

CHAPTER FIVE

CENTRAL BANKING

5.1 Introduction

National bank is a recent phenomenon. Before 20th century, there was no clearly defined concept of national banking system. In many countries like, England, France, Sweden, etc, some banks were assuming more power, were enjoying the right of note issue and were acting as a government banker and agent. They were not originally called the national or central of bank. The oldest central bank was Ritz bank of Sweden, which was established in 1556.

The variation in circumstances surrounding the origins of central banks means that their roles and functions have not all evolved in the same way. Some started life as special purpose government banks constructed to bring some order to the issuance of banknotes. Some were established to act as funding conduits for the government. Some were large commercial banks, whose dominance was subsequently boosted by the granting of monopoly rights to issue banknotes. The majority were, however, created in the 20th century specifically as central banks – public policy agencies for central banking functions.

Typically, an economy will have a central bank, like National Bank of Ethiopia, Federal Reserve in the US or the Bundesbank in Germany. Central banks are responding to the financial crisis by setting in place more healthy policy frameworks.

5.2 Definition and Functions of Central Banking

It is difficult to give accurate and brief definition of national bank. The definition is derived from the function performed by a national or central bank. In fact the functions of central bank now have grown rapidly with the passage of time and financial innovation. Form different definitions given to national bank the following definition is selected for our purpose.

The central bank is one which acts as the banker of the government and commercial banks, has the control of note issue, operates the currency and credit system of the country and does not perform the ordinary commercial banking functions.

The term 'central bank' is a general one that applies to the role of most state-owned financial entities. A central bank is a financial institution that is owned by the government, which has a central role of managing the currency. It is the government agency that oversees the banking system and is responsible for the conduct of monetary policy. Modern central banks have more *independence, accountability and transparency*.

To some extent, the functions and character of modern central banks reflect history. But the majority of central banks are comparatively new, having been created by governments to fulfill a range of tasks befitting a mid-20th century concept of economic

management. And key older functions of central banking, such as monetary policy, are now somewhat different than they were in the early days of central banking.

There is no any hard and fast rule regarding functions of a central bank. The range of functions of central bank varies from country to country. However, there are certain functions commonly performed by most of the central banks. *There are 3 core functions of central banks: monetary policy, financial stability, and payment system.*

And a variety of other central bank functions can also be summarized as follows:

- ✓ *Government debt management*– In many developing countries, the Central Bank often issues long term government debt,
- ✓ *Management of gold/foreign currency reserves* - The Central Bank manages the portfolio of foreign exchange reserves of the country and may buy or sell them to influence the exchange rate,
- ✓ *Bank of the government:*
 - The central bank acts as a bank, agent and advisor to the government
 - As a government bank, it keeps the banking account of the different government departments.
 - In keeping the banking account of the government, the central bank functions as an ordinary commercial bank. It accepts deposit of cash, checks, and draft on behalf of the government and undertakes the collection of check and drafts.
 - It supplies cash to the government required for salaries wages and other cash disbursement.
 - As a government bank it deals with foreign exchange transaction for the government.
 - It also provides short term loan and advances to the government.
 - It grants extraordinary advances during a depression, war or other emergency to the government.
- ✓ *Acting as ‘lender of the last resort’*- The central bank is the ultimate source of cash to the banking system, Whenever an individual bank is in need of cash to meet any emergencies , the bank can approach the central bank. In other words any commercial bank wanting financial assistance from the central bank, it can borrow from the central bank against eligible securities. By acting as the lender of last resort, the central bank promotes the flexibility and liquidity of the banking system.
- ✓ *Supervision of the banking system (banker of banks)* - In many countries including Ethiopia, the Central Bank regulates the commercial banking system to maintain financial stability. Central bank is responsible for the development of banking system in the country. Central bank supervises and monitors the activity of commercial banks. Some of the tasks are:
 - It acts as a guardian of cash reserve of commercial banks. That is, commercial banks deposit their excess reserve with the central bank.

