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NATIONAL OPEN UNIVERSITY OF NIGERIA

BHM 642

PRINCIPLES OF MONEY AND BANKING

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Course Title	Principles of Money and Banking
Course Writer/Developer	Patrick Chukwubike National Open University of Nigeria, Lagos
Course Coordinator	Abdullahi S. Araga National Open University of Nigeria, Lagos
Programme Leader	Dr. O. J. Onwe National Open University of Nigeria, Lagos

NATIONAL OPEN UNIVERSITY OF NIGERIA

National Open University of Nigeria
Headquarters
14/16 Ahmadu Bello Way
Victoria Island
Lagos

Abuja Office:
NOUN Building
No. 5, Dar es Salam Street
Off Aminu Kano Crescent
Wuse II
Abuja,

E-mail: centralinfo@nou.edu.ng
URL: www.nou.edu.ng

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MODULE 1

UNIT 1 EVOLUTION, NATURE AND FUNCTIONS OF MONEY

CONTENTS

1.0 INTRODUCTION

This first unit of the course introduces you to the course and setting the stage to the discussion on the meaning and evolution of money. This commences with the barter system, its shortcomings that finally led to the launching of generally acceptable medium of exchange, which in turn facilitates transactions. You will also be studying the various classes of money, the characteristics of commodity that shall meet the quality of being accepted as money. The unit will be rounded up with your examining the major functions of money in an economy. This is important and necessary because this course concerns the principles of money.

2.0 OBJECTIVES

At the end of this unit, you should be able to:

- Explain why and how money evolved
- Identify and describe the various classes of money
- Explain the distinguishing characteristics of money
- Describe the major functions money serves in a system

3.0 MAIN CONTENT

3.1 Evolution, Nature and Functions of Money

3.1.1 The Barter System of Exchange

Prior to the evolution and development of money, exchange was carried out on the basis of direct exchange of goods and services. This system is known in economics as barter system. Barter system of exchange involves direct exchange of one good/commodity for some quantity of another good/commodity. This swapping of one good for another is a very cumbersome system in which every transaction requires a double coincidence of want. For instance, if you have a cow to trade, you must search not only for someone who wants your cow, but also for someone who has something you would like to acquire and in the desired quantity. Again, a laundryman may be paid in kind for the services he rendered to you – with either a bag of rice, basket of fruits, etc. The barter economy is thus a moneyless economy where you produce goods either for self-consumption or for exchange with other goods and services, which you may want. The barter system, found in primitive societies required a lot of haggling and many other handicaps and difficulties.

3.1.2 Problems of Barter System

As you can glean from above section, the barter system of exchange is saddled with many problems, disadvantages and difficulties. These are highlighted below:

(a) Double Coincidence of Wants

The barter system requires that each time you wish to trade your goods or service, you must search for someone who possesses the goods or services you want and in the desired quantity.

(b) Common Measure of Value

The lack of a common unit in which the value of goods and services should be measured possesses a very big problem in barter system. This is in the area of measuring the proportion of each of the goods or services that should be exchanged for. One party is always disadvantaged since the rate of exchange is arbitrarily fixed according to the intensity of demand for each other's goods and services.

(c) Indivisibility of Certain Goods

This problem stems from the indivisibility of some goods. For instance, if you desire a horse while the other a chicken, the problem then arises as to how many chicken the other person will be willing to accept from you in order to part with his horse.

(d) Store of Value

Since barter system involves exchange of (perishable) goods/commodities, the storage of such goods over a long period becomes very difficult and expensive.

(e) Difficulty in Making Deferred Payments

Since payments in a barter system are made in perishable goods and services, debt contracts may generate controversy as to the quality of the commodities to be used for repayment in the future.

(f) Lack of Specialization

Barter system does not make for specialization in production system since every person will want to produce all kind of goods in some quality to be able to carry out transaction.

SELF-ASSESSMENT EXERCISE 1

Discuss the system of barter and its peculiar problems.

3.2 The Evolution of Money

Money as any medium of exchange that is widely accepted in payment for goods and services and in settlement of debts evolved as a result of the problems and difficulties the barter system of exchange poses to the economy. At various stages of human development and civilization, various commodities have been adopted as money. You will be basically required to note the five basic stages of this evolution. Each stage depends upon the progress of human civilization at different times and places. These are:

3.2.1 Commodity Money

These are some valuable commodities adopted as means of exchange to avert some of the problems of barter. These commodities were very useful, hence valuable and reliably scarce. They were mostly localized depending on the society and community. Some of these items are spears, precious stones, skins, bows and arrows, axes, manila, cowry shell, salt, cattle, grains, elephant tusks, beads, furs, etc.
These commodities had most of the defects associated with the barter system. Some include:

i. Non-uniformity in quality, thus, not generally acceptable.
ii. Difficulty in storage and loss of value
iii. Not readily available
iv. They lack portability hence difficulty in transporting
v. They are bulky hence problem of indivisibility, among others.

3.2.2 Metallic Money

With the problems associated with commodity money, the spread of civilization and trade beyond the frontiers of nations, metallic money replaced it. Prominent among the precious metals used as money are gold, silver, bronze, brass, zinc, copper, tin, etc.

These precious metals were in heavy and permanent demand for ornament and decorations and thus in continuous supply. They thus tended to have high and stable value. They were again easily recognised and generally known and acceptable and also divisible into extremely small units. All these qualities notwithstanding, metallic money had some defects/setbacks. These include:

1. Bulky and heavy to carry about
2. Sometimes too scarce.

3. They suffer from debasement by clipping a thin slice off the edge of coins, thus hoarding of full-bodied coins crept in.
4. They are easily adulterated and counterfeited.
5. They are very expensive in minting by government because of the counterfeiting resulting from the debasement.

3.2.3 Paper Money

This is the modern form of money, which originated from the **negotiable and redeemable receipts** issued by goldsmiths to depositors of gold in their safes. These goldsmiths, who were taken as honest merchants, issued the gold depositors receipts promising to return their gold on demand. These goldsmith's receipts were in turn given to sellers of commodities by buyers as substitute for money. Thus the first paper money evolved, which was a promissory note to pay on demand so much gold by the goldsmith. Eventually, the goldsmiths were replaced by bankers as time progresses. As long as these institutions were known to be reliable, such pieces of paper would be "as good as gold." The paper money was backed by precious metal and was convertible on demand into this metal. This ultimately led to the development of bank notes.

3.2.4 Credit Money

This is like the bank note that evolved from paper money. This is the use of cheques as money in the economy by banks. This is a means of transferring money or obligations from one person to another. It is however worthy to note that a cheque is made for a specific sum and expires with a single transaction. It is also only an order to transfer money and again used for large transactions. Bank notes are used only for small transactions. Credit money also known as bank money is the demand deposit a depositor holds with a bank.

3.2.5 Near Money

These are assets that can be easily converted to cash. Their ownership are now transferable simply by book entry. Near or Quasi money includes bills of exchange, treasury bills, bonds, debentures, savings certificates, postal orders money orders, etc. They are close substitutes for money and thus the final stage of the evolution of money.

Near money assets serve the store of value function of money temporarily and are convertible into medium of exchange in a short time without loss of their face value. Examples are time deposits, insurance policies, etc. They all have a market and are negotiable so that they can be converted into real money within a short time.

SELF ASSESSMENT EXERCISE 2

Enumerate and discuss the various forms of money in use overtime.

3.3 Nature and Concepts of Money

The concept of money is very difficult to define. This is because money fulfils three basic functions that will always come to bear in defining it. These are that of providing a criterion of "moneyness", that of a unit of account, as a medium of exchange, and as a store of value.

Many schools of thought have proffered various definitions of money. While some prefer the functional definition, which defines money in terms of the functions it performs, others define it in legal terms. The functional definition says that "anything is money which is used as money" and the legal definition says that "anything which the state declares as money is money."

Traditionally, in economics, money has been defined as "any generally accepted medium of exchange – anything that will be accepted by virtually every one in exchange of goods and services".

3.4 Characteristics of Money

Economists have proffered that for any commodity to discharge the functions of money, it must possess the following attributes or qualities:

1. General Acceptability

For anything to serve as money, it should be acceptable by everyone as a medium of exchange.

2. Durability

This quality maintains that money should not be easily damaged or lost in terms of its value or quality easily overtime. It is worthy to note that though paper money is less durable than metals yet they are money because they have been issued by law as legal tender (legal tender is money which people accept as a medium of payments and in discharge of debts because it has the authority of the government. They are also called fiat money).

3. Portability

Money should be easily carried from one place to another and also should contain large value in small bulk.

4. Cognisability

Good money should be easily recognisable by the users at sight or touch.

5. Homogeneity

The homogeneity characteristic says that a unit of any given money must be identical to another unit of the same denomination, both in shape, size, colour and weight.

6. Divisibility

Any money material should be divisible or fractionalised into smaller denominations to facilitate settlement of debts and exchange of varied sizes.

7. Stability

For money to serve as a measure of value and be used as a means of deferred payment, it should be stable in value over time.

8. Relative Scarcity

As a good means of exchange, money should be relatively scarce. If however it becomes too scarce, the means of exchange function will be disturbed. On the other hand, when it is in plentiful supply, it will lose its value and thus ceases to act as money effectively.

9. Transferability

To enhance the general acceptability quality of money, it should be easily transferable from one person to another without restriction.

10. Not readily Conterfeitable

A good money material should be one that will not be easily conterfeitable by the people. In this way, the quality and value of the money is protected.

SELF-ASSESSMENT EXERCISE 3

Discuss the characteristics of money.

3.5 Functions of Money

The importance of money in an economy lies in the functions it performs. These functions not only remove the difficulties of barter system of exchange but also oil the wheels of trade and industry in the economy. These have been classified as **primary, secondary and contingent** functions of money.

3.5.1 Primary Functions of Money

The primary functions of money are:

1. Money as a Medium of Exchange

This is the first and basic function of money from which other functions take their root. As a medium of exchange, money enhances economic activities by ensuring that market and exchange are created at internal and intentional levels, since goods and services used by you are produced by others and vice versa. In this exchange process, money stands as a medium with which individuals and nations get paid for their goods and services in the form of money, and with the money, they attempt to purchase their desired goods and services from others.

Thus, money eliminates the problem of double coincidence of wants associated with barter system and then facilitating the exchange of goods and services. By this function, money facilitates trade by acting as the intermediary, helping the indirect trading of goods and services.

2. Money as a Unit of Value

The problem uncounted in barter system in the choice of some standard of measurement for goods/services to be traded is ameliorated with the introduction of money. Money thus serves as a standard for measuring value – i.e. the monetary unit for expressing the value of each good or service. In the pricing process, money serves the measure of value as well as the common denominator in exchange rate determination. As a unit of value or account, money also facilitates accounting since assets, liabilities, incomes and expenses of all kinds can be stated in terms of a common monetary unit.

All economic important calculations such as the estimation of costs and revenues, hence profit/loss are expressed in monetary terms. Hence, since all economic goods and services have value, money thus becomes the basic and universally accepted standard of measuring this value.

3.5.2 The Secondary Functions of Money

The three secondary functions of money are:

1. Money as a Standard of Deferred Payments

The use of money makes the granting of credits possible, hence payments for goods and services rendered now can be deferred or postponed to a later date. By this function, money has simplified both the taking and repayment of loans because the unit of account is durable unlike in the barter system. It therefore simplifies credit transactions. This singular function of money helps in capital formation both by the government and business enterprises, thus developing financial and capital markets growth in an economy.

2. Money as a Store of Value

Not many goods can be kept in storage for long periods of time without deterioration or wastage. Since money is durable and relatively stable, you can keep money for as long a period as you may desire until such a time you may wish to spend it. Money is the most liquid of all financial assets, and thus makes it possible for you to postpone your current consumption (by saving) with a view to accumulating reserves for spending in the future.

It is important to emphasize that money can discharge this function as a store of value only if its value is stable. In severe inflationary periods, money becomes weak as a store of value. You will be better off if you stock your wealth in other assets than money during such periods/seasons.

3. Money as a Transfer of Value

Since money is a generally accepted means you can effect payments with and also since you use money as a store of value, it keeps transferring value from one person to another and place to place. This is mostly accomplished when the money you hold as cash or any other form of liquid asset is transferred to another person at possibly another location by any means.

3.5.3 Contingent/Incidental Functions of Money

Aside the two primary and three secondary functions of money, there exists some other incidental functions money can serve. These functions as enumerated by most economists include:

1. Money as the Most Liquid of all Liquid Assets

You may hold your wealth in varied forms – liquid assets such as currency, demand deposits, time deposits, savings, bonds, treasury bills, short-term government securities, long-tern government securities, stocks/shares, etc. These liquid assets can be converted into money and vice-versa, thus conferring on money that quality of being the most liquid of them all.

2. Money as Basic of the Credit System

You can transact your businesses either in cash or credit only if you have money backing. Same way commercial banks can give or create credit (money) equivalent only to the reserve of money in their treasury.

3. Money Confers Bargaining Power

Whenever you want to buy some products, the amount of money in your possession determines your bargaining power with as many sellers as possible – but only buys from whoever is ready to sell to you at the cheapest price.

4. Money as a Tool for Measurement and Distribution of National Income

The various goods and services produced in a country are aggregated and assessed in money terms. This was not possible in barter system. Again, the rewards for factors of production in form of wages, rent, interest and profits are determined and paid in money terms.

SELF-ASSESSMENT EXERCISE 4

Identify and discuss the distinct functions of money.

4.0 CONCLUSION

We have been able to x-ray in this unit the nature of money and its need and importance in any economy. It has been seen that for any society to survive and thrive competitively with others, it must have a standard and stable monetary system. In this way, transactions within and outside the nation's frontiers will be easily carried out.

5.0 SUMMARY

Money, a term economists traditionally define as "any generally accepted medium of exchange for goods and services by virtually every one serves many functions in every economy. The functions which had been traced to have evolved over time are being satisfied or discharged today because the system evolved from the barter system to the money economy.

The commodity now being adopted by various nations have some qualities and characteristics they ought to meet as to satisfactorily render the services/function and at the same time avert the inherent problems and disadvantages of the barter system economy. These are what the unit had addressed.

In the next study unit, we shall discuss the role of money in the macroeconomy.

6.0 TUTOR-MARKED ASSIGNMENTS

1. What problems/difficulties led to the evolution and emergency of money?
2. Discuss the distinguishing features between money and near money.
3. "Money is what money does." With the definition of money, explain this statement.
4. Discuss the major functions of money in an economy.
5. What qualities must be possessed by a commodity to serve as money effectively?

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UNIT 2 THE ROLE OF MONEY IN THE MACROECONOMY

CONTENTS

1.0 INTRODUCTION

In the operations of both internal and international economy money is at its centre. Thus money plays and has very crucial significance in the daily operation of activities in any organisation or economy, be it developed or developing. Also, individuals as consumers, producers, businessmen, politicians, administrators or academicians' lives and activities all revolve round the quantum of money at their disposal. This stems from the fact that allocation of resources are determined in the real part of the economy by the forces of demand and supply which in turn depended on the structure of relative prices. It is in recognisation of the foregoing, which depends on money that this unit is developed to study and expose you to the significance and role of money in a modern economy.

2.0 OBJECTIVES

The purpose of this unit is to make you appreciate the importance of money in any modern economy. At the end of the unit, you should be able to:

- Identify and explain the major roles of money in an economy.
- Distinguish the economic and non-economic defects of money.

3.0 MAIN CONTENT

3.1 The Role of Money

In Unit One, you studied the nature and functions of money in a modern economy. These functions when fully accomplished in the system will reveal the importance and significance of this singular item-money in the macro economy.

These significances/roles can be readily categorized into two viz: - Static and Dynamic roles. These roles arise from the money's traditional functions and its importance to the citizenry in particular and the entire economic system as a whole.

3.1.1 The Static Role of Money

The static role of money emanate from the traditional functions of money which lies in its ability in addressing and proffering solutions to the problems posed by barter System of exchange in the economy.

This is achieved in the following ways:-

a. Money serving as a medium of exchange, removes the problem of double coincidence of wants created by the barter system. Instead of your exchanging commodities directly with commodities, commodities are rather exchanged for money and money then in turn used to buy other commodities.

b. Money's function as a unit of account enhances a common measure of value, especially in quoting prices. This role eliminates the barter system's problem of quantifying commodities for exchange at each transaction since different commodities are expressed in monetary terms. This measurement of the values of goods and services in monetary units facilitates the process of measuring the exchange values of goods in the market.

c. Acting as a standard of deferred payment, money has simplified the difficulties created by barter in taking and repayment of loans, since the unit of account is both durable and stable at the same time in the qualities desired.

d. The act of saving is enhanced with the introduction of money. This is achieved since money being the most liquid asset, can be stored over a long period without deterioration or wastage. Thus, the problem of storing value with barter system is completely eliminated from the economy.

e. The transfer of value from one place to another is enhanced with money. You can transfer your money through drafts, bills of exchange, etc and also assets by selling them for cash and buying another at any preferred place.

3.1.2 The Dynamic Role of Money

The influence money has on various groups of people, activities and groups in the economy are grouped under its dynamic role. These are discussed below:

i. To the Consumer

The significance of money to the consumer is that you the consumer receive your income in form of money rather than in form of goods and services. Also, you can buy the commodity of your choice in the quantity, quality and time you so desire. In this way, the consumer maximizes his satisfaction, equalizes his marginal utilities of goods by substituting goods with higher utilities for others with lower utility values. Thus, the consumer, with the help of money makes a rational distribution of his income on various commodities of his choice.

ii. To the Producer

All record keeping of all productive activities are kept in money units. These are the account of several inputs, outputs, raw materials, purchases, wages paid to workers, capital borrowed, rent paid and all other expenses incurred in the process of production. In this way, the profits are also expressed in money value. Also, the general flow of goods and services from all sectors of the economy are again recorded in money terms. Thus, money is a major contributor in facilitating the growth of industries since all activities are carried out and recorded in money values.

iii. Money as the Basis of Credit Creation and Economic Growth

Since the entire modern business is based on credit which in turn is centred on money, its creation and operations are based and made easy by money. This is achieved through the use of credit instruments issued by banks to their depositors who in turn issue such instruments to investors. In this way, the circular flow of income within the economy is maintained as well as increase in capital formation to investors in particular and economic growth in general.

iv. Money is the index of Economic Growth

All economic growth indicators (national income, per capita income and economic welfare) are recorded, measured and calculated in money terms. This is achieved through the changes in the value of money or prices. A fall in the value of money or rise in price means a non-progressing economy and vice versa, thus money serving as an index of economic growth.

v. In National and International Trade

The use of money as a medium of exchange, store of value and as a transfer of value has facilitated trade transactions both nationally and across the frontiers of a nation (internationally). This has also aided in the establishment of money and capital markets. The money economy has also led to international cooperation and technical assistance between nations.

vi. The Role of Money to Government

The introduction and use of money facilitates the collection and recording of incomes and expenditures. Government incomes include taxes of all forms, fines, fees and prices of services rendered. Also, through the use of various instruments, modern governments achieve the goals of economic policy of improving the welfare and standard of living of the people among others.

vii. To the Society

Money is at the centre of social prestige and power in the society. Money acts as a lubricant for the social life of the people, and oils the wheels of progress of the people. In this way, money, on whose basis the super structure of credit is built, simplifies consumption, production, exchange and distribution in the society.

The foregoing roles of money in the macro economy reveal that money is the pivot around which the whole science of economics clusters and revolves.

SELF-ASSESSMENT EXERCISE 1

Identify and discuss the various role of money in any economy

3.2 The defects of money

Money, which economists regard as an extremely valuable social instrument in promoting wealth and welfare has some inherent defects/draw backs that make it often times misbehave and tries to act like a master. These defects which are both economic and non-economic are not due to money itself but are results of attitude of man towards the use of money. It is also seen that money is an indispensable lubricant, a tool of convenience in the society for a continuous and smooth functioning of the economic machine, but when not properly controlled and used, may lead to problems and complications in the economy. These drawbacks are discussed under economic or non-economic defects' subheads viz:

3.2.1 Economic Defects of Money

1. Instability in the Value of Money

A rise in the price level in the economy (inflation) leads to a fall in the value of money while in deflation times, i.e. period of general fall in price level leads to a rise in money value. These changes are brought about by increase or decrease in the supply of money. It has been seen that this instability in the value of money resulting from the movement of prices already affects consumers, producers and other sections of the society. It therefore behoves the controlling authority - the government to adopt a judicious monetary policy to be able to control the supply of money and thus have a reasonable stability in the value of money.

2. Creation of Class Conflict

The changes in the value of money leads to unequal distribution of wealth and income, which in turn creates class differences and conflicts between the rich and the poor.

3. Black Money

As a store of value, people are often times lured to hoard it in anticipation to becoming richer in future. This leads to black money. Also, black money results from tax evasion and concentration of income by the earners. Black money leads to "parallel" economy, which encourages conspicuous consumption, black marketing, speculation, etc.

4. Cyclical Fluctuations

The mechanism of supply of money affects production cycles in the economy. When the supply of money increases, there is boom (over production) in the economy while a contract in the supply results in a slump or under consumption. Such cyclical fluctuations bring untold miseries to the people – producers and consumers alike.

3.2.2 Non-Economic Defects of Money

1. The love for money in the society has brought **down the moral, social and political fibre of the society**. It also leads to corruption, political bankruptcy and artificiality in religion based on materialism.

2. **Political Instability**: Over-issuance of money leads to hyperinflation and then political instability and downfall of governments.

3. **Tendency to Exploit**: The love and greed for money leads people wanting to amass money and wealth at all costs. This leads to the tendency to exploit others as to accomplish this unwholesome desire.

SELF-ASSESSMENT EXERCISE 2

Identify and discuss the defects of money

4.0 CONCLUSION

For the smooth running of an economy, the dynamic and static significances and roles of money should be of upper most concern of both political and economic administrators and advisers. In the same way, the love of money by the generality of the people should be frowned at seriously and controlled by the government.

In addressing these, the drawbacks/defects of money shall be of paramount importance to the controlling agents of the economy. In the next study unit, we shall discuss the circular flow of money. In the next study unit, we shall discuss the circular flow of money.

5.0 SUMMARY

The role of money in a macroeconomy has been seen to be diverse stemming from its traditional functions. This identified significance if properly harnessed proffers solutions to the problems posed by the barter system to various groups and entities in the economy. You have also seem that though money being an extremely valuable social instrument has some drawbacks which if not properly handled and controlled will lead to adverse and unhealthy situations in the economy.

6.0 TUTOR-MARKED ASSIGNMENTS

1. Discuss the social significances of money.
2. Money with all its attendant roles in the development of an economy has its setbacks. Discuss these drawbacks of money and how they can be handled.

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UNIT 3 THE CIRCULAR FLOW OF MONEY

CONTENTS

1.0 INTRODUCTION

From unit two, you were able to glean the role and significance of money in any economy. This involves its importance to the consumer (individual), producer and the various tiers of government. As consumers pay for goods and services from producers with money, the later pays the former for their labour/wages in money terms too. The producers also procure their raw materials with money while government incomes that come in form of taxes, fines, fees and prices of services rendered are collected in monetary form. This depicts the fact that money forms the pivot around which the whole economic system revolves.

In the circular flow of money, you shall be examining the process whereby money payments and receipts of an economy – between the households and business sector in form of consumption/expenditure and income/payment and governments are affected and their effects on the entire economy.

2.0 OBJECTIVES

At the end of this unit you should be able to:

- Explain the concept of circular flow of money.
- Discuss the importance of the circular flow of money in the economy.
- Explain the circular flow of money with the government and foreign sectors.

3.0 MAIN CONTENT

3.1 The Meaning of Circular Flow of Money

In microeconomics, the households have members with needs and desires for goods and services to satisfy with limited resources/money at their respective disposals. In so doing, they make choices on the way to spend their money and resources, thus responding to market prices. These prices signal for the business sector/firms on what goods and services they may profitably provide, given the cost of factors of production. The payments by firms to factor owners provide the owners of the factors with income in form of money. The recipients of these money incomes are household members who as earlier said have needs and desires for goods and services from the firms – which they have to pay for.

