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CENTRAL BANK AUTONOMY, ACCOUNTABILITY AND GOVERNANCE IN NIGERIA

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1. Introduction

The concept of central bank policy autonomy, or the freedom of a central bank to use its own discretion for the design and implementation of monetary policy, has continued to attract both rigorous academic research and serious public policy debate. It is not difficult to see why. Central banks are important economic institutions whose activities are vital to the economic well-being of the populations that they are established to serve. Their significance derives, of course, from the fact that they not only influence the key institutions, arrangements and infrastructure which constitute a country's financial system, but also determine monetary policy. Macroeconomic management of a country is implemented through the manipulation of two key policy levers, i.e., fiscal policy and monetary policy. Hence, in many countries, the central bank typically wields an economic policy power which often stands at par with that of the fiscal authority.

Both the on-going academic research and policy debate reflect the rapidly changing perspectives about the role of central banks as economies evolve through various stages of development, and the unfolding political economy of policy making. The former relates to changes in the range of activities that central banks are uniquely suited to perform as the economic landscape changes. The latter is concerned with the division of labour between the fiscal and monetary authorities in the process of formulating and executing a series of optimal mix of fiscal and monetary policies in the context of each country's changing economic situation and prospects.

This paper seeks to review both the academic research and public debate on central bank autonomy, accountability and governance with a view to determining how and the extent to which these three concepts are combined to produce the current dominant framework of the monetary policy process. More recently, research as well as recent developments in the global economy is beginning to challenge the orthodoxy which the current dominant monetary policy framework represents. Hence, the paper takes account of these new developments in terms of the limitations of the current paradigin. Finally, the paper evaluates the evolution of the monetary policy framework in Nigeria against the emerging "best practices" and draws some lessons for institutional and policy reform.

This presentation is structured as follows. Section 2 focuses on the concept of central bank autonomy by examining its meaning, its rationale as well as the different types and dimensions of autonomy. This section ends with an analysis of why granting to the central bank any degree of autonomy must be balanced by specific accountability responsibilities and supported by appropriate governance structures. In section 3, the focus shifts to the key considerations which tend to limit the degree of autonomy which a central bank may enjoy. The research results used to support the granting autonomy to central banks are not entirely perfect; and new research results have raised doubts about the old ones. In addition, economic structures differ across countries and some country characteristics suggest that central bank autonomy may not necessarily provide an optimal solution. Hence, this section examines limitations to central bank autonomy.

Section 4 draws together the "best practices" that emerge from a balanced review of the on-going debate. These are used as benchmarks against which the paper evaluates central bank autonomy in Nigeria in terms of its evolution, extent, key features as well as performance in section 5. Finally, the paper concludes, in section 6, with suggested lessons for policy reform.

2. Central Bank Autonomy

Public discourse on the concept of central bank autonomy does not usually indicate that its theoretical justification dates back only to the early 1980s and that its operationalisation began in the 1990s. Similarly, its various dimensions and the relationship between them have not always been widely understood and appreciated. This section addresses these issues, and relates them to the need for accountability and appropriate governance arrangements.

(a) <u>Meaning</u>

Central bank autonomy refers to the freedom of monetary authorities from direct political control or government influence in the conduct of monetary policy. Fiscal policy and monetary policy constitute the twin major elements of macroeconomic policy which is crucial for the overall management of a country's economy. Hence, both monetary and fiscal policy relate to key public policy issues which are the direct responsibilities of government. In effect, the concept of central bank autonomy with respect to monetary policy implies that the central bank enjoys an authority that is delegated to it, as an agent, by government, which is the principal. As it is well established in the context of the principal – agent relationship, while the authority for a function may be delegated to an agent by the principal, the responsibility for that function cannot be delegated and, thus, remains firmly with the principal.

(b) <u>Rationale</u>

In basic economic terms, it may be argued that the primary purpose of the state is to maximize sustainable wealth of the population by growing the economy. If this economy is market-based, maintaining price stability becomes an important factor in achieving this key economic objective of the state: To meet this requirement, the central bank which is responsible for issuing the fiat money used in the economy must have, as one of its key functions, the responsibility for ensuring that money retains its value. In other words, the central bank must ensure price stability.

Money is, essentially, a record-keeping device which permits an efficient summary of past transactions in the economy. The central bank's responsibility, in this context, is to ensure in practice that the record-keeping service provided by money is performed in the most efficient way. This, in turn, implies a de facto mandate to safeguard price stability because otherwise inflation could distort the summary of past economic transactions and, perhaps more importantly, damage the trust in its record-keeping for the future. Obviously, money as the yardstick for measuring value should itself be as free as possible from distortions. By eliminating or at least, reducing the noise in price signals, price stability can ensure a more effective and efficient allocation of scarce resources in a market-based economy.

During the 1970s and early 1980s, major industrialized countries experienced sustained periods of high inflation. Based on the general assumption that inflation is primarily a monetary phenomenon which can only be influenced by the central bank in the medium term, research focused on why central banks in the affected countries allowed this to happen.

This research suggested that the inflationary experiences could be explained by three problems (Sargent and Wallace, 1981; Leeper, 1991). First is the problem of time-inconsistency which has two possible components, i.e., either that promises made in the form of future policies may not be adhered to, or that policies implemented in the short-term may make future policies sub-optimal. The second problem derives from the fact that to win elections, governments often implement expansionary fiscal policies before the elections only to try to unravel them after. The third problem is associated with the tendency of governments to use their central banks to manage their fiscal deficits.

