



CENTRAL BANK OF NIGERIA

**UNDERSTANDING
MONETARY POLICY SERIES
NO 13**

**CENTRAL BANK
INDEPENDENCE**

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Central Bank of Nigeria

Mandate

- Ensure Monetary and Price Stability
- Issue Legal Tender Currency in Nigeria
- Maintain External Reserves to safeguard the international value of the Legal Tender Currency
- Promote a Sound Financial System in Nigeria
- Act as Banker and Provide Economic and Financial advice to the Federal Government

Vision

“By 2015, be the Model Central Bank delivering Price and Financial System Stability and promoting Sustainable Economic Development”

Mission Statement

“To be proactive in providing a stable framework for the economic development of Nigeria through the effective, efficient and transparent implementation of monetary and exchange rate policy and management of the financial sector”

Core Values

- Meritocracy
- Leadership
- Learning
- Customer-Focus

MONETARY POLICY DEPARTMENT

Mandate

To Facilitate the Conceptualization and Design of
Monetary Policy of the Central Bank of Nigeria

Vision

To be Efficient and Effective in Promoting the
Attainment and Sustenance of Monetary and
Price Stability Objective of the
Central Bank of Nigeria

Mission

To Provide a Dynamic Evidence-based
Analytical Framework for the Formulation and
Implementation of Monetary Policy for
Optimal Economic Growth



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UNDERSTANDING CENTRAL BANK INDEPENDENCE ¹

SECTION ONE

Introduction

Central bank independence refers to the freedom of central banks or monetary authorities to conduct monetary policy without political interference. In recent times, considerable interests have been generated on the independence of central banks regarding the formulation and implementation of monetary policy.

Following the success of Bundesbank (Germany) in lowering inflation in post-World War II that was attributable to its independence, there has been a growing body of literature on the subject that links Central bank independence directly to price and monetary stability. Other reasons for the interest on the subject include, the Maastricht Treaty, which required an independent central bank as a pre-condition for membership in the Economic Monetary Union (EMU); and the Latin American view that central bank independence is a viable institutional arrangement that can reduce the likelihood of a return to high and persistent inflation. In addition, the creation of independent central banks in many former socialist countries as part of a more general approach to the orderly functioning of a market economy, justified the need for Central bank independence.

Recent literature suggests an inverse relationship between inflation and central bank independence. These findings have propelled many governments to consider enhancing the autonomy of their central banks. Again, international organizations such as the World Bank, the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) are strong proponents of central bank independence.

This paper discusses central bank independence. Following this introduction, section two examines some conceptual issues in central bank independence. Section three reviews arguments for and against central bank independence, while section four discusses selected countries' experiences, including lessons. Section five analyses the evolution and key features of central bank independence in Nigeria, while section six concludes the paper.

¹Monetary Policy Department wishes to acknowledge the efforts of **Mr. George Okorie** in producing the initial draft of this paper

SECTION TWO

Conceptual Issues

2.1 Central Bank Independence

A central bank is the monetary authority of a country with mandate to formulate and implement monetary policy. Central banks supervise the banking system of their respective countries. The central bank possesses a monopoly on printing the national currency, which usually serves as the nation's legal tender. The role of central banks globally, involves attaining and sustaining price stability, issuance of legal tender currency and maintenance of sound, safe and stable financial system.

Central banks in most developed nations are constitutionally insulated from political interference. Central bank independence or autonomy refers to the freedom of monetary authorities from direct political or government interference in the conduct of monetary policy (Walsh, 2005). Eijffinger and De Haan (1996) citing Friedman (1962), refers to central bank independence as a relation between the central bank and the government that is comparable to the relation between the judiciary and the legislative arm government. The judiciary can only rule on the basis of laws enacted by the legislature, and it can only be forced to rule differently through a change in the law. A central bank is deemed to be independent if it can make decisions at its own discretion, based on its mandate.

2.2 Dimensions of Central Bank Independence

The literature on central bank independence has identified a couple of scopes of independence.