The process described above is often referred to as the "circular flow of money/income," since money passes from households to firms in return for goods and services produced by firms, and money passes from firms to households in return for factors services provided by households.

It can therefore be said in general terms that the circular flow of money is "the process whereby money payments and receipts in an economy flow in a circular manner continuously through time.

The various components of money payment and receipts are saving, investment, taxation, loans; government purchases exports, import, etc. The flow is such that the total money payments equal the total money receipts in the economy. The circular flow of money shall be discussed under four subsections in the economy:

a) The Spendthrift Economy;
b) The Frugal Economy;
c) The Governed Economy, and
d) The Open Economy.

The first three are called closed economies because they are not involved in foreign trade. The open economy is that which engages significantly in foreign trade with some commodities produced internally are sold abroad while some sold at home are produced abroad.

SELF-ASSESSMENT EXERCISE 1

Explain the circular of money.

3.2 The Spendthrift Economy: - Circular Flow of Money between Household and the Business Sector

In discussing this issue, two basic assumptions shall be made. These are that in the economy, there are only two sectors – the household sector and the business sector/firms. While the household sector consisting of consumers owns all factors of production – land, labour, capital and enterprise. They receive from the business sector income in form of rent, wages, interest and profit. The business sector consisting of producers of goods and services (firms) in turn sells their products to the households for a monetary fee.

In this way, money received by the households for their factors of production are in turn spent in buying goods produced by the business sector. Thus, money flowing in a circular manner from the business sector to the household sector and vice versa in the economy. As long as income payments by the business sector for factor services are returned by the household sector to purchase goods, the circular flow of income payments and consumption expenditure tends to continue indefinitely. Given this situation when all conditions and assumptions are satisfied, production will equal sales or supply equals demand.

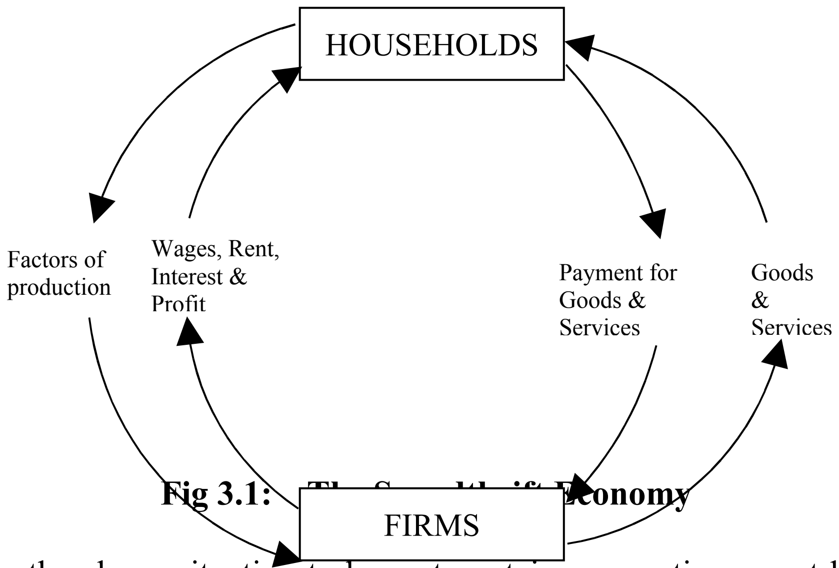


Fig 3.1: The Spendthrift Economy

For the above situation to be met, certain assumptions must have to be made. These assumptions are:

a) That the household sector spends their entire income on buying goods and services from the business sector.

b) That the business firms do not change their inventory level, thus keeping production equal to sales.

c) The entire money received by the business sector is fully spent in payments for factors of production. Thus, there is no savings or reserves.

It is worthy to note however that these assumptions are unrealistic and thus not fit in the actual working of any economy since there are regular withdrawals and injections from the flow. While withdrawals or leakages are those incomes that does not inter into the circular flow of money, the injection on the other hand are additions to the circular flow of money.

The scenario created above is what economists describe as a "Spendthrift economy." This is where the two groups – households and firms/business sector saves nothing. Everything that one group receives is paid out to buy goods and services from the other group. This means that in a Spendthrift economy, all income is spent on goods and services for current consumption and all current output are consumed.

3.3 The Frugal Economy: - Circular Flow of Money with Saving and Investment

The Frugal economy prevails in a situation where the households and firms provide for the future, and as a result both savings and investment occur. We shall try to understand what saving and investment mean and the purpose for saving and investment.

Saving is income not spent on goods and services for current consumption. Households save when they decide not to spend part of their current income on goods and services for consumption. Firms on the other hand save when they elect not to pay out to their owner some of the profits that they have earned, i.e. the undistributed profits which are held back. These undistributed profits constitute savings made by firms on behalf of their owners, since they are incomes earned but not spent on current consumption. Thus saving is regarded as a leakage in the circular flow of money.

On the other hand, investment is defined as the act of producing goods that are not for immediate/current consumption. Firms or households may buy these goods. Investment goods are classified into three viz:

1. Investment
2. Capital goods
3. Residential housing

Investment is thus regarded as an injection into the circular flow of money. Firms and households save for a variety of motives. These savings are invested in bonds, shares, debentures, etc in the capital market.

Firms on the other hand borrow funds from the capital market for investment. This implies that savings, which flow into the capital market, are taken away by the business sector for investment and thus the circular flow of money in the economy is maintained.

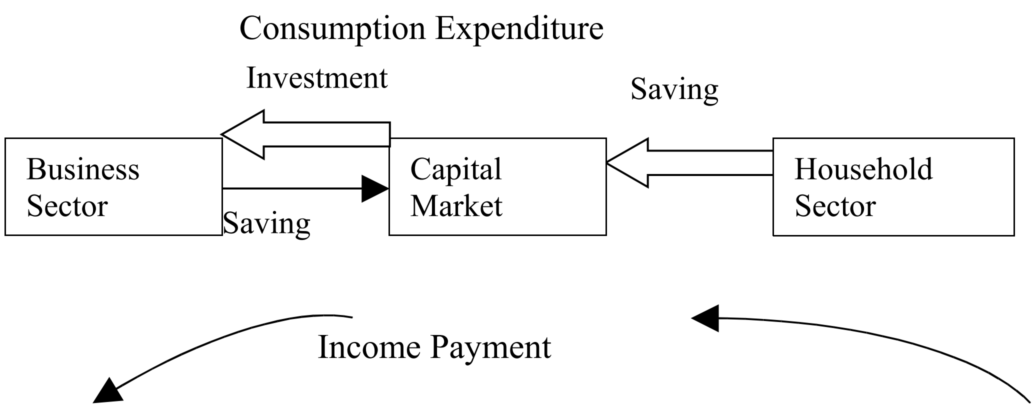


Fig. 3.2: The Frugal Economy

It is worthy to note that in the Spendthrift Economy, all currently produced goods and services by the business sector are sold to the households so that the value of final output is equal to the value of expenditure on that output. On the other hand, in the Frugal Economy, some final output is sold to households and other firms, such as plants and equipment while some newly produced inventories of the firms' output are not sold at all.

SELF-ASSESSMENT EXERCISE 2

Differentiate between spendthrift and frugal economies.

3.4 The Governed Economy

In the Spendthrift and Frugal economies, you see the working of a two-sector model in the circular flow of money. In a governed economy, you will see how a three-model system works with the addition of government sector. Government sector involves taxation, which is a leakage from the flow and government purchases (expenditure) - an injection into the circular flow of money. Considering the circular flow between household sector and the government sector, the households pay to government personal income taxes and commodity taxes. These are outflows or leakages from the circular flow. On the other hand, government purchases the services of the householders; makes transfer payments inform of old age pensions, unemployment relief, sickness relief, etc as well as the provision of some social services like education, health, housing, water, recreational facilities, etc. These expenditure by the government are injections into the circular flow of money in the economy.

Again, on the part of the business sector (the firms) all types of taxes they pay to government constitute leakages while government purchases from them in addition to subsidies and transfers (payments) to encourage the firms' production and existence. These are forms of injections into the circular flow of money.

Considering the three sectors together, taxation reduces households' consumption and savings in turn reduces the sales and incomes of the firms. Again taxation reduces firms investment and production level. In order to off-set these leakages and ensuring that the circular flow remains in a state of equilibrium, government makes purchases from the firms and buys the services of the householders which will equal to the amount of taxes they pay. Expressing these mathematically, let G stand for government expenditure, T for taxes, J for injection, W for withdrawals while S and I savings and investment respectively, then for a governed economy to be at equilibrium, $W = S + T$ and $J = G+I$.

If government purchases exceed net taxes, she will incur a deficit, which will be augmented by borrowing from the capital market that in turn receives funds from the households, inform of saving. Also, if net taxes exceed government purchases, a budget surplus situation, government will reduce public debt by supplying those excess taxes in form of funds to the capital market for investment.

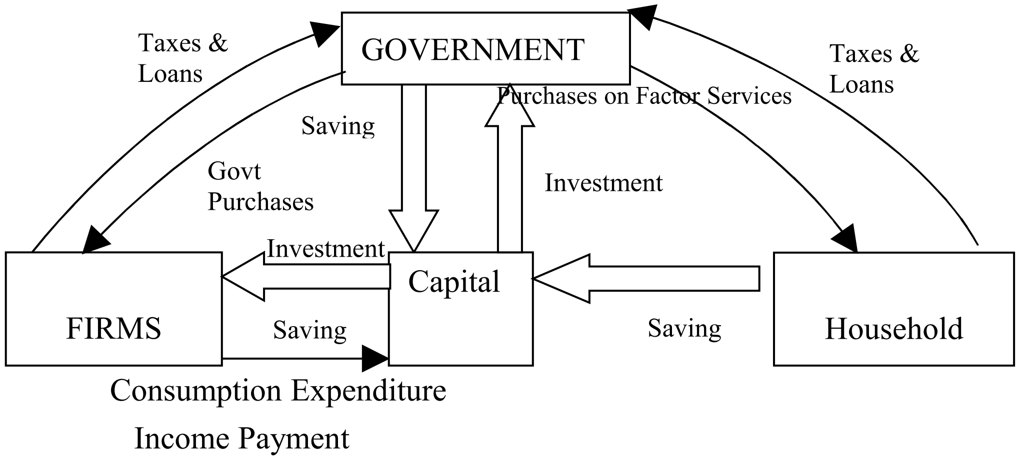


Fig. 3: The Governed Economy

3.5 The Governed Economy: -Circular Flow of Money with the Foreign Sector

In the previous sectors, you have seen the circular flow of money in a closed economy. This is where the flow of money is within a given national borders. In an open economy, sometimes seen as the actual economy, foreign trade, that is transactions with other nations in form of exports and imports, is introduced. Thus the foreign sector is introduced in the circular flow with its attendant significance influences.

In the open economy, exports constitute injections or inflows into the circular flow since they create incomes for the domestic firms because foreigners buy the good and services from the firms within the country of interest. On the other hand, imports form leakages or outflow from the circular flow since they are expenditures/payments by households and firms for goods and services from foreign countries.

In the open economy, four parties are involved thus:

i. The household sector that buys goods and services imported from foreign countries and make payments for them – leakages. They may in turn receive transfer payments for goods and services rendered to the foreign countries - injections.
ii. The business sector exports and imports goods and services from foreign counties, which they receive and make payments respectively for. The business sector also receives royalties, interests, dividends, profits, etc for investments made in foreign countries.
iii. The government also export and import goods and services from foreign countries as well as lending to and borrowing from them

for which they receive and effect payments for in various ways. The payments received from the foreign nations form injections into the circular flow while the payments made to them constitute outflow from the system.

iv. The fourth sector – foreign sector or foreign nations at the same time make and receive payments for goods and services to and from the country/nation of interest.

In general terms, in an open economy, imports are withdrawals/leakages from the circular flow while an export injects income into the circular flow. Thus, if W stand for withdrawals/leakages, J for injections, M stand for imports, X for exports while S, T, I, and G stand for savings, taxes, investments and government respectively, the $W = S + T + M$ and $J = I + G + X$.

For equilibrium situations in an open economy, all withdrawals must equal injections into the circular flow, thus $W = J$ or $S + T + M = I + G + X$.

For equilibrium situations in an open economy, all withdrawals must equal injections into the circular flow, thus $W = J$ or $S + T + M = I + G + X$.

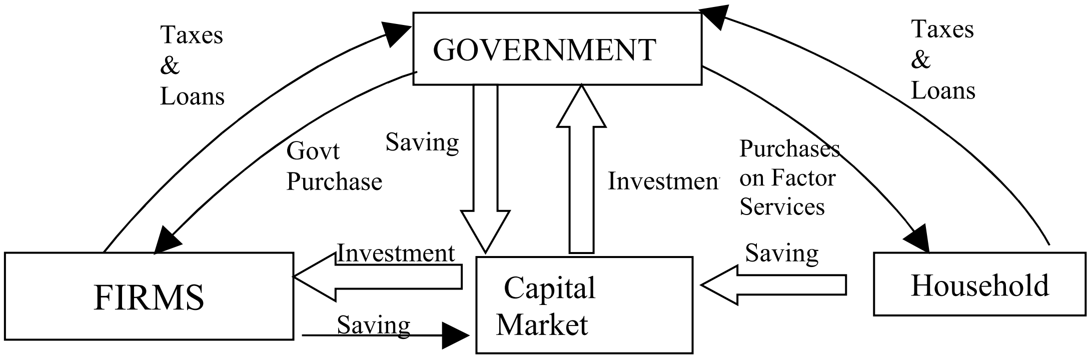
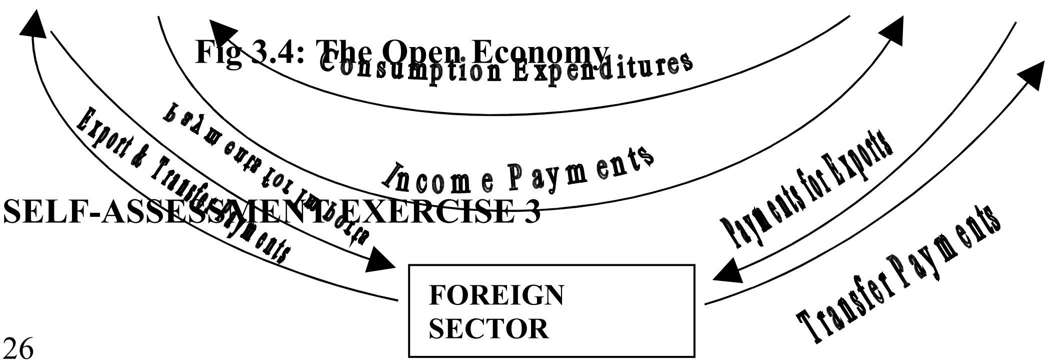


Fig 3.4: The Open Economy



SELF-ASSESSMENT EXERCISE 3

Explain the circular flow of money with government and foreign sectors.

3.6 The Significance of the Circular Flow of Money

The extent of development, working and stability of any modern economy depends on her circular flow of money. Thus the inflow and outflow of money – the lifeblood of a modern economy is of utmost importance in governance and policy formulations. The importance of this all-important system that are both theoretical and practical in an economy is discussed in this section.

1. Forms a link between producers and consumers

Factors of production employed by producers are paid with money while consumers pay for goods and services with money with ease. In this way, where both producers and consumers of goods and services converge forms a network of markets where problems relating to optional performance of the economy are harnessed.

2. Check on Inflationary and Deflationary Tendencies

With an eye on checking the leakages and injections into the system as to maintain a balance or equilibrium, a check is put on the inflationary and deflationary tendencies by the proper mechanism and operation of the circular flow in the economic system.

3. Forms the Basis of the Multiplier

The cumulative movement in the circular flow of money, i.e. the cumulative changes/movements in leakages and injections in the flow is the basis of the Keynesian Multiplier (a topic that will be discussed later in the course).

4. Monetary Policy

The level and equality between savings and investment is checked and controlled through the study of the circular flow of money.

This is possible since the government controls the capital market – (a market for investment of saved earnings) through the use of monetary policy.

5. Fiscal Policy

The study of the circular flow shows the importance of adopting a compensatory fiscal policy. This enables the government to maintain equilibrium in the flow such that leakages must always be balanced by injections. This further checks the price movements in the system, hence checking inflation and deflation too.

6. Trade Policies

In the open economy, the circular flow of money and operations help the government adopt a preferred trade policy – like export promotion and import control policies.

7. Basis of Funds/National Income Account

The circular flow of money helps in the calculation of the national income on the basis of the flow of funds accounts. This flow of funds accounts is concerned with all transactions in the economy and is accomplished by money transfers. This account shows the financial transactions among different sectors of the economy, as already seen, and the link between savings and investment, lending and borrowing.

SELF-ASSESSMENT EXERCISE 4

Discuss the significance of the circular flow of money in any economy.

4.0 CONCLUSION

The objective of any economy is to see to the well being of her citizens. This can be fully achieved if the circular flow of money and her monetary policies are effectively operated. The unit has actually exposed and shown you what the circular flow of money is and its effects on various sectors of the economy. It therefore behoves the operators of the economic activities in all sectors to brace up and ensure that the various variables – leakages/withdrawals and injections, outflows and inflows into the economy are properly harnessed.

5.0 SUMMARY

In this unit three, we have discussed the inflow and outflow of money in an economy. This is known as the circular flow of money – the process whereby money payments and receipts of an economy between the various sectors and the foreign nations are made.

This flow, which also facilitates the calculation of a nation's national income, has many other benefits to a nation's economy. These were also highlighted as the significance of the circular flow of money in an economy.

In the next study unit, we shall discuss the monetary standard.

6.0 TUTOR-MARKED ASSIGNMENT

1. With full explanation and illustrations, explain the circular flow of money in an open economy.
2. What is meant by the circular flow of money? Explain the importance of this flow in an economy.
3. Distinguish an open economy from a closed economy. Discuss the components of a closed economy.

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UNIT 4 MONETARY STANDARDS

CONTENTS

1.0 INTRODUCTION

As you have seen in unit three – The Circular Flow of Money, especially in an open economy, and also the role of money in any economy, there arises the need for the basis to which money of a country or group of countries may be converted. This unit will therefore discuss what this standard is, the various types or stages it has evolved over time, their merits and demerits. A brief attention shall also be the focus on the standard systems of note issue, the system that seems to possess the unique characteristics that seems to outweigh the others.

2.0 OBJECTIVES

It is expected that on completing this unit, you should be able to:

- Explain what monetary standard means.
- Identify the types of monetary standards with their merits and demerits.
- Explain the different types of gold standard and the rules and workings of the gold standard
- Outline the standard system of note issue

3.0 MAIN CONTENT

3.1 Monetary standards

3.1.1 The Meaning of Monetary Standard

The basic money of a country (or group of countries, as in the case of the European Union and the Euro), into which other forms of money may be converted and which also determines the value of other kinds of money, is called that country's money of redemption or standard money. The monetary standard of a nation then refers to the type of standard money used in the monetary system of that nation. Put more succinctly, monetary standard refers to the overall set of laws and practices, which control the quality and quantity of money in a country. The foregoing reveals that the standard money of a country determines and regulates the exchange value of goods and services within that country. The monetary standard of a nation is its standard monetary unit, this follows that if for instance, the standard monetary unit of a nation is gold, it is then said to have a gold standard.

The main aim of the monetary standard in an economy is the maintenance of stability in the internal and external value of her currency.

3.2 Types of Monetary Standards

Through the process of evolution of money, there have been different types of monetary standards. Modern standards have been either commodity or metallic standards, in which case either gold or silver has been chiefly used, or paper or fiat standards consisting of inconvertible currency paper units.

While the metallic standard refers to a monetary system in which the value of the monetary unit is expressed in terms of a fixed quantity of some metal, the fiat or paper standard, paper notes, which may or may not be convertible into metal for a fixed weight as circulated as legal tenders.

A situation called monometallism exists when the monetary system is related to only one metal while bimetallism is where the monetary unit is made in two metals. It is note worthy to mention at this stage that the bimetallic standards were rarely successful largely because of Gresham's law, which describes the tendency for cheaper money to drive more valuable money out of circulation.

3.3 The Gold Standard

The gold standard is a monometallic standard type in which the value of the nation's monetary unit is fixed in terms of a specified weight and purity of gold. Some economists however defined the gold standard simpler. While D.H. Robertson pointed out that "gold standard is a state of affairs in which a country keeps the value of its monetary and value of a defined weight of gold in an equality with one another", W.A.I. Coulborn simply put it as an arrangement whereby the chief piece of money of a country is exchangeable with a fixed quantity of gold of a specified quality"

Different countries at different times adopted different types of gold standards. These include:

a. Gold – Coin/Currency Standard

Where pure or full gold is circulated.

b. Gold - Bullion Standard

A situation where gold coins do not circulate within the country. Rather, legal tender currency in circulation consisted of paper currency notes and token coins of silver and other metals, which are convertible at fixed rates into gold bars or bullion.

c. Gold – Exchange Standard

This system operated with poor nations that did not possess sufficient gold, and under some colonial rule whose currencies were linked with that of the ruling/colonial country. Like the gold-bullion standard, gold coins did not circulate but paper notes and token coins of silver and other metals. The currency of a country that operates on gold-exchange standard is converted into the currency of some other country on the gold standard.

d. Gold- Reserve Standard

This was the aftermath of the abandonment of the gold standard by England, USA and France between 1931 and 1936. These nations with a view of maintaining exchange stability, entered into Tripartite Monetary Agreement known as Gold Reserve Standard. The system required the circulation of paper notes and token coin of cheap metals but maintaining an Exchange Equalization Fund.

e. Gold – Parity Standard

A system that emerges with the establishment of the International Monetary Fund (IMF) in 1944. It aims at keeping the exchange rate of every country stable in terms of gold by insisting that all members declare the par value of its monetary unit in terms of a fixed quantity of gold.

SELF-ASSESSMENT EXERCISE 1

Identify and discuss the various gold standards.

3.4 Rules and Working of the Gold Standard

It has been established that whatever form of gold standard that is operated, the underlying element is that the country's currency is, either directly linked to gold at one time or another, in either volume or in value.

In its effect in the maintenance of exchange rate stability, economists have distinguished domestic from international gold standards. While the domestic gold standard is mainly concerned with the volume of money and its influence in the domestic price level, the international gold standard is concerned with the external value of the currency and the problem of maintaining the stability of the country's foreign exchange. This feature of maintaining the stability of exchange under international gold standard, abandoned by countries of the world in the 1930s forms the rules of the working of the gold standard.

The condition for the success of this, known as the rule of the game – is hinged on the following three principles.

1. That the international gold standard should involve a common agreement among nations as to the objectives for which it existed.
2. That the standard should bring stability of prices and also guarantee stability of exchange.
3. That the individual central bank (regulatory authorities) should avoid such actions which might endanger stability of prices through their effects on the policy of other central banks.

For the successful and smooth working of the gold standard in maintenance of exchange rate internationally, the following rules or conditions are to be met between the countries concerned:

a. Free and unrestricted movement of gold between the countries
b. There should be expansion for importing and contraction for exporting of credits.
c. There should be high flexibility of economic set- up through price mechanism.
d. Free trade among themselves
e. First policy is the maintenance of exchange stability.
f. There should not be speculative activities.
g. The domestic currency should be stable.
h The period should be normal time, not times of war or emergency.

The gold standard can only work smoothly if these conditions / and rules are met by the countries, thus its being regarded as a "jealous god" that works provided it is given deviation.

SELF-ASSESSMENT EXERCISE 2

Identify the various rules of gold standard.

3.5 Bimetallism or Bimetallic Standard

Bimetallism or Bimetallic Standard is the system used in some countries, under which either gold or silver coins were the standard currency. There is always a law which expresses the ratio of the two coins to be in circulation simultaneously within the country, the coins are both unlimited legal tender, minted freely for a fee or sometimes free. They are imported and exported freely but exchanged for a fixed mint par ratio.

The study of Bimetallism is of historical and academic interest only because it was a complex and costly standard which could not work smoothly. This follows the fact that a constant supply of money could be answered in a much better way by the managed fiat or paper standard.

