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FACULTY OF MANAGEMENT SCIENCES

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UNIT 1 MONEY

CONTENTS

1.0 INTRODUCTION

In this unit, you will learn that the wealth of a community exists in the goods and services it produces and that money is merely a convenient way of measuring wealth. We must now investigate money more closely and determine what it does, and what problems it creates. Market economy or Money economy should be compared with the subsistence economy. Subsistence economy means that people consume what they have themselves produced and exchange nothing. In a market economy, exchange may take two forms: direct exchange (barter) or indirect exchange using money as a "means of payment" or "medium of exchange". It should be noted that barter involves such inconveniences at a comparatively early stage. In the development of an economy, we should expect a medium of exchange; money comes into use.

In every economic system, whether dominated by private interest as in capitalism or government interest as in communism and socialism, or mixed economy having a blend of capitalism and communism, money has very crucial roles to play. Its roles in the economy is pervasive, touching every aspect of the economy.

A special attention is given to money because the use of monetary policy as a stabilization tool by the government is based on the role of money in the economy. We cannot have a proper grasp of monetary theories and policies without first of all understanding money.

2.0 OBJECTIVES

It is hoped that by the end of this unit, you will be able to:

- define the meaning of money and its evolution.
- identify the various types of money and the functions that money performs in every economy.

3.0 MAIN CONTENT

3.1 Definition of Money?

Everybody who has reached the age of Kindergarten knows what money is. You possibly have touched money today. However, the term ‘money’ means different things to the ordinary man in the street. It is often used to describe wealth and financial resources, credit and income. When we say “the man has money or the man is in money”, we are referring to money as wealth or financial resources. It differs from the way an economist uses the term ‘money’.

Economists see money as anything that serves as a medium of exchange in a given society. Chandler and Goldfield (1997) defined money as “anything that is generally acceptable as a medium of exchange”. Amacher and Ulbrich (1986) defined it as “an item that people accept as payment for goods or services.” Cox (1983) defined it as “anything which passes freely from hand to hand and is generally acceptable in settlement of debt and other financial obligation is money.”Traditional view or view of the currency school and keynes defined money as " currency and demand deposits"($M = C + D$ where M - Money supply, C - Currency and D - Demand deposits). Friedman's empirical definition of money means "literally the number of cash people are carrying around in their pockets, the number of cash they have to their credit at banks in the form of demand deposits and commercial bank time deposits". Friedman's theoretical definition of money defines money as "any asset capable of serving as a temporary abode of purchasing power". His broader definition of money includes bank deposits, non - bank deposits and any other type of assets through which the monetary authority influences the future level of income, prices, employment or any other important macro variable (Here, money is expressed as $M2 = C + D + S + T$). The Radcliffe committee defined money as " note plus bank deposits". Gurley - Shaw definition regard a substantial volume of liquid assets held by financial intermediaries and the liabilities of non - bank intermediaries as close substitutes for money. Intermediaries provide substitute for money as a store of value. Money proper which is defined as equal to currency plus demand deposits is only one liquid asset. They have thus formulated a wider definition of money based upon liquidity which includes bonds, insurance reserves, pension funds, savings and loan shares. From these definitions, we have two things to note. The first is that whatever serves as money has to be generally acceptable in settling financial obligations. The second thing is that anything whatsoever can serve as money provided it is acceptable as money within a given community. The legal tender approach to defining money brings to fore the point that the law can help a commodity to achieve general acceptability.

3.2 Barter System

Trade by barter is the direct system and practice of exchanging goods and services for goods or services. The best way to understand the importance of money in any economy is to look at an economy that does not use money. When there is no generally accepted medium of exchange, individuals engage in barter. A barter economy is a moneyless economy. It is also a simple economy where people produce goods either for self - consumption or for exchange with other goods which they want. The problem or difficulties of Trade by Barter includes:

- The difficulty of double co-incidence of wants;
- It wastes time and energy, i.e. labourious and time-consuming;
- Lack of a common measure of value, i.e. ,difficulty in assessing the value of commodities using this model, $R = n\ (n - 1)/2$ where R and n denote respectively the total number of separate exchange ratios and the total number of commodities exchanged in the economy.
- The exchange always becomes uninteresting;
- It does not encourage deferred payments;
- It does not encourage the system of division of labour and specialization;
- There is no lending and borrowing;
- It discourages large-scale production.
- Difficulty in storing value;
- Indivisibility of certain goods;

STUDENTS ASSESSMENT EXERCISE

How did Trade by Barter encourage the introduction of money?

3.3 Types of Money

(i) Coins: They are metal money with definite amount.
(ii) Paper Money: It is in form of paper notes which originated from the receipts that the Goldsmiths issued to people.
(iii) Bank Money: It is deposit in both Savings Account, Current Account and Fixed Deposit Account.
(iv) Foreign Money: It is the money of other countries and it serves as money in the foreign exchange market.

(v) Legal Tender: It is money backed by the force of law in a country which is generally acceptable as a medium of exchange.
(vi) Gold Backed Money: It is money that can easily be converted or changed into gold by the central authority that issues money.
(vii) Commodity Money: It is commodity used as money in the olden days, e.g. cowries, shart teeth manilla etc.
(viii) Token Money: This is money whose intrinsic worth is less than its normal or face value.
(ix) Representative Money: It is a document or lieu of legal tender but not fully and freely acceptable
e.g. cheques, postal and money order bills, etc.
(x) Fiduciary Note Issue: This is the type of money that are not backed by either gold or any foreign currency.
(xi) **Standard money**: is money whose value as a commodity for non-monetary purposes is as great as its value as money.
(xii) **Subsidiary Money:** This type of money is to assist token money (coins) and are limited legal tender.
(xiii) **Credit money:** Credit money or bank money is money transferred by a commercial bank in the form of a cheque or draft.
(xiv) **Optional money or Non - Legal Tender:** This type of money does not possess any legal authority of the state or central bank. Such optional monies are time deposits, bonds, securities, debentures, bills of exchange, treasury bills, postal certificates, insurance policies, cheques and drafts.

3.4 Qualities of Money

This is also known as the characteristics of money.

(a) Homogeneity: Each unit of money must be homogenous, that is, each unit held by different individuals must be identical;
(b) General Acceptability: Each unit of money must be generally acceptable in exchange for goods and services purchased;
(c) Portability: Each money unit must be easily carried about. In other words, it must be easily transmissible;
(d) Divisibility: Money must be capable of being divided into small units;
(e) Recognisibility: Money must be easily recognizable by all and sundry in order to detect any counterfeit;
(f) Relative Scarcity: Money must be relatively scarce in order to maintain its value;
(g) Stability in Value: There should be absence of inflation and deflation to make money stable in value as well as enable it serve some useful functions such as the store of value and means of deferred payment;

(h) **Durability:** Money must possess durability quality. It should be storable and last long without losing its value over a period of time. i.e., money must be capable of staying long without spoiling or going bad.

3.5 Functions of Money

Money performs a number of primary, secondary, contingent and other functions which eliminate the difficulties of barter.
Primary functions:

(a) Money serves as a medium of exchange. With the introduction of money, goods and services are exchanged with money and thus exchange is facilitated. With money as a mean of exchange, the problems of barter are bye-passed.

(b) Money serves as a unit of account. All business transactions are accounted in oney units.
Whether it is payments, debts or costs, it is made in money units. This facilitates exchange or transactions.

(c) Money serves as a measure of value. With money, one can measure the quality or value of goods, services or different occupations.

Thus money is used to measure and compare the value of goods and services.

Secondary functions:

(a) Money serves as a standard for deferred payments - With the use of money, one can postpone or defer the payment for goods and services purchased. This function is important these days when business transactions are carried out mostly on credit basis.

(b) Money serves as a store of value. In-so-far as there is no inflation and deflation in the economy, money serves as a store of value since money would not lose its value any period it is kept.

(c) Money serve as a transfer of value: since money is a generally acceptable means of payment and acts as a store of value.

Contingent functions:
Money also performs certain contingent or incidental functions such as

(a) Money as the most liquid of all liquid assets - Money as the most liquid of all liquid assets in which wealth is held. Individuals and firms may hold wealth in infinitely varied forms.

(b) Basis for the credit system - Money is the basis of credit system. Business transactions are either in cash or on credit.

(c) Equaliser of marginal Utilities and productivities: Money acts as an equaliser of marginal utilities for the consumer. The main aim of a consumer is to maximise his satisfaction by spending a given sum of money on various goods. This happens when the ratios of the marginal utilities and prices of the various goods are equal.

(d) Measurement of National Income: It was not possible to measure the national income under the barter system.

Money helps in measuring national income. This is done when the various goods and services produced in a country are assessed in money terms.

(e) Distribution of National Income: Money also helps in the distribution of national income. Rewards of factors of production in the form of wages, rent, interest and profit are determined and paid in terms of money.

Other functions:

(a) Helpful in making Decisions: Money is a means of store of value and the consumer meets his daily requirements on the basis of money held by him. If the consumer has a scooter and in the near future he needs a car, he can buy a car by selling his scooter and money accumulated by him. In this way, money helps in taking decisions.

(b) Money as a basis of adjustment: to carry on trade in a proper manner, the adjustment between money market and capital market is done through money. Similarly, adjustments in foreign exchange are also made through money. Further, international payments of various types are also adjusted and made through money.

4.0 CONCLUSION

Money has a very crucial role to play in every economy. One good way to understand the importance of money to any society is to imagine a situation where there is no money in an economy. All the problems associated with the barter system will become very prominent in such economy.

In every economy, money performs four major functions. The first two can be classified as primary or basic function while the last two are secondary functions. They are said to be secondary because they are derived from the first two. Any commodity that can perform the primary function can automatically perform the secondary functions, but not all commodities that perform the secondary functions can perform the primary functions.

The primary functions of money are:

(a) Money as a medium of exchange.

(b) Money as a unit of value.

The secondary functions are:

(a) Money as a standard for deferred payment.
(b) Money as a store of value.

5.0 SUMMARY

In this unit, it is clear that money plays a vital role in the economic system of any country. Modern economic activity is based on specialisation and exchange. Money is a device for promoting specialisation and exchange. Specialisation and exchange would revert to the barter system of money that have ceased to exist. We are living in an economy based on money. Government development programmes as well as individual enterprise activities are calculated in terms of money as a unit of account. The existence of a unit of account permits the growth of a price system and this in turn promotes growth of markets. By serving as a medium of exchange, money facilitates the exchange of goods and services among specialists.

6.0 TUTOR-MARKED ASSIGNMENTS

(1) (a) In your own words, give a functional definition of money.
(b) Discuss the various types of money. Which of them is currently in use in Nigeria.
(2) What are the functions of money?
Describe clearly how money performs these functions.
(3) What are its main characteristics and major roles in the economy of a Nation.
(4) The inadequacies of Trade by Barter as an Exchange Mechanism gave birth to money. Name and explain these inadequacies.

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UNIT 2 DEMAND FOR MONEY

CONTENTS

1.0 INTRODUCTION

Money just like every other commodity has its own demand and supply. However, money has certain qualities, or characteristics, or attributes, which distinguishes it from other commodities. Money does not need to be converted to any other thing before it is used to pay for other goods and services. It is the most liquid of all commodities. Money confers to the holder a general purchasing power. Once you hold money, you can get other commodities. The most distinguishing feature of money is that it is a medium of exchange. It is generally accepted in settlement of financial obligations. Now, we know that money serves as a medium of exchange and a store of value. People, therefore, demand to hold money in order to utilise these services. Broadly speaking, there are three motives or reasons why people prefer to hold money instead of other assets. They are the Transactionary Motive, the Precautionary Motive and the Speculative Motive. This unit, therefore, presents a detailed discussion of the demand for money.

2.0 OBJECTIVES

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

- define the "Demand for Money".
- explain liquidity preference theory and the various reasons why people demand for money to hold as idle cash balances.

- explain Quantity Theory of money and the criticisms associated with it.

3.0 MAIN CONTENT

3.1 Demands for Money

Each individual or person tries to hold his wealth in any of two broad forms. It is either held as idle cash balances which yield no income or held as non-cash assets such as securities, houses, bags of rice, vehicles and other commodities. These other commodities yield some income, appreciate or depreciate in value over time. Wealth held as idle cash balances guarantees no income, instead it reduces in value during inflation. The decision to hold money as cash balances instead of spending it immediately in buying other assets is called the demand for money. Demand for money, therefore, refers to the total amount of money balances that people want to hold for certain purposes.

SELF ASSESSMENT EXERCISE

(i) Explain the term “Demand for Money”

Solution
Demand for money means the demand to hold money, that is, to keep one’s resources in liquid form instead of in some form of investment. OR it means the desire to hold money in liquid cash as against spending the money.

3.2 The Liquidity Preference Theory

If an individual decides to hold all his wealth in the form of other wealth-creating or financial assets, he faces the danger of illiquidity (that is, having no cash to settle his immediate illiquidity obligations). To avoid the danger of illiquidity, he may prefer to hold money instead of other assets. This is what Lord J. M. Keynes called Liquidity Preference. Liquidity Preference is the extent to which a person prefers to hold cash balances instead of parting with it or keeping his wealth as other assets. Keynes propounded the Liquidity Preference theory, which states that “the stock of money held by the public will vary inversely with the rate of interest (price of money).” The higher the return on income-yielding assets, the less likely it is that cash will be held (Leiter, 1968:55). There is a level to which interest rate will reach and people will no longer be willing to invest at all. This level is called the Liquidity trap level.

Apart from the level of income and rate of interest generated by other assets, there are other determinants of how much a person will be willing to hold as cash. These other factors include interval between pay days, general price level, level of expenditure, and availability of credit. These factors are, however, influenced by the level of income. Other factors such as a person’s attitude towards risks and expectations are equally influenced by the rate of return (or Interest Rate). When interest rates are high, more people will be willing to take risk.

SELF ASSESSMENT EXERCISE

i "The Demand for Money is a function of the rate of interest real income and the price level." Discuss.

3.3 Motives for Holding Money (DD for money)

Whoever is holding money is holding it to enable him get something else. Each person has his own reasons for holding money, and not because he wants to chew the paper called money. The demand for money is, therefore, said to be a derived demand.

Lord John Maynard Keynes who propounded the Keynesian theory identified three reasons that prompt people to hold money. These reasons are transactions, precautionary and speculative.

i Transactions Motive

The first reason people hold money balances is to enable them pay for their normal day-to-day transactions. People hold money as a medium of exchange. It is generally accepted by individuals and firms in payment for goods and services.

Keynes observed that the level of transaction undertaken by individuals and society as a whole has a stable relationship with the level of income. Keynes, therefore, confirmed that "the demand for money for transactionary purposes was proportional to the level of income". This means that the higher the income level, the larger the amount held for transaction purpose. The Monetarists led by Milton Friedman also agreed that "the demand for money will be proportional to the level of income for each individual and hence for the aggregate economy. Therefore, money is held for the purchase of goods and services because of the non-synchronisation of the periods of income receipts and their disbursements. This is determined directly by the level of income.

Given these factors, the transactions demand for money is a direct proportional and positive function of the level of income and is expressed as $L_t = kY$

Where L_t is the transactions demand for money, k is the proportion of income which is kept for transactions purposes, and Y is the income.

ii Precautionary Motive

The term “Precautionary Motives” refers to the desire to hold cash balances in order to meet expenditures which may arise due to unforeseen circumstances such as sickness and accidents. Uncertainties are a reality of life. We can never be quite certain what payments we have to make in the future. Lacking certainty we, therefore, arm ourselves with money against emergencies. Like the transaction motive, it is relatively interest-inelastic unless the rate of interest is really very high.

As the case of transactions motive, the amount of money an individual holds for precautionary purposes is also dependent on the level of Income. The higher the level of income, the more the amount held for precautionary purposes. Both Keynesians and monetarists agree on this point. But the post -Keynesian economists believe that like transactions demand, it is inversely related high interest rates. The transactions and precautionary demand for money will be unstable, particularly if the economy is not at full employment level and transactions are, therefore, less than the maximum, and are liable to fluctuate up and down. Since precautionary demand, like transactions demand is a function of income and interest rates, the demand for money for these two purposes is expressed in the single equation below:

$M_1 = L_1 (Y, r)$ where the amount held under these two motives (M_1) as a function (L_1) of the level of income (Y), and (r) is the interest rate.

iii Speculative Motive

The third reasons why people hold money is to enable them speculate on the possible outcome of business events. If people expect prices to fall in the near future, for instance, they can suspend further purchase now, and hold more money waiting to buy when prices will fall. In the same way, if people think that prices are relatively low now and expect prices to rise in the near future they will use their money to buy financial assets which they will sell later when prices will rise. The amount of money for speculative purpose is not based on the level of income. It is determined by what people expect to gain or to lose by holding other assets. This expected gain or loss depends on the interest rate.

Lord Keynes used movement in bond prices to illustrate the speculative motive for holding money and how this is influenced by interest rates. This is expressed in the equation below as:

$$V = R/r$$

Where V - is the current market value of a bond
R - is the annual return on the bond and
r - is the rate of return currently earned or the market rate of interest.

SELF ASSESSMENT EXERCISE

(iii) Discuss the motive for holding money?

Solution
Reasons or motive for demand for money includes

(i) Transaction Motive: The desire to keep or hold money for the day-to-day transactions;
(ii) The Precautionary Motive: Necessary in order to meet up with unforeseen circumstances or unexpected expenditure;
(iii) Speculative Motive: People also keep money with the hope of using such money kept in making quick money.

3.4 Determinants of Money Demand

Apart from the factors identified by Keynes, other factors were later identified by Professor Milton Friedman in his modern quantity Theory of Money. These include the price level, the rate of change of prices or inflation real permanent income or wealth and return on bonds and equities. Therefore, the determinants of money could be seen as

(a) Income
Demand for money varies directly with the level of income, that is, the higher the level of income, the higher the level of income, the higher the level of money demand.
(b) Interest Rate
Demand for money varies inversely with the interest rate.
(c) Price level
There is direct positive relationship between money demand and the price level.
(d) The Rate of Price Changes
Inflation rate varies inversely with money demand. This is a weak determinant of money.
(e) Real permanent Income
Real permanent income or wealth varies directly with money demand.
(f) Return on Bonds and Equities
The higher the return on bonds and equities the lower the demand for money.

3.5 Quantity Theory of Money

The classical quantity theory of money was developed by Irwin Fisher in 1911 and was generally accepted view until the 1930's about the relationship between the amount of

money in economy or circulation and the level of prices. It is a theory about how much money supply is needed to enable the economy to function.
The quantity theory took the view that money was used only as a medium of exchange to settle transactions involving the demand and supply for goods and services. The theory is based on the simple identity between total money spend and the price level in the economy. This is illustrated with an equation.

MV = PT
Where M - is the money supply
V - is the velocity of circulation i.e. the rate at which money changed hands in the society? P - is the Price level
T - rate of Transaction

Given the assumption that 'V' and 'T' are constant, the price level 'P' varies directly with the amount of change in money supply i.e. P = MV
T

3.6 Criticisms of Quantity Theory of Money

Today, no one accepts that the influence which money has on the economy can be explained in terms of a simple quantity theory. To a lesser or greater extent, they would question the three key assumptions necessary to convert the equation of exchange into a theory of the determination of prices. As we have seen, these three key assumptions were:

- the velocity of circulation of money is constant.
- the stock of money is an instrument which can be controlled.
- Say s Law (supply creates its own demand) will operate.

The validity of these three assumptions is critically on the grounds that

(a) prices cannot respond quickly to changes in money supply;
(b) an increase in the distribution of wealth might result from an increase in the money supply and price levels;
(c) if people expect price to rise, they might decide to hold more of their wealth in physical asset and less in money and so the velocity of circulation will fall;
(d) people must be fooled by inflation.

SELF ASSESSMENT EXERCISE

(iv) Examine the quantity theory of money.

Does it offer an adequate explanation of inflation?

4.0 CONCLUSION

Money is such an important asset in the asset market and this is why people choose to hold it. A person's decision about how much money to hold (his or her money demand) is part of a broader decision about how to allocate wealth among the various assets that are available. This analysis demonstrates that the price level in an economy is closely related to the amount of money in the economy.

5.0 SUMMARY

In this unit, we have succeeded in stating that The Demand for Money is the total amount of money that people choose to hold in their portfolios. The principal macro-economic variables that affect money demand are the price level, real income and interest rates. The Quantity Theory of Money is an early theory of money demand that assumes that velocity is constant, so that money demand is proportional to income.

The motive for holding money can be divided into three motives namely: Transactional motives, Precautionary motives and the Speculative Motives.

6.0 TUTOR-MARKED ASSIGNMENTS

Q1. Explain in details, the reason why an individual may decide to hold part of his money wealth as money balances pointing out the factors that can influence the amount he decides to hold.

Q2 (a) Explain the Liquidity Preference theory
(b) Define velocity. Discuss the role of velocity in the quantity theory of money.

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UNIT 3 SUPPLY OF MONEY

CONTENTS

1.0 INTRODUCTION

A type of financial asset that has long been believed to have special macro-economic significance is money. Money is the economist's term for assets that can be used in making payments such as cash and cheque accounts. One reason that money is important is that most prices are expressed in units of money used in the three markets in our model of the macro-economy. The three markets are the labour market, the goods market and the asset market. By asset market we mean the entire set of markets in which people buy and sell real and financial assets, money just like every other commodity or financial asset has its own demand and supply. In this unit, we shall consider the Supply of Money, in the asset market.

2.0 OBJECTIVES

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

- define the Supply of Money.
- evaluate the determinants of Money Supply.
- estimate the money stock.
- identify the problems associated with the definition of money supply.

3.0 MAIN CONTENT

3.1 Supply of Money

The supply of money in any economy at any particular period is the total sum of all money held by all members of the society. Generally, money supply is taken as the total amount of money in circulation at any given time e.g. notes and coins and demand deposits in commercial banks.

Afolabi (1991) explained “Supply of Money” as the amount of money which is available in an economy in sufficiently liquid and spendable form. “What constitutes the components of this supply of money depends on what has been officially accepted as the constitutes of Money Supply for that country”. Thus, each country’s money supply definition may be unique.

Ajayi and Ojo (1981) defined money supply in Nigeria as the total sum of currency outside the banks, demand deposit at Commercial Banks, domestic deposits with the Central Bank less Federal and State Government’s demand deposits with the Central Banks. They proved that the preponderance of the money supply in Nigeria consisted of currency outside banks and this probably still applies.

Bowden (1986:114) an American author simply defined it as the actual number of “spendable dollars” in existence. At first instance, his definition appears to refer only to the physical dollar in circulation. But notice that he put the “spendable dollars” in quotes. He used this term to include money created by the banking system such as demand deposits, which can be used to pay for debts by the issuance of cheques. Money supply is, therefore, the quantity of money available for spending at each point in time.

3.2 Determinants of Money Supply

It is normally assumed that the nominal money supply is exogenously determined i.e. it is supplied by the monetary authority or Central Bank. But the real money supply is endogenously determined since the price level variation cannot be fixed.

Ajayi and Ojo (1981) have also established that the following three economic factors determine the supply of money or the quantity of money in the economy.

(a) The behaviour of banks concerning the amount of reserves that they want to hold. This decision on reserves is a function of the profit maximising behaviour of banks and the expectation of the managers with respect to economic environment

(b) The behaviour of the non-bank public with respect to the way they divide their wealth or money holdings between cash and demand deposits (i.e. the proportion of total wealth that people want to hold in cash).

(c) The behaviour of the monetary authorities with regards to the decisions about the size of the monetary base, Legal reserve ratio, and the discount rate. (The monetary base is the currency in circulation plus all the assets that banks are allowed to count while computing their legal reserve ratio).

In determining the level of money through the exogenous factors, the government increases or reduces the supply in accordance with the desired economic target they want to achieve.

Ojo, M. O. (1993) puts it this way "a Monetary Control framework begins by establishing a link between the monetary control instruments and the ultimate target for output, growth, inflation and the balance of payments".

SELF ASSESSMENT EXERCISE

What are the determinants of money supply?

3.3 Money Stock Composition (Measuring Money)

Another important disagreement among economist is what to include or exclude in measuring the money stock. This disagreement, as Checkley P. (1980) explained arises because assets fulfill some of the functions of money but not all.

Focusing only on those assets that serve directly as a medium of exchange and are generally acceptable insetting financial obligations, we get the M definition of money stock. The M definition comprises currency 11 in circulation and demand deposits.
The monetarists led by Professor Milton Friedman of University of Chicago argue that savings and demand deposits should be included in money supply because they constitute "temporary abode of purchasing power". This definition of money stock as M plus savings and Time deposits is called M. This also agrees 12 with Keynesian interest sensitive demand for money.

These two definitions M and M were the only ones existing until 1970s. With new developments in the 12 banking system, two economists Gurley and Shaw quoted in Checkley (1980) argued that quasi-money should be included because they serve as good substitute for money. This led to M definition of money stock 3 as M plus deposits held in non-bank financial institutions. Money stock was later expanded to include invest-2 ments in government securities because they are easily cashable. This led to M definition of money as M 4 3 plus investment in government securities. In definition of money stock in Nigeria, the Central Bank of Nigeria focuses on M and M. 12

SELF ASSESSMENT EXERCISE

Examine the Composition of Money Stock.

3.4 Factors that affect Money Supply

The general belief is that the Central Bank of Nigeria issues notes and coins on behalf of the Federal Government, it must be the Central Bank that determines the stock of money supply, and this may not be entirely true.

Afolabi (1991) has given five factors that could affect money as follows:

(i) Monetary base or High Powered Money: The money supply will naturally increase if the Central Bank expands the monetary base. The monetary base or high powered money is the total of bank reserves plus currency in the hand of the public.

(ii) Credit Creation: When banks create credit, the credit will in turn lead to demand deposit and so on.

Supply of Money 15
The extent to which commercial banks are allowed to create credit will therefore affect the extent of money supply.

(iii) Portfolio behaviour of the Public: If most people keep their money in the bank, the banking system will have Liquid reserves to lend out and create derivative deposit which is the deposit created through lending. If the marginal propensity to hold currency increase, the Liquidity of commercial bank will go down and money supply will similarly fall.

(iv) Reaction policies of the Central Bank: Monetary policies of the CBN applied in reaction to the dictates of the economy will have effects on money supply.

(v) Foreign Exchange Transactions: Domestication of Foreign Exchange will have the tendency to increase domestic money supply.

Specifically, money supply is also influenced by the other following factors:

(a) Total reserves supplied by the Central Bank: If the total reserves supplied by the Central Bank are high, money supply will be high.

(b) Reserve Requirements: If the reserve requirement - percentage of commercial banks deposits legally required to be kept with the Central Bank is high money supply will be low.
(c) If the non-bank public increases its demand for time deposits, money supply will increase.
(d) Demand for Currency: If the non-bank public increases its demand for currency, money supply will increase.
(e) Demand for excused reserves: If commercial banks demand for excess reserves increases, money supply increases.
(f) Interest Rates: There is a positive relationship between money and interest rate. That is, the higher the interest rate the higher the money supply.
(g) The Bank Rate: If the rate at which commercial banks borrow from the Central Bank or discount bill rises, money supply falls.

SELF ASSESSMENT EXERCISE

Analyse the factors that affect money supply in the Nigerian Economy.

3.5 Problems in Defining Money Supply

There were difficulties with the monetarist thesis, neither of which was satisfactorily resolved.

First, in an advanced and more important an evolving-financial system, it was not possible to define the tock of Money in an unambiguous way, or at least there were a number of different but equally valid definitions of the money supply and there was no strong reason for choosing one in preference to any other. As we have seen, money can be defined either narrowly or broadly. However, there are or have been within the Nigerian institutional context a number of different definitions of the money supply. The definitions change frequently as does the popularity of one measure over another which partly illustrates the difficulty in trying to pin down the concept.

SELF ASSESSMENT EXERCISE

Examine the problems in defining money supply.

4.0 CONCLUSION

Money supply represents the total amount of money in the circulation of a given country. It comprises all those things which possess the characteristics of money. In Nigeria, money supply is broadly classified into two: (i) Narrow Money Supply (M_1) and (ii) Broad Money supply (M_2).

In Modern economics, the money supply is determined by the Central Bank such as Bank of England, Central Bank of Nigeria (CBN).

The terms ‘money supply and ‘money stock’ are used inter-changeably. The problem of defining money supply is still associated with a considerable degree of controversy.

5.0 SUMMARY

In this unit, we have tried to examine fully, the concept of money supply. In concluding our discussion of money supply, let us make few observations about the supply of money. First, is that, it affects the price level and hence other economic variables. The next observation is that, it expands as economics activities grow. Furthermore, as money stock increases, total spending increases. The money supply in an economy is influenced by internal and external factors.

6.0 TUTOR-MARKED ASSIGNMENTS

Q1 -What comprises the supply of money in Nigeria?
Pinpoint the problems in defining the money supply.

Q2 -Discuss the factors that help to determine the supply of money in Nigeria.

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UNIT 4 TYPES OF FINANCIAL INSTITUTIONS

CONTENTS

1.0 INTRODUCTION

In the last unit, we discussed exhaustively the supply of money and now we want to focus on the Financial Institutions that are responsible for the supply of money. The Financial Institutions operate and function in an economic system. In its ordinary usage, the word "System" can be used to refer to "a group of related parts working together". This is the sense in which it is used here - the financial institutions working together to provide the financial services required in an economy. The Nigerian Financial System comprises the banking system (all the banks) the non-bank financial institutions, the regulatory bodies, and other financial market participants, that play the role of financial intermediation in the Nigerian economy. The Central Bank of Nigeria Briefs (1996) defined a financial system as "a conglomerate of various institutions, markets, instruments, and operators that interact within an economy to provide financial services. Such services may in- clude resource mobilisation and allocation of financial intermediation and facilitation of foreign exchange transactions to enhance international trade.

2.0 OBJECTIVES

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

- define Financial Institutions fully.
- identify the various types of Financial Institutions.
- Explain the Financial Institutions into bank and non-bank financial institutions.

3.0 Definitions

3.1 Financial Institutions

Financial institutions are institutions which serve the purpose of channelling funds from lenders to borrowers. They hold money balance of, or borrow from individuals and other institutions, in order to make loan or other investments. Finance has to do with money. It is an organised system of managing money i.e. a system of lending and borrowing money.

A Financial Institution acts as an intermediary between those individuals or firms who wish to lend and those who wish to borrow. The existence of financial intermediaries reduces the risks by allowing specialist institutions to evaluate the credit worthiness of borrowers. The risk reduction may encourage lending and thus reduces the interest rate of most individuals and risk averters.

Institutionally, it is common to distinguish between banks and non-bank financial institutions. The importance of the former is that their liabilities enter the common definitions of the money supply. The liabilities of non-bank financial institution may enter some money supply definitions or they may be classed as "near money" depending on their liquidity. Examples of non-bank intermediaries/ institutions listed in terms of decreasing liquidity are: Building societies, Savings banks, Hire purchase, Insurance companies, Pension funds and Investment trusts

3.2 Types of Financial Institutions

Financial Institutions can be broadly classified into two: banks or bank financial institutions in the banking sector and non-bank financial institutions.

Commercial, Central, Merchant and Development banks are in the banking sector while Building Societies, Hire Purchase Companies, Insurance Companies, Pension Funds and Investment Trust are non-bank financial institutions.

While liabilities of banks form part of the money supply, the liabilities of non-bank financial institutions do not for they are referred to as "near money".

In Nigeria, the following types of financial institutions can be identified.

- Traditional Financial Institutions
- Commercial Banks
- Central Banks
- Development Banks

- Insurance Companies
- The Federal Savings Banks
- The People's Bank
- Community Banks
- Savings and Loan Associations
- Investment and Unit Trusts
- Credit and Cooperative Societies
- Pension Scheme (NPF), (NSITF)
- Financial Companies

SELF ASSESSMENT EXERCISE

List exhaustively the types of Financial Institutions in Nigeria.

3.3 Bank Financial Institutions

Structurally, the bank-financial institution is made up of:

Types of Financial lnstitutions

(a) The Supervisory and Regulatory Authorities: They comprise the Central Bank of Nigeria which is the Principal regulatory body, Federal Ministry of Finance. The Securities and Exchange Commission, Nigerian Deposit Insurance Corporation, Nigerian Insurance Supervisory Board (Now renamed National Insurance Commission) and to a lower extent the Federal Mortgage Bank and National Board for Community Banks. These Supervisory bodies are also referred to as monetary authorities.

(b) The Banking System (Banks): The banking system comprises all the banks that operate within the economy. This includes commercial banks, merchants banks, development banks and other specialised banks, such as the Community Banks and People's Bank of Nigeria. Apart from few development banks, all these banks collect deposits, and give out loans. They are key actors in performing the role of financial intermediation.

3.4 Non-Bank Financial Institutions

Apart from banks, there are other institutions that perform the role of financial intermediation. These other institutions are called non-bank financial institutions. At times, they are simply referred to as other financial institutions. These institutions include finance house, savings and loan institutions, insurance companies, the discount houses, Bureau de Change, Pension and other trust funds. There are also informal savings and loan associations like cooperative societies, ESUSU or Isusu groups known as "Ajo" and

Alashie in Hausa language. An Isusu group is an association of like-minded individuals who contribute a pre-determined amount of money which is given to each member of the group one after the other after each collection. The amount may be contributed on weekly or monthly basis.

4.0 CONCLUSION

Financial Institutions are establishments that issue financial obligations such as demand deposits in order to acquire funds from the public. The institutions then pool these funds and provide them in larger amounts to businesses, governments or individuals. Examples are commercial banks, insurance companies, savings and loan associations. In some countries, financial institutions are also known as “Financial Intermediaries”.

Financial Institutions can be classified into bank and non-bank Financial institutions. Bank Financial Institutions include the central banks, the commercial banks and the development banks. Non-bank financial institutions include discount houses, issuing houses, insurance companies, building societies and the stock exchange. These institutions operate in markets with instruments to acquire funds from the public for investment.

5.0 SUMMARY

What you have learned in this unit concerns the definitions/meanings of financial institutions and the various types of Financial Institutions grouped into bank and non-bank financial institutions. It has served to introduce the functions and control of financial institutions. The two units that follow shall build upon this introduction.

6.0 TUTOR-MARKED ASSIGNMENTS

Q1 What is a financial system? Discuss the various categories of institutions that make up the structure of The Nigerian Financial System.

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UNIT 5 FUNCTIONS OF FINANCIAL INSTITUTIONS

CONTENTS

1.0 INTRODUCTION

In the last unit, we have been able to compose and specify what financial institutions are. This will help to assemble the functions of the various financial institutions in this unit. Having defined what financial institutions are legally, the laws also establishes different types of financial institutions. The types of financial institution depends on the law establishing it and its functions. Depending on the stage of economic political and technological developments in a nation, each nation has the authority to grant licences to various types of financial institutions.

2.0 OBJECTIVES

It is hoped that by the end of this unit, you will be able to:

- identify the functions of banks financial institutions like CBN, Commercial Banks, Merchant Banks, and Development Banks,
- explain the functions of non-bank financial institutions like the insurance companies, Finance Companies, Primary Mortgage Institutions, NERFUND, Discount Houses, NSITF, etc., and
- defferenciate between the functions of specialised banks - Non-Conventional Banks.

3.0 MAIN CONTENT

3.1 Definitions

Financial institution is an institution either public or private that collects funds from the public or other institutions and invests them in financial assets.

3.2 Banks Financial Institutions

3.2.1 Central Bank of Nigeria

The Central Bank of Nigeria stands as the apex of the banking system. It licenses, supervises and regulates the banks within the banking system. It is owned by the Federal Government.

The CBN was established in 1959. It goes ahead to perform the following functions:

- Currency issue and circulation
- Promotion of monetary stability through the formation and implementation of government monetary policies.
- Acting as banker and financial adviser to the government.
- Encouragement of the growth and development of financial institutions.
- Supervision and regulation of banks and other financial institutions.
- Development of the money and capital markets through the creation of local government outlets.
- Helping in the clearing and collection of cheques by banks by providing the clearing house.

- Penalising of non-complying financial institutions to ensure compliance and help achieve government objectives.
- Undertake research and publications of a country
- Maintains close contact with other international financial institutions. The CBN safeguards the International value of the currency of the nation.
- The CBN mobilises capital resources for economic development.

Students Assessment Exercise
List the functions of Central Bank of Nigeria.

3.2.2 Commercial Banks

The Banks and other financial institutions Decree No 25 of 1991 defined a commercial bank as "any bank in Functions of Financial Institutions Nigeria whose business includes the acceptance of deposits withdrawable by cheques. This definition presents the major distinguishing functions of commercial banks from other banks. According to Osumbor (1984) in his book Business Finance and Banking in Nigeria, commercial banks are unique in their performance of services and are distinguished from other forms of financial institutions or intermediaries because of the following functions:

- Accept deposits from customers i.e. savings, current or demand deposit, fixed deposit or time deposit. Lend money to approved customers i.e. overdraft, loan.
- Allow the use of cheque
- Safe-keep valuable assets for customer.
- Provision of standing order facilities.
- Give business advice to their customers.
- Agents of government for monetary policy.
- Assists customers for acquisition and sales of shares.
- Issue of discount bills of exchange i.e. payment on behalf of customer. Commercial bank creates money, this is done through deposits.
  Money created = Original Deposits.
  Cash ratio or reserve requirements.
- They are involved in agricultural financing.
- They offer employment opportunities.
- They act as guarantors to their customers.
- They solve problem of foreign exchange.
- They issue traveller's cheques.
- Their activities accelerate the economic development of a nation since they act as intermediaries between large number of depositors and borrowers.
- These banks could assume the responsibility of carrying out the duties of attorney, executor and trustee.

SELF ASSESSMENT EXERCISE

Restate the Statutory functions of Commercial Banks.

3.2.3 Merchant Banks

According to the Nigerian Banking Amendment Decree (No. 88) of 1979, Merchant Bank means any person in Nigeria who is engaged in wholesale banking, medium and long-term financing equipment leasing, debt factoring, investment management issue and acceptance of bills and the management of unit trust. They are also called Acceptance Houses or Discount Houses.
Functions or services of merchant banks are often divided into two classes - banking and corporate finance services.

Banking Services / Functions:

- Acceptances of Merchant Banks (MB) accept bills of exchange from importers and exporters which are easily rediscountable.
- Loans and Advances - MB provides loans and advances of short, medium and long term nature.
- Deposits - MD accepts the following deposits- current account deposits for corporate clients, fixed-term deposits accounts for both corporate and non-corporate clients and Negotiable Certificates of Deposits.
- Equipment leasing - MDs lease equipment, machine, tools, motor vehicles to farmers and industrialists.
- Foreign Exchange Services: MBs as authorised dealers performing foreign exchange services: Corporate Finance Services.
- Project Financing: MBs finance the construction of new projects or ventures.
- Issuing House Services or Public Issue - MBs provide services to clients who want to raise money from the public through the offer for subscription of shares/ securities.
- Investment and financial advisory services.
- Portfolio management.
- Money Market Services.
- Help to finance international trade
- Debt factoring - Taking over the debts of a firm and thereafter provides her with the amount to finance the businesses.

STUDENTS ASSESSMENT EXERCISE

Compare functions of Merchant Banks with that of Commercial Banks.

3.2.4 Development Banks

Development banks are financial institutions which are set up to provide banking services that will help in the development of a particular sector or aspect of the economy. They are normally government owned institutions set up for the sole purpose of enhancing economic development rather than for profit motives. The major reason for the introduction of development banks is to bridge the gap in the provision of long-term finance for individuals. The existing Commercial and Merchant banks specialise in the provision of short term and medium-term finance because of their deposit structure. They could provide the much needed long-term finance. Another reason is the exigency of providing credit facilities to the priority sector of the economy. Other banks are reluctant to give such credit facilities because of the high-risk involved. Instances of such sectors are Agriculture, Commerce, Cooperatives, and small scale industries. This is what Professor G. O. Nwankwo (1980) called the "gap thesis" and "exigency thesis".

Currently, there are six development banks operating in Nigeria. Each is set up to perform specific developmental role as discussed below.

(1) The Nigerian Industrial Development Bank Limited (NIDB)
The bank which was established in 1964 has the main function of encouraging the establishment and growth of medium and large-scale industries in Nigeria. This is done through the provision of medium and long-term finance for the private and public sectors, promoting and development of projects and provision of financial, technical and managerial assistance to indigenous enterprises among other functions. It provides finance mainly for large scale industries but recently some small scale industries have benefited from NIDB loans.

(2) The Nigerian Bank for Commerce and Industry (NBCI)
The need to encourage the establishment and ownership of small scale industries and other business entures by indigenous Nigerian Investors after the promulgation of the Nigerian Enterprises Promulgation Decree of 1972 (also known as indigenisation Decree) led to the establishment of this bank in 1973. Its main functions were to assist indigenous business through share underwriting, identification of Functions of Financial Institutions viable projects, preparation of feasibility studies, offering of managerial and technical advice. It was therefore set up to provide the much needed capital for the implementation of the objectives of the Nigerian enterprises promotion. Thus, Nigerians were given ready sums of capital for the purchase of foreign business as provided for by the act.

(3) Nigerian Agricultural and Cooperative Bank (NACB)
As a step towards encouraging agricultural production, the NACB was established in 1973 mainly to provide the needed finance for agricultural development projects and allied industries including poultry, farming, pig-breeding, fisheries,

forestry and timber production, animal husbandry and any other type of Farming, as well as storage, and marketing of such production in Nigeria.

Its principal function is to promote agricultural assistance to interested individuals, Cooperative societies, companies and government agencies throughout Nigeria. It also offers technical assistance including advice and preparation of feasibility studies.

(4) Federal Mortgage Bank (FMB)

The Nigerian Building Society (NBS) was established in 1957 with the main aim of providing loanable funds to Nigerians who were keen on investing in real estate. The NBS later in 1977, under Decree No. 7 of the Federal Military Government of Nigeria, metamorphosed into what is today known as the Federal Mortgage Bank of Nigeria (FMBN). The Decree establishing FMBN assigned to it the responsibility of performing the following functions:

(i) The provision of long-term credit facilities to mortgage institutions in Nigerian at such rates and upon such terms as they may be determined by the Federal Government being rates and terms designed to enable the mortgage institutions to grant comparable credit facilities to Nigerian individuals desiring to acquire houses of their own.
(ii) The encouragement and promotion of mortgage institutional development at State and National levels.
(iii) The supervision and control of the activities of mortgage institutions in Nigeria in accordance with the policy directed by the Federal Government.
(iv) The provision of long-term credit facilities directly to Nigerian individuals at such rates and upon such terms as may be determined by the Board in accordance with the policy directed by the Federal Government.
(v) The provision of credit facilities with the approval of the Government, at competitive commercial rates of interest to commercial property developers, estate developers and developers of officers and other specialised types of buildings.
(vi) The Decree also allowed the banks to accept term deposits and savings from mortgage institutions trust funds, the post-office and private individuals as the board may determine and to promote the mobilisation of savings from the public.

(5) Urban Development Bank (UDB)

The Urban Development Bank was established by Decree 51 on 1992 mainly to take care of the problems of inadequate housing, transportation, electricity and water supply that have posed serious concern in most Nigerian Urban areas. The bank’s main function is to provide financial resources to both the public and private sectors of the economy for the development of urban dwellings, mass transportation and public utilities.

(6) Nigerian Export-Import Bank
The sharp decline in the prices of petroleum products in the international market during the late 1970s brought to fore the need to encourage non-oil export so as to ensure that Nigeria does not remain a mono-cultural economy. This and the need for financial import and exports generally led to the establishment of NEXIM in 1991. The bank is charged with the responsibility of helping the nation to attain increased export growth as well as a structured balance and diversification on the product composition and destination of Nigerian products. Its functions include the provision of export credit guarantee and export credit insurance functions, provisions of credit in support of support establishment and management of export funds and other related services.

STUDENTS ASSESSMENT EXERCISE

Examine the main functions of the various types of Development Banks.

3.3 Other Non-Banks Financial Institutions

3.3.1 Insurance Companies

Primarily, insurance companies provide against the various risks that often arise within the economy. They do these by spreading the losses to the unfortunate few over many people. In performing these functions, they collect premiums from several insured. This role is similar to the mobilisation of savings by banks in the sense that a large amount of money is pooled together as premium. The amount so collected by the government securities, public sector enterprises, and shares of private companies. By doing this, they have performed the role of financial intermediation, Insurance companies in turn insure the Nigerian reinsurance corporation which was established in 1977, and supervised by the Nigerian Insurance Supervisory Board (Okonkwo, 1998).
Functions/Roles of Insurance Companies

- Insurance companies provide the most effective method of handling many of the pure risks encountered by individuals and firms.
- Insurance companies facilitate risk transfer.
- They accumulate substantial funds which are used for long-term investment.
- Through their life and pension businesses they help to develop the financial markets
- They help to mobilise national resource by encouraging individuals to save.
- They operate pension scheme on behalf of companies.

- They grant loans to mortgages.
- They act as underwriters in the capital market.
- Insurance policies are used as collateral securities for bank loans.
- They help to improve the balance of payments position of the country by insuring imports and exports and through reinsurance, Marine Insurance facilities international trade.
- It promotes bilateral and multi lateral trade.
- Insurance gives the entrepreneur the confidence and provides him the security needed to venture into uncertain areas. It reduces the burden of losses of the entrepreneur.
- Information released by insurers on incidence of certain risks enable people to take more measures to avoid such loss.
- It provides employment opportunities to people.