- (i) **Goal independence:** The central bank has the right to set its own policy goals i.e., inflation targeting, interest rate management, control of the money supply and maintaining a stable exchange rate. While this type of independence is more common, many central banks prefer to announce their policy goals in partnership with the appropriate government departments or ministries. This increases the transparency of the policy setting process, and thereby, enhances the credibility of the policy. It also provides assurance that the goals would not be subject to discretionary impulses. In addition, setting common goals by the central bank and the government prevent conflict between monetary and fiscal policies.

- (ii) **Instruments independence:** Instrument independence refers to the central bank's ability to freely adjust its policy tools in pursuit of the goals of monetary policy. The central bank has the independence to determine the best way of achieving its policy goals, including the types of instruments used and the timing of their use. This is the most common form of central bank independence.
- (iii) **Operational independence:** The central bank has the authority to run its own operations (appointing staff, setting budgets, and so on.) without excessive involvement of the government. This type of independence helps to facilitate other forms of independence.

SECTION THREE

The Arguments for and against Central Bank Independence

3.1 The Justification for Central Bank Independence

One of the most important arguments for central bank independence is the time inconsistency problem (Kydland and Prescott, 1977; Barro and Gordon, 1983; Kasseeah *et al*, 2011). Time inconsistency occurs when what is thought to be best for some future periods is no longer desirable when that period actually comes, and so the policymaker has to readjust the pre-announced plan. In the framework of monetary policy, the time inconsistency problem arises when politicians attempt to exploit the short-run trade-off between unemployment and inflation. Due to political consideration, governments may be tempted to reduce interest rates ahead of elections. This may boost spending and employment in the short-term, but ultimately it causes higher inflation in the long term horizon, unless the capacity of the economy expands to accommodate the higher level of demand. Put differently, an elected government concerned about its immediate popularity might be tempted to go for the short-term gains from lower interest rates, at the risk of higher inflation further down the road, because the short term nature of its tenure in office. Central bankers normally operate with a longer-term perspective than politicians, and therefore, do not face the same temptation to relax policy to achieve short-term objectives. By delegating decisions about interest rates and other monetary matters to such an independent institution, with a clearly defined mandate, society can hope to achieve a better inflation outcome over the longer-term.

Another benefit of central bank independence is its impact on economic growth. Independence makes central banks to be less susceptible to political interference, and therefore, behave more predictably. This may enhance economic stability, thereby stimulating growth. Also, since high levels of inflation may hinder the price mechanism, central bank independence reduces inflation variability and promotes economic prosperity.

Studies have suggested that there is an inverse relationship between central bank independence and long-term inflation. In other words, a low and stable inflation rate is more likely to be found in countries with independent central banks than in those without independence. In addition, there tend to be a negative correlation between central bank independence and the long-term budget deficit expressed as a percentage of the gross national product. This suggests that

countries with independent central banks tend to have smaller budget deficits than those without independence.

3.2 The Objections to Central Bank Independence

Critics of an independent central bank argued that although the average inflation rate and the degree of central bank independence are negatively correlated, this relationship does not reflect any causal link running from central bank independence to low inflation. They claimed that in countries where economic agents strongly object to inflation, there is a strong will to keep inflation down. Conversely, where the economic agents are more tolerant of inflation, they are less inclined to see monetary policy turned over to an autonomous central bank. Furthermore, they claimed that the average inflation is determined by history and the preferences of a country's inhabitants, with causality running from inflation to the institutional structure.

Another argument against the autonomy of central banks is that they form part of overall economic policy, and that there can be no meaningful separation between fiscal, monetary, labour, trade and any other policy measures. If such a separation is attempted and if policies run at cross-purposes, then conflicting objectives may inflict considerable damage on the economy. These critics argued that efficient fiscal and monetary policy formulation and implementation require coordination.

The political argument is that turning over decisions about interest rates, exchange rates, the financial system and other monetary matters to a body of unelected officials, is simply "undemocratic". In a democracy, they argued, all decisions should be subject to scrutiny by the elected members of the legislature and the concept of an autonomous central bank is, therefore, not acceptable (Mboweni, 2000).

