementation centre around the early detection of the financial and economic conditions that call for change in the stance of monetary policy, the timing of necessary action and the nature and extent of action to be taken, and more importantly the uncertainty and unpredictability of the likely effects of the action when taken. The central bank requires other banks and financial institutions in the economy to report periodically on their activities so as to monitor the trend of monetary development in the economy. The central bank also requires data on the developments in the real sectors of the economy to enable it to reach an objective judgement of what policy actions to adopt at any point in time.

In the MDCs where reporting is regular and data collection machinery is more efficient, it is less difficult to detect in good time when things are getting out of hand in the economic scene. But in the LDCs reporting is often irregular and less adequate and consequently the detection of upsetting monetary trends are much more difficult and less timely. Relevant real sector statistics are even more difficult to obtain as adequately and timely as needed.

Even when detection of destabilising monetary developments is timely, the decision as to what corrective action to take and its extent is not often so clear-cut. The situation may be worse if the freedom of action of the Central Bank is seriously circumscribed. Few economies accord their central bank complete autonomy in deciding the instrument and timing of what monetary policy actions to take in correcting disequilibrating monetary forces. In the process of reaching an agreement with the government on what actions to take in periods of monetary disturbances, the central bank might find that whatever actions are eventually taken might not be adequate or timely for the attainment of identified objectives. That is why the central banker more often than not persists in asking for complete autonomy in monetary management. But because monetary management is expected to be operated within the context of specified national economic goals (which goals are invariably politically determined), the central bank has to defer to or at least cooperate with the whims and caprices of the government of the day. This is one of the fundamental problems of monetary management.

Part IV
CENTRAL BANK—GOVERNMENT RELATIONSHIP

Although a central bank is a government institution, it is not in all cases that it is completely government-owned in terms of capital. The newly established central banks in the LDCs are virtually government-owned. The authorised and paid up capital of most of the MDCs' central banks which formerly had been privately owned has been nationalised. But there are exceptions. The capital of the central banks of Belgium, Australia, U.S.A., Switzerland, Mexico and Japan are still partly privately-held. The capital of the Bank of Italy is owned by various financial institutions in which the government holds directly or indirectly a majority interest. However, whether a central bank is completely or partly government-owned, the government, in most cases, has less real power than would a majority shareholder in a private company. This is because although the members of the Banks Board and its senior management are appointed by the government the statute of the banks normally provides for a number of safeguards to give these appointees a reasonable measure of independence in the performance of their functions. In this section, we shall discuss the extent of government control of central banks in some selected countries.

Degree of Government Control

In most countries, it is recognised that the central bank is not just like any other parastatal or government agency. This is because it is accepted that the nature of its functions especially as the ultimate source of liquidity and controller of money supply which places it in a special class, calls for its not being controlled by government as other parastatals are. The rationale for this accepted relationship between government and the central bank in terms of control are:

(a) that freedom of operation for a central bank will promote greater flexibility and business efficiency;
(b) that monetary affairs are highly technical and deserve to be managed independently and objectively; and
(c) that undue government interference with central bank monetary management may subject the bank to political pressures that could result in unsound monetary policy and destabilising inflationary financing.

Three central banks that have substantial autonomy could be cited, viz; the Federal Reserve System of the U.S.A., the Deutsche Bundesbank of West Germany and Swiss National Bank. In the case of the Federal Reserve System, neither the Treasury nor even the U.S. President has the authority to dictate to the Board of Governors of the System whether regarding its internal administration or in the performance of its statutory duties or what monetary policy to pursue. The system's Board seek to support the governments economic policy so long and to the extent that such support will not involve compromising its responsibility for monetary and price stability. The Reserve system is only accountable to Congress and the public for the performance of its functions.

The West German Central Bank (Deutsche Bundesbank) is similarly autonomous and does not come under government supervision. Both in its internal administration, and in the performance of its statutory functions and choice of monetary policy it is as autonomous as the U.S. Federal Reserve System. Its relationship with the government is similar to that of the U.S. Federal Reserve System. The Swiss National Bank also enjoys the same degree of autonomy and relationship with the government as the two other central banks mentioned above.

Partial autonomy is enjoyed by other central banks outside the group discussed above. These central banks enjoy considerable autonomy but are subject to dictation from the Minister of Finance or other government functionary in respect of some specific functions of which the most important is monetary policy formulation and execution.

