CENTRAL BANK AND THE GLOBALIZING FORCES OF THE 21ST CENTURY

Director General, NIPSS,
Participants of the Senior Executive Course No. 25
Distinguish Lecturers and Staff,
Ladies and Gentlemen,

SECTION 1

1. Introduction

1.1 It is my honour and priviledge to address you once again on another important topic "Central Bank and the Globalizing Forces Of the 21st Century". Let me note at the onset that the closing decades of the twentieth century witnessed a world that has become spatially smaller as a result of globalisation, propelled by tremendous advances in science, and communication and information technology. Such advances as the internet have shortened the time and distance for production and distribution of goods and services. Thus, national borders have become less of a hinderance in international trade and financial transactions. These have also brought about lower transaction costs across businesses and new challenges for central banks.

1.2 Although many countries are at various stages of development, no country can ignore the significant changes in the world economy, which have been characterised by competitive pressures, volatile financial markets and paradigm shifts in the management of national and regional economies. In particular, central banks in developing countries can no longer remain inactive as the debate is no longer on whether globalisation is good or bad, but on how best to manage this irreversible process to ensure that the benefits are widely shared and the risks kept to the barest minimum.

1.3 The interdependence of national financial and economic systems has become greater today than ever before and nations that build protective walls around their economies would be undermining their growth and development. Thus, the interaction of development in technology with deregulation has contributed substantially to reshaping the financial landscape in most countries and therefore, challenged central banks in their task of maintaining monetary and financial sector stability.

1.4 The main objective of this paper is to highlight the implications of globalisation for central banks in the process of financial sector surveillance, monetary management and macroeconomic stabilization. The rest of the paper is divided into five sections. Financial markets and the forces of globalisation are discussed in section two. Section three discusses the role of the central bank in a globalised environment, while the experience of the Central Bank of Nigeria is discussed in Section 4 the constraints and challenges to monetary policy and management in Nigeria are discussed in section five. Section six concludes the paper.

SECTION 2

2.0 Financial Markets And The Forces Of Globalisation

2.1 Generally, globalisation can be viewed as the integration of national economies through trade, capital flows and the accompanying convergence of economic policies. Beyond the economic perspective, globalisation also includes the harmonisation of political and socio-cultural systems. However, my presentation in this paper is going to focus on the former.

2.2 Globalisation is rooted in multilateral trading and investment arrangements and the opening up of trade through liberalization of the financial sector, and the adoption of current and capital accounts liberalization. The reasoning behind the policy thrust is that the promotion of trade enriches the wealth of nations. For instance, the trade liberalization under the Uruguay Round of multilateral trade agreement of 1995 was estimated to have provided over $100 billion a year in net benefits accruing mainly to those countries that have removed trade barriers. These gains have translated to faster economic growth and improved standard of living for the citizenry.

2.3 Financial integration as a part of globalisation therefore, envisages the free flow of loanable funds. Openness of capital flows, when combined with sound domestic policies, allow countries access to a much larger pool of capital. High capital flows lead to enhanced investment and economic growth, particularly when the inflows are in foreign direct investment – as against potentially volatile short term portfolio flows. Furthermore, foreign direct investment not only complements domestic savings, but also enhances the depth and efficiency of the domestic financial market and the absorption of foreign technologies. However, the monetary and fiscal policy framework of the nation must be appropriate for the economy to benefit from financial globalisation.

2.4 Globalization is not a new phenomenon as it has progressed throughout the course of history, dating back to the late 19th century. The history was, however, chequered and the speed slowed down until the new era of global intergration, facilitated by the removal of barriers to trade and capital flows as well as the advancement in communications and computer technologies, which have made easy the collection and processing of data needed for decision making. Consequently, the world exports of goods and services have more than tripled between 1983 and 2003. These changes have also stimulated demand for cross-border finance, against the background of financial liberalization in many countries, promoted a pool of global capital and liquidity to meet such demand.

2.5 Financial sector liberalization and product innovation have, in many countries been helped by technological advances to create a more competitive market environment for financial institutions and enhanced efficiency in financial intermediation. The regulatory authorities in many countries have liberalized rules governing the provision of financial services to allow non-bank financial institutions, including investment banks, security firms, asset managers, mutual funds, insurance companies, finance companies, lodge funds, etc to provide services similar to those traditionally provided by banks. Even within the banking industry, the demarcation between merchant and commercial banking has been removed by globalisation and competitive funds, ushering in the era of universal banking, where banks are free to curve out their niches in the market.

