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Best Practices in Central Banking

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As the tidal wave of commentaries on the controversial Governor of Central Bank of Nigeria (CBN) ebbs, we can begin to soberly reflect on the economic principles underlying the mandate, functions, governance structure, independence and accountability in central banking. This article examines some of these key issues drawing from economic literature, global practices, with the objective of contextualizing central banking in Nigeria. The article also draws from my experience of having headed an international organization, which worked with Governors of Central Bank in West Africa, as well as having interacted with some peers and colleagues, who are Governors and Deputy Governors of Central Bank in Eastern and Southern Africa.

Why do Central Banks exist?

The economic justification for the existence of a modern central bank is rooted in a branch of Economics, called *Welfare Economics*, and not *Monetary Economics*! Government, its institutions or agencies exist and are justified due to the provision of public goods and presence of externalities, which implies that individuals will not capture the full benefits or costs from their actions. If the externalities are not properly internalized or taking care of, the issue of "*tragedy of the common*" will arise. Hence, with nobody having to take responsibility, we could have overgrazed land; sea and air that can be polluted and other resources overused. A classic example of public good is national defense, which is provided by a national government that is justified because most people will not voluntarily contribute their resources to the military; and once the national defense service is provided, most people cannot be excluded from benefitting from it.

How does this apply to central banking? Central banks exist to attain the public good of promoting the economic welfare of the citizens. The Bank of Canada captures this point very well by noting that its principal role "*is to promote the economic and financial welfare of Canada.*" The Central Bank of Mexico indicates that its main goal "*is to preserve the value of Mexico's currency in the long-term in order to improve Mexican's well-being.*" The Reserve Bank of Australia Act states that its duty is *"to contribute to the stability of the currency, full employment, and the economic prosperity and welfare of the Australian people."* It is worthy of note that the phrase "*economic welfare or well-being of Nigerians*" does not appear in the CBN Act, 2007.

The primary overriding task of a central bank is to improve general economic welfare by managing and reducing systematic risks and economy-wide instabilities, where everyone is impacted (i.e. cannot be excluded). The instabilities and systematic risks that threaten the general economic welfare are high inflation, high unemployment, low real economic growth, unstable exchange and interest rates, and unstable financial systems. While different countries may assign different ranking and priorities to these goals, central banks across the world have essentially the mandate of primarily ensuring low and stable inflation, low employment and sustainable economic growth.

Financial stability, exchange rate stability, and interest rates stability are secondary goals, and even instruments for achieving the primary goals.

Inflation, Unemployment and Sustainable Growth

Thus, the primacy of central bank's focus on inflation, employment and sustained economic growth is undisputable. The US Federal Reserve is mandated to "*maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates*." In Canada, the Central Bank is expected to "*mitigate by its influence fluctuations in the general level of production, trade, prices and employment."* The Bank of England's monetary policy objective is to "*deliver price stability and, subject to that, to support the Government's economic objectives including those for growth and employment.*"

In Korea, the Central Bank is expected *to "contribute to the sound development of the national economy by pursuing price stability through the formulation and implementation of efficient monetary and credit policies*." In South Africa, "*the Reserve Bank is required to achieve and maintain price stability in the interest of balanced and sustainable economic growth in South Africa."* In Kenya, in addition to monetary stability and financial stability, the Central Bank of Kenya is mandated *to "support the economic policy of the government, including its objectives for growth and employment."*

Interestingly, and in spite of the global practices and domestic economic realities, the words '*employment or unemployment'* and "*sustainable economic growth*" do not appear in the CBN Act, 2007. The Act states that the principal objects of the CBN are: to ensure monetary and price stability, issue legal tender currency in Nigeria, maintain the external reserves to safeguard the international value of the legal tender currency, promote a sound financial system in Nigeria; and act as banker, and provide economic and financial advice to the Federal Government.

Among the principal objects, it has become more glamorous and fashionable in Nigeria to devote attention to banking institutions. A modern economy cannot operate efficiently with an unstable banking system. Yet, there are models of banking supervision and regulation outside of the central banks that have worked well. Financial regulation and banking supervision are outside the remit of central banks in Canada, China, Korea, and a few other countries. Yet, in terms of soundness of its banks, Canada ranked 1st among 134 countries; they are well capitalized, managed, and regulated. Canada was also the only G7 country that did not have a government bank bailout in the aftermath of the global financial crisis.