Where the "dependent" central bank and the Treasury disagree over monetary policy issue, the Minister (or Commissioner) can, after consultations with the Bank's management, issue a directive to the central bank as to what policy to adopt. The process of issuing such a directive varies among such central banks. In the Netherlands, for example, the Minister of Finance can issue such a directive after consulting with the central bank which is empowered to appeal to the Cabinet or Executive Council. The cabinet or Executive Council's decision on such issues is final. In Botswana and Canada, if the Minister disagrees with the monetary policy being pursued by the central bank, he would initially inform the bank of his disagreement and subsequently take the matter to the President (in Botswana) or the Governor General-in-Council (in Canada) for consideration and determination. The decision at this level is final. Notwithstanding these powers of government over these central banks under discussion, the independence and prestige of these central banks are still protected through some safeguards or checks and balances.

These are: (a) the bank's right of appeal to the highest authority such as the Cabinet or Executive Council. (b) Where the directive is issued by the government, i.e., the Crown or the Executive Council, the directive together with the central bank's views and government motives for issuing the directive must be made public. In Botswana such a directive must be published in the Government gazette forthwith and laid before the National Parliament within 15 days after the Minister had informed the bank of the policy directives.

A third group of central banks could be described as legally subordinate in that the Treasury is empowered to issue the directive without the type of safeguards provided for the second group above to protect their relative autonomy. Examples are Bank of England, Bank of India, Bank of Zambia and the Bank of France since 1973 when the new Bank of France law was passed. However, in the case of the Bank of England, the Treasury while maintaining its superiority over the Bank is very conscious of the reality that the Bank needs an appreciable degree of independence.

There are however some limitations placed on the amount of government debt instruments a central bank can hold at any point in time. The limits are invariably tied to and set as a given percentage of the budgeted revenue of government in a fiscal year. The stipulated limit is in general practice stated in the statute that established the central bank. This can be ascertained by looking through the Acts setting up these banks. The idea behind setting a limit to central bank lending to government is to ensure that government does not plunge the economy into monetary chaos through excessive borrowing.

The Need for Central Bank Autonomy:

Many advantages have been associated with central bank independence within the government. One of them is that an independent central bank will be able to operate with greater flexibility, speed, and efficiency. Another is the fact that monetary affairs are highly technical and deserve to be managed independently and objectively. However, the most important reason for giving autonomy to central banks is that political control of the currency carries a danger of financial indiscipline and incessant monetary instability. This means that government control of a central bank may subject the bank to political pressures that could result in unsound monetary policy, where the exigencies of government finance may conflict with the dictates of sound monetary management.

If the operation of a central bank is to be in the best socio-economic interest of the people, monetary and banking policies should be as unbiased and detached from any type of partisan interest as possible. As a former Chairman of the U.S. Federal Reserve System (Mr. William M. Martins) put it, "when the Federal Reserve System succumbs to the pressures of political expediency or the dictates of private interest the ground work of sound money is undermined". A Central Bank is in a better position to carry out its functions more efficiently when it is independent within the structure of the government. This is further supported in a recent address given by Arthur F. Burns, former Chairman of the Board of the Federal Reserve System that "the capacity of the Federal Reserve to maintain a meaningful anti-inflation posture is made possible by its considerable degree of independence" and that it is "no accident that Germany and Switzerland which in recent years also have managed their economy better than most others happen to have strong and independent monetary authorities like ours". Similarly, a recent Royal Commission in Canada thought that protection from inflation and from influence on the monetary markets of day to day political considerations unrelated to the broad aims of monetary and fiscal policies were the major reasons for retaining the independence of the Bank of Canada.

It is generally recognised that in a Presidential system of government, a lot of power is concentrated in the hands of the President, and that the President is in a much more powerful position than, say, a Prime Minister under a Parliamentary form of government. This underlies the argument that there is special need for strong and independent central banks in countries that have a Presidential system of government.

Part V
THE NIGERIAN EXPERIENCE

The Central Bank of Nigeria (CBN) was set up under the Central Bank of Nigeria Act 1958 and started full-scale operations on 1st July 1959. The principal objects of the Bank as stipulated in the Act are: the issue of legal tender currency in Nigeria, the maintenance of external reserve to safeguard the international value of the currency, the promotion of monetary stability and a sound financial structure in Nigeria, and serving as a banker and financial adviser to the Federal Government.

The CBN, like any other central bank discharges all the traditional functions of a central bank. But because Nigeria is a developing economy the CBN has had to emphasize the developmental roles of a central bank enumerated earlier in this paper. Even, in discharging the important traditional function of monetary control, it has relied more on direct than on indirect control measures also because of the low level of the country's economic and financial development. For example, it has been prescribing rates of credit expansion and sectoral distribution of credit for the commercial banks since 1969 and merchant banks from 1977. From April 1976 it introduced new financial instruments to reduce banks' liquidity and credit expansion at a time when monetary stability was threatened by a surfeit of liquidity in the financial system.