SECTION FOUR

Country Experiences with Central Bank Independence

4.1 The European Central Bank (ECB)

The European Central Bank (ECB's) independence is laid down in the institutional framework for the single monetary policy (in the Treaty and in the Statute). Neither the ECB, the national central banks (NCBs), nor any member of their decision-making bodies, are allowed to seek or take instructions from EU institutions or bodies, any government of an EU Member State, or any other body. European Union (EU) institutions and bodies and the governments of the Member States must respect this principle and not seek to influence the members of the decision-making bodies of the ECB (Article 130 of the Treaty).

The ECB's financial arrangements are kept separate from those of the EU. The ECB has its own budget. Its capital is subscribed and paid up by the euro area NCBs. The Statute allows long terms of office for the members of the Governing Council. Members of the Executive Board cannot be reappointed. Governors of NCBs and members of the Executive Board have security of tenure: NCB governors have a minimum term of office of five years; members of the Executive Board of the ECB have a non-renewable term of office of eight years; both can be removed from office only in the event of incapacity or serious misconduct; and the Court of Justice of the European Union is the designated institution to settle any disputes.

The Euro system is functionally independent and is prohibited from granting loans to EU bodies or national public sector entities. This further shields it from any influence exercised by public authorities. The ECB has at its disposal all instruments and competencies necessary for the conduct of an efficient monetary policy and is authorised to decide autonomously how and when to use them. The ECB has the right to adopt binding regulations to the extent necessary to carry out the tasks of the European System of Central Banks (ESCB), and in certain other cases, as laid down in specific acts of the EU Council.

Although, price stability is mandated as the goal of the European Central Bank, the ECB can however, choose how to interpret this goal in terms of a specific price index and definition of price stability. In the European Union, central bank independence is a legal prerequisite for Eurozone membership.

4.2 The Deutsche Bundesbank

The Deutsche Bundesbank is the central bank of the Federal Republic of Germany and also part of the European System of Central Banks (ESCB). Due to its strength and size, the Bundesbank is the most influential member of the ESCB.

The Deutsche Bundesbank was the first central bank to be given full independence, making it a central banking model referred to as 'the Bundesbank model', as opposed, for instance, to the New Zealand model, which has a goal (i.e. inflation target) set by the government. The Bundesbank was greatly respected for its control of inflation throughout the second half of the 20th century. This made the German Mark one of the most respected currencies, and the Bundesbank gained substantial indirect influence in many European countries.

The Bundesbank has a prime, though less specific objective of price stability, formally referred to as the defense of the value of the currency. In addition, the Bank has the obligation to offer general support to the government's economic policy, provided such support does not prejudice the primary objective of price stability. The Bundesbank has no obligation to accept the government's pre-announced inflation targets.

Since 1974, the Bundesbank has been announcing the targeted rate (or zone) for money growth, which implies an inflation target. The German government has been responsible for decisions about exchange rate. In Germany the government can suspend the decisions of the Bundesbank for a maximum of two weeks, requiring only a change in the relevant legislature by a simple majority in parliament to overrule the decision of the Bank (Eijffinger and De Haan, 1996).

4.3 The Bank of England (BOE)

The Bank of England, is the central bank of the United Kingdom and the model on which most modern central banks have been based. It was established to act as the English Government's banker, and is still the banker to Her Majesty's Government. The Bank's monetary policy objective is to deliver price stability (low inflation) and, subject to that, to support the Government's economic objectives including those for growth and employment. Price stability is defined by the Government's inflation target of 2.0 per cent. The remit recognises the role of price stability in achieving economic stability more generally, and in providing the right conditions for sustainable growth in output and employment. The Government's inflation target is announced each year by the Chancellor of the Exchequer in the annual budget statement.