Bimetallism mechanism exists when there is a divergence between the mint ratio and the market ratio of the coins in circulation. This leads us to the Gresham's law, a situation where cheap money drives dear money, or bad money drives out good money.

The Gresham's law can be explicitly defined as "whenever the specific value of a certain class of coin exceeds their currency value, the coins will begin to go into the melting point or be exported." Bad money refers basically to debased or clipped or worn out legal tenders money such as coins and paper notes. When Gresham's law operates, the country would be on monometallism. This happens for example, if silver coin becomes cheaper than gold, people used it more as a medium of exchange and hoard or melt gold coins, with the result that gold coins disappear from the market. This happens when the market rate of gold exceeds its mint rate.

Again, Gresham's law operates when paper currency notes circulate along side with gold and silver coins. In such a case, paper notes are bad money while gold, and silver coins are good money. In general terms, Gresham's law describes the tendency for cheaper money to drive more valuable money out of circulation.

3.6 Paper Currency or Fiat Standard

Paper currency or fiat standard consists of paper money which is unlimited legal tender and token coins of cheap medal. This is the most adopted monetary system of the world. They do not allow free convertibility of the currency into a metallic standard, and money is given value by government fiat or edict rather than by its nominal gold or silver content. Modern systems are also refereed to as managed currencies or standards, because, the value of the currency units depends to a considerable extent on government management and economic policies issued by the central bank of the country.

The system has a recurrent problem of whether the value of inconvertible – credit currency can be maintained at a fairly stable level for extended period of time.

3.6.1 Merits of the Paper Standard

The paper standard, a system adopted by most countries of the world at the present time, has a number of advantages over the other monetary standards.

i. **Economical to operate**. Since the system does not require for gold or silver coins, these precious metals could be used for more productive purposes and making payment to foreign countries and storage for security reasons. This makes the paper system cheaper and economical to adopt by any country.

ii. The system is **greatly elastic** since the monetary theory can easily adjust to money supply in accordance with the economy's requirements. It can be increased by printing more notes or reduced when the situation demands for it.

iii. **Price Stability**: The paper standard ensures price stability through the maintenance of equilibrium between demand and supply of money using the appropriate monetary policy.

iv. The system is **free from cyclical effects** of business cycles arising in other countries.

v. With the use of the monetary policy, the paper system **ensures full utilization of a country's resources.**

vi. Restoration of **equilibrium in the exchange rate** of a country is affected easily in the paper system. This happens whenever disequilibria occur in the demand and supply of the countries currency in the foreign exchange market.

vii. It is very convenient to carry, thus **very portable**.

ix. **Storage** in huge quantities is easily accomplished with the system.

x. Paper notes of **different denominations** are easily recognizable.

xi. **Replicability** by printing notes of different types of the same denominations easily carried out.

3.6.2 Demerits of the Paper Standard

The advantages of the paper money discussed above not withstanding, the system has some defects.

i. **Inflationary Bias** – Because of the inconvertibility of paper notes, government may print notes in excess deliberately leading to excess money supply and thus inflation in the country.

ii. In actuality, its merit of **price stability is a myth** as seen from many countries in the past.

iii. Leads to **instability in exchange rates** resulting from fluctuation in external prices as against internal prices.

iv. As paper notes are not backed by gold reserves, they **lack confidence**.

v. Paper notes can be destroyed by insects and fire and therefore **lack durability** than metallic coins.

vi. Because its supply can be manipulated, it **lacks stability**, uncertainty/adverse effect in the business and economic activities resulting from paper money instability.

vii As token money, they have **no intrinsic value**, thus in the event of demonetarization, they are like waste papers.

viii Because it is a managed system, which requires much care and caution, it is said **not to be automatic in operation** but a function of the regulation authority.

The fore-going not withstanding, paper money has increasingly become common from the 18th century in the most monetary system of the world at present time.

SELF-ASSESSMENT EXERCISE 3

Identify the merits and demerits of the paper standard

3.7 Standard System of Note Issue

Countries of the world evolved and adopted various note issue standards. These systems that have their merits and demerits were adopted depending on the level of growth and development of the economy.

Some of these systems are:

1. The Simple Deposit or Full Reserve System
2. The Fixed Fiduciary System
3. The Maximum Fiduciary System
4. Proportional Reserved System, and
5. The Minimum Reserve System.

Each of these systems has its level of operation depending on the extent of gold backing to the amount of notes issued by the monetary authority.

The Minimum Reserve System is one that can be very useful to a developing country since the central bank of that country is authorized to issue notes up to any extent, only to keep a statutory minimum reserve of gold and foreign securities. If a country operates this system properly, it can help in checking inflation by reducing the money supply. Since the system requires only a small and fixed amount of gold to be kept in reserve, it is thus said to be very economical.

The operation and handling of the Minimum Reserve System can make or mar an economy. This stems from the fact that under the system, a corrupt and inefficient government can bring disaster to the economy by printing excessive notes. This will in turn create inflationary pressure and loss of confidence of the people. Also, judicious use of the system by honest and efficient administration can transform the economy. This system stands out unique among the other four systems of note issue because it is elastic, (i.e. response to changes in money supply in the economy), economical (does not require full gold backing for all notes issued), stable, convenience and safe to operate when compared with the other systems.

4.0 CONCLUSION

In the effort of trying to maintain stability in the internal and external value of their currency, many countries have evolved different types of monetary standards. The discussion so far on the various systems of monetary standards has made it clear that an ideal system should satisfy the criteria of elasticity, economy, stability, convenience and safety. Every nation of the world, therefore, tries to adopt that monetary standard which meets its needs of growth and development.

5.0 SUMMARY

In this unit, you have seen the meaning and evolution of monetary standards – ranging from gold, silver to paper/fiat standards. The unit also discussed the bimetallic standard whose break- down leads to the Gresham's law. The various types of gold standards were x–rayed then followed by the most modern monetary standard – fiat/paper standard with its attendant merits and demerits.

In the next study unit, we shall discuss the value of money and its measurement.

6.0 TUTOR-MARKED ASSIGNMENTS

1. Discuss the main aim of the monetary standard in an economy.
2. What is paper currency standard? Discuss at least four merits and demerits of the paper currency standard.
3. The minimum Reserved System of note issue has been acclaimed and adopted as being very unique among the various standard systems of note issues. List the other systems and discuss their features or characteristics.

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UNIT 5 THE VALUE OF MONEY AND ITS MEASUREMENT

CONTENTS

1.0 INTRODUCTION

In trying to give a good definition to money, some economists said that it is “the means of valuation of payments – payments for goods and services.” The problem that arises then is to what extent can we aggregate the monetary values of various goods and services, and then the general business activities and transactions in an economy, as to express the direction of growth in the economy?

This unit shall therefore endeavour to lead you through the analysis of the concept that expresses the relationship between a unit of money and the quantities of goods and services which it can purchase. This is also, a standard measure of the changes in the purchasing power of money over time. In this way, analysts can determine the growth direction in the economy and other economic policy decisions.

2.0 OBJECTIVES

It is expected that on completion of this unit, you will be able to:

- Explain the meaning of value of money.
- Explain the meaning and interpretation of index numbers.
- Compute simple and weighted price indices.
- Discuss the major uses of index numbers in an economy.

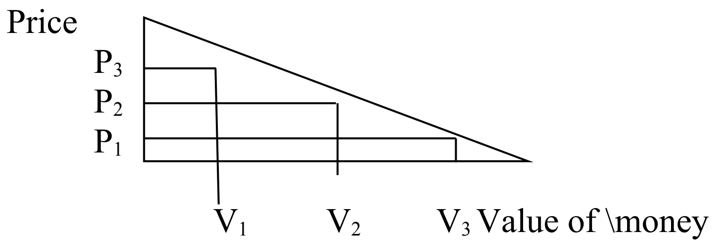
3.0 MAIN CONTENT

3.1 The Value of Money and its Measurement

3.1.1 Meaning of the Value of Money

Value of money means the purchasing power of money over goods and services in a country, or what money can buy in terms of good and services. The indicator of the value of money is the price level within an economy. Thus the term “value of money” is a relative concept which expresses the relationship between a unit of money and the goods and services which it can purchase. The relationship between the value of money (V) and price level (P) is an inverse one. Thus, when price level rises, the value of money falls.

Thus, $V = \frac{1}{P}$



Considering that money is adopted for both internal and external transactions there exists, therefore, two types of value of money viz:

i. Internal value of money referring to the purchasing power over domestic goods and services,
ii. External value of money – the purchasing power of money over foreign goods and services.

3.1.2 Index Numbers

The index number is the measure of the changes in the value of money. It is thus a number which represents the average price of a group of commodities at a particular time in relation to the average price of the same group of commodities at another time.

A price index number is a number used in comparing changes in the general level of prices of commodities for a given time period.

The index number is the number obtained after computing the price index is an average figure relating to a single group or commodities expressed in different units. It shows the net increase or decrease of the average prices for the group under study and the extent of changes in the value of money (price level) over a period of time, given a base period.

SELF-ASSESSMENT EXERCISE 1

Explain the meaning of money in relation to the index number.

3.2 Methods of Calculating Index Number

Before constructing an index number, the following points must have to be agreed upon:

1. Purpose of the index number must be specified.
2. Selection of commodities which should neither be too large nor too small.
3. Select the prices of the commodities of interest from reliable sources.
4. Select an average – arithmetic or geometric mean. While the former is easier to calculate, the later is more accurate. To avert some of the difficulties, the average prices are reduced to price relatives (percentages) on either a base period method or the chain base period.
5. Select and assign weights to the commodities on level of importance, value or quantity.
6. Select a base period, a period against which the comparisons are made. Such periods should be normal periods, devoid of unusual events like war, famine, draught, boom, etc, again not too recent or remote period.
7. Select from known formulas that is to be used. This is however subject to the availability of data and purpose of the index number.

3.2.1 Construction of a Simple Price Index

Compute the simple price index of the five commodities given below:

Figure 5.1

Commodity	**Unit**	**Base Year Price (P_0) (2000)**	**Current Year Price (P_i) (2006)**
Rice	Bags of 50kg	4000	6,500
Beans	Bags of 50kg	2,500	6,200
Vegetable oil	Tins of 4 Litres	600	950
Yam	Tubers	250	480

Using 2000 as the base year; the table will be transformed as follows:

Figure 5.2

Commodity	Base Year price (P_0)	Current Year Price (P_i)	Relative Prices (R_i)
Rice	4000	6,500	162.5
Beans	2,500	6,200	248.0
Vegetable oil	600	950	158.3
Yam	250	480	192.0

Table 5.2

Using the simple price index formula,

$$P_1 = \frac{\text{Prices in End Period } (P_i)}{\text{Prices in Base Year } (P_0)} \times 100$$

Using the arithmetic mean, the price index becomes:

$$P_1 = \frac{\sum Ri}{n} \qquad \text{Prices in Base Year}$$

where P_1 = Price index of end year (P_1) over base year (P_2)

R_1 = relative prices for each year/period.

$$P1 = \frac{760.8}{5} = 152.1$$

This means that the price level rose by about 52.16% in 2006 over prices in 2000.

3.2.2 Weight Price Index

Using this method, we assign weights to the commodities, with higher weights to these of greater importance to consumers and low weights to commodities of lesser importance to consumers.

Using the illustration in section 3.2.1, (Table 5.1), we assign weights (w) arbitrarily as shown below. We use the sum of the products of the weights and the relative prices to obtain the weighted mean.

Figure 5.3

Commodity	Weight(w)	Po	Pi	Ri	WR
Rice	10	4000	6500	162.50	1625
Beans	8	2500	6200	248.00	1984
Veg. Oil	5	600	950	158.30	791.50
Yam	9	250	480	192.00	1728

Total (Σ)	32				6128.5

Thus, the weighted price index in 2006 $= \frac{\sum WR}{\sum W} = \frac{6128.5}{32}$

$= \mathbf{191.52}$

Thus, using the weighted price index, there is an increase of 191.52% in the price level in 2006 over 2000 as against 52.16% obtained using the simple index.

3.3 Uses of Index Numbers

The Index Number - a measure of changes in the value of money is of great practical importance in the economy. Some of these are discussed below:

1. Measuring changes in the value of money. This aids in determining the direction of production. Index number techniques help in the measurement of different aspects of the value of money especially for specified purpose.

2. Measurement of the cost of living: The cost of living index indicates the rise or fall in the real income of workers which forms the bases for wage negotiation and wage contracts.

3. Analyzing Markets for Goods and Services – Consumer price index becomes of great help in analyzing the market for particular kinds of goods.

4. Measuring the Changes in Industrial Production - Industrial Production index number assist in measuring increase or decrease in industrial production over a given period.

5. In Internal and External Trades: The wholesale price index assets commerce and adjusting in expanding or contracting internal trade while export / input indices reveal the direction of growth of a country's external trade.

6. In Economic Policies – By comparing the index numbers of various index numbers, the government can know the trend of economic activities in the economy and adopt appropriate policies. These are in areas of price policy, foreign trade policy, wage and salaries policy, employment policy, etc

7. Determination of Foreign Exchanges Rate: The index numbers of wholesale prices of two countries are used to determine their respective rate of foreign exchange.

SELF-ASSESSMENT EXERCISE 2

Identify and discuss the uses of index number.

4.0 CONCLUSION

Money, a very vital instrument in the operation of any economy cannot be said to satisfy its functions and roles effectively if its value cannot be measured uniformly. In this unit therefore, we have tried to study the measurement of the changes in the value of money by considering the changes in the average prices of a group of commodities at a particular time in relation to the price of same group at another time. The results of these measures assist government in adopting appropriate monetary and fiscal measures in order to achieve growth in the economy with stability.

5.0 SUMMARY

In continuation of our study of money, this unit was devoted to the understanding of the value of money, a concept said to be the purchasing power of money over goods and services in a country. This was followed by the measurement of the changes in this purchasing power of money called index numbers or price index numbers.

Two methods of this measurement – simple and weighted price indices were discussed. The unit rounded up with the importance of the concept of index numbers in any economy. In the next study unit, we shall discuss the demand for money.

6.0 TUTOR-MARKED ASSIGNMENTS

1. What do you mean by value of money? How would measure changes in the value of money?
2. Discuss the methods of constructing an index number.
3. Given commodities A, B, C, D, and E with base year prices of ₦100.00, ₦200.00, ₦450,00, ₦380.00 and ₦750.00 and current year prices of ₦175.00, 325.00, ₦ ₦ ₦700.00, ₦420.00 and ₦800.00 respectively.

Determine the price index of using

(i) Simple price index
(ii) Weighted price index.

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UNIT 6 THE DEMAND FOR MONEY

CONTENTS

1.0 INTRODUCTION

Money, a concept generally defined by its functions had been seen to have varying important functions and roles in an economy. The three outstanding functions of money – as a unit of account, a medium of exchange and as means of store of wealth have given impetus to the desire for both household and firms wanting to hold money. These may be partly in cash balances and/or in form of liquid assets. In this unit, we shall be discussing the motives why individuals and businesses wish to hold cash in varied forms. The factors that determine the level of holding this money shall constitute the bulk of the discussion.

2.0 OBJECTIVES

At the end of this unit, you are expected to be able to:

- Explain the meaning, nature and motives of demand for money
- Discuss the effect of income and interest rate on the demand for money

3.0 MAIN CONTENT

3.1 The Demand for Money

3.1.1 Meaning and Nature of Demand for Money

The demand for money generally refers to the "total amount of money balances that everyone in the economy wishes to hold for all purposes". It also means the willingness, desire or enthusiasm of the people to hold their wealth in the form of cash as against holding each wealth in the form of investment in financial assets that have yield rates. This arises from the two important features of money - viz: That of acting as a medium of exchange and as a store of value. Thus, people wish to hold money in cash and/or in deposits or assets.

There is however always a cost of holding any money balance because the money held could have been used to purchase income assets which would have earned interest in return. The money could also have been deposited for a property or used to buy shares/bonds. This then shows that there exists an opportunity cost for each unit of money held. This opportunity cost of holding the money balance is called the interest rate or rate of interest, which could have been earned if the money had been used to purchase income earning assets such as bond.

The foregoing reveals that there are changes in the demand for money. Two schools of thought give explanations to these changes. These are:

a. **The scale view** which says that the demand for money is directly related to the income level. The higher the income level, the greater will be the demand for money.
b. **The Substitution view**: This says that when attractive assets like bonds become unattractive due to fall in interest rates, people prefer to keep their assets in cash, and thus the demand for money increases, and vice versa.

These two views explain the nature or motives of the demand for money.

SELF-ASSESSMENT EXERCISE 1

Explain the demand for money.

3.2 Motives for Demand for Money

There are three motives which can lead to demand for money in an economy. These are discussed under the following:

3.2.1 The Transactions Demand for Money

Almost all transactions in the economy are carried out with money. Households pay for goods and services from firms with money that in turn pay for factor services supplied by household with money. Thus, money balances held by individuals, household, firms or governments because of these flows are called **Transaction Balances.** The desire to hold money balances to finance these flows is called **Transaction Motive** while the quantity of transactions balances people want to hold is called **Transactions Demand for Money.**

Put more succinctly, the Transaction Demand for money is cash set aside by individuals, governments, and firms for settling pre-determined re-occurring expenditure such as transport costs, stock replenishment, payment of salaries, food, etc,. This arises from the medium of exchange function of money in making regular payments of goods and services.

Transactions demand for money is divided into two motives:

* **Income Motive**: meant to bridge the interval between the receipt of income and its disbursement; and
* **Business Motive**: meant "to bridge the interval between the time of incurring business costs and that of the receipt of the sale proceeds.

The Factors affecting Transactions Demand for money are as explained below. The quantity of money demanded for transactions purposes can be determined by the following variables:

a. Income

The level of one's income – be it household, firms or government affects its level and demand for money. Thus, when the people's income is higher, the volume of money set aside for transactions will also be higher and vice versa.

b. The Interval between pay days

The transactions demand for money is again affected and determined by the period between income pay days. When the pay period interval is long, the higher the quantity of transaction demands for money. On the contrary, when the payment interval is shorter, the quantity of money for transactions will be lower too.

c. The Credit Habit

Where the economy encourages credit transactions, there will be a negative effect on the transactions demand for money. Thus, while low credit habit increases the transactions demand for money, high credit habit will reduce it.

d. Price Level

Price Level has a direct positive influence on the transactions demand for money. Thus, when prices are high, the demand for money is high and vice versa.

e. Population

While an increasing population has large or increase quantity of money for transaction purpose, a decline population encourages reduced demand for money for transaction purposes.

The foregoing depicts that transaction balances are held because of the non-synchronization of payments and receipts within the economy among various units - households, firms and governments. These balances or demand for money for transactions purposes will be high if the value of the national income measured at current prices is high.

3.2.2 Precautionary Demand for Money

Where there exists uncertainty about the exact timing of receipts and payment between households and firms, they will tend to hold additional cash balances to meet any unforeseen expenditures. These balances are called precautionary balances while the reason for the action is called precautionary motives.

Thus, precautionary demand for money refers to the money set aside to settle unforeseen contingent expenditures like illness, unemployment, accidents, etc.

These are not predetermined expenditures and therefore for life to go on with less difficulty, cash must be set aside to meet them wherever it arises.

On the part of business sector, in order to be able to continue being in business during times when receipts for goods and services are abnormally low, and for disbursements/payments are abnormally high,

firms carry money balances. Temporary situations like this are such that make firms desire to hold cash.
Thus, whereas the transactions demand for money arises from the certainty of non- synchronization of payments and receipts, the precautionary demand for money arises from uncertainty about the degree of non – synchronization.

The Factors Affecting Precautionary Demand for Money are as explained below. Precautionary demand for money which arises out of uncertainties that has to be handled in the economy has some factors that influence it. Some of the variables are:

1. Income Level

The precautionary demand for money varies directly with the value of national income (income level). Thus, when income level is high, the quantity of money set aside for precautionary purposes will be high.

2. Degree of Optimism and Pessimism

While people who are optimistic in their approach to risks tend to set aside very little amount to meet unforeseen situations, pessimistic people always set aside large amount of money for such purposes in anticipation of the unforeseen situation. Thus, the degree of optimism and pessimism among the people greatly determines the precautionary demand for money.

3. Government Contingency Provision

The level of contingency provisions for emergency situations influences the precautionary demand for money. When government contingency provisions for emergency situations are very substantial, the level of precautionary demand for money will be low and vice versa. Thus, government contingency provision has an inverse effect on the precautionary demand for money.

4. The Economic/Social Status of the Individual

The level of precautionary demand for money is positively affected by the economic and social status of the individual. People of high status in the society tend to set aside reasonable amount of money for emergency situations and vice versa.

Other factors that affect the precaution demand for money include the level of business activity, opportunities for unexpected profit deals, availability of cash, cost of holing liquid assets in bank reserves, etc.

3.2.3 Speculative Demand for Money

A third major reason for holding money arises from uncertainty about the future. Thus, any transaction that takes place over time is necessarily somewhat speculative. If one therefore, thinks that prices are very low now and may soon rise, the tendency is to buy now and put off selling until prices rise. Again, if one thinks prices are high now and will soon fall, the tendency is to sell now and to postpone buying until prices fall. Thus, speculative demand for money is the money set aside for taking advantages of charges in the prices of financial assets. Money thus held for speculative purposes is a liquid store of value which can be invested at an opportune moment in interest bearing bonds or securities.

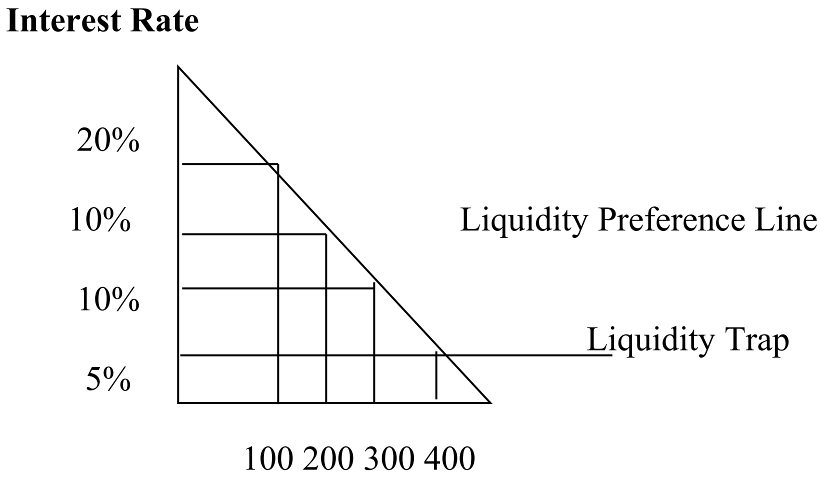
People who are certain about the direction in which they expect the price of bonds to move will tend to hold all their wealth in bonds (if they are expected to rise) or all wealth in money (if they are expected to fall). However, if investors are uncertain about the movement of bond prices will always hedge their bets by holding both bonds and money. The above explains that speculative demand for money or speculative balances are wealth held in the form of money rather than interest – earning assets because of expectations that the prices of those assets my change. The motive for holding such balances is called speculative motive as arises primarily out of uncertainty about future bond prices. It varies inversely with the rate of interest.

The Factors Affecting Speculative Demand for Money are as explained below.

The speculative demand for money that has its source in uncertainty about future bond prices is affected by the following factors.

1. Interest Rate

The interest rate has an indirect relationship with the speculative demand for money. Thus the higher the interest rate, the lower the speculative demand for money and vice versa. However, when the interest rate becomes too low, people will no longer be interested in investing in bond. They will rather prefer to keep cash because further investment in bonds will mean a deficit loss. This point is known as the Liquidity Trap (see graph below)



Speculative Demand for Money

2. Quantity of money set aside for transaction and precaution.

When the money set aside for transactions and precautionary motives is high, then speculative demand for money will be low and vice versa.

It is generally said that it is the expectations about changes in bond prices and the current rate of interest that defines the speculative demand for money.