Having identified the problems, the research also suggested that central banks which are endowed with the requisite degree of autonomy in the implementation of monetary policy could solve the problems and thus contribute significantly to more efficient and effective national economic management. When this theoretical conjecture was put to empirical test, the result was favourable in the case of developed countries. Central bank monetary policy autonomy was found to be negatively correlated with average inflation rate. In other words, the higher the degree of the central bank's monetary policy autonomy, the lower tends to be the rate of inflation. But the result for developing countries was not so favourable or robust (Alesina and Summers, 1993).

The up-take of this result in terms of policy reform was both quick and sharp. Many countries granted varying degrees of monetary policy autonomy to their central banks. Two other perspectives further boosted the rate of adoption. First, pressures from the international sector generated by the increasing integration of national financial markets through capital account openness have had a significant influence on nudging the relevant governments to make their central banks more autonomous. Second, many countries that implemented comprehensive policy reform programmes in the 1990s included central bank autonomy as part of the package. Thus, the policy reform agendas of the International Monetary Fund (IMF) and the World Bank played a significant role in the emergence of more autonomous central banks.

(c) Types of Autonomy

Central bank autonomy has several dimensions. The key types for the purpose of monetary policy making and implementation are discussed in what follows.

Goal autonomy refers to the ability of the central bank to determine the goals of monetary policy without the direct influence of the government. More specifically, goal autonomy in principle gives authority to the central bank to determine its primary monetary policy objective from among several objectives in the law which established the bank. With this authority, the central bank could set priorities among different goals and determine how much weight to be attached to each.

As most central banks are established by the government, the goals are generally specified by the government itself. For example, the European Central Bank has goal autonomy built into its creation by a special multilateral treaty. In the United Kingdom, the Bank of England lacks goal autonomy since its inflation target is set by the government. The goals of the Federal Reserve Bank in the United states are set in its legal charter. However, these goals are described in general terms. This permits the Bank to translate these into more specific operational goals; thus acquiring a high level of goal autonomy.

<u>Target autonomy</u> is relevant in the case of a central bank which has only one clearly defined primary objective stipulated in the law that establishes it. In contrast to goal autonomy, target autonomy entrusts the central bank with the responsibility for determining the target inflation and/or exchange rate.

<u>Instrument autonomy</u> permits the central bank to choose the tool-kit by which it will meet the goals set for it by the government. In effect, the central bank can freely adjust its policy instruments in pursuit of the goals of monetary policy. For example, the Bank of England which lacks goal autonomy was granted instrument autonomy in 1997. Under this arrangement, it is able to set its instruments to achieve the target set for it without influence from the government. But if the target is missed by more than one percentage point on either side of the 2% target, the Governor must write an open letter to the Chancellor of the Exchequer giving reasons why the target is missed and explaining what the Bank would do to ensure that the target is achieved. Similarly, the inflation target range for the Reserve Bank of New Zealand is set in its Policy Targets Agreement (PTA) with the government which frees the Bank to set its instruments without interference. Both the US Federal Reserve Bank and the ECB enjoy complete instrument autonomy.

<u>Financial autonomy</u> is exercised by a central bank that possesses sufficient resources to attain its fundamental monetary policy objectives. This is defined in terms of appropriate balance sheet structure and adequate earnings generation capacity to efficiently and effectively perform its monetary policy functions. This autonomy can be impaired by losses stemming with unfunded involvement with quasi-fiscal activities, including banking rescue operations and development banking mandates.

The central bank which has <u>limited or no autonomy</u> is basically a government department whose objectives, targets and policy instruments are determined by the government. <u>Goal</u> and <u>target autonomy</u> are generally perceived as very strong degrees of central bank autonomy. They raise the question why central bank officials, who are not elected by the general public, should have the authority to decide the short-term trade-off between employment and the rate of inflation. By delegating such critical policy decisions to a non-elected body, a democratic deficit is created. **Instrument autonomy** is a lesser degree of autonomy which should be sufficient in most cases to assure the general public that monetary policy implementation will be objectively done. Under this arrangement, political decision makers retain the authority to determine the goal and/or target, which also helps to facilitate coordination and consistency with other policies, especially fiscal policy.

(d) Accountability and Governance

Clearly, there are many dimensions to the relationship between a country's government and its central bank. The government typically fully or largely owns the bank, capitalizes it and appoints its governing board and key officials. These suggest that central banks cannot be fully autonomous; and that whatever degree of autonomy they have in fact represents delegated authority from the government. In a democratic political system, delegating public policy normally requires some mechanism for ensuring accountability. Therefore, central bank autonomy does not imply that the bank is not accountable for its actions.

The most usual way for linking central bank monetary policy autonomy to accountability is to grant the central bank instrument autonomy; while reserving a role for the government in specifying the goals of monetary policy and setting its targets, as well as monitoring the bank's performance in hitting the targets and achieving the policy goals.

Checks and balances, the key components of accountability, should be in place to prevent abuse of power (or its perception) by a central bank which enjoys delegated autonomy. The central bank's accountability provisions are essentially to ensure that it exercises its policy functions effectively and efficiently; and that it manages its resources in a cost-effective way. A key aspect of a central bank's accountability to its stakeholders for its delegated authority is the provision of timely, transparent and reliable information to the legislative and executive branches of the government, as well as the general public.