- It acts as a clearing house for settling the interbank financial movements (debts)
- The commercial banks keep required reserve with the Central bank by law.
- This function has benefits like;
 - It gives strength to the banking system of the country.
 - It also increases public confidence in the commercial bank.
 - It reserves as a basis of a larger and more elastic credit structure
- ✓ *Developmental and promotional function:* Beside regulatory function, central Bank also performs functions, like:
 - Encouraging banking habit or using banking system for any financial transactions among people,
 - Encouraging the development of saving habits among people,
 - Establishing specialized financial institutions,
 - Conducting research and surveys in banking,
 - Devising new schemes for the development of banking system,
- ✓ *Issue of banknotes:* The main reason is that:
 - It will bring about uniformity in currency circulation.
 - It enables central bank to control lending operation of commercial banks and thereby controls the circulation of money in the economy.
 - It gives the central bank the power of monetary management in the country.
- ✓ *Liaison with international bodies,*
- ✓ *Policy operations-* Operations to support policy are important among the functions of central banks.

Let us make clear to the 3 core functions as follows.

1) Monetary Stability

Monetary policy is the term applied to the means by which a central bank controls the supply of money and manipulates the rate of interest to encourage economic stability and growth, usually targeting specific goals such as low unemployment and stability in prices. Monetary policy decision-making and implementation are the defining characteristics of the central bank. Whichever institution undertakes these functions is, in essence, the central bank. However, there are differences between countries as to how extensive the central bank's independent responsibilities are for these aspects of monetary policymaking.

Monetary policy is responsible for price stability and promoting sustainable economic growth. Price stability is usually the dominant monetary policy. Central banks may focus on the control of the money supply and on the interest rate. The same operations are used to increase or decrease the money supply. If the central bank buys bonds, less money is available in the economy and the money supply is reduced. On the other hand, if the central bank sells bond, more money is available in the economy resulting in increased money supply. Note that it is impossible to control the money supply and the interest rate in isolation. A change in one is required to obtain a change in the other. In

other words, high inflation (increase in money supply) leads to low interest rates and vice versa.

The goals of monetary policy are: Price stability, to bring about high employment, to bring about economic growth, Interest rate stability, Stability of Financial market, and Stability of foreign exchange market.

2) Financial Stability

Financial stability involves promoting an effective and efficient payments system and a robust and healthy financial system that helps support economic growth. The central bank has the capacity to provide financial assistance to the government in times of difficulty. Via the lender of the last resort – provides emergency liquidity to ensure that financial institutions and nonprofit making companies do not collapse, damaging the whole economy. *Examples:* Ethiopian Metal Corporation, ETC, EEPCo, Abay dam.

3) Payment Systems

Finally national banks have a role to play in maintaining and improving a nation's payments mechanism. This involves clearing checks, providing an adequate supply of currency and coin, wiring funds, selling government securities and preserving confidence in the value of the fundamental monetary unit. A smoothly functioning and efficient payments mechanism is vital for carrying on business and commerce. If checks cannot get the currency and coin, it needs to carry out transactions, business activity will be severely curtailed. The result might well be large scale unemployment and a decline in both capital investment and the rate of economic growth.

5.3 Principles of Central Banking

Recent theorizing in monetary economics suggests the following basic principles that can serve as useful guides for central banks to help them achieve successful outcomes in their conduct of monetary policy. These are:

- i) Price stability provides substantial benefits;*
- ii) Fiscal policy should be aligned with monetary policy;*
- iii) Time inconsistency is a serious problem to be avoided;*
- iv) Monetary policy should be forward looking;*
- v) Accountability is a basic principle of fairness;*
- vi) Monetary policy should be concerned about output as well as price fluctuations;*
- vii) The most serious economic downturns are associated with financial instability.*

We will look at each of these principles in turn as follows.

i) Price Stability provides Substantial Benefits to the Economy

In recent years a growing consensus has emerged that price stability -- a low and stable inflation rate - provides substantial benefits to the economy. Price stability prevents overinvestment in the financial sector, which in a high inflation environment expand to

profitably act as a middleman to help individuals and businesses escape some of the costs of inflation. Price stability lowers the uncertainty about relative prices and the future price level, making it easier for firms and individuals to make appropriate decisions, thereby increasing economic efficiency. Price stability also lowers the distortions from the interaction of the tax system and inflation.

All of these benefits of price stability suggest that low and stable inflation can increase the level of resources productively employed in the economy, and might even help increase the rate of economic growth. While time-series studies of individual countries and cross-national comparisons of growth rates are not in total agreement, there is a consensus that inflation is detrimental to economic growth, particularly when inflation is at high levels. Therefore, both theory and evidence suggest that monetary policy should focus on promoting price stability.

ii) Align Fiscal Policy with Monetary Policy

One lesson from different "unpleasant monetarist arithmetic" discussions and the recent literature on fiscal theories of the price level is that irresponsible fiscal policy may make it more difficult for the monetary authorities to pursue price stability.

