Joseph O Sanusi: Central banking authority, economic stability and the rule of law

Paper presented by Dr Joseph O Sanusi, Governor of the Central Bank of Nigeria, at the Ninth Annual Harvard International Development Conference, Boston, 4 April 2003

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I. Introduction

It is a great privilege for me to participate in this year's Harvard International Development Conference. The theme of the conference is quite relevant to developing countries. I, therefore, thank the organizers for the opportunity offered me to share my thoughts and experiences with you on: Central Banking Authority, Economic Stability, and the Rule of Law.

The world over, the development process is anchored on the pursuit of sound macroeconomic policies that will promote sustainable economic growth, create more jobs, and ensure equitable distribution of income to raise the living standard of the populace. The successful pursuit of these goals requires policies that will promote openness in trade, efficient financial system, increased capital flows, development of information and communication technologies and enhanced technical capability. The implementation of such policies would enable a country to integrate into the world economy and derive the gains and, sometimes, the risks from globalization. The centrality of the central bank in forging the necessary macroeconomic environment for sustainable economic growth and development is generally incontrovertible. The theme for this panel discussion is very appropriate in this regard.

The key issues I seek to explore at this forum are:

- *What is the role of the central bank and monetary policy in the development process?*
- *What has been the experience of the Central Bank of Nigeria in the development process?*
- *What are the challenges and constraints facing the Bank in the process?*

In discussing these issues, my focus will be on the experience of the Central Bank of Nigeria, in the context of international best practices.

II. The role of the Central Bank and monetary policy in the development process

The pursuit of price stability has come to be regarded as the *raison d'etre* of central banks in recent times. The near universal acceptance of price stability as the overriding goal of monetary policy derives from the recognition that, in the long run, monetary policy impacts on the price level and its dynamics. Consequently, policy instruments at the disposal of central banks should be capable of influencing the price level and expectations in the desired direction, toward the achievement of non-inflationary economic growth.

The issue that arises at this juncture is whether the central bank's pursuit of price stability and financial sector soundness is the only requirement to sustain the development process. While the maintenance of price stability has increasingly become the main mandate of most central banks, those in the developing countries are charged with the responsibility to promote economic development, in addition to the pursuit of the macroeconomic stabilization objective.

Central banks' direct role in the development process, especially in less developed economies, stems from the absence of efficient financial markets and institutional structures, which are pre-requisite for the effective transmission of monetary policy to the real economy. In addition, in the pursuit of the overall economic goals of the nation, the stabilization objective of the central banker often conflicts with the sectoral pursuits of the political authority.

One thing all central banks, the world over, have in common is the maintenance of financial stability as a key factor influencing macroeconomic performance and efficient payments system. The legal framework and institutional arrangements vary widely country by country in the context of the act establishing the central bank. As we are all aware, a central bank is usually established by an Act of Parliament that clearly states its mandate.

III. The experience of the Central Bank of Nigeria (CBN)

The critical role of the CBN in the management of the Nigerian economy has been made obvious by the provisions of the law establishing the Bank. The core mandate of the CBN as spelt out in the CBN Act of 1958 include: issuance of legal tender currency, banker and financial adviser to the Federal Government, lender of last resort to banks, maintenance of external reserves to safeguard the international value of the currency, promotion of monetary stability and a sound and efficient financial system. In order to discharge its responsibility efficiently and effectively, the Bank must have credibility within and outside the country. Towards this end, the Act, with the subsequent amendments, goes further to establish a governance structure with an independent Board with responsibility for policy formulation and administration of the Bank, subject to periodic reports to both the Executive and Legislative arms of the government.

Although the original Act mandates the CBN to promote monetary stability, it was in the 1999 amendment to the Act that actually conferred discretionary powers on the Governor, the Board and Management of the Bank, in the formulation and implementation of monetary policy, especially the determination of the appropriate interest rate regime and exchange rate policy. In other words, the Bank was granted instrument autonomy under the amendment to the Act. In view of the destabilizing effect of monetary financing of Government deficits, the Acts specifies the limit of the CBN lending to government in terms of Ways and Means Advances to the Federal Government in the event of temporary deficiency of budget revenue, which should not exceed 12.5 per cent of its estimated recurrent budget revenue. Such advances should be repaid fully by the end of the Government's financial year. Moreover, the total amount of Government securities of more than two years tenor held by the CBN should not exceed 75 per cent of the total demand liabilitiies of the Bank.

Cognizant of the importance of central bank autonomy for and the significance of fiscal prudence to the effective conduct of monetary policy, the CBN was actively involved in the *Fiscal Responsibility Bill*, currently under consideration by the National Assembly of the Federal Republic of Nigeria. The law, if passed, would establish further limits on Government borrowing from the CBN. Under the current dispensation, the effectiveness of monetary policy is often constrained by fiscal surprises. In particular, monetary financing of large fiscal deficits, which averaged 7.5 and 5.6 per cent of GDP annually in the 1980s and 1990s, respectively, resulted in the over-burdening of monetary policy and its effectiveness. This has of course been moderated by the current democratic government and reduced to annual average of 4.0 per cent in 2001 and 2002.