This can be illustrated thus:

If a bond has an annual yield (I) of ₦50 at the interest rate (r) is 4% the current market price (Pc) of the bond is

$$P_c = I/r = \frac{\#50}{0.04} = \# \underline{1,250}$$

Again, if the expected rate of interest of the bond is 5%, the future price of the bond can be calculated then,

$$Pe = 1/r_e = \frac{\#50}{0.05} = 1,000$$

where Pe = expected price of bond, I = annual yield, r_e = expected rate of interest.

SELF-ASSESSMENT EXERCISE 2

Identify and discuss the various reasons for holding money.

3.3 Total Demand for Money

The demand for money is defined as the total amount of money balances that everyone in the economy wish to hold. The previous sections show that money held for transactions and precautionary purposes is primarily a function of the level of national income. Hence the higher the level of income, the higher the amount of money held for transactions and precautionary motives. Then, the demand for money is said to vary directly with the national income valued in current prices.

Also, you have seen that the speculative demand for money is a function of the rate of interest since the higher the rate of interest, the higher the cost of holding money and less money will be held for precaution purposes. The rate of interest also influences decisions as to whether to hold money for speculative purposes.

The foregoing show that the total demands for money is a function of both income and interest rate.

Let, LT = f(Y) be the transactions and precautionary demand for money and Ls = f(r) the speculative demand for money, and L = total demand for money, then

$$
\begin{aligned}
L &= L_T + Ls \\
&= f(Y) + f(r) \\
&= f(Y, r).
\end{aligned}
$$

The total demand for money varies directly with income and inversely with rate of interest.

4.0 CONCLUSION

The importance, role and functions of money in any economy cannot be overemphasized as you already have seen from previous units. These roles culminated in the desires by households, firms and governments alike in rooting to hold money. This desire to hold money balances/cash to fulfil the role of medium of exchange and as a store of wealth or value reveals the motive for holing money or demand for money. The various components in the economy that determine these motives for holding money are important variables in the macro – economy that calls for a better understanding. We therefore concluded that the total amount of money balance that everyone wishes to hold for the all purposes has an opportunity cost called the interest rate.

5.0 SUMMARY

We have attempted in this unit to define the nature and meaning of demand for money in an economy. We have also examined the various motives for demand for money, the determents or factors affecting these motives and finally the total demand for money in an economy.

In the next study unit, we shall discuss the supply of money.

6.0 TUTOR-MARKED ASSIGNMENTS

1. What is the nature and motives of the demand for money?
2. Bring out the relationship between the demand for money and interest and income.

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MODULE 2

UNIT 1 THE SUPPLY OF MONEY

CONTENTS

1.0 INTRODUCTION

In and attempt to define money in the previous units, we approached this by adopting some aspects of the functions of money are adopted that money is a medium of exchange while another states that money is the commodity that satisfies and services as a store of value which can be easily converted into a medium of exchange at a known and completely secure price that does not fluctuate with the rate of interest.

These functions of money form the basis on which the terms of supply of money or money supply has been narrowly and broadly defined respectively. The central bank of any nation charged with the responsibility of currency issue among others and commercial banks that create money in form of loans and advance are of great importance in the fulfilment of these functions of money. Thus, in the discussion on the money supply, we shall be examining the activities and operations of these organizations together with the business activities in the economy.

2.0 OBJECTIVES

It is expected that on the completion of this unit, you should be able to:

- Explain the meaning of money supply
- Identify the various factors that determine the supply of money

3.0 MAIN CONTENT

3.1 The Supply of Money

3.1.1 Definition and Meaning of Supply of Money

The term "the supply of money" is synonymous with such terms as "money stock," "stock of money," "money supply" and "quantity of money". This, in general terms, is said to be the total amount of money in the economy at any given moment".

The definition of money supply or the measures of money supply has three alternative views:

There are discussed as follows:

a. The Traditional or Keynesian definition of money supply. This approach defines money supply as "currency with the public and demand deposits i.e. savings and current accounts of depositions with commercial banks. This is regarded as a narrow definition of money supply denoted as M_1 and is liquid form of money. This definition stresses the medium of exchange function of money M_1 to include all currency with the public plus all demand deposits with commercial bank.

b. The Modern Quantity Theories headed by Freidman. This is a broad definition and defines money supply at any moment of time as "literally the amount of money people are carrying in their pockets, the amount of money in demand deposits of banks and also commercial banks time deposits (i.e. fixed deposit). This definition is M_1 plus time deposits of commercial banks and is characterized as M_2. It stresses the store of value function of money or what Friedman said is "temporary abode of purchasing power. $M_2 = M_1$ + Time deposit accounts.

c. The Gurley and Shaw definition of money supply. This is the broadest definition of money supply which includes currency in circulation with the public, demand deposit accounts, time/fixed deposit accounts and deposits with other credit and non – bank financial institutions. This is denoted as $M_3 = M_2$ + deposits with other credit and non – bank financial institutions.

The choice of any particular definition of the money supply depends on any of the following considerations.

i. The extent to which it facilitates business and the analyses of the motives for holding cash.

ii. The extent to which the monetary authorities should have direct influence on the supply of money.

Whereas M_1 may be analytically better as a medium of exchange, it is an inferior store of value since it earns no rate of interest. The central bank that is the monetary authority has narrower area of control under M_1 if only demand deposits are considered in the money supply.

In a highly developed financial structure, the consideration of the motives for holding cash – means if payments and time deposits is of great importance, hence M_2 becomes less satisfactory analytically. This further stem from the fact that time deposits lack perfect liquidity since they cannot be withdrawn prior to the fixed date without paying for a penalty.

However, it may seem more appropriate from the monetary policy control view since the central bank can exercise control over a wider area that include time and demand deposits.

The broadest definition M_3 is unsatisfactory on both criteria viz: M_3 neither satisfies the medium of exchange function of money nor remains completely within the control of the monetary authority. It is however a good store of value being highly liquid assets. The above not withstanding, non – bank financial institutions depositions are not included in the definition of money supply.

SELF-ASSESSMENT EXERCISE 1

Explain the meaning of the supply of money.

3.2 Determinants of Money Supply

The factors that influence the supply level of money in an economy at any given time can be broadly classified as:

a. Endogenous factors and
b. Exogenous factors

The exogenous factors are those controls that come from the monetary control authority - the central bank, from where the endogenous factors arises, the internal changes of the business activities of the people which affects their desire and willingness to hold money relative to deposits, interest rate, etc.

3.2.1 The Endogenous Factors

These factors are influences that arise from within the economic activities in the economy can be broadly grouped into two:

1. The public desire to hold currency and deposit. If people are in the habit of keeping less cash with themselves and none of deposits with the commercial bank, the money supply will be large.

   In such a circumstance, the commercial bank can create more money with the deposits. On the other hand, if the people's banking habit is poor, thus they prefer to hold their cash rather than banking them, the credit creation by bank will be less consequently, money supply level will be low.

2. High powered money

   High – lowered money of monetary base is the sum of commercial bank reserves and currency (notes and coins) held by the public forms the base for the expansion of bank deposits and their credit creation activity: - if the monetary base is high, the money supply in the economy set that time will also be high and vice versa. It can, therefore, be said that money supply varies directly with changes in the monetary base.

3.2.2 The Exogenous Factors

There are influences or control measures on the economy by the monetary control authority of the nation. These are called monetary control instruments. They can be broadly grouped into two:

1. The Required Reserve Ratio

This is also known as the minimum cash reserve ratio or reserve deposit ratio, in the ratio of reserve, central bank wants commercial banks to hold with it (central bank) against their commercial banks) deposits liabilities, i.e., the ratio of cash to current and time deposit liabilities in form of deposits determined by law, every commercial bank is required to keep with the central bank of the nation. Note that notes or cash to the bill of the commercial bank do not form part of their required reserve ratio. An increase by the central bank on the required ratio reduces the supply of money with the commercial banks while a decrease in the required reserve ratio will increase the money supply.

2. The Level of Bank Reserves

The central bank influences the commercial bank reserve (reserves on deposits with the central bank and the currency in their tills or vaults) in order to determine the supply of money in the economy. This affects the level of credit creation through loans and advances by the commercial bank deposits on her excess reserves. Then, excess reserves of the commercial banks are important variable in the money supply. Banks excess reserve (ERr) is the difference between total reserves (RT) and required reserve (RR); that is, ER = TR - RR.

The central bank thus controls the money supply by influencing the reserve of banks by adopting open market operations and discount rate policy.

Open market operations refer to the purchase and sale of government securities and other types of assets like bills, securities, bonds, etc. Both government and the private sector participate in the open market.

Selling of securities and bonds in the open market by the central banks reduces banks reserves thus leading to low money supply while the purchase of government bonds and securities by the central bank increases bank reserves, which in turn will increase the money supply. Then, money supply varies inversely with the purchase and sell of bonds in the open market.

The discount rate or bank rate is the interest rate at which commercial banks borrow from the central bank. A high discount rate means that the commercial bank gets less access to lending from the central bank. The commercial banks in turn will raise their lending rates to the public thereby making loans and advances costly. This will lead to contraction of credit and the level of commercial bank reserve leading to lower money supply. The reverse is the case with lower discount rate.

Other instruments of the central bank used in determining the level of money supply include liquidity ratio, legal reserve ratio, special directives, moral suasion, sectoral allocation of credit and other policies as may be adopted by the authority.

SELF-ASSESSMENT EXERCISE 2

Identify and discuss the various factors that affect the supply of money in any economy.

4.0 CONCLUSION

In this unit, you have the various views on the definition of money supply which all sums up to be the total amount of money in circulation within the economy at a given time. We have also seen that in practice, the money supply is partly endogenous because commercial banks are able to change if in response to economic incentives, and partly exogenous because of the central bank is able to set limits beyond which the commercial banks are unable to increase the money supply. All these sums up that money supply is greatly affected by the ability of the commercial banks in creating credit. This is determined by the internal operation and level of business activities in the economy and the activities of the monetary regulatory authority.

5.0 SUMMARY

This unit has, as in the previous units continue to discuss the importance and some of the roles of money in the macro – economy. It has exposed you to the definition of the concept and meaning of supply of money such as M_1, M_2 and M_3, highlighting how each of them meets the criteria of motives of demand for money and compliance to regulatory authorities. It was also established that the supply of money is determined both endogenously as well as exogenously in the economy.

In the next study unit, we shall discuss inflation and deflation.

6.0 TUTOR-MARKED ASSIGNMENTS

1 The choice of any particular definition of the money supply depends on two considerations. Discuss the extent each of the three definitions comply to them.
2. The supply of money is determined by endogenous and exogenous variables. Discuss them.

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UNIT 2 INFLATION AND DEFLATION

CONTENTS

1.0 INTRODUCTION

The price level of goods and services in any economy is not subject to government policy. The level of price of commodities and factors of production at which the economy's transactions occur is irrelevant to living standards but changes in these prices matter. The changes in these price levels resulting in changes in the value of money do have serious effects on the economic activities of any nation. It is also important to note that the study of the cause and consequences of these price changes called inflation or deflation is of prime importance in macro economics because of its income redistribution among the people, thus benefiting some and hurting others. This unit shall be devoted to the study of these changes, its causes and effects in the economy.

2.0 OBJECTIVES

It is expected that at the end of the unit you shall be able to:

- Explain and discuss the nature of inflation and deflation.
- Identify the causative factors of inflation.
- Explain the type of inflation and their effect on different groups.

- Discuss the inflation control measures.

3.0 MAIN CONTENT

3.1 Meaning and Nature of Inflation

In economics, the term “inflation” is used to describe a decline in the value of money in relation to the goods and service it can buy. Inflation is the pervasive and sustained rise in the aggregate demand of prices measured by an index of the cost of various goods and services. Repetitive price increases erode the purchasing power of money and other financial assets with fixed values creating serous economic distortions and uncertainty. Inflation thus results when actual economic pressures and anticipation of future developments causes the demand for goods and services to exceed the supply available at existing prices or when available output is restricted by faltering productivity and market place constraints. Such sustained price increases were historically directly linked to wars, poor harvests, political upheavals or other unique events.

There is the argument by economist that inflation does not reduce the average living standards. The main consequence of inflation is to redistribute income among people benefiting some and hurting others. These redistributions often are haphazard and produce serious social tension. This in itself is one of the reasons for trying to avoid inflation in the economy. It is important to note that if forces that cause inflation lower living standards then inflation will be accompanied by a fall in living standards. And if the forces that causes the inflation does not itself lower living standards, then the inflation itself will not do so.

3.1.1 Demand – Pull Inflation

Demand – pull inflation occurs when aggregate demand exceeds aggregate supply, forcing price increase and pulling up wages, materials, and operation and financing costs. It is also known as “excess demand inflation” and is described generally as when “too much money is chasing too few goods.” This inflationary rise in prices generated from an excess of aggregate demand over supply is the demand –pull inflation. This in effect reveals that demand-pull inflation is characterized by rise in the price of both consumer good and factors of production followed by rise in aggregate demand. Thus, it is virtually agreed by all economists that excess aggregate demand can be, and often has been the major cause of inflation.

3.1.2 Cost-Push Inflation

The cost-push theory of inflation says that rise in costs not themselves associated with excess demand, particularly wage cost/increases enforced by unions and profit increases by employers can also cause of inflation. The cost-push inflation can be seen in the system when the following situations occur:

1. Rise in money wages which are more rapid than the productivity of labour, especially when trade unions are very powerful. This raises the cost of production hence higher prices for the commodities. This will in turn lead to unions' demand for higher wages. Wage-cost spiral thus continues in the system. An upward adjustment of wages to compensate for rise in the cost of living index may as well induce cost – push inflation.
2. Sectoral rise in price: This is similar to money wage increase. It is however where a sector of the economy is affected by the money wage increase which in turn will affect the prices of their products.
3. Rise in the prices of imported raw materials. The import cost-push inflation arises when prices rise in a country is due to in rise in the prices of imports. Thus, it is a transmission of inflation from country of exports to receiving countries.

SELF-ASSESSMENT EXERCISE 1

Differentiate between Cost-push inflation and demand-pull inflation.

3.2 Kinds of Inflation

Inflation, a fundamental monetary phenomenon that can be produced by a more rapid increase in the quantity of money than output, has various kinds, some of which are discussed hereunder.

1. Creeping Inflation

This happened when the upward trend in prices is gradual and irregular, averaging only a few percentage points (of less than 3 percent per annum). Creeping inflation is not considered a serous treat to economic and social progress because it often times stimulate economic activity. For instance, investing in housing may increase in anticipation of future price appreciation, business investment in plants and equipment may accelerate as prices rise more rapidly than cost, and business, personal and government borrowers realize that loans will be rapid with money that has potentially less purchasing power.

2. Walking or Trotting Inflation

This is yet a rise in prices of less than 10 percent per annum. It is rather a warning signal to the government to control the inflation before it gets out of hand.

3. Running or Chronic Inflation

This is of greater rise increases at annual rates of 10 to 30 percent in some industrial nations and even percent or more in few developing countries. Chronic inflation tends to become permanent and ratchets upwards to even higher level as economic distortions and negative expectations accumulate. In order to accommodate running inflation, normal economic activities are disrupted. Such activities include consumers buying goods and services to avoid even higher price, real estate speculation increasing businesses concentrating on short-term investments, incentives to acquire savings, insurance policies, pensions and long term bonds are reduced because inflation erodes their future purchase power; government's rapidly expand spending in anticipation of inflated revenues, and exporting nations suffer competitive trade disadvantages forcing them to turn to protectionism and arbitrary currency controls. Such inflation affects the poor and middle class adversely and if not properly controlled, will led to hyper inflation

4. Hyper Inflation

This also known as "run away" or "galloping" inflation. It happens when prices rise very fast at double or triple digit rates from more than 20 to 100 percent per annum or more. It causes the entire economic system to break down because the rate of inflation is immensurable and absolutely uncontrollable. During hyper inflation periods the growth of money and credit becomes explosive, destroying any links to real assets and forcing a reliance on complex barter arrangements. Such a situation brings a total collapse of the monetary system because of the continuous fall in the purchasing power of money. As government tries to pay for increased spending programmes by rapidly expanding the money supply, the inflationary financing of budget deficits disrupts economic, social and political stability in the system.

SELF-ASSESSMENT EXERCISE 2

Identify and explain the various types of inflation.

3.3 Causes of Inflation

Most economists agree that inflation being a monetary phenomenon is caused basically by rapid expansions of the money supply among other issues. This can be assumed as resulting when the aggregate demand exceeds the aggregate supply of goods and services. We shall therefore discuss the major cases of inflation as it affects demand and supply.

3.3.1 Demand Related Causes

It is a general economic belief that inflation is caused by increase in the aggregate demand. The factors highlighted below are attributed to this:

(a) Increase in money supply

Increase in money supply leads to increase in aggregate demand which encourages the growth of inflation.

(b) Increase in disposable income

A rise in national income or reduction in taxes or reduction in the saving of the people increases disposable income hence raises inflation.

(c) Increase in public expenditure

In both developed and developing nations increasing public expenditure has led to increase in aggregate demand.

(a) Increase consumer spending resulting from conspicuous consumption, demonstration effect, or more credit facilities being provided.

(b) Cheap monetary policy or policy of credit expansion leads to increase in money supply. This leads to credit induced inflation.

(c) Deficit financing or printing more notes through borrowing leads to inflationary rises in prices (deficit induced inflation).

(d) Black money resulting form corruption, tax evasion, etc, leads to extravagant spending and consequently rise in price level.

(e) Repayment of public debt to domestic contractors/suppliers leads to increase in money supply hence raising aggregate demand for goods and services.

3.3.2 Supply Related Causes

Some of the variables in the economy that tend to reduce the aggregate supply hence enhancing the growth of inflation are:

(a) Shortage in factors of production leading to excess capacity and reduction in industrial production.
(b) Industrial disputes which helps in curtailing production where trade unionism are strong.
(c) Natural calamities like drought, floods, etc. *Artificial scarcities* created by hoarders and speculators indulging in black marketing.
(d) Increase in exports, thus producing more goods for export than for domestic consumption.
(f) Lop-sided production of a particular good in favour of consumer goods.
(g) Law of diminishing returns on industries resulting form the use of old machines and out-modelled method of production.
(h) International factors – Nations that engage in international trade seem to have much inflation on one another when inflation creeps into one.

SELF-ASSESSMENT EXERCISE 3

Identify and explain both the demand and supply related factors that can give rise to inflation.

3.3 Inflation Stabilization Measures

The discussion so far has revealed to you that the major cause of inflation is when the aggregate demand for gods and services exceeds the aggregate supply in the economy. Thus any stabilization or control measures of inflations must be such that will restore normal economic activity. Such measures or incentives must be sustained rather than being merely occasional fine turning actions that often exaggerate existing cyclical changes; such measures must be aimed at increasing supplies of goods and services and reducing money incomes in order to effectively control aggregate demand. These inflation stabilization measures can be broadly groped into three – monetary, fiscal, and other economic activity measures.

3.4.1 Monetary Stabilizing Measurers

Some monetary control measures that can be adopted to stabilize inflationary gaps in the economy are:

(a) Credit control

This is an important monetary policy used by the central bank to reduce money incomes. This is through the control of quantity and quality of credits by either raising bank rates, sale of securities in the open market, raising bank reserve ratios and adopting some credit control measures. This measure will generally control private consumption and investment. It becomes obvious however that monetary policy can only effectively control inflation due to demand-pull factors.

(b) Demonetize currency of high denomination

Where the illegal money market (black money market) is predominant in the economy, the government can check inflation by demonetizing high denomination currency to check the rapid growth of illegal money supply.

(c) Replacement of existing currency notes

This strategy may be adopted by the government in hyper inflation periods and excessive issue rates by issuing new currency in exchange of old ones. While the bank deposits are fixed, one new currency in exchanged for a number of notes of he old one.

It is worthy to note that this measure, though a very effective one in controlling excessive issue of notes (supply of money), it hurts the small depositors most in the economy, thus an inequitable control measure.

3.4.2 Fiscal Stabilizing Measures

Some fiscal stabilization measures that are highly effective in controlling inflation due to their effects on governing expenditure, personal consumption and tax polices are as discussed below:

(a) Reduction in Spending

There should be prudence on government and private spending. Unnecessary expenditures, non-development activities should be reduced. Large government borrow ring to finance deficit budgets and government loan programmes that leads to rapid expansion of the money supply with resulting inflation problems should be curtailed.

(b) Increase Taxation

As new taxes are recommended to be introduced, old rates should be increased but not very excessive. They should be such that shall provide incentives to savers, investors and producers to encourage higher output. These should include import duties reduction and increased export duties.

(c) Compulsory Savings

In order to reduce disposable income and hence consumption expending, there should be increase in compulsory savings. Such should be in areas of Provident Fund, Pension Schemes, etc. These compulsory savings fall within some economic called "deferred payments" since the saver gets the money back after some years.

(d) Surplus Budgets

The government should give up deficit financing in place of surplus budgets. In this way, they collect more in revenues and spend less.

(e) Public Debt Postponement

Government should adopt public debt postponement to some time when inflationary pressures are under control. This will affect the supply of money in the economy, thus checking inflation.

Some other measures in stabilizing inflation which advocates claim would supplement basic monetary and fiscal actions are centered on government intervention policies. Such policies range from mandatory government guidelines for wages like wage freeze, price control by fixing prices of commodities, rents and interest rates through tax incentives and disincentives. Other measures aimed at increasing supply-side efforts to restore productivity and new technology include encouragement of increased production of essential goods n all aspect and rationing of good aimed at distributing goods as to be available to a large number of consumers. Effective stabilization efforts require a better balance and more sustained application both monetary and fiscal polices not losing sight of the other measures.

SELF-ASSESSMENT EXERCISE 4

Identify and explain stabilizing measures that can be adopted against the effects of inflation.

3.5 Effects of Inflation

Inflation which indicates the changes in the value of money affects different people differently and it fluctuates over time. This is because when prices of goods and services rise some groups benefit while some lose.

During inflation, there tend to be increased inequalities in the distribution of income and wealth. While the poor and the middle class suffer because of their wages and salaries are more or less fixed while the prices of goods continue to rise, this makes them more impoverished. On the other hand, businessmen, industrialists, traders, real estate holders, speculators and others with variable incomes gain during rising price periods. This leads to an unjustified transfer of income and wealth from the poor to the rich, making the poor poorer, and the rich richer.

Also during period of rising prices, production of goods and service will be increased. This follows that producers will invest more in anticipation of higher profits in future. It translates to increase employment, production and income at full employment level- a point beyond which any further price rise will lead to severe inflationary pressure. The foregoing shows that inflation leads to misallocation of resources by producers to produce non-essential, more profit yielding goods. Other adverse affects of inflation include a fall in quality because of sellers market being created in terms of hoarding and black marketing as well encouraging speculation. Inflation erodes the real purchasing power of current incomes and accumulated fixed assets resulting in reduced consumption and increase in personal debts. Business investment suffers as overall economic activity declines and profits are restricted.

Domestic inflation may temporarily improve the balance of trade if the same volume of exports can be sold at higher prices. Government spending rises because many programmes are explicitly or informally indexed to inflation incomes. Under inflation borrowers usually benefit while lenders suffer, because mortgage, personal, business and government loans are paid with money that has lost purchasing power over time and interest rate tend to lag behind the average rate of the price increase.

SELF-ASSESSMENT EXERCISE 5

Identify and explain the effects of inflation.

3.6Deflation

Deflation is yet another economic term used to describe an "increase in the value of money in relation to the good and service it will buy." It is a state in which the value of money in rising, i.e. prices are falling associated with falling productive activity and employment in the economy. Deflation, in most cases the opposite of inflation, is caused when prices are falling more then proportionately to the output of goods and services in the economy as a result of decrease in the money supply. The effects of deflation are the reverse of inflation affecting different groups differently - individual firm and government alike.

The control of deflation is adopting those monetary, fiscal and other stabilizing measures of inflation in the opposite direction.