The developmental functions emphasised by CBN include the promotion of local money and capital markets and the establishment of other related financial institutions, as well as engaging in direct and indirect financing of economic development.

To promote the indigenous money market, the Bank designed and issued the first Nigerian treasury bills in 1960. This was followed by the introduction of treasury certificates in 1968. But before then, it established in 1962, a call Money Fund (Scheme) managed by itself, for investing temporary funds of commercial banks and other financial institutions on overnight basis. This scheme was however terminated in July 1974 at a time when large increases in government revenue from crude oil made it unnecessary to issue the amount of treasury bills requisite to sustain the continued operation of the scheme. At the same time the growth rate of deposit liabilities of the banks accelerated because of the generally high liquidity of the economy. To provide the banks with outlets for their fast growing idle funds three new money market instruments were designed and introduced by the CBN in between 1974 and 1976. These are:

(i) Certificates of deposits aimed at facilitating the channelling of commercial banks' surplus funds to the merchant banks;
(ii) Bankers' Unit Fund (BUF), to provide an avenue for the short-term investment of commercial banks' funds in Government development stocks; and
(iii) Eligible Development Stocks—development stocks of not more than three years maturity which could be counted as banks' liquid assets.

The development of an indigenous capital market has also been the concern of the CBN. In 1961 the Bank participated in the planning and setting up of the Lagos Stock Exchange and acted as its main financier at the early stages. Since then the Bank has contributed to the transformation of the Lagos Stock Exchange to the Nigerian Stock Exchange (N.S.E.) which now has three branches in Lagos, Kaduna and Port Harcourt. This market deals in government securities which are issued and managed by CBN and private securities which have increased both in volume and in value between 1972 and 1978 when the Indigenous Enterprises Promotion Scheme was implemented. The CBN contributed immensely to the successful financing of that scheme through its credit policy which excluded from credit ceilings loans granted by commercial banks to individuals for the purpose of buying shares and business under the scheme.

Another way in which CBN has contributed to the development of the financial system and the economy is through participation in the establishment of specialised financial institutions such as the Nigerian Industrial Development bank in 1964, the Nigerian Bank for Commerce and Industry in 1973, the Nigerian Agricultural and Cooperative Bank in 1973 and the Federal Mortgage Bank in 1977.[1] It advised the government and carried through the set up of a ₦100 million Agricultural Credit Guarantee Fund in 1977 to guarantee commercial and merchant banks' agricultural credit up to 75 per cent. This aims at increasing the flow of credit to the agricultural sector in an attempt to restore the importance of that sector in feeding the nation, foreign reserve earnings and providing industrial raw materials.

The CBN also contributes significantly to economic research and the assembly of economic and financial statistics which are very essential for objective planning by individuals, institutions and the nation. Its publications such as the Annual Reports, Economic and Financial Review and Monthly Reports are concrete evidence of these contributions.

Banking Supervision

The Central Bank took over the responsibility of examining and supervising the commercial banking system in January, 1966. Even before then, reports on bank examinations carried out by the Bank Examiner who was then based in the Ministry of Finance had to be submitted to the Minister of Finance through the Governor of the Central Bank. This was a recognition of the close relationship between monetary policy and banking policy. The bank examines all applications to establish new banks. It receives monthly reports prescribed in the Banking Acts and Annual Monetary Policy Circulars which enable the Bank to monitor the activities of the banks on a continuous basis. The Bank also carries out full scale examination of individual banks at intervals of between 12 and 18 months.

Recent Development in Central Bank of Nigeria/Government Relationship

Although the CBN has existed for only twenty years, there have been some dramatic changes in its relations with the Federal Government of Nigeria which has affected the degree of its autonomy. For purpose of clarity and convenience, the discussion in this section will be carried out under two broad periods—the pre-military era (1958-1966), and the military era (1966-1979).

The Pre-Military Era

The Act that set up the CBN in 1958, entrusted it with specific powers, functions and responsibilities. Under the Act, its Board of Directors had responsibility for the policy and general administration of the affairs of the Bank. Regarding monetary policy, the CBN was entrusted with the responsibility for promoting monetary stability and financial structure. There was no provision in the Act empowering either the Ministry of Finance, the Government or any external body to intervene or dictate to the Bank in these matters. It was not an omission; it was a recognition of the need to leave Central Bank free from interference for political ends. Thus, while recognising that the political arm of the government must retain ultimate responsibility for policy formulation, the original Act guaranteed the Central Bank a measure of independence which is necessary and essential for efficient central banking and sound monetary policy.