3.3.2 Finance Companies

Finance Houses mobilise funds from the public mainly through the issuance of money market instruments like certificates of deposits, and other commercial papers. They provide these funds to investors in the form of short-term and medium-term finance such as local purchase order (LPO) financing, leasing, hire purchase, debt factorising and investment in securities. These assets being financed by them often act as a security for their lending.

These are sometimes referred to as Hire Purchase Companies.

3.3.3 Primary Mortgage Institutions

These are institutions involved in mortgage financing apart from the Federal Mortgage Bank. They are referred to as primary because they deal directly with individuals and firms, while the Federal Mortgage Bank serves as a supervisory body. These institutions are also involved in the financial intermediation process. They mobilise savings from savers and borrow from other institutions to finance the development of the housing sector.

A mortgage bank is a financial institution established for the acceptance of fixed deposits from members of the public with the aim of encouraging them to build their own house by offering them long-term loans. They are also known as building societies.
Functions of Mortgage Banks

- They accept fixed deposits from members of the public.
- They encourage members of the public to save money.

- The construct and provide houses to low group.

3.3.4 National Economic Reconstruction Fund (NERFUND)

As part of the economic reconstruction under the Structural Adjustment Programme, the NERFUND was established by Decree No. 25 of 1988. The primary aim of this fund is to provide soft Medium and Long-term finance to small and medium scale enterprises that are 100 per cent owned by Nigerians. As a financial intermediary, NERFUND sources its funds through the Federal Government, the Central Bank of Nigeria and Foreign Government, The Central Bank of Nigeria and Foreign Government and International Development Finance Institutions like the African Development Bank. The fund so mobilised both from local and foreign sources are made available to small and medium scale industries provided they are 100% Nigerian owned.

3.3.5 Traditional Financial Institutions

Traditional financial institutions are traditional credit groups such as “Esusu” which were originally the institutional agencies for credit supply to members and Esusu or Nsusu or Asuu. It is a kind of cooperative which consists of people who agree to contribute a certain sum of money and hand it over to a member of the group. They take the form of associations of people in the same place of work who mutually agree to come together in order to encourage one another to save, lend and manage money.

Functions of Traditional Financial Institutions

- They encourage their members to form the habit of saving money.
- They encourage their members to invest the money they have saved.
- They lend money to their members.
- They save their members the pains of going to banks to borrow.
- They inculcate the principles of democracy in their members.
- They discourage their members from being extravagant.

3.3.6 Discount Houses

Discount houses are institutions that specialise in the provision of discounting and discounting facilities, buying and selling of securities, especially government securities. They act as financial intermediaries. They also issue their own securities to banks as a mean of raising funds.

There are four Discount houses in Nigeria operating presently. Banks in need of funds approach them instead of going to discount their bills with the CBN.

3.3.7 Nigerian Social Insurance Trust Fund

The Nigeria Social Insurance Trust Fund (NSITF) was established in 1993 by Decree No 7. It replaced the National Provident Fund which was established in 1961. Its main function is to provide a more comprehensive social security scheme for Nigerian private sector employees. It raises funds through a compulsory contribution to the fund by private and public sector employees and employers. The funds so mobilised are used to provide pension benefits to contributors. But, before it is time to pay the contributions, these funds are invested by the fund managers or given out as loans. These investments, apart from serving as a source of credit to investors earn some dividends or interests which help to ensure that the contributor are paid more than their contributions.

Pensions are often the only form of savings for retirement which a person will make. They are a part of the remuneration of the employee, deferred until he has finished active work, to which he has right. Thus pension fund constitute another reliable source of funds for investment in commerce and industry and for financing the economy.

3.3.8 Thrift and Credit and Co-operative Societies

The main functions of Thrift, Credit and loans Cooperative societies are to raise investment finance. Members pay an agreed sum of money every month into a common fund. The members borrow at a certain interest rate. This type of Co-operative society is a savings club and is popular amongst traders, artisans and peasant farmers.

Functions:

- It is a valuable means of mobilising some capital for investment
- .Members obtains loans easily from their society and there is no requirement for collateral. The only condition required is an approved project plant for which the loan is required.
- Members form the habit of saving a little of their income, especially in the rural areas, where banking facilities are scarce.
- Exposure of monthly meetings and regular co-operative education means greater enlightment for members.

3.3.9 Investment and Unit Trusts

Many investment companies were established in Nigeria to complement the rapid industrial development efforts of both the Federal Government and the State/Regional Government. Most investment companies have common objectives bordering on developmental functions.

These companies mainly finance and complement Government efforts in developing industrial and commercial ventures in those states.

The function of investment and unit trusts is to raise collective capital from the public and to direct such funds into profitable investment channels. The two different types of organisation enable the small investors with limited capital to spread his risks over a wide range of securities under full time specialist management.

A unit trust on the other hand, is a method of investment whereby money subscribed by many people is pooled in a fund, the investment and management of which is subject to the legal provisions of a trust deed.

3.3.10 Savings and Loans Associations

These are said to be the best known non-bank intermediaries. These associations were originally organised to make mortgage loans to their own members, but they have increasingly emphasised theirs as savings institutions, catering to small investors and local governments and even state government.

The principal asset of these associations is conventional mortgage loans for family dwellers while their liabilities consist of depositors funds, principally from the government and share accounts savers. The associations normally in good time pay interest which is usually higher than that paid by commercial banks on their savings deposits. They are also allowed to issue large denomination of certificates of deposits.

STUDENTS ASSESSMENT EXERCISE

Assemble all the functions of Non-bank Finance Institutions.

3.4 Specialised Bank (Non-Conventional Banks)

3.4.1 People's Bank of Nigeria (PBN)

The People's Bank of Nigeria (PBN) was established in October, 1989 but was given Legal Status by Decree No. 22 of 1990. The Decree specified its functions as

(i) the provision of basic credit requirements of under-privileged who are involved in legitimate economic activities in both urban and rural areas and who cannot normally benefit from the service of the orthodox banking system due to their inability to provide collateral security.

(ii) the acceptance of savings from the same group of customers and making repayments of such saving together with any interest thereon after placing the money in bulk sums on short-term deposits with commercial and merchant banks.

People's Bank of Nigeria (PBN) is a non-conventional bank established to provide specialised services and grant credit facilities to the urban and rural poor masses who cannot satisfy the stringent collateral requirements normally demanded by conventional banks. Those served by the bank include the poor roadside hawkers, mechanics, vulcanizers, plumbers, electrician, food seller, truck pusher, hair dressers, dress makers, etc.

Therefore, from the foregoing, People's Bank of Nigeria has the following aims:
(a) Increasing investment and savings;
(b) Raising per capital income and PNG;
(c) Halting rural urban migration;
(d) Bridging the gap between the rich and the poor;
(e) Increase productivity, and
(f) Providing credit facilities to the disadvantaged classes who could not have ordinarily benefited from credit facilities in conventional banks.

3.4.2 Community Bank

The Bank and other Financial Institutions Decree 1991 defined a community bank as "a bank whose business is restricted to a specified geographical area in Nigeria. Operationally, it is also defined as a self sustaining bank owned and managed by a community or a group of communities to provide financial services to that community or communities. A community bank may be owned by Community Development Associations (CDAS), Cooperative Societies, farmers groups, clubs, trade groups and their similar groups or by indigenous businessmen or individuals within a community. Community Banks operate basically like commercial banks, except that they are prohibited from engaging in "sophisticated banking services" like foreign exchange transactions and export financing. Again, their operations are restricted to a specified geographical area like a unit bank. Thirdly, they are not members of the cleaning house. As such, their cheques are cleared through commercial banks.

Functions of Community Banks

- Accept various types of deposits including savings, time and target deposits from individuals, groups and other organisations.
- Issue redeemable debentures to interested parties to raise funds from members of the public.
- Receive money or collect proceeds of banking instruments on behalf of its customers.
- Provide ancillary banking services to its customers such as remittance of funds.
- Maintain and operate various types of accounts with or for other banks in Nigeria.

- Invest surplus funds of the bank in suitable instruments including placing such funds with other banks.
- Pay and receive interests as may be agreed between Community Banks and their clients in accordance with public policy.
- Provide credit to its customers, especially small and medium scale enterprises based in its area of operation.
- Operate equipment leasing facilities.

3.4.3 Federal Savings Bank

The Post Office Savings Bank established in 1889 was later rebaptised in 1974 to be known as the Federal Savings Bank (FSB). The FSB even though carries out certain commercial banking functions still has as its objectives, as was stipulated in its parent bank act - the Post-Office Savings Act, 1958, has the following:

(i) to provide a ready means for the deposit of savings, especially in the rural areas, and
(ii) to encourage thrift and the mobilisation of savings, also, especially in the rural areas.

These special savings scheme were at that time designed to mobilise funds for national development, especially at rural levels.

STUDENTS ASSESSMENT EXERCISE

Analyse the functions of Community Banks

4.0 CONCLUSION

The banks Financial Institutions is the most important component of the Nigerian Financial System. The same applies to other countries of the World. It is the heart of the Financial System. This is because apart from being the key operators in the Financial markets, monetary policies of the government are implemented through the banking system. Moreover, the banks Financial Institutions creates money, and by doing this, influences the economy of a country in no small measure. These are in addition to the traditional roles of savings mobilisation, and financial intermediation, and provision of settlement mechanism. Banks constitute the major source of credit to the economy.

The Bank Financial Institutions comprises all Banks that operate within the boundaries of Nigeria by whatever name they are called and their branches. These include the Central Bank of Nigeria, which stands at the apex of the system, commercial banks, merchants banks, development banks, community banks and the People’s Bank of Nigeria.

The non-bank financial institutions also known as other financial institutions are those institutions, apart from banks, that help to perform the role of financial intermediation. They collect funds from the surplus unit under various titles, and go ahead to make the funds available to the investors who have need for such funds.

Development banks are specialised in lending to different sectors of the economy depending on government priorities.

Insurance and Pension Schemes aim to return the money borrowed to the policy holder. Investment and Unit trusts buy shares and keep them for the benefit of the members.

For credit and co-operatives societies, they on-lend the money they get from their members to various other members for various purposes.

Finance companies use the money they get to lend to people wanting to buy capital goods over a period.

5.0 SUMMARY

In this unit, we have been able to compose all the functions of financial institutions of various types. There- fore, the institutions in the world has made possible, and of course, efficiently and effectively, a situation where the surplus money of savers could be mobilised to finance the worthy needs of reliable borrowers through these Financial Institutions discussed thus far.

6.0 TUTOR-MARKED ASSIGNMENTS (TMA)

Q1 Discuss the various roles that Commercial Banks play in the Nigerian Economy.
Q2 In which ways does a Merchant Bank differ from a commercial bank?
Q3 What reasons justify the establishment of Development Banks in Nigeria?
Q4 How many development banks do we have in Nigeria? Mention them and briefly discuss the major reasons for the establishment of each.
Q5 Discuss the difference between the People's Bank of Nigeria and Community Banks in terms of ownership, geographical spread and customers served.
Q6 Explain how the following institutions perform the role of the financial Intermediation.
- (a) Insurance Companies
- (b) Finance Companies
- (c) Discount Houses
- (d) NERFUND

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UNIT 6 THE CONTROL OF FINANCIAL INSTITUTIONS

CONTENTS

1.0 INTRODUCTION

In the last unit, we have examined fully the functions of financial institutions. Now we have to look at the control of financial institutions in this unit. To ensure that good standards are maintained by the various operators within the financial system to check any excesses of these operators, and ensure a well functioning and safety of the system, certain institutions are created by the Federal Government to regulate and oversee their activities. These institutions are the regulatory and supervisory authorities. The specific roles of these authorities will be discussed in this unit.

2.0 OBJECTIVES

At the end of this unit, we shall be able to:

- identify the regulatory and supervisory authorities of the various Financial Institutions.
- examine how Central Bank of Nigeria controls the various Financial Institutions.
- explain the importance of the Federal Ministry of Finance incorporated.
- explain the activities of the Securities and Exchange Commission (SEC).
- appreciate the role of the National Insurance Commission.
- explain the impact of the Federal Mortgage Bank of Nigeria.
- categorise the very essence of the National Board for Community Banks.

3.0 MAIN CONTENT

3.1 Central Bank of Nigeria

The Central Bank of Nigeria is the principal regulator and supervisor of the entire Nigerian Financial Institutions. The Central Bank of Nigeria stands at the apex of the banking system. It licenses, supervises and regulates the banks within the system in order to pursue an effective monetary policy and to control credit in the economy, the Central Bank uses the following weapons:

- Open Market Operations
- The Bank Rate
- Moral Suasion
- Special Directives

The CBN is charged with the responsibility for promoting a sound financial structure in Nigeria. To this end, the Bank acts as a banker to and supervisor of banks and other financial institutions by providing the following:

- Bankers' Clearance
- Banks' Examination
- Foreign Exchange Monitoring
- Prudential Guidelines
- Acts as lender of the last Resort
- Reserve Requirements
- Cash Reserve Requirement
- The stabilisation Securities
- Interest Rate Policy
- Capital Funds Adequacy

STUDENTS ASSESSMENT EXERCISE

How does the CBN Control the Financial Institutions?

3.2 The Nigerian Deposit Insurance Corporation (NDIC)

The NDIC was established by Decree No. 27 of 19 June 1988. Although it is a special type of insurance company, it complements the efforts of the Central Bank in the regulation and supervision of banks. Specifically, NDIC performs the following functions:

1. Provision of deposit insurance of related services for banks.

2. Examination of the books and affair of insured banks and other deposit taking institutions to ensure a healthy operation.
3. Identification and restructuring of acting banks to avoid bank failures.
4. Settlement of the depositors of failed banks up to a maximum indemnity of N50, 000. Deposits in excess of this amount are to be settled along with other creditors as part of the bank liquidation process in the event of bank failure.
5. Resolution of the problem of distress in the Nigerian Financial system.

In performing the above functions, the NDIC works hand-in-hand with the CBN. This regulatory body is meant to insure all deposit liabilities of licensed banks and other financial institutions.

STUDENTS ASSESSMENT EXERCISE

"It has been said that the existence of Nigeria Deposit Insurance Co-operation serves in itself to reduce the frequency of loss by depositors" Develop arguments to support this position and then examine the basic reasons behind the adoption of an insurance plan in Nigeria.

3.3 The Federal Ministry of Finance

This ministry acts as an agent of the government in the financial system. Its functions are:

(1) Advising the government on its monetary and fiscal operations after consultations with the Central Bank of Nigeria.
(2) Preparation of the Federal Government Budget and its break-down.
(3) Licensing of bureau de change. It was also involved in the licensing of banks until 1991 when it became the sole responsibility of the Central Bank of Nigeria.
(4) Carrying out related financial institutions as directed by the Presidency. Before the CBN was given more autonomy, the CBN was reporting to the Ministry of Finance.

3.4 The Securities and Exchange Commission (SEC)

This body is responsible for the regulation of capital market operations in Nigeria. It was established in 1979 by the SEC Act of 27 September 1979 to replace the capital issues Commission that existed before then. The SEC Decree of 1988 further strengthened its activities. Its functions among others are as follows:

- Promotion of an orderly and active Capital Market.
- Determination of the amount and timing of securities to be offered privately with intent to transfer them later.

- Registering and supervising stock exchange and branches stock brokers issuing houses investment advisers and other bodies involved in securities trading.
- Approval of companies to be listed in the capital market.
- Creating the necessary atmosphere for orderly growth and development of the capital market.
- Approval and regulation of mergers and acquisitions vide the companies and Allied matters Decree 1990.
- Issuance of guidelines on foreign investments, in the Nigerian Capital Market.
- Maintenance of Surveillance over the Capital Market.

STUDENTS ASSESSMENT EXERCISE

In Nigeria, apart from the CBN, the financial system consists of bank financial institutions and non-bank financial institutions. Name the institutions in these groups and discuss the differences between them as well as their importance to the society.

3.5 The National Insurance Commission

The National Insurance Commission (NIC) was established in 1997. This body which was established by the president in his 1997 annual budget speech took over the Supervision and control of the business of insurance in Nigeria from the National Insurance Supervisory Board which was established by the Insurance Special Supervision Fund (Amendment) Decree No. 62 of 1992. This commission is the apex institution in the insurance industry. However, it collaborates with the Central Bank of Nigeria in performing its (NIC) functions. Prior to 1992, the insurance department of the Federal Ministry of Finance carried out the supervision of insurance companies and their operations.

The functions of the Nigerian Insurance Commission include among other things:

(a) The supervision and control of insurance business in Nigeria.
(b) Settings of standards for the conduct of insurance business.
(c) Establishment of a bureau to receive and resolve public complaints against insurance companies and intermediaries.
(d) Consideration and approval of insurance premium rites applicable to various classes of insurance.

Now that the distress syndrome is affecting the insurance industry, this commission is expected to be involved in the resolution of distress in the industry.

3.6 The Federal Mortgage Bank of Nigeria

To help tackle the problem of housing which has been an issue of serious concern in most Nigeria cities, the Federal Mortgage Bank was established by Decree No. 7 of 1997. This new body took over the assets and liabilities of the Nigerian Building Society which was established in 1956. From inception, the bank has been functioning as one of the development banks. It provided both finance and advisory services in the area of housing. The regulatory and supervisory role of this institution became prominent from 1991. To help imple- menting the National Housing policy which was adopted in 1990 by the government, Decree No. 3 of 1991 gave more powers to the Federal Mortgage Bank of Nigeria to act as the apex Mortgage institution in Nigeria.

Furthermore, in 1993, the finance functions of this institution were transferred to a new institution known as Federal Mortgage Finance Limited which was carved out of the bank. This is to enable the bank concentrate on its regulatory role.

In this new position, the functions of the bank include:

- The Licensing supervision and regulation of primary Mortgage Institutions.
- Management of the National Housing Fund.
- Acting as a banker and adviser to other mortgage finance institutions who retail functions to individuals, organisations and estate developers.
- Carrying out researches aimed at improving housing patterns and standards in both urban and rural areas.
- Encouragement and promotion of the development of mortgage institution at states and national levels and provision of long-term finance for them (Ugwuanyi 1997).

3.7 The National Board for Community Banks

Following the introduction of a new set of self-sustaining banks called Community Banks in 1990, the National Board for Community Banks was established to serve as an apex institution for Community Banks. Like other supervisory bodies, its roles are performed in collaboration with the Central Bank of Nigeria. Specifically, the functions of the Board are:

(i) To receive and process application for the establishment for Community Banks and issuance of provisional license to Community Banks before their formal licensing by the Central Bank of Nigeria.
(ii) To supervise and control the activities of Community Banks, provide them with long-term finance and set standards to ensure the safety of Community Banks

STUDENTS ASSESSMENT EXERCISE

(i) What is a Community Bank?
(ii) What are the aims and objectives of Community Bank in Nigeria?
(iii) Propose some operational strategies for Community Bank in Nigeria.

4.0 CONCLUSION

A Central Bank is the government's representatives in the financial system. It has a very close association with both the government and the financial sector of any Nigerian economy, advising the government on monetary policies and implementing the policies on behalf of the government. A Central Bank helps to control the Commercial Banks, Merchant Banks, Development Banks, Community Banks, Peoples' Bank, Finance Companies, Insurance Companies, etc. The effective implementation of regulatory measures will likely give earlier warning about the potential problems of Financial Institutions and hence provide financial regulations with more time to prevent failures.

5.0 SUMMARY

In this unit, we have succeeded in focusing exhaustively on the controls of Financial Institutions. This is very necessary for greater efficiency and effectiveness of the Financial Institutions.

6.0 TUTOR-MARKED ASSIGNMENTS

Q.1 Certain institutions are created by the Government to ensure that good standards are maintained by the various operators within the Nigerian Financial System. Mention these institutions and briefly discuss how they maintain such standards.

Q.2 As a supervisor in the Nigerian Financial System, what are the roles of the Nigerian Deposit Insurance Corporation (NDIC) and the Federal Ministry of Finance?

Q.3 (a) what led to the establishment of National Board for Community Board?
(b) Discuss the role of the National Insurance Commission.

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UNIT 7 INFLATION

CONTENTS

1.0 INTRODUCTION

In the last unit, we examined the control of financial institutions and the consequent role that the various supervisory and regulatory authorities play in the determination of money supply. In this unit, we shall review inflation.

The economic spectre of the Nigerian Inter Civil War period was the demoralising level of unemployment. The implementation of economic policies following the war allowed over 30 years of unemployment problems. The worry of unemployment has given way to a concern over inflation, the condition of generally rising prices and the bulk of post-war Nigerian economic policies may be seen as a continuing fight to restrain price increases and the distortions created by them.

In a very general sort of way, inflation simply means rising prices. Although prices do not always change together, the interdependence of different parts of the economy does tend to punch up all prices together. The main purpose of this chapter is to examine some of the causes/theories of inflation and to see if they are applicable in Nigerian situation. In earlier units, the causes of inflation have already been considered implicitly. Firstly, an excess of aggregate demand over aggregate supply when output cannot increase will cause a rise in prices. This sort of inflation is called "demand inflation" (sometimes also demand-pull-for some obvious reasons). For these reasons inflation is usually an important element in an excess demand situation. The second type of inflation already considered is what might be called “monetary inflation”, that is rising prices caused by increases in the money supply.

2.0 OBJECTIVES

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

- define inflation.
- itemize the types of inflation.
- explain the causes of inflation in Nigeria.
- explain the effects of inflation.
- identify the various ways of controlling inflation.

3.0 MAIN CONTENT

3.1 Meaning/Definitions of Inflation

Inflation has become a household word in Nigeria. It is no longer a strange economic jargon to any student. There is hardly any Nigerian citizen who does not worry about rising prices and the high cost of living.

In the ordinary sense, inflation is seen as an increase in the average level of prices. In economics, it is defined as a condition in which supply persistently fails to keep pace with the expansion of demand. It is a state of disequilibrium in which too much money is chasing too few goods.

The literature is full of plethora of definitions of inflation. Selow (1979) for instance, see inflation as going on when one needs more and more money to buy some representative bundle of goods and services or a sustained fall in the purchasing power of money. As Johnson (1972) notes, and for most purposes, inflation is generally and conveniently defined as a sustained rising trend in the general price level.

Inflation is a period of general increases in the price of goods and services in an economy. Inflation can be measured using the following methods.

(a) Consumer Price Index - It measures inflation at the price where goods are consumed.
(b) Wholesale Price Index - In this, inflation is measured at the wholesale stage.
(c) Gross Development Product Deflator - More often this is used to measure variations in the computation of economic activity in developing countries.

None of these indices will give an unbiased result because at any point in time, there is a new product being introduced in the economy.

STUDENTS ASSESSMENT EXERCISE

What is Inflation? or Define the term "Inflation".

3.2 Types of Inflation

(a) Demand-Pull Inflation: This is induced by excessive demand not matched with increase in supply.

Here, too much money is chasing too few goods. Give a fixed stock of goods, any increase in demand brought about by increase in people's disposable income will force prices up in the market. This was the situation during the Biafran-Nigerian War and after the Udoji Salary Awards in 1974 when wages extensively increased. Higher wages increased the purchasing power of consumers thus leading to increased demand. The pressure on commodities therefore led to increase in their prices.

(b) Cost-Push Inflation: This is induced by rising cost of production, particularly rising wages. If we take the four factor rewards/wages, profit, interest and rent, we would note that only wages could be influenced considerably by human factors. The trade union could be very vocal and militant and this may lead to increase in wages without corresponding increase in productivity. This wage-price spiral inflation is such that the increase in wage, which is a production cost will lead to price rise and the price rise is another argument by labour unions for higher wages and therefore, higher prices will once again set in and so on. The problem is more pronounced when such wage increase is well anticipated by sellers such that prices may actually rise in anticipation of pay rise. In fact, the cycle continues and prices continue to rise, hence the name wage-price spiral.

(c) Hyper-Inflation: This occurs when the level rises at a very rapid rate. In this case, money loses its function as a store of value and its medium of exchange function may be affected if people are unwilling to receive it, preferring trade by barter. This was the situation in Germany after World War II in 1945 when people preferred cigarette to money.

The main cause of hyper-inflation is an enormous expansion of the money supply.

STUDENTS ASSESSMENT EXERCISE

(i) Distinguish between the various kinds of inflation relating yours to the Nigerian Economy.
(ii) "Trade Union causes Inflation". Comment.

3.2.1 IMPORTED INFLATION

If a country depends so much on imports, inflation in the exporting country will readily be transmitted to the importing country. Let us assume that Nigeria imports commodity X from Britain and at the same time produces some small but inadequate quantity of that commodity X. If there is inflation in Britain and assuming that commodity X must be imported because it is essential and from Britain, the importation will be at the inflated price and this will force domestic prices upwards because the imported ones would have to be sold side by side with their local counter parts and the high price will be transmitted especially if there are no differences in quality or preference.

3.3 Causes of Inflation in Nigeria

Generally, the following could be said to be the causes of inflation.

(1) Excessive Money Supply: Excessive money supply through poor monetary policy or other methods invariably lead to inflation in Nigeria, the 1974 Udoji Salary Award and the 1981 Minimum Wage Act injected a lot of money in the economy thus causing inflation. Expansionary monetary policy is also a contributory factor.

(2) Fall in the Supply of Goods and Services: Agriculture is virtually abandoned in Nigeria. It is only left to the aged in the remote villages who practice subsistent farming using out-dated or archaic methods. This shortage of commodities has been one of the most influential causes of inflation in Nigeria today. Rising wages also increase production costs. This, thus, leads to decreased supply of commodities thereby causing rise in prices.

There were marked shortages in the supply of essential commodities. This became particularly notice-able when the country could not obtain necessary foreign exchange to pay for the expanding imports.

Thus, the prices of few commodities that found their ways into the country and those produced locally were soaring.

(3) Budget Deficits or Government Expenditure Programme: Almost all the governments of West African countries have been experiencing budget deficits since the 1970s. There is also enormous increase in government expenditure on development programme and other capital projects or expenditures. These have contributed greatly to inflationary trends.

(4) Imported Inflation: Almost all our manufactured goods in Nigeria are imported from the advanced nations of the world who are currently experiencing inflation. This means a direct importation of these higher prices to West African nations. Importation of goods from countries suffering from inflation could lead to imported inflation into the country which also increase domestic price.

(5) Rural-Urban Drift/Migration: The mass drift to urban areas has left the Agricultural sector unattended to. Moreover, the little goods and services in the urban areas are grossly inadequate hence inflation results.

(6) Increase in population Explosion: There is enormous increase in the population of West African nations in particular and the whole world in general. For Nigeria, her estimated population increased from about 55m in 1963 to more than 88.5m in 1991. The situation is worsened by the fact that majority of the population are children who fall under the unproductive sector of the society. They are, therefore, dependent on the working population hence they put pressure on the little goods and services available.

(7) Activities of Middlemen and Monopolistic Tendencies: There are too many middlemen in the chain of distribution of goods and services in Nigeria. These people are very exploitative hence they hoard available goods in order to sell at higher prices in “Black Markets”. Many others who have the influence from government quarters monopolise the supply of certain essential commodities thereby charging higher prices than hitherto or what ought to be. Therefore, large scale hoarding in the hands of the major and minor distribution, particularly the lucky few that had access to import license contributed in a very large way to the severity of inflation in Nigeria.

(8) Excessive Demand by Consumers: Increase in the purchasing power of consumers leads to higher demands and thus inflation. This is the case in Nigeria due to higher wages resulting from frequent upward salary adjustments and revisions.

The inflation we have in Nigeria can be rightly described as demand-pull because there has been an upward trend in demand for goods and services for the past thirty years which may be the result of a rising standard of living of many Nigerians. The oil boom further increased and aggregated demand with no corresponding increase in supply most especially essential goods and food stuffs, hence persistent rise in their prices.

(9) Higher Production Costs: Higher wages, as is the case in Nigeria are higher costs of production.

They may hinder increased productivity, thereby resulting to inflation or the higher production costs are passed onto consumers in the form of higher prices on commodities.

(10) War-Caused Inflation: During wars like Nigerian/Biafran War, efforts were directed to production of war equipment or armaments. Labour which could have produced foods was deployed to the war fronts. Hence, demand could not equate supply. Inflation therefore resulted.

(11) Wage Increase Unrelated to Production: Since there have been general wage increases, the most notorious was the Udoji wage review reports, the implementation of which almost troubled the wage levels of most of the working groups. The most recent of this wage increase in the country is the SAP relief and 45% wage increase. These wage increases were unrelated to increases in productivity of workers. Hence high wages means high prices.

(12) Bad Management of Resources: The large-scale fraud and corruption which has started since the oil boom era of early 1970s has been increasing the tempo of inflation in Nigeria. Contracts most of which were not executed, were unbelievably inflated. Large sum of money were siphoned into private pockets, some particular individuals become richer than the states. Thus, money lost its traditional value. In pursuit of Naira, most people abandoned productive employment to become sales agents, contractors, importers and exporters. The effects of all these were the disappearance of many essential and other goods from the Nigerian Market, coupled with usually rising prices.

STUDENTS ASSESSMENT EXERCISE

(i) To what extent is it possible to regard inflation as a purely monetary phenomenon?
(ii) Examine the quantity theory of money. Does it offer an adequate explanation of inflation?

3.4 Effects of Inflation (Problems)

(i) Distributive Injustice: Inflation imposes a lot of distributive injustice on the society by re-distributing income in favour of one group to the disadvantage of the other groups. Examples are discussed below:

(a) People on fixed income suffer: Such people like pensioners, fixed salary earners etc, because there is no in-built flexibility in their income to make their income adjust in line with the continuous rise in the prices of goods and services they buy. Thus the quantity of good and services that their money income can buy will be diminishing progressively until they succeed in improving their lot through bargaining for higher wages. On the other hand, those whose income is flexible will benefit from inflation because they can always increase their income ahead of price increase. Business men and other profit earners thus benefit from inflation

(b) Inflation imposes adverse effects on savings: This is because real value of savings cannot be maintained. By discouraging savings, inflation could be perpetuated because people will want to keep their wealth in real assets as opposed to money. The Central Bank can, however, maintain the real level of savings by adjusting interest rates but this will be an extra cost to the economy.

(c) Inflation Reverses the Position of Debtors and Creditors: Debtors gain while creditor loses. The only way which the creditor could be saved is by imposing an interest rate which should reflect the inflation rate; otherwise he will get cheap money back for dear money lent out.

(ii) Loss of Confidence in Money: At the extreme case of Hyper-inflation, there would be economic depression such that business men may not know what to charge for their products like the 1930s inflation in Germany when a packet of cigarette sold for millions of German marks and buyers too will not know what to pay. In such severe cases, money virtually becomes worthless. Suppliers of productive factors want to be paid in kind and not in cash, and creditors will keep away from debtors as they do not want to obtain such cheap money from debtors. Money will be deprived of its functions as an exchange medium and as a standard for deferred payment. We have seen above that because of inflation, savings will fall thus money will cease to be a store of value. As a measure of value or unit of account, money will also fail because the instability of its own value will make it difficult for it to measure other values. With all these developments, money will become virtually useless and this may bring a tendency for the society to go back to barter exchange and subsistent production.

(iii) Expectation Effects: As a buyer, if I expect that price will rise tomorrow, I will want to buy today so as to avoid paying higher price tomorrow whereas as a seller, I would wish to withhold stock until the price rises tomorrow.

A situation of scarcity will, therefore, arise today and the current high demand will create inflation today. This makes economist believe that "inflation will occur if people expect it to occur".

(iv) Wrong Investment Priorities: Inflation will precipitate wrong investment because it is only those items whose prices are rising that people will concentrate production upon whereas they may not be actually important. It follows in real life that ostentatious goods and such goods like beer will attract more attention than essential items like agricultural products.

(v) Inefficiency and Poor Quality: In an inflationary period, goods will no longer be of the required standard because of the haste to make profit. Emergency contractors and innumerable unskilled people will go into contract jobs and such jobs as distributorship, increasing distribution cost which is an aid of inflation.

(vi) Distortion of Government Development Plans: the costs of major investments are disturbed by inflation such that government development plans are severely distorted. This may lead to re-appraisal and deficit financing and some projects might be dropped out of the plan for reason of prohibitive cost.

During inflation, new plans become difficult to formulate because the planner will not know the prices to use.

(vii) Distortions in Accounting Reports

(viii) Balance of Payment Effect: Because domestic prices are higher, home made goods would become more expensive relative to those in other countries. The country, therefore, becomes a dumping ground for foreign goods, a good place to sell but a bad place to buy from and this will have significant impact on foreign exchange earnings and on the balance of payment situation.

STUDENTS ASSESSMENT EXERCISE

(i) Consider carefully the economic effects of inflation.
(ii) "Those who cause inflation are rarely those who suffer its effect" Comment.
(iii) What is inflation and what are its causes?
(iv) Describe three different types of inflation you know.

3.5 MEASURES TO CONTROL INFLATION

Monetary measures	**Fiscal measure**
1. Bank rate (rate extended to commercial banks).	1. Reduction in expenditure.
2. Open market operations.	2. Increase in taxes
3. Legal Reserve ratio.	Increase in saving
4. Legal reserve ratio shows the proportion of liquid assets to deposit liabilities that must be maintained by banks), liquid assets include bank notes, coins, treasury bills, treasury certificates, certificates of deposits approved by CBN, inland bills of exchange, stocks issued by FGN.	4. Surplus budget
5. Special deposits	5. Public debt (stop repayment)

6 Stabilization security	
7. Selective control (Directives)	

Elective credit controls consist of;

- Credit ceiling
- Sectoral allocation of credit
- Interest rate ceiling
- Indigenization of credit
- Loans to rural borrowers
- Grace period on Loans
- Small scale industry credit.

3.5.1 General Ways of Controlling Inflation in Nigeria

(1) Price Control Measure: This involves the setting up of Price Control Board by the government which fixes maximum prices charged for certain commodities experiencing inflation. Experience, however, has shown that this system bedeviled with a myriad of problems does not work. The Nigerian case is typical example. What usually results are hoarding, profiteering and black-marketing, thus negating the initial aims.

(2) Wage Control or Wage Freeze: Most of governments place freezes on wage increases as a measure to combat inflation but this policy does not work or is ineffective since workers have deviced methods of making the government or employers of labour dance to their tune. These ways include go-slow, work-to-rule, industrial actions, etc. These are most often used in democratic nations/ societies.

(3) Monetary Policy: This involves the use of traditional monetary instruments to reduce the quantity of money in circulation. These include increase in the Bank or Discount Rate, increase in the Liquidity ratio, use of open market operation - contractionary monetary policy in this case, sectoral allocation or special directives, etc., however, the experience in the developing world has shown that these traditional instruments of monetary policy have a lot of deficiencies hence their effectiveness.

(4) Fiscal Policy: A combination of increase in personal income tax and reduction in government expenditure may prove effective especially when inflation is demand-pull in nature. These reduce the purchasing power of consumers thus reducing demand and prices of commodities.

(5) Total Ban on the importation of certain items: Especially when inflation is imported, the government is strongly tempted to place total ban on the importation

of certain non-essential items. However, retaliation by other nations and political pressure lead to the lifting of the ban no sooner than it was placed hence the ineffectiveness of such a policy.

(6) Increase in the Production of Goods and Services: Increase in the production of goods and services are the most effective measure to inflation. Increase in the supply of products will naturally force prices down. In Nigeria, concrete efforts should be made to increase production of essential but scarce commodities.

(7) Over-hauling of the entire Distribution Network: Only genuine distributors should be appointed and any one found hoarding and profiteering should be prosecuted to serve as a deterrent to others.

STUDENTS ASSESSMENT EXERCISE

(i) What are your suggestions for control of inflation in Nigeria today?
(ii) Discuss three types of inflation in Nigeria and the methods of control of each type.
(iii) Why have the efforts being made for some years proved unsuccessful in curbing inflationary problems in Nigeria?
(iv) To what extent is a formal prices and incomes policy likely to control the rate of inflation?
(v) For what reasons do government set to control inflation?

3.6 Inflation and Unemployment: The Philips Curve

The Philip curve examines the relationship between the rate of unemployment and the rate of money wage changes. Known after the British economists A. W. Philips who first identifies it, expressed an inverse relationship between the rate of unemployment and the rate of increase in money wages. Basing his analysis on data for the United Kingdom, Philips derived the empirical relationship that when unemployment is high, the rate of increase in money rate is low.

This is because “workers are reluctant to offer their services at less than the prevailing rate when the demand for labour is low and unemployment is high so that wage rate fall very slowly. On the other hand when unemployment is low, the rate of increase in money wage rates is high. This is because, when the demand for labour is high and there are very few unemployed we should expect employer to bid wages rates up quite rapidly.
The second factor which influences this inverse relationship between money wages rate and unemployment is the nature of business activity. When unemployment falls with increasing demand for labour, the employers will bid up wages. Conversely in a period of falling business activity when demand for labour is decreasing and unemployment rising, employers will be reluctant to grant wage increase.

Rather, they will reduce wages. But workers and union s will be reluctant to accept wage cuts during such periods. Consequently, employers are forced to dismiss workers, thereby leading to high rate of unemployment. Thus, when the labour market is depressed, a small reduction in wages would lead to large increase in unemployment.
Philips concluded on the basis of the above arguments that the relation between rates of unemployment and a change of money wages would be highly non-linear when shown on a diagram. Such a curve is called the Philips curve.

These trades off-between the inflation rate and unemployment rate is explained in figure above where the inflation rate (p) is taken along with the rate of change in money wages (w). Suppose labour productivity rises by 2percent year and if money wages also increase by 2 percent, the price level would remain constant.

Thus point B on the PC curve corresponding to percentage change in money wages (M) and unemployment rate of 3 per cent (N) equal zero (0) per cent inflation rate (P) on the vertical axis. Now assume that the economy is operating at point B. If now, aggregate demand is increased this lowers the unemployment rate to O.T. (2%) and raises the wage rate to OS (2%) and raise the wage rate to OS (4%) per year. If labour productivity continues to grow at 2 per cent per annum, the price level will also rise at 2 percent per annum OS in the figure. The economy may operate at C. with the movement of the economy from B to C unemployment falls to T (2%). If points B and C are connected, they trace out a Philip curve PC.

CRITICISMS

Economists have criticized and in certain cases modified the Philip curve. They argue that the Philips curve relates to the short run and it does not remain stable at all time.
According to Friedman, there is no need to assume a stable down ward sloping. Philips curve to explain the trade-off between inflation and unemployment. In fact, this relation is a short-run phenomenon. But there are certain variables which cause the Philips curve to shift over time and the most important of them is the expected rate of inflation. So long as there is discrepancy between the expected rate and actual rate of inflation, the downward sloping Philips curve will be found but when his discrepancy is removed over the long run, the Philips curve becomes vertical.

(2) James Tobin an American Economist also believes that there is a Philips curve within limits. But as the economy expands and employment grows, the curve becomes even more fragile and varnishes until it becomes vertical at some critically low rate of unemployment.

Generally economists have accepted the vertical Philips curve. They agree that at unemployment rate of about 4 per cent, the Philips curve becomes vertical and the trade-off between unemployment and inflation disappears. It is impossible to reduce unemployment below this level of market imperfections.

3.6.1 Policy Implication of the Philips Curve

- It suggests the extent to which monetary and fiscal policies can be used to control inflation without high levels of unemployment. In other words it provides guidelines to the authorities about the rate of inflation which can be tolerated with a given level of unemployment.

- for this purpose, it is important to know the exact position of the Philips curve. If the curve is PC, as in the figure below, where labour productivity and wage rate are equal at point E, both full employment and price stability would be possible.

Again, a curve to the left point E suggests full employment and price stability as consistent policy objectives. It implies that a lower level of inflation can be trade off for a low level of unemployment.

If on the other hand, the Philips curve is PC as in the figure it suggests that authorities will have to choose between price stability are more unemployment. Thus, by observing the position of the Philips curve the authorities can decided about the nature of monetary and fiscal policies to be adopted, for instance if authorities find that inflation rate P_2 is incompatible with the unemployment rate U_1 in the figure they would adopt such monetary and fiscal policies as to shift the Philips curve PC to the left in the position of PC_1 curve. This will give a better trade-off between a lower inflation rates P_1, with small level of unemployment U_1.

4.0 CONCLUSION

The tendency of prices to rise and the value of money to fall is known as inflation. One of the main aims of government is to control the rate of inflation because of its undesirable effect on the economy. For a full understanding of inflation, it is important to realise the relationship between the supply of money and the rate at which prices are rising for the supply of money is important consideration in the question of inflation. This leads many people to regard inflation as a condition of excess Aggregate Monetary Demand (AMD) over Aggregate Supply in conditions of full employment. The importance of this definition of inflation lies in the fact that it draws attention to Aggregate Monetary Demand and consequently to the supply of money.

While acknowledging the importance of the money supply to the inflationary process, it is useful to consider other powerful forces which make their contribution to rising prices. The standard distraction is between “Cost-Push inflation” and “demand-pull” inflation. The names indicate the main causes of the particular inflation although it is usual for one kind of inflation to lead to the other kind in a particularly unpleasant circle.

Cost-push inflation occurs when prices rise as a result of the costs of production increasing more rapidly than output. When cost inflation of this kind is widespread, it necessarily leads to demand inflation as the recipients of extra income want to increase their purchases. Once an inflationary atmosphere is established, the process is in danger of becoming not only self-perpetuating but self-accelerating.

While there is a minority view that a degree of inflation is a necessary stimulant to the economy slightly rising prices encouraging investment, the strenuous efforts of governments to restrain its pace suggest that it produces many undesirable side effects.

5.0 SUMMARY

In the unit, we have successfully defined inflation and were able to recognise the different types of inflation, analyse the causes and effects of inflation. Reasonable suggestions on the various ways of controlling inflation were also reproduced.

6.0 TUTOR-MARKED ASSIGNMENTS

Q.1 What is inflation and what are its causes?
Q.2 What problems are created in the economy by inflation?
Q.3 What are your suggestions for control of inflation in Nigeria today?
Q.4 Discuss three types of inflation in Nigeria and the methods of control of each type.

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UNIT 8 DEFLATION

CONTENTS

1.0 INTRODUCTION

The last unit was dominated by the discussion on inflation. In this unit, we shall concentrate on deflation in order to be able to distinguish between two of them.

When the prices of most goods and services are rising over time, the economy is said to be experiencing inflation. Prior, to 1950, several European countries including Germany, France and Italy had periods when prices rose very rapidly. This usually occurred during wartime and in the years of rationing that followed.

These wartime periods of inflation were often followed by periods of deflation, during which the prices of most goods and services fell. In some countries, such as Sweden, the Netherlands and the U.K., the result of these offsetting periods of inflation and deflation was that over the long run, the level of prices was fairly constant. The last significant deflation in Europe occurred during 1929 - 33, the initial phase of the Great Depression. Since then, inflation without offsetting deflation has become the normal state of affairs. Deflation is a situation in which the prices of most goods and services are falling over time.

2.0 OBJECTIVES

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

- define deflation.
- determine the effects of deflation.
- examine the various ways of controlling deflation.

3.0 MAIN CONTENT

3.1 Meaning/Definitions and Causes of Deflation

Deflation is a reduction in the general price level due to a decrease in the economic activity of a nation. The price levels as well as national income; output and employment will all fall. During the twentieth century, the only sustained period of deflation in the U.K. existed between 1920 and 1938 when the general prices level fell by almost 50%. Government introduced deflationary policies for several reasons to decrease the rate of inflation, to cut the volume of import or to prevent the economy from becoming "overhead." Among the deflationary policies available to the government are increases in level of taxation, and "credit sequences."

Deflation is also the conversion of a factor such as a wage, the cost of raw materials, etc, from a nominal to a real amount, when measured in monetary terms. For example, the nominal increase in the price of consumer durables must be divided by the rate of inflation to arrive at the real increase in the price. Also, Deflationary Gap is the difference between the amount that is actually spent in an economy and the amount that would have to be spent in order to maintain output at a level corresponding to employment.

Furthermore, Deflation refers to a persistent fall in general price level due to a reduction in the amount of money in circulation. It is the opposite of inflation.

It is a continuous fall in the price level of goods and service in a country as a result of decrease in the volume of money in circulation used in the exchange of large available goods and service.

From the foregoing, the cause of deflation is summarised below.

- Under population
- Increase in production
- Increase in taxation
- Increase in bank rate
- Compulsory bank savings
- Executive price control

· Surplus budget or reduction in government expenditure.

STUDENTS ASSESSMENT EXERCISE

(i) Explain the term Deflation and examine its causes.
(ii) (ii) Distinguish between Deflation and Inflation.

3. 2 Effects of Deflation

Since deflation is the opposite of inflation, its effects are the opposite of the effects of inflation already discussed in Unit Seven.

(a) Effects on Incomes
People with fixed incomes - salary earners, pensioners benefit from the fall in price level while people whose income is not fixed lose. Income of businessmen, manufactures, shareholders fall because of fall in profits. The real value of fixed income earners rises when prices fall.

(b) Fall in investment and employment: Fall in profits leads to decline in investment and consequently in employment. The total output (or national income) working through the multiplier process also falls.