Traditionally, central banks have been accountable to the Minister of Finance, head of state and/or government, or the cabinet. Newer central bank laws have tended to also make central banks accountable to the legislature with respect to the implementation of their monetary policy function. Both the executive and legislative branches of government have an interest in monitoring the financial conditions of central banks. But the Minister of Finance, as the representative of government, tends to have stronger incentives for closely monitoring the central bank's finances. In striking a balance between protecting the financial autonomy of the central bank and enforcing its financial accountability, appropriate governance structures have to be developed for entrenching autonomy and facilitating accountability by depoliticizing the process.

The delegation of monetary policy authority to an autonomous central bank while fiscal policy remains in the hands of political authorities can result in a non-coordinated policy mix which may be costly for overall national economic management. To ameliorate this problem, it is often necessary to establish clear conflict resolution mechanism and procedures which can be applied when policy disagreements occur between the central bank and government. Such arrangements could indicate whether and the extent to which the government may over-rule the central bank, as well as how the public is informed of this development.

3. Limits to Autonomy

Within a decade of its becoming a widely accepted norm in monetary economics and policy, the concept of central bank autonomy had come under serious scrutiny. This has evolved in, at least, three broad directions, each of which challenges the accepted norm in fundamental ways. The first direction has been in terms of the critique of the research which gave impetus to the concept of central bank monetary policy autonomy. The second direction has focused on the characteristics of particular economies under which central bank autonomy would not be effective in taming inflation; while the third suggests that fiscal policy can generate inflation directly, rather than through the monetization of fiscal deficits. Each of these is examined sequentially in what follows.

(a) Critique of Research

Recent evaluations of the research underlying the concept of central bank autonomy suggest that while the empirical results of the studies are generally supportive of the concept, they are not in fact compelling (Lybeck and Morris, 2004). Many of the studies did not adequately control for other factors that could account for cross-country differences in inflation experiences. Some of those that do have found little support for the hypothesis that central bank monetary policy autonomy plays a significant role in inflation control. Similarly, the treatment of a country's degree of central bank autonomy as exogenous is problematic. It is in fact more likely that the existence of both low inflation and substantial central bank autonomy in a country over a specific time period simply reflects the presence of a strong constituency for low inflation in the country. Thus, in countries which introduce central bank autonomy as part of a comprehensive economic policy reform package, it may be difficult, if not impossible to be certain that the fall in inflation rate was solely due to central bank autonomy. Finally, a high degree of central bank autonomy may cause frictions between fiscal and monetary policy which can be costly for the overall economy. In particular, a strong and autonomous central bank may be tempted to take monetary policy actions which are sub-optimal for a developing country, even though they may be in line with international best practice. Such actions may be sub-optimal because the economy may be too underdeveloped in terms of its fiscal and financial systems to be managed in the context of such policies.

(b) Fiscal Dominance

New insights suggest that the concept of central bank autonomy with respect to monetary policy generally works in the absence of fiscal dominance. Most economies in the world operate within the spectrum of two extreme bipolar policy regimes. One extreme is characterized by complete monetary dominance while the other features complete fiscal dominance (Turner, 2011).

Under the complete monetary dominance regime, there can be full central bank autonomy over monetary policy. In this context, any increase in fiscal debt, which is generated through the sale of government bonds in the open market, must be followed by increases in the current or future primary surplus (i.e., excess of the current government revenues from all taxes over current government expenditures) by the fiscal authority, such that it is able to back the principal and interest payments on the newly issued debt. In effect, the central bank is in a position to define its monetary policy independently and, in the process, determine the amount of revenue (or seigniorage) from the issuance of fiat currency that the fiscal authority will be entitled to, if needed. In return, the fiscal authority passively accepts the condition that any deficit in its budget must be financed by the combination of bonds sold to the public and the seigniorage determined by the central bank.

This describes the ideal situation in which it can be said that inflation is everywhere and at all times a monetary phenomenon. The autonomous central bank can, in this context, effectively control inflation by simply increasing interest rates as a means of reducing any emerging inflationary pressures.

In the opposite extreme, fiscal dominance occurs when the fiscal authority independently determines the current and future budget and, in the process defines the share of revenues from bonds and seigniorage (revenue from the issuance of currency). In this case, the central bank faces restrictions imposed by the demand for bonds issued by the government, since it has to finance the difference between the revenue needed by the fiscal authority and the value of bonds sold to the public by means of revenue obtained from the issuance of currency. More specifically, as the fiscal authority's deficits can't be financed only by the sale of new bonds, the central bank will be required to issue new currency and thus finance the balance through seigniorage.

In effect, fiscal dominance implies that expectations about inflation are intrinsically linked to fiscal performance. In this context, the standard monetary policy tightening option for reducing inflationary pressures tends to produce a perverse result. Instead of leading to an increase in real interest rates, reduction in aggregate demand and inflation, it may in fact lead to an unsustainable deterioration in the government's financial position. Increases in real interest rates will worsen the deficit by increasing the value of the debt. Sooner or later, the unsustainable fiscal position will require a forced adjustment, either through debt default, more inflation, or both.

Heavy reliance on seigniorage for financing fiscal deficits can be regarded as the simplest and most common manifestation of fiscal dominance. The reasons for fiscal dominance include weak revenue base, rudimentary tax collection system that encourages tax evasion, the contingent bailout liabilities attached to weak banking systems, as well as simple overspending. Stories of fiscal cum financial crises in many developing countries have a direct bearing on fiscal dominance. Governments of these countries often do not have the option of financing budget deficits with long-term bonds issued in local currencies and sold to the non-bank domestic private sector. Hence, they have generally relied on seigniorage and borrowed from their domestic banking systems, which make the monetary accommodation of significant fiscal deficits largely inevitable.