2.6 These developments and the attendant innovations in financial products have altered the structure of financial markets with implications for central banks in the conduct of monetary policy and surveillance activities. Some of these notable changes are highlighted below:

i. Financial intermediation has increasingly shifted from bank loans and deposits to the use of tradable securities for corporate financing.

ii. Cross-border financial activities increased as investors diversify their portfolios internationally and major borrowers gain access to international capital markets from major financial centres

iii. Non-bank financial institutions compete aggressively with banks for household savings and corporate finance, thereby, driving down the prices of financial instruments.

iv. Banks have expanded their operations outside the traditional banking areas into investment banking, asset management and even insurance business because regulatory barriers to such operations have been relaxed, thereby enabling them to diversify their earning sources and business risks.

2.7 Globalization of financial markets has no doubt increased opportunities for accessing capital funds from both domestic and foreign sources more cheaply and on better terms. Moreover, investors can more easily diversify internationally and tailor their portfolio risks to their preferences. Thus, savings and investment which promote real economic activity and growth are encouraged. The downside to those benefits is that international capital flows could be very volatile and, thereby, pose serious threats to financial and macroeconomic stability. The surge in inflows, often results in problems of macroeconomic stability, often requiring efforts by the monetary authorities to sterilize. On the other hand, reversal of capital flows as witnessed during the Mexican crises of 1994 – 95 and the Asian and Russian crises of 1997- 98 could endanger the financial stability of the individual countries particularly where banks are weak and poorly regulated. The contagion effect could as well threaten the stability of the international financial system. There is also the risk that during a period of boom and bust, asset prices may over-shoot economic fundamentals, thereby saddling banks with non-performing loans backed by collaterals that have lost much of their value. The central bank is therefore faced with challenges and a myriad of problems in ensuring macroeconomic stability and financial sector soundness.

SECTION 3

3. Central Banking In A Globalized Financial Environment

3.1 In a globalized and dynamic financial environment shaped by technological revolution and deregulation, a central bank has responsibility to maintain price stability as well as a sound and stable financial system.

3.2 The maintenance of price stability has indeed, become the primary objective of every central bank, the world over. While, central banks are of course, not insensitive to the growth objective, they believe that it should not be stimulated at the expense of price stability, because such a stimulus would be short-lived and would imply longer-term costs. Moreover, it is important to recognize that monetary policy would exert influence on the demand side of the economic, but cannot solve structural problems that could impede output and employment growth. Nevertheless, they can contribute to sustainable output growth, as far as the risks of price stability are linked to the business cycle.

3.3 The challenge of globalisation to central banking is that technological changes and financial developments have influenced changes not only on the instruments of monetary policy but also the transmission mechanism. Consequently, the strategy for the conduct of monetary policy by the central bank has changed as evidenced in the shift from direct instruments of monetary policy to indirect tools, in the wake of financial sector deregulation. The development of e-money, e-banking and e-finance also presents a great challenge in the conduct of monetary policy. With regard to the task of ensuring banking soundness and stability, central banks face similar challenges in their surveillance activities. Financial market developments induced by technological changes could also be associated with high risks. The adoption and effective monitoring of international prudential standards, in line with the new Basle proposals are compelling. In this regard, national authorities have to streamline their supervisory structure and procedures.

3.4 In addition, a more globalized financial market calls for a more globalized approach to banking supervision. Already, several cooperative bodies and mechanisms have been established, either in form of unilateral fora or by means of bilateral protocols between the supervisory bodies of different countries to ensure effective coordination. The role of market discipline involves forcing financial institutions to be more transparent in providing credible and reliable information to guide public decision making. Also, central banks contribute to the strengthening of the financial system by developing efficient payment and settlement systems which are facilitated by these developments.

3.5 Overall, the close connection and the convergence existing between the two goals of financial and monetary stability must be recognized in a globalized world economy.

SECTION 4

4. The Role of the Central Bank Of Nigeria h a Globalised Economic Environment

4.1 Globalisation influences the financial sector in different and complex ways. Typically, capital flows, exchange rate crises and inflationary pressures are some of the major avenues through which the impact of globalisation can be quickly transmitted into the domestic economy.