(c) Borrowers lose while lenders gain, since the repaid debts can buy more because of falling prices

(d) Exports are encouraged while consumption of imported goods fall because their prices are relatively dearer than domestic projects.

(e) Due to falling imports and rising exports, foreign exchange rises while balance of payments problems or deficits are eliminated or corrected.

The effects of deflation are further summarised as follows:

- Money gains more value
- It encourages export
- It discourages imports
- Decrease in investment
- It encourages savings
- Reduction in profit
- Fall in prices of goods and services
- It causes unemployment
- Money lenders gain at the expense of borrowers
- Improvement in the balance of payments
- Fixed income earners will gain
- It will instill sense of hardwork on the people.

STUDENTS ASSESSMENT EXERCISE

Discuss the effect of Deflation.

3.3 Control of Deflation

Earlier, we explained that economic theory distinguishes two "types" of Inflation - demand-pull inflation and cost-push inflation. In practice, demand-pull and cost-push inflation tend to co-exist, though it is possible in theory at least to distinguish "demand pull" and cost-push" inflation.

If demand-pull inflation is diagnosed, the appropriate policy is one which reduces the level of demand -what is called deflationary policy - if on the other hand, cost-push inflation is diagnosed, deflation would not be appropriate. Rather a policy to restrain cost increases is necessary. In practice, the appropriate policy would depend upon the nature and source of the cost increases.

The terms deflation, reflation "both refer to demand. Deflation means a reduction in demand. Reflation is the opposite - an increase in demand. The odd one out is inflation, since it refers to prices. Curiously or perhaps not so curiously, there is no single word, which is the opposite to inflation - we have to use a phrase such as " a fall in the price level."

Deflation can be checked by reversing those measures for checking inflation: Specifically, these measures are as follows:

(a) Government should encourage investment by reducing the bank rate thus making it cheaper for investors, businessmen and consumers to borrow money. That is, expansionary monetary policy that liberalises credit facilities can remedy deflation.

(b) Reduction of Taxes
The government should also reduce taxes (particularly income taxes) to increase people's disposable income and thus purchasing powers.

(c) Increase in Government Expenditure
The Government expenditure should rise in order to increase employment and personal income of consumers.

(d) Increase in Salaries and Wages
There should be a general increase in salaries and wages so as to raise consumers' purchasing power and push up prices to acceptable levels (stable prices).

The control of deflation is further summarised as follows:-

(i) Deficit budget
(ii) Increase in wages
(iii) Reduction in bank rate
(iv) Reduction in income tax
(v) The use of Open Market Operation

STUDENTS ASSESSMENT EXERCISE

Deflation, Reflation and inflation. Which is the odd one out?

4.0 CONCLUSION

Deflation is almost the opposite of Inflation. This is experienced when the amount of money in circulation is not sufficient. In other words, the total demand for money is greater than the available amount. This may be due to the contraction of money supply with a view to raising the value of the national currency.

Volume of goods and services in the economy is expanding without corresponding increase in the supply of money. OR the same volume of goods and services. But part of money circulating over them have been withdrawn as indicated above leaving more goods and services with little amount of money.

The general result is the appreciation of money value. This leads to a fall in the general level of prices. With the little amount of the money in your possession, you can purchase as many goods and service as possible. This is deflation. It reduces the National Income as it reduces personal income. This is general distress resulting from jungle economic activities. Its effects could be more caustic than inflation both in the short-run and in the long-run.

By deflation; we mean a time when most prices and costs are falling. The effect of deflation is the opposite of inflation. During the period of deflation, the entrepreneurs lose because of the declining profit of their investment. The creditors and fixed receivers tend to gain at the expense of debtors. Wage earners and pensioners obtain increased purchasing power for their income. Debtors gain at the expense of the creditors.

In terms of production, profit margin decline, entrepreneurs are less inclined to expand their operation. This decline in production leads to growing unemployment to labour and capital.

The standard of living falls. When an economy faces this type of depression, private and public spending has to be stimulated to encourage and accelerate production, which creates more job and more real income.

6.0 TUTOR-MARKED ASSIGNMENTS (TMA)

Q1. Discuss Deflation under the following headings.

(i) Meaning/Definitions
(ii) Causes
(iii) Effects
(iv) Control

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UNIT 9 TOOLS OF MONETARY POLICIES

CONTENTS

1.0 INTRODUCTION

In this unit, we will focus our attention on the effectiveness of monetary policies in changing the level of real income. We will attempt to delineate the conditions that are favourable and those that are unfavourable for the successful operation of the respective policies. We will also resort to the findings of empirical research to see the impacts of the policies.

As we have seen, in the previous units from our study of financial institutions, the Government needs to influence the level of employment, the rate of inflation or economic growth, or the balance of payments; it will implement some kind of monetary policy. Such a policy is designed to influence both the supply of money and its price. If the volume of money circulating in the economy is increased, the level of Aggregate Monetary Demand (AMD) is likely to rise. If the price is the money, that is the rate of interest payable for its use, is reduced, the level of AMD is again likely to be stimulated.

The onus of formulating monetary policies in Nigeria rests on the Central Bank of Nigeria. In this unit, therefore, we shall specifically take a look into the techniques and instruments of monetary policies. We shall also look at the procedure for the formulation and administration of monetary policies and how to minimise lags in monetary policy formulation and implementation.

2.0 OBJECTIVES

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

- explain the meaning, objectives and stance of monetary policy.
- discuss the various tools and techniques of monetary policy.
- examine the administrative procedure of formulation of monetary policy and the lags that often occur.

3.0 MAIN CONTENT

3.1 What Is Monetary Policy? - The concept of Monetary policy

Simply put, monetary policy is a government policy about money. It is a deliberate manipulation of cost and availability of money and credit by the government as a means of achieving the desired level prices, employment output and other economic objectives. The government of each country of the world embarks upon policies that increase or reduce the supply of money because of the knowledge that money supply and the cost of money affect every aspect of economy. By affecting the aggregate demand, money supply affects the level of prices and employment. It also affects investment levels, consumption, and the rate of economic growth. An increase or reduction in the cost of money (interest rate) affects all these variables.

Monetary policy is defined in the Central Banks of Nigeria Brief as “the combination of measures designed to regulate the value, supply and cost of money in an economy, in consonance with the expected level of economic activity.” (CBN) Brief 1996/03.

One idea is central in this and other definitions given above - that monetary policy focuses on money supply as a means of achieving economic objectives. If the government thinks that economic activity is very low, it can stimulate activities again by increasing the money supply. But when the economy is becoming so much that the rate of inflation is high, it will reduce the supply of money. This will reduce aggregate demand in and the general price level. However, it can also lead to unemployment and stunted economic growth. As you will see later, there is often a conflict between the objectives of monetary policy. It is difficult to achieve all the objectives simultaneously.

Monetary policy is a major economic stabilisation weapon which involves measures designed to regulate and control the volume, cost of availability and direction of money and credit in an economy to achieve some specified macroeconomic policy objectives.

That is, it is a deliberate effort by the monetary authorities (the Central Bank) to control the money supply and credit conditions for the purpose of achieving certain broad economic objectives (Wrightsonan, 1976).

Monetary policy is administered by the Central Bank of Nigeria, in some cases with degree of political/ Government Interference. As a watchdog of the economy, the Central Bank has the duty of ensuring that policies are set in motion to ensure that the monetary system is directed towards achieving national objectives.

Monetary policy is the control of the supply of money and liquidity by the Central Bank through "open market" operations and changes in the "minimum lending rate" to achieve the government's objectives of general economic policy.

The control of the money supply allows the Central Bank to choose between "a tight money" and "easy money" policy and thus in the short to medium-run to affect the fluctuation in output in the economy.

Monetary policy could, therefore, generally be defined as follows:

(a) As an attempt to influence the economy by operating on such monetary variables as the quantity of money and the rate of interest; OR

(b) As a policy which deals with the discretionary control of money supply by the monetary authorities in order to achieve stated or desires economic goals; OR

(c) As steps taken by the banking system to accomplish, through the monetary mechanism a specific purpose believed to be in the general public interest; OR

(d) The use of devices to control the supply of money and credit in the economy. It has to do with the controls that are used by the banking system.

STUDENTS ASSESSMENT EXERCISE

(i) What is monetary policy?

(ii) Who carries out monetary policy in Nigeria?

(iii) Distinguish between contraditionary and monetary policy.

3.2 Objectives of Monetary Policy

Generally, the objectives of monetary policy in various countries are the same as the economic objectives of the government.

In Nigeria, the objectives of monetary policy as explained by the government of Central Bank of Nigeria are as follows:

(i) Promotion of price stability
(ii) Stimulation of economic growth
(iii) Creation of employment
(iv) Reduction of pressures on the external sectors, and
(v) Stabilisation of the Naira exchange rate (ogwuma 1997:3). These are discussed briefly in turns:

(i) Promotion of Price Stability
This involves avoiding wide fluctuation of prices which are highly upsetting to the economy. Not only do such wide prices gyrations produce windfall profits and losses, but they also introduce uncertainties into the market that make it difficult for business to plan ahead. They therefore, reduced the total level of economic activity. This objective of avoiding inflation is desirable since rising and falling prices are both bad, bringing unnecessary losses to some and necessary undue advantages to others. Prices stability is also necessary to maintain international competitiveness.
(ii) Slowly rising prices, slowly falling prices and constant prices (though the last option is rather unrealistic in the world).
(ii) Stimulation of economic Growth i.e. - Achievement of a High, Rapid and Sustainable Economic Growth: This mean maximum sustainable high level of output, that is, the most possible output with all resources employed to the greatest possible extent, given the general society and organizational structure of the society at any given time. This highly desirable economic growth implies raising people's standard of living. The growth of the economy is the wish of every government and monetary authorities. Therefore, when growth is achieved, it should be sustained.
(iii) Creation of Employment: Attainment of High rate or Full Employment: This does not mean Zero unemployment since there is always a certain amount of frictional voluntary or seasonal unemployment (Acklay, 1978). Thus, what most policy makers aim is actually minimum unemployment and the percentage that varies among countries.

The monetary policy should always aim at reducing the level of unemployment in the economy. Unemployment is a social ill which should not be allowed to exist in the economy. The effects of unemployment to individuals as well as the society as a whole is so enormous that if left unchecked it will spell doom for both individuals and society.
(iv) Reduction of pressures on the external sectors - i.e. Maintenance of balances of payments

Equilibrium: This involves keeping international payments of receipts in equilibrium that is, avoiding fundamental or persistent disequilibrium in the balance of payments positions. Usually, however, nations worry about persistent balance of payments deficits. The pursuit of this objective, arises from the realisation that deficit in the balance of payments will retard the attainment of the other objective of other objectives, especially the objective of rapid economic growth. Deficit balance of payment is not healthy and therefore the monetary authorities should try to achieve healthy balance of payment.

(v) Stabilisation of Naira Exchange Rate - This involves avoiding wide swings (undue and unnecessary fluctuations) in the currency exchange rate. This is meant to help in protecting foreign trade.

Instability in the economy creates an atmosphere of uncertainty for the investors and discourages them from investing while stability encourages investment. Monetary policy will, therefore, endeavour to achieve economic stability so as to encourage both local and foreign investors to invest in the economy.

The above discussed objectives of monetary policy are achieved through the manipulation of the monetary policy tools by the Central Bank of Nigeria (CBN).

STUDENTS ASSESSMENT EXERCISE

Examine fully the objectives of monetary policy in Nigeria.

3.3 Stance of Monetary Policy

The stance of monetary policy refers to the position taken by (CBN) - the monetary authorities about whether to increase or reduce the supply of money in the economy during a policy period, usually one year. This gives rise to two types of monetary policies, namely expansionary or a monetary ease policy, and contractionary or stringent or tight monetary policy.

Monetary policy is said to be an expansionary or a monetary ease policy when the monetary authorities decides to increase the supply of money or reduce the cost of money in the economy so as to stimulate an increase in economic activities. This can be accomplished through the buying of securities in the open market, a reduction in interest and discount rates, a reduction in reserve requirements, and relaxing of credit controls, among others. The overall effect of expansionary monetary policy is to have more money in the hands of the public. This will lead to an increase in aggregate demand, investment, savings, employment, output and economic growth, while at the same time increasing the rate of inflation.

A contractionary stringent or tight monetary policy does the opposite of an expansionary policy. Monetary policy is said to be contractionary, stringent, or tight when the monetary authorities embark on policies that will reduce the supply of money or increase the cost of money in economy, in other to generate a contraction in economic activities. The effect of contractionary policies is to reduce the general price level and curb inflation. However, it will equally lead to a reduction in the level of investment, employment, output and economic growth.

The government switches from contractionary to expansionary policies as the need arises depending on the economic objectives, which she is giving priority. In Nigeria, the stance of monetary policy adopted has been varying from one regime to another.

STUDENTS ASSESSMENT EXERCISE

Differentiate between Expansionary and Contractionary monetary policy. Examine/ discuss why both are necessary.

3.4 Monetary Policy Instruments/Weapons/Tools

Instruments of monetary policy are many and varied. Their respective effects on the economy also vary in terms of where they start and transmission route. Sometimes, some tools are not compatible with others i.e. in which case, the adoption of one set instruments will negate or be at cross purposes with the effects of others. That is why monetary authorities usually consider the operational efficiency, the technical features, the lags and other effects of any given instruments before it can be used.

Apart from minor variations based on level of economic development of each country, the tools used to attain the monetary objectives of various countries of the world are virtually the same. In discharging its obligations, the Central Bank of Nigeria has at its disposal a number of control mechanism usually referred to also as tools of monetary policy.

Instruments or tools of monetary policy can be classified into two:-

(a) Quantitative Instruments (Traditional and Non-Traditional).
(b) Qualitative Instruments (Ranlett, 1977).

A. Qualitative Instruments

These are "impartial or impersonal" tools which operate primarily by influencing the cost, volume, and availability of bank reserves. They lead to the regulation of the supply of credit and cannot be used effectively to regulate the use of credit in particular areas or sectors of the credit market.

Quantitative tools are further classified into traditional or market weapons and nontraditional tools or credit direct control of bank liquidity.

1. Traditional or market weapons.
   This are called market weapon because they rely on market forces to transmit their effects to the economy. Specifically, these tools include Open Market Operations (OMO), Discount Rate Policy and Reserve Requirements.

   (i) Open Market Operations
   This is the buying and selling of securities by the monetary authorities in the open market. Securities are sold to reduce money supply and bought to increase money supply.

   (ii) Discount Rate Policy or the Rediscount Rate Policy or Bank Rate
   Discount rates are interest rates paid in advance based on the amount of credit extended by increasing the rediscount rates those Central banks charges from borrowing for the Central Bank and makes banks to increase their own discount rates and interest rates. This discourages banks lending and reduces money supply. A reduction in rediscount rates increases the supply of money. Interest rates are the cost of borrowed money. An increase in interest rates discourages people from borrowing from banks. This reduces money supply. A reduction in interest rate does the opposite.

   (iii) Reserve Requirements/ Required Reserve Ratios
   The monetary authorities set a minimum level of reserves that will be maintained by banks. In Nigeria, banks maintain two types of reserve - Cash Ratio, and Liquidity Ratio. An increase in bank reserves reduces money supply by reducing bank loanable funds, while a decrease in reserves increases the supply of money.

(a) Non-traditional Instruments or Direct Control of Bank Liquidity: These tools are non- market tools that strike directly at bank's Liquidity. They include supplementary reserve requirements and variable Liquidity ratios.

(b) Supplementary reserve requirements or special deposits: The Central Bank here requires banks to hold over and above the legal minimum cash reserves, a specified percentage of their deposits in government securities such as stabilisation securities issued by the Central Bank, hence it is also called special deposits policy. The main objective is to influence banks' lending by freezing a certain percentage of their assets.

Stabilisation securities which the Central Bank of Nigeria is authorised by law to issue and sell to banks compulsorily at any rate they may fix and redeem them at any time they may fix. It is used to mop up excess liquidity to reduce money supply.

It is important to understand how this works. Assuming that the Central Bank wants to reduce the money supply in the economy, it may impose a special deposit of say 5% on banks and this will force the banks to deposit 5% of their total deposits liquidity with the Central Bank on a special account. The special deposit is mainly used when other instrument fail to achieve their objectives or targets. This is, therefore, regarded as instrument of the last resort.

(2) Variable Liquid Assets Ratio

Here, Banks are required to diversify their portfolio of liquid assets holding. These means that banks are required to redefine the composition of their Liquid assets portfolios at different times to reduce or increase their credit base.

B. Qualitative or Selective Controls or Instruments

These confer on the monetary authorities the power to regulate the terms on which credit is granted inspecific sectors. These powers or control seek typically to regulate the demand for credit for specific uses by determining minimum down payments and regulating the period of time over which the loan is to be repaid. In other words, they involve official interference with the volume and direction of credit into those sectors of the economy which planners believe are a crucial importance to economic development. These tools include moral suasion and selective credit controls or guidelines.

(1) Moral Suasion

Moral suasion is an appeal of persuasion from the Central Bank to other banks to take certain actions in line with government economic objectives. Unlike directives, no penalty is attached to non-compliance to moral suasion. Banks have the freedom not to comply, but they often comply so as to have a good relationship with the Central Bank.

This involves the employment of persuasions or friendly persuasive statements, public pronouncements or outright appeal on the part of monetary authorities to the banks requesting them to operate in a particular direction for the realisation of specified government objectives. For example, the Central Bank or the government may appeal to the banks to exercise restraint in credit expansion by explaining to them how excess expansion of credit might involve serious consequences for both the banking system and the economy as a whole. Moral suasion is supposed to work, through appeal and voluntary action rather than the regulation and authority.

(2) Selective Credit Controls and Guideline

These are specific instructions given by the Central Bank to other banks which they must comply with. Such directives come in the form of credit ceilings, special deposits and sectoral allocations of credits, among others. This can be used to increase or reduce money supply.

Selective credit controls or guidelines involve administrative orders whereby the Central Bank, using guidelines, instructs banks on the cost and volume of credit to specified sectors depending on the degree of priority of each sectors. Thus, selective credit controls are examples of the use of monetary policy to influence directly the allocation of resources indicating a lack of faith in the working of the free market. Apart from the quantitative control which regulates the amount of money in circulation, the Central Bank can monitor the economy by giving directives to banks in all areas of operation. The selective control or directives can be in form of:

(a) Credit Ceiling: Every year the Central Bank dictates the rate of credit expansion in the economy.
(b) Sectorial Allocation of Credit: The Central Bank divided economic activities in the country into sectoral allocations. The divisions are agriculture, forestry, fishing, mining, quarrying, manufacturing and real estate.
(c) Interest Rate Ceiling: The interest rate may be controlled to favour particular sectors.
(d) Loans to Rural Borrower: This is aimed at improving investment in the rural areas.
(e) Grace Period on Loans: Longer period may be granted to some important sector like agriculture.
(f) Refinancing Facilities
(g) Indigenisation of Credit

STUDENTS ASSESSMENT EXERCISE

(1) "If you control the supply of money you control the economy." Comment.
(2) Explain the monetary steps that should be taken to induce conditions of full employment.
(3) What effects does a rise in interest rate have on the price of gilt-edged securities?

3.5 Phases of Monetary Policy in Nigeria

The Central Bank of Nigeria from its inception had various instruments of monetary control at its disposal. However, the extent to which each of the monetary policy instruments has been changing from time to time. In this regard, it has become usual to classify monetary policy in Nigeria into two phases based on the typed instruments been emphasised by the bank, during each phase. They are the era of direct monetary control (1958 to 1986) and the era of indirect or market-based monetary control.

During the first phase covering 1958 to 1985, the emphasis of the Central Bank was on the use of those tools which directly affect the price of money and the flow of bank credit such as interest rates policy, directives or direct controls, moral suasion, and stabilisation securities. The Central Bank had direct control on the maximum amount of credit to be allocated by each bank and the sector to which the credit would go. Apart from giving specific directives, although the use of indirect tools like reserve requirements, Open Market Operation, and Discount Rates were attempted during this period, the emphasis on their use was not much.

The second phase of the administration of monetary policy in Nigeria began in 1986 when the Babangida administration began a gradual deregulation of the economy under the Structural Adjustment Programme (SAP) introduced in that year. This phase placed much emphasis on the use of market oriented instruments to achieve monetary policy objectives. The determination of interest rates which is the price of money the ceiling on banks credits and its allocation to the various sectors of the economy were left to be determined by the market mechanism. Rather than fixing rates and the flow of bank credit, the Central Bank controlled the monetary base or its components which are intermediate variables and left the market forces of demand and supply to determine interest rates, credit ceilings and credit allocations.

3.6 Formulation and Administration of Monetary Policy in Nigeria

The monetary policy for each fiscal year is contained in a circular currently titled the monetary, credit, foreign trade and exchange policy for a given year. This circular which is released by the Central Bank of Nigeria at the beginning of each year comes after the annual Presidential Budget speech and its break down have been announced.

Although this circular is a publication of the Central Bank of Nigeria, inputs are made into it by various sectors of the economy through a comprehensive administrative process. This administrative process involves five stages: preparation of policy disposals, review by the committee of Governors approval by the Board of Directors, review and approval by the government, and publication by the Central Bank Governor.

(a) Preparation of Proposal Memorandum

The first stage in the administrative process is the preparation of policy proposals. This stage is coordinated by the Research Department of the bank, which collect inputs from the various policy departments of the bank and tries to reflect the views of the financial and non-financial sectors of the economy about the prevailing economic conditions.

These inputs along with suggestions are complied as a memorandum usually captioned "Monetary, Credit, Foreign Trade Exchange Policy Proposals" for a particular year and forwarded to the committee of Governors.

(b) Review of Proposals by Governors Committee

The next stage is the review and amendment of the policy proposals by the committee of Governors. The committee is the highest management body responsible for the day-to-day administration of the Central Bank of Nigeria. The committee made up of the Central Bank Governors and the five Deputy Governors discuss the proposals and make amendments and new inputs where necessary. The amended copy of the memorandum is then forwarded to the board of Governors for approval.

(c) Approval of Proposals by Board of Governors

The third stage is the approval of the policy proposals by the Board of Governors. This board which is chairman by the Governor is the body directly responsible for the formulation of monetary banking and exchange rate policies. The Board discusses the memorandum extensively if they are satisfied with it; they add their approval to it. Despite the approval of the board of Governors, the memorandum remains the proposal until it receives the approval of government.

(d) Securing the Government Approval

The next thing required after approval by the Board of Governors is, therefore, government approval. To get this approval, the memorandum is forwarded to the President (Head of State) for consideration. According to the Governor of the Central Bank of Nigeria, this is "for all government economic policies to be co-ordinate and harmonised for internal consistency" (Ogwuma, 1997.6) the policy proposals are usually referred to various committees and councils of the government before final approval by the senate and signed by the Head of State.

(e) Publication of policy by CBN Governor

This is the final approved copy of the memorandum that is published by the Governor of the Central Bank of Nigeria as the Monetary, Credit, Foreign Trade and Exchange Rate Policy of the Central Bank for the particular year. Apart from publishing the circular, the Central Bank sees to the monitoring and implementation of the policies contained therein (CBN Briefs 1996. vol 3).

Specifically, the issues covered in the formulating of monetary policy and published in the circular are as follows:

- Review of Macro economic Problem
- Setting of Objectives
- Monetary and Credit Policy Measures
- General guidelines on banking practices
- Foreign Trade and Exchange Policy Measures
- Guidelines for other Financial Institutions

STUDENTS ASSESSMENT EXERCISE

Analyse the formulation of monetary policy in Nigeria.

3.7 Lags in Monetary Policy

Monetary policy affects the economy in two major ways - the magnitudinal (size) dimension and the time dimension. Here we are concerned with the time dimension which measures the lag in the effect of monetary policy. (Friedman 1961, Cultertson, 1960, 1961; Ando et al, 1963, Ranlet 1977 and Willes, 1968).

Lags occur because of the time lapse before changes in monetary variables have effect on the economy. The need to formulate monetary policy arises as a result of existing economic problems. It is only when the monetary authorities recognise the existing problems and the need to take action about it that they will adopt appropriate monetary policy measures. This may take some time even after they have taken action, it may take another period of time before the effect of their action is felt in the economy. The time that elapses between when the economic problems arose and when the effect of the action of the monetary authorities is felt in the economy is the monetary policy.

Lags in the Monetary Policy affect its effectiveness. In Nigeria, for instance, the Central Bank Monetary Policy circular is released at the beginning of each year. Assuming an inflationary pressure arises in the economy in August, 1998, if it took six months for the Central Bank to notice the problems, they will only become aware of it in February, 1990 after the monetary policy for 1999 has already been released. The monetary authorities may then include anti-inflationary measures to be felt in their monetary policy circular for the year 2000. By then, 14 months have elapsed. It may take another 6 months for the impact of those anti-inflationary measures to be felt in the economy. This gives a total lag of 20 months.

It is possible that during the 20 months lag, the level of inflation may have been reduced already by market forces. The anti-inflationary measures may end up pushing the economy to deflation and economic depression. Even if the inflationary pressure is still present and unreduced, the lag of 20 months means that the effect of the policy is 20 months late. Thus, the shorter the lag the more effective and appropriate the monetary policy would be.

STUDENTS ASSESSMENT EXERCISE

Write short notes on
(i) Objectives of monetary policy;
(ii) Monetary policy Lags.

3.8 Conflicts in Achievements of Monetary Policies Objectives

A look at the objectives of monetary policy shows that these multiple objectives are not compatible at all. In some cases, they are not achieved simultaneously but rather the achievement of one objective may take the economy further away from the other objective. This actually means that the attainment of one objective may preclude the attainment of another or even in other word there is existence of trade-offs in the attainment of objectives. Authorities have identified two types of conflicts in the attainment of monetary objectives. These are necessary conflict and policy conflict.

The relevant questions here are:
(1) Are the multiple objectives of monetary policy compatible?
(2) Can they be achieved simultaneously?
(3) Or thus the pursuit of one objective leads us further away from another? Two types of conflicts in the attainment of policy objectives exist.

(i) Necessary Conflict

The necessary conflicts exist whenever the attainment of one objective precludes the attainment of the other.

In other words, this is a situation where the said objectives are inherently incompatible with each other. In fact, a good example will make the understanding of this clearer. Let us look at the twin objectives of attaining full employment and price stability. The full employment in this context means unemployment rate of between 3% and 5% or employment rate of between 95% and 97%.

Experience has shown that the pursuance of the objectives of full employment normally works against price stability. Full employment situation means that almost anybody who wants to work is able to find job at the existing wage rate. The fact that almost everybody is working makes individuals to have high purchasing power and the economic activities will be high indeed. This situation will induce inflation which will eliminate price stability in the economy.

Philip's curve is used to demonstrate the trade off that exists between unemployment and inflation or the relationship between them. It shows that whenever unemployment rate is very low, inflation rate will be very high and vice-versal. This means that there is a trade off between unemployment and inflation.

(ii) Policy Conflict

The policy conflict exists when government takes a measure that would jeopardise the simultaneous achievement of two objectives. In other words, policy conflict exist when monetary policy has difficulty in pursuing or achieving both monetary and fiscal policy objectives simultaneously. Take for example, during an inflationary period, a tight monetary policy may be embarked upon to fight inflation. This policy may reduce the rate of investment and affect growth adversely. On the other hand, an easy monetary policy designed to stimulate economic growth will definitely lower the rate of interest and this will generate higher rate of inflation.

STUDENTS ASSESSMENT EXERCISE

(i) Distinguish between necessary conflict and policy conflicts in monetary policy.

3.9 Monetarists versus Fiscal Policy–The Associated Conflicts

Monetary and fiscal policies are two out of a menu of government policies used to stabilize and regulate the economy. The usual argument between the monetarists and the fiscalists is regarding whether it is monetary or fiscal policy that matters. The fiscalists or Keynesians adduce to fiscal policies or actions that is increase in aggregate demand. These two actions they argue have a multiple effect. However, the monetarists argued that from empirical evidence, government expenditure multiples with a constant stock or money in positive. But in the long run, it is zero, thus explaining the growing out effect. To the monetarist's government, expenditures can increase aggregate demand permanently, if only it is financed by a continual creation of money stock.
Inspite of this controversy and the rationale expectation proposition, what is adopted in most countries especially the developing nations is an appropriate mix of both monetary and fiscal policy.

3.9.1 Conflict in Achievement of Monetary Objectives

The basic questions here is, are the multiple objectives of monetary policy compatible? Are they mutually exclusives? Can they be achieved together simultaneously or would the pursuits of one objective lead us further away from another?

To a large extent, the objectives are usually incompatible and they do conflict. In most cases, the attainment of one objective may preclude attainment of others. As a result, tradeoffs do exist in the attainment of monetary policy objectives, have been identified.

There are (i) Necessary conflicts and (ii) Policy conflicts.

- **Necessary conflicts:** This occurs when the attainment of one objective affects the attainment of another. E.g. If in an attempt to improve the level of unemployment, there is increase in government expenditure and other monetary policy instrument are attained towards ensuring increase in money supply, in order to create investment and increase employment level, this may be achieved on the short run. However, later it would only be achieved at the cost of additional inflation.

  Full employment as a policy objective may also be in conflict with rapid economic growth as an objective since this depends on the acceptance of innovation and changes.

- **Policy conflicts:** This occurs when monetary policy has difficulty in pursuing two goals simultaneously or when the government takes measures that will jeopardize the simultaneous achievement of the objectives. E.g., a very easy monetary policy designed to stimulate economic growth is likely to lower the rate of interest and may generate higher inflation, if the growth is not sufficient enough to absorb it. In the same vein, in a situation where the economy is experiencing inflation and the rate of economic growth is slow, a tight monetary policy adopted to fight inflation will reduce investment and economic growth even further.

3.9.2 Conflicts Resolution Strategies

Where monetary policy objectives are mutually exclusive that is, cannot be achieved together, then we will need to consider tradeoffs among them and each objective would be ranked with respect to its relative form importance. Such ranking is usually the responsibility of the monetary authorities, depending on the state of the economy.

According to Milton Friedman 1968, there is no trade off between inflation and unemployment in the long run, representing monetarist's view of the Philip curve. Freidman argued that any attempt to hold the unemployment rate at an artificial low level would cause inflation to accelerate indefinitely. His reasoning is based on neo-classical economic theory. His proposition began that there is a natural ratio of unemployment where the real wages rate is in long run equilibrium. He believes that the unemployment ratio to be below its natural ratio, employers must be willing to hire more employers and the potential must be willing to be hired. But, employers will engage more employees if there is an actual decrease in wage rate. Potential employees on their own part would accept work, only if there is increase in real wage rate, since the real wage rate cannot increase and decrease at the same time.

Any employment ratio below the natural ratio must in long run be at disequilibrium rate. According to Freidman workers are not likely to suffer from money illusion. i.e. they will not ignore what happens to their pay in the long run. An initial increase in wages will lead to increase in prices as employers will be forced to raise their prices in order to afford paying the higher wages. This may lead to general inflation. This inflation may lead once again to higher rate of demand which in turn lead to another higher price etc. Therefore, there is no end to the wage price special at any rate of unemployment below the natural rate.

EXPANSIONARY AND CONTRACTIONARY MONETARY POLICY

For monetary authorities to influence the quantity of money supply in the economy, either expansion any or contractionary monetary policy. When the money supply is increased, it is an expansionary policy and when money supply is decreased, it is a contractionary monetary policy.

EXPANSIONARY MONETARY POLICY:

This is a monetary policy used to overcome a recession or a depression or a deflationary gap. When there is a full in aggregate demand for goods and services a deflationary gap emerges. Demand and Supply of Goods expansionary monetary policy.

CONTRACTIONARY MONETARY POLICY

Policy which is used to overcome inflation gap. During an inflationary period, there is general and persistent rise in prices of goods and services without corresponding rise in the outputs. Demand and Supply of Goods contractionary monetary policy.

LIMITATIONS OF MONETARY POLICY IN NIGERIA

When monetary policy is used to influence the level of income, its potential effect is lessened because of the lack of consumer and investor responses to interest rates changes. Other things may occur to dampen the effect of monetary policy on the level of income and keep spending from rising or falling when the Central Bank engages in activities such as open market purchases.

Most economists are of the view that monetary policy plays a limited role in a developing economy like Nigeria's as a result of the following reasons:

(a) There is the existence of largely non-monetised sectors which hinders the success of monetary policy. Most of the people live in the rural areas where there is absence of financial institutions and knowledge. Thus, monetary policy fails to effect the lives and activities of this bulk of the people of these economies.

(b) The money and capital markets are both inadequate and undeveloped. These markets lack in securities (shares, stocks, and bonds and bills which limit the success of monetary policy.)

(c) Most of the banks in the banking system possess high liquidity so that they are not affected by the credit and hence monetary policies of the monetary authorities.

(d) There is the large-scale operation of non-bank financial intermediaries, most of which are not under the control of the Central Banks.

Commercial banks are just only one of many types of financial intermediaries that exist in money using economies. In Nigeria today, there are many savings and loans Associations, Insurance Companies and Finance Companies that handle huge sum of money. The activities of these non-bank financial intermediaries if not checked may render Central Bank's expansionary or contractionary policies ineffective.

(e) In addition, bank money or demand deposits comprise a small proportion of the total money supply in these countries, rendering the monetary authorities ineffective in monetary control.

(f) Monetary policy is hindered by time lags (recognition, administrative and result lags).

(g) It conflicts with government policies.

(h) Monetary policy is influenced by politics and hence it is an attempt to fulfill political ambitions of parties in office.

(i) There is the problem of inability to predict how people will react to any monetary policy measure.

It is unable to deal with the business cycle.

STUDENTS ASSESSMENT EXERCISE

What are the constraints on effective monetary policy? Or what are the weaknesses of monetary policies in Nigeria?

4.0 CONCLUSION

In general, monetary policy refers to the combination of measures designed to regulate the value, supply and cost of money in an economy in consonance with the level of economic activity.

In a nutshell, the objectives or aims of monetary policy are basically to control inflation, maintain a healthy balance of payments position for the country in order to safeguard the external value of the national currency and promote an adequate and sustainable level of economic growth and development.
However, monetary authorities are not free to deal with these objectives separately but are required to pursue them simultaneously. This makes their tasks very difficult because of the constraints to manipulate a set of policies to achieve sometimes incompatible objectives.

One of the principal functions of the Central Bank of Nigeria (CBN) is to formulate and execute monetary policy to promote monetary stability and sound financial system in Nigeria. the CBN carries out this responsibility on behalf of the Federal Government of Nigeria through a process outlined in the Central Bank of Nigeria Decree 24, 1991 and the Banks and other Financial Institutions Decree 25, 1991. In formulating and executing monetary policy, the Governor of Central Bank of Nigeria is required to make proposals to the resident of the Federal Republic of Nigeria who has power to accept or amend such proposals. Thereafter, the CBN is obliged to implement the monetary policy approved by the President. The CBN is also empowered to direct the banks and other financial institutions to carry out certain duties in pursuit of the approved monetary policy.

Usually, the monetary policy to be pursued is detailed out in the form of guidelines to all banks and other financial institutions. The guidelines generally operate within a fiscal year. Penalties are normally prescribed for operators that fail to comply with specific provisions of the guidelines.

The techniques/tools/instruments by which the monetary authority tries to achieve the objectives of monetary policy can be classified into two categories - the direct control approach and indirect market approach.

The indirect/portfolio control instruments place restrictions on a particular group of institutions, especially deposit banks by limiting their freedom to acquire assets and liabilities. Examples of such instruments for indirect control are quantitative ceilings on bank credit, selective credit controls and administered interest and exchange rate.

The indirect method of control relies on the power of the monetary authority as a dealer in the financial markets to influence the availability and the rate of return on financial assets, thus affecting both the desire of the public to hold money balances and the willingness of financial agents to accept deposits and lend them to users. Examples of such instruments are reserve requirements discount rate and open market operations.

5.0 SUMMARY

This unit enlightens the reader/student on monetary management in Nigeria with specific focus on the concept, objectives, tools/techniques of monetary policy, its administration and general direction in Nigeria.

6.0 TUTOR-MARKED ASSIGNMENTS (TMA)

Q1 - Examine the objectives of monetary policy of the Federal Government. Access its ability to achieve its goals.

Q2 - Briefly discuss the various tools that the Central Bank of Nigeria can use to influence the flow of money and credit in Nigeria in order to achieve government economic objectives.

Q3 (a) Identify and discuss the various stages the Central Bank of Nigeria goes through in the process of formulating its annual monetary policy circular.

(b) What crucial issues are normally covered in such circulars?

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UNIT 10 THE NIGERIAN CAPITAL AND MONEY MARKETS

CONTENTS

1.0 INTRODUCTION

To the ordinary man in the street, a market is a place where goods and services are sold and bought like the Alaba International Market at Lagos and the Central Market at Kaduna.

Just as people go to such market to sell what they have, and others go there to buy what they need but do not have, so do firms and individuals who need money (Finance) but do not have money go to a financial market to buy money (long-term and short-term finance) from those who have it and want to sell. The buyer pays a price for such money known as interest dividend or discount.

A financial market is a market where long-term and short-term funds are bought and sold. And as Nwanke (1980) puts it “money like any other commodity, is bought and sold in a market”.

Financial markets are traditionally classified into two broad classes based on maturity funds traded in the market. The market for short-term funds is known as money market while the market for long-term funds is known as capital market. The institutions and instruments traded in each market will be discussed in this unit.

2.0 OBJECTIVES

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

- define the meaning of financial market, money market, capital market and their operators, instruments.
- identify the money market instrument and institutions.
- identify the feature of a Developed Money Market
- explain the functions of the Nigerian Money Market.
- explain the reasons for the establishment of Nigerian Capital Market.
- evaluate the problems of the Nigerian Capital Market.

3.0 MAIN CONTENT

3.1 Meaning of Money Market

The money market is a market for short-term funds. Funds obtainable from this market usually include working capital loans production cycle loans and other funds that are repayable within short period of about one to three years. Those who need funds for longer period have to go to the capital market.

Or the money market deals in short-term instruments that are readily convertible into cash, and whose maturity range between a few days to the two years.

Or the money market refers or a group of financial institutions or exchange system set up for dealing in short-term credit instruments of high quality, such as treasury bills, treasury certificates, call money, commercial paper Bankers’ Unit Fund, Certificates advance, as well as the dealing in gold and foreign exchange.

Or while denoting trading in money and other short-term financial assets, the money market comprises all the facilities of the country for the purchase and sale of money for intermediate and deferred delivery and for the borrowing and lending of money for short period of time.

Or it is a manifestation of dealing in short-term financial instruments (their sale and purchase as also borrowing and lending for short periods) on the one hand and a collection of the dealers in these assets on the other hand.

Or it is thus a collection of financial institutions set up for the granting of short-term loans and dealing in short-term securities gold and foreign exchange.

STUDENTS ASSESSMENT EXERCISES

Arrange for the definitions/meaning of Money Market.

3.2 Money Market Operators and Methods of Sourcing for Funds

Key operators in the Nigeria Money Market are Commercial Banks, Merchant Banks, Community Banks, People's Bank of Nigeria, the Central Bank, Discount houses and other non-bank financial institutions that provide short-term finance. Since we have discussed the activities of these institutions in the proceeding units, it is no use repeating them here.

When sourcing funds through the money market, two approaches are adopted, namely the use of securities and private negotiation. A borrower can approach lender and negotiate for short-term funds privately without the issue of securities. Funds obtainable in this manner include overdraft facilities and short-term loans and advances.

The market for securities is further segmented into the market for newly issued securities and the market for old and existing securities

3.3 Money Market Instruments

Money Market instruments are mainly short term securities that are used to obtain money from the money market. The borrower issues (or sell) the instruments which in fact is piece of paper to the lender who buys and holds them as an evidence of the debt. He can decide to hold it until maturity or re-sell to another person usually at a discount (i.e. below the actual price) if he needs his money before the maturity date. The major instruments currently used to evidence debts are treasury bills, treasury certificates, certificates of deposit, money at call commercial papers, and stabilisation securities. The features of these instruments are as follows:

(a) Treasury Bills: Treasury Bills are money market (short-term) securities issued by the Federal Government of Nigeria, they are sold at a discount (rather than paying coupon), interest matures within 91 days of the date of issue and are default-free. These instruments are promissory notes to be paid to the bearer 90 days from the date of issue. They provide the government with a highly flexible and relatively cheap means of borrowing cash. They also provide a sound security for dealings in the money market and the Central Bank of Nigeria in particular, can operate on that market by dealing in Treasury Bills.

The first money market instrument to be issued in Nigeria was the Treasury bill. It was first issued by the Federal Government of Nigeria through the Central Bank of Nigeria in April 1960. The issue for the first time in Nigeria (in April, 1960) was provided for under the Treasury Bill ordinance of 1956.

(b) Treasury Certificates (TCs): The second money market instruments to appear in the Nigerian money market was treasury Certificates. It was first issued in 1968. Treasury certificates, just like Treasury Bills are short-term government securities designated as Treasury Certificates by which the government borrows from the public for periods ranging from one to two years. The major difference between

Treasury bills and Treasury Certificates is that Treasury Certificate has longer maturities than Treasury Bills.

The reason for the issue of Treasury Bills and the issue of Treasury Certificates are the same, namely for development of the money market, government borrowings and for open market operations.

(c) Certificate of Deposit: These are inter-bank debt instrument meant to provide outlet for the commercial bank surplus funds. It was introduced in Nigeria by the CBN in 1975. It was also meant to open up a new source of funds for the merchant banks who are the major issuers. Two types of certificate of deposit are the negotiable and the non-negotiable certificate of Deposits.

These are short-term debt instruments issued by banks evidencing that the issuing bank has received an amount certain of money from a named person on deposit which the issuing bank undertakes to repay on a given date with interest to the named person or to a bonafide holder. It is in fact a form of fixed deposit receipt. Certificates of deposits are issued for various maturities ranging from 3 months to 36 months. The certificate may be designated as negotiable or non-negotiable by the issuer. Negotiable certificate can be transferred from one person to another by endorsement.

(d) Call Money: This instrument is the most liquid money market instruments next only to cash. It is an inter-bank arrangement whereby banks in need of immediate cash can borrow from the participating banks on overnight basis on the conditions that the funds so borrowed are repayable on demand.

Initially, the placing of money at call was arranged by banks themselves. By 1962, the Central Bank instituted the call money scheme. Under that arrangement, participating banks that maintained a minimum balance with the CBN which banks that have immediate liquidity requirements, can borrow on call basis. This arrangement was later changed. Banks now carry out the arrangements themselves.

(e) Commercial Papers (CP): CP is documents that are issued in the normal course of business as evidence of debt. Examples of such papers are commercial bills of exchange, letters of credit and promissory notes. These debt instruments often have maturities ranging from 330 days to 180 days. Commercial Papers used in the money market are often bills of exchange that carry the acceptable or confirmation of a reputable bank. Such bills can be discounted easily with by the holder. Banks who hold such discounted bill can further rediscount them with the discount houses or the central bank if they have immediate need for liquidity.

CP may also be sold by major companies (blue-chips-large, old safe well-known national companies) to obtain a loan. Here, such notes are not backed by any collateral rather; they rely on the high credit rating of the issuing companies.

(f) Stabilisation Security: These are special securities which the law authorises the CBN to issue and sell compulsorily to banks at any interest rate and such conditions as the CBN may deem fit for the purpose of moping up the excess liquidity of banks. These instruments are not an instrument of the government but that of the CBN.

The use of stabilisation security was introduced in 1976 but was later phased out. It was reintroduced again in1993 but by 1998 further issue was stopped.

The issue of this type of security is usually made when banks in the system are perceived to hold excess liquidity. Banks that hold such securities can discount it if they have immediate liquidity need.

(g) Bankers Unit Fund (BUF): This was introduced by the CBN in 1975 and initially meant to mop up excess liquidity in the banking system. It was also designed to sweeten the market for the Federal Government stock. To this end, Commercial banks' holdings of the stock are accepted as a part of their specified liquid assets and are repayable on demand. Under the BUF Federal Government stocks of not more than 3 years to maturity were thus designated Eligible Development Stock's (EDS) for the purpose of meeting the bank's specified liquid assets requirements. This placed banks in position to earn long-term rates of interest on what is essentially a short-term investment. Though, initially designed to mop up excess liquidity in the banking system by conferring on instrument cash substitute status repayable on demand acceptable in meeting reserve requirements, the capability of the banks for credit expansion was unaffected. In effect, the BUF was intended to provide avenue for the commercial and merchant bank and other financial institutions to invest part of their liquid funds in a money market asset linked to Federal Government Stocks.

(h) Ways and Means Advances Section 34 of the CBN Act 1958 (Cap 30 as amended 1962 -1969) empowers the CBN to grant temporary advances in the form of Ways and means" to the Federal Government to 25 per cent of estimated recurrent budget revenue.

STUDENTS ASSESSMENT EXERCISE

(i) Although money Market instruments are mere pieces of paper, they are used to obtain money. Discuss in details five of such instruments, showing how they can be used to obtain money.

3.4 Features/Characteristics of a Developed Money Market

A developed money market refer to one which is comparatively efficient in the sense that it is responsive to changes in demand and supply of funds in any of its segments and effects initiated in any part of it quickly spread to others without significant time lag.
To meet the definition, a money market should possess these features:

(a) Presence of a Central Bank
A Central Bank with adequate legal power, sufficient relevant information and the expertise, must exist as a lender of last resort and as the initiator and executor of monetary policy as a whole.