By definition, therefore, fiscal dominance impedes the effective implementation of any monetary strategy aimed at controlling inflation. Thus, while an appropriate degree of central bank autonomy could play a useful role in a situation of monetary dominance, it is neither necessary nor sufficient in the presence of fiscal dominance. Perhaps more importantly, an aggressive use of central bank autonomy in the context of fiscal dominance is likely to worsen rather than reduce inflationary pressures. In very broad terms, a monetary policy regime of tighter money now which generally will reduce inflation in a situation of monetary dominance is more likely to lead to higher inflation eventually.

For countries, such as Nigeria, which rely heavily on the exploitation of non-renewable natural resources for government revenue, changes in the monetary base may occur as a result of fiscal policy without being reflected in net credit to the government in the central bank accounts. The overall fiscal balance and stock of debt may also not adequately reflect the presence and/or extent of fiscal dominance. Doing this more appropriately requires not treating oil-related receipts as fiscal revenue, defining non-oil fiscal balance as the difference between revenue from domestic sources and domestic expenditures. The ratio of domestic fiscal balance to oil-related receipts provides a more robust indicator of the extent of oil/fiscal dominance (Costa and Olive, 2008).

(c) <u>Fiscal Theory of the Price Level</u>

Fiscal policy determines inflation through the monetization of fiscal deficits in the presence of fiscal dominance. The fiscal theory of the price level offers a more direct channel through which fiscal policy influences inflation. In doing so, it cuts out a role for monetary policy in fighting inflation (Leeper, 1991|).

More specifically, this theory shows that, from an equilibrium condition of the government's inter-temporal budget constraint, if government introduces a tax cut (not balanced by equivalent expenditure reduction) which reduces the sum of the present discounted value of future primary balances, real household wealth is increased. As a result, economic agents will increase their consumption expenditures thus raising aggregate demand, and inducing an increase in the price level. The rise in the price level will, in turn, induce a decline in the real value of government debt thus restoring balance in the inter-temporal budget constraint. In effect, the fiscal deficit, though not monetized, has in fact induced a change in the price level. Just as in the case of the standard fiscal dominance situation, monetary policy tightening through raising interest rates will worsen rather than ameliorate the inflationary pressure.

4. Best Practice Guidelines

The central bank occupies a special place in every country's overall economic management structure. Differences in country characteristics, levels of development, and political structures obviously translate into corresponding differences in the specifics of the role and place of central banks in different economies. There are, however, several areas of commonalities around which a set of global “best practices” may be derived (IMF, 1999; Lybek and Morris, 2004; BIS, 2009). The focus of this section is to identify and discuss the emerging patterns in these areas.

(a) Objectives

A clear consensus exists among the research and policy community on the idea that sustenance of price stability is the best contribution that monetary policy can make to balanced and sustainable economic growth. Hence, there is the tendency for most central banks to focus on a single or primary objective which is typically expressed in terms of preserving price stability. In addition to this, however, virtually all central banks take other economic considerations into account. Since it is generally recognized that too many goals and objectives may run the risk of overburdening monetary policy and compromising its credibility, most central banks have implicit or explicit procedures for prioritizing their mandated objectives. In particular, the price stability objective is often ranked above that of exchange rate or financial system stability, when there is a policy conflict.

(b) Autonomy

Central bank autonomy is most relevant in terms of decision-making with respect to monetary policy. Hence, its essence is policy autonomy. In addition, financial autonomy may be crucial as a means of providing assurance that the exercise of policy autonomy can be implemented without financial constraints.

There is a general move towards increasing the formal independence of the central bank from the government with respect to monetary policy decision-making. Since monetary policy action can be politically sensitive, decisions relating to them are typically insulated from political pressures through granting central bank’s monetary policy autonomy. It should be clear, of course, that central bank policy autonomy is a means to an end, not an end in itself.

More specifically, most central banks are provided with instrument autonomy; i.e., the freedom to use all the means necessary to maintain price stability. In other words, the use of quantities and interest rates should be the exclusive responsibility of the central bank. To sustain their instrument autonomy, central banks are advised to refrain from certain activities. For instance, if not prohibited, direct credit to the government should be strictly limited. Similarly, temporary advances or loans to the government should be limited to a small percentage (not more than 5%) of the recurrent revenue of the preceding fiscal year, should attract full market interest rate and be securitized by negotiable securities. In addition, the central bank should not underwrite and participate as a buyer in the primary market for government securities. Indirect credit to the government through buying outright existing government securities held by the market or accepting them as collateral should be avoided. The central bank should also not finance quasi-fiscal activities.

It is generally not recommended that central banks be granted goal and target autonomy over monetary policy. Preserving a role for the government in establishing the goals of policy and in monitoring the central bank's performance in achieving these goals includes the retention by government of the determination of specific targets of policy goals. This ensures that the political authorities retain the responsibility for driving the short-run trade-off between inflation and unemployment.

Exchange rate stability and financial system stability are two other important objectives with respect to which many central banks have some responsibility. These two areas are not directly covered by the concept of central bank autonomy. In general, central banks almost always participate in the choice of exchange rate regimes and exchange rate policy. But considerations involved in the decisions on both of these typically extend beyond the mandate of the central bank. Hence, a central bank should not have formal authority to make such decisions unilaterally. Similarly, responsibility for maintaining financial system stability is, by necessity, typically shared with several other agencies and the government.