Large government deficits may put pressure on the monetary authorities to monetize the debt, thereby producing rapid money growth and inflation. Restraining the fiscal authorities from engaging in excessive deficit financing thus aligns fiscal policy with monetary policy and makes it easier for the monetary authorities to keep inflation under control.

iii) Time Inconsistency is a Serious Problem to be Avoided

One of the key problems facing monetary policymakers is the time-inconsistency problem as described by various writers. The time inconsistency problem arises because there are incentives for a policymaker to try to exploit the short-run tradeoff between employment and inflation to pursue short-run employment objectives, even though the result is poor long-run outcomes.

Expansionary monetary policy will produce higher growth and employment in the short-run and so policymakers will be tempted to pursue this policy even though it will not produce higher growth and employment in the long-run because economic agents adjust their wage and price expectations upward to reflect the expansionary policy. Unfortunately, however, expansionary monetary policy will lead to higher inflation in the long-run, with its negative consequences for the economy.

The time-inconsistency problem by itself does not imply that a central bank will pursue expansionary monetary policy which leads to inflation. Simply by recognizing the problem that forward-looking expectations in the wage- and price-setting process creates for a strategy of pursuing expansionary monetary policy, central banks can decide not to play that game. Central bankers are very aware of the time-inconsistency problem and are indeed extremely adverse to falling into a time inconsistency trap. However, even if

central bankers recognize the problem, there still will be pressures on the central bank to pursue overly expansionary monetary policy by politicians. Thus, overly expansionary monetary policy and inflation may result, so that the time-inconsistency problem remains.

The time-inconsistency literature points out both why there will be pressures on central banks to pursue overly expansionary monetary policy and why central banks whose commitment to price stability is in doubt are more likely to experience higher inflation. In order to prevent high inflation and the pursuit of a suboptimal monetary policy, monetary policy institutions need to be designed in order to avoid the time inconsistency trap.

iv) Monetary Policy Should Be Forward Looking

The existence of long lags from monetary policy actions to their intended effects on output and inflation suggests that monetary policy should be forward looking. If policymakers wait until undesirable outcomes on inflation and output fluctuations actually arise, their policy actions are likely to be counterproductive. For example, by waiting until inflation has already appeared before tightening monetary policy, the monetary authorities will be too late; inflation expectations will already be embedded into the wage and price-setting process, creating an inflation momentum that will be hard to contain. Once the inflation process has gotten rolling, the process of stopping it will be slower and costlier. Similarly, by waiting until the economy is already in recession, expansionary policy may kick in well after the economy has recovered, thus promoting unnecessary output fluctuations and possible inflation.

To avoid these problems, monetary authorities must behave in a forward-looking fashion and act preemptively. For example, if it takes two years for monetary policy to have a significant effect on inflation, then even if inflation is quiescent currently but with an unchanged stance of monetary policy policymakers forecast inflation to rise in two years time, then they must act today to head off the inflationary surge.

v) Monetary Policymakers Should be Accountable

A basic principle of democratic system is that public should have the right to control the actions of the government: in other and more famous words, "*the government should be of the people, by the people and for the people.*" Thus the public in a democracy must have the capability to punish incompetent policymakers through other methods in order to control their actions. If policymakers cannot be removed from office or punished in some other way, this basic principle of democracy is violated. In a democracy, government policymakers need to be held accountable to the public.

A second reason why accountability of policymakers is important is that it helps to promote efficiency in government. Making policymakers subject to punishment makes it more likely that incompetent policymakers will be replaced by competent policymakers and creates better incentives for policymakers to do their jobs well. Knowing that they

are subject to punishment when performance is poor, policymakers will strive to get policy right. If policymakers are able to avoid accountability, then their incentives to do a good job drop appreciably, making poor policy outcomes more likely.

vi) Monetary Policy Should be Concerned with Output as Well as Price Fluctuations

Price stability is a means to an end, a healthy economy, and should not be treated as an end in itself. Thus, central bankers should not be obsessed with inflation control, and become as "inflation nutters". Clearly the public cares about output as well as inflation fluctuations, and so the objectives for a central bank in the context of a long-run strategy should thus not only include minimizing inflation fluctuations, but should also include minimizing output fluctuations. Objective functions with these characteristics have now become standard in the monetary economics literature which focuses on the conduct of monetary policy.