In that environment the CBN had a free hand not only in matters concerning its internal administration but also with regard to the performance of its statutory functions. It formulated monetary policy without any dictation from the government or any other external body. However, recognising the fact that monetary policy operates as one important element in the totality of national policies (both financial and non-financial) which are directed towards broad economic objectives, the CBN's process of formulating monetary policy included consultation with the government through the Ministry of Finance. This was done to achieve a desirable degree of coordination of monetary and other economic policies in order to achieve the overall economic objectives of the community. Thus, the relation between the central bank and the government was based on consultation and co-operation which worked satisfactorily.

With regard to internal administration of the Bank, the original Act gave the Bank a free hand to manage its affairs in line with the normal practice all over the world. As specified in the original CBN Act, "All appointments of officials and other employees of the Bank shall be only to positions created by the

[1] The Federal Mortgage Bank was reconstituted from the former Nigerian Building Society.

decision of the Board". The stipulations were adhered to from the inception of the Bank till 1970. The Board of Directors was (as it should be) the highest authority in the management of the affairs and business of the Bank. It employed the various categories of its staff and determined their conditions of service in such a way as to ensure that it was able to attract qualified and capable staff needed to run efficiently the important and delicate business of central banking. The functioning of the Central Bank under these legislations could be said to have been smooth and of a high level of efficiency.

The Military Era

Under the Military regime, the powers and independence earlier conferred on the Central Bank by Acts of Parliament were persistently eroded, particularly by two Decrees, namely Central Bank of Nigeria Act (Amendment) Decree (No. 3) of 1968 and Central Bank of Nigeria (Amendment) Decree (No. 40) of 1970.

The Central Bank of Nigeria Act (Amendment) Decree of 1968 directed that the Board of Directors of the Central Bank shall keep the Commissioner for Finance informed of the monetary and banking policy pursued by the Central Bank. The amendment gave the Commissioner power to present his own case where he disagrees with the CBN, and that of the CBN before the Federal Executive Council for the final and binding decision.

It would appear at first sight that this amendment to the Bank Act did not create a serious dent on the independence of the Central Bank since in the event of disagreement, the final decision would be taken at the Federal Executive Council. However, the danger lies in the fact that the (Amendment) Decree did not specify the mode of presenting Central Bank's case to the Executive Council. The Commissioner is left to present it the way he thinks fit. Since the Central Bank would not be represented at the Council when the matter is being discussed, the Commissioner could intentionally or unintentionally distort the Bank's case with serious consequences to the Bank's status, prestige, and efficiency. True, there has, so far, not been serious conflicts of views between the Treasury and CBN on monetary policy. However, the danger posed by the (Amendment) Decree potentially exists. In recognition of this, the Financial System Review Committee in their report dated December 1976 recommended "an amendment to strengthen the process whereby the Central Bank's proposals on monetary and banking policy reaches the Federal Executive Council". The recommendation was that in case of disagreement, the Commissioner of Finance, should "submit his representation and the representation of the Central Bank, without any abridgement, to the Federal Executive Council". Unfortunately, the Federal Military Government (in its white paper on the Committee's Report) rejected this recommendation.

The provisions of the Central Bank of Nigeria Act (Amendment) Decree No. 40 of 1970 may be summarised as follows:—

(i) any contract relating to any project of a value of not less than ₦0.1 million (now increased to ₦1.0 million) shall be referred to the Federal Executive Council through the Commissioner, for approval, before any award of such contract is made, (section 2(3)).

(ii) The Board of Directors is required to seek the approval of the Commissioner for Finance before it can open branches of the Bank and appoint its correspondents or agents; (section 5).

(iii) "The salaries of the employees of the Bank (other than those of the Governor or his Deputy shall be as stipulated from time to time by the Federal Executive Council, and the Board shall accordingly be guided in terms of the scales of salary provided thereof; and without prejudice to the generality of the foregoing, the scales of salary set out in the schedule to the statutory corporations (salaries) and allowances, etc.) The allowances and benefits, other than salaries and retiring benefits, as may from time to time be stipulated by the Federal Executive Council for members of the public service of the Federation shall in like manner apply to the employees of the Bank."

A superficial observer might, in the light of the foregoing be tempted to think that the Central Bank is just a little more than a department or an office of the Federal Ministry of Finance. But I can say that on the really important issues of monetary policy the views and advice of the Central Bank have generally been respected.