In trying to understand and compare the two phenomena - inflation and deflation, some economist pointed out that while inflation is unjust, deflation is inexpedient and thus worse than inflation. Inflation is unjust because it widens the gulf between the rich and the poor by making the rich richer at the expense of the poor and makes savers lose in the long run among other social harmful effects. Deflation on the other hand is inexpedient because it reduces national income, output and employment, impoverishes the poor and plunges the economy into depression with people suffering for too long and the economy remains in a state of stagnation for two long.

SELF-ASSESSMENT EXERCISE 6

Differentiate between inflation and deflation.

4.0 CONCLUSION

The level of price of goods and services in an economy is of great importance to both economist and politician. This has been the case as revealed in the discussion on inflation and deflation. It is also revealed in this unit that the causes of inflation lower living standards of the people, it therefore becomes an important consideration of any economy to study and come up with stabilization measure that will bring the two phenomena not only under control but that which will be prolonged and sustained. It is important to note that widespread price declines have become rare, however inflation has come to become the dominant variable affecting public and private economic planning in most nations, developing and developed nations alike.

5.0 SUMMARY

In this unit, we have discussed the meaning and nature of inflation in an economy considering its various types, causes and its effects especially

the adverse ones and the measures that are necessary to keep them under control and at manageable level. The unit is rounded up with a brief introduction to the concept of deflation and comparison between its effect and that of inflation in the economy.
In the next study unit, we shall discuss development and structure of banking system.

6.0 TUTOR-MARKED ASSIGNMENTS

1. What is inflation? Explain the effects of inflation on different group of people in the economy.
2. What are the causes of inflation? How can these be controlled or stabilized?
3. Distinguish demand – pull inflation from cost- push inflation.

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UNIT 3 DEVELOPMENT AND STRUCTURE OF BANKING SYSTEM

CONTENTS

1.0 INTRODUCTION

In the earlier units, especially in the evolution, nature and functions of money, we examined how money evolved and also its role in the macro economy. To effectively serve its roles in the economy, various characteristics were considered. Also, the commodity that will satisfy the qualities of money becomes of paramount importance in the possession and use of each commodity. As business continued to grow, the need for more efficient means of payment and other business transactions become very vital. Ship merchants, who were involved, most of the time, with trade across nation's frontiers, needed more efficient way of meeting their business needs. This gives rise to the custodian and credit delivery services of the early goldsmith. This formed the hub of the functions of a modern banking system.

2.0 OBJECTIVES

It is anticipated that at the end of this unit, you should be able to:

- Discuss the evolution of banking.
- Define and explain the basic functions of a bank.
- Outline and distinguish the types of banks in an economy.
- Describe what a correspondent bank is

3.0 MAIN CONTENT

3.1 Evolution and Origin of Banking

In unit one, you saw in the evolution and development of money, how the goldsmith, whom people deposited their valuables like gold for safe-keeping for a fee were issued negotiable and redeemable receipts. These receipts were in turn given to sellers of commodities by buyers as substitute for money (paper money). This shows that the goldsmith's receipts served as promissory notes and was then accepted as both a medium of exchange and as a means of payment.

The goldsmith later found out that on the average, the withdrawals of the gold (coins) were much less than the deposits with him, he then started advancing them on loans to those who wanted them and charge interests on them. Through such loans the goldsmith-cum-money lender stared performing two functions of modern banking- that of accepting deposits and advancing loans. The foregoing reveals that banking development therefore came out of the habit of "safe-keeping of valuable" for a token payment for the services rendered by the goldsmith.

3.2 Definition of a Bank

A bank can be defined in either of the following two aspects:

(i) **Functionality**, i.e. functional definition of a bank as "any type of institution that renders banking services" thus, a bank is an "institution for the keeping, lending and exchanging of money".
(ii) **Legal requirements,** i.e. legal definition of a bank.

Banking business means the business of receiving deposits on current accounts or any other similar accounts, and the payments or deposits of cheques which are drawn by or paid by customers on themselves. It is important to understand that the primary business of banking is the custody services, credit delivery schemes, among others.

On the other hand, a bank can be defined legally as any financial institution that performs banking services and at the same time licensed as a bank under the law of the land established by the authorizing body."(BOFIA)"

In addition to the above legal requirement, the institution or organization must also be incorporated under the Company and Allied Matters Act of 1990. Some economists have defined banks and banking business various ways, all pointing to the functions or services they render. While

G. Crowther defines it as “the business of taking debts of other people to offer his own in exchange, and thereby create money”. R.S. Sayers gives a more detailed definition as “ordinary banking business consists of changing cash for bank deposits and bank deposits for cash, transferring bank deposits from one person or corporation (one depositor) to another, giving bank deposits in exchange for bills of exchange, government bonds, the secured or unsecured promises of businessmen to repay, etc.” The above discussion generally sums up that a bank is a legal institution which accepts deposits from the public and in turn advances loans by creating credit. This makes it different form other financial institution in that the later cannot create credit though they may be accepting deposits and making advances.

SELF-ASSESSMENT EXERCISE 1

Explain the term bank in relation to the functions it renders in the society.

3.3 Types of Banks

In general terms, about seven different types of banks can be identified in an economy. These are:

i. Commercial Banks (retail banks)
ii. Exchange banker (bankers that deal with foreign exchange and specialize in financing foreign trade).
iii. Industrial banks (banks that provide finances to industries and underwrite the debentures and share of industries).
iv. Agricultural Banks - banks that provide finances to farmers.
v. Corporative banks- banks organized in the principle of cooperation.
vi. Savings banks- banks that help promote small savings.
vii. Central Bank – the apex bank in a country which controls its monetary and banking structure

The banks and other financial institutions (BOFIA) of 1990 allowed for registration and licensing only four types of banks in Nigeria. These can be differentiated legally as follows:

(a) Commercial banks.
(b) Merchants banks
(c.) Profit and Loss sharing banks and
(d) Community banks.

These four banks are differentiated legally or can be legally defined as follows:

a. A commercial bank in Nigeria means any bank whose business includes the acceptance of deposits which are withdrawn by cheques.
b. A merchant bank means a bank whose business includes receiving deposits on deposit account, provides finances, consultancy and advisory services relating to corporate and investment matters, makes and manages investments on behalf of any person or organization.(NB: A deposit account is a time-deposit one that has time frame.)
c. A profit and loss sharing bank means a bank that transacts investment or commercial banking business and maintains a profit and loss account such as the Islamic banking principle.
d. Micro Finance Institution (formally Community bank) means a bank whose business is restricted to a special geographical area in Nigeria. Its major and only distinguishing feature is its locality of operation. They however do not operate clearing account but clear their cheques through a corresponding bank.

SELF-ASSESSMENT EXERCISE 2

Identify and explain the various types of banks operating in an economy.

3.4 Correspondent Banking

Correspondent banking is an arrangement whereby a banker enters into an agreement to represent another bank, either in another country or in an area of banking operations where one of the banks has limited or no access. It may be viewed as a special arrangement by banks to undertake the banking transactions of one another such as clearing account arrangements, international monetary transfers, local currency exchange, trade financing and other financial services associated with funds movements across the national borders.

The correspondent bank is not a branch of a respondent bank but acts as an agent to it. The major services the correspondent banks render to their respondent banks include:

(i) Cheque clearing and processing facilities.
(ii) Loan arrangement.
(iii) Electronic data processing of respondents deposit accounts.
(iv) Provision of information in financial market and other economic conditions.
(v) Provision of assistance in opening new branches.
(vi) Helps in recruiting personnel especially when foreigners are to be recruited.

(vii) Offers safe custody facilities.
(viii) Offers remittance/money transmission facilities.
(ix) Collection and negotiation of bills of exchange
(x) Participates in documentary letters of credit

SELF-ASSESSMENT EXERCISE 3

What are the functions of a correspondent bank?

3.5 Services Rendered by Banks

Two major and initial outstanding services rendered by any institution accepted as a bank were:

(i) Custody Services

This is the safe-keeping of valuables for ship merchants and others by mostly the goldsmith. Due to the time lag between the time of deposit and time of reclaim by the owner, they took advantage of this to service the need of those who wish to use the valuables for a fee before the depositor comes up for reclaim.

(ii) Credit delivery

This came up as the first major concept of banking which resulted from the time lag between the time of deposit and that of reclaim by the owner. The custodian of these valuable then give them out to people who need them, receive some payment as income for the use of those valuables. This income concept gave rise to the need to solicit for more custody services on which interest is paid.

4.0 CONCLUSION

The habit of safe-keeping of valuables of the merchants by goldsmith for which he changes them a fee and the subsequent credit delivery/creation to those in need resulting from the time – lag between time of deposit and reclaim gave rise to the establishment of banking. These two services form the hub of the services rendered by modern banking and the types of banks that evolved. These services of the goldsmith over time evolved and became modernized that organized institution that still commands the interest and confidence of the business community came into operation. Bankers and banking services evolved and developed over time depending on the need and requirements of the business community and nation's regulation on its establishment and operation.

5.0 SUMMARY

The unit has endeavoured to trace the development and structure of banking system by reviewing the origin and evolution of banking, a concept that traced its origin to the services rendered to merchants by goldsmiths. It then highlighted the services rendered by banks to the economy and the functional and legal definitions of an institution called a bank. The global type of banks and those recognized and allowed for registration in Nigeria were distinguished. The unit is rounded up with a highlight of what a correspondent bank is as well as the services it renders to her respondent bank.

In the next study unit, we shall discuss the structure and functions of banks.

6.0 TUTOR-MARKED ASSIGNMENTS

1 Banking developed out of the habit of safe keeping of valuables. Trace the development of banking explaining fully the major and initial out standing services rendered by a bank.
2 The Banks and Other Financial Institutions Act (BOFIA) of 1990 allowed for registration and licensing some types of banks. State and differentiate these type of banks
3 With the help of the services rendered, explain what a correspondent bank is.

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UNIT 4 THE STRUCTURE AND FUNCTIONS OF BANKS

CONTENTS

1.0 INTRODUCTION

Banks have been defined by some economists as "an organization whose principal operations are concentrated with the accumulation of the temporarily idle money of the general public for the purpose of advancing to others for expenditure". This functional definition of a bank reveals the important role such organizations or institutions play in the economy. These roles and functions are varied but all aim at ensuring that business transactions are carried out with less difficulty. As discussed in the previous unit, the various types of banks have different and peculiar functions they render to various sectors of the economy. This unit shall be dedicated to the discussion of the structure and functions of some of these institutions in ensuring that business activities are carried but with ease. The similarities and differentiating features shall also be highlighted.

2.0 OBJECTIVES

It is anticipated that on the completion of this unit you will be able to:

- explain the functions of a commercial bank, merchant bank, development bank and a community bank.
- outline the distinguishing features between these types of banks in the Nigerian economy.

3.0 MAIN CONTENT

3.1 Structure and Functions of Commercial Banks

The Bank and Other Financial Institutions Act of 1991 (BOFIA) defined a commercial bank to mean any bank in Nigeria whose business includes the acceptance of deposits and withdrawal by cheques. Commercial banks are generally referred to as retail bank started operation in Nigeria in 1892 with three basic functions viz:

(i.) Acceptance of deposits,
(ii.) Granting of loans to customers, and
(ii.) Participation in the clearing system.

The commercial banks continue to dominate the banking sector in terms of their share of total assets and deposit liabilities and have wider reach in terms of branch network.

The Nigerian commercial banks operate branch banking structure. This is a system where few large banks with network of branch offices (though not autonomous) dominate the economy. They take instruction from their head offices. The ownership structure of the bank is vested completely on the private entrepreneurs. They may however be mixed banks, that is jointly owned by Nigerian and foreigners with minimum indigenous ratio of 60% and 40% to foreigners.

The Central Bank of Nigeria (CBN) controls on the commercial banks operations in Nigerian.

Commercial banks perform a variety of functions in the economy. Some of their primary functions are discussed hereunder.

1. Accepting Deposit (Acceptance and Safe-Keeping of Deposits)

This is the oldest function of a bank, keeping money (valuable) in its custody for a fee (commission). These deposits from customers are of three kinds nowadays, savings deposits, current account demand deposits and time or fixed deposits. The rate of interest paid on each kind of deposit depends on the length of time it stays with the banks and other conditions laid down by the bank.

2. Granting of Loans and Advances

Granting of loans and advances to her customers is one of the primary functions of a commercial bank. This they do by lending a certain percentage of the cash lying in deposits on a higher interest rate than it pays on such deposits. In this way, the bank earns profits and carries on its business. These are in the following forms;

(i.) cash credit – against certain securities
(ii.) Call loans – to bill broker for not more than fifteen days but can be recalled at a very short notice.
(iii.) Overdraft – allowing customer draw cheques for a sum greater than the balance lying in his current account.
(iv) Discounting of bills of exchange held by a customer which matures within 90 days.

3. Credit Creation

Since they aim at earning profits, the commercial banks accept deposits, advance loans by keeping small cash in reserve for day-to-day transactions. The loanee is not however paid cash but allowed to draw money by cheque according to his need. In this way the bank creates credit or deposits.

4. Financing Foreign Trade

They rendered this service to its customer by accepting foreign bills of exchange and collecting them from foreign banks. They also trade in foreign exchange.

5. Agency Services

They act as agents to their customers by collecting and paying cheques, bills of exchange, drafts, dividends, among other services.

Other functions of the community bank can be outline as follows:

6. Transferring of funds
7. Management of customer's investment
8. Executor and trustee of wills.
9. Provisions of facilities for safe-keeping of important documents.
10. Foreign exchange (FOREX) facilities to travelers.
11. Advising customers on insurance matters.
12. Night safe facilities
13. Provision of services to importers and exporters.
14. Providing business status report and reference by writing reports or ensuring inquiries about the financial standing of the customers when the need arises.

SELF ASSESSMENT EXERCISE 1

Define a commercial bank and explain its role in any economy

3.2 Structure and Functions of Merchant Banks

The banking Act of 1990 defines a merchant bank to mean "a bank whose business includes receiving deposits on deposit account, provision of finance, consultancy and advisory service relating to corporate and investment matters, making or managing investment on behalf of any person." Merchant banks are generally referred to as "wholesale bankers", that is, they cater for the needs of corporate or institutional customers. The first merchant bank to be established in Nigerian was in 1960. The major role of merchant banks in the economy includes the provision of long term finance by engaging in activities such as equipment leasing, loan syndicating, debt factoring and project financing.

The primary functions of merchants banks is the provision of medium and long-term finances and issuing of securities. Others can be outlined as below:

1. Banking functions

The banking services rendered by merchant's banks can be outlined as follows:

- ❖ Time and demand deposits facilities with cheque. This is limited only to corporate customers, mostly large blocks which are not withdrawable with cheques.
- ❖ Loans and advances facilities to customers by providing:

- Short term credits covering exports and imports.
- Medium term credits for industrial equipment provision.
- Long term finance for real estate, industrial agric development.
- Loan syndication which helps customers diversifies their risks and loan portfolio.
- Equipment leasing.

2. Corporate Finance Functions: These include:

- ➢ Acting as issuing house at the Nigerian Stock Exchange (NSE) by being involved in the public equity and debt issues.
- ➢ Private placement of equity and debt issue.

- Stock- broking service at the floor of the NSE.
- Project financing.
- Equipment financing.
- Investment and financial adversary services.
- Project management and structuring.

3. Operational Services (i.e. international business):

- Documentary and clean credits and collection.
- Remittances and receipts of funds.
- Foreign Exchange transactions.

4. Treasury services: These include:

- Investment in money market assets.
- Issue of private sector money market assets.
- Issue of negotiable certificates of deposits.

The foregoing reveals that merchant banks - as wholesale banks, create money through the intermediation of commercial banks. As wholesale banks, they serve as banker to banks and therefore do not accept small deposits. They are long-term lenders therefore acting as finances to industrialists. The nature of merchant banking does not require high branch network. Most of them have just one office while the highest number of branches recorded stood at about five as at 1989 in Nigeria.

SELF ASSESSMENT EXERCISE 2

Define a merchant bank and explain its role in any economy

3.3 Meaning and Evolution of Development Banks

The need for direct government participation in promoting capital investment particularly in some priority sectors of the economy gave rise to the establishment of development banks. They are to serve as development finance institution to such areas as agriculture, small scale industries, etc.

Development banks therefore sprang up in response to the clamour for the establishment of specialized financial institutions for the interest of investors in need of medium and long term finance for the accelerated development in the Nigeria economy. Some economies recognized the need for the creation of institutions that could undertake or promote investment in areas where the private investors inspired by private gain, might for the moment be reluctant to go. This thus constituted the main objective in the creation of development institutions which provide funds for direct investment on medium and long term base, or in assisting private initiatives or providing technical assistance and supporting services to productive sector of the economy. There services help to stimulate and sustain rapid growth in the economy.

The development banks in Nigeria include:

1. **Bank of Industry** created as a result of the merger of NIDB, NBCI, NERFUND, etc.

   Its main aim is the provision of credit and other facilities to medium and large – scale enterprises. Its main function include:

* Provision of medium and long-term finance to SMEs.
* Identification of investment bottlenecks.
* Supervision of the implementation of projects by requesting for progress and project reports.
* Provision of technical and managerial advice to indigenous enterprises.

2. **Nigerian Agricultural, Cooperative and Rural Development Bank (NACRDB)** charged with the major objective of financing agricultural development project and allied industries as well as developing the rurality through the provision of short medium and long term loans.

3. **The Federal Mortgage Finance (FMF)** has the responsibility of supervising and controlling the activities of mortgage industries in Nigerian. It was the apex financial institution for the mortgage industry.

SELF-ASSESSMENT EXERCISE 3

Identify and explain the functions of development banks.

3.4 Community Banks or Micro Finance Banks

A community bank is defined by BOFIA 1990 as "a bank whose business is restricted to a specific geographical area in Nigerian." It is a self-sustaining financial institution owned and managed by a community or a group of communities to provide financial service to that community.

The body charged with the responsibility of receiving and processing applications for the establishment of community banks in Nigeria is the

National Board for Community Banks (NBCB). The first community bank in the country stated operation in December 1990.
The community bank provides banking services to members on the basis of self recognition and credit worthiness. They therefore, de-emphasize the demand of collateral securities as is the case with the conventional banks before granting loans. They have dual functions of providing banking services to its members and being a very active agent in the economic development of its community. They are restricted from undertaking foreign exchange transactions, issuing of letters of credit and also not members of the cheque clearing system.

The objectives for setting up community banks, among others, include:

(a) The promotion of rural development through the provision of banking and financial services.
(b) Enhancing the rapid development of productive activities, especially in the rural areas.
(c.) Improving the economic status of the small scale producers both in the rural and urban areas.
(d) To inculcate the banking habits among rural dwellers, and ensuring the development of an integrated national financial system.

SELF-ASSESSMENT EXERCISE 4

Define a micro finance bank and explain its role in Nigerian economy

3.5 Distinguishing Features between Commercial, Merchant and Development Banks

The three main banking systems- commercial, merchant and development banks can be distinguished under the outlined headings as shown below;

COMMERCIAL BANK	MERCHANT BANK	DEVELOPMENT BANK
1) BANKING SYSTEM: Retail banking system- mobilizes deposit and lends in small and large amount to individuals and firms. Deals with a relatively large number of small accounts.	Wholesale banking system- mobilizes deposits and lend in large amount mainly from institutional investors and firms. Deals with a relatively small number of large	Specialized banking – emphasizes less on deposit mobilization, but concerned with detailed technical and credit worthiness appraisal of the many projects at the grass root level.

	accounts.	
2) DEPOSITS: Deposits large number of small accounts on either fixed or demand deposit with or without interest.	Small number of large account usually fixed or on demand account and interest yielding.	May accept in any amount, but emphasis is on providing fund for economic development usually lower than other hanks.
3) LOANS: Loans more on overdrafts and short term nature.	Less of over draft type. Specializes in large and medium term loans.	Could be on matching basis to customers need, either short or long term.
4) NETWORK: Need wide- spread branch network to mobilize funds from saving – surplus unit to saving- deficit unit.	Need less branches hence concentrates more on industrial/commercial centers.	Depends on its specialization and its statutory functions.
5)SERVICES OFFERED: More of general services to the customers needs and more conservative in services offered.	Of specialized nature to special customers need. More dynamic and flexible in operational conduct. Emphasis mainly on international banking and financing.	Dependent on statutory requirements.
6) OPERATIONAL EFFICIENCY: Sources and uses of funds tied to deposits and other accessories which border much on the need to adhere to CBN liquidity requirement than rely more on law of large numbers	Sources and uses of funds allow for flexibility in management and less concerned with liquidity need because of matching principle	Sources and uses of funds differ from the others. Rely on subvention from government.
7) OBJECTIVE Profit oriented main objective.	Profit oriented main objective.	Economic development as major objective.

8)OWNERSHIP STRUCTURE: private/business or jointly owned by Nigerians and foreigners.	Public sector or jointly owned like commercial banks.	Government and the CBN.

SELF-ASSESSMENT EXERCISE 5

Compare and contrast commercial banks and merchant banks.

4.0 CONCLUSION

The banks and Other Financial Institution Act (BOFIA) 1990 states that banking business means the business of receiving deposits on current account, savings account or other similar account, collecting cheques, drawn by or paid in by customers. Provision of finance or such other business as the governor of the CBN may by order published in the gazette, designate as banking business. This business which is very important and vital for the growth and survival of any economy has been the crux of the services and functions various banks do address, depending on the type and objective for setting it up. These various function were what this unit has endeavoured to discuss.

5.0 SUMMARY

The structure and functions of banks as discussed in this unit was discussed according to the structures of the banks. The commercial banks which form the nucleus of the banking system are the first to be addressed. Their function which was preceded by the meaning and structure was elaborately discussed. This was then followed by merchant, development and community banks. A comparison and distinguishing features between the three main banking systems summed up the unit.

In the next study unit, we shall discuss credit instruments and credit creation by commercial banks.

6.0 TUTOR-MARKED ASSIGNMENTS

1. Explain the structure and main features of the Nigerian commercial banks

2. The merchant bank is generally referred to as wholesale banking" explain.
3. Explain the justification or objective for establishing development banks in Nigeria.

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UNIT 5 CREDIT INSTRUMENTS AND CREDIT CREATION BY COMMERCIAL BANKS

CONTENTS

1.0 INTRODUCTION

In the previous unit we saw one of the important functions of the commercial banks in the economy, that of credit creation. The question that quickly comes to mind is what does credit exactly mean?

In economics and commerce, transactions are carried out of which cash payments are not always effected but may be agreed to be effected at a later but fixed date. This transaction is referred to as credit and is of varied types and employ different instruments in accomplishing its purpose.

In this unit, we shall therefore be discussing credits, its instruments and the process of its creation in an economy.

2.0 OBJECTIVES

It is expected that at the end of this unit, you will be able to:

- Explain the features and types of credits.
- Explain the role of credit in economic development.
- Identify the various types of credit instruments.
- Explain the process of credit creation by commercial banks and factors militating against this process.

3.0 MAIN CONTENT

3.1 Meaning and Features of Credit

In general terms, credit, a word that took its origin from Latin meaning "to believe or trust" has been adopted as an economic term. As an economic term, credit usually refers to "a promise by one party to pay another for money borrowed or goods or services received. It is also a medium of exchange to receive money or goods on demand at some future date. "It can however be referred to, as many economists do, "as the right to receive payments or the obligation to make payment on demand at some future time on account of the immediate transfer of goods."

As a commerce and finance term, credit denotes transaction involving the transfer of money or other property on promise to repay money usually at a fixed date.

For credit to successfully satisfy its object, the following essential features must be present:

1. Trust and confidence on the part of the borrower or buyer to the lender or seller.
2. Time element, when the money or goods will be paid back or returned.
3. Transfer of goods and services between the seller and buyer.
4. The willingness and ability of the parties concerned, this is hinged on character (honesty), capacity and capital of the parties in the transaction.
5. The purpose of the credit presupposes the credit transaction-either production or consumption purpose.
6. Security or collateral which is, in most cases, the base or important element for raising the credit.

SELF-ASSESSMENT EXERCISE 1

Identify the factors that affect credit creation.