vii) The Most Serious Economic Downturns are Associated with Financial Instability

Literatures suggest that financial instability is a key reason for the depth of the economic contractions. For example, U.S. monetary history indicates that the most serious economic contractions in U.S. history, including the Great Depression, have all been associated with financial instability. The financial crises and depressions in Mexico and East Asia in 1990s and in US in 2008 also support this view. Preventing financial instability is therefore crucial to promoting a healthy economy and reducing output fluctuations, an important objective for central banks, as we have seen above.

Implications for the Role of a Central Bank:

Armed with these guiding principles, we can now go on to look what *institutional features a central bank should have in conducting its operations*. We derive the following implications/criteria for the role of a central bank:

- 1) Price stability should be the overriding, long-run goal of monetary policy;
- 2) A central bank should be goal dependent;
- 3) A central bank should be instrument independent;
- 4) A central bank should be accountable;
- 5) A central bank should stress transparency and communication;
- 6) A central bank should also have the goal of financial stability.

5.4 Central Banking and Commercial Banking

Basically, a National Bank is an agency of government-which is not concerned with maximizing its profit, has an important public policy functions in monitoring the operations of the financial system and controlling the growth of its money supply. National bank ordinarily does not deal directly with public; rather it is "bankers' bank,"

communicating with commercial banks and securities dealers in carrying out their essential policy making functions.

As mentioned above, the National Bank has the power to regulate money supply and value. It is the source of currency and coin (pocket money) used by the public, but also the principal government agency is responsible for stabilizing the value of currency and protecting its integrity in the international financial markets.

Whereas, a commercial bank is an institution which accepts deposits, makes business loans, and offers related services. Commercial banks allow a variety of deposit accounts, such as checking, savings, and time deposit. These institutions are run to make a profit and owned by a group of individuals. While commercial banks offer services to individuals, they are primarily concerned with receiving deposits and lending to businesses.

5.5 Banking in Ethiopia and National Bank of Ethiopia

One can trace the history of using modern money in Ethiopia to more than 2000 years (Pankhrust in Belay, 1990). This had flourished in what is called the Axumite era which can stretch from 1000BC to around 975 AD. Leaving that long history aside, modern banking in Ethiopia started in 1905 with the establishment of *Abyssinian Bank* based on a 50 years agreement with the Anglo-Egyptian National Bank.

The agreement that was reached in 1905 between Emperor Minilik II and Mr. Ma Gillivray, representative of the British owned National Bank of Egypt marked the introduction of modern banking in Ethiopia. Following the agreement, the first bank called Bank of Abyssinia was inaugurated in Feb.16, 1906 by the Emperor. The Bank was totally managed by the Egyptian National Bank.

Generally, in its short period of existence, Bank of Abyssinia had been carrying out limited business such as keeping government accounts, some export financing and undertaking various tasks for the government. These banks were criticized for being wholly foreign owned. Moreover, the Bank faced enormous pressure for being inefficient and purely profit motivated and reached an agreement to abandon its operation and be liquidated in order to disengage banking from foreign control and to make the institution responsible to Ethiopia's credit needs. Thus, by 1931 Bank of Abyssinia was legally replaced (renamed as) by Bank of Ethiopia shortly after Emperor Haile Selassie came to power.

The new Bank, Bank of Ethiopia, was a purely Ethiopian institution and was the first nationally owned and indigenous bank on African continent and established by an official decree on August 29, 1931 with capital of £750,000. Bank of Ethiopia took over the commercial activities of the Bank of Abyssinia and was authorized to issue notes and coins. The bank continued operations successfully until the Italian invasion in 1935.

During the five-years of Italian occupation, there was an expansion of banking activity. In particular the Italian banks were active. The Italians established branches of their main Banks namely Banco d'Italia, Banco di Roma, Banco di Napoli and Banco Nazionale del lavoro and started operation in the main towns of Ethiopia. However, they all ceased operation soon after liberation except Banco di Roma and Banco di Napoli which remained in Asmara.

Following the liberation, in 1943, the Ethiopian government established the 'State Bank of Ethiopia'. The establishment of this Bank by Ethiopia was a painful process since Britain was against it (Befekadu (1995) for an interesting neo-colonial story). This bank was operating both as commercial and central bank until 1963 when it was dissolved into today's National Bank of Ethiopia.