4.2 The implications of globalisation for monetary policy can be seen mainly through two channels. First, volatile short-term capital flows and exchange rate movements, which are associated with globalisation can cause an increase in the uncertainties surrounding the outcome of monetary policy. This leads to changes in market expectations. Secondly, globalisation forces policy makers to undertake structural adjustment/reforms, which change the conditions under which monetary policy is implemented. This in turn can lead to changes in monetary policy targets, strategies and instruments. It is generally believed that the more discretionary monetary and fiscal policies are constrained the more open an economy becomes.

4.3 Globalisation compels governments to exercise greater fiscal discipline and to ensure sound institutional and political frameworks. In other words, it does "act as a force for stability by limiting the scope for countries to pursue policies that are consistent with medium-term financial stability". High fiscal deficits and unsound financial policies that lead to inflationary pressures, current account deficits and/or high real interest rates, sooner or latter tend to be penalized by international investors and global capital markets. Thus, the room for fiscal rascality or unsustainable policies is much reduced in a globalized world.

4.4 Specifically, monetary and exchange rate policies have undergone changes in line with broad economic objectives. From independence and up until 1986, the conduct of monetary policy was mainly by direct control, which involved the imposition of ceilings on aggregate bank credit expansion, sectoral allocation of credit, administrative control of interest rates, prescription of cash reserve requirement, exchange rate controls and the mandatory holding of government securities. The financial market during this period was mainly underdeveloped, repressed and restricted; with a few money market instruments and, fixed and inflexible interest rates. While sectoral allocation of credit was meant to stimulate investment and growth of the productive sectors, the fixed interest rate regime was expected to provide cheap credit to the preferred sectors of the economy.

4.5 Unfortunately, these policies produced unintended consequences during the period. The huge inflows from the oil boom of the 1970s fuelled accelerated growth of monetary aggregates. Government fiscal deficits increased substantially, averaging 4.2 per cent of nominal GDP in 1975–1978. Consequently, there was macroeconomic instability as inflationary pressures mounted and real GDP growth slowed from an average of 11.2 per cent in 1970-1974 to 2.3 per cent in 1975-1979. (see table 1).

4.6 The picture in the early 1980s was not different. Indeed, the oil shock of the period worsened economic performance. The sharp fall in the spot price of Nigeria's crude oil from US$38.82 per barrel in 1980 to US$30.0 per barrel in 1983 and to a low of US$14.16 per barrel in 1986 necessitated the enactment of the Economic Stabilization Act of 1982 designed, to stem further decline of the economy. However, direct monetary and exchange rate control was retained as the policy framework. Quantitative restrictions and high tariff walls to protect infant local industries also characterized the trade regime. The outcome of the policies was disastrous. Output growth averaged –3.8 per cent between 1980-1985. Despite the stringent stabilization measures adopted in 1982, imports continued to dominate foreign trade and as a result, net non-oil export was in deficit in dollar terms up to 1985 (see table 2).

4.7 The failure of monetary and exchange rate policies to achieve the desired economic objectives under the control regime, led to the adoption of the IMF

Structural Adjustment Programme (SAP) in 1986. In particular, its major elements were the deregulation and liberalisation of the financial sector and the trade regime. Thus, 1986 marked the beginning of Nigeria's response to the globalizing forces of the 21st century – and the adoption of international best practices in macroeconomic management.

4.8 Consistent with the policy of deregulation and globalisation, the CBN adopted the policy of liberal licensing of banks in order to improve the efficiency of financial sector, and enhance financial deepening. In addition, the Bank adopted a market based interest rate regime in August 1987. This was complemented by the subsequent deregulation of the foreign exchange market. However, market failure and pressures, caused by fiscal shocks compelled the monetary authorities to reintroduce ceilings on interest rate in 1991 as a temporary measure. In October 1996, interest rates were fully deregulated. In line with market-based approach to monetary control, the CBN also introduced the Open Market Operations (OMO) and discount window operations. These have remained the dominant instruments of monetary policy in Nigeria.

4.9 Similarly, the Bank had since 1986 adopted different techniques of exchange rate management including the Dutch auction system under a dual exchange rate regime (1986-1987), the Inter-bank foreign exchange Market (IFEM) (1992), the fixed exchange rate (1993), the managed float – the Autonomous foreign exchange market (AFEM 1995), and the re-introduction of the Dutch Auction System (DAS) since 2002 to date. These changes in exchange rate management policies were as a result of unintended policy outcomes and shocks from the external sector. In addition to deregulating the exchange rate, external sector policy such as the abolition of import and export licensing were implemented in recognition of the influence of globalisation. Indeed, the virtual adoption of current account convertibility by the CBN would not have happened if Nigeria were not a major player in international trade.