The central bank should have sufficient financial autonomy to support its monetary policy autonomy. The typical central bank normally generates sufficient revenue to cover its operating costs and to set aside contingency reserves to provide it with the necessary financial autonomy. For most central banks, the amount of currency issued, the counterpart of which is invested at prevailing rates of interest, generates net interest income sufficient to comfortably cover their operating expenses. In addition, government should continually ensure the solvency of the central bank by maintaining its capital. It is the adequacy of both operating revenue and capital that underlies the financial autonomy which allows the central bank to conduct open market operations in the amounts required to achieve its monetary target and policy goal.

This financial autonomy can be abused and therefore compromised for various reasons. For example, when a central bank is given responsibility for development finance, it may be tempted into implementing quasi-fiscal operations which could deteriorate its finances. Similarly, when a central bank is assigned the mandate of preserving the stability of the financial system, two problems may be encountered. The discretionary and permissive use of the lender-of-last-resort role to the financial system may lead to the abuse of the central bank's financial autonomy. Central bank lending to troubled financial institutions, especially when it is large and over a prolonged period of time, is equivalent to indirectly financing the fiscal deficit. This is because bailing-out of financial institutions in the context of a financial crisis is the primary responsibility of the government rather than the central bank.

Economic development functions comprise quasi-fiscal activites that are not closely related to the purpose of central banking. Most of these are intended to boost favoured activities, using instruments that substitute for taxes, transfers and subsidies. The appropriate economic management principles suggest that most of the quasi-fiscal operations should be put into a more explicit fiscal footing, with the government bearing their costs.

(c) <u>Governance</u>

The primary concern with respect to governance is to ensure that the Board of Directors of a central bank has the authority to take monetary policy decisions without undue interference from the executive and legislative branches of government. Thus, like financial autonomy, appropriate governance provisions are designed to support the central bank's monetary policy-making autonomy.

The key governance provisions relate to nomination and appointment, length of tenure, performance evaluation, and dismissal of the Governor, Directors and top officials of the central bank. More specifically, members of the Board of Directors of a central bank should be nominated by the executive branch of the government and be confirmed for appointment by the legislative branch. In most cases, there is no direct representation of either the government or the private sector on the Board of Directors. The Board members should be appointed for a term that is longer than that of the appointing authorities. The grounds for their dismissal should be solely of a legal nature and clearly stated in their appointment letters. The basis for evaluating their performance, to the extent that this could also be ground for dismissal, should also be clearly established in law.

(d) <u>Conflict Resolution</u>

The relationship between the government and the central bank is, essentially, that between a principal (i.e., the government) and its agent (i.e., the central bank) since it is the former which delegates authority over monetary policy – making to the latter. It is not unlikely that conflicts over policy may arise between the government and the central bank. Therefore a pre-established, clear, and open mechanism must exist to resolve any conflict over monetary policy. If this process allows the government to over-rule the central bank, it should also include provisions for ensuring that a formal statement issued jointly by the government and the central bank is made public.

(e) <u>Accountability</u>

Autonomy of the central bank with respect to decision making on monetary policy issues is a two-sided coin; the other side of autonomy is accountability. Through its monetary policy autonomy, the central bank has significant state powers delegated to it. The use of these powers will affect the size of the country's wealth as well and the distribution of this wealth across individuals and firms in the society, as well as across generations. There are two problems that arise in this context. One is the perceived need to shield the proper and efficient exercise of these powers from political threat, which is the justification for granting autonomy to a central bank. The other is that insulating the central bank entirely from the legitimate oversight of elected representatives of the people could create a degree of democratic deficit since the officials of the central bank would not be accountable. Hence, central bank autonomy must be balanced with accountability.

The process of balancing central bank autonomy with its accountability for the use of the associated powers to its stakeholders begins with the recognition that as a public institution, the central bank has to interact with both the executive and the legislative arms of government. More specifically, it is common in all countries for the Governor of the central bank and the Minister of Finance to meet often and at regular intervals. Similarly, central bank officials normally report to and are examined by legislative committees as part of the oversight functions of the legislature. It would appear that, regardless of the degree of autonomy exercised by a central bank, both it and the government are likely to make better decisions in their respective areas of primary mandate through an active and continuous exchange of information and views during the periods of both deliberating upon and implementing their policy decisions.

Thus, it is a well-established fact that central banks are formally accountable to the executive as well as the legislative branch of government. Ideally, the central bank should formally report to both branches of government periodically and at regular intervals, perhaps quarterly or at least every six months, on the <u>conduct of monetary policy</u>, including on the achievement of the inflation target and the implementation of actions and policies aimed at achieving the specific goal. In the United Kingdom, for instance, the Bank of England is accountable to Parliament generally, but with respect to the Bank's inflation target set in the remit letter, more specifically accountable also to the Chancellor of the Exchequer.

The central bank's accountability for its finances is just as important. A comprehensive statement of the central bank's financial conditions should be drawn up and certified by an independent auditor at least once a year. In addition to the audited financial statements, a central bank should provide more frequent summaries of its financial status, accompanied by detailed explanatory notes on the most important revenue and expenditure items, including remuneration of directors and administrative salaries and expenses.

The determination of the central bank's operating budget is less clear-cut in terms of the process and who does what and when. There are, at least, three modalities that are currently used in different countries. At one extreme is the modality which delegates the approval of the central bank's budget to its supervisory board. In this case, neither the executive nor the legislative branch of government has to approve the budget ex ante. In practice, some central banks disclose their draft budgets to the Minister of Finance before Board approval; many others do so only ex post. At the other end of the spectrum, the current and capital budgets of central banks are subject to approval, veto or amendment by an external body, such as Parliament and/or Ministry of Finance. In particular, budgeted expenditures are subject to government authorization as an expenditure control mechanism. The third is a mid-way modality which seeks to reduce the risk that monetary policy decisions will be subject to political influence through the budget process while, at the same time, insisting on a degree of accountability on the part of the central bank with respect to its budget. In this context, the government establishes a framework that limits the overall size of the central bank's budget for a multi-year period. The Board of the central bank then approves the annual budgets within the established bounds. The Bank of England and the Reserve Bank of New Zealand constitute examples of central banks which operate under this modality.