In keeping with the principle of transparency and accountability in the conduct of monetary and financial policies, the CBN publishes its monetary policy objectives, targets and measures for a two-year period. The exercise involves the review of developments in the economy during the preceding year, the identification of the prospects and problems in the years ahead and the outlining of the policy goals and performance targets for the period. The *Monetary Policy Committee* (MPC) meets every fortnight to appraise the performance of the economy and conditions in the money and foreign exchange markets with a view to reviewing the current policy measures, either in terms of adopting new policy initiatives or fine-tuning the existing ones as the need arises. The Committee is made up of the Governor as Chairman, four Deputy Governors and heads of relevant departments as members. Others are two members of the Board of Governors, including the Permanent Secretary, Federal Ministry of Finance.

In the spirit of transparency, the summary discussions and decisions of the MPC are communicated to the general public in newspaper publications every month. Similarly, another committee, the *Financial Sector Surveillance Committee* (FSSC) also meets every fortnight to review developments in the financial sector with a view to taking appropriate regulatory/supervisory action that will ensure the stability and soundness of the system.

Moreover, in order to enhance regulatory effectiveness and stability of the financial sector, the *Financial Services Regulation and Coordinating Committee (FSRCC), meets to* coordinate activities of the various regulatory institutions in the sector. *The* CBN Governor acts as the chairman, while other members include chief executives of the Securities and Exchange Commission, Insurance Commission, Corporate Affairs Commission and the Federal Ministry of Finance. The Committee works towards minimizing arbitrage opportunities that are usually created by differing regulatory and supervisory standards among the various agencies; deliberates on problems experienced by every member in its relationship with any financial institution, and bridges any information gap encountered by any regulatory agency in its relationship with any type of financial institutions.

The CBN takes its obligation to enlighten stakeholders in the economy on monetary and financial policies seriously. In this regard, the need to communicate to and obtain feedback from the public was instrumental to the establishment of the *Monetary Policy Forum*, as a medium for dialogue and public enlightenment among the monetary authorities, the banks, academia, organized private sector and other stakeholders in the economy. The Forum was created, bearing in mind that monetary policy works best in an environment in which the views of key stakeholders are taken into consideration in both its formulation and implementation. This initiative is consistent with the global move towards greater transparency and openness in the conduct of monetary and financial policies. The Forum also serves as a medium for educating the public on CBN's monetary policy operating framework, targets and outcomes. It meets quarterly, while the wider forum, the *Annual Monetary Policy Conference, holds* every November. Finally, consistent with Section 9, (a) and (b) of the Act, the Bank, from time to time reports to the President and makes a formal report to the National Assembly of the Federal Republic of Nigeria bi-annually. Clearly, these processes and structures have contributed in no small measure to the positive profile of the CBN in recent times.

The CBN, like most central banks in the developing economies, undertakes some non-traditional central bank functions such as promotion of economic development, especially during the formative years in the 1960s and 1970s. The contribution of the CBN in this regard, was focused on the creation of the financial environment and institutional framework conducive to the mobilization and channeling of financial resources into productive investment. Thus, during the first decade of its establishment, the Bank concentrated on the task of promoting and transformation of the rudimentary financial structure of the economy. These included the issuance of money and capital market securities such as the Nigerian Treasury Bills and Federal Government Development Stocks. Moreover, it provided technical assistance to other relevant institutions, and start-up capital for the development of money and capital market institutions. The CBN nurtured from the cradle such institutions like the Nigerian Stock Exchange, Securities and Exchange Commission and Nigeria Export-Import Bank. The specialized finance institutions established by the CBN, in collaboration with the Federal Government, included the Nigerian Industrial Development Bank (NIDB), Nigerian Bank for Commerce and Industry (NBCI) – both now merged to form the Bank of Industry (BOI) to provide long-term capital for development. The CBN initiative to encourage long-term bank lending to the economy included the establishment of various refinance and guarantee schemes, focused on the priority sectors of the economy. Two of such schemes are *the Agricultural Credit Guarantee Scheme Fund (ACGSF), and Export Refinance Scheme.*

IV. Challenges and constraints

As central bankers, it is beneficial to evolve the culture of a regular critical appraisal of our performance with a view to improving on our effectiveness and adapt to changes in the economic environment. Clearly, every central bank faces constraints in the conduct of economic policies, some of which create the problem of policy credibility. While some of such constraints are attributable to external factors, most are induced from within the domestic economy. Our experience in Nigeria is not an exception.

Trade off in price stability mandate

One of the major problems is policy conflict in the pursuit of the overall economic objectives of government, particularly the trade-off in the pursuit of stabilization and growth objectives. Sometimes central banks are confronted with problems of inflation and stagnation, otherwise known as stagflation. If the central bank sticks rigidly to the mandate of price stability, it might address the problem of inflation in such a way that the fall in aggregate output might be exacerbated. If, on the other hand, the problem of weak growth performance is to be addressed, policies designed to stimulate higher levels of economic activity might result in further acceleration of the inflation rate. The need to maintain a delicate balance between the two conflicting objectives is, therefore, obvious.