(b) Presence of a Developed Commercial Banking System, Development banking System and Merchant Banking System

A well developed money market should be characterised by the presence of a developed Commercial Banking System, Merchant Banking System and Development Banking System along with a wide spread banking habit on the part of the public.

(c) Adequate Supply of a Variety and Quantity of Financial Assets
In a well developed money market, there should be an adequate supply of a variety and quantity of short-term financial assets or instruments such as Trade Bills, Treasury Bills, Treasury Certificates, Commercial Papers, etc.

(d) Presence of well-developed sub-market

The existence of well-developed sub-markets and their adequate responsiveness to small changes in interest and discount rates make room for a well developed money market. If the demand and supply of certain instruments dominate, the interaction between different interest rates will be limited.

(e) Existence of Specialised Institutions
For competitiveness and efficiency, there must exist specialised institutions, in particular, types of assets e.g. specialised discount houses, acceptance houses, specialising in accepting bills or Specialised dealers in government securities.

(f) Existence of Contributory Legal and Economic Factors
For the money to be well-developed, there must exist appropriate legal provisions to reduce transaction costs, protect against default in payment while prerequisite economic forces such as speedy and cheap transmission of information, cheap fund remittance and adequate volume of Trade and Commerce must exist.

STUDENTS ASSESSMENT EXERCISE

What are the basis features of money market?

3.5 Reasons for the Establishment of the Nigerian Money Market

(a) To provide the machinery needed for government short-term financing requirements.
(b) As an essential step on the path to independent nationhood, hence it was part of a modern financial and monetary system, which was to enable the nation to establish the monetary autonomy which is part and parcel of the working of an independent, modern state.
(c) To Nigerianise the credit base by providing local investment outlets for the retention of funds in Nigeria and for the investment of funds repatriated from abroad as a result of government persuasions to that effects.
(d) To perform for the country all the functions which money market traditionally performs, such as the provisions of the basis for operating and executing an effective monetary policy.
(e) To effectively mobilise resource for investment purpose.

3.6 Functions of the Nigerian Money Market

(a) It provides the basis for operating and executing an effective monetary.
(b) To provide an orderly flow of short-term funds
(c) To ensure supply of the necessary means of expanding and contracting credit.

(d) It is a Central Pool of liquid financial resources upon which the banking system can draw upon when it is in need of additional funds and into which it can make payments when it holds funds surplus to its needs.
(e) It provides the mechanism through which the liquidity of the banking is maintained at the desired level.
(f) To provide banks the basic financial instruments for effective management of their resources. It thus helps them to diversify their assets holding by providing them with a forum for investment of their surplus cash.
(g) To provide the machinery needed for the government short-term financial requirement - hence achieving even seasonal variation in the normal flow of revenue.
(h) Mobilisation of funds from savers (lenders) and the transmission of such funds to borrowers (Investor).
(i) It provides a channel for the injection of Central Bank cash into the system or the economy.
(j) To maintain stable cash and liquidity ratios as a base for the operation of the open market operation.

STUDENTS ASSESSMENT EXERCISE

Why is a Money Market necessary in Nigeria?

3.7 Meaning of the Capital market

While short-term funds are traded in the money market, the capital market is the financial market for longterm funds. Those who need long-term capital for projects of long gestation to be repaid after five years, ten years or more go to the capital market to source such funds. The Capital Market for securities is further subdivided into two: the primary and secondary market. When new securities like shares, stocks and bonds are issued, they are sold initially in the primary market. But when the holders of these securities want to re-sell them, the securities are re-sold in the secondary market. Thus, the primary market is a market for initial issue while the secondary market is a market for subsequent trading in securities.

The Capital Market refers to a collection of financial institutions set up for the granting of medium and long-term loans. It is a market for long-term instruments which included market for the government securities, market for corporate bonds, market for corporate shares (stocks) and market for mortgage loans. That is a market for the mobilisation and utilisation of long-term end of the financial system. Thus, it is the mechanism whereby economic units desirous to invest their surplus funds, interact directly or through financial intermediaries with those who wish to procure funds for their business (Phillips, 1985). In the Nigerian context, participants include the Nigerian Stock Exchange, Discount Houses, Development Banks, Investment Banks, Building Societies, Stockbroking Firms, Insurance and Pension Organisation, Quoted Companies, the government, individuals and the Nigerian Securities and Exchange Commission (NSEC)

STUDENTS ASSESSMENT EXERCISE

Define or explain the term Capital Market.

3.8 Reason for the Establishment of Nigerian Capital Market

1. To introduce a code of Conduct check, abuses and regulate the activities of operators in the market.
2. To provide local opportunities for borrowing and lending for long-term purposes.
3. To enable the authorities to mobilise long-term capital for the economic development of the country.
4. To provide facilities for the quotation and ready marketability of shares and stocks and opportunities and facilities to raise fresh capital in the market.
5. To provide foreign business with the facility to offer their shares and the Nigerian public an opportunity to invest and participate in the shares and ownership of foreign businesses.
6. Through participation and ownership to provide a healthy and mutually acceptable environment for participation and cooperation of indigenous and expatriate capital in the joint effort to develop the Nigerian economy to the mutual advantage of both parties.

The following are the functions of an active capital market. * The promotion of rapid capital.

- The provision of sufficient liquidity for any investor or group of investors.
- The creation of a built-in operational and allocational efficiency within the financial system to ensure that resources are optimally utilised at relatively little costs.
- The mobilisation of savings from numerous economic units for growth and development.
- The encouragement of a more efficient allocation of new investment through the pricing mechanism.
- The provision of an alternative source of fund other than taxation for government.
- The broadening of the ownership base of assets and the creation of a healthy private sector.
- The encouragement of a more efficient allocation of a given amount of tangible wealth through changes in wealth ownership and composition.
- Provision of an efficient mechanism for the allocation of savings among competing productive investment projects.

- It is machinery for mobilising long-term financial resources for industrial development.
- It is a necessary liquidity mechanism for investors through a formal market for debt and equity securities.
- It is an avenue for effecting payments on debt.

STUDENTS ASSESSMENT EXERCISE

i. Examine fully why the establishment of a capital market is inevitable in Nigeria.

3.9 Capital Market Institutions (ORGANS)

Generally, any person who provides long-term capital fund is a participant in the capital market. However in the organised market as Nigerian Capital Market, participating institutions are as follows:-

(a) The Nigerian Securities and exchange Commission
(b) The Nigerian Stock Exchange
(c) Issuing Houses
(d) Merchant Banks
(e) Central Bank of Nigeria
(f) Commercial Banks
(g) Development Banks
(h) Non-bank Financial Institutions

Having discussed the activities of most of these institutions in the proceeding units, we shall briefly discuss the activities of the Securities and Exchange Commission, and the Nigerian Stock Exchange.

(a) The Nigeria Securities and Exchange Commission

The Securities and Exchange Commission (NSEC) is the apex institution for the regulation and monitor- ing of the Nigerian capital market. The commission was established under the security and Exchange Commission Decree 1979, operating retrospectively from 1st April 1978.

Prior to the SEC, two bodies had in succession been responsible for the monitoring of capital market activities in Nigeria. The first was the capital issues committee, which operated between 1962 and 1972. It could not bee seen as the superintendent of the capital market because its functions were more or less advisory without the force of instruction even though its functions included the co-ordination of capital market activities. The next body was the Capital Issues Commission (CIC), which came into being in March 1973. The CIC, unlike its predecessor, had full powers to determine the price, timing and volume of security to be issued. Despite these wider powers, the CIC could not be seen as the apex of the Capital Market because it concerned itself with public companies alone and its activities did not cover the stock exchange and government securities.

The enabling Act of the Securities and Exchange Commission specifies its overriding objectives as “investors protection and development while its functions were divided into two: regulatory and Developmental. To the extent that it combines developmental functions with regulatory matters, it could be seen to be fully established as the apex of the Capital Market. Its functions, as contained in SEC Quarterly Journal Vol. No 1 December, 1984 are as follows:-

(1) to determine the price, amount and time at which security of the company are to be sold either through offer for sale or subscription companies within the grip of the Commission’s functions are:
   (a) all public companies and
   (b) all enterprises with foreign interest.

(2) to determine the basis of allotment of Security of a public offering to ensure wider spread of share ownership,

(3) to monitor the activities of the Nigerian Stock Exchange trading floors in order to ensure orderly, smooth and equitable dealings in securities to forestall illegal deals by privileged insiders at the expense of the innocent and often ignorant investors,

(4) to register:
   (a) all securities proposed to be offered for sale to or subscription by the public or offered privately
   (b) stock exchange and its branches.
   (c) person/instruction involved in securities dealings in stock and securities, registrars, security, brokers and their agents, issuing house, fund managers, etc.
   (d) securities to be traded or being traded (share, debentures)

(5) though the above, to sustain and uplift the integrity and ethical standard of the security market and enhance the public confidence and mass participation in Capital Market activities.

(6) to create the necessary atmosphere for orderly growth and development of the capital market through public enlightenment processes, seminars, workshops, publicity, etc., stimulating ideas, initiating policy and programmes and innovation for the growth of security market.

(7) to protect investors against misleading or inadequate information, fraud, deceit on the part of securities offered for sale hence acting as the watch dog of the public.

(8) to remove all bottlenecks which may hinder easy transfer of shares
  (a) to provide avenue for wider spread in ownership this avoiding monopolistic tendencies or concentration of shares in few but influential hands.
  (b) The Nigerian Stock Exchange (NSE)

Formation of NSE

Following the favourable report of the Barback Committee (Set up in May, 1958) the Lagos Stock Exchanges was established. It was granted certificate of registration of business name on 1 March 1959 and incorporated on 15 September 1960 commencing business on the 5 June 1961.

This exchange is the key player in the Nigeria Capital Market. Although the activities of the exchange is regulated by the Securities and Exchange Commission, it is privately owned. The exchange has three categories of membership. These are the foundation members, the ordinary members and the dealing members.

The foundation members are the seven members that signed the memorandum of association on inception: Shehu Baker, Theophilus B. Doherty, Sir Odumegwu Ojukwu, Akintola Williams, C.T. Boweighs and Co. (Nig) Limited, Investment Company of Nigeria and John Holt Nigeria Limited. The ordinary members are shareholders of the Register of members. These categories of members are those who share any profit or loss made by the exchange.

The dealing members are those ordinary members who are licensed by the council to trade in the floors of the exchange. They act as intermediaries between buyers and sellers of securities. In doing this, they advise their clients on lasting procedures, act as their agents when they want to buy or sell securities and also offer professional advise on portfolio selection.

In order to meet the aspirations of the users of its services, the Lagos Stock Exchange was transformed by the Federal Government on 2 December 1977 into the Nigerian Stock Exchange (NSE) with additional branches at Lagos, Kaduna, Port Harcourt, Kano, Onitsha, Ibadan. A new Stock Exchange is also to be opened at Abuja known as Abuja Stock Exchange as contained in the 1998 Presidential Budget Speech.

Functions of NSE:

(a) To provide appropriate machinery to facilitate further offerings of stocks and shares to the public.

(b) To promote increasing participation by the public in the private sector of the economy.

(c) To encourage the investment of savings as soon as it is clear that stocks and shares are readily available as Professor G. O. Nwankwo (1980) noted other functions as in other economics books.

(d) To provide a central meeting place for members to buy and sell existing stocks and shares and for granting quotations to new ones.

(e) To provide opportunities for raising new capital.

(f) To provide the machinery for mobilising private and public savings and making these available for productive investment through stocks and shares. That is to assist in the mobilisation and allocation of the nation's capital resources among numerous competing alternative uses.

(g) To facilities dealings in Government securities and foreign investment in Nigeria Manufacturing since Government goes into joint venture with foreign investor.

(h) To act as a channel for implementing the indigenisation policy by providing facilities to foreign business to offer their shares to the Nigerian public for subscription.

(i) To reduce the risk of liquidity by facilitating the purchase and sale of securities.

(j) To protect the public from shady dealings and practices in quoted securities as to ensure fair trading through its rules, regulations and operational codes.

STUDENTS ASSESSMENT EXERCISE

Discuss fully the main functions of the Nigerian Securities and Exchange Commission (NSEC) and The Nigerian Stock Exchange (NSE).

3.10 Capital Market Instruments

This comprises long-term securities traded in the capital market. These instruments include the following:

(a) Shares: A share is a security evidencing part ownership in a company. According to Orji (1996), it is a unit of ownership interest which a holder has in a business unit translated into financial terms. There are two types of shares traded in the exchange - Ordinary Shares and Preference Shares.

(b) Debentures: These are long-term instruments evidencing the borrowing of funds by a company from the holders measured in units with a financial value. They carry fixed interest charged. Debenture holders are creditors to the company and are given preference on liquidation over all classes of shareholders.

(c) Government Stocks: These are long-term debt instruments evidencing that the government has borrowed from the holder. It is similar to debentures, and carries a fixed amount of interest. Government stocks are often issued for to raise development funds. They include treasury stocks, and development stocks.

(d) Bond: A bond is a long-term debt instrument which carries a definite nderstanding of the (issuer or borrower) to repay the amount so borrowed on a given date with interest. It carries a fixed interest.

3.11 Problems of the Nigerian Capital Market

The experience of our capital market will not be complete without recounting the challenges and problems which are historical, institutional and structural.

Perhaps the most important single challenge that faces all those interested in the emergence of an active capital market is the problem of impacting depth and breath to the market. By breadth is meant the number and range of securities, which are available for trading, and by depth is meant the volume and the value of such securities. The market has not succeeded in generating sufficient securities from companies and institutions. The number of equities is considered grossly inadequate. The situation has not encouraged active buying and selling in the market.

Second as with the money market, the nation’s capital market is dominated by the government securities in value terms.

Thirdly, the market is characterised by infrastructural inadequacies. There are delays in effecting transactions between issuing houses broker - dealers, registrars, investors and their banks due largely to the inadequacy of postal and telegraphic services. The drag in the delivery services discourages many investors who sometimes view with distrust their registrars and brokers when shares certificates are undelivered or proceeds of shares are not received promptly. Infrastructural limitations insulate many investors, especially those in the rural areas from broker-dealers, thereby restricting trading in securities.

Other problems of this market have to do with ignorance on the part of most members of the Nigerian Public as to the meaning of shares and stocks as well as benefits derivable from market operations and the reluctance of the Nigerian businessman to go public for fear of losing control of family business.

4.0 CONCLUSION

The financial market is segmented into two: the money market which deals in short- term funds and the capital market for long-term dealings in loanable funds. The basis of distinction between the money market and the capital market lies in the degree of liquidity of instruments bought and sold in each of these markets.

Suffice it to say, therefore, that both the Money and Capital Market exist to cater for the fund requirements of both the public (government) and private sector of the economy. Through the Money Market, for example, the government obtains some of its funds to bridge budgetary gaps and business enterprises to realise cash for working capital purposes by issuing short-term debt instruments. The Capital Market makes it possible for the government to raise long-term capital to execute its development programmes and also facilitates the establishment, expansion and modernisation of businesses for increased output employment and income.

In Nigeria, the debt instruments traded in the money market include treasury bills, treasury certificates, commercial papers bankers' acceptances, promissory notes, certificates of deposits bankers unit fund and money at call.

Participants in the money markets include - the most dominant of the financial institutions in the intermediation of short-term funds, merchant banks, insurance companies and other savings type institutions such as savings banks, individuals, and others. The Central Bank supports the market as lender of last resort.

The financial instruments or securities traded in the market include equities or ordinary shares, industrial loans and preference shares, Federal Government development stocks, state government bonds, company bonds and debentures and mortgages. Participants include the commercial, merchant and development or specialised banks finance and insurance companies, provident and pension funds, other financial intermediaries like the Federal Savings Bank and individuals. The non-bank financial institutions are dominant in this market just as commercial banks dominate the money market. As with the Money Market, the CBN is a major participant in the Capital Market as it is statutorily required to absorb unsubscribed portions of government debt issues into its portfolio.

5.0 SUMMARY

In this unit, an attempt has been made to examine the structure and roles of the money and Capital Markets in Nigeria, and the evolution of the markets including institutional developments in the markets.

6.0 TUTOR-MARKED ASSIGNMENTS

Q.1 Distinguish between the Money Market and the Capital Market. Examine the various instruments traded in each market.

Q.2 What are the objectives of the Nigerian Stock Exchange? What are the contribution of this body to the economic development of Nigeria?

Q.3 What is a Capital Market? Discuss the role of the main institutions and participants in this market in Nigeria.

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UNIT 11 INTERNATIONAL TRADE

CONTENTS

1.0 INTRODUCTION

So far in the previous units, we have examined domestic economic problems and noted that the Government has monetary and fiscal policies at its disposal for dealing with them. The technicalities of these policies have been considered in the previous units, but the extent to which they are effective is frequently limited by the repercussions they may have on the external trading position of the country.

Historically, International trade has been in existence since ancient times. Even in the Bible, references were made to trading activities between different countries. Mention was made in the book of Genesis of sons of Jacob who went to Egypt to buy grains. With increase in civilisation and travelling added to the known benefits of specialisation and division of labour, International trade among countries of the world has even increased tremendously.

Although early writers recognised the existence of International Trade they felt that it was not much different from domestic trade to warrant the existence of a separate theory. The fist economist to propound the classical theory of International Trade was Adam Smith in his much celebrated work published in 1776 and titled “An Inquiry into the Nature and causes of the wealth of Nation” other classical economists that helped publicise the theory included David Ricado, John Stunt Mill, Alfred Marshall and others.

While trying to demolish the classical proposition for a separate theory, Ohlin (1933) argued that "International Trade" should be regarded as a special case within the general concept of International Economies. He further argued that nations engage in trading for the same reasons for which individuals or groups within the country trade with each other instead of each one producing his own requirement. That reason is that they are enabled to exploit the substantial advantages of division of labour to their mutual advantage. Trade between different countries developed first where one country could produce something desirable which others could not. International Trade, therefore, owes its origin to the varying resources of different regions.

2.0 OBJECTIVES

The key object of this unit is to introduce the students to international arrangements for the movement of money and goods across national boundaries. After reading this unit, you will be able to:

- explain the concept, reasons for and importance of International Trade,
- quote the classical Theories of International Trade, especially the theory of comparative advantage and other rationals for trade between nations.
- identify the advantages and disadvantages of International Trade.
- evaluate the various arguments presented for and against the idea of trade, and protectionism.

3.0 MAIN CONTENT

3.1 Concepts, Reasons and Importance of International Trade

International Trade refers to the buying and selling of goods and services between countries e.g. between Nigeria and the United States of America, Ghana or Britain, etc.

In other words the term "International Trade" refers to the exchange of goods and services that take place across International Boundaries.

International Trade also is simply defined as the trade across the borders of a country. This may be between two countries, which is called bilateral trade or trade among many countries called multilateral trade.

International Trade is also referred to as International specialisation or International division of labour. The essence of International Trade is to enable countries obtain the greatest possible advantage from the exchange of one kind of commodity or another.

International Trade is across the borders involving different nationalities with different languages and currency. e.g. Nigeria and England.

Vaish (1980:589-592) observed some distinguishing special features of International Trade. One of those salient features according to Vaish (1980) is the immobility of factors of production. The fact remains that in recent times, international movement of factors of production is subjected to much restriction while domestic factor mobility has been on the increase with increase in means of transportation and communication. Thus, this is a difference enough to indicate or distinguish between domestic and International Trade.

Another distinguishing feature is the presence of single currency in domestic trade and multiplicity of currency in international trade.

The third feature of International Trade that makes it distinct is the controls and regulations inherent in the existence of boundaries. Such controls take the form of import restrictions, protectionism, custom duties and other controls, which do not exist, in domestic trade. Critics cannot disprove the fact that both the payment and every aspect of international trade are highly controlled.

The next difference is the presence of linguistic, cultural and political differences between the people of one country and those of another international trade. Although critics argue that language and cultural barriers can still be present in domestic trade in a country with more than one official language and cultures, the fact still holds that people from the same country tend to have a way of understanding themselves more even when their cultures and languages differ. This makes the domestic trade to have less barriers than international trade.

The fifth point to consider is the difference in geographical and transportation, more complex and costlier whether by land, sea or air in international trade. The packaging, insurance, banking and other processes involved in international trade do not apply in the national or domestic trade.

Other differences include differences in the legal systems of various countries, difference in customer demands and also the issue of balance of payment.

From the foregoing, it becomes clear that even when there are some similarities in home and foreign trade they are not exactly the same. It needs be stated, however, that both types of trade are not independent of each other. Both domestic and foreign trade helps to satisfy the needs of the citizens of a country.

No country in the world produces all that her people need. Thus, International Trade is as important as domestic trade if not more.

Nations trade with each other due to the following reasons:

(a) Necessity: - No country is self-sufficient which means that they have to buy from other countries those things they cannot produce.

(b) Because of the uneven distribution of National resources: National resources are not distributed evenly in all countries e.g. in Nigeria we have oil, tin, coal, etc., but Ghana has Gold, etc. Different countries have different mineral resource endowment. Such mineral deposits include coal, tin ore, oil, gold, lead, etc. A country largely supplies of one but with less of others, hence such a country will trade with countries that have such so as to obtain the one she does not have.

(c) Differences in climate: Some crops can only do well under certain climatic conditions e.g. tropical crops such as cotton, cocoa, etc., will not do well in Temperate zones and vice versa. Many commodities, particularly agricultural products are produced under different climatic conditions. Tropical countries produced Cocoa, palmoil products, rubber, etc., while variation of diary products are produced in the temperate regions, hence the need to exchange.

(d) The existence of special skills in some countries: Some countries have acquired worldwide reputation at making certain products e.g. Switzerland is known for making watches. Japan is known for making electronics, etc.

The inhabitants of a region may develop a special skill for the production of a commodity, which in time may acquire a special reputation for quality. Wines such as champagne sherry, port, chianti owe their distinctive qualities partly to the special flavour of locally grown grapes and partly to the local method of manufacture, Scotch and Irish Whisky have similarly acquired distinction.

By exchanging some of its own products for those of other regions, a country can enjoy a much wider range of commodities than otherwise would be open to it.

(e) Differences in tastes: Countries have to import different or some commodities required by citizens which they cannot produce in great quantities e.g. manufactured goods, shoes, plastics.

(f) Differences in Industrial development and the level of Technology: The more advanced countries are developed both industrially and technologically hence the developing nations have to import most manufactured goods from them.

The advanced technology in most of the developed countries enables them to produce a good number of machines and equipment, which the less developed countries could not produce. By trading they can exchange.

(g) Access to Capital: International Trade enables countries with limited capital to either borrow from capital rich countries or attract direct investment into the countries and thus enjoy the benefits of imported capital and technology.

STUDENTS ASSESSMENT EXERCISE

1. What gives rise to international trade?
2. Are there any circumstance in which international trade should be discouraged by the government of a country?
3. Explain carefully the circumstances in which nations find it beneficial to trade with each other.

3.2 Classical Theories of International Trade

The classical economists led by Adam Smith and David Ricardo presented two important explanation to justify International Trade. One is the absolute cost difference in production of various commodities at different countries. The other argument, which in fact incorporates the first, is the theory of comparative advantage.

Absolute Costs Differential Argument: This argument holds that where one country can produce a given commodity at a lower absolute cost than another both countries will benefit more from international trade by allowing the country that can produce it at a lower absolute cost to specialise in this production while the other country buys from them.

According to Smith (1776), trade between two countries will take place if each of the two countries can provide one commodity at an absolute lower cost of production than the other country because of the difference in absolute cost and the absolute advantage that one has over the other.

Samuelson (1982:627) used the term “diversity in conditions of production” to present the argument for absolute cost differential. In line with this, Vaish (1980) sees the superiority of one country in the production of a commodity, as being also her comparative advantage in the production of that commodity.

Thee Theory of Comparative Advantage: Based on the absolute cost difference explanation, international trade will only be beneficial when one country can produce a commodity at a lower absolute cost or more efficiently than another. There may be a situation where one of two countries can produce all commodities at a cheaper rate than the other. The theory of comparative cost also known as the theory of comparative advantage holds that as long as there is a variation in the degree of efficiency at which one country produces various commodities as compared to another, both countries will benefit from engaging in international trade.

Samuelson (1982) explained this theory with the simple example. He likened that example to countries and concluded that the key word "comparative" implies that each and every country has both definite "advantage" in some goods and definite "disadvantage" in other goods. According to him, international trade is mutually profitable even when one of the countries can produce every commodity more cheaply in terms of labour or all resources than the other country.
The theory of comparative advantage centers on international specialisation and international division of labour, it was originally popularised by David Richardo.

Lepsey (1986) also agreed that specialisation will help people learn by doing which in turn leads to greater efficiency in production.

The theory of comparative advantage supports the principle of free trade among nations. It is only on that condition that Specialisation would be beneficial to a country. It only emphasises that those industries should shift to the area where the country has a comparative advantage.

STUDENTS ASSESSMENT EXERCISE

What do you understand by the theory of comparative costs? Can it be applied to home trade?

3.3 Advantage of International Trade

Basically, trade between nations become necessary for the same reason that an individual engages in trade with another. No nation is so independent that it produces within its borders all that her citizens need. Butressing this point, Vaish (1981) observed that "since the creation of earth its inhabitants, natural resources and man's innate abilities were not uniformly apportioned by the Almighty God to all parts of the globe and to all persons and since techniques of production do not advance at equal rates among all nations, regional specialisation in production offers ample scope for international trade.

International trade is, therefore, of much benefit to both consumers in term of improved satisfaction and living standards, the country and the word in general in terms of better utilisation of the world resources and increased international understanding, which helps to promote world peace.

One of the outstanding benefits of international trade is that it encourages international division of labour and specialisation, which in turn increases the wealth of the nation.

By encouraging specialisation, more goods and services are produced, and at reduced prices. This reduces the monopolistic tendencies of local suppliers. International Trade also make it possible for each county to have access to world's raw materials and other resources, which the Almighty God had distributed unevenly to various countries.

Ahukannah et al (1992:45) pointed out that foreign trade makes possible the importation of machinery and spare parts needed for local production and for the operation of local industries.

Oyebola (1977:154) also added that "under international trade, there is a free movement of skilled labour between different countries of the world". As we know, in developing countries like Nigeria, local industries still depend on technological transfer from the developed countries, without international trade, this will not be possible. It, therefore, accelerates economic development, especially the developing world where modern equipment can be used for industrial and agricultural purposes. The developing world gains in technical knowledge from the more advanced world. International Trade attracts foreign investment to Nigeria.

International trade provides revenue for the countries concerned. In Nigeria for example, import and export duties form a great percentage of the total revenue from taxes.

Another advantage of international trade is that it provides employment for many inhabitants of the countries concerned. For example, many people in West Africa are engaged in importation and exportation of goods.

STUDENTS ASSESSMENT EXERCISE

(i) Comment on the view that an extension of international trade will raise the living standards of all those countries which engage in it.
(ii) Should two countries trade if one of them is more efficient at producing everything?
(iii) Why do countries trade with each other?

3.4 Disadvantage of International Trade

Despite all the advantages of trade between countries, it is criticised on the basis of some observed disadvantages.

1. Any nation that is solely dependent on the sale of a single major product is liable to adversities of a decline in world demand for the product e.g. the on economies of Nigeria and Ghana which depends solely on crude oil and cocoa respectively.
2. Economically, weaker nations are likely to be dominated by the more advanced countries of the world.
   West African nations are subjected to economic subservience by their former colonial masters.
3. International trade leads some nations not to make serious efforts to be self-reliant.
4. International trade can also lead to over-production of goods and services, which can rise to depression.
5. It breeds mistrust, suspicions, jealousies and unhealthy competition among countries and these have often accounted for wars and other forms of unrests in the world.
6. Over-dependence of some countries on others for the supply of some products may result in lack of development of knowledge and skill along the lines of the dependant nations. In times of war, dependent nations economically can be at great disadvantage.
7. Some economies concentrate on the production of certain commodities at the expense of many essential ones. It could be a source of handicap in times of war. This is because the other country can place an embargo on these goods that the nation highly depended upon.
8. The next argument is that international trade can stifle local industries and cause unemployment to result from such industries. It is also said to cause economic instability because the economic problems of a supplier country may affect the buyer country. Moreover, goods that are currently imported at lower prices can rise in prices in the future.

STUDENTS ASSESSMENT EXERCISE

Explain the disadvantages that can be experienced from foreign trade or international trade and the principal difficulties, which can arise.

3.5 NIGERIA'S TRADE POLICY REGIMES

Nigeria's international trade policy regimes can be classified into four restrictive, highly restrictive, liberal and highly liberal (see table 9d for detail for 1960 to 1979). The dominant instruments of the nation's trade regimes were tariff and non-tariff trade barriers. The tariff rate included import duties and export duties, which were varied, depending on the exigencies of the times. On the other hand, the non-tariff trade barriers included licenses, import quotas, export quotas, supervisions, restrictions, direct importation, prohibitions, and outright bans.

The introduction of SAP in 1986 brought in a liberalization scheme such that in 1988 a comprehensive tariff structure was adopted to last seven years. This resulted in lower levels of protection than those before SAP. It was characterized by the abortion of exchange controls, placing exercise duties on some items while removing them on others, reintroduction of import duty surcharge, introduction of duty free raw materials and intermediate products for manufacturers of exportable (processing to take place within 1½ years), refunding of import duties on raw materials for exports, reduction of import prohibition list. Table 9e shows nominal protection rate accorded by customs and excise tariff between 1984 and 1995. Restrictive policies reappeared in 1990 with high tariff rates. Between 1991 and 1994, duties were reduced with amounts set aside for duty drawback scheme raised from N50 million in 1991, manufacturing in bond scheme and import monitoring scheme were also set up.

From February 1995, a new tariff structure was introduced to replace that of 1988 and it was meant to cover the period 1995 to 2001. It is characterized by:

Table 9d: Nigeria's trade policy regimes, 1960-1997.

Year	Trade Regime
1960-69	Restrictive
1970	Liberal
1971-74	Highly liberal
1975-78	Restrictive
1979	Liberal
1980	Highly liberal
1981-83	Restrictive
1984-86	Liberal
1987-89	Highly liberal
1990	Restrictive
1991-94	Liberal
1995-97	Highly liberal

Source: CBN, Annual Report and Statement of Account, (Various Years). Lagos; Federal Budget Statements (Various Years)

Table 9e: Nominal protection Rates Accorded by Customs and Excise tariff (%), 1984-1990.

Sector	1984	1986	1988	1994	1995
1. Food, beverages and tobacco	43	37	38	39	37
2. Textile and leather	48	42	80	54	43
3. Paper and printing materials	29	23	27	21	17
4. Metal products and machinery	30	20	22	22	17
5. Basic metal industries	29	17	26	34	16
6. Average Un-weighted Rates**	35	25	34	33	24

Nominal protection is computed by adjusting the customs duty plus surcharge for the effect of the excise on comparable domestic products, un-weighted average rates are based on tariff code items, including banned items.
Source: adopted from Soludo and Adenikinju (1997).

3.5 .1 Restrictions to International Trade and Specialisation

Barriers to international trade could be both natural and artificial. These barriers include:

(a) Linguistic or Language Barrier: All over the countries of the world, different languages are spoken. For instance, in France, they speak French, in Britain they speak English, in Spain they speak Spanish while in Nigeria the official language is English in addition to numerous other local languages. The problem of communication arises when different languages engage in trade. However with Western education and the increased use of English Language all over the world, this natural barriers is being broken.

(b) Distance Barrier: Nations are thousands and millions of kilometers apart. This delays messages or goods involved in foreign trade. However, the development of modern communication system like the telephone and modern transport systems has helped to minimise this natural barrier.

(c) Religious Barrier: Religion also poses a barrier in foreign trade. For instance, in West Africa, cow meat is a good source of protein but in some parts of India and other Asian Countries, cow meat is forbidden. This can go a long way in hindering the development of foreign trade, especially when people are dogmatic and fanatical about their beliefs and religious practices.

(d) Communication Barrier: In many developing countries, telephone and the telex system are not developed while the existing ones are poor, inefficient and inadequate.

(e) Transport Barrier: Many developing nations have very poor and inadequate transport systems and network such as inaccessible roads, under developed maritime system and poor airport services constituting delays in international transactions.

(f) Currency differences Barrier: Each country uses its domestic currency in domestic trade. For instance, in Nigeria, naira is used, in Ghana, cedi is used, in Britain the British sterling or pound is used while in America, the American dollar is used. Most of these local currencies are not convertible currencies and cannot be used in the settlement of international transactions. This poses the problem of being involved in securing foreign exchange involving convertible currencies such as the US dollar, the pound sterling.

(g) Measures and Weights Barriers: Technical problems arise since different countries use different units of measures and weights. For instance, Nigeria has gone metric and hence uses metres, etc., as well as grammes, kilogrammes, etc. However, some other nations she trades with still use yards, feet, and inches as well as ounces and pounds.

(h) Traditional differences Barriers: The traditions and customs of different countries differ and thesemay pose a problem to foreign trade.

(i) Ideological differences Barrier: The countries in the Western bloc practice capitalism while those in Eastern bloc used to practice socialism, capitalism or mixed economies. Many a time, these ideological differences pose a great obstacle to foreign trade since nations under different idealogical learnings may refuse to trade with each other. Where they do trade at all, a lot of caution and restrictions are adopted.

(j) Economic Independence/Self-reliance barrier: Many countries today want to be economically independent and self-reliant so that they reduce their participation in foreign trade even when they do not have comparative cost advantage in the goods they produce in as much as this is a good policy. It can limit or hinder foreign trade.

(k) Protectionist Policy Barrier: Many countries take measures to protect their economies from dumping from overseas or to protect strategic sectors of their economy such as agriculture. This limits the extent of foreign trade.

(l) Trade Inbalance Barrier: When many developing nations experience continuous trade inbalance with some advanced nations, there is the tendency to limit their imports from those nations so as to improve their balance of trade and hence balance of payments.

(m) Foreign Exchange barrier: Many developing nations such as Nigeria lack enough foreign exchange to purchase foreign goods. Such nations will thus reduce imports and hence their participation in foreign trade.

(n) Credit Shortage barrier: In many countries, credit facilities are inadequate or lacking such that there is not enough money to engage in external trade.

(o) Artificial Barriers: Government also takes measures to restrict foreign trade. Such measures include the imposition of custom duties, import and export duties placing bans on some goods, placing quantitative controls or quotes exchange controls, and non-tariff barriers, etc.

Factor Mobility: Factors of production, especially labour, are not mobile. Raw materials are subjected to controls which include sanctions. If factors of production are not mobile, specialisation is limited to the extent of international restrictions.

Imperfect competition between countries: Sometimes there is opposition from groups with vested interest. This prevents free trade among nations and makes difficult the operation of the comparative advantage principle.

Multi-lateralism: The theory of comparative costs assumes trade to be bilateral that is between two countries that specialise. The real world, however, is a system of multi-literalism in which many countries trade with one another at the same time. Among countries that produce cheaply, some may have greater advantage over others, while some countries may prefer to buy from one country rather than from one another. This factor sometimes leads to an unfavourable balance of trade for countries that import more than they export to other countries.

3.6 Instruments of Foreign Trade Protection and Promotion

In an ideal world in which the principle of comparative costs specialisation is practiced, there is free trade and no duty is placed on traded goods. Almost all countries around the world impose some form of restrictions on the flow of international trade. Despite the advantages of foreign trade, different governments place restrictions on it. These restrictions take different forms as described below:

(a) Import Duties of Tariffs: These are charges or taxes levied by the government on goods imported into the country. The major objective of imposing such duties is to raise revenue or to restrict the importation of the concerned goods.

(b) Export Duties or Tariffs: These are charges of taxes levied by the government on goods exported out of the country. It may be to raise revenue or to discourage the exportation of certain commodities that are in short supply locally.

(c) Import Quotas or Quantitative Restrictions: These are direct restriction on the quantity of goods that can be bought into the country. This limits importation. Embargo is also a form of quantitative control.

(d) Exchange Control: This includes the rationing of foreign exchange available for purchases e.g. through import licencing or through the foreign exchange market (FEM). Exchange control measures specify the value of foreign exchange.

(e) Non-Tariff Barrier: This may take the form of administrative practices, such as deliberately channelling government contracts to home companies even where their tenders are not competitive or insisting on different technical standards.

(f) Total Ban: This involves placing total ban on the importation of certain commodities, especially harmful and non-essential goods. It may also be to encourage the local production of such goods and save foreign exchange e.g. Nigeria has placed total ban on the importation of wheat (before December, 1992) barley, vegetable oil, etc. Occasions may also arise when the government places total ban on the exportation of certain commodities to meet local demand. For instance, in January, 1988. The Federal Government of Nigeria banned the exportation of certain grains such as maize.

(g) Export Promotion Incentives/Subsidies: Nations such as Nigeria (since 1986) give export promotion incentives in order to stimulate non-oil exports to earn longer foreign exchange. This reduces hitherto imported items. Standards and complex customs regulations such as import deposit schemes and pre-shipment inspections are trade protection measures.

The Case for Free Trade

Free trade on its own refers to an open door trade policy which encourages free flow of foreign goods and services without any barrier. It is, therefore, the absence of protectionism. According to Adam Smith, free trade policy is “ a system of commercial policy which draws no distinction between domestic and foreign commodities and thus neither impose additional burden on the latter nor grants any special favour to the former” Vaish (1980:644).

The major argument presented for free trade is that it will make the maximisation of world output possible by encouraging each country of the world to specialise in the production of those commodities in which they have a comparative advantage.

Furthermore, such specialisation will lead to a more efficient utilisation of the world resources. This in turn will lead to cheaper imports. It does this by encouraging perfect competition, which safeguards consumers from monopolistic tendencies of local producers.

According to Haberler (19509:4-10) free trade encourages the economic development of under-developed countries. It does this by enabling them to import capital goods machinery and essential raw materials, and also to import the technical know-how managerial talents, and entrepreneurship from developed countries. It also serves as a carrier for international capital movement and promotes free competition in those countries.

The Case for Protection

Why Nations impose Restrictions on Foreign - International Trade.

(a) Infant Industry Argument: Nations impose restrictions in order to protect new or infant local industries from foreign competition with respect to long-standing but similar large industries.

(b) Revenue Argument: Nations impose duties or restrictions in order to earn enough revenue to execute other projects locally. This is particularly so in the case of the imposition of import duties.

(c) Balance of Payments Arguments: Some countries impose restrictions to improve their balance of payments via import restrictions or to correct balance of payments deficits. Measures taken here include those which restrict imports and stimulate.

(d) Anti-dumping Argument: Countries take measures to prevent the dumping of cheap commodities in their countries.

(e) Employment Stimulation Argument: Restrictions are also used as a deliberate instrument of planning to stimulate employment. This is done by encouraging local production of hitherto foreign imported goods by businessmen.

(f) Changing Pattern of Consumption Argument: The government also imposes restriction to discourage the consumption of some commodities which are either considered harmful or non-essential. Those considered harmful are meant to protect the health of the nationals while the non-essential but expensive ones are placed on restrictions to change consumption pattern while generating revenue to the government as well as redistributing income.

(g) Bargaining Power Argument: Some countries also impose restrictions on foreign trade in order to have bargaining power during negotiation at trade conferences.

(h) Self-Sufficiency Argument: Some countries impose restriction on certain goods to enable them to be self sufficient in the production of those commodities. This helps to eliminate or reduce foreign domination and neo-colonialism.

(i) Self-Reliance Argument: Some nations tend to rely on their abilities, initiatives and resources in the production of certain commodities hence they impose restrictions on certain goods.

(j) Recovery from Depression Argument: During periods of economic depression when there is low economic activity and rising unemployment, imports are usually restricted to stimulate the domestic economy.

(k) Strategic Sectors Argument: Strategic tariff could be imposed to protect some strategic sectors of the economy such as industries whose products may be essential in times of war or international crisis.

Also protection given to agriculture in most developing nations even when comparative costs are high compared to other nations could be seen as a measure to protect a strategic sector of the economy.

STUDENTS ASSESSMENT EXERCISE

(i) Explain carefully the circumstances in which nations find it beneficial to trade with each other.
(ii) "Government can always justify the establishment of trade barriers". Examine critically the arguments in favour of trade barriers.
(iii) Describe and Comment on the significance of various forms of trade barriers to trade.

4.0 CONCLUSION

When trade takes place within the borders of a country, it is said to be home trade, domestic trade or internal trade. But, when trade takes place beyond the boundaries of a country, it is said to be foreign, external or international trade. International Trade is the trade between one country and another.

The most obvious reason for trading with other countries is to obtain goods which cannot be produced in our country or can only be produced at great expense. Climatic and geological differences account for a proportion of International Trade. Less obviously perhaps, differences in the skills of labour and in accumulation of capital account for some of the exports of the wealthy countries. It was differences in factor endowments that underlay the traditional pattern of world trade.

The basic explanation underlying International Trade is to be found in the "Law" of comparative costs.

This shows that trade will be beneficial to a country if it concentrates but not necessarily specialise entirely on the production of those goods in which it has the greatest relative advantage over its trading partners.

Economists have frequently praised the virtues of free trade- trade unhampered by any artificial barriers such as tariffs and they have seen it as a means of inducing the most economic allocation of resources.

Despite this, all Governments take steps to reduce the volume of imports entering their country, or exports leaving their country. They do this for a variety of reasons and in the certain knowledge that they invite retaliation from their trading partners. There are a number of ways of protecting the home economy from overseas competition. Those most frequently used include the following: Tariffs, subsidies, Quantitative restrictions, non-tariff barriers, exchange controls.

We may conclude that there are frequently important economic and social strategic reasons for the protection of home industries.

5.0 SUMMARY

In this unit, we have tried to look at the concept and importance of International Trade, the theories of absolute and comparative advantages, the issues of protectionism and free trade, briefly.

6.0 TUTOR-MARKED ASSIGNMENTS (TMA)

Q.1 Explain the theory of Comparative Advantage in International Trade. What makes international trade different from domestic trade?

Q.2 What arguments are often presented in support of protectionism?

Q.3 Why do countries trade with each other? Is it ever desirable for a country to restrict the amount of international trade it permits its inhabitants to participate in?

Q.4 It is Comparative Advantage not Absolute Advantage, which determines the pattern of trade between countries, elucidate and discuss.

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UNIT 12 THE BALANCE OF PAYMENTS

CONTENTS

1.0 INTRODUCTION

In the analysis of comparative costs in Unit Eleven, we confined ourselves to trade by barter, deliberately excluding any idea of money of currency. In practice, it is the use of different (token) currencies that causes most of the problems associated with International Trade. This unit shows the need for careful recording of international transactions, the nature of these transactions, recent changes in their structure as far as the Nigerian economy is concerned, and the methods available for dealing with short-term Balance of Payments difficulties.

2.0 OBJECTIVES

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

- Differentiate between Balance of Trade and Terms of Trade.
- Explain the meaning of Balance of Payments and its various items.
- distinguish between the various parts of the current and capital accounts that constitute the component/ structure of the Balance of Payments.
- evaluate the consequences of chronic balance of payment deficits.
- evaluate the merits of the policies that can be used to tackle a balance of payments deficit.

3.0 MAIN CONTENT

3.1 Balance of Trade - Meaning/Definitions

Foreign Trade is made up of Exports and Imports. Exports are the goods and services which a country sends to other countries (abroad) in return for some payment made in foreign exchange. We have "visible exports" and "invisible exports". Exports of goods refer to visible exports while exports of services refer to invisible exports.

Imports are goods and services which are brought into a country from foreign nations for which the receiving country pays for in foreign exchange. There are also "visible and invisible" imports. Imports of goods are visible imports while imports of services are invisible imports. Nigeria's major imports include manufactured goods, machinery, transport, equipment, chemicals, foods and live animals, etc.

Balance of Trade shows a country's receipts and payments for goods and services, such as crude oil, cocoa, machines, equipment, baking, etc. That is, it deals with exports and imports of goods and services which may be visible or invisible. Visible trade is that concerned with buying and selling of goods. Invisible trade consists of services provided to or by other nations, e. g. Insurance, Banking, etc. It can also be called Balance of Current Accounts.

3.2 Terms of Trade and Measurement

Terms of Trade means the rate at which one country's products exchange with those of another and this depends on the countries' prices of exports and imports. That is, it is the rate at which a nation's exports exchange for its imports.

To say that the terms of trade of a country is favourable means that the prices of its exports are higher relative to the prices of its imports. Otherwise, it is unfavourable if the prices of imports are higher relative to the prices of exports.

The measurement of TOT is given as follows:

$$TOT = \frac{\text{Index of Export Prices}}{\text{Price Index of Import Duties}} \times \frac{100}{1}$$

- Bilateral Trade - This means trade between two countries
- Multilateral Trade - This occurs when there are more than two (2) countries involved in trade.

Nigeria exports barrels of crude oil, Cocoa, tin and some other commodities to the rest of the world. At the same time, Nigeria imports machinery, milk, ink, writing paper, services of exports and so on from other countries. With the income earned from exports, Nigeria is able to buy a certain amount of imports. It follows that a certain amount of exports has to be exported to the rest of the world before Nigeria can import a certain quantity of import. This rate of exchange between Nigeria's exports and imports it gets from the rest of the world is Nigeria's terms of "Trade". In other words, the term of Trade of any country is the rate at which its exports equates its imports at any given time.