While financial stability is a desirable goal, it is also a secondary means of achieving the primary objectives of low inflation, low unemployment, and high sustainable economic growth. While commenting on sustainable banking initiative, the Acting Governor of CBN recently noted that "*the financial sector in emerging markets has a critical role to play in fostering sustainable economic growth."*

The economic literature has also established that, at least in the short-run, there is a trade-off between inflation and unemployment. Thus, it is important to know the welfare cost of inflation and the sacrificing ratio between inflation, growth and unemployment. It has been estimated that for Nigeria, the welfare cost of inflation is more than a third of gross domestic product (GDP). With inflation down by half from a high of 15.6% to 8% over a period of five years, the cost of disinflation is estimated to be close to a fifth of GDP. With an estimated protracted unemployment rate of 24% in Nigeria, it is not possible to recover the economy-wide output that unemployed people could have produced.

Nigeria's real GDP growth has averaged about 7% in the same period, while its potential output growth is in the neighborhood of 12%. Growth has been driven more by accumulation of factors of production than by sustained productivity of the factors of production. When population growth is factored in, adjusted real per capita GDP growth will be around 5%, while its adjusted potential growth will about 10%. An economy that grows at 10% will double in size in 7 years, while a growth rate of 5% will double the economy in 14 years.

Technocratic and Economic Management Institution

Given the justification for its existence as promoting the public good of general economic welfare of citizens and its primary focus on inflation, unemployment and sustainable economic growth, central bank, all over the world, is essentially a technocratic economic management institution. For the positions of Board of Directors, Central Bank Governor, Deputy Governors, and members of Monetary Policy Committee, it has been well articulated that there are global best practices that support the theme of a combination of strong economics expertise, evident by a PhD in Economics, hands-on banking and finance experience, and policy and institutional leadership exposure.

The global best practices cut across developed, developing, and African countries. Of the seven members of the Board of Governors of the Federal Reserve Bank of the USA, four are highly trained Economists, including the Chairman and Vice Chairman. Of the 12 Presidents of the Federal Reserve Banks, 10 are PhD Economists. At the European Central Bank, the President is an Economist, and four of the five deputies are Economists. The Governor of Bank of England has a PhD in Economics, with a decade of leadership and operational experience at Goldman Sachs, an investment bank. The Governor of the Bank of Canada has a PhD in Economics, with leadership experience in central banking and served as President and CEO of Export Development of Canada. All five Deputy Governors of Bank of Canada are highly trained Economists. The Governor of Japan's central bank is an Economist and a former President of Asian Development Bank. Australia's Reserve Bank Governor and its 8 deputies and assistant governors are all Economists.

The practice of emphasizing economic credentials is well established among the BRICS and in developing countries as well. In Brazil, the Governor and seven of the eight Deputy Governors of the central bank are PhD Economists. China's People Bank central bank governor and its 8 deputies are economists; ditto for Russia, also with a Governor and 8 Deputies. Three of the four Deputy Governors of India's Reserve Bank are Economists. Half of its Board members are Economists. The Governor of Central Bank of Mexico has a PhD in Economics, with policy and leadership experience in central banking and in international organization. Three of the four Deputy Governors of Central Bank of Mexico are PhD Economists. Chile's Governor and 5 Deputies are all highly trained economists. The same practice is obtainable in Korea, Israel and in several African countries including Ghana, Kenya, Tanzania, Uganda, and Zimbabwe, where PhD Economists hold sway in top management and governance structure of their central banks. Kenya has separated the Chairman of the Board from the executive position of Governor. Yet, both the Chairman and the Governor are PhD Economists.

For the CBN, a specialized technical institution, entrusted with the management of Nigerian economy, what is puzzling is the preponderance of non-economists in the governance structure of central banking, formulation and implementation of economic and monetary policies. Among the six outside or non-executive board members of the CBN, there is only one member with a BSc Degree in Economics. Among the five executive board members, and with effect from July, only one has a Master's Degree in Economics. Among the 12 members of the Monetary Policy Committee (MPC), only three members are PhD Economists. It is, therefore, not surprising that the written statements of some of the MPC members lack depth and understanding of economic issues and the linkages among the goals of inflation, unemployment, and economic growth on the one hand, and economic and monetary policy instruments on the other. We certainly would not have an engineer as the accountant-general, auditor-general, or attorney general of the Federation!

In a first best world, central banking is dominated by those who understand the business: seasoned Economists. All over the world, central banking is a specialized economic function undertaken mostly by seasoned Economists, with an understanding of the welfare function for the economy, the macroeconomics of inflation, employment, and growth, the microeconomics and financial economics of banking and financial markets, and the monetary economics of monetary policy instruments.

