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The Role of Central Banks in Economic Development

by

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The terms economic growth and development are sometimes used interchangeably by some economists. Such usage can lead to confusion. It is, therefore, appropriate to point out the distinction between economic growth and development since both terms have different meanings. Generally, economic growth refers to increases over time in a country's real output of goods and services. Output is conveniently measured by the gross national product or national income. Economic development implies not only more real output but growth accompanied by changes in the structure of the economy, including its social and political structures. Indeed changes in both the technical and institutional arrangements by which output is produced and distributed are part of economic development. In some cases there is no development to the extent that there is growth in poverty. Thus, within the framework of the definition above, it is possible to have growth without development since both of them are not exactly the same'.

A look at economic history indicates that no nation has ever developed without an appreciable growth in the financial sector. Both the financial sector and the real sector of the economy are interwoven. Developments in the real sector influence the speed of growth of the financial sector directly; while the growth of finance, money and financial institutions influence the real economy. Saving is a major determinant of the rate at which productive capacity and hence income can grow (WDR, 1989). Evidences have shown that the faster growing developing countries have had higher savings rate than the slower growing ones. Availability of financial institutions makes savings possible and these savings are in turn, through the process of financial institution's intermediation role, directed at investments which lead to the accumulation of capital stock. Indeed, "faster growth, more investment, and greater financial depth all come partly from higher saving. In its own right, however, greater financial depth also contributes to growth by improving the productivity of investment. Investment productivity... is significantly higher in the faster-growing countries, which also have deeper financial systems. This suggests a link between financial development and growth" (WDR, 1989, p. 31). Systematic analysis of the relationship of financial development has been undertaken by a number of authors including Goldsmith (1955, 1969), Gurley and Shaw (1955, 1969), Mckinnon (1973), Gupta (1984), and Fry (1988). Explicit or implicit in these sets of studies is the idea that a financial system enhances economic development at least in the early stages, through the improvement in efficiency brought about by the provision of a means of payment and payments system and the reduction in search and information costs which could otherwise be prohibitive. Yet, for the growth of a financial sector, an apex institution which is a central bank plays a vital role.

II. A Historical Perspective.

A Central Bank is an institution charged with the responsibility of regulating the supply,

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availability and the cost of money in the interest of social welfare. In doing its job, a central bank is empewered through various acts setting it up. Today, it is hard to think of several countries without a central bank because of the importance and relevance that central banking has gained. The conception of central banking in the modern sense started with the establishment of the Bank of England. It, however, took mainly the complex financial problems that wars and economic crises produced to accord central banking the distinctive role that should be given to it both in practice and theory. What really catapulted the principles and operations of central banking into the center of the economic stage was the various economic, political and social changes which occurred between the two world wars. Throughout the world, governments have taken necessary measures to ensure the integration of central banking more closely into the machinery for carrying out macro-economic policy.

In Africa, having a central bank was considered the *sine qua non* of political independence since moving away from the currency board system was considered essential. As explained by the then leader of Ghana, Dr. Kwame Nkrumah, "Our political independence will be worthless unless we use it to obtain economic and financial self-government and independence".[2] Central banks in Africa are state owned and have a powerful role in macro-economic policy making.

As an apex financial institution, the functions of a central bank (widely defined) are uniquely different from those of all other financial institutions. By and large, the most important traditional function of central banks to which the others are subsidiary is the regulation of the stock of money in such a way as to promote the social welfare. This general purpose, which is characteristic of all central banks, is singularly unique. The roles of a central bank in an economy are necessarily influenced by a host of factors. These include the characteristic of the monetary system, the organisation of financial markets, the political and sometimes ideological environment, and the stage of economic development.

III. Roles of Central Banks

A thorough examination of the roles of central banks is important in putting in perspective the importance of these roles in economic development. The first role is that of issuing currency in adequate quantity for the smooth running of an economy. As the ultimate source of liquidity in the system, it has the monopoly of issuing a nation's currency. A central bank, therefore, has the responsibility of ensuring the adequate provision of currency to a nation so that economic activity is not impeded by inadequate stock. Similarly, it also has to ensure that the possibility of excessive issue, which can lead to inflation, is eliminated. In performing this role adequately and in an efficient manner, central banks ensure that the course of economic growth and development is not impeded.

The second function is that of the fiscal agent of government. The services of a central bank in this role include the holding of government account, cashing of cheques drawn against it, the transfer of funds throughout the country and internationally, the payment of outstanding government obligations both nationally and internationally as well as the payment of interest on outstanding government obligations. These seemingly routine tasks are very important for the smooth operation of an economy. More important than these routine tasks is the need to guard against the disturbance to the economic system which the fiscal operations of government activities may bring about. Thus, a central bank should be in a better position to advise government as to its timing of spending and monetizing its earnings. This is an important task which often is not allowed to be performed by governments in developing countries with dire negative consequences on their economies.