Whatever policy mix is adopted, it is bound to influence the way central bank’s policies are perceived by the public and the confidence it engenders in the financial system. One of the ways we have addressed this dilemma in Nigeria is to ensure that, in the pursuit of the primary objective of price stability, due consideration is given to developmental objectives. As much as possible, the CBN has avoided direct intervention in development financing, particularly where lending at interest rates below the market rates are involved. The Bank has, in this regard, embarked on schemes to establish quasi-government institutions and encouraged government funding through the Budget. There are also some relevance in the provision of refinancing and credit guarantee schemes, as earlier outlined, particularly for the agricultural and industrial sectors. The risk is that such schemes could discourage the growth and efficiency of financial intermediation, particularly the mobilization of domestic savings.

Macroeconomic policy environment

Economic policies can only succeed where infrastructural impediments to supply response have been substantially minimized. Because most macroeconomic policies (especially monetary policy) work best through their effect on aggregate demand and supply conditions, structural problems could make the economy less responsive to policies. When a policy fails to achieve the intended objectives, it creates credibility gap for the central bank and outright pessimism in the process. Our approach to dealing with this problem has been to enhance public understanding of what monetary policy can and cannot do, while collaborating with other organs of government to ensure the complementarity of the various economic policies.

Financial market infrastructure and institutions

The absence of efficient and sound financial institutions and necessary market infrastructure, which are critical to effective conduct of monetary policy and its transmission mechanism, constitutes a major constraint to the achievement of policy goals in most developing countries. Institutional reforms, enforceable tax policy, simplified accounting framework and a fair and efficient judicial system, are important for effective policy implementation in a coherent, credible and consistent manner.

Credible information

Poor and unreliable data is another major constraint to credible policies. The lack of timely and reliable data renders monitoring and evaluation of policy implementation difficult and the analysis arising from such data, less reliable. This undermines the setting of accurate targets and causes delays in policy response to changes in economic conditions.

Fiscal dominance

The essence of complementarity between monetary and other policies, particularly the fiscal policy, has always been emphasized as critical to the effectiveness of monetary policy. In countries characterized by fiscal expansion, resulting from large deficits financed by the banking system, particularly the central bank, the achievement of monetary policy objectives becomes very difficult. Indeed, the outcome of the central bank policies becomes uncertain. This problem has been addressed, effectively, in many countries particularly among those that have experienced intractable problem of inflation, through the prohibition of central bank lending to the government. Efforts to limit the financing of government deficits by the CBN have not been successful, despite its operational autonomy. The problem of fiscal surprises in the country is compounded by lack of control in the expansionary fiscal operations of the state and local governments.

Corporate governance

For credibility of the central bank to subsist, a widely accepted corporate governance arrangement must be put in place. In this regard, good governance must begin with internal consistency in the bank’s operational framework and administrative structure such that the attainment of the primary objective of monetary and financial sector stability will be ensured, while high quality of service to government, financial institutions and other stakeholders in the economy is maintained. Besides, robust contingency plans that will promote the soundness and stability of financial institutions must be strictly implemented.

In recognition of the fundamental role of the effective conduct of monetary policy in any economy a central bank should accord special attention to enhancing its efficiency. Towards this end, the central bank must be mindful of the quality of its staff in terms of technical skill, competence and knowledge. Cognizant of the need for capacity building to ensure enhanced efficiency in meeting its mandate, the CBN has in the past three years embarked on a comprehensive reform agenda under which its work processes and procedure have been upgraded and re-engineered.

V. Conclusion

In conclusion, I would like to make some suggestions on how good governance can be enthroned and measured, drawing on international best practices. In consonance with the principles of good governance, central banks should be autonomous from government in discharging their statutory mandates. Such independence has often been associated with the powers to limit credit to the government, given the destabilizing effect of central bank lending to finance public sector deficits. Governments should be forced to balance their budgets or borrow at market rates to finance their deficits. Although this might be a problem for countries with under-developed financial markets, the effect in promoting fiscal discipline and facilitating the achievement of growth objectives is deemed to be more profound. An independent central bank should ensure that its policy intervention is well coordinated in the context of the overall government economic policies and objectives.

Policy Credibility can also be enhanced if central banks submit themselves to third party assessments, e.g. by the IMF, World Bank, and subscribe to acceptable international conventions and codes on central banking. Such a convention is the 1988 Basel Accord, which established guidelines on international minimum capital standard that limits banks' capital requirement to their credit exposure. Adopting such standards would encourage central banks to reform their procedures and processes in line with international best practices.

Moreover, accountability and transparency are best enhanced through effective information dissemination. Central banks should periodically subject themselves to public scrutiny on their operations and frameworks. Another best practice that comes to mind is the example of the Reserve Bank of New Zealand, where every year, an outstanding economist is appointed and mandated to review the monetary policy of the previous year.

These are some of my thoughts on strategies for enhancing the effectiveness of monetary policy in achieving economic stability. I sincerely thank you all for your kind attention.