The terms Trade change from time to time, following the prices of traded commodities. If the price of motor cars rise in Japan, Nigeria will have to sell more barrel of crude oil assuming that there is no change in the price of crude oil in order to buy the number of motor cars. In this case, the terms of trade are unfavourable to Nigeria. If the price of oil rises in favour of Nigeria, Japan will have to sell more cars to buy the same quantity of crude oil from Nigeria. In this case, we say that the terms of Trade are favourable to Nigeria as its exports if it exports the same amount of crude oil but get more cars from Japan.

Briefly, if a country gets more imports for a given amount of exports, the term of trade are favourable to the country. If on the other hand, the same country gets less imports for the same amount of exports the terms of Trade are unfavourable to the country. The terms of Trade are important determinants of the balance of payments.

The concept of the terms of Trade is of great importance in the theory of International Trade since it measures the terms on which a country's exports are exchanged for its imports. It thus determines how much a country gains from foreign trade. Because money is so important in foreign trade, the terms of Trade are measured as a ratio of changes in exports and import prices.

STUDENTS ASSESSMENT EXERCISE

(i) How does a change in the terms of Trade affect the economies of trading nations?
(ii) How are the terms of Trade of a country measured? Is it important in the terms of trade bound to lead an improvement in the balance of Trade?
(iii) How is a country affected by a change in its favour of the terms of Trade?

3.3 The Concept of the Balance of Payments

A country's balance of payments refers to a systematic record of all economic transactions between the residents of the reporting country and residents of foreign countries during a given period of time, usually a year. An economic transaction, as used here, is an exchange of value, typically an act in which there is transfer of title to an economic good, the rendering of services or the transfer of title to assets from one country's residents to another.

Thus, the balance of payments is a statistical record which summarises all transactions which take place between the residents of a country and the rest of the world. It is a statement of a country's economic transaction with other countries and it shows, for that accounting period usually a year, total income (receipts) and total expenditure (payments) and the balance of income over expenditure. The transactions include buying, selling, borrowing and lending, investment and disinvestment, income from investment and repatriation of profits and dividends, in addition to gifts and grants, etc. All transactions which entail inflow of payments are taken as credit plus entries while debit or minus entries are those transactions which generate an outflow of payments.

Thus, a balance of payments account refers to a classified summary of the money value of all international transactions of an economy, in some form of aggregation, pertaining to a given period of time, usually a year.

Both in the accounting and economic sense, a country's balance of payments must always balance since every purchase of goods and services by a country is recorded both as a credit item (the goods received and as a debt item) (the debt owed by the purchasing country to the supplier). This is an accounting procedure based on common sense rather than on mere fancy.

3.4 The Reasons for Measuring the Balance of Payments

(a) To measure performance

A country's Balance of Payment may be likened to the annual income and expenditure of a household, although the comparison must not be carried too far. The household receives income by supplying the services of factors of production and spends that income on the purchase of goods and services it requires. If the household spends all its income, no more and no less, it is in the same position as a country whose Balance of Payments just balances, if it spends more than its income either by borrowing or drawing on past savings, the household has a balance of payments deficit for the year, if its expenditure falls short of income, it may regard itself as having a balance of payments surplus.
This illustrates one reason for assessing the Balance of Payments. It shows whether or not the country as a whole is paying its way in the world. The Government needs an

assessment of the Balance of payment in order to check that the community is living within its means.

(b) To protect the foreign currency reserves

Goods imported from abroad have to be paid for in currency acceptable to the supplier. Individual importers do not keep stocks of foreign currencies needed to buy goods overseas but they can acquire them from the Central Bank of Nigeria (CBN). A second important reason for keeping track of the Balance of Payments is that a deficit leads to the reduction in these reserves and prolonged deficits force the Government (CBN) to take restrictive actions in order to preserve the currency for essential purposes.

(c) To inform governmental authorities of the international position of the country.
(d) To aid governmental authorities in reaching decisions on monetary and fiscal policy on the one hand and trade and payment questions on the other.
(e) They are used to measure the resource flows between one country and another.

(f) Information on payments and receipts in foreign exchange constituting a foreign exchange budget, helps to assure monetary authorities that the country could go on buying foreign goods and meeting payments in foreign currency when they become due.
(g) To measure the influence of foreign transactions on national income.

STUDENTS ASSESSMENT EXERCISE

(i) Define the terms "Balance of Payments" and Balance of Trade"
(ii) There is no reason to expect the balance of Trade to balance. But the balance of payment must always balance. Discuss.
(iii) What are invisible exports and invisible imports? Give examples of both and discuss their relative's importance for Nigeria.
(iv) Can deterioration in a country's international terms of Trade cause an improvement in that country's balance of Trade?

3.5 The Components/Structure of the Balance of Payments

Lipsey (1983) said that a more analytically convenient way to present a nation's balance of payment is to divide it into three components, viz Current Account, Capital Account, and Official Financing.

The Capital Account
These records transactions related to movement of long and short-time capital i. e. it shows the volume of private foreign investment and public grants and loans from individual nations and multilateral donor agencies such as UNDP and the World Bank. It

includes direct investment, portfolio investment, long-term capital and short-term capital. The capital account will be a deficit if payment exceeds receipts but a surplus if receipts exceed payments.

The capital account section records all capital movements. They do not consist of goods and services but debts and paper claims such as long term and short term loans that government and private citizens make or receive from foreign government and private citizens. The capital account is very crucial because it is used to finance any deficit on the balance of trade (i. e. current account deficit) and also used to finance a net flow of goods to the recipients' country. This explains why the balance of payments must always balance.

The Current Accounts

The account of import and export goods and services is known as the current account. This is the basic component of the balance of payments. It equally has the largest entries. The current account is further divided into two sections: merchandise trade items and service transaction items.

The merchandise items refer to the import and export of goods (merchandise). This is also known as visible items or visible trade items. The service items are known as invisible. items.

The difference between the debit and credit entries in the current account is known as balance of Trade. The balance of Trade is said to b e "favourable" or surplus if exports (sources of foreign exchange) exceeds imports (use of foreign exchange). It is also said to be "unfavourable" or "deficit" if the imports exceed exports.

In most cases, when the balance of payment is said to be in deficit or in surplus, reference is being made to the current account or one account heading not to the total of all balance of payment entries. This is because, in totals the balance on the Capital Account normally offsets the balance on current account. An excess of imports over exports (a debit balance on current account), creates an international debt obligation which is an equivalent credit balance in the capital account.

Official Financing

After summation of the investment and capital flows, a balancing item is added in the Capital Account. This has noting to do with the size of the Balance of Payments deficit or surplus but merely indicates the errors and omissions which have occurred. That part of the accounts which we have so far overlooked is called "Official Financing". This records the changes that have occurred, in government holdings of foreign currency of liquid claims to currency over the year.

Official financing items or official settlements represent transactions involving the Central Bank of the country whose balance of payment is being recorded and there are three ways in which credit items may occur on the official financing account.

(a) The Central Bank may borrow, say from the IMF and this represents a capital inflow and is hence a credit item on the balance of payment. Repayment of old IMF is a debit item.
(b) The Central Bank may run down its official reserves of gold and foreign exchange and this is a credit item since it gives rise to a sale of foreign exchange and a purchase of naira.
(c) The Central Bank might borrow from other Central Banks though a network of arrangement and these will be on the credit side of the BOPs account.

There is also a Cash Account showing how cash balances (foreign reserves) and short term claims have changed in response to current and capital account transactions. Such a cash account is, thus, the balancing items which is lowered (i. e. a net outflow of foreign exchange) whenever total disbursements on the current and capital account exceed total receipts (Todaro, 1977).

Finally, actual recording of BOPs can rarely be quite complete and accurate, hence there are bound to be certain omissions and error in some other entries in terms of their values. Some of the errors and omissions on credit side might be compensated by errors and omissions on credit side. This, a balancing item of “errors and omissions” is provided to equate the two sides of the account, and it could be positive or negative, and hence might appear on the credit or the debit side of the balance. This entry does not violate the principle that debits and credits will equal each other, but only reflects the reality that actual recording is bound to be incomplete in more than one ways.

STUDENTS ASSESSMENT EXERCISE

What part do Capital Movement play in the Nigerian Balance of Payment?

3.5.1 Balance of Payments Disequilibrium

A state of disequilibrium occurs in the balance of payments when an adverse or unfavourable balance results in movements in short-term capital and or adjustments to reserves. Disequilibrium has two aspects: surpluses and deficits. A country is said to have a surplus in the balance of payments if its income flow exceeds its expenditure flow. On the other hand, a deficit or debit in balance is of two kinds: temporary and fundamental. A deficit is temporary, if it can be corrected or adjusted within a short-time. It is persistent, if it is of long duration. If it is not corrected, reserves will run out and other countries will lose confidence in the country. As a result, such a country will find it difficult in raising external loans for the development of its economy.

The following are the causes of disequilibrium in the balance of payments.

(i) Excessive importation of goods and services
(ii) Deficiency in domestic output
(iii) Inadequately patronage of home made goods which are regarded as inferior goods and
(iv) High-level of importation of technical know-how in developing countries,.

In an accounting sense, credit and debit side totals of the BOPs must balance. Therefore, an inherent tendency for the balance of payments to balance refers to equilibrium in the balance of payments since when there are variations in the balance, the surpluses tend to cancel out the deficits. However, the absence of an inherent tendency for the balance of payments to balance refers to disequilibrium in the balance of payments since when there are variations in the balance, the surpluses do not tend to cancel out the deficits. Then disequilibrium or gap in the balance of payments generally refers to an inherent tendency of an absence of balance the balance of payments "unfavourable or deficit balance is considered more undesirable than an "active", "positive", favoruable or surplus one.

Such as disequilibrium may be due to factors which cause an imbalance in trade account and/or in capital account. The factors include:

(a) Persistent inflationary pressures at home hence the nation's cost-price structure makes it unprofitable for foreigners to import from this country, but making imports to rise.
(b) Inflationary pressures in trading partners' economies hence the country in question is forced to import at higher prices and hence bear the burden of high wages and other types of exploitation by the richer economies.
(c) Servicing of existing debts through fresh loans without generating an adequate export surplus.
(d) Political disturbance such as war of threat of war which result in large imports of arms, ammunitions, food and strategic raw materials for stockpiling. This sudden spurt in imports and possibly a planned reduction in exports result in a deficit in the trade and payments.
(e) Economic calamities such as drought, flood, earthquake or general crop failure which increase imports reduce exports.
(f) Lacks of capacity to meet changing requirements of importers due to lack of resourcefulness, diversification and resiliency. This export lags behind imports more so when the latter is influenced by demonstration effect, (Bhatia, 1984).

STUDENTS ASSESSMENT EXERCISE

(i) "Living beyond their means". Does this well describe citizens in any country with a balance of payments deficit?
(ii) How does inflation affect our export and import trade?

3.6 Ways of Correcting Balance of Payments Disequilibrium/Deficits

Thus, while a temporary balance of payments can be financed (official financing) by running down foreign currency reserves and by foreign borrowing, these cannot go on indefinitely since such financing cannot carry a persistent balance of payments deficit. This calls for corrective action/policy on the part of the government. Government corrective action can be grouped into two broad categories: Expenditure Reducing Policies and Expenditure Switching Policies.

(a) Expenditure Reducing Policies

These are meant to achieve a deflation of aggregate demand in the economy such that the demand for imports will reduce. Also, it is expected that domestic industry, faced with a contraction of demand in the domestic market, will attempt to export more aggressively. Specific expenditure reducing policies include:

(i) Fiscal Policy: This involves increase in taxes and decrease in government expenditure. This is expected to lower purchasing power in the domestic economy and hence lower imports of goods and services, and therefore correct the persistent deficits in the BOPs.
(ii) Monetary Policy: This involves measures which include contraction for restrictions on money supply, raising interest rates and restriction of credit. Again, this lower people are purchasing power and hence lower demand for imports.

(b) Expenditure Switching Policies

These are meant to switch expenditure away from imported goods toward domestically produced substitutes, as well as to stimulate the level of exports and hence export earnings. These policies can also be categorised into two - Trade Policy and Exchange Rate Policy.

Trade Policy includes

(i) Control of imports or direct controls -Attempts to directly control imports of goods and services can take the form of tariffs or import duties, quantitative restrictions (quotas) exchange control and export schemes.

- Tariffs or import duties: The deficit nation can impose a tax on imports to increase their price and reduce demand for them. The government might also change licence fees for the imports.
- Quantitative Restrictions or quatos or ban: These involves physical controls on the amount of a good which are imported from a particular source in a given time period. At the extreme, it may involve outright ban on the importation of certain items.
- Exchange Control: A country which has a balance of payments problem may restrict the supply of foreign exchange. This is meant to regulate both the inflow and the outflow of foreign exchange hence all transaction in foreign exchange pass through the hands of the authorities.
- Export Schemes: These involves scheme meant to increase exports to subsidise export industries and for which might make exporting simpler to finance and less risky. For example, in Nigeria, there is the export promotion strategy meant to encourage exports and generate foreign exchange and enhance the nation's BOPs position. It involves such measures as duty-free export of some goods and services, tax holidays or elimination of export subsidy, retention of a percentage of the foreign exchange earnings by the exporter, assistance on export costing and pricing, liberalised export and the establishment of an Export Credit Guarantee and Insurance Scheme to provide insurance risk of default by foreign buyers and cheap finance for exports.
- Exchange Rate Policy: In addition, to foreign exchange restriction, a country can intervene in the foreign exchange market by fixing its own rate. This also essentially involves devaluation i. e. reduction in the value of the home country in terms of one or more currencies or gold. This is a deliberate measure of shifting the exchange rate against the home country. Devaluation means a fall in the exchange value of a country's currency in relation to the currencies of other countries.

  Devaluation cheapens exports and makes imports clearer, thus improving the balance of payments. For devaluation to be effective, the demand for the devalued exports should be elastic.

  Apart from elasticities, the success of devaluation also depends on other factors including Retaliation by Trading Partners. If the devaluating country's trade partners retaliate by devaluing their currencies then devaluation will have disruptive effects without improving the balance of Trade.

STUDENTS ASSESSMENT EXERCISE

(i) In what ways could a balance of payment deficit be corrected?

(ii) Define "Devaluation" and state briefly how devaluation of a country's currency may reduce its imports.

(iii) Distinguish between a balance of payments surplus and a balance of payments deficit.

4.0 CONCLUSION

International Trade gives rise to indebtedness between countries. The BOPs shows the relation between a country's payments to other countries and its receipts from them, and thus a statement of income and expenditure on international account. In other words, it is the country's monetary and economic transactions with the rest of the world over a period of time usually one calendar year.

Like the Balance Sheet of Income and Expenditure of a company or a person, the balance of international payments or accounts shows credit (+) for payment received by the country and debit (-) for payment made to other countries. The overall balance enables the government of a country to see its position in international economic order and to take measures to improve correct or adjust its position.

There are three main accounts of the balance of payments into which all economic transactions between a nation and the rest of the world are classified. They are (i) the current account, (ii) the capital account and (iii) the official settlement account or financing.

When a country has an adverse or debit balance in its balance of payments, it regards it with serious concern, when it has a favourbale or credit balance there is satisfaction.
A variety of instruments are available for correcting balance of payment deficits.

5.0 SUMMARY

In this unit, we have succeeded in stating that all transactions between one country and the rest of the world involving the exchange of currency are brought together annually under the heading of the Balance of Payments. This effectually summarises the country's economic relationships with the rest of the world during the proceeding 12 months.

6.0 TUTOR-MARKED ASSIGNMENTS (TMA)

Q1 What is "Balance of Payments"? Explain the various components of the Balance of Payment
Q2 Why is it necessary to make an estimate/measure of the Balance of Payment?
Q3 In what ways could a balance of payment deficit be corrected?

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UNIT 13 SCOPE OF PUBLIC FINANCE

CONTENTS

1.0 INTRODUCTION

Public finance is not a new field of study. It dates from emergence of governments which means that it is not as old as governments. From time immaterial, governments imposed taxes to raise enough revenue only to cover the cost of administration and defence. The state is supposed to provide security and prohibit or regulate those activities by individuals or by groups within the society which might injure the community as a whole. To provide for these necessary services, government began to raise money in form of taxes. This is why taxes were regarded as payment for services rendered by the government. Today, the number of services which the governments provide have increased tremendously. Government development expenditure, roads and equipment required to provide government social and economic services.

Since independence in 1960, the government has sought to control the level of economic activity by alterations in fiscal policy, and it has used monetary policy mainly to create the general economic atmosphere. “Public Finance” is the term applied to the study of the methods employed by the government to raise revenue, and the principles underlying Government expenditure.

It is important to understand that Government expenditure is just as much as part of public finance as adjustments to taxation.

In order to emphasise this, we shall in this unit examine the expenditure side of government before investigating the main sources of revenue and later examine the role of fiscal policy in the next unit.

2.0 OBJECTIVES

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

- explain the meaning of Public Finance.
- differentiates between Public Sector and Private Sector of the economy.
- examine the objectives of Public Finance.
- differenciate betwen Public goods and Private goods.
- analyse the differences between Public Revenue and Public Expenditure.
- identify the factors responsible for the increased government expenditure in Nigeria.

3.0 MAIN CONTENT

3.1 Meaning of Public Finance

Public Finance refers to that branch of economics that is concerned with the revenue, expenditure and debt operations of the government and the impact of these measures. It identifies and assesses the effects of governmental financial policies. That is it tries to analyse the effects of government taxation and other sources of revenue and expenditure on the economic situations of individuals, institutions and the economy as a whole. It develops techniques and procedures to increase that effective in effect, it looks into the financial problems and policies of the government at different levels and studies the inter-government financial relations.

Public finance can be defined from two major perspectives. Firstly, Public Finance can be defined from the perspective in which finance is defined as money. If this view is held, then Public Finance as a technical term would refer to the pool of resources (borrowed or earned) available to government for the satisfaction of public wants. As a course of study, public finance can be defined as that part of economics that deal with the economic behaviour of governments. It discusses the various ways by which the government carries out its allocative, redistributive and stabilisation functions in the economy. This will include government taxing, spending, borrowing, transfers, aids subsidy and other operations that pertain to the use of scarce resources of government.

In common usage, the term public finance means the financing of the government including the economics of finance as well as the social effect and consequences of government policies. Public Finance can equally be called the study of public sector economics. It is an aspect of economics which deals with government revenue and expenditure.

The study of public finance involves a detailed analysis of the various sources from which the government derives its income, the items on which the government spends its money and the impact of such government revenue sources and government expenditure on different aspects of the economy.

STUDENTS ASSESSMENT EXERCISE

In a broad sence, explain the term Public Finance

3.2 Distinguish between Public Sector and Private Sector of the Economy

It is usually necessary to look at the economy from the point of view of the degree of influence and economic resources of the government and of individuals. In this context, we are talking of public and private sectors of the economy.

Public Finance is described as that branch of economics which studies the economic bahaviour of governments. Economics itself is the study of man making decision in a world where scarcity of resources relative to human wants makes choice a necessity. Economists have broadly divided the economy into two related sectors. i.e.

(a) Private Sector and
(b) Public Sector

Though the end problem in both sectors are the same, that is, the satisfaction of human wants, their behaviour and decision making processes vary. Hence their separate treatment in economic analysis.

The public sector refers to all production that is in public hands. That is, in public sector, the organisation that produces goods and services is owned by the state. It is thus a combination of control, government, state government, local authorities, the nationalised industries, public corporations, government administration, defence and similar public service, including commercial and non-commercial undertakings of the government. Some public sector activities are in the form of “nationalised industries” put differently, this sector is that portion of the economy whose activities (economic and non-economic) are under the control and direction of the Federal/State/Local Government.

The private sector refers to that part of the economy not under direct government control. It entails all production that is in private hands. There, the organisation that carries out the production is owned by households or other firm. Beyond the productive activities of private enterprises (the sole Proprietorship, Partnership, Private Limited Liability Company, Public Limited Company and Cooperative Societies), the private sector also includes the economic activities of non-profit-making organisation and private individuals. Put differently, this sector is that part of an economy whose activities are under the control and direction of nongovernmental economic unit such as households and firms.

Modern private economy is market oriented and operates on the principles of economic efficiency con-sumer preference and market exclusion. This implies that resources should flow to where they are most economically efficient and are appropriately rewarded. Price mechanism rations the scarce goods to the consumers whose preferences are expressed through the market forces of demand and supply. Thus the problem of relative scarcity is solved by excluding buyers who cannot buy and sellers who cannot sell at the market price.

Modern public economy on the other hand organises its own want satisfying activities on the budget instead of the market. Though the budget contains the priority list of public goods, the solution to the problem of scarcity is determined by the political system.

STUDENTS ASSESSMENT EXERCISE

Differentiate the “Private” from the “Public” Sector.

3.3 Objectives /Functions of Public Finance

Traditionally, public finance serves three major functions: Allocation, Stabilisation and Distribution functions.

(a) Allocation function of Public Finance

Public Finance, traditionally ensures the provision of special goods as well as ensures that total resources use is divided between social and private goods. It also ensures a proper mix of social goods provision.

Through its Public Finance activities, government allocates the productive resources of government to their optimal use. It determines for instance how much of the resources should go to the production of consumer or producer goods. Besides and very importantly, the government ensures that resources are allocated to the production of public goods (social goods) which otherwise would be neglected by the market system.

(b) Stabilisation function of Public Finance

Public Finance is a means traditionally used to maintain price stability, high employment, high and sustainable economic growth and favourable balance of payments.

Government through its public finance activities aim at removing or reducing such fluctuations so that growth can be achieved without serious unemployment and inflation. Every government wants to have a stable economy. Stability here implies stable prices at full employment. Inherent in the economy are forces which could cause fluctuations and thus engender unemployment and stagnation on one hand and inflation and balance of payments disequilibria on the other.

(c) Distribution Function of Public Finance

Public Finance was also used traditionally to promote equality in income and wealth distribution.

This was to ensure the attainment of what society see as a "just or fair" state of distribution in (Musgrave and Musgrave 1989).

The market system guided by the principle of economic efficiency equates the price of a factor with the value of its marginal product. This system breeds in equalities in income distribution. Through its public finance activities, government tries to change the market distribution so that a higher level of equality can be achieved e. g. Government can also use tax revenue to finance the provision of the social goods free of charge. Examples include free Primary Education, free Primary Health-Care delivery, etc., which usually benefit the lower income earners.

3.4 Public and Private Goods

A proper understanding of the meaning and scope of public finance will benefit greatly from the knowledge of the existence of public and private goods, the difference thereof, and the corresponding roles of private and public institutions in supplying them. Broadly, goods and services consumed in a given economy are divided into two viz:

(i) Public Goods
(ii) Private Goods

Goods are said to be o f a public nature if they have the following characteristics:

(1) Indivisibility: The use of such commodities is not divisible in the sense that each individual has access to the entire amount of the commodity under consideration, and the enjoyment of that commodity under consideration by one person does not diminish its availability to other persons. For instance, several persons tune into a particular radio programme without reducing the availability of the programme to several other persons.

The major problem associated with indivisible goods is that the cost of producing or supplying them cannot be met voluntarily through the price mechanism. Since the financing of such goods/services is by public expenditure and not through price mechanism, their production supply must be in the hands of the public sector.

(2) Neighbourhood Effects: This is variously reffered to as spillover effects, third party effects of externalities constitute an integral part of the qualities of pure public goods. By neighbourhood effects, we mean the economic effects on other parties arising from production use of the good. These externalities can be either positive or negative i. e. economic gain or economic loss.

(a) Non Market externalities and
(b) Market externalities

For instance, the benefits of a new Federal highway cannot easily be proportioned. Also the economic hazards associated with the environmental pollution which results from locomotive aim service cannot easily be apportioned.

(3) Zero Marginal Cost: The Marginal cost of a pure public goods tends to analysis of almost zero. This means that the inclusion of one more members of the society as a beneficiary of the said good does not appreciably increase the total cost.

(4) Decreasing Average Cost: A pure public good is expected to be subject to the law of decreasing average costs. By this, we mean that as more of a given public goods is provided, the average limit cost decreased because of the economics of scale.

Private Goods are said to be purely private if they have the following characteristics:

1. Product Divisibility

This characteristic requires that the availability and use of this good can be decided on a discriminatory manner through the price mechanism. This means only those who can afford the price and are willing to pay can have use of the commodity. Others who cannot pay the price or who are not willing to pay the price are excluded from using the product/service. In this way, the product/service is divisible as far as its use is concerned. Hence everybody does not have equal access to the use of the goods. The essential elements of this characteristic are:

(i) The ability to price the good
(ii) The divisibility of the good
(iii) The exclusion principle

The presence of all these elements in a good/service makes it possible for one to voluntarily pay for the supply of it because those who do not pay will not be supplied. Hence, through the market forces of demand and supply, the consumers can determine the volume of any of the said goods that can be produced.

2. Economics of Scale

Pure Private goods yield favourably to the concept of large scale production. This will lead to decreasing average cost.

3.5 Public Revenue and Public Expenditure

Public revenue or fund, it meant all moneys received for the interest of the whole economy. Every citizen has right to it. Because government is the custodian of public wealth and welfare, it has the responsibility to collect such revenues for the public.

Generally public revenue is divided into two as follows:

(a) Revenue Receipts and
(b) Capital Receipts

(a) Revenue Receipts: This refers to all revenues accruing to the public through tax and non-tax sources other than all forms of borrowing. Revenue receipts are therefore generally classified into two viz:
    (i) Tax revenue and
    (ii) Non-tax revenue

For tax revenue, government generates a large proportion of its revenue from tax. For non-tax revenue, this is the collective name for the revenue generated from all non-tax sources of revenue other than borrowing. This will include fees, fines and penalties as well as aids and grants, profits, interests and dividends.

(c) Capital Receipts: This is the collective name for all resources of government arising from borrowings and returns its own lending activities. Capital receipts include borrowing from certain statutory funds and recoveries of loans given to state and local governments.

The term public expenditure is a collective name for all the monies spent by government to maintain the machinery of government itself, for the benefit of the society, and the economy to meet its obligations to external bodies as well as gratuitions assistance to other countries.

On the basis of their life span, expenditures are classified broadly into two viz,

(i) Recurrent expenditure
(ii) Capital expenditure

The term recurrent expenditures refer to those expenditures/spendings made by government for its day-by-day operations. This will include salaries and other emolument of workers and other monies spent to maintain current levels of government services such as health, education, communication, road maintenance, defence and internal security. They also include transfer of payments like pensions and gratuities, internal and external public debt charges. In Nigeria there have been a gradual but continuous increase in the recurrent expenditure of the Federal Government.

The term capital expenditure refers to those spending that are investments in nature. In other words, they are expenditure that add to or increase the existing stock of Wealth/Capital. They are spendings on the provision of physical facilities like roads, bridges, hospitals, schools, construction of dams, communications, mining and quarrying outfits. In Nigeria, the capital expenditure have gradually continued to increase perhaps because of our development needs.

3.6 Factors Responsible for Increased Government Expenditure in Nigeria

It was mentioned in the last section that the size of public expenditure in Nigeria has continued to grow. Several factors may be responsible for this continued rise. Among these factors are:

(1) Accelerated development of the new Federal capital Territory in Abuja: This monumental project has gulped quite a lot of money. The speed with which it was pursued in the recent past also contributed significantly to the increased pressure on government expenditure on both current and capital items.

    The new Federal Capital has taken huge sums of money in terms of both capital and recurrent expenditure.

(2) Rising Population: Though accurate statistics are not available because the 1989 census figures are yet subject to abjudication, the population of Nigeria has continued to grow at an increasing rate. In fact, unconfirmed sources put the current figure at an average of eighty million persons. This has necessitated increased government expenditure on all items necessary for the provision of economic, social and health serviced to the teaming population.

(3) Infrastructural Development: As a developing country, the need for infrastructural development has always been recognised as a catalyst to our economic and

industrial development. Hence, so much money has been spent on the provision of roads, bridges, electricity, communication facilities, portable water, etc.

(4) Changes in Political and Bureaucratic Structure: In Nigeria certainly, the country's political and bureaucratic structure has undergone many changes over time. The change from a four regional structure to twelve-state structure and then to nineteen, twenty one, thirty and lately thirty six has led to huge increase in government spending during particular periods in which they took place. The cost of providing physical facilities and other machineries for these governments at the various levels have contributed in no small measure to the increasing size of the government expenditure.

(5) Campaign for Agriculture and Rural Development: The successive administrations of the Federal Government have attempted to organise programme/directorates aimed at improving agriculture and rural development. The expenditure of government on such programmes have been quite colossal, some of such programme are the Operation Feed the Nation (OFN), the Green Revolution, Directorate for Foods, Roads and Rural Infrastructural (DIFFRI), Better Life and currently Family Economic Advancement Programmes (FEAP). The success or otherwise of these campaigns are not the subject for our discussion here, the point being made is that these programmes have contributed significantly to the increasing expenditures of the government.

(6) The various programmes and organisations set up by the Federal Government to mobilise popular support for the programme and activities of the ruling government has taken quite a lot from the purse of the government. These agencies include the Mass Mobilisation for Social and Economic Reform (MAMSER) and the National Orientation Agency (NOA).

(7) Inflation: The increasing size of government expenditures can also be traced to the rising prices of goods, labour and other services, indeed the inflation in Nigeria has the double digit level and by extension affects the level of the public expenditure. The continuous increase in the price level means an additional expenditure for individuals, households and the government. Government expenditure have to reflect rise in prices of goods and services, wages and salaries.

(8) Debt Servicing: There was an extensive borrowing both internally and externally to pursue the development programmes. Some of these debts have matured. The servicing of these debts (i. e. paying of interest, due repaying the principal sum due) has continued to add to the size of the government expenditure.

(9) National Crises/Wars: Such crises and wars always necessitate huge government spending and these partly account for the growth. In Nigeria, the civil war and the

national reconstruction expenditure which followed later, contributed significantly to the growth in public spending. Also the ECOMOG, operation in Liberia in which Nigeria was reported to have contributed over seventy per cent of the total budget is a significant factor in government expenditure growth.

(10) The idea of planning and economic growth are being increasingly accepted by the modern government and this implies an increase in public expenditure with the growing awareness of its responsibilities to the society. The government started to expand its activities in the field of various welfare measures.

4.0 CONCLUSION

Public Finance is regarded as a branch of economics concerned with the finance and economic activities of the public sector. Three aspects of the subject matter of Public Finance have been emphasised. The three aspects emphasised include the revenue aspect, the expenditure aspect and the public debt. The above theory of public finance may be broken down into two. These are:

(a) The principle of Taxation and
(b) The principle of public expenditure

Leading authorities on the subject of public finance such as Musgrave and Prest tended to emphasise the resources allocation, distribution and stabilisation functions of public finance.

5.0 SUMMARY

In this unit, we have succeeded in establishing the fact that the theory of public finance is the theory of the economic functions of government; why they are undertaken, how many should be undertaken, who should perform them and how the resources should be provided. The classic work on this subject identifies three main economic functions of government: the distribution of income, allocation of resources between private and public sectors, and the stabilisation of national income. To these three functions, most people would now add a fourth, which is the active promotion of economic development.

6.0 TUTOR-MARKED ASSIGNMENTS

Q1 Examine critically the main areas of Government expenditure.
Q2 In a broad sense, explain the term Public Finance.
Distinguish between public and private sector of the economy.
Q3 Is there any need for public sector in any economy?

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UNIT 14 TAXATION AND FISCAL POLICIES

CONTENTS

1.0 INTRODUCTION

We have made reference in earlier units to the division of the economy into various sectors, one of which is the public sector. The principal feature of this part of the economy is that ownership and control are in the hands of government in one form or another. Therefore the public sector consists of Federal or Central government, state government authorities, and public corporations. However, public expenditure includes all expenditure under the control of the public sector which has to be financed mainly by taxation or borrowing.

In unit thirteen (13), public finance is explained as that aspect of economics which deals with government revenues and expenditure. Again it involves detailed analysis of the various sources from which the government derives its income. Taxation is one of the major sources of the revenue to the government. This unit looks at taxation in all aspects and effects of taxation in the economy.

Monetary policy is advocated by the monetarists as the most effective means of controlling economic variables. However, Keynesian economists argue that monetary policy alone is not sufficiently powerful as a stabilisation policy. To them, the most effective way of controlling the economy is the use of fiscal policy. They see monetary

policy as playing only a supportive role. The emphasis of our discussion in this unit is fiscal policy. We shall, therefore, give attention to fiscal policy in this unit.
Fiscal policy is the influence of economic activities through variations in taxation and government expenditure or public sector expenditure.

2.0 OBJECTIVES

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

- state clearly the reasons why Government levy tax or tax objectives.
- define the principles of taxation, what tax is, its effect and various types of tax .
- point out the characteristics or features of a good tax system
- define fiscal policy, identify the limitation and types of fiscal policy.
- understand the various instruments of fiscal policy.

3.0 MAIN CONTENT

3.1 What is Tax?

Several definitions of tax appear in the economy literature. These definitions do not really vary as the same though/runs through all of them.

According to Dalton, tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the tax payer in return. Elsewhere, tax described as a compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to the special benefits conferred. From these definitions, three principal features of tax can be deduced as follows:

(i) It is a compulsory contribution imposed by government on private persons, groups and institutions within the country. Since it is a compulsory payment, a person who refuses to pay a tax is liable to punishment.

(ii) A tax is a payment made by the tax payers which is used by the government for the benefit of all citizens. The state uses the revenue collected from taxes for providing economic, social, educational, health and general administrative services which benefit all people.

(iii) Tax is not levied in return for any specific or direct services rendered by the government to the payer.

In summary it can be said that tax is a compulsory payment of money to government by individuals, groups and corporations. It can be levied on wealth income or as surcharged on prices. Or taxation can simply be seen as compulsory transfer or payment of money from private, individuals, institutions or groups to the government.

STUDENTS ASSESSMENT EXERCISE

Discuss the term “Tax”.

3.2 Taxation Objectives - Reasons why Government Levy Tax

(1) The primary objective of tax is to raise revenue for the government. Indeed, to the most economics, tax constitute the major source of revenue for the treasury.

(2) To encourage even development: The tax proposals can be designed to push productive resources, especially capital from relatively more developed areas to relatively less developed areas of the nation.

(3) To control and regulate the production of certain goods, taxes may be imposed on the production of certain commodities considered harmful or injurious to either consumers or the workers.

(4) To check the cyclical fluctuations in income and employment: Tax system can be adjusted to motivate saving and investment which through the multiplier can accelerate income and thus increase employment.

(5) To redistribute Income: One way of achieving the government’s role of reducing the irregularity gap is to operate a highly progressive income tax system. This will reduce the consumption and health accumulation tendencies of the rich. Taxation is used to reduce the gap between the income of the rich and the poor.

(6) To check Inflation: With reasonable level of economic growth and full employment, an increase in tax unaccompanied by increase in government expenditure will reduce the purchasing power of consumers and thus check demand-full inflation.

(7) To regulate the consumption of certain commodities. Taxes can be imposed to control the consumption of certain commodities considered either harmful/injurious to consumer or non-essential and too luxurious.

(8) Taxes may be imposed to influence the method and kind of business. This may take the form of encouragement in which a subsidy will be adopted. The underlying motive may be to protect or subsidise the said business and commerce. This may take the form of agricultural price support tax reduction or input subsidisation (e. g. fertiliser procurement and distribution in Nigeria).

(9) To prevent Dumping: There is a tendency for the industrialised world to dump their cheap products on the developing countries where such products may not even be considered as necessaries heavier tariffs can be imposed to prevent this act.

(10) To protect Infant Industries: Protective tariffs are also imposed to prevent the demise of infant local industries as a result of foreign competition. Import duties are specifically designed to serve this purpose.

(11) To control Monopoly: Certain types of taxes may be anti-monopoly in purpose. Such taxes include undistributed profits tax, excessive profits tax, intercorporate dividends tax and consolidate returns tax.

(12) To allocate resources: Taxation is also aimed at allocating resources between, for example, private and public goods and between investment and consumption goods. It may also be aimed at correcting deficiencies in the pricing mechanism resulting, for example, from monopoly elements, the existence of external economics or diseconomics and in case where the social costs sharply diverge from private costs.

(13) To maintain balance in the nation's foreign accounts: Certain taxes may be imposed to reduce imports and encourage exports such that balance of payments deficits are avoided, i. e. in Export Promotion.

STUDENTS ASSESSMENT EXERCISE

Mention and explain the reasons why governments levy taxes in any economy.

3.3 Principles of Taxation

Also called the cannons tax, the principles were enunciated by Adam Smith. These principles have largely been accepted by subsequent writers who have also elongated the list. Some of the principles include:

1. The Cannon of Equity: This means that the tax payable by a tax payer should be based on the tax payer's ability to pay. This principle demands economic justice in which each person's contribution to the state should be as much as possible be proportionate to the person's ability. In order words the rich should pay or contribute more than the poor.
2. Cannon of Certainty: This principle holds that a tax payer should be made to know the exact amount of tax he should pay and when. This is to avoid the tax payer being cheated by corrupt tax officials.
3. Cannon Convenience: This means that the amount of tax and the timing of tax payment should be made to suit the tax payer. It should be related to the way he receives and spends his income.
4. Cannon of Economy: Proponents of this principle posit that the costs of assessment, administration and collection of tax should as much as possible be small relative to the volume of revenue generated in practice. The cannon requires that the tax structure should be such that it is economically correct.
5. The Principle of Flexibility: Proponents of this principle posit that the tax system should make room for changes in the tax structure to meet the changing requirements of the economy and treasury. It should not be too rigid.

6. Principle of Diversity: The sources of Tax revenue should be as diverse as possible to ensure the certainty of some revenue to the treasury at all times. It is, however, noted that too much multiplicity of taxes may negate the principles of economy.
7. The Principle of Buoyancy: The system should be such that tax revenue would have inherent tendency to change with changes in the National Income level without any changes in the tax coverage and rates.
8. Principle of Neutrality: The willingness of tax payers to work, invest or save must not be discouraged by the tax system.
9. The Principle of Productivity of Fiscal Adequacy: It requires the tax system to yield so much revenue that the government would not need to borrow or be forced to resort to deficit financing. It should not be too high as to discourage Productivity.
10. The Principle of Simplicity: This cannon holds that the tax system and laws should be clear and simple enough for the tax payer to understand. The tax schedule should be simple and easy to calculate by both the tax collector and the tax payer. If the tax system is complicated and difficult to administer and understand, it breeds problems of differences in interpretation and legal tussles.
11. Cannon of Impartiality: This cannon advocates that no partiality should be shown in the distribution of tax burden.
12. Cannon of Acceptability: This principle holds that the rate of taxation should be such that is politically acceptable.

STUDENTS ASSESSMENT EXERCISE

Discuss the various principles that should guide the government in determining the level of taxation.

3.4 Types of Taxes - Nigerian Tax Structure

Two major groups of taxes can be identified. They are direct and indirect taxes.

Direct Taxes are levied on incomes and profits of firms. On the other hand, indirect taxes are levied on goods and services. They can easily be avoided by not buying the goods to which they are attached to.

Direct Taxes

1. Income Tax: This is the type of tax paid according to one’s income. Companies like human beings are legal beings. Corporations, therefore, pay taxes on their income. Personal taxes are paid on total wages, salaries, profits, interest and rent which a person receives with due allowances for family size, home ownership, insurance contribution and other factors. Company or Corporate Income Tax is paid only on corporate profit.

2. Poll tax is imposed at a flat rate per head of population: It is a regressive tax because no matter the size of a person's income, everyone has to pay the same amount. Nigeria has a poll tax for people with low incomes.
3. Capital Tax: These are taxes imposed on property and other capital assets. For instance, when a person dies his assets are subject to capital tax, in this case the term death duty or estate duty is used.
4. Capital Gains Tax: This is paid on property, when you buy a property and over time it rises in value, the amount by which it rises over what you paid is capital gain. The tax paid on this gain is called capital gains tax.
5. Petroleum Profit Tax: In Nigeria, a tax is charged, assessed and payable upon the profits of each accounting period of any company engaged in petroleum operations during any such accounting period, usually one year.

Indirect Taxes

These are taxes levied upon persons or groups whom they are not intended to bear the burden or incidence, but who will shift them to other people. They are normally levied on commodities or services hence their services does not fall directly on the final payers. Ability to pay here is assessed indirectly.

Examples of Indirect are:

- Custom Duties - Import and Export duties

Import duties are levied on goods coming into the country from abroad.

- Export Duties: These are taxes levied on goods which are exported or sold to other countries by the home country.

- Excise Duties: These are levied on certain goods produced or manufactured locally.

- Value - added - Tax (VAT) - This belongs to the family of sales taxes. The valued - added tax is not a tax on the total value of the goods being sold but only on the value added (the difference between the value of factor services and materials that the firm purchases as inputs and the value of its output) the value that a firm adds by the virtue of its own activities to it by the last seller. Thus, the seller is liable to pay a tax on its gross value but net value that is the gross value minus the value of the services and materials purchased from other firms, etc.

- Sales Tax - These are taxes on selected sales transactions but applied at only one stage of business activity. Stamp Duties: These are taxes on documentary evidence of particular transactions such as transfer or property loans, bonds, mortgages, debentures, bills of exchange, promissory notes, cheques bills of lading, letters of credit, policies of insurance, transfer of shares, proxies and receipts.

It is evidence and not the transactions itself that are taxed.
Inheritance Tax - This is tax payable by the recipient or beneficiary of a deceased property.

3.5 Effects of Tax

The question posed now is whether tax has other effects and the answer is yes. The imposition and payment of taxes elicit some responses from the imposition of tax engenders distortions in the production, employment, consumption, wealth distribution and other variables in the economy. These distortions which are collectively called the effects of tax could be for good or for bad. We shall take a global look at these effects.

For this purpose, four groups of effects shall be considered. These are:-
1. Effects on Inflation
2. Effects on Wealth and Income distribution
3. Effects on Economic Stability
4. Effects on productive growth

Effects on Inflation
Inflationary pressures will be heightened if taxes are increased on commodities with high demand elasticity and low supply elasticity. On the other hand, the pressure on prices may not be increased if there is an increased tax on commodities with high supply and low demand elasticities.

Effects of Wealth and Income Distribution
Government assumes the responsibility for reducing the inequality gap (in income and wealth) in the economy. Under certain circumstances, taxation can be a potent tools for achieving this noble objective.

Market economics are characterised by great deal of income inequalities through the institutions of private property and inheritance. Taxation has the egalitarian objective of reducing this income and wealth inequalities which incidentally conflicts with increasing production and economic growth objectives.

Effect on Economic Stability
While some economist has faith in the inbuilt stabilisers that automatically adjust the economy if there is any variation in one variable, others like Keynes opine that the economy is incapable of stabilising itself. Hence government must intervene by way of tax and or expenditure adjustments. Progressive taxation is thus used as an instrument to neutralise the fluctuations in output, employment, income, prices, etc.

Effect on Production and Growth
Tax can affect the production and growth of the economy in several ways. Indeed tax can influence the supply of resources for production. High taxes, for instance, can reduce disposable income which will in turn reduce savings and investment. If investors are taxed on their retained profits, they will resort to borrowing since retained earnings will no longer be a sure way of getting finance. Even when resources are available, their allocation to different areas of production can be influenced by tax. It is, therefore, necessary to be careful and judicious in the choice of taxes as well as items and industries to be taxed. Taxes influence the location of industries as well as the supply of labour, suppliers of labour must move to tax heavens from areas of high tax.

Fiscal Policy works through and regulates the market mechanism without taking over the responsibility of the market mechanism itself.

3.6 The Goals of Fiscal Policy

Fiscal policy, as an effective instrument of policy, may be used to accomplish the following goals:

(a) To increase employment opportunities or to attain full employment: The goal of fiscal policy is the reduction of unemployment rate. Fiscal policy aims at achieving full employment in the economy and at the same time ensure reasonable price stability. It is the wish of every government to reduce the rate of unemployment to the lowest minimum.

High rate of unemployment requires expansionary fiscal policy but the government must also guard against the inflationary impact of expansionary fiscal policy.

(b) Price Stability: Control of inflation fiscal policy aims at stabilisation of prices in the economy that is counteracting or avoiding inflation and deflation. Expansionary fiscal policy is used to fight deflation while a contraction fiscal policy is used to fight inflation taking into cognizance the aims of attaining full employment.

(c) To promote economic growth and development: One of the primary goals of fiscal policy is the achievement of steady growth in national resources and in national output as well as structural and attitudinal changes in the economy.

Economic growth here means continuing increase on the annual basis in production of goods and services or a rise in per capital income made possible by continuing increasing in per capital productivity where as economics development refers to the changes in economic growth and social structure that always accompany economic growth.

(d) To achieve equity in income redistribution: Fiscal policy is used to redistribute income so as to achieve equity and for the attainment of social and economic justice. In equities in income, distribution is very high in the developing countries of the world. Progressive tax structure is one of the measures taken by the government to arrest the issue of inequality in income distribution.