Nevertheless, it is important that under the imminent Presidential system, the legislation enacted by the Military Regime restricting the independence of the Central Bank should be repealed in order to enhance the efficiency and prestige of the Bank. It may also be pointed out that one of the provisions of the new Constitution is that there will be a National Economic Council to be headed by the Vice-President of the Federation. Other members of the Council are the Governor of each State and the Governor of the Central Bank of Nigeria. The function of the National Economic Council is to advise the President on the economic affairs of the Federation, and in particular, on measures necessary for the co-ordination of the economic efforts or economic programmes of the various Governments of the Federation. The membership of the Governor of the Central Bank in the National Economic Council indicates the important role envisaged for the Bank under the new system of administration. It will therefore be very appropriate to repeal those Decrees enacted by the Military Regime which are inconsistent with the autonomy of the Central Bank enshrined in its original Charter.

Early in July this year the Central Bank celebrated the 20th Anniversary of its commencement of full scale operations. Perhaps it will be quite in order to conclude this lecture by quoting a part of the congratulatory message of the Head of State, His Excellency, General Olusegun Obasanjo to the Bank on the occasion, as follows:—

> "The Central Bank of Nigeria has so far successfully arranged and successfully administered few currency issues since its foundation and on each occasion, the Bank confounded the sceptics and critics by making a complete success of the currency change. The Bank further witnessed the period when Nigerian External reserve suddenly rose from a very small amount to the 1973-74 period when it suddenly swelled to literally unmanageable pro-

portion only for the reserve to be fast expended to the dangerously low 1978/79 level when drastic fiscal measures had to be introduced to keep Nigeria out of bankruptcy. As we witness some positive developments in this direction, I can say without reservation that some of the credit for piloting the country away from the path of financial and economic disaster must go to the Central Bank of Nigeria for its timely advice and the dedication with which it implemented Government measures".

"The growth and development of the Central Bank coincided with unprecedented growth in the Nigerian economic and commercial sector the effect of which led in many cases to the overwhelming and crumbling of many a public institution. The survival and indeed the success of the Central Bank of Nigeria in spite of the odds in question therefore amounts to the testing of the resourcefulness, efficiency and dedication of the Board, Management and staff of the Central Bank. Having triumphantly overcome its problems during the last 20 years and particularly in the recent past, I am therefore fully confident that the Central Bank would overcome any problems and challenges that would confront it in future and continue to grow from strength to strength."

Part VI
CONCLUDING SUMMARY

To summarise, we have examined in general the identity, raison d'etre, origin and role of a central bank and its relationship with government. The Nigerian case has been used to exemplify in several cases the features covered in the general case. The salient points emanating from the text are outlined as follows:—

1. The central bank occupies the apex of the institutional structure of the financial systems of mixed economies. This is clearly indicated by its traditional and developmental roles of issuance of legal tender currency, monetary management, supervision of the operations of the financial system; the rendering of various banking services to government and the financial system and the promotion of sound financial structure for the economy, as well as acting as an agent of economic development and as a nation's ambassador in international financial relations.

2. Central banking originated in the more developed economies when these economies decided to replace the proven unreliable automatic control mechanism of the "invisible hand" with discretionary control of their economies. The less developed economies, have also adopted and adapted banking to suit the needs of their economies.

3. Modern central banks are generally completely government owned although some cases of joint public/private ownership still exist. They are generally accorded some measure of autonomy ranging from complete autonomy in some countries to meagre autonomy in others, in carrying out their functions. Central bank autonomy is recognised because of the specialised and technical nature of central bank's pivotal function of monetary management which requires objectivity and freedom from political pressures.

4. The Central Bank of Nigeria like any other central bank has been conditioned by its economic environment both in establishment and in its operations. It is wholly owned by the Federal Government. Although it performs traditional functions of a central bank, but conditioned by environment, it found traditional instruments and approach hardly applicable and resorted to more direct control measures. It also had to emphasise developmental roles for the same considerations. The relation between the Bank and Government was also conditioned by environment. In its early history it enjoyed a high degree of autonomy. But later on when government changed from civilian to military and especially during the civil war the environment required more direct intervention in the affairs of the Bank.

5. Certain Legislations enacted between 1968 and 1970 have eroded the autonomy of the Central Bank. In spite of these constraints, the Bank has successfully, in co-operation with the Government, steered the economy through years of varying monetary and economic experiences.

O. Ola Vincent
Governor
Central Bank of Nigeria,
Lagos.

Lecture delivered on the 10th September, 1979, at National Institute for Policy and Strategic Studies, Kuru, near Jos.