The 1998 Bank of England Act made the Bank independent to set interest rates. The Bank is accountable to parliament and the wider public. The legislation provides that in extreme circumstances, depending on the national interest, the Government has the power to give instructions to the Bank on interest rates for a limited period. The inflation target of 2.0 per cent is expressed in terms of an annual rate of inflation based on the Consumer Prices Index (CPI). The remit is not to achieve the lowest possible inflation rate. Inflation below the target of 2.0 per cent is judged to be just as bad as inflation above the target. The inflation target is therefore symmetrical.

If the target is missed by more than 1.0 percentage point on either side – i.e. if the annual rate of CPI inflation is more than 3.0 per cent or less than 1.0 per cent – the Governor of the Bank must write an open letter to the Chancellor explaining the reasons why inflation has increased or fallen to such an extent and what the Bank proposes to do to ensure inflation reverts to the target. The Monetary Policy Committee's aim is basically to set interest rates, so that inflation can be brought back to target within a reasonable time period, without creating undue instability in the economy.

The Bank seeks to meet the inflation target by setting an interest rate, which is decided by a special committee – the Monetary Policy Committee (MPC). The MPC consists of nine members – five from the Bank of England and four external members appointed by the Chancellor. It is chaired by the Governor of the Bank of England. The MPC meets monthly for a two-day meeting. Decisions are made by a vote of the Committee on a one-person one-vote basis. The Bank, while lacking goal independence, has instrument independence; given its inflation mandate set by the government, it is able to set its instruments without influence from the government.

4.4 The Federal Reserve Bank (The Fed)

The Federal Reserve is an independent government agency but also one that is ultimately accountable to the public and the Congress. The US Congress established maximum employment and stable prices, as the key macroeconomic objectives, for the Federal Reserve, in its conduct of monetary policy. The Congress also structured the Federal Reserve to ensure that its monetary policy decisions focus on achieving these long-run goals, and do not become subject to political pressures that could lead to undesirable outcomes. So, members of the Board of Governors are appointed for staggered 14-year terms and the Chairman of the Board is appointed for a four-year term. Elected officials and members of the Administration are not allowed to serve on the Board.

The Federal Reserve does not receive funding through the congressional budgetary process. The Fed's income comes primarily from the interest on government securities that it has acquired through open market operations. Other sources of income are the interest on foreign currency investments held by the Federal Reserve System; fees received for services provided to depository institutions, such as cheque clearing, funds transfers, and automated clearinghouse operations; and interest on loans to depository institutions. After paying its expenses, the Federal Reserve turns the rest of its earnings over to the U.S. Treasury.

While Congress establishes key objectives that the Fed must follow, the Fed generally works independently of the federal government to administer its core responsibilities.

These duties include:

- I. Conducting monetary policy
- II. Supervising and regulating banking and financial institutions
- III. Providing payments services to financial institutions

In the U.S., the Federal Reserve's goals are set in its legal charter, but these goals are described in vague terms (e.g., maximum employment), leaving it to the Fed to translate these into operational goals. Thus, the Fed has a high level of goal independence as well as complete instrument independence.

4.5 The Reserve Bank of New Zealand

The Reserve Bank of New Zealand is the nation's central bank. The Bank has three main functions, which contribute to New Zealand's monetary policy, financial stability, and currency management. The Reserve Bank has only one formal objective - price stability. The Bank is not independent with respect to its goals. It must agree with the government about a target for inflation, but is free to choose its instruments. The Governor of the central bank can be dismissed if he fails to deliver on the inflation target, although there are escape clauses such as a rise in indirect taxes or a change in exchange rate regimes.

Under the Reserve Bank of New Zealand Act 1989, the Bank is given instrument independence to manage monetary policy and to maintain overall price stability. The operational details of the Bank's inflation target are set out in a separate agreement between the Governor and the Minister of Finance, which is known as the Policy Targets Agreement (PTA). The PTA is a written contract between the Minister of Finance and the Governor, detailing the monetary policy outcomes that the Bank is required to achieve. The key document in relation to

the Reserve Bank's monetary policy decision-making is its quarterly Monetary Policy Statement. The Monetary Policy Statement describes in detail, factors that go into the Reserve Bank's monetary policy decisions, which are based on the Policy Targets Agreement.