In a second best world, the ideal will be to have seasoned Economists, who are also professional chartered bankers in the governance structure of a central bank. But the objective will not be to turn central banking into commercial banking, where processes and deals making rule the day. This will amount to, as has been remarked elsewhere, turning a central bank into "*a public cartel of private banks established to protect powerful financial interests.*"

Independence, Transparency, and Accountability

Central Bank Independence (CBI) is a recent global practice that gained currency in the 1990s. Central banks in France, Chile, New Zealand, Argentina, Mexico, Venezuela and a host of other countries gained CBI in early 1990s, thereabout. The Bank of England, which is more than 200 years old, gained independence in 1998; same year as Bank of Japan. Prior to this period, only the US Federal Reserve, Germany's Bundesbank, and Swiss National Bank have a semblance of legal and operational CBI.

The modern economic argument for CBI is a theory of the second best, as the essence of CBI is that monetary policies should be made independently of fiscal policies. On the one hand, fiscal and monetary policies in the first best world would be perfectly coordinated to work for the public good of promoting general economic wellbeing, and there would be no need for CBI. On the other hand, in an imperfect second-best world, politicians tend to favor short-term gains, while discounting long-term costs—time inconsistency. CBI is one way of ensuring that central banks are insulated from political pressures, especially to print money. CBI is expected to enhance the credibility of the institution in focusing on the long time horizon and in formulating monetary policies.

There are various forms of CBI: de jure legal, operating/functional, *de facto*, goal and instruments independence. Legal measures of CBI are those enshrined in the CB Act or in the Constitution as in South Africa. These organic measures usually provide safeguards relating to appointment, terms of office, and dismissal, prohibitions and restrictions on activity of officials, and voting power of government officials on the board. These are matters best left for lawyers to comment on.

Operational and functional safeguards of CBI include limitations on lending to the public sector, conduct of monetary policy, regulatory and supervision powers, instruments independence, decisional autonomy, and irreversibility by government of its policy decisions. The functional CBI is generally similar, but not identical, among central banks. The *de facto* independence is determined by the personalities of the governor and the management, the degree of understanding and interaction between the Governor, the Minister of Finance and other high level public sector officials. Much of the events relating to the CBN that we have witnessed in recent months appear to deal more with *de facto* independence.

Although the economic arguments for CBI appear sound, the political authorities must still take the ultimate decision to grant it. Thus, CBI is a relative term, and is not absolute. In order to avoid "a *Government within a Government*," the central bank is a non-partisan and apolitical institution that enjoys independence because it is expected to uphold professional economic meritocracy and technocracy within a democracy. In line with public choice theory, and without effective accountability, the incentives for bureaucratic behavior by an independent central bank and its management to further its own benefits and prestige instead of the general economic welfare become more pronounced. Even for admirers of the CBN Governor, it is difficult to comprehend his foray into non-core business of the CBN, with not well-thought out statements. Examples abound including: asking a former President to mind his farming business; proffering explanations for Boko Haram crisis; asking for Afenifere, Ohaneze, and Arewa to be banned.

There are various means of ensuring that a central bank is accountable to the legislators, executive, and judiciary and the general public. Accountability includes ensuring transparency and disclosure, bi-annual presentation to legislative authorities, and auditing of its financial books. Over a period of three to five years, accountability should also focus on assessing the central bank's reaction function or use of its policy instruments independence to achieve a well-defined economic welfare function of citizens.

It has also generally been established that central banks should not have goals independence. In most countries, the principal goals of a central bank are set by political authorities, as in the CBN Act. In New Zealand, Canada, and England, the governments go further to set inflation targets over a medium-term period, which the central banks' performance are measured against. For Nigeria, some targets are set within the context of international agreements, such as the convergence criteria on single digit inflation rate of the West African Monetary Zone and the lower inflation target rate of ECOWAS. Once the goals and targets are set, the instruments for achieving them are left independently with the central banks; and their decisions cannot be reversed.

The CBI has been discussed in the context of political pressure or fiscal dominance of monetary space. However, the Bank for International Settlements (BIS), the banker to central banks, recently observed that there is a need to include insulation against pressures from financial markets or financial dominance, which also serve as a threat to CBI. Given a well-defined economic welfare function of the citizens, the central bank's primary constituency is domestic rather than playing to the gallery of and pandering to a coterie of foreign analysts and portfolio investors, who have made handsome returns from a combination of high domestic interest rates, short term capital flows, and carry trade, but now threaten exchange rate stability and financial stability.

Conclusion

A central bank exists to attain the public good of promoting the economic wellbeing of the citizens. Its principal objective is to minimize economy-wide risks and instabilities manifested in high and unstable inflation, high unemployment, and low economic growth. It does this by ensuring monetary, price, payment and financial stability. It is a technocratic economic management institution. It requires independence to discharge its functions creditably, yet it must at the same time be accountable.

Unfortunately, the economic welfare function of Nigerians has not been well defined for the CBN; its governance structure skewed, and now its independence may be threatened. Meanwhile, little attention has been paid to the welfare cost of disinflation, high interest rates, and high unemployment. These are the tragedies of the common.

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