The third function is that of acting as the lender to government. Some investments are needed to be made which cannot be undertaken with limited revenue from the tax system and the need arises to borrow from central bank. Such borrowing, depending on how it is done and how the fund is utilized, can lead to growth. Fourth, as the lender of last resort to a fractional reserve banking system, it provides much needed finance to the banking sector and thereby serves as the necessary lubricant for economic development. Fifthly, there is also the developmental function of central bank which assumes a position of prominence in developing countries. In these countries, improvement in the existing banking/financial institutions, promotion of new financial institutions and direct or indirect provision of credit for economic development are very important and certainly not less than that of the traditional monetary management functions. Thus, an efficient financial system is part of the essential financial infrastructure without which economic development cannot take place. Thus, part of the functions of central banks is to facilitate and encourage the establishment of financial institutions and markets. Such institutions and markets include those that are to give long term funds, specialised financing, and securities markets etc.

Sixthly, central banks have important supervisory and regulatory role to play in order to ensure that the banking system operates in both a prudent and efficient manner in order to avoid distruption to the economy and financial distress. There is need for the laying down of rules for the establishment of banks and other financial institutions' supervision to ensure proper accounting as well as auditing standards. The legislations establishing central banks in Africa endowed them with a number of functions one of which is to promote sound and efficient financial structures through regulations governing the operation of other financial institutions, including commercial banks, finance houses, insurance companies etc. In all cases, the objective of the financial regulations and supervision includes the promotion and development of the widest possible ranges of financial services to meet the adequate needs of an economy.

The role of central banks is not only to regulate and monitor the financial system but also to ensure its development and prevent financial disaster which would not only undermine confidence in the financial system but also have serious consequences for the economy. Lastly, as the watchdog of the economy, central banks have special roles to play in the stabilization. Thus, central banks have the responsibility to regulate the level of aggregate demand and direct the application of credit controls in the interest of fostering certain sectors of the economy. The stabilization role of central banks is not easy in Africa because of large external shocks which they have been experiencing in recent times and the poor state of stabilization instruments in general.

IV. The Central Bank of Nigeria and Economic Development

The role of a central bank has to be appreciated within the context of an economy in which it operates. It is therefore pertinent to relate the issues mentioned in earlier sections to the reality of the Nigerian situation and examine the extent to which the Central Bank of Nigeria (CBN) has promoted economic growth and development. Perhaps a very good way of looking at the CBN can be summarized in the words of its Governor:

"The establishment of the Central Bank of Nigeria (CBN) was motivated by the need to have an appropriate financial environment for development. When it was established, it was charged specifically with the responsibility of contributing to growth and development through the provision of financial services. Although the law establishing it has undergone some changes over the years, the immediate functions for its establishment remain the same" (Ogwuma, 1993, p. 151).

When the CBN was established in 1958, there was no dynamic banking policy and regulation. The financial system was dominated by expatriate banks which accounted for about 90% of Nigeria's banking business, the preponderant of the indigenous banks having crashed in the 1950-52 era. Given the underdevelopment of the financial system which was considered an essential factor in the mobilisation of resources, the efficient allocation of credit and the pooling, pricing and trading of risks. While the initial emphasis was finance for the government sector, it soon became obvious that the private sector is important in the process of growth and development of any economy.

The original source of the legal authority of the CBN was the CBN Act of 1958 and its amendments. Today, the main sources of the Bank's legal authority in the discharge of its responsibilities are the CBN Decree No. 24 of 1991 which replaced the CBN Act of 1958 and amendments and the banks and other Financial Institutions Decree (BOFID) of 1991 which replaced the Banking Decree of 1969, and its subsequent amendments. The former is intended to strengthen the powers of the CBN as an agency of government charged with the responsibility of maintaining macroeconomic stability widely conceived, developing the financial sector and thereby enhancing the growth and development as well as the stability of the economy. The BOFID is designed to provide effective regulation of financial institutions.