3.2 Types of Credit

Credit as we have earlier seen as a commerce and finance term, has the following principal classes:

1. **Mercantile or Commercial credit-** These are credits, merchants extend to one another to finance production and distribution of goods.
2. **Investment credit** – Those credits used by business firms to finance the acquisition of plant and equipment and represented by corporate bonds, long-term notes, and other proofs of indebtedness.
3. **Bank credit-** This consists of deposits, loans and discounts of depository institutions.
4. **Consumer or Personal credit-** Comprises advances made to individuals to enable them meet expenses or to purchase, on a deferred payment basis, goods or services for personal consumption.
5. **Real – Estate credit** comprises loans secured by land or buildings.
6. **Public or government credit –** represented by the bond issues of federal, state or local governments.
7. **International credit**, which is extended to particular government by other governments, by nationals of foreign countries or by agencies, like the International Bank for Reconstruction and Development (the World Bank).

All these types of credit reveal the principal function of credit – that of transferring property from those who own it to those who wish to use it, as in the case of banks granting loans to individuals who plan to initiate or expand a business venture.

SELF-ASSESSMENT EXERCISE 2

Identify and explain various types of credit.

3.3 Credit and the Economy

Credit transactions have been indispensable to the economic development of the modern world. It puts to use property/funds that would otherwise lie idle, thus enabling a country to more fully employ its resources.

One of the most significant differences between some nations of the developing nations and the advanced western nations is the extent to which the use of credit permits them to keep their savings continuously at work. Without credit, the tremendous investment required for the development of the large-scale enterprises on which the high living standards of the West are based would have been impossible. Thus, credit encourages investment and finance development in economy. The performance of some complex modern business operations are made

possible by the use of credit, thus minimizing the constant handling of cash. These are in areas of internal and international trades, which it thus makes to be more convenient in operation.
Some economic problems like inflation - changes in general price level are controlled through the adoption of some credit control policies by the central bank. This policy helps in maintaining price stability in the economy. The condition of this credit system gauges the business activities in the economy.

Expanding credit availability generally reflects a period of prosperity, whereas contracting credit usually reflect a period of declining economic activity or depression. It can then be seen that fluctuations in the volume of credit affects the level of prices, as credit expands the money supply increases; thus causing prices to rise. The converse is also true. The extension of international credit to developing nations by such institutions as the International Bank for Reconstructing and Development (World Bank) contribute to their economic growth and survival.

Some government exigencies or emergencies are mostly met with credits when it becomes obvious that the usual fiscal measures have failed to fulfill them. This is achieved mostly, through deficit financing for economic development buy creating excess credit.

SELF-ASSESSMENT EXERCISE 3

Identify and explain the various in which credit helps the economy.

3.4 Credit Instruments

Credit instruments are these financial or legal documents on which the credit transaction is contracted. They are usually written or printed financial documents that serve as order to pay or promise to pay. These credit instruments enable the parties effect the transaction, which is the transfer of funds from one party to another at a specified time and conditions.

Some well known and widely used credit instruments include:

i. Promissory Note

This is a written promise by a debtor to pay another or his order a specified amount of money within an agreed date. It is an “I.O.U” (I owe you) which is usually effected between 30 days to one year. Promissory notes may be issued by individuals, corporate bodies and government agencies which have to be acceptable by the debtor’s bank.

The creditor or the holder of the note can discount it before the date of recovery for a fee.

Specimen of a Promissory note

XYZ Enterprises

N25,000.00 15th Sept. 2004

Three months after date, I promise to pay ABC/order the sum of

N25,000.00 (twenty-five thousand naira) only for value received.

Authorized signature:

XYZ Enterprises

ii. Bill of Exchange

This is an unconditional order in writing addressed by one person giving it, requiring the person to pay whom it is addressed to pay on demand at affixed or determinable future time a sum certain in money to or to the order of a specified person or to bearer. The payment period is usually 90 days. For a bill of exchange to be valid, it must be

a) A definite order or command to pay, thus not an unconditional order;
b) In writing; oral bills are not valid;
c) Addressed by one person (drawer) to another (drawee) to be identified at a stated address where the bill is expressed to be paid;
d) Signed by the drawer as his consent to the bill;
e) Payable on demand or at sight or on presentation or at a future date;
f) A sum sufficiently certain in money, even if payable with interest
g) Payable to a person or to bearer or a holder of an office for the time.

The bill of exchange is a negotiable instrument which can be bought or sold by the holder of the bill till the time of its maturity, at the prevailing rate of interest/discount. The holder of the bill presents it only after maturity to the drawee who pays the amount written on the bill. The bill can also be discounted and cashed by the holder before maturity date.

Specimen of a Bill of Exchange

Specimen of a Bill of Exchange

<table><tr><td>
25 Kingsway Road Enugu
14th April, 2006.
<u>₦30, 000.00</u>
Ninety days after date, pay to the person or bearer / order the sum of
thirty thousand naira only for value received.
John James
To: Patrick Ede
2, Aka Street, Enugu
</td></tr></table>

iii. Bank Notes

These are all circulating medium of exchange (currency) of a country issued by her Central Bank. They all carry the promise of the governor of the Central Bank to pay on demand to the bearer of the note an amount mention on it.

iv. Credit Cards

These are credit instruments issued by banks where the holder is allowed some credit facilities by the concerned bank for a specified period of time without any security. They can be used to effect some payment for purchases made without cash for goods and services from certain establishments. There are national and International credit cards.

ii. Cheques

A Cheque is defined as a bill of exchange drawn on a banker and payable on demand. It is on order on a bank by the drawer, who has his deposit with other bank, to pay on demand the stated sum of money to the person named on the Cheque.

A Cheque may either be

(a) "Bearer Cheque" where it can be cashed by the payee/ the person whose name appears on it or any other person holding it,

(b) "Order Cheque" where the responsibility of payment to the payee is on the bank,

(c) "Crossed Cheque" where the Cheque is crossed with two parallel lines with the words "payee's the A/C only" written and amount shown must be credited to the account of the payee in his bank

iii. Drafts

This is also called "bankers Cheques or demand drafts" which constitute an order of a bank to its other branch to pay an amount on it to specified person, firm or organization. The bank charges a commission for preparing the draft to the debtor who then sends it to the payee for presentation and payment.

SELF-ASSESSMENT EXERCISE 4

Identify and explain the various types of credit instruments.

3.5 Factors Affecting Volume of Credit

The previous section has shown that the quantum of credit available to those in need of it are influenced by some variable in the economic system. These are when credit expands or contracts. The factors that contribute to these conditions are discussed below.

(i) The business cycle or state of business activity

During periods of prosperity or boom conditions, business are growing and therefore demand for credit will increase with its attendant rise in interest rates. Periods of recession or depression, there is general declining business activity. Though interest rates are low, the entrepreneurs will not be ready to borrow, thus having contracting credit.

(ii) Credit control policy

The central bank's credit policy affects the volume of credit. A cheap credit policy reduces the cost of credit (interest); this increases in the demand for credit while the quantity of credit is contracted with a dear credit policy leading to a high interest rate.

(iii) The stage or level of economic development of a nation

In developing economies, the demand and supply of credits are usually high because of the operation of many financial institutions that are ready to provide credits no matter the quantity. The banking development and system also contribute to the volume of credit available to creditor as the level of development of the entire economy, when fully developed; the quantity of credit expands, while the converse is also true.

(iv) The political stability of an economy

During periods of political stability, credits expand since investment is encouraged hence increase demand for credit. Periods of political instability and insecurity, investment level is low leading to contraction in the quantity of credit.

SELF-ASSESSMENT EXERCISE 5

Identify and explain the factors that affect volume of credit in any economy.

3.6 Credit Creation by Commercial Banks

Credit creation, a very important function of commercial banks is the process where they (Commercial banks) make available to borrowers in the form of loans and overdrafts deposits in their possession. Bank customers who want to enjoy credit facilities with them usually open and operate current accounts. They therefore make withdrawal of credits granted them from such accounts through the use of cheques, in most case, not cash. Credits are therefore credit by the banks by their making use of cheques and clearing facilities.

Thus, credit creation requires bank opening a deposit every time they make loan available to customers. The customers in turn open chequering account through which payments and withdrawals are made finally effected through the Cheque clearing system. Thus bank loan creates deposits and it is in this sense that credit is credited by commercial banks.

It is worthy to note that banks do not give out all deposit they receive on loans and also depositors do not withdraw their money simultaneously. They therefore keep small cash in reserve for day-to-day transactions, and then advance the excess on this reserve on loans. Also, the banks are legally required to keep a fixed percentage of their deposits in cash, and lend or invest the remaining amount which is called excess reserves. The entire banking system can lend and create credit upon a multiple of its original excess reserves. The deposit multiplier depends upon the required reserved ratio which is the basis of credit creation process. The formula for credit creation multiplier is:

$$M = \frac{1}{r} \text{ or } \frac{1}{I-c}$$

Where:

M = multiplier
r = Required reserved ratio
c = Excess reserve

An Illustration

A Commercial Bank has an initial deposit of ₦ 50,000.00 and a required reserve ratio of 10%, Determine the total deposit to be created by the bank.

Solution

Let TD be the deposit to be created by the bank, ID be the initial deposit then

$$TD = M\,(ID)$$

Where

$$M = \frac{1}{r} = \frac{1}{0.1} = 10.$$

Then

$$TD = 10\,(50,000)$$
$$= 500,000$$

Thus, an initial deposit of ₦50, 000.00 with a bank whose required reserve ratio is 10% can create a total deposit of ₦500, 000.00

Also, given the reserved ratio and total deposits required, we can determine the initial deposit that created that sum thus;

Since

TD = M (ID), in solving for ID, we have

$$ID = \frac{TD}{M}$$

An illustration

If the total deposit generated by the commercial banks in an economy is ₦5, 000,000 and their required reserved ratio is 10%, determine the initial deposit.

Solution

First solve for M thus,

$$M = \frac{1}{r} = \frac{1}{0.1} = 10.$$

Then

$$ID = \frac{TD}{M} = \frac{5,000,000}{10}$$

$$= 500,000$$

Thus, the initial deposit was ₦500, 000.00 that generated the 5million naira.

The process of deposit creation or credit expansion can be illustrated thus:

$$7D = 1D + IDC + IDC^2 + IDC^3 + IDC^4 + \text{-----} + IDC^n$$

Where

ID = New or initial deposit
c = Excess Reserve
n = Number of stages the credit creation will go through.

An illustration

A bank has an initial deposit of ₦ 250,000 with Legal Reserve Ratio of 10%.

a) Determine the total credit created by the banks.
b) Determine the amount of credit creation at the 5^{th} stage.

Solution

$$r = 10\% = 0.1$$

$$ID = ₦\ 250,000$$

$$M = \frac{1}{r} = \frac{1}{0.1} = 10.$$

a) TD = M(ID)
= 10(250,000)

= ₦ 2,500,000

STAGES	NEW DEPOSIT	RESERVE	LOANS CREDITED
1^{st}	250,000	25,000	225,00
2^{nd}	225,000	22,500	202,500
3^{rd}	202,500	20,250	182,250
4^{th}	182,250	18,225	164,025
5^{th}	164,025	16,402.50	147,622.50
Total	**1,023,775**	**102,377.50**	**921,397.50**

(b)

The above illustration show that in the long run a total of ₦2.5 million deposits will be created with ₦2.25 million (i.e. T.D – r (TD) = 2.5 – 0.1 (2.5) = 2.5 – 0.25 = 2.25) at the disposal of the banks on loan. Again, at the fifth stage, a total of ₦1, 023,775 deposits will be created with ₦921, 397.50 on loan.

The process of loan creation continues to a stage when the last (new) deposit will be too small to generate any fresh loan and therefore all banks said to be loaned-up.

This is when the total deposits created hits ₦2.5 million.

SELF-ASSESSMENT EXERCISE 6

Explain with example, the process of creation of credit creation from deposits by commercial banks.

3.7 Bank Constraints in Credit Creation

In its process of credit creation by commercial banks, there exist some inhibiting factors. These factors that limit the power of commercial banks to credit creation are:

1. **The banking habit of the populace**, i.e. the willingness of the people to use the facilities of the banking system. Where this is high and people adopt and embrace banking habits, more cash/ deposits will be available to the banks, thus more credit creation. The converse is also true.

2. **Legal Reserve Ratio**: The higher the legal reserve ratio of bank the lower the credit creation ability of the banks and vice versa.

3. **Security/Collateral Requirements by banks for loans**. Where this is too stringent to borrowers, their borrowing ability is lowered hence low credit.

4. **The income level in the economy**. The larger the income of the people, the greater the bank deposits, all things being equal, hence higher credit creation.

5. **The credit control policy by the central bank**. A contractionary credit policy will limit the credit creation ability of banks, while an expansionary credit policy boosts the capacity. (refer to unit 12.)

6. **The level of economic activities:** Banks credit creation ability in period of depression is curtailed because of its attendant consequences. Conversely credit is expanded when the economy is in full swing; boost periods.

7. **The Banking behaviours and policy:** The efficiency of the banking cheque clearing system, rate of interest or (bank charges) for lending money to qualified borrowers and most especially the bank's willingness to make loans available to the investors all contribute and limits the credit creation ability of banks.

8. **Leakages from the banking system** by way of cash withdrawal for spending or hoarding at home limits the credit creation ability of banks.

The foregoing has revealed that the commercial banks do not possess unlimited powers in its credit creation, but there are some variables to be kept in sight and monitored properly, where possible as to keep the benefits of this their important function in the economy.

SELF-ASSESSMENT EXERCISE 7

Identify and explain the various constraints against credit creation by commercial banks.

4.0 CONCLUSION

Credits and credit instruments are of utmost importance in an economy. They help in mobilizing savings, increasing investments and the rate of capital formation by raising production and employment. Credit is essential for the overall economic development of the economy since it has been seen that it may be impossible to think of the present-day economies without the use of credit. Thus, credits and credit creation are indispensable lubricants and tools of convenience for the economic progress of a country. It is, however, worthy to note that its uncontrolled use brings untold problems for the economy.

5.0 SUMMARY

In this unit, we have discussed credit, credit instruments and credit creation process and abilities by commercial banks in an economy. The meaning, features, types and role of credit in an economy were extensively discussed. The various credit instruments used in the economy and the factors affecting their volume were also examined. The concluding section is on the commercial, banks credit creation process and the constraints that affect this credit creation process.
In the next study unit, we shall discuss the central bank functions and credit control.

6.0 TUTOR-MARKED ASSIGNMENTS

1. What do you mean by credit? Mention at least five types of credit prevalent in the economy.
2. a) Discuss the role of credit in an economy.
   b) What is a credit instrument? Mention at least four well know credit instruments.
3. a) Describe the process of credit creation by commercial bank
   b) Outline the constraints that inhibit commercial banks' power in credit creation.

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UNIT 6 THE CENTRAL BANK FUNCTIONS AND CREDIT CONTROL

CONTENTS

1.0 INTRODUCTION

Banking transactions are businesses usually carried on by any individual or firm engaged in providing financial services to consumers, businesses or government enterprises. In the broadest sense, a bank has been seen as a financial intermediary that performs functions such as safeguards and transfers funds, lends or facilitates lending, guarantees credit worthiness, and exchanges money. These services are provided by such institution s as commercial banks, central banks, savings banks, trust companies, life insurers, and investment banks. All these banks most frequently organized in corporate form an downed by either private individuals, governments or a combination of private and government interests are subject to government regulation and supervision, normally implemented by the nation's apex bank – central banking authority.

2.0 OBJECTIVES

At the end of this unit is that on its completion you should be able to:

1. Know the need for the establishment of a nation's apex bank – central bank.
2. Discuss the major functions of the central bank.
3. Explain the monetary control policy of the central bank

3.0 MAIN CONTENT

3.1 Evolution and Definition of a Central Bank

With the growth and development in the economy in areas of business and trade – internal and international, there became the need for a monetary control and regulations. Again, with the volume of transactions in the banking sector the question arose regarding where the private banks will keep their cash reserves, their own vaults were not really safe against a really determined attempt of robbery. Where were the commercial banks to turn if they had made good loans and investment that would mature in the future, but were in temporary need of reserves to meet an exceptional demand to withdraw by their depositors? If banks provided loans to the public against reasonable security, why should not some other institution provide loans to them against the some sort of security? The Central Bank, which was itself a natural outcome of the whole system, therefore emerged in response to these and other needs. At first, they operated as private profit oriented institutions, providing services to ordinary banks, but their potential to influence the behaviour of commercial banks was high than that of the whole economy which led them to develop close lies with their central governments. Hence they became fully government owned, and then refrain them from being non-profit making institution. The central bank has grown in many nations of the world to become the apex institution of the monetary and banking structure.

The central bank has been defined in varied ways, each touching only an aspect of its functions. One of the broadest definitions of the central bank is that credited to De. Kock. It says that a central bank is a bank which constitutes the apex of the monetary and banking structure of its country and performs, as best as it can in the national interest, the functions outlined as functions of the central bank". This definition can therefore be summed up as "an apex financial institution which is charged with the responsibility of managing the cost, volume availability and direction of money and credit in an economy with a view to achieving some desired economic objective".

3.2 The Central Bank of Nigeria (CBN)

The central bank of Nigeria is the apex bank in Nigeria established under the central bank Act of 15th May, 1958 to discharge critical statutory functions to the economy which the law empowered it to do with an authorized capital of N1.5m of which N1.25 was paid-up.

The organization structure of the CBN comprises Board of Directors as the highest policy making organ presided over by the governor of the

CBN and members appointed by the presidency. This is following by the committee of governors charged with the responsibility of manning the daily administration of the bank; it is again headed by the governor, and the deputy governors are the members. These are followed by the principal officers of the bank made-up of the directors of various departments/branch/services.

The CBN operates zonal offices in the following locations in Nigeria – Abuja, Bauchi, Enugu, Ibadan and Kano with branches or cash centres in some state capitals.

3.3 Functions of a Central Bank

The central bank is the foremost monetary institution in a market economy; usually government owned whose responsibility is to the national interest. The functions performed by most central banks can be broadly grouped as follows:

1. Banker to government

The central bank as banker to the government collects and disburses government incomes and receipts in an account into which they can make deposits and also draw cheques.

2. Manager of government/public debt

The central bank helps the government with its debt requirements; managing the issues and redemption of all government debts, advises her on all matters pertaining to financial activities, and makes loans to the government. The central bank sources funds from various avenues both internally and externally in form of borrowing, after considering its cost, convenience in repayment, maturity and its availability.

3. Banker of the banking system

The central bank holds and transfers commercial banks' deposits/funds among themselves (cheques clearing system) and supervises their operations. The central bank also acts as "**lender of last resort**" to the commercial bank by lending money to them when all other sources failed. The commercial banks hold their required cash reserves against their outstanding deposit liabilities in the form of their own deposit at the central bank. The central bank can act as lender of last resort to the commercial banks, i.e. providing assistance when the banking system is short of cash either by:

i) Lending money to the discount house i.e. borrowing against approved financial assets or
ii) Buying bills and bonds directly from the commercial banks

The central bank also provides technical and advisory services to the commercial banks.

4. Supporter of money market

The central bank tries to promote a sound financial structure in the economy through the management of the money and capital markets. In this process, it creates a number of financial instruments to keep the market alive; these include treasury bills, treasury certificates, certificates of deposit, etc.

5. Agent of Monetary policy

The central bank attempts to regulate the economy by regulating the supply of money and the terms and availability of credit. This they do for both domestic and foreign purposes by using its variety of direct and indirect control over the financial institutions. This includes prescription of cash ratio, liquidity ratio, and credit ceilings for the different sectors of the economy. Other tools include the direct manipulation of the interest and discount rates, open market operation (OMO), and moral suasion.

In most countries, the central bank has the sole power to issue and control her currency (coins and notes in circulation). These are usually the liability of the central bank.

SELF-ASSESSMENT EXERCISE 1

Identify and explain the functions of a central bank.

3.4 Monetary Policy Control Methods and Instruments

The operation of a nation's monetary policy, a responsibility of the central bank, attempts to influence the economy by the control of the monetary magnitudes which in turn checks inflationary and deflationary pressures within the economy.

The major objectives of the monetary policy include the following:

1. Stabilization of internal price level.
2. Stabilizing the rate of foreign exchange
3. Protection of the outflow of foreign reserve

4. Control of business cycle.
5. Promotion of stable growth in the economy.
6. Meeting the monetary requirement of the business sector.

These could be summed into two viz:

- Influence on aggregate demand and through the national income, employment and price, and
- Protection or support on the country's financial system from the kinds of panics and crashes that have caused occasional havocs.

The primary instruments of general monetary control by the CBN are discussed hereunder.

(a) Open market operations (OMO)

The open market operations (OMO) refer to a monetary management techniques widely used by monetary authorities to control the growth of liquidity in an economy. In Nigeria, the CBN began to apply OMO from 3oth June, 1993, as part of the final place of the shift to the market – based method of monetary management; ever since then it has remained the main instrument of monetary policy. It is conducted on a weekly basis during which government securities are traded by authorized dealers through the discount houses.

When actual money supply grows too slowly, the CBN purchases government securities such as Treasury Bills, Treasury certificates and other instruments which they may deem appropriate to stabilize the system. This increases the monetary base and thus enabling the banking system to create additional deposits, which constitute the major portion of the money supply. Buying government securities by the CBN injects liquidity into the economy by increasing the stock of bank reserves and banks' ability to create and increase the quantity of money in circulation. Conversely, should money supply grow more rapidly than is desired, the CBN will pursue a tight monetary policy by reducing liquidity in the economy. The CBN thus sells government societies on the open market to authorized dealers. Such sales reduce bank reserves and thus the ability of the banking system to create deposits, thus contraction in banks reserves. As long as the CBN keeps such reserves in its vault and the banks ability to access new money from abroad, the ability to create new money is eventually reduced.

OMO transaction consists of outright sales/purchases of government securities and is expected to have a permanent effect on the level of liquidity in the economy.

(b) Cash Reserve Requirement (legal Reserve Ratio)

This is the percentage of deposits that banks must maintain on reserve with the CBN whatever amount that remains with the commercial banks over and above the minimum reserve is known as excess reserve on whose basis they create credit. When the CBN raises the required reserve ratio, banks excess reserve will be reduced then unable to create as much money as they previously were able to because a large portion of their assets must be held in reserve. Conversely, where the reserve ratio is reduced, the banks will be able to create more, money in the economy. Thus, the larger the cash reserve requirement the smaller the excess reserve and the lower the ability of banks to create credit and vice versa.

(c) Bank Rate or Discount Rate Operation

Bank rate or discount rate is the rate at which CBN rediscounts first class bills of exchange and government securities when the commercial bank needs to borrow from the apex bank. It is the interest rate charged by the CBN at which it provides rediscount to banks through the discount window. Thus, the CBN can make changes in the discount rate in monetary control. When banks seek additional reserves by borrowing from the CBN, a significant escalation in the discount rate makes such borrowing more expensive and consequently reduces demands for reserves, hence contracting credit. Conversely, if the CBN wants to expand credit, it lowers the bank rate, making borrowing from the CBN cheap. A discount rate change may, at times, reinforce OMO

(d) Moral Suasion

This involves the use of persuasion by the CBN to the commercial banks to comply with the CBN guidelines on any economic problem arising from the banking sector. Such guidelines arose from a democratic conference of representation of the CBN and the banks on such identified problems. Agreement reached at such conferences on how best to handle the problem becomes the guidelines banks are asked to implement at their branches. Non-compliance with the provisions of the guidelines may be punished by the CBN.

(e) Liquidity Ratio

The liquidity ratio, the percentage of a bank deposits held in form of cash or eligible liquid assets in the tills of the bank are also used as a monetary policy instrument. Money supply is reduced when this liquidity ratio is increased resulting in reduction in the banks excess reserves.

A reduction in the liquidity ratio leads to increase in the excess reserve, thus increase in the credit supply by banks.

SELF-ASSESSMENT EXERCISE 2

Identify and explain the monetary policy instruments being used in the economy.

4.0 CONCLUSION

The central banking system, the national apex financial institution, is sometimes considered as a fourth branch of government because it is made up of a powerful group of national policy makers. However, they still work according to the objectives of economic and financial policy established by the executive branch of the government.