4.10 In the area of fiscal policy, a major step towards globalisation had been the harmonisation of the tariff regime to some extent along the WTO principles. Nigeria has discontinued the policy of import licensing, quotas and non-tariff protection. Bold steps have also been taken towards the commercialisation and privatisation of public enterprises to encourage private ownership and to improve their efficiency.

4.11 The deregulation and liberalisation of trade and the financial sector, embarked upon in 1986 has produced positive and negative macroeconomic outcomes. Overall, financial deepening has occurred, while real output (GDP) and employment performance have remained lacklustre. GDP, grew at an annual average of 6.2 per cent in 1971-1980 and stagnated at an annual average of 3.8 per cent in the post liberalisation years of 1986 up until 2001. However, counterfactual evidence strongly suggest that economic performance would have worsened in the absence of liberalisation. Similarly, inflation, which averaged 16.1 per cent in 1970-1985, intensified in 1986-2001 to an annual average of 26.7 per cent and reached an all time high of 72.8 in 1995 (table 1). Also, the external sector performance has remained under severe pressure since 1986, despite repeated episodes of positive terms of trade shocks. The lack of external sector viability is actually manifested in the naira exchange rate volatility.

4.12 Nigeria's trade regime has been geared towards the dismantling of trade barriers and tariff harmonisation, in line with the WTO agreements. However, it appeared that the net gains from globalisation have been disappointing relative to expectations. The terms of trade in the non-oil sector have been persistently against Nigeria in dollar terms since the 1970s. Non-oil exports earnings which rose to a peak of US $1,195.3 million in 1979 dropped to an annual average of US $409.5 million in 1981-1985 and further to US $388.7 million and US $288.5 million in 1986-1990 and 1991-2001, respectively (table 2). The ratio of non-oil exports to non-oil imports, which averaged 20.2 per cent in 1970-1980, fell to an average of 3.4 per cent in 1981-1985, and recovered sluggishly to an average of 12.1 per cent in 1986-1990. However, it fell sharply to an average of 4.1 per cent in 1991-2001. Similarly, the balance of trade deficit, which peaked at US$19,433 million in 1981 improved significantly in 1986 when it moderated to US$1,362.12. Nigeria would have remained a net importer of goods and services in the absence of the oil sector (table 2).

4.13 Data on flows of foreign private capital between Nigeria and her major trading partners show that net flow of capital has been dwindling. For example, net flow of private capital between Nigeria and the United Kingdom, the United States Of America and Western Europe stood at annual average of US$560.7 million, US$87.3 million, US $166.4 million, respectively in 1980-1985. This average dropped to US$133.4 million, US$16.8 million and US$19 .0 million in 1986-1990. In 1991-2001 the average stood at US$49.9 million, US$60.4 million and US$156.3 million, respectively (table 3). The dwindling flow of capital could be attributed to Nigeria's political instability and un-conducive macroeconomic environment particularly during the military regimes.

4.14 What is evident from the foregoing is that globalisation per se, may be a necessary but hardly a sufficient condition for the flow of foreign direct investments into Nigeria. What the theory may have failed to acknowledge is the fact that capital will naturally flow only where the socio-economic fundamentals are right.

SECTION 5

5. Constraints and Challenges to Monetary Management In Nigeria

5.1 The CBN continues to face challenges in the conduct of monetary policy, especially, since the financial sector reforms began in 1986. Some of these challenges relate to fiscal, structural, legal/institutional, infrastructure and data issues. One factor that has constrained and undermined the efficacy of monetary policy is fiscal dominance. For instance, in the recent past, monetary expansion had exceeded stipulated targets by substantial margins, due largely to fiscal expansion, arising from the monetization of revenue from crude oil sales. At such times, advice by the CBN to government urging the sterilisation of excess revenue from crude oil had been ignored under the oegis of Federal capitalism,

5.2 Indeed, some State Governments even borrowed from commercial banks to spend on non-productive ventures. Although the Bank had made some progress in eliciting cooperation from the Federal Government, it has been difficult to get the state governments to appreciate the negative impact of fiscal indiscipline on the macroeconomy. Macroeconomic instability gives rise to market distortions, inflationary pressures and exchange rate volatility. Under such conditions, the economy cannot be internationally competitive and will therefore, not be in the position to exploit the advantages of globalisation.