(e) To achieve a satisfactory or favoruable balance of payments: Fiscal policy is used to avoid and or correct balance of payments deficits in the nation's external trade relations. In such a situation, efforts should be geared towards the reduction of importation by increasing import duties. Import substitution industries should be established and exports should be given a big boost.

(f) To achieve a stable exchange rate: To avoid fluctuations in the nations external reserves and to avoid fundamental disequilibrium in the nation's balance of payments position, effective fiscal policy measure are adopted. Stability in the price has great influence on the value of a country's currency which will equally affect the exchange rate between that currency and other currencies of the world.

(g) To increase the rate of investment, low rate of investment is not good for any economy. Low rate of investment will lead to low rate of employment and eventually low income. Fiscal policy is employed to generate revenues which should be used to increase investment in major sectors of the economy to avoid recession. With government spending in the form of investment, the multiplier effect will help to put back the economy on the right track.

The process will help to accelerate economic growth (National income via the multiplier process)

STUDENTS ASSESSMENT EXERCISE

(a) Distinguish between monetary and fiscal policies.
(b) Examine the various objectives/goals of fiscal policies.

3.7 Types of Fiscal Policy

There are basically two types or approaches to fiscal policy. These are compensary and counter cyclical approaches and they deserve good treatment.

(1) Compensatory Fiscal Policy: This refers to the management of government finance to compensate for fluctuations in National income and employment. The

compensatory fiscal policy which combines deficit and surplus financing attempt to achieve high level of National Income. It uses taxation and spending to produce the desired balance.

The point here is that the government budget should be used as the major instruments for achievement of macro-economic objective and the budgetary changes should be made as often as desired and in whatever magnitude desired. To maintain a desired level of income during a business decline, any decrease in private spending or investment must be balanced by government policy of either increasing government spending or raising total government purchases from private business or reducing taxes i.e. increasing the income of consumers, business or both has to be noted that the reverse will be the case during the inflationary period. To maintain a desired level of income during a period of over expansion and inflation, government policy would comprise a reduction in the government spending, a possible increase in tax or both steps.

(2) Counter Cyclical Action: The counter cyclical fiscal policy is the government effort to combat the cyclical instability of the private enterprise system. Such actions take many counter cyclical forms, including fiscal policy, monetary policy and transfer payments. The basic aim of all such actions is to eliminate the effects of the periodic fluctuations of the economy and to stabilise national income and production.

Under this countercyclical approach, the government plays the role of varying its expenditure policies with the objective of moderating, fluctuations in income and employment over the business cycle, there, the government is required to unbalance its budgets during deflationary and inflationary periods. This means that the government will increase its expenditure and cut taxes when private spending declines.

STUDENTS ASSESSMENT EXERCISE

(i) Distinguish between the main forms of taxation in the Nigerian economy.
(ii) To what extent does the Nigerian fiscal system meet main principle of taxation?

3.8 The Instruments of Fiscal Policy

There are a number of instruments which the government employs in order to achieve its fiscal policy. Such instruments include:

(1) Government Expenditure: This is the total amount spent by the various three tiers of government within a given period through governmental ministries, and departments including transfer payments.

According to Anyafo (1996), Transfer payments in the Nigerian content include "debt service i.e. internal payment and capital repayments on internal and external debts, pensions and gratuities, external financial obligations such as animal subscriptions to international bodies, and others".
There are two types of government expenditure: Capital expenditure and recurrent expenditure.

Capital expenditure is that expenditure made on items that can retain their value for more than one year. Example of capital expenditure includes costs of constructing new roads and buildings, acquisition of plant and machinery, and other fixed assets.

Recurrent expenditure is expenditure made on revenue items that will set up its value within one year. Such expenditure is called recurrent expenditure because they are made repeatedly on a yearly basis. They include salaries and other personnel costs, telephone services, stationeries and other running costs of the various ministries and department of the government.

As a tool of fiscal policy, government expenditure can be used to influence the economy by influencing aggregate demand.

The increase in government expenditure will make money available in the hands of the public. This will increase aggregate demand which will make business of invest more and to employ more hands.

Moreover, the new government projects will create employment opportunities. Thus, the decline in the economic activity will be reversed in government; expenditure may lead to an increase in the rate of inflation.

During inflation, government can reduce the level of government spending and pursue a surplus budget. The surplus fund is used in servicing public debts. The reduction in government expenditure will reduce the spendable money in the hands of the public. This will lead to a reduction in aggregate demand and general price level. Thus, the rate of inflation will be reduced; the negative aspect of a reduction is the level of unemployment and level of economic growth.

(2) Taxation: The second instrument of fiscal policy is taxation. Government can increase or reduce the amount of tax payable by individuals and organisations as a means of influencing the macro-economy.

An increase in taxation reduces the spendable money in the hands of the public and hence the aggregate demands. Such increase in taxation can, therefore, be used to reduce the rate of inflation in the economy.

A reduction in taxation does the opposite. It leaves more money in the hands of the public since only a small percentage of their income is paid back to the government. A reduction in taxation can be used by the government to stimulate aggregate demand, investment spending and employment when there is a slow down in the economy.

Note that there is an inter-relationship between the two tools of fiscal policy. A reduction in taxation can be used to achieve a deficit budget even when the level of government expenditure remains unchanged. In that same manner, an increase in taxation can also be used to achieve a budget surplus.

(3) Subsidy: This is another instrument of fiscal policy. While high rate of taxation will reduce economic activities of the firm and the purchasing power of individuals, subsidy to the business firm will help to boost economic activities. Subsidy will help the business firms to produce at a very low cost and make the product of the firms affordable by the customers. Subsidy is only useful, during depression and low economic activities while taxation will be very useful during boom and high economic activities.

(4.) Budget Surplus and Budget Deficit: Tools/Instruments of fiscal policy are basically budgetary policy.

The Federal budget is a statement of planned revenue and expenditure of the government within a fiscal period. It shows how the government intends to get money and how she intends to spend the money got.

A budget is said to be a balanced budget when the planned expenditure of the government equals expected budget. When government expenditure is more than government revenue the budget is said to be a deficit budget. A simple budget or budget surplus, occurs when planned revenue is more than planned expenditure.

Surplus budget and deficit budget are unbalanced budget. An unbalanced budget can be achieved in any of two ways. First is by increasing or reducing government expenditure. Second by increasing or reducing taxations. That is the reason why the tools of fiscal policy are said to be government expenditure and taxation. State in another ways, the tools of fiscal policy are surplus and deficit budget. Either way the tools are the same and they have been discussed as government expenditure and taxation.

STUDENTS ASSESSMENT EXERCISE

(i) Examine the case for raising an increasing proportion of government revenue through taxing expenditure.
(ii) Compare the economic effects of different kinds of expenditure taxes.

3.9 Limitations of Fiscal Policy

(a) There is the problem of how to make accurate short-run forecasts of the economic situation. Therefore, fiscal policy action should be geared not to forecasts, but to actual situations since early solution to the problem is unlikely. So long as a forecast is inaccurate, governmental action based upon it might be harmful rather than remedial.

(b) There is the problem of how to appraise the effective force of the numerous techniques of fiscal policy.

The more tractable nature of this problem calls for the exploration of the issues by academic economists to add to our knowledge of the force of specific measures of fiscal policy. This calls for speeding up by governmental research in the CBN, the Ministry of Budget and planning, the Ministry of Finance and Economic Development, etc.

(c) There are political obstacles in the way of a success fiscal policy, arising because the economy is shaped to allow full expression of dissent which may be anti-thetical to execute parliamentary decisions about debatable issues.

(d) There is also the problem of accurate data, which may become available only with a delay.

(e) The uncontrollable protions of the budget pose a problem in the use of fiscal policy.

(f) The use of fiscal policy is also limited by the time long involved.

(g) It is also discriminatory in effect since it is non-neutral not affecting the whole economy equally.

There are, however, a number of situation in which measures such as variations in government spending and taxes may not have the desired effects on the level of economic activities.

Suppose the government in an attempt to stimulate growth, increases its expenditure. The resulting spending on goods and services may be earned as income but people do not spend this income, it will constitute a leakage out of the circular flow of income. The multiplier effect will therefore, be greatly reduced, and the resulting effect on the level of output, income and employment may not be realised.

Again, people who earn the resulting income as a result of the government increased spending may not spend these incomes on locally produced goods and services. They may decide to spend the incomes on impacts of the particular economic exhibits, a high propensity to import as is the case with Nigeria. The multiplier may be generated abroad and not in the domestic economy. Thus, the level of income, output and employment may not change much as a result of the increased government spending.

Furthermore, it is argued that there are time lags between the time when fiscal policy is required and the time it is actually implemented. This in turn may result in a situation in which by the time a particular fiscal policy becomes operational, the result may be contrary to what was required originally. This particular criticism applies as well to other economic policy measures, monetary policy and incomes policy.

From the foregoing above, there are broad limitations to the effectiveness of fiscal policy. These are (i) Operational Limitations and (ii) Fundamental Limitations. The operational limitations to the effectiveness of fiscal policy are usually associated with its timing and magnitude of the policy options, in terms of time, there exist lags in the system. There is also the implementation or action lag. This is the length of time between the realisation of the need for action and the implementation of new policy.

Before this time, however, the problem of determining the size of (or magnitude of the policy) government spending and/or tax needed had to be contended with.

Fiscal policy is usually ineffective when the problem in the economy is fundamental, such fundamental problems calls for basic adjustments in the economy. Examples include adjustment of production pattern to changes in the pattern of demand and adjustment of wages to the productivity in various lines of economic activity.

4.0 CONCLUSION

The problem of paying for government services is very much apart of the theory of public finance. There are ways of meeting the cost of government services, most of them require a degree of compulsion. This is taxation. Taxes are compulsory contribution from individuals and for business organisations for the purpose of financing government expenditure.

Modern experts in public finance have argued that there are principles of taxation that sufficiently meet all the purposes of modern economic policy which are partly achieved through budget.

There are two forms of taxes. These are (a) direct taxes and (b) indirect taxes.

Direct taxes, in very broad terms, are those taxes levied directly on individuals and business firms. Indirect taxes on the other hand are taxes levied on goods and services.

Fiscal policy is concerned with deliberate actions which the government of a country take in the area of spending money and/or levying taxes with the objectives of influencing macro-economic variables such as the level of national income or output, the employment level aggregate demand level, the general level of prices, etc., in a desired direction.

Generally, fiscal policy measures usually attempt to achieve one or some of the following objectives:

- influence the rate of the growth of the economy.
- raise the level of national income, output and employment.
- protect local industries from unfair competition from abroad.
- moderate inflationary pressure.
- improve the balance of payment.

The two key instruments of fiscal policy are:
- Government expenditure and
- Taxation

5.0 SUMMARY

In this unit, we have succeeded in establishing that a modern economy, taxation is normally by far the most important way of providing resources to the government, but other methods do exist. This unit dealt mainly with the principles of taxation, different types of tax but also other ways of allocating resources from private to the public sector, i.e. fiscal policy.

6.0 TUTOR-MARKED ASSIGNMENTS

Q1 (a) What do you understand by the "term of fiscal policy"?
(b) How does it differ from monetary policy?

Q2 Discuss in full types or approaches to fiscal policy
Discuss the goals of fiscal policy in modern economy.
Q3 Discuss in full types or approaches to fiscal policy.
Q4 List and explain five instruments of fiscal policy stating when each instrument will appropriately applied.
Q5 Mention and explain the reasons why government levy taxes in any economy.
Q6 What are the features of a good tax structures?
Q7 Distinguish between direct and indirect taxes.
Q8 Discuss the main cannons or principles of taxation.

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UNIT 15 BUDGETING IN THE NIGERIAN PUBLIC SECTOR - (GOVERNMENT BUDGETING)

CONTENTS

1.0 INTRODUCTION

In the proceeding/previous unit, fiscal policy was taken to refer to that part of government policy concerning the raising of revenue through taxation and other means and deciding on the level and pattern of expenditure for the purpose of attaining some desirable marco-economic goals. Such fiscal policy can be used for allocation stabilisation and distribution.

In essence, a primary objective of official policy is to balance the use of resources of the public and private sectors and by so doing to avoid inflation unemployment balance of payments presents and income inequality.

Budgeting can be seen as setting of expenditures priorities and the weighing of alternatives. It is a system of resources allocation hence it implies looking ahead and planning since decisions involved in the process are of future orientation. In this sense, budgeting involves the converting of the multi-year plan of operations into more exact short-term installments of inputs and outputs usually for the year ahead. It is no wonder it is taken a part of the managerial cycle of planning executing learning and applying the lessons to plan, execute, learn an so on. The national Budget or Government budget itself is the financial statement of the government's proposed expenditure and expected revenue during a particular period of time, usually a year. Such budgets are usually employed to attain the objectives of full employment in the economy, price stability, rising growth in National output balance of payments equilibrium and equity in income distribution.

To attain these objectives, the budget must be seen as exhibiting certain features. It is a plan (a financial plan) of Operation, it is for a fixed period, it must be an authorisation to collect revenue and incur expenditure. It must be a mechanism of control of both revenue and expenditure and it must be objectives oriented.

On a broader basic, therefore, the budget is not only an instrument of economic and social policy but also as planning tool instrument for co-ordination and an instrument for communication.

Therefore, a good budget requires comprehensiveness, a meaningful presentation of the state of budgetary balance and an appropriate grouping of expenditure items.

2.0 OBJECTIVES

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

- define what a Budget is, know how government prepares budget, presents it to the national assembly and recognise the steps to be taken in the presentation of a National Budget.
- examine what is budget deficit and budget surplus.
- explain the main roles of the budget.
- distinguish between state and Local Government Budgets.
- explain budget as an instrument of Economic Policy.
- explain how to finance a deficit in the Government Budget.

3.0 MAIN CONTENT

3.1 Budget Conceptual Issues

A budget is an estimate of the expected revenue and expenditure of individual, group, organisation or government for a seated period of time, usually one year.
Put in another way, a budget is schedule of all the revenues and expenditures that an individual, group, organisation or government expects to receive and plans to spend during some future time period, usually the following year.

Budget ranges from very simple and casual one like the typical family budget, to extremely complex and sophisticated one like the Federal Government Budget.

3.1.1 The Government Budget

The government budget shows clearly the expected incomes and proposal expenditure of the government for the coming year. It contains estimates of anticipated revenues from sales, taxes, gifts and it specifies what expenditures are planned during the time period. If revenues exceed expenditures, a budget surplus is expected. If on the other hands, expenses are expected to be greater than revenues, a budget deficit must be confronted and some methods of financing it must be planned.

A budget is usually used to control the allocation of revenues so that spending is rational. It is an important instrument in the planning and control of the financial matters of a country. The Federal Government's budget is usually prepared by the ministry of finance. The Ministry of Finance requires other ministries to submit their expenditure proposals to it before the budget is prepared. The expenditure proposals by different ministries may be adjusted or pruned depending on government policy and the resources available. It is important to note the four stages that are involved in the budget of a Federal Government. The four states are as follows:

(1) The formulation of the National Budget by the Director of Budget.
(2) The appraisal of the National Budget by the National assembly.
(3) The implementation of the content of the approved budget by the Executive arm of the government.
(4) The auditing of the budgeted revenue mapped out for expenditure in the process of the execution of the content of the budget.

3.2 Budget Preparation

The preparation of the budget begins before the end of the present fiscal year. Each ministry sends its own expenditure proposal to the Ministry of Finance and goes there to defend it. After each department of ministry has successfully defended its proposals, the revised or amended proposals made in the budget are presented to the National Assembly for deliberation. The debate on the budget is expected to be completed before the end of the present fiscal year. After all the debates and amendments, the budget is finally sent to the president for final approval and the remaining conflicts within the various departmental claims are to be resolved by the president.

3.3 Budget Presentation

It is important to note that there are various forms of budget presentation today in Nigeria. Only two parts in the presentation of the budget will be discussed here.

(a) The Presidential budget speech which is usually on the last day of the old fiscal year. In the Presidential budget speech, the major points contained in the budget are summarised by the President.

(b) Analysis of some selected aspects by the Minister of Finance: The second part is the careful analysis of some selected aspect of the budget. This is usually done by the Minister of Finance. During this analysis, the general public, especially the business, the institution, the ministries and the parastalas are invited and questions raised by them are responded by the minister.

It is important to emphasis again that in the budget, the means of raising revenue will be stated and any new tax proposed or any loan expected will be clearly stated. Normally, a country will try to cover all the items of the recurrent expenditure from revenues from taxation and other recurrent sources. If possible, it will aim at a surplus of such revenue over recurrent expenditure in order to have fund available for the capital projects.

A budget has two sides - the expenditure and the revenue. Every government tries to balance the two sides. This means that the expected revenue income is made equal to proposed expenditure. In some cases, the expenditure is greater than the revenue and in other cases, the revenue is greater. This is why the term budget deficit and budget surplus are used.

3.4 Budget Deficit

In any budget whenever the expenditure of the government is greater than the revenue, it is usually referred to as budget deficit. In most cases, the government spends more than what it collects in form of revenue. The excess of expenditure over revenue can be covered by loans from outside the country. In most cases the deficit is usually covered by government borrowing either from the public or financial institutions.

Although no individual or business firm can incure deficit over an indefinite period, some economists believe that the Federal Government is in a different category and that budget deficits for some years are acceptable and sometimes recommendable. They point out that a balance budget is instabilising in recession, aggravating the effects of a drop in national income. They suggest instead a deliberate unbalancing of the budget to create a deficit.

The deficit according to them will increase total spending, which in turn will increase national income. Because of the operation of the national income multiplier, the increase in the income will be larger than the deficit. The budget deficit can be achieved by lowering taxes, raising government expenditure or by adopting both measures. Although an increase in government spending may be more effective in raising national income. Since it has a higher income multiplier, a tax cut may be preferable, since it can be made effective more quickly.

If the total revenue of the government in a fiscal year is N250 billion, and the expenditure for the same period is N275 billion, then there is a deficit of N25 billion. Again, budget deficit is usually used to increase government expenditure so as to generate more economic activities and increase employment.

3.5 Budget Surplus

Budget surplus occurs when the government revenue is greater than expenditure. This means that the government collects more revenue than what it spends. Budget surplus can be used to reduce inflation because the surplus may come from taxation which will reduce the disposable incomes of individuals and as a result reduce their purchasing power. The use of the government budget surplus is an important part of countercyclical fiscal policy. During periods of inflation, it is desirable to reduce total spending in the economy, diminishing the excess demand which is forcing up prices. At such times, the government budget can be adjusted to produce a surplus and achieve the desired lowering of income.

The budget surplus may be accomplished by lowering government expenditure, raising taxes or adopting both measures. The reduction of government expenditures is more effective than a tax increase as an anti-inflationary measure, since its negative income multiplier is greater, but it is generally harder to put into effect, especially when the budget consists of many large items. It has to be noted that for the budget surplus to be effective, the surplus money must not find its way back into the spending stream. The surplus funds may be used to retire part of the outstanding debt of the Federal Government or build up the balance of the Treasury account. If debt retirement is undertaken, the purchase of government bonds held by banks has a greater anti-inflationary effect than the refunding of bond held by citizens and non-financial business firms. But budget surplus can lead to lower economic activities and increased unemployment.

3.6 Four Main Roles of the Budget

There are four main roles of the budget and these include:

(1) The Authorisation Function

As soon as the budget is approved, it constitutes an authority for implementation. The budget normally contains a break down for the limit of expenditure that could be made on each expenditure head during the budget period and once approved, it constitutes the authority limit within which expenditure could be made. However, any required expenditure beyond such limit will require approval by higher authority.

(2) Directional Function

One of the roles of the budget is to provide a guide as to the intended direction of the economy during the budget period in terms of priority, focus and attention. The budget is therefore expected to influence individuals, organisations or institutions along the desired direction.

(3) Control Function

Control function is the most important role of the budget. This is the proper monitoring of the budget and it helps to inject discipline in the Chief Executive of each unit as regards fund management. This helps to ensure optimum use of resources.

(4) Development Function

The budget makes provision for development. The capital expenditure of the budget is, therefore, linked to the development plan and integrates the budget with the plan. The budget then serves as the medium for the actual implementation and actualisation of development plans.

3.7 Steps in Presentation of National Budget

In the present Nigeria, the government budget involves the following steps:

(1) An appraisal of the economy for the past budgeting period showing achievement, failures and things that posed as problems during the period.
(2) The appraisal of the economy in the past budget period is followed by an analysis of the present day situation in economy, stating problem and prospects in the present budget periods.

(3) The budget then specifies the national objectives in the budgeting period and the various policies aimed at achieving them. In some of the budgets, specific targets are set and efforts are directed toward achieving them.
(4) The budget then forecasts the future economic trend over the given period.
(5) Finally, the budget gives an outlay of expected revenue and intended expenditure over the budget period. This involves an analysis of the expected government resources during the budget period and the way the resources will be utilised to ensure justice and equity.

Note
In most cases, the government bases the current year budget on the figures in the previous year budget and this system is normally referred to as incremental system of budgets.

3.8 State and Local Government Budget

Like the Federal Government, the state and local governments prepare and present their own budgets almost in the same manner as the Federal government. The only difference is that each tier of the government prepares its own budget according to its own resources

As already mentioned the Federal government presents its budget on the last day of previous fiscal year.

As the fiscal year in Nigeria runs from 1st of January to 31st of December, the Federal government budget is usually presented on 31st day of December each year. This will be followed by presentation of budgets by different state Governors. The presentation of State budget has no specific date like that of Federal Government. In preparing the budget, each state takes into account its resources, peculiarities and priorities. The revenues generated from the state are meant to urgument the state's share of the 'Federation Account'. The presentation of the state budget is done by the state chief executives. This is followed by detailed analysis of the budget by the Commissioner of Finance during which he answers questions from the general public.

It has to be noted that the implementation of the approved budget is usually carried out by the executive arm of the government whether it is Federal or State. The budgeted revenue mapped out for expenditure in the process of the execution of the content of the budget is later audited. This is to ensure that the approved money is spent in the project for which it is meant or in other words to avoid the diversion of fund from the project it is meant for to another and less important project.

The local government as the third-tier of the government presents its budget last after the State. The order in the presentation is so because the local government that presents last expects some amount from both the Federal and State Governments to make up what it will generate by herself. The expenditure of the local government is mostly directed towards meeting the recurrent expenditure of the local government as well as developing the resources of the local government.

3.9 The Budget as an Instrument of Economic Policy

The budget can be used as an instrument of economic policy. This is why we have balanced budget, budget deficit or budget surplus. Each of these three type of budgets has its own advantages as well as disadvantages. Each one plays a good role in the economy.

The classical economists believed that the budget must be balanced and they saw an unbalanced budget as an unhealthy phenomenon. Much is sometimes made of the need for balanced budgets to ensure a healthy economy even in the recent past. But even if optimum amount of government transfers and purchases occur, balanced budgets do not necessarily prevent inflation or solve any other economic problem. Instead with a balanced budget, total customer spending may be so high that inflation or shortages occur, or so low that there is unemployment.

Budget deficits were no longer to be viewed as extraordinary and potentially dangerous acceptable only as temporary expedient during recessions. Instead they were to be viewed as just another tool of economic policy. Some economists at present argue that if budget deficit are needed to provide the additional spending required to ensure a full employment economy, then such deficit should be encouraged in expansionary period as well as in recessions. These economists suggest that annual deficits in most years might be required as the price of economic growth.

The following are some of the main ways in which the budget can be used as an instrument of economic policy.

1. To Stimulate Recovery from a Recession

In the later years of the Great Depression, it was suggested that the budget should be deliberately unbalanced, a policy known as deficit financing in order to promote recovery. This worked successfully during the period and also during a period of serious slump, it is necessary, but in the case of recession, it may be sufficient simply to reduce taxation.

2. To Check Inflation

The aim of an anti-inflationary budget is to reduce the amount of purchasing power in the hands of the consumers, and this is done by increasing the rate of taxation so that a substantial surplus is achieved. So during the time of inflation, governments should increase tax rate so as to reduce the disposable income of the consumers which will help to reduce the inflation rate.

3. To Reduce Inequality of Incomes

In a country where great inequality of incomes exists, attempt should be made in the budget to introduce progressive tax system. This will make the high income group to pay more proportion of their income or wealth as tax than the low income group. Again inequality of incomes can still be reduced by the provision of some social services which, though available to everybody are generally of most benefit to people in the lower income group.

4. To improve the Balance of Payment Position

Duties on particular imports may be imposed or increased for the purpose of curtailing the demand for these goods, thereby reducing imports. Again duties on export goods can be reduced to encourage export which will equally improve the balance of payment position.

5. It is used as a Means of Raising Revenue

This was the original role of the budget. Through the budget, the government plans to raise enough money to finance the cost of national emergency such as war or disaster. It is also used as a means of raising revenue for the various development projects of the government. This is true because in the budget, the government sets out how it plans to raise its revenue.

6. Budget is used as a Tool of Economic Planning

Through the budget, the government assesses the economic performance of the various sectors of the economy during the previous year. Sectors which require special attention i.e. priority areas are identified and carefully enumerated.

3.10 Disposing of Surplus Revenue in the Budget

Whenever a budget is not a balanced one, it would either be budget surplus or a budget deficit. Care must, therefore, be taken in handling either of the two. When there is a surplus budget giving rise to surplus revenue due to increase in taxation or decrease in government expenditure, the government must be very careful to handle this surplus in a way that will not offset the intended deflationary effect. The government must withdraw the money form circular flow and not allow it to creep back into the circular flow.

One way by which to accomplish this goal is to actually destroy the money i.e. to burn the bills. An alternative to this is to hold the money in idle treasury deposits. The third option is to use the money to retire some portion of the public debt.
Ordinarily, when holders of government bonds cash in their holdings, the government simply issues new bonds, selling the same amount of bonds to some different bondholders so that the amount of national debt remains constant. But when the government has a surplus, it can elect to pay off the old bondholders without selling new bonds thus retiring the debt.

However, there is a risk that some of this money will find its way back into the circular flow. But for the most part, the money, that the households and business have invested in government bonds is intended to be saved. Receivers of the money are, therefore, most likely to reinvest it in other form of saving-stocks in private industry, savings account or other securities.

3.11 Financing a Deficit in the Budget

It has already been stated that whenever the government expenditure is greater then the revenue collected deficit will accrue. How can this deficit be financed? There are many ways through which such deficit can be financed.

In the first place, the government may choose to meet the deficit by increasing the supply of money; that is the government will simply print up new bills in the amount equal to the deficit. Under certain circumstances, this is a satisfactory solution but in some cases it may be inflationary. The inflation which is the reduction in the purchasing power of the currency may be acceptable or even beneficial with certain limits. However it carries with it potential dangers for the economy.

Historically, many cases of hyperinflation were either started or fed by the printing of new money to meet budget deficit. So in some cases, the governments are somehow hesitant about making extensive use of this method of financing. But the introduction of certain amount of new money is often a sound economic policy. In fact the relationship between the supply and value of money and the stability of the economy is an important monetary policy, The other way that government can finance a budget deficit is by selling bonds i.e borrowing money from households and businesses. One possible drawback to this method of financing deficit is that it may take from households money that would otherwise be spent or from the business money that would otherwise be invested in capital goods. Any such decline in spending or investment would of course offset the basic goal of an expansionary fiscal policy.

STUDENTS ASSESSMENT EXERCISE

Q1 a. Explain what is meant by the term “Budget”.

b. Discuss how government budget can be used as an instrument of economic policy.

Q2 a. Distinguish between budget deficit and budget surplus.
b. Under what situations will each one be applied in the economy.

Q3. Write briefly on the following
a. Balanced budget
b. Budget deficit
c. Budget surplus
d. Budget presentation

4.0 CONCLUSION

A budget may be simply defined as a document indicating the total and composition of government expenditures and the sources from which such expenditure are expected to be financed in the course of the year.

When a government plans its annual expenditure and revenue in such a way that both are equal, the budget is said to be balanced. Where annual expenditures and tax revenues are planned in such a way that the expected revenue exceed expenditure then the budget is referred to as a surplus budget, however, the total intended expenditures for the year exceed the anticipated revenues, then the budget is referred to as a deficit budget.

Essentially, the budget process in Nigeria involves the determination of the expenditure priorities of the government together with the methods of applying the revenues from which these expenditures are met.

Although they may be variations among countries, the objectives and functions of a typical budget in general include the following.
- The allocation function
- The distribution function
- The stabilisation function
- The control and management function
- Protection for local industries.

There are a number of ways in which the budget deficits may be financed. The popular ways include:

- Raising loans from members of the public
- Raising the level of taxation
- Borrowing from the commercial banks
- Printing of more currency notes.

A typical annual budget composition in terms of expenditure is made up of recurrent and capital expenditure. The revenue items includes petroleum profit tax, mining company income tax, PAYE, import duties, export duties, exercise duties, interest and repayment of loans, fines, penalties, sales of goods and services, rents, fees and charges, etc.

5.0 SUMMARY

In this unit, we have usefully interpreted the term budget in several ways thereby analysing in one conceptual issues like objectives goods of national budget, functions of budget, kinds of budget, budgeting system, deficit budget, financing, capital and recurrent expenditures.

6.0 TUTOR-MARKED ASSIGNMENTS

Question - What is “deficit budgeting”?
Examine four (4) ways the government can finance the deficit, explaining the most inflationary and the reasons for thinking so.

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UNIT 16 PUBLIC DEBTS

CONTENTS

1.0 INTRODUCTION

The act of borrowing creates debt. Debt, therefore, refers to the resources of money in use in an organisation which is not contributed by its owners and does not in any other way belong to them (Oyejide et al 1985:9). It is a liability represented by a financial instrument or other formal equivalent.

When a government borrows the debt in a public debt. Public debt, internal and external is debt incurred by government through borrowing in the domestic and international markets in order to finance domestic investment. Therefore, public debt is seen as all claims against the government held by the private sector of the economy or by foreigners whether interest bearing or not (and including bank held debt and government currency, if any), less any claims held by the government against the private sector and foreigners (see Anygnwu, 1993). It is the obligation of a public debtor including the national government, a political subdivision (or an agency of other) and autonomous public bodies (Klein, 1994).

In broad terms, all kinds of obligations of a government (including the currency obligations) are included in the public debt such obligations include the currency short-term debt, floating debt, and funded debt and unfunded debt.

Public debt can be internal or external gross or net, marketable or non- marketable, short-term, medium-term or long-term, interest bearing or non-interest bearing and/or project or jumbo loans (see Anyanwu, 1993).

The classical principles of loan finance rationalise loans to provide inter-generation equity pray as you use capital formation, old-age insurance, self-liquidating projects, adjusting distribution, and reduction often friction.

Borrowing may be considered as a second-best alternative to money creation during periods of unemployment. In this way, it is seen as an instrument of managing the economy. Foreign loan, in particular is seen as a means of filling domestic savings gap, especially in the face of dwindling government revenues from domestic sources. It is particularly so in the face of fluctuating prices of primary commodity exports and hence dwindling foreign exchange earnings. External borrowing is also seen as enabling a developing country increase its rate of real investment just as it is seen as an engine of growth. In this sense, it increases per capital GNP or its component measures. (Cairncross 1961). Thus, debt acts as a source of capital formation.

Public internal borrowing acts as an anti-inflationary measure by mobilising surplus money in people's hands.

2.0 OBJECTIVES

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

- define the meaning of public debt.
- analyse fully the rationale or reason for public debt.
- examine the effects of public debt, public economy.
- evaluate the relationship between public debt and inflation.
- Explain how to manage public debt.
- evaluate the relationship between fiscal policy, public debt and the various types of debt.

3.0 MAIN CONTENT

3.1 The Meaning of Public Debt

Public debt can be defined as the total indebtedness of the Federal government, state government and local government in any country. This is quite different from national debt which is the total indebtedness of the national or Federal government alone. From the above definitions, we can see that the national debt is smaller than public debt.

In Nigeria, the national debt refers to the accumulated borrowing by the Federal government and it represents the money owned by the Federal government to its citizens and the oversea governments and residents.

The Central Bank undertakes the administration of both national debt and public debt on behalf of the Federal government.

The structure of the public debt needs to be looked into. As already stated, the public debt is made up of all the total indebtedness of the Federal government, the total indebtedness of states as well as those of the local government. So the three-tiers of the government contribute to the continuing growth of the public debt in our country as well as other countries.

3.2 The Reasons for Public Debt

Infact, there are many reasons why some countries accumulated public debt. Some of the reasons are to be discussed here. In the first place, the Federal government usually borrows from foreign countries, agencies or individuals as well as from the public within the country in order to meet its expenditure plan. Although the government can always increase the note issue to meet its own expenditure plan, such policy is likely to be inflationary.

Some governments atimes engage in wars with other countries and this will necessitate an external loan. Such governments cannot help going for such external loan or they will definitely pay the price of not getting the loan which is losing the war.

There are some projects which are likely to yield revenue to the government when completed and the government will like to borrow money to execute them. There is no doubt that some heads of government involve themselves in an external borrowing for personal benefits and not necessarily to embark on a useful venture.

It is important to realise that both the wealthy countries as well as the poor ones accumulate public debts. In 1945, the national debt of the United States of America stood at $258.7 billion while the Gross National Product figure stood at $258.9 billion.

Nigeria is one of the countries whose national debts figure is alarming. Nigeria's national dept in 1966 was N3,044.6 billion and N5,002.1 billion in 1977. This then means that the substantial part of Nigeria's G.N.P. will be used for the servicing of the national debt. It has to be noted that in each of the countries mentioned, the public debt was greater than the quoted national debt figures of the mentioned years.

3.3 The Effects of Public Debt on the Public and Economy

Many countries are worried over the increasing size of their public debt because of many reasons. Some of such reasons include:

1 . The increasing burden of public debt is being passed on in the future generation:

   There is no doubt that the increasing burden is being passed on the future generation but if the government totally avoids the public debt, it may distort the economic behaviour of the firms and individuals.

   In most cases honest government increases the national debt in order to ensure proper public and private spending. In order to avoid depression or recession, a lot of money is required to be pumped into the economy for greater economic activities.

2 . Interest Payment Continues of Increase: As the public debt or even the national debt gets higher, there is tendency for more interest to be paid on it. The lender then gets more and more purcashing power than the debtor. If the debt is allowed to grow very high, it may require more proportion of the G.N.P. to pay the interest on the debt and this will affect both the people and economy.

3 . The Increasing public debt may lead to bankruptcy on the part of the government: This may adversely affect the economy so much and the government may find it difficult to get future loan for developmental projects.

4 . It may necessitate higher tax rate: In an attempt to pay the interest on the debt, there may be need for higher interest rate which means more tax for the public. The higher tax will affect the disposable income of the individuals and this will equally affect the standard of living of the people.

It has to be noted that in 1988 budget, the President of the Federal Republic of Nigera, General Ibrahim Babangida stated that the sum of N3.915 billion is allocated for the payment of interest charges on external loans while N3 billion is for the payment of interest on the domestic loans. This will give a clear idea of the amount of money involved in payment of interest charges only and the impact of the huge amount of money on the public.

The big question which many people usually ask is whether public debt can be avoided. The answer to that question is that it is not really possible to avoid public debt. Every country of the world owes another or is being owed. A country which always fears owing other countries will never take a bold step towards economic development. It is not always bad if a country owes, provided the money borrowed was optimally utilised.

The best thing the planners of the economy should do is not to avoid borrowing but to make sure that borrowed money is invested in a viable projects that will be capable of generating enough fund for the repayment of the debt.

3.4 Limit to Rising Public Debt

In most countries today, public debt has shown a continuous upward trend during the last few decades. There have been various reasons or factors responsible for this mentioned above. But the question now is whether there is a limit beyond which a government cannot increase its public debt.

In order to answer the question, we should distinguish between the will and capacity to raise loans on the part of the government and both of them should be considered in the context of short-run and long-run possibilities.

It has to be borne in mind that a modern government would not resort to borrowing for the sake of it. It does not have a tendency to borrow and squander it away on wasteful consumption beneficial to the section of the rulers. A reasonable government borrows for only such consumption purposes which are considered absolutely necessary for the economy such as defense, protection against national calamities and some important other welfare activities.

In a normal circumstance, the government of a country might borrow as a part of its anti-cyclical operations i.e. for stabilisation purposes while in the developing countries, the government may borrow for capital accumulation and economic growth and development. At times there is self imposed limitation by the government which stipulates that the borrowing must be for public purposes. In some cases, specific legislature provisions may prohibit the government from borrowing under certain circumstances or beyond certain limits.

Government borrowing reduces the supply of funds available to the authorities to borrow too much and unnecessarily. Only short-term loan will attract low interest rate for the government.

In the long-run, however, the situation is different. Total volume of public debt can increase gradually in harmony with the growth in the National income. Therefore, no definite limit may be stated to exist for the volume of public debt in the long-term. Furthermore, the borrowing power of the government can be assumed to be unlimited.

3.5 Public Debt and Inflation

Most government while raising loan for their investment and even for consumption purposes, will claim that such activities will not be inflationary. They claim that such borrowing will divert funds from the market into the hands of the government and that they are spent by the government instead of the market. This according to the argument is only a diversion of demand but no net addition to it.

The logic is wrong since the economy's resources will be divided from production of consumption goods into those of capital goods, therefore, making the demand for consumer goods to be greater than supply, thereby leading to inflation.

Whenever effort is made to increase economic activities so as to ensure greater employment opportunity for the citizens, it is likely to be inflationary. In fact, inflation is the cost of full employment. It can, therefore, be concluded that public debt if continuous will likely cause inflation but that will not make the government avoid public debt but to guard against its adverse effect.

3.6 Management of Public Debt

The term debt management refers to the debt policy designed to achieve certain objectives and actual implementation of the policy. According to the traditional philosophy, the debt management consisted of raising the necessary debt at the cheapest interest cost and paying it off as early as possible. However, with the development of the concept of welfare state, various objectives are being considered as the cornerstones of a sound debt management policy.

There is no doubt that every government is still interested in keeping the interest cost of its debt at the minimum possible, but when this objectives comes into conflict with other objectives, it may be sacrificed. Other Important objectives attracting the attention of the government authorities include anti-cyclical measures or stabilisation objectives, economic growth and development.

It is expected that debt management policy has to be in harmony with the monetary policy of any country. They both should influence the stablisation and economic growth. Through general and selective credit controls, monetary policy tries to influence the volume and the direction of the flow of funds and thereby guide the working of the economy. The ways in which debt management can also contribute to the monetary policy objective have been stressed. We cannot loose sight of the fact that the objective of reducing the interest cost on debt can come into conflict with the stabilisation policy of the country.

It is important to bear in mind that the aggregate volume of debt is as a result of fiscal action, that is the budgetary policy of the government. The volume of debt will increase or fall in line with the deficit or surplus budgeting.

In monetary policy, there is no such limitation. The volume of money and credit in the market may be regulated quite independently to a large extent. In the case of public debt, the management part would mainly consist of changing the maturity composition so as to effect its yield structure and the liquidity content. But the emphasis is still that the monetary policy and the public debt are closely linked.

3.7 Public Debt and Fiscal Policy

When the government finances a budget deficit by borrowing from the public, it creates a public debt. This raises a fundamental macro-economic issue. What is the effect upon the economy of the existence of a large public debt?

Classical economists believed that any amount of public debt was harmful to the economy. They insisted that the government budget should always be balanced, implying that it was practically sinful for a country to be in debt to its citizens. The balanced budget was considered to be a necessary right up till the 1930s.

The experiences of the depression and the conclusion drawn from them by Keynes changed economists attitude toward the balanced budget. Economists began to see the difference between private and public finance and to realise that the balanced budget that was desirable for a household was not necessarily desirable as an annual practice for the government.

Keynes demonstrated that effort to balance the budget when NNP is changing rapidly in either direction will intensify economic instability. According to him, if NNP is falling, government can balance the budget only by increasing taxes or by reducing expenditure as either of them will lead to recession. If NNP is rising, the government will have to cut taxes or increase spending to achieve a balanced budget as such a policy will add to the inflationary pressures.

It is currently accepted that an annually balanced budget may do more harm than good to a dynamic economy, depending on how close the economy is operating at full employment. While some economists are of the opinion that long-term balance is necessary, others are of the view that any magnitude of national debt is acceptable as long as the rate of growth of the debt is less than the rate of growth of Net National product.

3.8 Categories of Public Debts

Public debts are mostly of two kinds or types, depending on the purpose for which the money was borrowed.

(1) Reproductive Debt: In a situation where a particular loan has been obtained to enable the government to purchase some real asset, the debt is said to be a reproductive one. A good example may make this more understandable. Assuming that the Federal government embarks on natinalisation of industries owned by private companies and some foreign nationals instead of the current privatisation excise, the former owners may receive compensation in the form of government stock. In this example, the Federal government has just inquired debt in order to acquire some real assets. In other words, the Federal government has just increased its debt by the amount of compensation paid, but has acquired in exchange of real assets in form of more industries.

(2) Deadweight Debt: The second type of public debt known as "deadweight debt" is public debt that is not covered by any real asset. This is a situation where the government borrows money and spends it in something that is not tangible. Greater proportion of many countries public debt is in this category and this makes the burden of the debt much on the people.

Most countries borrowed huge sum of money in order to prosecute one war or the other. During the Nigerian civil war of 1967-1970 the public debt of this country increased but after the war the then Head of State, General Yakubu Gowon paid completely the national debt owed Britain against the wishes of many people. Many countries of the world accumulated huge public debt in the way of the deadweight debt.

STUDENTS ASSESSMENT EXERCISE (SAE)

(1) What is public debt and how does it differ from national debt?
(2) Discuss the effect of public debt on
(a) The people of a country
(b) The economy
(3) Explain how a government will figure public debt.
(4) Discuss some advantages and disadvantages of public debt.
(5) The public debt is inevitable. Discuss.
(6) List and discuss the reasons for public debt
(7) Mention and explain two categories of public debt showing how each affect the people in the economy.

4.0 CONCLUSION

Before analysing the issues involved in public or national debt, it is important to distinguish between a national debt and a budget deficit. A budget deficit is the difference between a particular year's total government receipts and the year's total government expenditure.

The national or public debt on the other hand is the accumulated total of past deficits less pass surpluses.

Public debt may also be categorised as to whether it is internal or external. In the case of internal public debt, payment of interest or repayment of principal involves a transfer from tax payers to security holders.

External debts on the other hand are debts owed by a country to institutions or countries abroad. To the extent that interest payments are made abroad and principal repaid, there are implications for the country's balance of payments.

There are a number of causes which has led Nigeria and other developing countries into the debt crisis now facing them. These factors include the following:

- Huge Budget Deficits.
- Heavy Dependence on oil Revenue.
- Short-term loans being used in Financing long-term projects.
- Reckless contraction of loans.
- Rise in interest Rates on Commercial loans.
- Poor performance of Non-Oil Export.
- Structural in-balance in the Economy.
- The effects of the public debt depends on whether it is internal debt or external debt that we are talking about.

The more important effects on the economy as far as internal debt is concerned include the following:

- Large internal debt tends to "crowd out private investment.
- Internal debt may create income Distribution problem.
- Internal debt may Aid Government stabilisation programme.
- Debt Financing may create inflationary Effects.

The effects of external debt on an economy shall be examined in the context of the Nigerian situation. The effects of the debt and its financing continue to generate debate on the Nigerian economic scene. Although people tend to concentrate on the negative effects of the debt in their discussion, there are positive consequences as well. The more important positive effects include the following:

- External Debt has made the financing of certain projects possible.
- The Debt helped in Balance of payments support.

The negative effects includes:

(a) The debt and its servicing are draining away resources which could be used to finance development.
(b) The debt and difficulties being encountered by Nigeria in its servicing have created the problem of Foreign Investors confidence in the Nigerian Economy.
(c) Greater control on the direction of the economy by foreign creditors

The question of the debt burden of the public debt is a complex one since it raises question about the nature of the burden and its intertemporal incidence. That is which future generation that bears the burden.

The term debt management is used to describe strategies adopted by a government to minimise the negative impact of debt on the economy as well as the burden of the interest charges. The methods used in managing the internal debt are important since they have implications for both the money supply and the structure of interest rates.

The policy aims of debt management strategies of government including the Nigerian government include policies designed to regulate monetary variables maintenance of stable market in securities and minimisation of debt service charges.

Debt management strategies being used to tackle Nigeria's External debt obligation are a number of policies put in place to tackle Nigeria's external debt problems.
The policies includes:

- Debt rescheduling strategy
- Debt conversion strategy
- A lid on External Borrowing
- Economic Restructuring
- Brady plan
- Debt Repudiation

5.0 SUMMARY

In this unit, we have succeeded in examining the meaning, nature, the structure, trend and consequences of public debt in Nigeria including the debt management strategies.

6.0 TUTOR-MARKED ASSIGNMENTS

Question - One
(a) Define Public Debt.
(b) What is the rationale for external borrowing?
(c) What to you understand by "debt burden"?
(d) Examine Nigerians external debt strategy.

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UNIT 17 NATIONAL INCOME

CONTENTS

1.0 INTRODUCTION

The purpose of economic activities is the production of goods and services and a look at a modern economy will reveal that its output is an endless flow of goods and services. As a result of the cooperation of factors of production during a particular period, a certain output of goods and services is achieved. It is common that factors of production are generally paid for their services in money, these payments being variously known as rent, wages, interest and profit. These four types of payment are income and all incomes are received by someone.