Economists have over time felt that in the long run, the policies of the central banks have had both positive and negatives effects on the economy. The central bank functions in the economic system in the issuance of the national currency, regulation of the monetary policy and supervision and regulating banks and bank holding companies; make it the pivot of any nation economy and survival.

5.0 SUMMARY

The central bank, a government wholly owned bank that is charged with the responsibility of managing the cost, volume, availability and direction of money and credit in an economy has been traced to the need for its establishment. Its structure and various functions in the economy discussed. The monetary policy of the nation controlled by the CBN was also discussed, explaining the major instruments employed in this operation. All the instruments are hinged in the supply of money and credit creation by the commercial bank.

In the next study unit, we shall discuss the role of the central bank in a developing economy.

6.0 TUTOR – MARKED ASSIGNMENTS

1. Trace the evolution of a central bank.
2. Discuss the general functions of the central banks
3. The most important and difficult function of the central ban is to control money and credit in the system. Outline the objectives of this monetary control.
4. Discuss the following monetary control instruments:

(a) Open Market Operation (b) Legal Reserve Ratio. (c) Moral Suasion

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MODULE 3

UNIT 1 THE ROLE OF THE CENTRAL BANK IN A DEVELOPING ECONOMY

CONTENTS

1.0 INTRODUCTION

The position of the central bank in any developing economy is of dual purpose. It performs the normal or traditional central bank functions and at the same time non-traditional functions of stimulating the general economic development of the country by direct participation in key establishments.

The principal traditional functions of the central banks as you have already learnt in unit twelve include – issuance of the nation's legal tender (currency), banker to the government, banker's bank, lender of last resort, maintenance of external reserves and the controller of credit and maintenances of stable foreign dealings.

In developing nations, the central bank helps the economy to develop fast by making money available for rising level of production and distribution, helping the drive to increase exports and keep prices stable. It further through the use of its monetary policy, maintains stability in the supply of money and credit. These functions of the central bank in the economic development of nation are discussed hereunder.

2.0 OBJECTIVES

It is expected that at the end of this unit, in addition to fully appreciating the general functions of the central banking system, you will be able to identity and explain how the central bank controls and enhances stability in the economic and financially system of a developing nation.

3.0 MAIN CONTENT

3.1 Creation and Expansion of the Financial System

The commercial banks that have the function of credit creation in the economy are mostly profit oriented institutions. They therefore prefer to be localized in the big cities to provide credit facilities to estates, plantations, big industrial and commercial ventures.

The commercial banks hitherto provide only short-term loans to the aforementioned groups, thus credit facilities in the rural areas to peasant farmers, small business men/women and traders were mostly non-existent. The central bank in its bid to improve the currency and credit system of the country issues directives to the commercial banks to extend branch banking to rural (i.e. rural banking scheme) areas to make credit available to the rural business operatives. Also they are directed on the provision of credit facilities to marginal farmers on short, medium and long term basis. The central bank also encourages the establishment of community banks and other programmes through which deposit mobilization and investment s are encouraged in the rural areas. The central bank also helps in establishing specialized banks and financial corporations in order to finance large and small industries.

3.2 Price Level Stability Role

In units six, seven and eight where we discussed the demand and supply of money and inflations, you learned about the movement in price level resulting from the imbalance between demand and supply of money. It is a general economic system that as the economy develops; the demand for money is likely to go up due to increase in production and price. This if not properly checked may result in inflation. The central bank controls the uses of policy that will prevent price level from rising without affecting investment and production adversely.

3.3 Interest Rate Policy Stability Role

In developing economies, the existence of high interest rates in different sectors act as an obstacle to the growth of both private and public investment. Since investors borrow from the banks and the capital market for purposes of investment, it therefore, behoves the system to encourage them by ensuring a low interest rate policy. Low interest rate policy is a cheap money policy, making public borrowing cheap, cost of servicing public debt low and finally encouraging and financing economic development. The policy becomes more effective if the central bank operates a discriminatory interest rate, charging high rates for non-essential and unproductive loans and lower rates for productive loans.

3.4 Debt Management Role

In developing economies in particular and every economy in general, the central bank manages the domestic and foreign debts on the instruction of the Federal Ministry of Finance. Debt management involves debt service payments and participation in debt restructuring through rescheduling, debt refinancing, as well as debt conversion to ensure that the debt is reduced to a manageable size. The aim of the bank in this results in areas of proper timing and issuing of government bonds and securities, stabilizing their prices and also minimizing the cost of servicing the public debt.

In order to achieve this role, it becomes essential that the central bank should ensure a low interest rate policy on these bonds to make them more attractive. Thus, for this role of debt management to be successful, the central bank will ensure and encourage the existence of well-developed money and capital markets where both short and long-term securities abound.

3.5 Momentary Stability

Monetary policy–the credit control measures adopted by the central bank of a country, is of vital importance in the process of development. This is important because of how they influence the pattern of investment and production through the conscious action taken by the bank in the control of the supply of money. This mechanism in effect, when the proper mix of the control instrument is adopted effectively, controls inflationary pressures arising in the process of development. These instruments as we saw in the previous unit include – open market operations, required reserve, ratio, bank rate or discount rate, among others.

3.6 Foreign Exchange Management Role

The central bank manages and controls the foreign exchange resources of a nation – its acquisition and allocation in order to reduce destabilizing short-term capital flows. The bank thus monitors the use of scarce foreign exchange resource to ensure that foreign exchange disbursement and utilization are in line with the economic priorities at the same time in line with economic priorities and within the foreign exchange budget. In this regard the central bank further acts as the technical adviser to the government on foreign exchange policy, especially in maintaining a stable foreign exchange rate.

This, the bank still achieves this through exchange controls and variations in the bank rates (discount rates). This role generally helps in achieving a balance of payment equilibrium; a problem prevalent in the developing economies.

4.0 CONCLUSION

The central bank with its general functions to a nation's financial system in particular and the entire economic system in general cannot be overemphasizes. Their role in the general development of an economy in achieving economic growth especially in a developing nation has been discussed and the measures it adopts in this area without losing sight of economic stability. At the pivot of a nation's financial and general economic development, the central banks have been blamed and criticized by the public for having too frequent changes in monetary policies among some other issues. These not withstanding, the central bank has been seen and adjudged to be of great value and importance in developing economies.

5.0 SUMMARY

The role of the central bank in a developing economy as we discussed in this unit was seen as the crux of the existence of the bank. It has been revealed that this is mostly hinged on the control, management and quality of credit at the disposal of the investors in the economy. Thus, the creation and expansion of the financial system role of the bank, price and interest rate stability roles topped the list of its major and outstanding ways to enhancing the growth of developing nations. Other roles discussed are debt and foreign exchange management roles.

In the next study unit, we shall discuss monetary policy and fiscal policy.

6.0 TUTOR-MARKED ASSIGNMENTS

1. Outline the role of the central bank in the economic development of a nation.
2. Discuss extensively three of the roles outlined above.

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UNIT 2 MONETARY POLICY AND FISCAL POLICY

CONTENTS

1.0 INTRODUCTION

In any economy to operate effectively, policies which are codes, guides or general rules that stipulates the referenced procedure to follow in handling recurring situations or in exercising delegated authorities must be followed. These policies theoretically serve to ensure that decisions support set objectives and describes plans to follow in a coordinated and consistent manner. Policies should however be controlled, monitored and considerably enforced in order to be effective.

Macro economic policies are those measures taken by government intended to influence the behaviour of the economic policies, to achieve desired objectives through the manipulation of a set of instrumental variables. The scope for macroeconomic policy depends upon the economic system in operation, and thus the framework of laws and institutions governing it. The most important class of macroeconomic policy is demand management, which seeks to regulate the pressure on the community's resources by operating on the level of spending power and so of demand. This generally takes the form of measures we shall be discussing in this unit – monetary policy and fiscal policy.

2.0 OBJECTIVES

By the end of this unit, you should be able to:

- Explain the meaning and objectives of monetary policy and fiscal policy
- Explain their respective roles in the economy.

- Identify and explain their respective instruments of operation
- Explain the constraints of monetary policy.

3.0 MAIN CONTENT

3.1 Monetary Policy: Meaning and Objectives

Monetary policy is the means by which the Central Bank (i.e. the monetary regulatory authority) manipulates the money supply in order to influence the overall direction of the economy; particularly in the areas of employment, production and prices.

Monetary policy can therefore be seen as any conscious action taken by the Central Bank to change the volume, quantity, availability, cost and direction of money and credit in the economy.

It therefore involves the regulation by the Central Bank of the supply and interest rates in order to control inflation and stabilize currency. Monetary policy is one of the two ways the government through its regulatory agencies can impact on the economy.

The principal objectives of monetary policy include:

1. Full Employment

This is the economic term used to describe a situation in which every body who wants to work gets work; thus, the absence of involuntary unemployment. The U.N. experts on National and International measures for full employment define it as 'a situation which employment cannot be increased by an increase in effective demand and unemployment does not exceed the minimum allowances that must be made for the effects of fractional and seasonal factors'. It further states that full employment stands for 96% to 97% employment. This can be achieved in the economy by following expansionary monetary policy.

2. Economic Growth

The general goal of monetary policy is to promote a stable economy. Thus, one of its objectives is the rapid growth in the economy. Economic growth is the process whereby the real per capita income of a country increases over a long period of time and is measured by the increase in the amount of goods and services produced in that country. Economic growth is therefore a desirable goal of a country since it raises the standard of living of the people and reduces inequalities in income distribution. A good monetary policy influences this by controlling the real interest rate through its effect on the level of investment in the economy at the same time controls hyper-inflation.

3. Balance of Payment

The monetary policy of a country also has as one of its objectives the maintenance of equilibrium in the balance of payments. This follows from the phenomenal world trade growth as against the growth in international liquidity.

SELF-ASSESSMENT EXERCISE 1

Identify and explain the principal objectives of monetary policy.

3.1 The Central Bank of Nigeria and Monetary Policy

The Central Bank of Nigeria in its conduct of monetary policy in Nigeria undertakes monetary policy in order to:

- Maintain Nigeria's external reserves to safeguard the international value of the legal currency.
- Promote and maintenance of monetary stability and a sound and efficient financial system in Nigeria.
- Act as banker and financial adviser to the Federal Government; and
- Act as lender of last resort to banks.

The recent CBN economic reforms and monetary policy which focused on structural changes, monetary policy, interest rate administration and foreign exchange management, encompasses both financial and market liberalization and institutional building in the financial sector. The broad objectives of this reform include:

a) Removal of control on interest rates to increase the level of savings and improve allocative efficiency;
b) Elimination of non-oil rationing of credit to reduce misdirected credit and increase competition;
c) Adoption of indirect monetary management in place of the imposition of credit ceiling on individual banks;
d) Enhancing of industrial structure and supervision;
e) Strengthening the money and capital markets through policy changes and distress resolution measures; and
f) Improving the linkages between formal and informal sectors.

SELF-ASSESSMENT EXERCISE 2

Identify and explain the objectives of the CBN's economic reforms and monetary policy.

3.2 Instruments of Monetary Policy

The tools, techniques or instruments of monetary policy in an economy are of two broad groups. First, the **general, quantitative or indirect** instruments, which are meant to regulate the overall level of credit in the economy through the commercial banks. The second group – **selective, qualitative or direct** instruments that aims at controlling specific types of credits in the economy. They all affect the level of aggregate demand through the supply of money, cost of money and availability of credit.

Most of the monetary instruments, which had earlier been discussed in unit 12 – Central Bank Functions and Credit Control include:

1. **Open Market Operation (OMO)**: This is the sale and purchase of government securities in the market by the Central Bank.

2. **Legal Reserve Ratio (Cash Reserve Requirement) of Banks:** This is the proportion of commercial banks deposits kept with the Central Bank for the purpose of monetary control.

3. **Bank Rate Policy or Discount Rate Operation**: This refers to the interest rate at which the CBN lends to the commercial banks or rediscounts first class bill of exchange and government securities to the commercial banks.

4. **Liquidity Ratio**: This is the percentage of a bank's deposit held in form of cash or liquid assets to meet sudden rush on banks by depositors.

SELF-ASSESSMENT EXERCISE 3

Identify and explain the instruments of monetary policy being used by the Central Bank. .

Others include Moral Suasion, CBN Directives to banks on credit and banking policies like sectoral allocation of money in the form of credit to some preferred sectors of the economy and Discriminatory interest rate aimed at stimulating demand for loans for participants in such sectors.

When implementing these instruments, if the policy makers feel that employment is too low and interest rates too high in the economy, the

CBN could enact **EXPANSIONARY (i.e. easy)** monetary policy. This will encourage economic growth by doing one or all of these three things:

1) Direct the purchase of government securities and bonds in OMO;
2) Lower the reserve ratio/requirement;
3) Lower the discount rate.

Each of these choices increases the supply of money and creates a chain reaction. For instance, the direct purchase of securities in OMO lowers the lending rate as there is more supply of loanable monies, thus encouraging growth. Also, lowering the reserve requirement makes more banks' deposits available for lending, thus lowering price of funds and debt cheaper. On the other hand, lowering the discount rate makes banks borrowing rate from the CBN cheaper which in turn will make lending to customers cheaper.

Conversely, if policy makers felt that employment was too high and interest rates too low, a situation that could lead to runaway inflation, the CBN would want to encourage an economic slow down, i.e. it will implement **RESTRICTIVE (dear)** monetary policy. A policy designed to curtail aggregate demand. This could be achieved by adopting one or all of the following:

1) Direct sell of securities in OMO, a phenomenon that slows down demand and lowers prices across the economy.
2) Raising the reserve requirement, thereby leaving less of a bank's deposits available for lending, thus making it less lucrative to borrow money as to lend to customers.
3) Raising or increasing the discount rate. This phenomenon makes it more expensive for banks to borrow from the CBN, thus less lucrative to lend to customers also.

3.4 The Role of Monetary Policy in Economic Development

The economists' measure of the effectiveness of a monetary policy is its influence on inflation, employment, and industrial production. This stems from the already mentioned principal objectives of monetary policy, especially in a developing economy. We can restate these objectives again as the major role monetary policy plays in a developing economy thus:

a) Credit Control

With a view of controlling inflation and inflationary pressures within the economy. This is achieved through the adoption of one or a combination of the instruments of monetary policy discussed above.

b) Price Stability

The adoption of various tools of monetary policy brings a proper adjustment between the demand for and supply of money. In a developing economy, the gradual monetization of the non-monetized sector leads to increase in the demand for money. This also results from increase in agricultural and industrial production. All these will lead to increase in the demand for transactions and speculative motives, which monetary policy reacts to by raising the money supply more than proportionate to the demand for money in order to avoid inflation.

c) Exchange Rate and Interest Rate Stability

Towards bridging the balance of payment deficit, monetary policy in the form of interest rate policy plays an important role. A developing economy must have to increase imports to meet their respective development needs. On the other hand, exports in such economies are almost stagnant, thus leading to imbalance in balance of payments. This could be narrowed through the adoption of a high interest rate policy which will in turn attract the inflow of foreign investments. The policy will also have a positive effect on the exchange rate favourable to the development of the economy.

In Nigeria, the implication of the monetary policy reforms highlighted in section 3.2 has the following implications on the economy:

i) Increase in the number of Banking Institutions resulting from the provision of a liberalised and level playing field for the emergence of effective and efficient institutions that would serve as an engine of growth for the economy.
ii) Improved service delivery through new innovations and new product development like the Automated Teller Machines (ATM), use of debit and credit cards, e-money and e-banking.
iii) Shift in Monetary Policy management from direct to indirect approach to monetary management. This led to a better development of the primary and secondary markets for treasury securities. These took advantage of the liberalization that discount houses, banks and some selected stock brokers are now very active in the primary market for treasury bills.
iv) Between 1987 and 1996, the CBN had adopted different interest rate regimes in 1987 to a total deregulation of interest rates in October 1996.

v) Modernisation in the Nigerian payment system process with the implementation of Magnetic Ink Character Recognition (MICR), ATMs and electronic banking (e-banking). These are all aimed at promoting the automation of the payments system, thus reduce delays in the clearing of payment instruments, reduce cash transactions and enhance transmission mechanism of monetary policy.

vi) In area of Foreign Exchange Management, the CBN as part of the reform liberalised the foreign exchange market with the reintroduction of the Dutch Auction System (DAS) in July 2002 with the objective of realigning the exchange rate of the naira, thus conserving external reserves, enhancing market transparency and curbing capital flight from the country. The system brought a good measure of stability in exchange rate as well as a reduction in the arbitrage premium between the official and parallel market rates.

The foregoing reveals that monetary policy has a global reach in addition to its domestic effects. This revolves around its main objective of promoting a stable economy. Through its effect in the economy, many economists agree that the central bank of a nation is the most important political tool a government has. This stems from the fact as discussed above that each of a monetary policy's effects influences the everyday financial decisions of the citizens of the economy, whether they should buy a car, save more money, or start a business.

SELF-ASSESSMENT EXERCISE 4

Explain the role of monetary policy in economic development.

3.5 Fiscal Policy

Fiscal Policy is a deliberate government policy designed to change the level of government expenditure or varying the level of taxation or both; for the purpose of achieving some desired economic objectives. It is therefore government's decisions relating to taxation and its spending with the goals of full employment, price stability, and economic growth. Fiscal policy objectives are implemented and achieved through changes in the budget [a financial statement of the sources (revenue) and uses (expenditure) of fund of the government).

Government is said to adopt a "loosened fiscal policy" when it reduces taxation or increases public expenditure with the aim of stimulating aggregate demand. On the other hand, "tightened fiscal policy" prevails when taxation is increased or public expenditure is reduced.

Thus, by changing tax laws, the government can effectively modify the amount of disposable income available to its tax payers. For example, during tightened fiscal policy regime, when taxes are increased, consumers would have less money to spend on goods and services. Also, government could choose to increase her spending by directly purchasing goods and services from private companies. This would increase the flow of money through the economy and would eventually increase disposable income available to consumers.

3.6 Fiscal Policy and Economic Development

Fiscal policy which has been seen as government policy in relation to taxation and public spending is one of the two most important components of a government's overall economic policy concerned with money supply.

In times of recession and inflation, government can apply fiscal policy to solve the resulting problems. Some of the mechanisms as discussed partly in section 3.5 follow the fiscal policy regime adopted by the government. Either loosened or tightened fiscal policy regimes when adopted aids in achieving the desired objective.

During times of recession, reduction in taxation, increase in government spending and government grants or/and financial assistance to industries will get the economy out of the problems.

Conversely, in periods of inflation, increased taxation, reduction in government expenditure and reduction of grants and/or financial aids to industries will reduce inflationary pressure on the economy.

4.0 CONCLUSION

We have seen that government influences the behaviour of the economy by adopting some economic policies. The two most important of these economic policies are monetary policy and fiscal policy. In all these measures, the government operates through the market, giving market forces a new direction but not attempting to supervise them. The objectives and purposes of these polices are all geared towards attaining full employment, price stability and general economic growth.

5.0 SUMMARY

The unit discussed two important policies of government – monetary policy and fiscal policy under their respective meanings and objectives, their instruments of operation and how they affect the economy.

6.0 TUTOR-MARKED ASSIGNMENTS

1) Discuss the objectives and principal instruments of monetary policy.
2) Distinguish between cheap (or easy or expansionary) and dear (or restrictive) monetary policy.
3) Discuss the role and instruments of fiscal policy in a developing economy.

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UNIT 3 THE NIGERIAN FINANCIAL SYSTEM

CONTENTS

1.0 INTRODUCTION

Finance, a term applied to the purchase and sale of legal instruments that gives owner specified rights to a series of future cash flows. These legal instruments, known as financial assets or securities, are issued by private concerns, such as companies and corporations, and government bodies, and they include bonds, stocks, and shares.

In business generally, finance whose need in the economy is paramount refers to the raising of capital funds and using them for generating returns and paying returns to the suppliers of those funds, which may be equity or borrowed funds.

In this unit and the following two units we shall be introducing you to the system of financial system, features, structure and finally hinging on the regulatory authorities in the system.

2.0 OBJECTIVES

By the end of this unit you should be able to:

- Explain the meaning and features of an efficient financial system.
- Understand the structure of the Nigerian Financial System

- Identify the various regulatory bodies in the Nigerian financial system
- Identify and explain the reasons for regulating the Nigerian financial system.

3.0 MAIN CONTENT

3.1 Meaning and Features of a Financial System

The financial system refers to family of rules and regulation, institutions, instruments and operators that interact within an economy in the provision of financial services and the facilities through which they are transferred to various members in the economy. The services they provide may include resources mobilization and allocation, and financial interactions with a view of enhancing international trade.

The foregoing reveals that the financial system plays important role in the process of economic growth and development of a country. These roles could be well achieved if the system is well developed with adequate attention given to the measurement indicator of the system. These indicators which measure the efficiency of the financial system are:

1. The availability of multiple financial assets of varying characteristics that will meet the need of the operators for effective competition.
2. The awareness of the articles of trade in the system to the participant. This implies the existence of unrestricted access to the traded securities liquidity, safety, current yield, capital gain, etc.
3. Stability of the cost of capital (i.e. interest rate).
4. The availability of infrastructure in the system, most especially in areas of information transmission and communication.
5. The absence of external intervention (by the government or other institutions) in price determination of securities.
6. The availability of sufficient discounting facilities.
7. The availability of experts/qualified personnel that will be able to read the value of the securities.
8. The cultural/general attitudinal behaviour of the participants toward credit facilities.
9. The independence of the productive sector on foreign exchange.

It could therefore be seen that a well developed financial system dictates the development of that economy.

SELF-ASSESSMENT EXERCISE 1

List the indicators that measure the efficiency of a financial system.

3.2 The Structure and Objectives of the Nigerian Financial System

The Federal Government of Nigeria in 1976 set up a committee to review the Nigerian financial system that was almost near existing void. The committee headed by Dr. P.N.C. Okigbo among others recommended the following objectives for the financial system:

(a) The Nigerian Financial System should be able to facilitate effective management of the economy.
(b) The system should provide non-inflationary support for the economy.
(c) The achievement of greater mobilization of savings and its efficient and effective channelling.
(d) Ensures that no viable project is frustrated simply for lack of funds.
(e) Insulate the economy as much as possible and as much as desirable from vicissitudes of the international economic scene.
(f) Effectively sustain the indigenization of the country.
(g) Assist in achieving significant transformations of the rural area, and
(h) Assist in achieving greater integration and linkages in agricultural, commerce and industry.

These recommendations formed the bedrock on which today's Nigerian financial system has developed though it is still any thing but very efficient.

The Nigerian financial system is made up of the regulatory supervisory authorities that provide the rules governing the mode of activities and the system and also the institutions that provide the facilities for exchanging funds in the financial market. The regulatory authorities are the Central Bank of Nigeria (CBN) at the apex, the Nigeria Deposit Insurance Corporation (NDIC), the Securities and Exchange Commission (SEC), the Federal Ministry of Finance (FMF), the Nigerian Insurance Supervisory Board (NISB), and the Federal Mortgage Bank of Nigeria (FMBA).

SELF-ASSESSMENT EXERCISE 2

List the recommended objectives of a sound financial system.

3.3 The Regulatory Authorities

The regulatory /supervisory authorities in the financial system are very crucial in the functions and orderly development of the system. Highlights of these authorities are provided hereunder.

3.3.1 The Central Bank of Nigeria (CBN)

The CBN established by the CBN Act of 1958 and started operate on 1st July, 1959 is the apex regulatory authority of the financial system. As discussed in earlier units, the CBN has among its primary functions the promotion of monetary stability and a sound financial system in addition to acting as banker to last resort to the banks. The bank also encourages the growth and development of the financial institutions.

The CBN was given more flexibility in regulating and supervising the banking sector and licensing finance companies framework by the CBN Decree 24 and BOFID all of 1991.