5.3 The structure of the banking industry in Nigeria is oligopolistic with a few banks controlling over 60 per cent of the deposit market. This in itself constrains the much needed competition and efficiency in the industry. Secondly, it constrains the effective transmission of monetary policy pulse to the real economy due to inherent distortions in the financial market. Banks constitute the wheels of commerce, thus, the role, which banks play in international trade, cannot be overemphasised.

5.4 The changing financial landscape brings with it new challenges for bank management as well as the regulatory and supervisory authorities. The major challenges stem from the need to benefit from increased cross-border transactions, resulting from drastically lower transaction costs, greater ease of communication, and increased reliance on technology to provide banking services with the necessary security. Besides, financial opening means that banks can move beyond national frontiers. For example, some Nigerian banks have started to open branches outside the country. Moreover, globalisation has brought with it new innovations in the delivery of banking services/products. It is worth noting that Nigerian banks have joined the league of e-banks; moving away from the traditional “brick and mortar” branch delivery of banking services toward electronic and tele-service delivery that is not limited by physical boundaries. Although still at their rudimentary stages, banking services such as tele-money transfers, telephone banking, electronic money purse, internet banking and automatic teller machines (ATMs) etc, are already available in Nigeria. Such innovations as virtual financial services may be difficult to regulate. Therefore, a major challenge facing the CBN is how to rapidly increase its competence and capacity in the design of appropriate regulatory and surveillance framework to deal with the emerging scenarios.

5.5 Another challenge that faces the CBN's monetary management in a globalized financial environment is the inefficiencies that characterize our payments system. The dominance of cash in financial transactions and the high ratio of currency outside the banking system (83.0 per cent in 2002) (table 4) is particularly worrisome. Under the circumstance, the transmission mechanism of monetary policy is constrained thus making it difficult for the CBN to gauge the pulse of the financial system.

5.6 Ensuring financial sector stability is a major challenge for open financial systems. A well functioning financial sector is critical for the growth of the economy because its role in financial intermediation links it to other sectors. A large-scale failure among financial institutions will negatively affect the supply and demand for loanable funds. It is widely acknowledged that only a few developing countries have the capacity to put imported capital safely to work. The experiences of the East Asian countries and others that have witnessed financial crises arose largely from mistakes in liberalising and regulating the financial sector.

5.7 In a globalized market environment, e-banking poses various challenges to consumers of banking services, deposit money banks and the monetary authorities. A fundamental implication of globalization is that e- banking could promote money laundering. Funds transfer executed from one country to another, involving the use of e-banking services, leaves the transactors sometimes in the shade. Once a customer opens an e-banking account, it is difficult for banks to identify who is conducting a transaction or even where the transaction is taking place. Thus, Money laundering can be facilitated by e-banking because of the anonymity it affords. The anonymity afforded by e-banking and internet banking makes fraud easier both for the inside and outside perpertrators. The reliance on technology to provide services makes security of the e-banking system problematic. This imposes great responsibilities on the Central Bank to take advantage of developments in information and computer technologies to design monetary mechanisms that will ensure the efficiency and effectiveness of its surveillance activities.

5.8 To ensure that electronic fraud do not lead to bank failure, the CBN has formulated appropriate guidelines that would guarantee the security, integrity and confidentiality of transactions in the system.

SECTION 6

6. Conclusion.

6.1 The paper highlighted the forces of globalisation, merits and demerits as well as its implications on the financial sector and management of monetary policy in Nigeria. Globalisation, driven by the ever-changing advancements in information technology is expected to bring about further changes in the financial system as well as the way monetary and financial policies are conducted. Overall, the net benefit of globalisation will differ within and among countries – depending on the mix of macroeconomic policies and trade regimes being pursued by the policy markers. The age of information technology will not only bring changes in monetary policy but also influence its effectiveness. Whatever the changes and their effects, it is important for central banks to adopt strategies and policies that will minimise the unintended adverse consequences of globalisation.

6.2 In the case of Nigeria, we do not really have a choice. The only option is for Nigeria, to understand and grapple with the changes that accompany globalisation promptly and to adopt policies that will have minimize down-side risks associated with it.

6.3 Thank you for your kind attention.

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