On 15th April 1943, the State Bank of Ethiopia commenced full operation after 8 months of preparatory activities. It acted as the central Bank of Ethiopia and had a power to issue bank notes and coins as the agent of the Ministry of Finance. In 1945 and 1949 the Bank was granted the sole right of issuing currency and deal in foreign currency. The Bank also functioned as the principal commercial bank in the country and engaged in all commercial banking activities until December, 1963.

Then the Ethiopian Monetary and Banking law that came into force in 1963 separated the function of commercial and central banking creating National Bank of Ethiopia and Commercial Bank of Ethiopia. Moreover it allowed foreign banks to operate in Ethiopia limiting their maximum ownership to be 49 percent while the remaining balance should be owned by Ethiopians.

The National Bank of Ethiopia with more power and duties started its operation in January 1964. Following the incorporation as a share company on December 16, 1963 as per proclamation No.207/1955 of October 1963, Commercial Bank of Ethiopia took over the commercial banking activities of the former State Bank of Ethiopia. It started operation on January 1, 1964 with a capital of Eth. Birr 20 million. In the new Commercial Bank of Ethiopia, in contrast with the former State Bank of Ethiopia, all employees were Ethiopians.

The first privately owned bank, Addis Ababa Bank Share Company, was established on Ethiopians initiative and started operation in 1964 with a capital of 2 million in association with National and Grind lay Bank, London which had 40 percent of the total share. In 1968, the original capital of the Bank rose to 5.0 million and until it ceased operation, it had 300 staff at 26 branches. There were other financial institutions operating in the country like the Imperial Savings and Home Ownership public Association (ISHOPA) which specialized in providing loans for the construction of residential houses and to individuals under the guarantee of their savings.

Subsequent to the declaration of socialism in 1974 the government extended its control over the whole economy and nationalized all large corporations. Accordingly, all privately

owned financial institutions including the three private owned banks, Addis Ababa Bank, Banco di Roma and Banco di Napoli, were nationalized on 1 January 1975 to form the second largest Bank in Ethiopia called Addis Bank with a capital of Eth. birr 20 million. Then Addis Bank and Commercial Bank of Ethiopia S.C. were merged by proclamation No.184 of August 2, 1980 to form the sole commercial bank in the country till the establishment of private commercial banks in 1994. The Commercial Bank of Ethiopia commenced its operation with a capital of Birr 65 million, 128 branches and 3,633 employees.

The nationalized banks were reorganized and one commercial bank (the Commercial Bank of Ethiopia), a National Bank (recreated in 1976), two specialized banks (the Agricultural and Industrial Bank – renamed recently as the Development Bank of Ethiopia; and a Housing and Saving Bank (formerly called ISHOPA) – renamed recently as the Construction and Business Bank) as well as one insurance company – Ethiopian Insurance Company were formed.

Following the change in the economic policy, financial sector reform also took place. Monetary and Banking Proclamation of 1994 established the National Bank of Ethiopia as a judicial entity, separated from the government and outlined its main functions.

Monetary and Banking proclamation No.83/1994 and the Licensing and Supervision of Banking Business No.84/1994 laid down the legal basis for investment in the banking sector. Consequently shortly after the proclamation the first private bank, Awash International Bank was established in 1994 followed by Dashen bank and Bank of Abyssinia.

In undertaking this task the Ethiopian government adopted a strategy of (a) gradualism: gradual opening up of private banks and insurance companies alongside the public ones, gradual liberalization of the foreign exchange market etc and (b) strengthening domestic competitive capacity before full liberalization (i.e., restrict the sector to domestic investors, strengthening the regulatory and supervision capacity of the NBE, providing autonomy to banks as well as opening up inter-bank money market etc). In line with this strategy various proclamations and regulations were passed since 1994.

In conclusion, many authors suggest that given the relatively good shape in which the existing financial institutions find themselves, given the weak supervision and regulation department of the NBE (which is new and lack skilled human resource), the government's strategy of gradualism and its overall reform direction need to be appreciated and be supported by World Bank, IMF and relevant institutions. The only compromise that the government has to make is to clearly chart out a time schedule for its liberalization program and explore and joint venture scheme with foreign banks – obviously it cannot rationally protect the sector forever.