The duties and responsibilities of the CBN which have essentially been the same since inception have nevertheless been substantially influenced by external shocks and domestic macroeconomic factors, complexity of the economic system and the intricate linkage with the global economy all of which combine to test the efficacy of orthodox method of monetary control. Additionally, the vicissitudes in the fortune of Nigeria have influenced the type of controls (direct or indirect) adopted. Before the adoption of the Structural Adjustment Programme (SAP) in 1986, reliance was placed on direct controls to carry out its responsibilities of contributing to economic growth and development by developing the financial sectors.[3] Before the SAP, the monetary and banking policy was designed to foster macroeconomic stability and the development of the financial sector, while the external sector policy was one of fixing administratively the exchange rate, and maintaining adequate reserves to protect the international value of the naira. With the adoption of SAP, reliance was placed on market forces and deregulation was in vogue.

A. The Promotional Role of the CBN

(i) Establishment of Money and Capital Markets

With the importance of the money and capital markets in mind, the CBN took active part in their establishment. The former facilitates the intermediation of short-term funds, while the latter deals with the mobilization and channelling of longer-term capital resources. The advantages of the emergence of these markets are enormous. The emergence of capital markets can greatly improve the management of risk in individual enterprises. Additionally, money and capital markets can help inject a higher degree of competition into the financial markets and this will be normally welfare-enhancing. Given now the present trends, the existence of appropriate security markets is an essential prerequisite for the move to an indirect form of monetary control. The money market instruments have widened over the years. The fortune of these instruments have been affected by the fortunes of the economy: in particular the earnings form oil.

(ii) Specialized Financial Institutions

In addition to the development of money and capital markets, the CBN has also been instrumental in the setting up of specialized institutions and has in addition equity participation in them. These include the Nigerian Bank for Commerce and Industry (NBCI), the Nigerian Agricultural and Co-operative Bank (NACB), the Nigerian Export Import Bank (NEXIM) and the Federal Mortgage Bank (FMB). The first four institutions have been the driving force in the development of the industrial and com mercial sector of the Nigerian economy. These institutions have not been total success because they have not been able to mobilize funds on their own and have depended mostly on donor and government support.

(iii) Promotion of Banking Habit

The CBN has encouraged savings and fund mobilization especially in the promotion of rapid expansion of banking services to both the rural and urban areas. The expansion of banks to the rural areas developed through the rural banking scheme and ensured that banks at that time fulfilled the necessary balance between urban and rural branches. The expansion and growth of banks since the adoption of the SAP in 1986 came about as a result of the liberal licensing policy, the macroeconomic advantage which make banking ventures lucrative with less risk, and the expectations of a buoyant economy. With the liquidity squeeze in the economy, the removal or the imposition of restrictions, the political instability and the economic decline associated with it, some of the banks have seen better days. Some banks have collapsed as a result of chronic financial dis tress, while others still have financial distress hanging over them like the sword of Damocles.

(iv) The Monetary Policy Role of the CBN

The CBN has the responsibility of implementing the monetary policy approved by the Presidency. In other words, monetary and banking policies of the CBN are implementable only when approved by the Federal government.[4] The objectives of monetary policy in Nigeria aimed at economic growth and development widely defined include (see Ojo, 1995, and Ogwuma, 1993):

(i) Reduction of pressure from the external sector;
(ii) Stabilization of the naira exchange rate;
(iii) Stabilizing the inflation rate in the economy;
(iv) Inducing increased savings and investment;
(v) Increasing local production and employment;
(vi) Increasing savings from non-oil exports;
(vii) Enhanced external reserves; and
(viii) Improving capital inflow.

For the achievement of the objectives, the strategies adopted have varied between the pre 1986 era and after. Before 1986, the policy instruments comprised the imposition of credit ceiling on banks, fixing the interest rate and exchange rate administratively, and the stipulation of sectoral credit allocation. These were also supported by special deposits and cash requirements. Between 1986 - 1994, attempts were made to develop and promote a deregulated, competitive and sound financial system. This led to the deregulation of interest rates, and the strengthening of the legal and institutional framework.[5]

(v) What judgement can we make about the role of the CBN in economic development?

There are many ways of judging the contributions of the CBN to the growth and development of the economy. In doing so, it is necessary to separate growth from development. Given the rising level of poverty in the economy and other associated economic malaise, it would be unfair to link all these directly to the performance of the Central Bank of Nigeria because other forces which are really external to the CBN are at work.

The CBN cannot be rightly said to have dealt with poverty. In judging the CBN, it is necessary to take a historical perspective of its role within the economy, and assess what it has achieved taking due cognisance of the external influences on its action, the changing nature of the economy in terms of its complexity, etc. The assessment can be made on three sets of criteria. The first is the promotional role of the CBN, the second is an assessment of the intermediate indicators of its policy, and the third is an assessment of its ultimate indicators.