The Bank's Funding Agreement is a five-yearly agreement between the Governor and the Minister of Finance that specifies how much of the Bank's income can be retained by the Bank to meet its operating costs; and the Statement of Intent (SOI), which is an annual statement provided to the Minister of Finance covering the Bank's operating environment, functions, objectives and strategies for the next three years, and projected income and expenditure for the first financial year.

The Reserve Bank Act makes the Bank's Chief Executive – the Governor, accountable for the Bank's actions. In monetary policy, and in most other matters, decision-making authority resides with the Governor. The Governor is appointed for a five-year term. The Act sets specific criteria for the appointment, reappointment, and dismissal of a Governor.

The Reserve Bank has a Board of Directors. The Governor is a Board member; the Chair must be a non-executive member. The Board's primary function is to monitor the performance of the Governor and the Bank, on behalf of the Minister of Finance. It has the responsibility to confirm that the Monetary Policy Statements (MPSs) are consistent with the PTA. The Board also provides advice to the Governor. The Board does not direct Bank policy, monetary or otherwise.

4.6 The Bank of Japan (BOJ)

The BOJ's legal independence came in 1998 after central bank officials argued for decades for more autonomy. Its previous charter, based on the Reichsbank of Nazi Germany, was enacted as part of Japan's World War II-era mobilization.

The current law sets the BOJ's objective as achieving "price stability." The BOJ does not have a dual mandate like the U.S. Federal Reserve, which is tasked with keeping inflation in check and pursuing jobs growth.

The Bank's Law also does not have an explicit numerical target for inflation. The Bank can set an inflation target for itself, but has no legal obligation to achieve it. The government is prohibited from firing the central bank governor or members of its board, but has the right to appoint them with approval from both houses of parliament.

4.7 The Reserve Bank of South Africa

The constitution of the Republic of South Africa provides for an independent central bank. Section 224(2) of the constitution states that "The South African Reserve Bank, in pursuit of its primary object must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters". The Bank adopted a formal inflation targeting framework for monetary policy in February 2000. The setting of monetary policy instrument values (like the level of the 'repo rate') is entirely up to the Reserve Bank. Indeed, the Reserve Bank Act, Act No 90 of 1989, allows the Bank a great deal of autonomy in its operations. Section 10(2) clearly states that "the rates at which the Bank will discount or rediscount the various classes of bills, promissory notes and other securities, shall be determined and announced by the Bank from time to time". This plainly gives the Bank the right to determine Bank Rate, or rather the repo rate, in an autonomous manner (Mboweni, 2000). Therefore, the inflation-targeting variable chosen provides for the instrument independence of the Reserve Bank, but not goal independence. The Bank conducts monetary policy in a transparent manner. The Government and public are informed about the monetary policy stance of the Bank, through monetary policy communiques and regular appearance at the Parliamentary Portfolio Committee on Finance. On the basis of this information, the public can evaluate the actions of the Reserve Bank in attaining these objectives.

4.8 Major Lessons from Country Experiences

The major lessons from the foregoing analysis of country experiences include:

- I. The degree of central bank independence varies across countries.
- II. The central banks are accountable to elected parliament and the public in most countries.
- III. Most central banks enjoy instrument independence
- IV. Independence of central banks does not necessarily undermine the monetary-fiscal policy co-ordination.

SECTION FIVE

The Evolution and Key Features of Central Bank Independence in Nigeria

5.1 Evolution of CBN's Independence

The CBN independence began with the promulgation of CBN Decree (now Act) No. 24 of 1991. The enactment of the Banks and Other Financial Institutions Act (BOFIA) 1991, was considered a landmark accomplishment in the Bank's history as they conferred on the CBN some degree of instrument autonomy for the effective discharge of its core mandate. However, the law and its subsequent amendments could not keep pace with the challenges that emerged as a result of the rapid reform programmes of the 2000s. These necessitated a comprehensive review of the existing legal framework in order to strengthen monetary policy formulation and implementation framework, while ensuring its effective transmission as well as the enhancement of the supervisory capacity of the Bank.