3.3.2 The Nigeria Deposit Insurance Corporation (NDIC)

The NDIC which complements the regulatory and supervisory role of the CBN was established in 1988 following the promulgation of Decree 22 of 15th June, 1988, but it became effectively operational in February 1989. The NDIC was set up to provide deposit insurance and related services to banks in order to promote confidence in the banking industry. The NDIC is therefore empowered to examine the books and other deposit – taking financial institutions. Licensed banks are therefore mandated to 15/16 of 1% of their total deposit liabilities as insurance premium. The decree also limited to a maximum of N500, 000.00 in event of a bank failure. The NDIC in collaboration with the CBN has intensified its effort to resolve the problem of distress in the banking industry.

3.3.3 The Securities and Exchange Commission (SEC)

The SEC, formerly called Capital Issues Commission was established by the SEC Act of 27th September, 1979 and future strengthened by SEC Decrees of 1988. Like the CBN, SEC is the apex regulatory organ of the capital market with its major objective of promoting an orderly and active capital market and major function of ensuring adequate protection of the investing public. One of the major functions of the SEC – that of price determination was on the course of the regulation of the capital market transferred to the issuing house. However, the SEC has continued to maintain surveillance over the capital market to enhance efficiency. Other outstanding functions of the SEC worthy of mention include the registering of all securities dealers, investment advisers and market places (such as stock Exchanges and their braches). The Companies and Allied Matters Decrees of 1990 further enlarged the role of the SEC by empowering it to approve and regulate mergers and acquisitions and authorize he establishment of unit trusts.

3.3.4 The Federal Ministry of Finance (FMF)

The Federal Ministry of Finance as one of the regulatory bodies of the financial system advises the Federal Government on its fiscal operations and interacts with the CBN on monetary matters. The FMF is also charged with the responsibility of licensing bureau de change nationwide.

3.3.5 Nigerian Insurance Supervisory Board (NISB)

The NISB, established by the Insurance Special Supervision Fund (Amendment) Decree 62 of 1991, is charged with the effective administration, supervision, regulation and control of the business handled by the FMF. It was transferred to NISB to ensure better results and more effective control and reserves, good management, high technical expertise and judicious funds placement.

The NISB therefore is centred on the establishment of standards for the conduct of insurance policy holders and establishment of a bureau to which complaints may be submitted against insurance companies and their intermediaries by members of the public.

3.3.6 The Federal Mortgage Bank of Nigeria (FMBN)

The FMBN established by Decree 7 of 1977 had its main functions to include the provision of banking and advisory services and research activities pertaining to housing in the country. The FMBN was empowered by the National Housing Policy in 1990 and Decree 3 or of January 1991 to license and regulate mortgage institutions in Nigeria and to act as the apex regulatory body for the mortgage. Federal Mortgage Finance was later carved out of the FMBN. The financing functions of the Federal Mortgage Bank of Nigeria were therefore transferred to the Federal Mortgage Finance while the FMBN retains its regulatory role.

SELF-ASSESSMENT EXERCISE 3

Identify and explain the functions of the various regulatory authorities in the Nigerian financial system.

3.2.2 The Rationale for Regulating the Financial System

The financial system as already stated consists of institutions engaged in the provision of money and credit or simply financial services both locally (nationally) and internationally. The system cannot be said to be with out problems that militates against its efficient operation. Some of these problems which could be managed from within the system become obvious that they should be nipped in the bud. This gave rise to the need for the institutions of the above discussed regulatory bodies in the financial system. These reasons could be summarized as follows:

1. To ensure safety of depositors funds.
2. To control bank charges.
3. To scrutinize entry into the system and thus avoid under-capitalization
4. To control credit expansion in the economy.
5. To control effectively capital distribution.
6. To control the conduct of directors and employees of the institutions.
7. To limit the risk taking by banks and other finance houses.
8. For channelling of funds to productive sections.
9. To ensure healthy competition among banks
10. To ensure sensitivity to macro-economic objectives and social responsiveness by participants.

SELF-ASSESSMENT EXERCISE 4

What are the reasons for regulating the financial system?

4.0 CONCLUSION

The importance of finance in an economy hence financial service cannot be over-emphasized for an effective economic development. The financial system which consists mainly of regulatory authorities and the financial institutions play remarkable role in the economy. The regulatory authorities has at its apex the Central Bank of Nigeria has wide ranging powers to regulate the volume of activities in the economy, with very important consequences for incomes, prices and employment.

5.0 SUMMARY

This unit has dealt with the Nigeria financial system, the general meaning and features that enhance its efficient operation. The regulatory authorities were highlighted with the major objectives for their establishment that hinged on regulating the financial system. Some of the regulatory authorities discusses include the CBN, NDIC, SEC, FMF, NISB and FMBN.

In the next study unit, we shall consider the Nigerian money market.

6.0 TUTOR-MARKED ASSIGNMENTS

1. Define a financial system, highlighting its measurement indices.
2. The Nigeria financial system developed on the recommendations of the Dr. P.N.C Okigbo's committee in 1976. Discuss the level of achievement of these recommendations by the present day Nigerian financial system.
3. The CBN is at the apex of the regulatory authorities of the Nigerian financial system; discuss the reasons for regulating the system.

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UNIT 4 THE NIGERIAN MONEY MARKET

CONTENTS

1.0 INTRODUCTION

The place of money in the economy enables us to separate our decisions on how we want to make a going from how we want to live. This therefore enables us to separate our production decisions from consumption decision thus enabling us to improve and facilitate our transaction methods of exchange. Also, money, as seen in earlier units, functioning as a medium of debt transaction gives a time dimension to it. This function of money necessitates the establishment of financial markets, a market or facilities created by financial institutions for holding and transferring of funds from one economic unit to another. It is a market that is concerned with the flow of funds from savings – surplus to saving – deficit economic units. The organized financial market has two major outstanding segments – **the money market** and **the capital market** these are distinguishable mainly on the basis of the maturity structure of the instruments traded in them. While the money market forms the basis of the discussion of this unit capital market shall form the content of the subsequent one.

2.0 OBJECTIVES

By end of this unit, you would have been able to:

- Define and explain the reasons for establishment the of money market.
- Identify and explain the institutions that operate in the Nigerian money market
- Identify and explain the various types of instruments traded in the Nigerian Money Market.

- Explain the functions and role of the money market in a developing economy.

3.0 MAIN CONTENT

3.1 Development of the Nigerian Money Market

The money market is the financial market for short-term debt instruments that are close substitutes for money. It therefore provided facilities for the exchange of financial claims and obligations for materials, that very from one day to one calendar year. The importance of this market derives from the opportunities which it created for raising short-term funds and/or for investing such funds, thus serving those economic units that require money market facilities for the profitable investment of their temporary excess funds.

The need for local investment outlets became move imperative with the establishment of the CBN in 1959. This led to CBN setting in motion the necessary machinery for the establishment of the Nigerian money market. Consequently, in April, 1960, the CBN launched the CBN first Treasury Bills, a bill that was used for raising short-term finance for the government. This marked the birth of the Nigerian money Markey.

The reasons for the establishment of this market which stem for the consequences of its absence in the economy can be summarized thus:

(a) To check the outflow of surplus funds from the Nigerian economy unit investment outlets in the London financial markets.
(b) To Nigerianize the credit base.
(c) To enhance an effective monetary management
(d) To ensure management of commercial banks' portfolio of assets and liabilities.

The foregoing reveal that for the money market to operate effectively, the under listed conditions are obvious.

(i) The CBN should act as lenders of last resort to enable the banking sector operate at lower level of liquidity, thus making full use of available resources.

(ii) There must be an integrated structure of financial organization holding a variety of assets with differing liquidity level, and profitability. This will facilitate free movement of money and financial assets form surplus to deficit sectors of the economy. To prevent limited scope of operation, there must be large number of institutions in operation.

(iii) The regulatory bodies (CBN, etc) must formulate and implement a system of central and classification of market assets to inspire confidence in the system.

3.2 Composition and Institutions of the Nigerian Money Market

The Nigerian money market institutions constitute the hub of the financial system. They include the discount houses, merchant banks, low income and rural sector-targeted institutions like the then People's Bank of Nigeria and commercial banks which are special purpose banks and the parallel market.

While the discount houses and the banks, which are financial institutions, deal in bills of exchange by discounting them of less than their respective face values, the parallel money market is where there is horizontal transfer of credit to meet the "tailor –made" requirement of both lenders and borrowers.

It is important to note that the Central Bank of Nigeria (CBN) in collaboration with the Nigeria Deposit Insurance Corporation (NDIC) is the principal regulatory authority in the money market.

A discount house is a special non-bank financial institution which specializes in mobilizing funds from the surplus sectors of the economy for channelling into the deficit sectors. It achieves this by providing discounting or re-discounting facilities in government short-term securities. In the process of shifting from direct to indirect monetary control which place emphasis on OMO, discount house have been established to serve as financial intermediaries between the CBN, licensed banks and other financial institutions.

SELF-ASSESSMENT EXERCISE 1

Identify the institutions of the Nigerian money market.

3.3 Instruments in the Nigerian Money Market

The money market instruments introduced by the CBN provide the government with short-term funds in addition to providing financial institutions with opportunities for local investment of idle funds by trading in these short-term instruments. These instruments are highlighted hereunder:

(a) Treasury Bills (TB)

These are 91-day maturity short-term debt instrument introduced by the CBN first in 1960 to raise finances for the Federal Government weekly. The TB serves dual purposes for the government viz:

- As an source of short-term fund to cover temporary excess of state expenditure over income, and
- As an instrument of monetary policy of the CBN in the execution of OMO to mop up excess liquidity or the purchasing power in the economy.

(b) Call money (CM)

The CM was introduced in 1962 as a means used by the commercial banks and other participating financial institutions to keep their temporary surplus cash with the CBN. They are later invested in short-term money market instruments like TB. The CM earned interest at slightly less than TB.

(c) Commercial Bills/Trade Bills

These are instruments issued by commodity boards in respect of export produce. They are rediscounted by the CBN with most of the commercial banks participating as consortium. This bill which was introduced in 1962 crumbled in 1965 and finally abandoned in 1986 when the CBN took over financing of agricultural produce.

(d) Treasury Certificates (TC)

This was introduced in 1986 to file the gap created by the termination of commercial bills. They have one to two years tenure and are similar to TB's except in tenure, thus referred to sometimes as medium – term security instruments.

(e) Certificates of Deposit

These are inter-bank instruments with maturity dates ranging from 3 to 36 months. The certificates of deposits are mostly used by merchant banks to attract the surplus funds of commercial banks. They are two categories of certificates of deposit

* Negotiable Certificates of deposit issued for periods ranging from 3 months to 36 months, and
* Non- negotiable certificates of deposit issued for shorter periods ranging from 3 to 28 months.

(f) Bankers' Unit Fund

This was introduced in September, 1975 for banks and other financial institutions to invest part of their excess liquid resources. They were in multiples of ₦10, 000.00 while the CBN invests the pooled fund in government stocks. They are reparable on demand in whole or part and attract some interest which is dependence on the maturity period.

(g) Eligible Development Stocks (EDS)

These were government development stock with less than 3 years maturity period and used by the CBN to meet commercial bank's liquidity ratios requirements.

(h) Stabilization Securities

These introduced in 1976 were used by the CBN to mop up the excess liquidity of the banks. This is an effective monetary policy instrument which empowers the CBN to issue the securities and sell same by allocation to banks and other financial institutions that are compelled by law to take up such, failure leads to imposition of stiff penalties by the CBN.

SELF-ASSESSMENT EXERCISE 2

Identify and explain the instruments of the Nigerian money market.

3.4 Role of the Money Market in Economic Development

The money market which mirrors the economic health of a nation's economy is of great importance. Its activities which are influence by the country's reserves, balance of payments and the states of the economy generally serves the following functions in the economy.

1. Promotion of efficient allocation and utilization of funds by ensuring that no idle fund is in existence.
2. Helping in the indigenization of the credit base of the economy.
3. Helps the commercial banks to hold lower cash reserves through the operation of the call money scheme.
4. Provides an avenue for the implementation of the CBN monetary policy.
5. Acts as an important source of short-term borrowing to the government.
6. Provides opportunity for investment in fairly liquid and riskless assets in the economy.

7. Minimized cash holdings by banks by helping them invest their secondary line of reserves in earning assets.
8. Provides avenue for fund mobilization and allocation in the economy.
9. Its interest rates serve the CBN as a barometer to judge the shortages and surplus of funds in the system.
10. It promotes liquidity and safety of financial assets thereby encouraging saving demand investments.
11. Promotes equilibrium between demand and supply of loanable funds.
12. It helps in economizing the use of cash by dealing in near – money assets and not paper money.

SELF-ASSESSMENT EXERCISE 3

Identify the areas of contribution of the money market to the economic development of Nigeria.

4.0 CONCLUSION

The money market, one of the components of the financial market has been seen as the market for short-term securities. As a part of the financial market whose function is to make available idle funds in a surplus sector to deficit areas of the economy. By so doing, it links up investors and savers thus facilitating the transfer of these funds (short-term) for use in economic development. In this way, the money market has been seen as very important for rapid economic growth of a nation. Since the activities of the market are influenced by the nation's reserves, balance of payment and the state of the economy generally it could be deduced that the money market mirrors the economic health of the country.

5.0 SUMMARY

In this unit you have seen the meaning, features and development of the Nigerian Money Market. The reasons for its establishment and the conditions that will enhance its effective operation were also discussed. The operations of the market together with the various instruments traded were discussed too. Finally, the important roles the money markets play in an economy, especially a developing one concluded the discussion on this unit.

In the last study unit, we shall discuss the Nigerian capital market.

6.0 TUTOR-MARKED ASSIGNMENTS

1. What is a money market? Why was the Nigerian money market established?
2. Who are the operators of the Nigerian money market? Discuss the major role of at least two of such operators/institutions in the market.
3. What are money market instruments? Highlight at lest four of such instruments.

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UNIT 5 THE NIGERIAN CAPITAL MARKET

CONTENTS

1.0 INTRODUCTION

In our discussion in the previous units, we saw that the financial market is a place where individuals, institutions and instruments which make it possible for the deficit spending units of an economy use the surplus funds of surplus spending units. The Nigerian financial market is grouped into Money Market, Capital Market, Foreign Exchange Market and the Mortgage Market.

The Nigerian Money Market formed the crux of unit sixteen; this unit shall therefore be devoted to the Nigerian Capital Market.

2.0 OBJECTIVES

It is expected that at the end of this unit, you should be able to:

- Explain the meaning and reasons for the establishment of the Nigerian Capital Market.
- Identify the institutions in the market and the classes/segments of the markets
- The major instrument traded in the market
- The problems that impair the optimal output of the Nigerian Capital Market.

3.0 MAIN CONTENT

3.1 Development of the Nigerian Capital Market

One of the segments of the financial market is the capital market. The Nigerian Capital Market is a market for long term financial claims or obligations. It deals with long term funds and procedures for financing long term investments. Interactions in the market facilities the exchange of long term funds between savings- surplus and saving – deficit economic units. The capital market instruments have maturely periods of the years and above.

The development of the capital market in Nigeria has been induced and fostered by the government. Before the establishments of the stock exchange in Nigeria, there existed some less formal market arrangements for the issue of securities for sale and for their transfer. Government securities were floated in Nigeria as far back as 1946 but the basic institution for the operation of capital market was not provided until 1961 when the Lagos Stock Exchange commenced business as formal and specialist capital market institution.

Following Governments adoption of the recommendations of the Financial System Review Committee of 1976, the Nigerian Stock Exchange (NSE) was set up in 1977.

The capital market is classified into two segments, the **primary and the secondary segments.** While the primary market is market where stocks are issued for the first time to members of the public, the secondary market is same as the stock exchange market. It is a market for stocks which are not being sold for the first time is the primary market. It can be referred to as the market for second hand stocks, though without diminishing value. The mode of offer in the primary market includes offer for subscription, right issues, offer for sale and private placement.

SELF-ASSESSMENT EXERCISE 1

Differentiate between the primary segment and the secondary segment of the capital market.

3.2 Reasons for the Establishment of the Nigeria Capital Market

The reasons for the establishment of the capital market in Nigeria could be likened to the following:

a) The provision of local opportunities for borrowing and lending on long-term basis.
b) To enable the government mobilize funds for long-term economic development.
c) To provide both the foreign and local companies with the opportunities to offer their shares for the purpose of raising capital.
d) The provision of opportunities for quotation and marketing of corporate stocks and securities.
e) To introduce a code of conduct, check abuses and regulate activities of the participants in the capital market.

SELF-ASSESSMENT EXERCISE 2

Identify the reasons for the establishment of the Nigerian capital market.

3.3 Instruments of the Nigerian Capital Market

The major instruments used to raise funds in the capital market include equities, debentures, bonds and stocks. These are all long-term finance instruments which supplies investors with the opportunity to borrow and lend money on medium and long-term bases. Brief description of these instruments is given below:

i) Equity

This is a permanent source of capital for a business organization which confers ownerships right to the individual(s) through subscription to the shares of the company. There are two classes of equity viz – **Common/Ordinary shares and Preferred Share**. While common share holders' area not entitled to fixed earnings of the company, preferred shares holders have fixed rate of returns attached to them.

ii) Debentures

These are also long-term debt instruments issued by a limited liability company. They are thus long-term promissory notes issued by a borrower who agrees to pay a fixed rate of interest on a specified amount on loan for a specific period of time and to redeem the loan on a stated future date. They are thus unsecured bonds, backed up only by the credit standing of the company issuing it.

iii) Bond

A bond is like a debenture but secured by some kind of collateral. A bond is generally a promise by a borrower to reply the principal sum and interest to the lender at the expiration of the bond period. A bond issued by an individual is known as private bond while that issued by a company is known as corporate bond.

SELF-ASSESSMENT EXERCISE 3

Identify and explain the instruments of the Nigerian capital market.

3.4 Institutions of the Nigerian Capital Market

The institutions that operate in the Nigerian capital market can be categorized into two viz: **Mediators** and **Facilitators**.

The mediators or financial intermediaries are those institutions that obtain financial resources from a lender and supply them to a borrower. They thus allow serves with small amounts of capital to pool their funds in order to diversify across a large number of investments. They through their expertise in portfolio management and diversification provide a high return for the savers on their investment. These institutions include commercial banks, building/mortgage societies, insurance companies and pension funds.

On the other hand facilitators help in the process of issuing, sale, registration and orderly transfer of shares in the market. These include the merchant banks, development banks Stock Exchange, issuing houses and stock broking firms.

It could however be seen that the main institutions of the Nigerian Capital Market include the Securities and Exchange Commission (SEC) which is the apex and serves as the regulatory authority, the Nigerian stock Exchange (NSE) which provide a mechanism for mobilizing private and public savings and making such funds available for productive purposes of trading in existing securities, the issuing houses and the stock broking firms. The key institutions are SEC and NSE.

3.4.1 The Nigerian Securities And Exchange Commission (SEC)

This is the apex institution for the regulations and monitoring of the Nigerian capital market. The SEC superseded the Capital Issues Commission which itself superseded the ad hoc Capital Issue Commission in 1973. The establishment of SEC was however approved in 1977 and started operation in July 1977 with retrospective legislation – SEC Act of 27th September, 1979. This act was further strengthened by the SEC Decree of 1988 which made it the apex regulatory organ of the capital market whose major objective is the promotion of an orderly and active capital market. (The functions of the SEC had already been highlighted in Unit 15).

3.4.2 The Nigerian Stock Exchange (NSE)

A stock exchange is a market which facilities buying and selling of shares, stocks, bonds, debentures and other securities. It is essentially a secondary market for buying and selling of already existing securities, but some new issues may be traded in the Stock Exchange.

The NSE as earlier stated in section 3.1 above was set up in 1977 on the recommendations of the Financial System Review Committee. The NSE was charged with the major responsibility of providing a mechanism for mobilizing private and public savings and making such funds available for productive purposes.

The NSE in its bid in providing a means for trading in existing new securities, it encourages small and large-scale enterprises to gain access to the public listing. The NSE however operates the main Exchange for relatively large enterprises and the second-Tier securities market, where listing requirements are less stringent, for small and medium-scale enterprise.

The overall management of the exchange was vested in a single council and operates from their headquarters in Lagos with trading floors at Abuja, Ibadan, Port-Harcourt, Kano, Kaduna and Onitsha.

NSE has four categories of membership viz:

i) **The Foundation Members**: These initial members who signed the memorandum of association of the Exchange on 15th September, 1960 at incorporation;

ii) **The Council Members:** These are the policy making body of the exchange elected from the members;

iii) **Ordinary Membership**: This is a precondition to all other categories, open to all individuals and firms whose applications are acceptable to the council and

iv) **Dealing Members:** These are persons, firms or corporate bodies who in addition to being ordinary members are licensed by the council to trade in stock, shares and bonds, on the floor of the exchange. Since the NSE operates a double – capital system, dealing members, combine jobbing and brokerage functions. In their capacity as brokers, they act as agents for their clients, with license to buy and sell securities in the exchange. As jobbers, they do business in their own account.

The dealing members also act as advisers to institutional investors, paddling their clients through the intricacies of security transfer and registrations.

The transactions/dealings in the NSE take any of the following forms:

a) Direct issue or offer for subscription of securities;
b) Offer for sale;
c) Private placing, and
d) Right issues of Pre-emptive Rights.

3.4.3 The Issuing Houses

These include the Merchant banks and non-bank financial institutions that serve as advisers on new issues. They provide technical assistance to companies which desire to raise capital, undertaking to issue the securities and also assisting in the allotment of shares.

SELF-ASSESSMENT EXERCISE 4

Identify and explain the functions of the institutions of the Nigerian capital market.

3.5 Problems of Nigerian Capital Market

The capital market plays an important role in mobilizing savings and channelling same into productive investment for the development of commerce and industry in particular and the general economic growth in the country. Despite this important role of the market, its efficient operation for optimal output is impaired by a number of variables. These which are either indigenous or exogenous are highlighted below:

i) Government Policies: This is in area of income policy and the rigid interest rate structure.
ii) Over –regulation of the exchange rate by the regulatory authorities who assert much control on the capital market.
iii) Low savings Attitude: Accumulated funds for investment is lacking in Nigeria because of the low level of savings caused by low income of the people.
iv) Infrastructure problems: This includes the lack of reliable communication network, electronic data and reliable storage capacity from where reliable information on the market can be called upon when necessary. Also, the unreliable public power

supply constitutes a cog in the wheel of progress in the developments of the capital market.

v) The listing requirements in the market are rather severe and also the restrictive provisions for companies wishing to get listed in the market.

vi) Dearth of securities: When compared to those of the developed economies, the Instruments used in the market are limited; the number of quoted companies is very small same with the number of shares they offer to the market.

vii) Lack of Adequate Publicity/Awareness: The existence, functions and operations of the capital market has not been well publicised. Most people in the hinterland area yet to be very much aware of the services offered by the capital market.

viii) Retention Attitude of Investors: Most of the people who purchase securities buy them for keeps and not for trading in the market. This restricts activities in capital market.

SELF-ASSESSMENT EXERCISE 5

Identify and explain the problems of the Nigerian capital market.

4.0 CONCLUSION

The capital market which provides industries with fixed and working capital deals in stocks, debentures, bonds and securities of government. The market achieves this by working through the stock exchange – a market that facilitates buying and selling in the market. The capital market is related to the supply and demand or new capital. The difficulty encountered by some industries in raising capital for economic and productive activities are ameliorated by the proper operations of a well developed capita market. In this way the capital market encourages economic growth by facilitating the movement of streams of capital to be used more productively and profitably and these increases the national income.

5.0 SUMMARY

The unit has tried to discuss the Nigerian Capital Market, a segment of the Nigeria Financial System. The meaning, segments development and reasons for its establishment were discussed. The instruments traded in the market and the major participants/institutions of the market formed greater part of the unit. Some problems that hinder the attainment of optimal and efficient operation of the market were highlighted with a view that proper attention be given to them because of the important role the capital market plays in the Nigerian economy.

6.0 TUTOR-MARKED ASSIGNMENTS

1. What do you understand by capital market? Why is it important in the economy?
2. Explain the instruments and institutions of the Nigerian Capital Market.
3. The Nigerian capital market is faced with some operational problems, identify and discuss these problems.

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