Taking a historical perspective, it is appropriate to assert that the promotional role of the CBN which can contribute to growth has been successfully performed. Of particular note in this respect is the promotion of the money and capital markets. Even though the number of instruments of the money market has grown, there is need for further deepening and diversification of instruments. The necessary financial infra-structure for the growth of the money and capital market can be said to be in existence.

We can now look at the intermediate variables: the growth of M2/GDP, the credit to the economy measured by the ratio of banking sector claims on the private sector, and distribution of changes in domestic credit, and changes in interest rates. These and other data are shown in Tables 1, 2, 3 and 4. the ratio of M2/GDP measures the degree monetization of the economy. As can be seen there is a high degree of variability in this ratio. The variation in the changes of domestic credit is also indicative of the contribution of the CBN to development of the economy. Investment as a percentage of GDP shows the extent to which there has been capital formation within the economy. Total savings in the economy grew substantially between 1986 and 1992 with an average growth rate of 20%. The quantity of money as shown in the monetary survey shows the percentage rate of increase in both the narrow and broad definition of money supply. All these are variables which could be meaningfully utilized to judge the performance of the CBN in the economy.

It is appropriate to examine the final outcomes to see the extent to which the CBN has performed the job of economic growth and development. This can be done by examining the rate of growth of output, inflation rate, savings and investment, money supply and the balance of payments. This is shown partly in table 1 and the changes in interest rate are shown in table 5. As can be seen, inflation in the economy has been very difficult to contain. This might not be unconnected with the fiscal deficit of the government. This has also generated exchange rate depreciation. Over the last several years in particular between 1986 - 1993, the naira exchange rate has fluctuated widely. Given the important role which the exchange rate plays as a price within the economy, the ripple effects on the rest of the economy have been significant. The balance of payments has also suffered from some severe pressure and this has no doubt affected the development of the economy.

On balance, the Central Bank of Nigeria has fared well in some aspects and poorly in others. In a way, this is normal in life. It will be inappropriate, however, if we do not mention some of the constraints under which the CBN operates. The most significant is that the CBN is the fiscal agent of the Federal Government and has little or no say in the process of granting advances to the Federal Government. From all available evidences, on the amount of grants given to the Federal Government, the CBN has no power to call the former to order on its borrowings! This to my mind, is one of the problems and great constraint on the management efficiency of the CBN. There are stipulations in the Decree as to the amount of money that can be borrowed as a proportion of Federal Government revenue and for what duration. Keeping to the rules as it is in the various decrees will go a long way to assist the CBN in the performance of its job of economic stabilization.

VI. The Future Role of the CBN

In discussing the future role of the Central Bank of Nigeria, certain questions are really pertinent. The first is to ask if the Central Bank of Nigeria is trying to do more than it should be doing? Given the roles of the Central Bank, is it presently overstressed or stretched? My answer to both question are "Yes". The first principle the CBN must learn on the road to wisdom is an appreciation of what it can meaningfully do within its powers since certain functions are really exogenous to it, as well as having a proper understanding of what lies within its power to control. A Central Bank is more effective in dealing with those parameters or variables which are within its immediate control than those which are outside its control. Using that rule of thumb, it would seem obvious that the CBN can achieve more effectiveness if it concentrates more on fostering the development of the payments mechanism, and intensify its promotional role in the economy.

The payments mechanism is a catch phrase for a number of things including fostering a culture that moves away from a basically cash and carry economy to one that utilizes cheques. It also involves the strengthening of its traditional function of currency issue, and the mobilization of financial institutions in general and fostering the development of appropriate technology to deal with the issues of mobilization and payments mechanism, in particular. Part of this function includes also its traditional of controlling other financial institutions: its control and supervision, and the conduct of monetary policy in general.

FOOTNOTES

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   There can be growth without development as shown by Robert Clower *et al.* (1966) *Growth without Development: An Economic Survey of Library.* Evaston, Ill.: North Western University Press. There is also Stopler's book on growth without development in Nigeria.

2. Kwame Nkrumah. (1961) **I speak of Freedom**. London: Mercury Books.

3. The instruments for the execution of monetary and banking policy included cash reserve requirements, liquidity ratio, special deposits, stabilization securities, direct regulation of interest rates, direct controls, moral suasion and general directives.

4. Since 1988, the proposals of the CBN are sent directly to the presidency as opposed to an earlier system where proposals were sent through the Minister of Finance.

5. Besides the principal monetary policy role of the CBN, significant contributions are also made in other spheres of the national economy. The CBN maintains a research departmeht that undertakes studies dealing with the national economy, and publishes the results for government and other policy analysts and decision-makers. The competence of the department notwith standing, the research output can benefit immensely through outside participation with University researchers with competence in the areas of the research department's interests.