Another critical issue which influences the extent of financial autonomy exercised by a central bank relates to the distribution of its income. On this issue also central banks are split into two broad categories in terms of how the distributable income is dealt with. Some central banks operate under a sharing approach in which a proportion is transferred to reserves, with the balance going to government in its capacity as owner of the bank. A second group of central banks transfers virtually all of net income to the government. For instance, in the case of the Bank of England, the income of the Issue Department (which issues the currency) is automatically transferred to the government. The earnings accruing to the Bank from its other operations are similarly treated, unless the Chancellor of the Exchequer agrees to a share of income being retained in the Bank as reserves.

Most countries have established formal mechanisms through which their central banks are held accountable for their activities. These include monitoring by both branches of government on the policy and financial activities of central banks. This typically involves regular meetings and consultations, particularly between senior central bank officials and their counterparts in the Ministry of Finance on the side of the execituve branch; and with relevant oversight committees on the side of the legislature. In some countries, the government is actually represented on the central bank Board, through the Ministry of Finance. In some countries, the oversight bodies in the executive and legislative branches have the power to use external expertise to review the activities of their central banks. In Norway, the Ministry of Finance funds an annual independent review of the central bank's monetary policy making activities.

These monitoring and review exercises are not without purpose. In many cases, they provide the opportunity of evaluating the performance of the central bank. Their results are also not taken lightly. In the case of the United Kingdom, when established inflation targets are missed, the Governor of the Bank o England is required to write an open letter to the Chancellor of the Exchequer to explain why and to indicate what steps are being taken by the Bank to achieve the target.

Finally, the Governor of a central bank is generally expected to exercise some reticence in the public discourse on government policies. In this context, it is pointed out that (BIS, 2009, p. 100):

> "……snares await the governor who either indulges in
> disputes with the government or more broadly chooses to
> speak publicly about matters unrelated to central banking".

This is, essentially, because (BIS, 2009, p. 101):

> ".....problems can emerge if the governor speaks out
> on a wide range of topics that are not related to his or her
> professional responsibilities. In such cases, the governor

can be perceived as attempting to advance a personal
or political agenda and thereby lose his or her
reputation as an impartial expert".

5. Central Bank of Nigeria: Mandate, Powers and Performance

In analyzing the performance over time of the Central Bank of Nigeria (CBN) in relation to its monetary policy mandate, it is useful to discuss, as a background, the evolution of its mandate and powers. Clearly, whether and the extent to which its performance has been satisfactory should be influenced, for good or bad, by the coherence among its objectivities and the relevance and adequacy of the powers it has been given. Similarly, an evaluation of the relevance and adequacy of the powers of the CBN can most usefully be examined in a comparative context. Hence, in this section, the paper sequentially traces the evolution of CBN's assigned mandate and responsibilities over time, evaluates its monetary policy performance.

(a) Evolution of Mandate and Powers

There are several key elements of central bank mandate and powers. One of these consists of the objectives established for the bank. At its beginning in 1958, the CBN Ordinance No 24 of that year stated, in section 3(4) that the principal objects of the CBN are (i) issue legal tender currency, (ii) maintain external reserve to safeguard the international value of the currency, (iii) promote monetary stability and a sound financial structure, and (iv) act as banker and financial adviser to the Federal Government. Among these four objectives, only two, i.e., (ii) and (iii) require explicit <u>policy</u> actions. In this context, what objective (ii) calls for is <u>exchange-rate policy</u>; while objective (iii) is to be accomplished with <u>monetary policy</u> measures. The CBN Act No 24 of 1991 repeats these four objectives word for word. But the CBN Act No 7 of 2007 contains a list of objectives which is longer and presented in a different order. According to section 2 of this Act, the principal objects of the Bank include (i) ensure monetary and price stability,

(ii) issue legal tender, (iii) maintain external reserves to safeguard the international value of the legal tender currency, (iv) promote a sound financial system in Nigeria, and (v) act as banker and provide economic and financial advice to the Federal Government. Compared to the first two versions of the CBN establishment law discussed above, that of 2007 is more specific and explicit with respect to the maintenance of price stability, previously embedded in "monetary stability". Otherwise the two broad areas of policy action remain unchanged. But it is probably significant also that price stability occupies the first position in the 2007 list of objectives. As suggested earlier in this paper, maintenance of price stability is generally regarded as the primary objective of central banks.

The second key element of the mandate and powers of the CBN is the provision of financial support to government. The CBN Ordinance of 1958 identifies three areas of this support. In section 29 (1 and 2) of this Ordinance, the CBN was endowed with the "power to purchase, sell and discount securities issued by Federal and Regional Governments and their corporations" as long as the total value of such treasury operations does not "exceed in value 20% of the total liabilities of the Bank". In addition, section 34 (1 – 3) allows the Bank to "grant temporary advances to the Federal Government in respect of temporary deficiencies of budget revenue not exceeding 12.5% of the estimated recurrent budget revenue". Finally, section 35 states that the "Bank shall be entrusted with the issue and management of Federal government loans publicly issued in Nigeria".