The important thing in any economy is that the total income of a community or the economy depends on the total volume of production. If people are to understand the behaviour of the modern economy, there is then need to measure its performance. There are needs to measure the total output of goods and services and also the total income received by all the people in the economy. This unit will look at the national income i.e. the total income of a nation, the measurement of the national income of many nations, the problems encountered in the measurement of national income as well as the uses of National income statistics.

2.0 OBJECTIVES

In this unit, you should be able to:

- define the meaning of National Income, Personal Income and Disposable Income, arrange for the measurement of National Income.
- identify the need for regular measurement of National Income;
- explain the factors determining the size of National Income;
- identify some difficulties in measuring National Income;
- explain why West African Countries have lower National Income figures than developed Countries.

3.0 MAIN CONTENT

3.1 Meaning of National Income, Personal Income and Disposable Income

(1) National Income

National income means the total compensation of the elements used in production (land, labour, capital and entrepreneurship) which comes from the current production of goods and services in the economy. It is the income earned hut not necessarily by all persons in the country in a specific period. It consists of wages, rents, interest, profits and the net income of the self-employed. In other words, national income is the market value of all goods and services produced in a country over a specified period of time usually one year. It is important to note that national income can be classified according to the industry in which it originates, such as mining, manufacturing and construction.

(2) Personal Income

This is the amount of current income received by persons from all sources, including transfer payments form government and business. It is the total income the people in an economy usually receive i.e. their actual receipts from all sources. Personal income also includes the net incomes of unincorporated business and non-profit institutions and non-monetary income such as the estimate of the value of homes occupied by their owners. The major monetary components of personal income are labour income, rental income, proprietors income, dividends, interest and transfer payments.

(3) Disposable Income

The disposable income refers to the income that individuals retain after they have deducted personal income taxes. Disposable income is the concept closets to what is commonly known as take-home pay. It is the amount which individuals can use either to make personal outlays or to save. It is the amount of income actually available for the individual in an economy to use in purchasing goods and services for consumption. Disposal income tends to differ from personal income because of personal income taxes. These taxes arbitrarily removed a portion of the personal income received by individual and thus leave a smaller amount for disposal by the income recipients.

3.1.1 Measurement of National Income

The national income of any country can be measured in three different ways; the output method or G.N.P. approach, the income method and expenditure method.

1. The Output Method or GNP Approach
   In the output method or G.N.P. approach, the national income is arrived at by adding together the market value of all the output of goods and services in a country and net income form abroad less capital consumption allowance. In this method, the Gross Domestic Product (GDP) is first arrived, at then the Gross National Product (GNP) and finally the national income.

   The Gross Domestic Product (GDP) is the total value of all the goods and service produced in any economy of country in a particular year. The Gross National Product (GNP) on the other hand is the gross domestic product plus net income from abroad i.e. the value of exports less the value of imports.

   When the capital consumption allowance is taken away from gross national products, what is left is the national income. An illustration of this with some figures will help to make the explanation clearer.

3.1.1 (a) Table 12.1: ***Gross National Product of a Hypothetical Country 1997***

Product or Service	N Million
Goods and Services produced by:	
Agriculture, forestry and fishing	95,000
Manufacturing	45,000
Building and construction	30,000
Mining	20,000
Insurance, banking and finance	15,000
Other services	20,000

Gross domestic product	225,000
Net income from abroad	8,000
Gross national product	233,000
Less capital consumption allowance	10,000
National income	223,000

The table above shows that the national income for our hypothetical country is N223,000 million. It has to be stated that in output method or GNP approach, there is every likelihood of double counting or repeating the value of some items and therefore arriving at a wrong figure of national income.
In other to avoid double counting in the output method approach, the value of the finished product or the value added is used for example.

3.1.1 (b) Table 12.2 Illustration to avoid double counting

Producers	Cost of raw Materials	Sales Value	Valued Added
Wool farmer	0	100	100
Wool comber	100	150	50
Wool spinner	150	210	60
Wool weaver	210	280	70
Wool traitor	280	340	60
Total	740	1080	340

In figure 12.2 above the figure that should be used for the purpose of the calculation of the national income is the value of the final product which is N340 or the total value added, which is also 340. If all the sales values are taken, it will mean double counting and the amount will be 1,080 which is wrong.

2. The Income Method

This is the method of calculating the national income by calculating the incomes of the four factors of production. In the method, the total income earned by business organisations and individuals during a period of one year are added up. The addition got is known as the national income at "factor cost", the total cost attributed to all factors of production employed. In other words, national income at "factor cost" include the total of all wages, salaries, rents, dividends and interests received. It also includes income in kind. The income of entrepreneurs and profits of companies before deduction of taxes. This then means that adjustment has to be made.
ADJUSTMENT: In practice income figures are obtained from income tax figures. Therefore, an adjustments to be made.

a. Transfer Income

Sometimes an income is received without any corresponding contribution to the output of goods and services e.g. unemployment insurance benefits, retirement pensions, students grants included in the national income figures should not be there because they do not add to the output of goods and services. They only represent a redistribution of income within a nation. It has to be noted that the usefulness of this method is limited in West African by the existence of tax evasion and the refusal of many individuals and firms to make correct returns of their income.

3. The Expenditure Method

The third method of obtaining the national income is through the expenditure method. This is the calculation of expenditure incurred by individuals and the public. In other words, this method measures the total amount spend on consumer goods and services and net addition to capital and goods and stocks in the course of the year which can be referred to as savings.

It is important to note that in theory, any of these methods used will give the same result. The reason is that the expenditure on goods and services must equal the sales value of those goods and services. This in turn must be equal to the amount of money paid by firms as wages, salaries, interests, dividends, rent and undistribution profit. But in practice, measurement problem can result to differences in the figure obtained from the three methods.

3.2 The Need for Regular Measurement of National Income

The fact that the measurement of national income is not a simple exercise makes some people ask why nation should embark on such painstaking exercise. Nevertheless, there are many good reasons why the national income of every country should be measured yearly. Some of the reasons include:

(1) The Volume of Production Determines a Nation’s Economic Well-being
The fact that the volume of production determines the economic well being of any nation makes it more than necessary for any country to measure its national income. National income is a good indicator of economic progress as well as good measure for a standard or living of people in a country.

(2) National Income is an Important Instrument of Economic Planning
A country needs to know the trend of business activity in the economy so as to make adjustments in its planning. There is need to know the proportion of national agriculture, industry, mining, services, etc. The knowledge of this will help to

determine where greater efforts should be directed. This is based on the fact that one year's achievements will form the basis of plans for the following year.

(3) National Income helps to determine the Economic Strength of different Nations
Measurement of national income is very important because that helps to determine the economic strength of different countries, and this again will help to find out the countries that may need economic assistance.

(4) National Income is Necessary to Determine Different Countries Contributions to International Institution.

The measurement of national income is very vital for equitable assessment of different nations. Contributions to international institutions such as the United Nations Organisation, Organisation for African Unity and Economic Organisation for West Africa States.

3.3 Factors Determining the Size of National Income

Some countries have larger national income than others. There are a number of factors that influence the size of national income of any country. These factors are:

(1) The Stock of Factors of Production

One of the factors that influence the size of a country's national income is the quality and quantity of the factors of production. Land for an example may be fertile or infertile and this will greatly affect the productivity and national income. The quality of labour will depend on education and training which will equally affect the productivity. Equally the extent of a country's stock of modern forms of capital determines the total volume of production.

(2) The State of Technology

The second important factor in determining the size of a country' national income is the state of technology. The national income of any country increases as the country's state of technology improves. For example, the national income of Great Britain increased tremendously after the Industrial Revolution of the 18^{th} century as a result of the introduction of new method of production both in industry and in agriculture. Also the national income of some West African countries increased recently as a result of the introduction of modern technology.

(3) Political Stability of Instability

Political stability is very essential if highest level of production is to be maintained. Political instability on the other hand has been a great hindrance to the output and development of many countries of the world, especially the countries of West Africa and South America who suffered setbacks in their economic progress as a result of political instability.

(4) Natural Endowment

The gift of the nature is one of the things that make some countries to have greater national income than others. For an example, Kuwait which is one of the smallest countries of the world has greater national income than the majority of the countries of the world. This is as a result of huge, deposits of crude oil in the country which is not the handiwork of any human being. Countries with huge deposits of important mineral resources have far greater national income than other countries not having any of such mineral resources.

(5) Willingness and Development to Duty

The willingness and devotion to duty of the people in a country will in no small way increase the national income of that country. When people are willing to work and devote their entire energy in the production, productivity will be increased and this will subsequently increase the size of national income. In the past, the Nigerians looked at the civil service work as 'Oyinbo' work and as a result, productivity was very low.

3.4 Some Difficulties in Measuring National Income

Certain difficulties are encountered in measuring the national income. These difficulties are of different nature and they include:

(i) Information is not always Available

While some agencies provide some figures and information needed for the calculation of national income, others not available have to be estimated. Some people do refuse to give any information about their income by refusing to fill the income tax form. Under such a situation, there is nothing to be done than to base everything on some estimate. More estimates will never give an accurate measurement of national income.

(ii) The Problem of Double Counting

This particular problem arises when the price of raw material is counted and at the same time the cost of production and finished goods are included in the calculation. Care must be taken to avoid such double counting so as to arrive at an accurate figure. In this case, only the price of the final product should be taken, or the sum of the values added during the process of production.

(iii) Unpaid Services

In the process of the production of goods and services some services are not paid for. In measuring national income, therefore, only those goods and services for which payment is made are taken into account. Services which people for themselves; friends and neighbours are not included. This means that where there is greater division of labour, national income will be greater even when there is no increase in the actual out-put.

(iv) Foreign Payments

Income usually comes from abroad in the form of dividends, interest on foreign government stock and payment from export and income also goes out to foreign countries in the same way. The different between the foreign receipts and payments made to foreign countries which is called net income from abroad must be added in other to get the national income. When this is ignored, wrong figure will be arrived at.

(v) Changes in the Value of Money

The value of money is not steady and as a result of this, comparison between national income of one year and another is difficult to make. If the prices of goods and services go up by 5%, the national income will increase by the same percentage even if the same amount of goods and services produced in the previous year is produced in the current year.

(vi) Depreciation

Depreciation means the reduction in the value of an asset through wear and tear. An allowance has to be made for this in the calculation of national income. The main problem here is that sometimes, it is not easy to calculate the exact amount of depreciation of some equipment and other assets due to the fact that the rate of wear and tear is not the same throughout the life span of the asset.

(vii) Payment in Kind

There are some people who are paid in kind for their services. The value of such payments cannot be calculated easily. Again in some places, farmers sometimes retain some of their products without bringing them to the market. Usually no account is taken of such goods and this normally leads to incorrect accounting of national income. The value of all payments in kind is supposed to be included in the calculation of national income.

3.5 Why West African Countries have Lower National Income Figures than Developed Countries

The national income figures of West African countries are very small when compared with those of the developed countries of Western Europe and the United States of America. There are some reasons behind this situation and then include the following:

(i) The Stage of Economic Development

The state of economic development is very important in determining the size of national income. The countries of Western Europe and the United States are more developed and highly industrialised and therefore, have more national income than the countries of West Africa.

(ii) Shortage of Capital Goods and Funds

The relative shortage of capital goods and funds in West African compared with the highly developed countries accounts for lower than national income in West Africa. Capital is an important factor of production which can raise both productivity and national income in any country.

(iii) Limited Exploitation of National Resources in West Africa

Most of natural resources in West Africa as well as other developing countries are not fully exploited as in United States of America, Japan or Western Europe. As a result of this, some natural resources are lying idle in some of these countries which if fully exploited could have helped to raise the national income figures of such countries.

(iv) Labour in West Africa is not highly Skilled

While many countries of West African have abundant supply of unskilled labour, some lack skilled labour. This situation leads to lower national income because skilled and well-trained man-power enjoys higher pay than unskilled man-power. But with the establishment of many secondary schools and institutions of higher learning, reasonable proportion of West African labour force is now skilled.

(v) Political Instability in West Africa

Political instability which characterised West Africa for many years now does not create healthy climate for foreign investments which are essential for increase in productive capacity and national income. The fear of nationalisation of foreign owned businesses discourages foreign investors in West Africa.

3.6 The Uses of National Income Statistics

The use of national income statistic is not unique for any particular type of economy or any region. They are relevant to all countries both developed and undeveloped. Some of the uses of national income statistics are as follows

(i) National Income Statistics are used for estimating per capital income of a country. They give us a summary of appropriate changes overtime in the per capital income and overcall standard of living.

(ii) The national income statistics can give the structure of production at a glance, i.e. the items that make up the national income are clearly shown. This will help to know the combination of each sector in the economy to the national income of the country in question.

(iii) National income statistics are useful in the formulation of fiscal policy. The figure of the previous year is compared with the current year and on the basis of this, a forecast on the state of the national economy is made for the coming year.

(iv) The national income figures present the best method used in measuring economic growth. They show the progress made in each sector of the economy by giving the clear picture of the anticipated and realised rate of economic growth.

(v) The national income figures can be used in comparing the living standard in one country with that of another, especially when the countries are in the same level of economic development.

(vi) National income figures can influence the decision of foreign investor, e.g. an investor may like to establish an industry where there is high per capital income as that will induce greater demand for the product of the industry.

3.7 The Limitations of the Uses of National Income Statistics

(i) For the domestic and international comparison, it is necessary to bear in mind that the standard of living is not merely measured by the amount of material goods available in the economy or even available to individual. There are other things that contribute to the standard of living of people in a country such as the health condition of the people; the amount of leisure time for the average worker, political and religious freedom.

(ii) There are some unnecessary assumption that should not be allowed to exist e.g. if there is a 10% increase in the GNP of a country, there is always a tendency for people to think that the people's wellbeing or standard of living has increased by the same percentage. Economic growth may occur but it may not lead to economic development of the country.

(iii) Specialisation may lead to higher national income figure when actually there is no increase in the output of goods and services. Where there is no specialisation, people can do certain works for themselves and no payment can be made so as to include it in the national income calculation. But with specialisation, it will be difficult for one to do some other things for himself rather he will empty the services of a specialist which will necessitate payment and inclusion in the national income figure.

(iv) In developing countries, most of the agricultural products are consumed by the producers and as such their values are not known because they did not find their way to the market. In such a country, the national income figure, is seen to be very low where as in actuality is not so. The value of national income in such a country will be highly higher that what records show by the value of the amount of goods consumed by the producers.

(v) When comparing the changes in the standards of living, the average income per head. i.e. per capital income, may be a more valuable indicator than total national income. This is because the national income figure may rise but the population may rise more in the percentage, increase in population may be greater, making the per capital income to be lower and consequently the standard of living of people.

(vi) Finally, the basis of the statistics may vary from country to country. The proportion of goods and services not reaching the market is likely to be much greater in a developing country than in a developed country and again the transport expenditure in a place where there are no mass transit services will definitely be higher than in a country where there are highly developed mass transit facilities. These differences will make the use of national income figure for international comparison of the standard of living useless.

3.8 The Keynesian Cross

Aggregate Demand – Aggregate supply method.

The Keynesian cross shows:

- That production always generates an equilibrium amount of income.
- That planned expenditure may exceed or be less than income.

In a closed economy, where the total value of production or expenditure is the summation of consumption expenditure ‘C^{o}, government expenditure ‘G’ and investment expenditure “I”.

Y = C+I+G

Given that the total expenditure must be equal to the total income generated in the economy, that is,

Y = C+S+T

Therefore, the sum of consumption, savings and taxes must always be equal to the sum of consumption expenditure, government expenditure and actual investment expenditure.

That is

Y = C+I+G = C+S+T.

3.8.1 OPEN ECONOMY AND CLOSE ECONOMY

Open economy is an economy with external sector while close economy is an economy without the external sector.

The major contributions of the Keynesian theories were the role given to government to maintain the aggregate demand through the use of government expenditure (injections) and taxes (withdrawals or leakages).

In this model, the sum of income that is available to the whole economy is equal to the sum of expenditure in the economy. Symbolically written as:

Y = C+I+G+X-m

3.8.2 NOMINAL AND REAL INCOME NEXUS

The nominal product of a nation can be valued at the current market price (using the domestic currency). This gives us the Nominal National Income (NNI) of the nation. Nominal Income can also be calculated at the current factor cost. The Real Income of a nation for a given period however is gotten by deflating the nominal income by an appropriate price index. In other words, the prices of goods and services or factors costs which prevailed in a given period (called the based period) is used to value the goods and services of factor costs for the present period. Thus, an inverse relationship exists between the real income and the price index. The higher the price index ceteris paribus, the higher the nominal income but the lower the real income. Real values are important in the measurement of a nation's income because they take account of price changes.

3.9 TYPES OF PRICE INDICES

Three major forms of price indices are commonly used in National Income Accounting (NIA). These are the consumer's price index (CPI), The GDP deflator and the producers or wholesale price index (PPI or WPI).

3.9.1. CONSUMER'S PRICE INDEX (CPI).

To derive the CPI, a representative basket consisting of some good and service common consumed such a good, drinks, clothing, footwear, accommodation, fuel and light, household goods, medical care, transportation etc. and their prices are taken for a given year called the base year. The CPI is obtained by multiplying the current prices of the same goods and services by the base year quantity weights.

3.9.2 The GDP deflator

This is also implicit GDP deflation which is the most comprehensive measure of inflation used in national income accounting. It is the ratio of nominal to real GDP in a given period (that is the nominal GDP) deflated by the price index using a given period as the base period).

3.9.3 The wholesale price index (WPI)

The (WPI) is similar to the CPI but differ in terms of coverage. Here, the emphasis is on the price of raw materials and semi finished goods.

3.10 THE THEORY OF MULTIPLIER

The multiplier is defined as the ratio of the change in national income to the change in the expenditure that necessitated it. The change in expenditure may come, for example, from new government spending, from a rise in export or form household consumption expenditure accompanied by a reduction in household savings. All these may necessitated a change in national income.

The multiplier may be defined as amplified effect of a change in autonomous expenditure on national income. The multiplier process is a process where aggregate demand is multiplied over several times.

3.10.1 The Multiplier Process (Close Economy)

Given a simple macro-economic model of a closed economy as:
Y = C+I+G
C = 20+0.8Y
I = N40m
G = N80m

Suppose investment expenditure increased by 50 percent. What multiplier effect will this change in autonomous investment have on the national income?
Solution:
Y = C+I+G
Y = 20+0.8Y+40+80
Y =140 +0.8Y
Y(1-0.8) = 140
0.2y =140
$$Y = \frac{1}{0.2} = 140$$
Y = 5(140)
Y =**N700m**

(b) The multiplier (K) = $\frac{1}{1-0.8} = \frac{1}{0.2} = 5$

The process of multiplier in this economy is that, a one naira increase in autonomous expenditure will result in a five naira increase in the national income.

- Therefore, when the autonomous investment expenditure increased by 50 percent (N20m) the resultant multiplier effect on the national income is that income will be increased by N10m (that is N20m multiplied by five). Determined thus:

  Y = 20+0.8Y+60+80
  Y =0.8Y+160
  Y (1-0.8) = 160
  0.2y =160
  $$Y = \frac{1}{0.2} = 160$$
  Y = 5(160)

Y =**N800m**

Hence, income increased from N700m to N800m as a result of N20m increase in investment expenditure via the multiplier.

Illustration II:
Given:
Y = C+I+G
C = 20+0.6Yd
Yd =Y – T
T = 10+ 0.2Y
I = N50m
G = N80m

Required:

- Determine the equilibrium national income
- Determine the income multiplier
- What is the value of the tax multiplier?
- What effect will a 50 percent increase in government spending have on the national income?
- Suppose the government pursues a balanced budget. What effect will this policy have on the equilibrium national income?

Solution:
Y = C+I+G
Y = 20+0.6Yd+I+G
Y =20+0.6(Y-T)+I+G
Y 20+0.6[Y-(10+0.2y)]+50+80
Y 20+0.6[Y-10-0.6y]+130
Y =20+0.64-6-0.12y+130
Y=150-6-0.48y
Y=144-0.48y
Y(1-0.48) =144
0.52y =144

$$Y = \frac{1}{0.52}(144)$$

Y_{eq} = N276.48m

(b) Income multiplier K = $\frac{1}{0.52} = 1.92$

(c) Tax multiplier = $\frac{-b}{1-b+b_t} = \frac{-0.6}{1-0.6+0.12}$

$= \frac{-0.6}{0.52} = -1.15$

(d) Government expenditure $\frac{1}{0.52} = 1.92$

Therefore, a N40m (50% of N80m) increase in government spending will cause a 40x1.92 (N76.8m) increase in national income. That is, national income will be increased by N76.8m.

Mathematically, it can be calculated as follows:
Y = 20+0.6y – 6 – 0.12+50+120
Y – 0.6y+0.12y =20+20+120-6
(1-0.6y+0.12)y=184

New $Y_{eq} = \frac{1}{1-0.6+0.12} = (184)$

New $Y_{eq} = \frac{1}{0.52}(184)$

New Y_{eq} = 1.92 (184)
New Y_{eq} = **N353.28m**

The increase in equilibrium national income due to a 50 percent increase in government expenditure is given by the difference between the old equilibrium national income level and the new level of income.
N353.28 -276.48 =N76.8m.
(e) If government pursues balanced budget it means that:

ΔY = ΔT---------- (1)

Since ΔG = N40m,
Therefore,

ΔT =N40m, from equation (1), ΔY = ΔG - ΔT =0

ΔY = 40 – 40 = 0

This means that a balanced budget financed entirely by the volume of tax revenue will neither increase nor reduce the equilibrium level of national income.

Illustration III: Given structural equation of an Open economy as:
Y = C+I+G+(x-m)
C = N50m +0.8yd
Yd = Y – T

T = N50m
I =N40m
G =N52m
X =32m
M=N37m

(i) What is the equilibrium level of National income?

(ii) If full employment level of income is N500m, what amount of change in movement is required to restore equilibrium at full employment level?

(iii) Derive savings functions.

Solution:
C = 50+0.8Yd where yd = Y- T
= 50+0.8(Y-T)
50 +0.8(Y-50)
50+0.8y -40
=10+0.8y

(i) National income equilibrium is:
Y=10+0.8y +40m+52m (N32m-N37m)
Y=102m+0.8y-5m
Y=97m+0.8y
Y(1-0.8) =97

$$Y = \frac{1}{0.52}(97)$$

Y = 5(97)
Y = **N485m**

(ii) Full employment level of income (multiplier)

$$= \frac{1}{1-0.8} = \frac{1}{0.2} \quad 5$$

$$\text{N500m} - \text{N485m} = \frac{15}{5} = N3m$$

• Savings function is derived: Y – C
S = Y – C
S = 0.2y -10
S = 0.2(485) -10
S =97-10
S = N87M

STUDENTS ASSESSMENT EXERCISE (SAE)

Q1. Explain what you understand by the term national income.
Q2. Distinguish between the gross domestic product and gross national product.
Q3. Explain three major methods of measuring the national income of a country.
Q4. Discuss in details the factors that determine the size of a country's national income.
Q5. Why is the national income figure of West African Countries far smaller than those of the developed countries of Western and the United States?
Q6. Discuss the uses of national income statistics. What are the limitations of the uses of national income statistics?
Q7. Explain the reasons for measuring the growth trends in national income
Q8. Comment on this statement and discuss the view that the natural income does not provide the best single measure of a nation's economic progress.

4.0 CONCLUSION

In the previous units, we learnt that the purpose of economic activity is the production of good and services and the output of a modern economy is an endless flow of such utilities. As the creation of both goods and services is counted as production by the economist then no distribution is made between the work of a farm labourer, a skilled physician a shop girl or a lorry driver. Thus a manufactured commodity is "produced' in the economic sense at every stage of its journey from its basic ingredients to its sale across the counter. Potatoes, wheat, fish, coal, natural gas, pig, iron sheet, steel, motor cars, tractors, roads, medical services and a million other items as well as a host of services are produced in Nigeria in any year. It would be possible with a great deal of effort to draw up an inventory of the goods and services produced in one actual year, but such a list would be of little economic significant as it would be so complex that comparison with earlier years or other economic would be impossible. If all the good and services produced in a given year were reduced to their monetary value that they could be added to give the value of total output for that year, this is called the gross national product (GNP). This concept is one of the most important economic indicators and is frequently mentioned in parliament and the press. Its correct economic definition is the aggregate value of the goods and services produced during the year by the factors of production within the economy plus the net income from abroad. The GNP is more popularly known as the national income and it is occasionally called the national expenditure.

Therefore, the national income of a country is the record of all economic activities during the course of a year. In more specific terms, it is the market value of all goods and services produced in any economy during a particular year.

There are three ways of measuring the national income. These are

(a) the product approach
(b) the income approach
(c) the expenditure approach

The expenditure have three approaches, they should normally give the same figure for national income;

There are a number of difficulties encountered in an attempt to measure the national income of a country.

Some of the problems are conceptual while other are practical resulting from the under developed nature of the economy.

- The first problem is to decide on what to include in the calculation and what to exclude.
- A second difficulty with national income measurement rendered by consumer durable goods.
- Thirdly, there are some activities which produce goods and services and generate incomes but which are excluded in national income calculation because they are illegal. Good examples are armed robbery activities, gambling and prostitution.
- Fourthly, often inadequate information leads to errors in national income calculation.
- Fifthly, the way depreciation is treated constitutes another difficulty.
- Perhaps, the real difficulty in national income calculation is in the danger of double counting.
- In the seventh place, there is the problem of owner-occupied houses, an accurate data collection is a difficult track, some production systems are subsistence, technical expertise for collecting, national income data is lacking and this makes the publication fit an irregular affair and finally a significant proportion of the Nigerian population are self-employed and they include traders and market women who are illiterates. These people do not usually keep accounts of their businesses and this makes it difficult to calculate their incomes.

The figures obtained from national income computations have a number of uses. The per capital income is sometimes used in comparing the standard of living of countries. The national income show the contribution made by various economy. National income estimates also enables economic plans to compare the performance of the economy over the years. It is used in deciding how much revenue should go to particular states or regions, and also enables a country to contribute to international organisations like United Nations, IMFS, etc.

5.0 SUMMARY

In this unit, we have succeeded in looking at the national income, i.e. the total income of a nation, the measurement of the national income of many nation, the problems encountered in the measurement of national income as well as the uses of national income statistics.

6.0 TUTOR-MARKED ASSIGNMENTS

What is the gross national product?
What are the main difficulties associated with its measurement?

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UNIT 18 ECONOMIC GROWTHS AND DEVELOPMENT

CONTENTS

1.0 INTRODUCTION

In recent time, the idea of economic development occupied the minds of the authorities in governments, especially in the developing countries of the world. But no meaningful development can be properly achieved without a good development plan. It is a common belief by economists that it is only through proper allocation of resources that the developing countries can accelerate their pace of economic development.

In view, of this, emphasis must therefore be laid on the right priorities, and planning is essential in order to obtain aid from developed countries, loan from the World Bank and other development agencies. It is quite clear that a government without any development plan may not be considered for aid and loan by some international organisations.

The approach to development differs from country to country. While some countries feel that development can be easily and better achieved through industrialisation, others think that rapid development can only be achieved through agriculture. Again, the role of the government in the economy is still a controversial issue. There is no consensus of opinion among economists as to the extent to which governments should be involved in the economy. But there is no doubt that there will be an agreement on that issue in the future.

2.0 OBJECTIVES

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

- distinguish between Economic development and growth.
- identify the factors that inhibit rapid economic development in developing countries.
- define privatisation of public enterprises and know the merits of privatisation.
- identify the problems associated with Privatisation
- explain the sources of Government revenue and the relative importance of the various sources of Government Revenue.

3.0 MAIN CONTENTS

3.1 Economics Growth and Development (Conceptual Clarification)

Economic development is not quite the same things as economic growth. It is, therefore, necessary to make a clear distinction here.

Economic growth means a rise in average per capital income made possible by continuing increase in per capital productivity (Hagen 1975). It also means a continuing increase on an annual basis in the production of goods and services which will help to raise the living standard of the people of the country as a whole. The growth rate is usually expressed in percentage and it shows the percentage by which a nation's production increases per year. Substantial growth can only be achieved through planning.

Economic development on the other hand refers to the changes in economic and social structure that always accompany economic growth. The changes in economic and social structure can be in form of better health services, better housing condition and improvement in sanitation. It is necessary to note that the United Nations International Development Strategy for the 70s stated that the ultimate objective of development must be to bring about sustained improvement in the well-being of individual and bestow benefit to all.

It has to be emphasised that planning is very important for economic growth and development of any country. The objectives of the planning have to be clearly known and stated.

3.2 Factors that Inhibit Rapid Economic Development in Developing Countries

Rapid economic development in developing countries is faced with a number of obstacles. These include the following:

(1) Inadequacy of Infrastructural Facilities
In order to attain a rapid development, a developing country needs a stock of public capital goods usually called the infrastructure of an economy. Inadequacy of infrastructure facilities reduces the pace of development and since this is the case of developing countries, the rate of development is usually slow.

(2) Low Accumulation of Capital

One problem that all under-developed countries have in common is relatively low stock of capital. The inadequacy of capital within the country or from outside makes acceleration in the tempo of development very difficult.

(3) Political Instability

Political instability is another important factor inhibiting rapid economic development in many developing countries, especially in West Africa. Some countries of West Africa changes government as people change dresses. This does not only prevent foreign investors from investing in such countries but also upsets the fulfillment of development programme.

(4) Persistent Deficit in the Balance of Payment

The continuous deficit in the balance of payment for most developing countries makes it difficult for them to achieve economic development. The money which could have been used in acquiring materials to promote rapid economic development is used to offset the balance of payment deficit.

(5) Population Problems

Public health revolution in many developing countries has made possible a fall in death rate and consequently rapid population growth as the birth rate is still high. As a result of high population, more of the available resources which could be used for capital formation necessary for development are used for the production of consumer goods for the growing population.

(6) Unfavorable Cultural and Social Attitudes

Cultural and social attitudes play an important role in motivating people to do certain kinds of work and accept certain working condition. It also affects attitudes to work and land tenure system in many West African countries. An example of this can be found in most countries where women are not allowed to work outside their homes and this will definitely reduce total production and consequently national income.

(7) Lack of Entrepreneurs with Innovative Ideas

There are not sufficient entrepreneurs with innovative ideas in most developing countries. For rapid economic development to take place, there should be enough entrepreneurs with innovative ideas as well as high level man-power or skilled personnel.

(8) Dependence on One or Few Export Crops

Some countries depend on one or few export crops. This makes it difficult for such countries to earn foreign exchange which is needed to buy equipment required in the development project. Again, if there is a decline in demand for such product, the country concerned will suffer. This happened to Nigeria with the oil glut of late 70s and early 80s.

STUDENTS ASSESSMENT EXERCISE

(i) What are some of the common characteristics of less developed countries? Can you think of others not mentioned in this units

(ii) Briefly describe the definition of the meaning of Economic Development not mentioned in this unit

(iii) Why is a strictly economic definition of development inadequate?

3.3 Privatisation of Public Enterprises

Privatisation of the public enterprises is one of the features of Nigerian economy in the 1980’s and 1990’s. One feature of public enterprises in the world over, but more particularly in developing countries is inefficiency leading to waste, slow growth and unnecessary dependence on government support, even when the business is a profitable one.

As a way of improving performance of public enterprise, countries the world over have embarked on commercialisation of public enterprises and they have profit orientation as the main motive of these enterprises, As one of the features under commercialisation, government retains ownership and control but subventions do not continue and the institution is allowed to pursue their objectives in their own style, having profit as their main target.

Privatisation which many people advocate for is a little different from commercialisation. Privatisation is a complete takeover of public enterprises by individuals or private sector by buying them and having the ownership and control power in such companies. Privatisation, however, can imply commercialisation because once an industry or enterprise is sold to the members of the public i.e. private individuals, the social objectives will have to give way to profit motive.

3.4 The Merits of Privatisation

Privatisation has numerous advantages over government ownership, and management of such enterprises. The advantages include:

(i) Efficiency

Experience has shown that improved efficiency and effectiveness of enterprises emerge as a result of privatisation. It has been mentioned earlier that profit is the main motive of the private sector and in order to achieve this profit objective, the management of these enterprises must ensure efficiency.

(ii) Management Capability

There is improved management capabilities as the private sector is believed to have better management capability that the public sector. Again, board of director membership will be appointed on the basis of competence and not on political patronage.

(iii) Reduction on Subvention

Reduced dependence on the government and therefore, reduction in public expenditure is one of the outcome of good management resulting from privatisation.

(iv) Reduction in Waste

The private sector is noted for employing resources only whey they are needed. This will, therefore, prevent waste from occurring. Also over staffing will be avoided.

(v) Quick and Efficient Decision

Bureaucracy is one of the characteristic of civil service and public enterprise. This is not so in the private sector where decision making is quick and efficient.

(vi) Profit Retention

It is clear that profits generated by public enterprises are usually transferred to the government. But with privatisation, most of these profits are retained in the organisation for development.

(vii) Management Stability / Continuity

The board of public corporation usually changes any time. There is change of government and this leads to management instability and absence of long-term corporate planning. This situation, will change immediately the enterprise is privatised and board stability will prevail.

(viii) Attention of Government to its Real Objective

Privatisation will no doubt enable government focus more on its role as sustainer of peace and orderliness and its supervisory roles in the economy.

(ix) Cash Flow Effect

It is believed that the sale of such enterprises to the private sector will have positive cash flow effect for the government since the money so realised could be reinvested on other socially desirable ventures like road maintenance, electricity and water.

(x) Flexibility

While the public sector is guided by rigidity, bureaucracy and general order which hinders flexibility, the private sector is always flexible and makes changes as the condition requires.

3.5 Problems of Privatisation

The advantages of privatisation have already been made clear in the previous discussion. This does not mean that privatisation is not with some problems. Privatisation of public enterprises may have the following problems.

(i) Unemployment

With privitsation, such enterprises would naturally trim down their staff and use small number of staff more intensively. This will no doubt lead to unemployment and we are very much aware of the social effect of unemployment.

(ii) Price Effect

It is quite clear that prices of services provided by such privatised enterprise will rise and this will have substantial real income effect. Some essential items like electricity, telephone and postal services may subsequently be outside the reach of the low income earners. NEPA is a typical example today.

(iii) Problem of Share Valuation

The actual, prices of which the shares are to be transferred may cause a lot of problems. Again, there are fears that the share may be deliberately under-valued to favour the elitist group who will be in position to buy them, this indirectly transferring national wealth to few individuals through under-pricing.

On the other hand, there are fears that government may over-value the shares to earn more revenues.

(iv) Problem of Fund to Pay for the Shares

Problem may arise as to the possibility of the availability of fund to pay for the shares. Sales of public enterprises may, therefore, place the few rich in monopoly power. It may also be difficult to ensure equitable distribution to the various income groups, occupational groups and the share may be undersubscribed for, especially if large number of enterprises is involved.

(v) Externality

In a situation of privatisation, it may be difficult to control externalities. Externality here refers to spillovers or neighborhood effects. This also refers to the discrepancies between private and social costs or private and social benefits. The key aspect of externalities is interdependence without compensation. Here some individuals or firms benefit without paying anything or they cause others to have higher costs without compensation.

Loss of Control

The control of public enterprises is usually achieved through the appointment of the board members. Under privatisation, the control of these enterprises may be difficult as laws will have to be introduced and there will be problems and cost of enforcing compliance.

3.6 Sources of Government Revenue

Revenue refers to money which comes in from any source. It is income which comes to individuals, group, firms and government on the annual basis. This chapter will look at the sources of revenue to the government. The sources of revenue to any government must be a great concern to such a government whether it is federal, state or local government because without adequate revenue, no government can carry out its programme successfully. In the light of this, efforts should be made by the government or its agency to ensure that the expected revenue in the annual budget is realised for utilisation in the fiscal year.

The government derives its income or revenue from a number of sources. The main sources of revenue to the government, especially in Nigeria include the following:

(i) Taxation

Taxation is one of the major sources of revenue to the Federal Government of Nigeria.

(a) Direct Taxes: The direct taxes comprise personal income tax, corporate or company profit tax, capital gain tax, death or inheritance tax, and pool tax. Actually, these are taxes that are levied on specific individuals or institutions and the burden of the tax falls on the individuals or institution concerned. In the 1970s and 1980s, greater proportion of the government revenue came for direct taxes.

(b) Indirect Taxes: Government also gets its revenue from indirect taxes. The indirect taxes include import duty, export duty, excise duties, purchase or sales tax. These taxes are levied on goods and services. In other words, they are levied on the activities of individuals and institutions and the burden of the taxes can be shifted to the final consumer.

(ii) Court Fines

Part of the government revenue comes from court fines throughout the country. For the Federal Government, this comes from Federal High court, Appeal Courts as well as Supreme Court while the states get from the magistrate courts, as well as state high courts. This source contributes a little proportion of the government revenue in this country.

(iii) Fees and Licenses

Other sources of the government revenue are fees and licenses. These include vehicle license fees, liquor license fees, postage charges, etc.

(iv) Royalties from Mining Sector

The major source of revenue to the Federal Government of Nigeria at this present time is royalties from the mining sector. The declining of the agricultural sector of our economy and the importance of mineral resources in Nigerian economy have made the mining sector to be the major source of revenue to the Federal government. Mining sector contributes up to 70% of total revenue of Nigeria today.

(v) Borrowing

The government gets part of its revenue from borrowing. This involves domestic and foreign loans by the government. Loans may be taken from individuals and institutions within the country by sale of government security by the central bank. Equally, loans can be raised from foreign government and from world financial institution like the World Bank and the International Monetary Fund (IMF). Nigeria has got a number of loans from African Development Bank (ADB). It has to be borne in mind that international loan always posses a great problem to any nation because of its conditionalities.

(vi) Grants, Aids and Gifts
The government also gets its revenue from grants, aids and gifts from private and public spirited individuals and institutions within the country as well as friends and government agencies of foreign countries. However, these sources cannot be relied upon as a source of revenue as they are limited.

(vii) Profit made by Government Corporations and Commodity Boards Revenue also comes to the government from profit made by government corporation and the Commodity Board. Commodity Boards have replaced the former Marketing Boards in this country.

3.6.1 The Relative Importance of the Source of Government Revenue

In the earlier section, the major sources of government revenue were discussed.
This section look at the relative importance of each source of revenue to the government.

(i) Indirect Taxes: Taking Indirect Taxes as one of the sources of government revenue, we see that in most countries of West Africa, Indirect Taxes for a long time have been the major source of government revenue. The reason for this is not far fetched. The heavy dependence on international trade has led to the importance of indirect taxes as a source of revenue to the government, especially in the 1960s and 1970s. During this period, a lot of revenue came from import duties and export duties. As the economy of this country was not very developed then, most manufactured goods were imported from abroad. Secondly, the country depended largely on the exportation of primary products and export duties have to be imposed on the exports of these primary products.

(ii) Direct Taxes: Direct Taxes only made much impact in the revenue of the country recently. With rapid economic growth and development in the last two decades, many industries were established which provided good jobs for people thereby making the number of people in wage employment to increase significantly. Equally the number of taxable companies in the country increased tremendously as well as mining companies. It is likely that direct taxes will continue to be a major source of revenue to the government in many years to come. The relative importance of direct taxes as a source of revenue in this country in future will depend on whether this country will actually embark on greater industrialisation or not. With greater industrialisation, people's income will increase and their tax will, as well, increase. More companies will also spring up thereby increasing the revenue from corporate profit tax.

(iii) Borrowing as an important source of revenue to government may not be seen as an ideal source of revenue. Much money is sometimes borrowed from other countries and world financial institutions, but most countries try to avoid borrowing except when the conditionalities are bearable.

(iv) The importance of profit made by government corporations and commodity boards as source of revenue depends on the recent rate of privatisation exercise in this country. If more government owned companies are privatilised and passed over to private individuals, less will be left for the government and much revenue will no longer be realised from such companies. Again with much attention given to agriculture as before the era of crude oil domination, there may be hope that much revenue will accrue to the government from that source.

(v) Other sources like grants licenses and fees are not all that important because the amount of revenue derived from them are relatively small. No country can, therefore rely on these sources in order to carry out any meaningful project in the economy.

STUDENTS ASSESSMENT EXERCISE

Q1 What do you understand Economic Development and Economic growth to mean?
Q2 Why is an understanding of the meaning of development crucial to policy formulation in third World nation?

Do you think it is possible for a nation to agree on a rough definition of development and orient its strategies for achieving these objectives accordingly?

What might be some of the road blocks or constraints in realising these developmental objectives?

Q3 What is the difference between commercialisation and privatisation. Q4 Discuss the merits or advantages of privatisation
Q5 Explain the possible problems of privatisation in economy.

4.0 CONCLUSION

Every nation strives after development, it is an objective that most people take for granted while economic progress is an essential component of development. This is because development is not purely an economic phenomenon ultimately it must encompass more than the material and financial side of peoples lives. Economic development should therefore be perceived as a multi-dimensional process involving the reorganisation and reorientation of entire economic and social systems. In addition to improvements in incomes and output, it typically involves radical changes in institutional social and administrative structures as well as in popular attitudes and sometimes even customs and beliefs.

Economic development has redefined in terms of the reduction or elimination of poverty inequality and unemployment within the context of a growing economy. The three core values of development are life sustenance self-esteem and freedom representing common goals sought by all individuals and societies. They relate to fundamental human needs which find their expression in almost all societies and cultures at all times.
The major factors in or components of economic growth in any society are:

(1) Capital accumulation including all new investments in land and human resource.
(2) Growth in population, growth in the labour force.
(3) Technological progress. Professor Simon Kuznets has defined a country economic growth as a long-term rise in capacity to supply increasingly diverse economic goods to its population, this growing capacity based on advancing technology and the institutional and ideological adjustments that it demands. All three principal components of this definition are of great importance.

(a) The sustained rise in national output is a manifestation of economic growth and the ability to provide a wide range of goods is a sign of economic maturity.
(b) Advancing technology provides the basis or pre-conditions for continuous economic growth - a necessary but not sufficient condition, in order to realise the potential for growth inherent in new technology however.
(c) Institutional attitudinal and ideological adjustments must be made. Technological innovation without concomitant social innovation is like a light bulb without electricity, the potential exists but without the complementary input nothing will happen.

In his exhaustive, analysis of modern economic growth, Professor Kuznets has isolated six characteristic feature of the growth process of almost every contemporary developed nation. They included two aggregate economic variables:

(1) High rates of growth of per capital output and population.
(2) High rates of increase in total factor productivity.
  - Two structural transformation variables.
(3) High rates of structural transformation of the economy.
(4) High rates of social and ideological transformation.
  - Two factors affecting the international spread of growth.
(5) The propensity of economically developed countries to reach out to the rest of the world for markets and raw materials.
(6) The limited spread of this economic growth to only a third of the world's population.

5.0 SUMMARY

In this unit, we have successfully attempted to identify certain common characteristics and economic features of developing countries. These are classified as the factors that inhibit rapid economic development in developing countries. We can classify these common characteristics into six broad categories as -

- low levels of living.
- low levels of productivity.
- high rate of population growth and dependency burdens.
- High and rising levels of unemployment and under development.
- Significant dependence on agricultural production and primary product exports.
- Dominance / dependence in international relations.
- Economic and social forces both internal and external are responsible for the poverty inequality and low productivity that characterise most developing nations. The successful pursuit of economic and social development will, therefore, require not only the formulation of appropriate strategies within the third world but also a modification of the present international economic by system to make it more responsive to the needs of developing nations.

6.0 TUTOR-MARKED ASSIGNMENT

Q Discuss fully the factors that inhibit rapid Economic Development in Developing Countries.

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UNIT 19 DEVELOPMENT PLANNING

CONTENTS

1.0 INTRODUCTION

In the four decades since Nigerian Independence in 1960, the pursuit of economic development has been crystallised by the almost universal acceptance of development planning as the surest and most direct route to economic progress. Until recently only few would have questioned the advisability or desirability of formu- lating and implementing a national development plan. Planning has become a way of life in the government ministries of Nigeria and every five years or so the latest development plan is paraded with the greatest of fanfare.

But why, until recently, has there been such an aura and mystique about development planning and such universal faith in its obvious utility? Basically, because centralised national planning was widely believed to offer the essential and perhaps the only institutional and organisational mechanism for overcoming all obstacles to development and for ensuring a sustained high rate of economic growth. In some cases, central economic planning even became regarded as a kind of “Open Sesame” which allows Nigerians to pass rapidly through the barrier dividing their pitiably low standards of living from the prospect of their former rulers. But in order to catch up, Nigerians were persuaded and became convinced that they required a comprehensive national plan. The planning record, unforntunately has not lived up to its advance billing and sceptism is now growing about the planning mystique.

In this unit, we shall treat the economics of planning, we are not going to deal with any specific country’s plan as such but occasional reference will be made to the different

West African countries. Having grasped this approach and idea, the reader is placed in a position to make comments on any of the West African Government's Economics Plans.

2.0 OBJECTIVES

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

- define development planning;
- state the distinction between budget and development plan;
- explain the objectives, usefulness and advantages of development plan;
- identify the sources of finance for development plans;
- explain the limitations and problems of development plans;
- explain the prerequisites for successful planning in under-developed countries.