Following the CBN (amended Decree No 3) and BOFIA (amended Decree No 4) of 1997, the CBN was directly under the responsibility of the Ministry of Finance, with respect to supervision and control of banks and other financial institutions. The amendment placed enormous power on the Ministry of Finance, while leaving CBN with subjugated role in monitoring financial institutions with little room for the Bank to exercise discretionary power. However, the CBN regained operational autonomy in 1998, as a result of the CBN amendment Decree No 37 of 1998 that repealed the 1997 Decree.

In 2007, the Bank proposed a number of measures for strengthening both the CBN and BOFI Acts. Eventually, only the Bill embodying the CBN Act was passed into law by the National Assembly (NASS) and assented to by the President.

5.2 Key Features of CBN's Independence in the CBN Act of 2007

- i. **Autonomy of the Bank (Section 1(3)):** In the CBN Act of 2007, the operational autonomy of the Bank is clearly expressed in line with international best practice. This will not only facilitate the achievement of its mandate but will also engender stakeholders' confidence. Section 1(3) reads "In order to facilitate the achievement of its mandate under this Act and the Banks and Other Financial Institutions Act, and in line with the objective of promoting stability and continuity in economic management, the Bank shall be an independent body in the discharge of its functions". For instance, the Act in

Section 30, empowers the Bank to carry out open market operations, issue other forms of securities including treasury bills, as may be deemed necessary for the purpose of liquidity management.

- ii. **Objects of the Bank (Section 2):** The objective of price stability is explicitly stated as the core mandate of the Bank. This is informed by the fact that the core function of every central bank is the maintenance of price stability, which is a precondition for economic growth and development.
- iii. **Appointment and Qualifications of the Members of the Board (Sections 8, 10 & 11):** In order to facilitate the achievement of its mandate, the Act states that the appointment of the Governor, the Deputy Governors and non-executive directors shall be by the President subject to confirmation by the Senate while the removal of the Governor is also subject to Senate confirmation i.e., two-thirds majority of the Senate requesting that he be removed. The Governor, as the chairman of the Board, is required to keep the President informed of the affairs of the Bank, including a report on its budget; and appear before the National Assembly periodically to present a report on the activities of the Bank.
- iv. **Establishment of the Monetary Policy Committee (MPC) (Section 12):** The MPC is established to facilitate the attainment of the Bank's objective of price stability. In order to improve the process for monetary and credit policy formulation and implementation, the MPC, with the Governor, as the Chairman, has been formally constituted with membership drawn from within and outside the Bank. Membership of MPC includes the Governor and four Deputy Governors, two external members appointed by the Governor and three external members appointed by President as well as two members representing the Board. This is intended to enhance the quality of monetary policy, introduce transparency into the process as well as facilitate its transmission mechanism. The MPC meets bi-monthly to review the conditions and challenges that confront the domestic economy and take appropriate decisions in line with its price stability objective. The communique is read by the Governor at the end of the meeting, and is published on the Bank's website along with the personal statements of members.
- v. **External Reserves Management (Section 24):** The Act gives the Bank greater flexibility in the selection of instruments and assets in which to invest external reserves. While the existing restrictions are based on considerations of safety and security of the reserves, the dynamics of

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modern day reserve management makes it necessary for the CBN to retain some flexibility in determining the choice of instruments. The Bank has also been empowered to invest part of the external reserves, by way of loan or debenture, in any suitable development financial institution subject to appropriate limitations.

SECTION SIX

Conclusion

The broad consensus is that monetary policy committees could be established by the government, but the conduct of monetary policy must be free from political interference. To achieve both price stability and sustainable employment, monetary authorities must steer the economy toward economic growth. In view of the lags in the effects of monetary policy, achieving this objective requires policymakers to take a longer-term perspective in decision making. An independent central bank with a mandate to achieve the best possible economic outcomes in the longer term, should take such a perspective. Excessive political influence on monetary policy decisions can also weaken the ability of the central bank to control inflation.

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