The 1991 Act, in its section 26 (g) expands the value of government securities that the Bank can buy, purchase, sell or discount to 75% of its total liabilities, while retaining advances to the government at not more than 12.5% of recurrent budget revenue. However, it drops the management of government debt from the Bank's responsibilities. The 2007 Act takes the CBN's mandatory government support to even higher levels. For instance, in section 28, the CBN's treasury operations could invest up to 75% of its total demand liabilities in short-term securities of the Federal Government. Under its credit operations in section 29, the Bank could grant advances against publicly issued short-term and long-term securities of the Federal Government within the 75% limit. In addition, under its development functions (section 31), "the Bank may subscribe to, hold and sell shares of any corporation or company or debentures thereof set up with the approval of or under the authority of the Federal Government for the purpose of stimulating financial development of money or capital markets in Nigeria or of stimulating financial or economic development". The total value of these is limited to ten times the aggregate of the Bank's paid-up capital and the general reserve fund of the Bank. Furthermore, section 32 permits the Governor of CBN, at his discretion, to extend the powers conferred by sections 28, 29, and 30 to the securities of the any State Government. Finally, temporary advances that may be granted to the Federal government against budget deficiencies is fixed at not more than 5% of the previous year's actual revenue of the Federal Government.

Beyond this extensive financial support to government, the CBN has also developed its own "development" agenda consisting of programmes to finance initiatives in support of agriculture, small and medium scale enterprises, as well as education. More recently, community support initiatives have included substantial cash donations in aid of flood affected areas and victims of terrorist attacks. In other words, the mandatory direct and indirect financing of governmental and associated parastatal activities appear to have been further supplemented by discretionary quasi-fiscal operations across various states and sectors of the economy.

With respect to autonomy, various versions of the CBN's establishment law clearly indicate significant movement in the direction of increasing degrees of decision-making powers delegated to the Bank of particular interest to this analysis is autonomy relating to monetary policy decision-making, and that associated with the Bank's finances. As an important pre-requisite for enhanced autonomy in these areas, it is often required that the Board of Directors of a central Bank be populated by people whose appointment and tenure of office are placed beyond transitory political influence. In keeping with this stipulation, CBN Act of 2007 section 8 (1 and 2) and section 10 (1 and 3) provide for a Board composed of a Governor, 4 Deputy Governors, the Permanent Secretary (Ministry of Finance), the Accountant-General of the Federation, and 5 other Directors. The Governor and Deputy Governors have a tenure of five years renewable for another five. The other 5 Directors have tenure of four years, renewable for another four. Each of these is nominated by the President and their appointment is subject to confirmation by the Senate.

In section 1(3), the Act indicates that "the Bank shall be an independent body in the discharge of its functions". In this context, the Board of Directors shall be responsible for (i) consideration and approval of the annual budget of the Bank (section 3), (ii) formulation and implementation of exchange rate policy (section 3), and (iii) the policy and general administration of the affairs and business of the Bank. With particular reference to its responsibility for safeguarding the international value of the legal tender currency, section 16 specifies that "the exchange rate of the naira shall be determined, from time to time, by a suitable mechanism devised by the Bank for that purpose". In addition, section 12 (1 and 2) of the 2007 Act created the Monetary Policy Committee (MPC) made up of the Governor, the four Deputy Governors, two other members of the Board of Directors, as well as 5 external members (3 of which are appointed by the President and 2 by the Governor). The MPC has specific mandate to facilitate the attainment of the objective of price stability and the responsibility for formulating monetary and credit policy.

In terms of autonomy, therefore, the CBN has made significant progress over time. Beginning from 1958 and through the next three decades or so, the Bank operated, essentially, as a parastatal agency of the Federal Ministry of finance. It was granted its first level of autonomy when its supervision was moved from the Federal Ministry of Finance to the Presidency. By 1998, the Bank achieved a higher level of autonomy implied by the responsibility for the:

- Formulation and execution of the monetary and credit policy for Nigeria,
- Fixing the rate or rates of discount or re-discount and the rate or rates of interest on advances to Government and to the customers of the Bank, and

- Devising suitable mechanism to determine rates exchange at which the Bank shall buy and sell foreign currencies".

(b) <u>Performance</u>

The performance of a central bank is generally evaluated in terms of the effectiveness of its monetary policy in ensuring price stability. This general practice derives from the consensus that the most valuable contribution which a central bank can make to a country's overall economic management is to ensure price stability. When this yardstick is applied to the CBN, the general conclusion of research by those outside and within the Bank is that its monetary policy performance has been uniformly poor.

The search for the key determinants of inflation in Nigeria and the extent to which monetary policy may assist in sustaining price stability has received considerable research and policy attention over the past forty years. For instance, Oyejide (1972) examined the impact of deficit financing in propagating inflation processes in Nigeria and found that there was a very strong and direct relationship between inflation and the various measures of deficit financing that were in use between 1957 and 1970. In Batini (2004), it is suggested that monetary policy implementation in Nigeria is complicated by several factors, including fiscal largesse, lack of operational autonomy of the central bank, a weak transmission mechanism, and a weak financial system. Olubusoye and Oyaromade (2008) which reviewed the period from 1960 – 2006 concluded that fiscal deficit and changes in broad money drive inflation in Nigeria in the long run. In CBN (2007), a detailed examination of Nigeria's inflation experience during the 1981 – 2005 period revealed that monetary expansion, reflected either by an increase in domestic credit or government fiscal operations, is a major determinant of inflation. In his evaluation of the 1986 – 92 period, Odozi (1992, p.141) concluded that the "effectiveness of monetary policy in regulating money supply over the years has depended, to a large extent, on government spending and fiscal deficit". More specifically, Odozi (1992, p. 145) confirmed that "the greatest problem which has reduced the effectiveness of current monetary and banking policies in Nigeria is the persistence of a large government deficit and its mandatory financing by the Central Bank".

In spite of the CBN's being granted instrument autonomy in 1998, its Annual Report of 1999 (p. 21) asserted that "the problem of excess liquidity…… was induced mainly by the expansionary fiscal operations of the federal government". This view was re-echoed in the CBN Annual Report (2002, p.24) which revealed that "the excessive growth in money supply was induced by the expansionary operations of the three tiers of government". A review of the accumulated evidence in Oyejide (2005, p. 60) led to the conclusion that "even though the CBN has achieved relatively greater independence over time, the increasing significance of fiscal dominance had tended to nullify that independence".

6. Conclusion

As argued in section 3 of this paper, central bank monetary policy autonomy of whatever degree tends to be rendered impotent in the presence of significant fiscal dominance. All available evidence points to the existence of fiscal dominance in the Nigerian fiscal-monetary interactions. Up to now, all efforts to restore the ability of the central bank to effectively use monetary policy for the purpose of achieving its mandate of price stability have focused on acquiring higher and higher degrees of monetary policy autonomy. Clearly, these efforts are not working; and it is time to look for other alternatives.

A major part of the problem is that the quest for increased autonomy has been accompanied by growing tendency to induce even more fiscal dominance. One possible explanation for this may be that it is not (yet) fully understood that the concept of central bank autonomy which has a decent theoretical justification applies only and strictly to monetary policy focused solely on the maintenance of price stability. Therefore, this autonomy does not cover other functions that either the government may impose on the Bank or the Bank may choose to engage itself with. In fact, other desirable objectives, such as exchange rate stability and financial system stability do not require central bank autonomy for their achievement. When central banks have mandates over these additional objectives, as many indeed do, it is often advised that the priority attention should be placed on the price stability objective; and that both exchange rate stability and financial system stability objectives are best achieved through more active interactions between the Ministry of Finance and the Central Bank (as well as other agencies in the particular case of financial system stability). It is also generally the case that in these interactions, the Minister of Finance should take the lead, given that the decisions emanating there from tend to have significant fiscal consequences.

This suggests that the mandate and powers specified in the CBN Act of 2007 may need to be adjusted. For instance, it should be recognized that monetary policy autonomy cannot guarantee monetary policy effectiveness in maintaining price stability unless the CBN avoids significant direct and indirect lending to the government as well as its current penchant for carrying out quasi-fiscal operations across various sectors of the economy either on its own account and/or jointly with others. Much of the CBN's "development" functions need to be explicitly treated as fiscal operations and be dealt with by development finance institutions established and publicly funded for that purpose.

It is the case, of course, that central bank's monetary policy autonomy requires some degree of financial autonomy to make the former operationally effective. This does not necessarily imply that public funds placed at the disposal of the central bank should be shielded away from the normal oversight exercised by the elected representatives of the people. In countries (such as the UK) where annual budget appropriation processes have been found to be unsuitable for the central, some medium term begets approval and monitoring arrangements have been adopted.

In the end, delegated authority must be associated with accountability in the case of central bank monetary policy autonomy, mechanisms need to be established for conflict resolution and for monitoring for conflict resolution and for monitoring and evaluation. There will, undoubtedly, be differences of opinion between the principal (i.e., the government) and the agent (the central bank) on critical monetary policy issues. An established and robust conflict resolution process helps to smoothen things over when conflicts occur.

Much of the research on central bank autonomy with respect to monetary policy suggests that instrument independence is sufficient. This implies that the government should retain the authority to determine the goal of policy as well as its specific targets. This leaves the central bank with the freedom to use whatever policy instruments it deems appropriate. By implication, therefore, the central bank should be monitored and evaluated in terms of how well it uses the instruments to achieve the target set by the government. Current CBN law and practice do not reflect this important perspective. Reform to ensure that this is reflected would include the explicit recognition that only instrument autonomy should be conferred on the CBN and that this autonomy should be restricted specifically to monetary policy directed at maintenance of price stability. Correspondingly, it should be understood that the objectives enshrined in CBN law represent the goals of policy which do not change frequently over time, which is the reason that they can be specified in broad terms in a legal document. In addition, however, these objectives (and, in particular, that of price stability) should have targets which are determined periodically (quarterly, annually, etc) by the government, in close consultation with the central bank (only in the case of monetary policy) and other relevant agencies (especially in the case of financial system stability).

The current perception that CBN law has endowed the CBN with both target and instrument autonomy over not only monetary policy to sustain price stability, but also over exchange rate policy and financial system stability policies is counter-productive. In one sense, it seems to let government off the hook too easily in terms of its responsibilities. Government knows or should know that granting central bank autonomy with respect to monetary policy is not sufficient for ensuring price stability. That autonomy needs to be complemented by ending the mandatory requirement that the central bank should provide significant direct and indirect financing of fiscal deficits.

This does not necessarily mean that the government should not borrow; it only means that government should borrow only from the non-bank public. It also does not mean that government would not obtain some revenue from seigniorage; but it means that the amount of seigniorage revenue available to the government must be limited to the level that is consistent with the maintenance of price stability. Finally, relieving the central bank of the responsibility for financing quasi-fiscal operational does not necessarily mean that those activities should not be done. What it means is that they should be done by the relevant development finance institutions that are publicly funded for that purpose.

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