3.0 Main Content

3.1 Meaning of Development Planning

Development plan can be defined as a country's collection of strategies mapped out by the government of the country to achieve a rapid economic growth and development. It contains broad outlines of line of action which the government or its agents in the country will follow within the specified period of time to achieve the goals which the country wants to achieve.

Development or Economic planning may be described as the conscious governmental effort to influence, direct and in some cases even control changes in the principal economics variables - (Consumption, Investment, Savings, Exports, Imports, etc.) of a certain country or region over the course of time in order to achieve a predetermined set of objectives. The essence of economic planning is summed up in these notions of governmental influence, direction and control.

Similarly, we can describe a development plan as a specific set of quantitative economic targets to be reached in a given period of time.

In one of its first publications dealing with developing countries in 1951, the limited Nations department of economic affairs distinguished four types of planning, each of which has been used in one form or another by most LDCs.

- First, planning refers only to the making of a programme of public expenditure, existing over from one to say ten years.

- Second, it refers sometimes to the setting of production targets, whether for private or for public enterprises, in terms of the input of manpower of capital or of other scarce resources or use in terms ofoutput.
- Thirdly, the word may be used to describe a statement which sets targets for the economy as a whole, purporting to allocate all scarce resources among the various branches of the economy.
- And fourthly, the word is sometimes used to describe the means which the government uses to try to enforce upon private enterprise the target which have been previously determined.

There is no agreement among economists with regard to the meaning of the term development or economic planning. The term has been used loosely in economic literature. It is often confused with communism, socialism and economic development. Any type of state intervention in economic affairs has also been treated as planning. But the state can intervene even without making any plan. What then is planning? Planning is a technique, a means to an end being the realisation of certain predetermined and well-defined aims and objectives laid down by a central planning authority. The end may be to achieve economics, social, political or military objectives (L. Ribbons, 1958).

Professor Lewis (1954) has referred to six different senses in which the term planning is used in economic literature.

- Firstly, there is an enormous literature in which it refers only to the geographical zoning of factors, residential buildings, cinemas and the like. Sometimes, this is called town and country planning and sometimes just planning.
- Secondly, "planning" means only deciding what money the government will spend in future, if it has money to spend.
- Thirdly, a "planned economy" is one in which each production unit (or firm) uses only the resources of men, materials and equipment allocated to it by quota and disposes of its product exclusively to persons or firm indicated to it by central order".
- Fourthly, "planning" sometimes means any setting of production targets by the government, whether for private or public enterprise. Most governments practice this type of planning if only sporadically, and if only for one or two industries or services to which they attach special importance.
- Fifthly, here targets are set for the economy as a whole, purporting to allocate all the country's labour, foreign exchange, raw materials and other resources between the various branches of the economy.
- And finally, the word "planning" is sometimes used to describe the means which the government uses to try to enforce upon private and public enterprises the targets which have been previously determined.

But Ferdyn and Zweing maintains that "Planning" is planning of the economy not within the economy. It is not a mere planning of towns, public works or separate section of the national economy but of the economy as a whole. Thus planning does not mean piecemeal planning but overall planning of the economy.

According to Dr. Dalton, "Economic Planning" in the widest sense is the deliberate direction by persons in charge of large resources of economic activity towards chosen ends.

Lewis Lordwin defined economic planning as "a scheme of economic organisation in which individual and separate plants, enterprises, and industries are treated as co-ordinate units of one single system for the purpose of utilising available resources to achieve the maximum satisfaction of the people's needs within a given time".
In the words of Zweig, "Economic planning consists in the extension of the functions of public authorities to organisation and utilisation of economic resources. Planning implies and leads to centralisation of the national economy".

One of the most popular definitions is by Dickinson who defines planning as the making of major economic decisions what and how much is to be produced, how, and when and where it is to be produced, to whom it is to be allocated, by the conscious decision of a determinate authority, on the basis of comprehensive survey of the economic system as a whole.

Even though there is no unanimity of opinion on the subject, yet economic planning as understood by the majority of economists implies deliberate control and direction of the economy by a central authority for the purpose of achieving definite targets and objectives within a specified period of time.

STUDENTS ASSESSMENT EXERCISE (SAE)

(i) What is the nature and purpose of development planning?

3.1.1 Distinction between Budget and Development Planning

There are important differences between a budget and a development plan. A budget, as already implied in one of the previous units, is a short-time plan depicting the way and manner government intends to undertake the expenditure and generate the revenue for a given year.

A development plan on the other hand is a long term programme designed to achieve some permanent structural changes in an economy. It involves a deliberate attempt by the government to speed up the process of social and economic development.

- Firstly, while a budget is usually planned for a year, a development plan may cover a period for a year, a development plan may cover a period ranging from two to twenty-five years.
- Secondly, difference is in terms of coverage. While a budget may not cover the whole system of the economy and may in fact be designed to correct an inflationary situation, a perceived imbalance in income distribution or resolve a balance of payments disequilibrium, a development plan on the other hand covers the entire structure to the economy. It seeks to find permanent solution to the problems of the economy like changing the structural base from agriculture to industrialisation.
- Thirdly, a budget is concerned with current problems such as debt servicing meeting of pressing social needs like schools, road maintenance, or the financing of planned capital projects.

A development plan, however, may attempt to change the distribution system from a capitalist oriented one to a socialist system or vice versa. It may also attempt to shift the ownership and control of the commanding heights of the economy from foreigners to citizens.

- Finally, a budget relies heavily on internal direct and indirect taxes and the flow of revenue is relatively more stable.
- A development plan, on the other hand, at least in the context of West African Countries, depends heavily on foreign exchange earnings and heavy capital inflow from abroad for implementation and achievement of growth targets.

3.2 Objectives/Usefulness/Advantages of Development Planning

Most of the development plans formulated by West African countries have tended to establish some form of mixed economy in which the state plays a more significant role. Almost all plans are based on the recognition that if economic development is left solely to the market forces engendered by private firms seeking profits, an adequate measure of economic growth will not be attained from any stand point. The stated objectives of most of the plans can be briefly summarised.

(i) To create conditions for self-sustained economic growth and development. However, it should be real-ised that the basic objective of most plans is not merely to accelerate the rate of economic development and the rate at which the level of living of the population can be raised. It is also to give West African Governments and the masses an increasing measure of control over their own destiny.

The objective not only focus on the achievement of growth but also the sustenance of the growth to ensure steady improvement in the standard of living of the people. This can only be achieved when selfness and right thinking people are placed is authority.

(ii) To ensure a steady rate of economic growth. It is realised that much can be achieved through steady growth as compared with intermittent development. In the absence of plans which attempt to allocate resources in the best way possible, the countries cannot avoid unbalanced growth. There is use or necessity for the overall balance in the economy.

(iii) To expand and improve the productive machinery of the countries in question, diversification of the economy is necessary. It is thus realised that the level of living of the people depends very much on the productivity of the people. It, therefore, become inevitable that a substantial amount of the West African resources available should be used for increasing productivity rather than for immediate consumption, measures to mobilise domestic resources both through the government and through private business must have high priority.

It allows for diversification of economics base. A good development plan will create a proportional sectoral development because each sector is planned to develop according to a rate that fits it into the entire development of the economy.

Diversification may lead to the development of many industries which will help to reduce our import bills. Diversification will not only lead to the production of many products for domestic uses and exports but will improve the country’s foreign exchange position.

(iv) To organise a proper allocation of resources in order to achieve the objectives of the plans. It is with the recognition of this objective that greatest emphasis has been placed upon the expansion of agriculture, both for exports and for domestic use through crop diversification and modernisation of techniques, emphasis is also laid on a shift of manpower from agriculture to industry, expansion of industrial establishments, encouragement of more exports of manufactures and processed goods. If all these could be done, it is hoped that it would lead to a loosening of trade and financial links with ex-colonial masters and more economic co-operation among African States.

Good development plans will make it possible for resources both human and material to be fully harnessed and utilised for economic growth and development. Here again proper allocation of scarce resources is not only necessary for the success of the plan but also for the sustenance of the growth in the economy.

(v) To increase employment opportunities. With proper allocation of resources to those projects and to those sectors of the economy which promotes a high rate of growth, it is contended that more employment opportunities would be provided for the growing population in West African countries. The successful implementation of various objectives contained in the plan will definitely generate employment opportunity for greater number of people.

The increase in employment opportunities will only be achieved through proper allocation of resources to those sectors of the economy as well as projects that promise high rate of growth.

(vi) To increase the inflow of capital on terms suitable for sustained economic growth and to mobilise domestic resources and to effectively utilise external assistance. It is realised that external capital is a necessity in order to implement the plans.

Development planning is a tool for stimulating foreign and indigenous investment. A good development plan by setting targets for key sectors of the economy provides opportunities for interested foreign investors to bring in capital to invest in sector which are attractive to them. This is also true of indigenous investors.

Development plan is a base for seeking foreign loans. A realistic development plan when presented to foreign international financial organisation, may win tier support and encourage soft loans to implement some of the projects to be embarked upon in the plan.

(vii) To stimulate the vigorous growth of the private sector, in particular the development of manufacturing production. Since the private sectors in many West African economics are substantial and the governments generally recognise this, any plan that fails to co-ordinate the activities of this sector could not easily achieve its objectives.

(viii) It is argued that development plan allow for cohesion of the various sectors and the development of linkages for the entire economy. A project is not looked at from its viability alone as an independent project but rather in terms of how it is dependent on other projects as well as other projects depending on it. A textile industry can be set up upon the background of a planned cotton industry.

(ix) Development of Infrastructure: The social capital of the developing country need to be fully developed.

The social capitals include good network or roads, railways, waterways, telecommunications, education and hospitals to ensure good health facilities. The presence of well-developed infrastructure of the economy will enhance productivity.

(x) To achieve even distribution of income: It has been noted that in developing countries, there is always unequitable distribution of income. In Nigerian for example, about five per cent of the population is owning fifty per cent of the total wealth of the country. With the implementation of the objectives of development plan, income will be more equitably distributed.

From our foregoing discussion one can say without any fear of contradiction that the basic aim of most of the development plans of West African governments is to give a sense of direction to the economy, a sense of priorities and urgency and to enlist the support and co-operation of all sections of the community to work for a better future. It is aimed to attract popular enthusiasm which is both the lubricating oil of planning and the petrol of economic development - a dynamic force that almost makes all things possible.

The planning for development is indispensable for removing the poverty of nations. For raising national and per capita income, for reducing, inequalities in income and wealth, for increasing employment opportunities, for all round rapid development and for maintaining their newly won national independence, planning is the only path open to under-developed countries. There is no greater truth than this that the idea of planning took a practical shape in an under-developed countries of the world.

To sum up in the words of Professor Gadgil, "Planning for economic development is undertaken presumably because the pace of direction of development taking place in the absence of external intervention is not considered to be satisfactory and because it is further held that appropriate external intervention will result in increasing considerably the pace of development and directing it properly. Planners seek to bring about a nationalisation, and if possible and necessary some reduction of consumption to evolve and adopt a long-term plan of appropriate investment of capital resources with progressively improved techniques, a programme of training and education through which the competence of labour to make use of capital resources is increased, and a better distribution of the national product so as to attain social security and peace. Planning, therefore, means in a sense, no more than better organisation, consistent and far-seeing organisation and comprehensive all-sided organisation. Direction, regulations, controls on private activity and increasing the sphere of public activity, are all parts of organisational effort.

STUDENTS ASSESSMENT EXERCISE (SAE)

(i) What are usually the primary objectives of economic development plans formulated in West Africancountries?

3.3 Sources of Finance for Development Plans

Development planning calls for a feasibility study of the plan to see that the projects envisaged are economically viable and to make sure that the aggregate amount of resources required to carry out the plan does not exceed the aggregate amount of resources available. This point emphasises that deficit financing and inflation are to be avoided and this is to check at the sectoral level by making such that the projected rate of expansion in the output of commodities by a certain critical margin. Furthermore, it is necessary to check the consistency of the plan, to make sure that demand and supply for particular commodities and services are equated to each other and that there is an equilibrium relationship between the different parts of the economy.

If the plan is found to be both feasible and consistent, the next stage is how to finance it.

Finance for development plans had been obtained from various sources by West African governments. Let us look briefly at the financing methods which West African governments use in procuring necessary funds for implementing development plans.
The key sources of finance for development plan include both domestic and foreign sources:

(i) Domestic sources includes export proceeds and buoyant funds realised from the sale of export commodities like cash crops, minerals, crude oil, etc. but as from 1960s there was great dependence on external sources i.e. export earnings to finance development plans.

(ii) Other sources of domestic finance include:
   (a) Fiscal Measures: The governments have introduced various fiscal measures to provide funds for developmental purposes. They use the well-known method of budget surplus whereby there is an excess fiscal revenue over expenditure. New tax reforms are also introduced to provide funds for development e. g. Taxes, especially indirect taxes as tariffs. However, indirect taxes in particular custom duties provide a lot of funds for governments. It must be realised that the decline in export proceeds has affected receipts from export duties. In addition, the drive for substitution of imports by local production, a common feature of all development plans of West Africa tends to reduce the receipts from import duties.
   (b) Revenues from Publicly owned Enterprises: Full cost pricing for the services of public enterprises and utilities can add very much to the financial resources available for public investments. This means that the people would have to pay full cost for public services and utilities such as water, electricity, transport, etc.

In most of the development plans and especially, those of Nigeria, Ghana and Senegal there is the provision for abolishing most subsidies to public services. This will bring about substantial saving on government account.

In Nigeria for instance, the Statutory Corporations are expected to participate in the government capital programme and they are expected to make profits. The business organisations also contribute from their profits and reserves to the financing of development plans, etc., - Education Tax Fund.

(c) Internal Borrowing: Government now device various ways to encourage savings. In their plans, several governments envisaged to obtain substantial amounts to finance public investment by borrowing from the private sector.

To promote and mobilise effectively personal savings for development, governments expects to establish a variety of new financial institutions and broaden existing ones. These institutions are expected to offer the potential investor a variety of inducements to invest his savings in the public sector, either directly by purchasing government securities or indirectly by saving through such government institutions such as post office savings bank, insurance companies and pension funds. The Central Bank of each country are expected to provide investment avenue for institutional savers - banks, business firms, insurance companies, etc.

In most of the West African countries development corporations and development are created to supply funds to the private sectors for the development of agriculture and small-scale industries, the development of which are envisaged in the plans.

(d) Deficit financing sometimes includes resorting to the printing of currency notes. However, deficit financing in the accepted sense of the word can only be practised by countries that have their own Central Bank.

(e) Domestic Resources of the Private Sector - Accumulated Savings. The domestic resources required for financing investments in the private sector are to come mainly from private savings of individuals and business enterprises reinvested profits and other internal and external resources of foreign and domestic residents.

(f) Share proceeds of government owned enterprises.

Foreign Sources

Since capital formation in very low in most of West African countries, there is need for foreign savings and foreign capital. We should realise that foreign capital cannot be avoided by developing countries willing to industrialise even if the governments decided to build and operate all the plant and equipment themselves. The machinery must come from abroad and even the workers who build the factories and who construct the necessary infrastructure. Foreign exchange is needed to pay for essential imports for the investment programme, and the demand for foreign capital rises sharply with increasing investments such as projected in most of the development plans. West African countries rely heavily on foreign capital to finance their development plans. Most of this foreign capital comes in different ways.

(a) External Borrowing

(i) Long-term Credits: These consist of loans and grants from developed countries for long duration.

It may be loan for ten or more years. Both the principal and the interest have to be repaid.
Countries such as USA, United Kingdom, West Germany, etc., and other International Organisations such as the World Bank - IMF, IFC, IDA, BRD, etc., do give such long-term loans.

(ii) Short-term Credits: Most of West African countries make use of this method of financing. These credits include contractor finance and export credits.

(b) Foreign Aid and Grants from Foreign Government and Organisation: These are in form of gifts, technical assistance, and official donation to developing countries in order to accelerate their economic development.

STUDENTS ASSESSMENT EXERCISE (SAE)

(i) Analyse critically main sources of finance for National Development plans in West Africa.
(ii) How might the differing kinds of financial institutions created affect the implementation of the Economic development plans in Nigeria?

3.4 Limitations/Problems of Implementation of Development Plans

Most of the development plans in developing countries were not fully implemented because of some problems facing the plans. Nigeria in particular and West Africa in general cannot be exceptions. Some of these problems include:

(i) Political Instability

Most of the governments in developing countries, especially in Africa and South America are not stable. Governments in those countries are changed just as people change their dresses. As a result of this constant change, some of the projects in the plans are dropped and new ones chosen by the new government. Lack of stability in the government leads to abandonment of already started projects and picking up others and this causes a wastes of scarce resources.

(ii) Priorities are not well chosen
Some of the projects are chosen on a political grounds and not on economic grounds. As a result of this, some projects are not profitable and money spent on them are wasted. This occurs more in countries with heterogeneous population where condiments overrides right judgment. Tribalism is one of the banes in this country and has just delayed development of the country.

(iii) Shortage of Highly Skilled Manpower
In most of the developing countries of the world there are not enough technicians to carry out some of the projects drawn on the plans. However, some of the countries presently are no longer lacking technician in any way. In the case of Nigeria, with the introduction and expansion of secondary schools and the establishment of many institutions of higher learning, priority is given to the development of human resources. So skilled manpower is no longer a problem in Nigeria rather the problem is now that of unemployment.

(iv) Dependence on Foreign Capital
In most of the development plans drawn, especially in very poor countries, greater proportion of the capital for the implementation of the development plan is expected to come from foreign countries. In some cases, the capital may not be received and the plan becomes a great failure. Government should, therefore, not rely completely on foreign capital as the failure to get that paralyse the project.

(v) Lack of Statistical
For a good development plan to be successfully implemented, it has to spend on accurate statistical data. In developing countries, where development plans are usually drawn, statistical data are not available and where they are eventually available, they may not be reliable. So it is not wrong to say that developing countries lack reliable statistics on which plans can be based.

(vi) Lack of Provision for Effective Implementation
In most plans, there is no provision for effective implementation of some of the projects in the plan. There is always need to include in the plan the strategies for implementation. For example, a project may have the monitoring team and the project may be divided into stages and expected date or the completion of each stage clearly stated. This will ensure that the work will be carried out without unnecessary delay.

Finally, the achievement of development plan objectives requires the efforts and support of all the elements in the economy without any exception. It is only through this way that the objectives of a development plan can be realised.

Nigeria's Third National Development Plan, 1975 -1980
It is necessary to discuss one of the national development plans and the one that will require our attention is the third one. Nigeria's third National Development plan which lasted from 1975-1980 was estimated to cost N445 billion. The long-term objectives of

this plan are not different from the previous ones. The objectives aimed at achieving these:

(i) A united, strong and self-reliant nation
(ii) A great and dynamic economy
(iii) A just and egalitarian society
(iv) A land of bright and full opportunities for all the citizens, and
(v) A free and democratic society.

In this third development plan, the economy was divided into four (4) broad sectors.

(i) Economic sector which includes all types of agriculture, mining, manufacturing commerce, transport and communication.
(ii) The social overhead sector which comprises development and sports.
(iii) Regional development sector which comprises town and country planning.
(iv) Administration comprising defence, general administration, manpower development and utilisation and plan implementation and control. Of the 45 billion estimate, the private sector accounted for 10 billion while the public sector provided the rest. It has to be noted that the third National Development plan was a break-through to modernity. It was infact a real and historic turning point in the history of the economy. The period also represented a glorious era in the history of Nigeria as great changes in the economy were witnessed.

STUDENTS ASSESSMENT EXERCISE (SAE)

Q1 Explain the role of fiscal policy in developing country.
Q2 Discuss the role of government spending in contractionary fiscal policy.
Q3 What is public finance? How does it differ from private financing.
Q4 List and discuss the instruments of fiscal policy showing how they are applied.
Q5 Discuss the tools of monetary policy in the country.
Q6 What are the similarities and differences between fiscal policy and monetary policy?
Q7 Why is public expenditure continuously increasing in most of the developing countries?
Q8 What are the actual difference between national debt and public debt?
Q9 Discuss any of Nigeria's National Development plan.

3.5 Pre-requisites for Successful Planning in Under-Developed Countries

There are certain conditions or pre-requisites which must be fulfilled for the successful working of a development plan in under-developed countries. They are as follows:

(1) Planning Commission
The first pre-requisite for the success of a plan is the setting up of a planning commission.

(2) Statistical Data
A pre-requisite for sound planning is a thorough survey of the existing and potential resources of a country with its deficiencies.

(3) Fixation of Targets and Priorities
The next problem is to fix targets and priorities for achieving the objectives laid down in the plan. Targets must be bold and cover every aspects of the economy. They include quantitative production of targets.

(4) Maintaining Proper Balance
Successful working of the plan requires the existence of proper balances in the economy to avoid lopsided development and bottlenecks.

(5) Incorrupt and Efficient Administration
A strong, efficient and incorrupt administration is the sine que non of successful planning.

(6) Proper Development Policy
The state should lay down a proper development policy for the success of a development plan and to avoid any pitfalls that may arise in the development process.

(7) Economy in Administration
Every effort should be made to effect economics in administration particularly in the expansion of ministries and some departments.

(8) An Education Base
For a clean and efficient administration, a firm educational base is essential. For planning to be successful, it must take care of the ethical and moral standards of the people.

(9) A Theory of Consumption
An important requirement of modern development planning is that it has a theory of consumption.
Under-developed countries should not follow the consumption pattern of the more developed countries.

(10) Public Corporation

Above all, public corporation is considered to be one of the important levers for the success of the plan in a democratic country. Planning requires the sustained co-operation of the people.

4.0 CONCLUSION

Development plan usually involves both private and public sectors of the economy. Any development plan is supposed to specify or show the investment policy of the country. This means that the volume should be made clear.

In any development plan, efforts are usually made to specify the key sectors in the country's economy which need priority attention so as to make the achievement of the objectives of the plan possible. In some countries, emphasis is laid on speedy industrilisation as a priority for rapid economic growth and development while in others people feel that rapid economic growth and development can be achieved through the development of agriculture. We cannot say that rapid economic growth and development can be better achieved through industrilisation or through the development of agriculture.

5.0 SUMMARY

In this unit, we have discovered that usually the strategies for economic growth and development are embedded in a development plan. Therefore, in order to achieve rapid economic growth and development the developing countries usually draw up development plans.

In this unit, we examined the goals, objectives, financing, problems and limitations of development planning as practiced in Third World nations, both in its own right and in the broader framework of national economic policy.

6.0 TUTOR-MARKED ASSIGNMENTS

(a) What is Development Plan?
(b) What are the objectives of Development Plans in most countries?
(c) What are the problems facing the implementation of National Development plan in most countries?

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UNIT 20: UNEMPLOYMENT

CONTENTS

1.0 INTRODUCTION

As we noted in the previous units, the control of unemployment is a key target of macro-economic policy. Indeed, following the widespread mass unemployment of the inter-war period, the control of unemployment was at the top of the political agenda in the hey-day of most governments all over the world in the post-war period. As this time and up until the mid-1970s, 1990s, economists and politicians spoke glibly about full employment as an objective of macro-economic policy.

In the 1980s, worldwide unemployment rose to levels that were unprecedented since the end of the Second World War. Not only was the overall level of unemployment wastefully large, the structure of unemployment was highly varied. Currently, the most serious problem of localised unemployment is the very high rates among the many unskilled residents of the decaying inner cores of large industrial cities. The effects of high long-term unemployment are still serious. Disillusioned workers give up trying to succeed within the system and sow the seeds of social unrest. The existence of two-worlds the affluent employed and the unemployed - strains the social fabric, and offends many people's sense of social justice.

Unemployment is a hazard of an industrialised economic system. Primitive communities were usually self-sufficient and had no unemployment problems, though they had to accept a very low standard of living. The people shared the work that had to be done, and if any time remained afterwards they enjoyed their leisure.

Industrialisation, with division of labour and specialisation brought about a higher standard of living than communities had ever previously enjoyed, but it also brought with it the risk of unemployment. In fact, some unemployment can be attributed directly to industrial progress. That is why, perhaps rather belatedly; it was the leading industrial nations that were the first to introduce schemes of social security.

There are a number of different causes of unemployment. Clearly, before plans can be formulated for maintaining full employment, it is necessary to distinguish between these different causes, for only after an accurate diagnosis has been made can the appropriate remedy be applied.

2.0 OBJECTIVES

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

- Define unemployment and identify its effects.
- Explain why some individuals in the population choose to be economically inactive;
- distinguish between various types of unemployment - Frictional, Structural, demand deficient and classical;
- explain the Keynessian view of unemployment
- examine the policies that can reduce unemployment;
- established the trade off between inflation and unemployment.

3.0 MAIN CONTENT

3.1 Problems of Definitions

The causes of these phenemena are of course, the subject of considerable disagreement among economists. First of all, there are problems of definition which are by no means trivial.

To begin with, unemployment cannot be equated with ‘not working’ since in our society there are many people who are not working - such as babies and young people, the elderly, house wives and so on. These individuals should not be regarded as unemployed. Economists use the term economically inactive to refer to those people who are neither in employment nor actively seeking work.

The economically inactive will comprise

- those below employment age (babies, and school-age children);
- those above employment age (65years old for men and 60 for women);

- those who for some other reason are unfit or unable to work (e.g chronically sick and disabled people);
- those in prisons
- those in full time further education or on government training scheme;
- those who for reasons other than those above choose not to enter the labour market (e.g. the very wealthy or mothers who stay at home to look after children).

In contrast, the economically active part of the population consists of both those who are in employment plus those who indicate their willingness to work by registering as unemployed. The activity rate also known as the participation rate refers to that proportion of the population of working age who are economically active. This can be expressed as

Activity Rate = Total Employed plus registered unemployed
Total population of working age

STUDENTS ASSESSMENT EXERCISE

(i) What is meant by the activity rate (or participation rate)?
(ii) Are you economically active or inactive?

3.2 Causes / Types of Unemployment

In analysing the causes of trend in unemployment, it is helpful initially to distinguish different types of unemployment. This classification of unemployment into different types is also of course, in part an explanation of why unemployment occurs.

The unemployed can be classified in various ways: by age, sex, occupation, degree of skill and even by ethnic groups. We may classify by location, e.g. unemployment in the South East, North West, South West, etc. We may also classify by the duration of unemployment between, say, those who are out of jobs for long periods of time and those who suffer relatively short-term bouts of unemployment. Finally, we may classify the unemployment by the reasons for their unemployment.

In the present unit, we concentrate on the reasons for unemployment. Different economists find it convenient to identify different causes, in what follows we take one common scheme for classifying unemployment by types:

- Financial Unemployment
- Structural Unemployment
- Real wage or classical Unemployment

- Demand - deficient Unemployment
- Seasonal Unemployment
- Regional Unemployment
- Technological Unemployment
- General Unemployment

Frictional Unemployment

Overtime the pattern of consumer demand in the economy will change, both as a result of changes in incomes and tastes and in response to a changing set of relative prices. The change in the pattern of demand will in turn lead to a change in the amounts and the types of goods and services produced. This will then lead to a change in the type of labour required. Moreover, technical improvements will bring about changes in the way in which goods and services are produced, and this will alter the demand for the various types of labour. In short, all of these changes will lead to a change in the pattern of the demand for labour.

Frictional unemployment results from this change in the pattern of demand for labour as some workers will not find that their skills are no longer required. These workers will become unemployed for a period until they eventually become re-employed either in a similar or in a different occupation. The use of the term "Frictional" to describe such unemployed suggests that is results from frictions in the Labour Market. If there were perfect information - so that workers knew that jobs were on offer and employers knew what labour was available - and if labour were perfectly able and willing to move, there would be little or no unemployed of this type, since the unemployed workers would be immediately redeployed in a new occupation.

Unemployment that is associated with the normal turnover of Labour is called Frictional unemployment.

People leave jobs for many reasons, and they take time to find new jobs, young persons enter the labour force but new workers do not often fill the jobs vacated by those who leave. This movement takes time and gives rise to a pool of persons who are "Frictionally unemployed." They are moving between jobs. Frictional unemployed would occur even if the occupational, industrial and regional structure of employment were unchanging. '

Frictional unemployment is therefore defined as the irreducible minimum amount of unemployment caused by the Labour turnover when new people enter the labour force and look for jobs and existing workers change jobs.

Structural Unemployment

In contrast to frictional unemployment, which in theory at least is of short duration, structural unemployment is of a longer-term nature. However, it too results from the dynamic nature of an economy in which the changing pattern of consumer demand and changes in the way in which goods are produced lead to a decline in the demand for certain types of labour. For example, in the U.K. from the 1960s onwards there was a decline in the demand for certain types of labour. For example, in the U.K. from the 1960s onwards there was a decline in the demand for British built ships and hence a decline in the demand for ship-builders. Equally noticeable in the last decade has been the decline in the demand for coal miners brought about, first by labour saving technical progress, which has enabled coal to be minded using more capital-intensive and hence labour-saving techniques, but more importantly by the decline in the demand for U.K. produced coal, as power stations have opted to buy cheaper imported coal or switch to gas.

By its very nature, structural unemployment tends to be concentrated in certain geographical areas. For example, ship-building was concentrated in the north east of England, so this area was severely affected by the decline in ship-building. This led to a further decline in the region because of regional multiplier effect. Thus structural unemployment and regional unemployment tend to go hand in hand.

Structural changes in the economy can cause unemployment. As economic growth proceeds, the patterns of demands and supplies change constantly. Some industries, occupations and regions suffer a decline in the demand for what they produce while other industries, occupations and regions enjoy an increase in demand. These changes require considerable economic readjustment. Structural unemployment occurs when the adjustments are not fast enough. Severe pockets of unemployment then arises in areas, industries and occupations in which the demand for labour is falling faster than its supply. Structural unemployment is defined as the unemployment that exists because of a mismatching between the unemployed and the available jobs in term of any relevant dimension such as regional location or required skills. Structural unemployment occurs because changes in the regional, occupational and the industrial structure of the demand for labour do not match the changes in the structure of the supply of labour. Structural unemployment can increase because either the pace of economic change accelerates or the pace of adjustment to change slows down. National forces and social policies that discourage movement among regions, industries and/or occupations can raise structural unemployment. Policies that prevent firms from replacing laour with new machines may protect employment in the short-term. If, however, such policies lead to the decline of an industry because it cannot compete with more innovative foreign competitors, they can end up causing severe pockets of structural unemployment.

Demand - Deficient Unemployment

We expect the demand for labour and therefore, the level of unemployment to be correlated with the business cycle. When the economy is in a recession, the demand for goods and services falls. Consequently, there will also be a fall in the demand for the labour that produces those goods and services. Hence unemployment will rise. Because the level of such unemployment will vary with the business cycle, it is termed cyclical unemployment. It is also sometimes referred to as demand-deficient or Keynesian unemployment.

One of Keyne's great contributions was to argue that demand-deficient unemployment could be removed by bringing about the increase in the level of aggregate demand. For example, the government could bring about a budget deficit thereby injecting spending power into the economy and raising the overall level of demand. This increase in the demand for goods and services would bring about an increase in demand for labour and hence unemployment would fall.

The term demand-deficient unemployment or cyclical unemployment refers to unemployment that occurs because aggregate desired expenditure is insufficient to purchase all of the output of a fully-employed labour force. It is the main subject of the national income theory. This theory seeks to explain the unemployment that is caused by variations in the total demand for the nation's output.

The feature of a trade depression is a general deficiency of demand. Consumers' wants may be as great and extensive as ever but people do not have the means to satisfy them. The result is that nearly all industries are affected at one and the same time - though not all to the same extent - and there is wide spread mass unemployment. Unemployment arising from a general deficiency of demand is known as cyclical unemployment on account of its association with the nineteenth century trade cycle.

Classical Unemployment - Real Wage Unemployment

In the previous units, we described the foreign exchange market as an example of a perfectly competitive market. In such a market, we argued, price would be determined by relatively scarcity and the market would be in equilibrium when demand equalled supply. Some economists believe that this same analysis can be applied to the workings of the labour market.

This view is variously known as the classical view, the neo-classical view and (sometimes) the monetarist view. It stands in contrast to a Keynesian analysis which suggests that, as a matter of observable fact, the market for labour does not function in the same way as the textbook model of a perfectly competitive market.

The demand curve for labour will be downward sloping indicating that the higher the wage, the less labour will be demanded, and the lower the wage, the more labour will be demanded. This is explained by the fact that labour is a factor of production, which is combined with other factors of production to make goods and services. The higher the price of labour, the more incentive to economise on its use and to substitute other factors such as capital.

A real wage that is held above its free market level causes unemployment in that market. Setting wages above their equilibrium levels in some markets can cause unemployment in those markets.

Seasonal Unemployment

Seasonal factors may cause unemployment in some industries. Many building workers are temporarily unemployed in January and February when weather prevents outside working. The tourist industry employs most of its labour during the summer holidays and, for a much shorter period, at Christmas. Much of the labour force is not required for the rest of the year and may be regarded as seasonally unemployed.

In some occupation such as planting agriculture and building, there is a demand for labour only at certain periods of the year. For instance, fruit gathering and building construction demand labour at certain periods of the year. In Sweden, for instance, building constructions are usually stopped in winter, and hence some workers become unemployed. In West Africa those who work on harvesting crops often become unemployed after the harvesting period.

In some outdoor occupations, such as building and road making, bad weather often causes a suspension of work, so that temporary unemployment occurs. The weather, too, may prevent a fishing fleet putting out to sea. In some occupations, there is a demand only at certain periods of the year - hop-picking, potato-lifting, fruit-gathering, entertaining at holiday resorts, etc.

Technological Unemployment

Whereas structural unemployment results from a change in the pattern of demand, technological unemployment is a result of a change in the methods of production. In the dock industry, the introductions of containers have enabled a given volume of cargo to be handled by a much smaller work force. Dockers who leave the industry in consequence may be considered to be unemployed because of changes in Technology. One of the dilemmas of economic efficiency, which normally involves substituting capital for labour, actually generated technological unemployment.

The introduction of office machinery - typewriters, computers, book-keeping machines, etc., has resulted in the employment of fewer clerks. This kind of unemployment may result from the invention of a new machine or an innovation which may reduce the demand for labour concerned.

Residual Unemployment

This includes all those people who, on account of physical or mental disability are of so low a standard of efficiency that few, if any, occupations are open to them. Payment of standard rates of wages, too makes it more difficult for people so handicapped to find work.

Regional Unemployment

This type of unemployment occurs when the basic industries of an area go into decline without being replaced by others. One way of reducing regional unemployment is to increase the geographical mobility of labour so that the work force migrates towards areas of high economic activity, but as we have seen, the general policy is to move industry and jobs to the regions of high unemployment.

STUDENTS ASSESSMENT EXERCISE

Analyse the various types of unemployment.

3.3 Unemployment and Inflation - Is there a Trade-off?

Newspaper editorials and public discussions about economic policy often refer to the "trade-off" between inflation and unemployment. The idea is that to reduce inflation, the economy must tolerate high unemployment or alternatively that to reduce unemployment, more inflation must be accepted.

Unemployment, and inflation - sometimes referred to as the "twin evils" of macro-economic are among the most difficult and politically sensitive economic issues that policy-makers face. High rates of unemployment and inflation generate intense public concern because their effects are direct and visible: almost everyone is affected by rising prices.

Moreover, there is a long standing idea in macro-economic that unemployment and inflation are related. This was discussed in detail under the concept of the Phillips curve - that there is an empirical relationship between inflation and unemployment. The Phillips curve suggested that it was possible to reduce inflation, but only at the cost of higher unemployment. According to the Phillips curve, inflation tends to be low when unemployment is high and high when unemployment is low.

The origin of the idea of a trade-off between inflation and unemployment was a 1958 article by Economist

A. W. Phillips. Phillips examined 97 years of British data on unemployment and nominal wage growth data; he found that historically, unemployment tended to be low in years when nominal wages grew rapidly and high in years when nominal wages grew slowly. Economists who built on Phillips work shifted its focus slightly by looking at the link between unemployment and inflation that is, the growth rate of prices - rather than the link between unemployment and the growth rate of wages. During the late 1950's and the 1960's many statistical studies examined inflation and unemployment data for numerous countries and time periods, in many cases finding a negative relationship between the two variables. This negative empirical relationship between unemployment and inflation is known as the Phillips curve.

In the following decades, however, this relationship between inflation and unemployment failed to hold. i.e. the 1970s, 1980s, 1990s. During those years, unlike the 1960's, there seemed to be no reliable relationship between unemployment and inflation, and this applied equally to other European countries. From the perspective of the Phillips curve the most puzzling periods were the mid-1970s and early 1980s during which many countries experienced high inflation and high unemployment simultaneously. High unemployment together with high inflation is inconsistent with the Phillips curve.

3.4 The Effects/Problems of Unemployment

There are two principal costs of unemployment. The first if the loss of output that occurs because fewer people are productively employed. This cost is borne disproportionately by unemployed workers themselves, in terms of the income they lose because they are out of work. However, because the unemployed may stop paying taxes and instead receive unemployment benefits or other government payments, society (in this case, tax payer) also bears some of the output cost of unemployment.

The other substantial cost of unemployment is the personal or psychological cost faced by unemployed workers and their families. This cost is, especially important for workers suffering long spells of unemployment and for the chronically unemployed. Workers without steady employment for long periods lose job skills and self-esteem and suffer from stress.

3.5 Policies to Reduce Unemployment

Many people would argue that, for both economic and social reasons, economic policies should be used to try to lower the natural unemployment rate. Although no certain method for reducing the natural rate exists, several strategies have been suggested .

(i) Government support for job training and worker relocation.

Thus a case can be made for policy measures such as tax breaks or subsidies for training or relocating unemployed workers. If these measures had their desired effect, the mismatch between workers and jobs would be eliminated more quickly and natural unemployment rate would fall.

(ii) Increased Labour Market Flexibility

Currently, government regulations mandate minimum wages, working conditions, workers' fringe benefits, conditions for firing a worker, and many other terms of employment. Such regulations may be well intentional but they also increase the cost of hiring additional workers, particularly workers with limited skills and experience. New and existing labour market regulations should be carefully reviewed to ensure that their benefits outweigh the costs they impose in higher unemployment.

(iii) Unemployment Insurance Reform

Although unemployment benefits provide essential support for the unemployment, they may also increase the natural unemployment rate by increasing time that the unemployed spend looking for work and by increasing the incentives for firms to lay-off workers during slack times. Reforms to benefit systems that preserve the function of supporting the unemployed but reduce incentives for increased unemployment are needed. For example, taxes on employers might be changed to force employers that use temporary layoffs extensively to bear a greater portion of the unemployment benefits that their workers receive.

(iv) Monetary and Fiscal Policy

These are used aggressively to keep unemployment as low as possible, the natural rate of employment will eventually fall.

So, for example, if current employment is stimulated by monetary expansion, workers may be able to acquire more on-the-job training which reduces mismatch and lowers the natural unemployment rate in the long-run.

(v) Labour Turnover Causes Frictional Unemployment

In so far as frictional unemployment is caused by ignorance, increasing the knowledge of labour market opportunities can help.

(vi) Frictional unemployment

This is inevitable part of the learning process. Policy changes that make it easier for youths to find jobs from which they can learn and hence raise their productivity could help. Youth training, and schemes aimed at subsidising the wage rate for young workers have also helped.

STUDENTS ASSESSMENT EXERCISE

(i) What is the Phillips Curve? Does the Phillips Curve relationship hold for modern data in a modern economy?
(ii) Why is unemployment an important economic variable? What policies, if any, might be used to reduce unemployment?

4.0 CONCLUSION

Unemployment is inability to obtain work although work is actively sought. It excludes those who are seeking work even if they have refused work at some derisory wage. It has been an aim of governments to intervene in the economy with fiscal and monetary policies to ensure a low level of unemployment.

Unemployment may be broken down into smaller components of which some of the most important are Frictional unemployment, Structural unemployment, disguised unemployment, seasonal unemployment.

The costs of unemployment include output lost when fewer people are working and the personal or psychological costs for unemployed workers and their families. Policies to reduce the unemployment rate include government support for job training and worker relocation, policies to increase labour market flexibility and unemployment benefit reform.

Following the famous 1958 article by A. W. Phillips, empirical studies often showed that inflation is high when unemployment is low and low when unemployment is high. This negative empirical relationship between inflation and unemployment is called the Phillips curve. Inflation and unemployment in European economics conformed to the Phillips curve during the 1960s but not during the 1970s and 1980s. Economic theory suggests that in general, the negative relationship between inflation and unemployment should not be stable.

5.0 SUMMARY

In this unit, we have succeeded in establishing that all people who could work choose to do so. Some such as married women may be economically inactive in the sense that they have no paid employment.

Various explanations for the existence of unemployment can be offered. These are sometimes described as different ‘types’ of unemployment. They consist of frictional unemployment, structural unemployment, demand-deficient unemployment and classical unemployment, frictional and structural unemployment result from a mismatch between the type of labour being offered and that being demanded. Demand-deficient employment is correlated with the business cycle, rising in recessions and falling in booms. The classical explanation for the existence of unemployment is based on an analysis which views labour as a commodity to be bought and sold in the market. In this analysis, unemployment can only be understood as a disequilibrium situation brought about because the price of labour (the real wage) is too high to allow the market to clear.

Finally, unemployment is the number of people who are available for work and are actively seeking work but cannot find jobs.

6.0 TUTOR-MARKED ASSIGNMENT

Examine the various types of unemployment and the remedies for them.

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UNIT 21 MANAGEMENT OF FOREIGN OPERATION AND INTERNATIONAL TRADE

CONTENTS

INTRODUCTION

Many companies that have significant foreign operations derive a high percentage of their sales overseas. Financial manager of the company regime an understanding of the complexities of international finance to make sound financial and investment decisions. International operations in the finance aspect or perspective involves consideration of managing working capital, financing the business, control of foreign exchange and political risks, foreign direct investments. Most importantly, the financial manager has to consider the value of the US dollar relative to the value of the currency of the foreign country in which business activities are being conducted. Currency exchange rates may materially affect receivables and payables, and imports and exports of the US Company in its multinational operations. The effect is more pronounced with increasing activities abroad.

2.0 OBJECTIVES

Upon successful completion of this unit, you should be able to do the following:

- examine the major types of foreign operation we have.
- discuss joint ventures as a type of foreign operation.
- identify the major issues of nations/organizations with foreign operations.
- explain currency risk management in international operations management.
- identify the financial strategies concept in foreign operations management.
- dilate copiously types of foreign exchange exposure (risk).

3.0 MAIN CONTENT

3.1 Management of Foreign Operation and International Trade

The efficient and cost effective production and delivery of goods and services to customers is essential for business to flourish. Achieving this in the global marketplace poses unique and exciting challenges, and international companies require skilled operations managers to deliver these goal.

3.2 Types of Foreign Operations

Companies, nations involved in foreign operations business may structure their activities in the following three ways:
A large, well established company with much international experience may eventually have wholly owned subsidiaries.

3.2.1 Wholly Owned Subsidiaries

A wholly owned subsidiary is a subsidiary company whose parent company owns 100% of the company's outstanding common stock.

In a wholly owned subsidiary, the parent company owns all of the shares of the company and there are no minority shareholders. The subsidiary continues to operate with the permission of the parent company. The parent company may or may not have direct input into the subsidiary operations and management.

A company may continue the operations of a wholly owned subsidiary rather than merge and integrate their operations for a variety of reasons. For example, the subsidiary may be located in a country different from that of the parent company. Having a subsidiary may be important for a variety of tax and tariff reasons. Another reason may be to preserve the brand and identity in of the wholly owned subsidiary.

Wholly owned subsidiaries enable holding companies (i.e. the parent company) to maintain operations in diverse geographic areas, market areas, and even entirely separate industries, creating an important hedge against changes in the market, geopolitical and trade practice changes, and declines in industry sectors.

3.2.2 Imports/Exports Activities

A small company with limited foreign experience operating in "risky" areas' may be restricted to export and import activity. If the company's sales force has minimal experience in export sales, it is advisable to use foreign brokers when specialized knowledge of foreign markets is needed. When sufficient volume exists, the company may establish a foreign branch sales office, including sales people and technical service staff.

3.2.3 Joint Ventures

A joint venture with a foreign company is another way to proceed international and share the risk. Some foreign governments require this to be the path to follow to operate in their countries. The foreign company may have local goodwill to assume success. A drawback is less control over activities and a conflict of interests.

3.3 Issues of Nations/organisations with foreign operation.

Nations involved in foreign operations are to take cognizance of the three key issues below:

- Multiple –currency problem: Sales revenues may be collected in one currency, assets denominated in another and profits measured in a third.
- Various legal institutional and economic constraints. There are variations in such thing as tax, labour practices, balance of payment policies and government controls with respect to the types and sizes of investment, types and amount of capital raised, and repatriation of profits.
- Internal control problem: When the parent office of a foreign operation company and its affiliates are widely located, international organizational difficulties arise.

3.4 The Concept of Currency Risk Management

Foreign exchange rate exists when a contract is written in terms of the foreign currency or denominated in the foreign currency. The exchange rate fluctuations increase the riskiness of the investment incurs cash losses. The financial manager must not only seek the highest return on temporary investments but must also be concerned about changing values of the currencies invested. You at this point do not necessarily eliminate foreign exchange risk.

3.5 Financial Strategies

In countries where currency values are likely to drop financial managers of the subsidiaries should.

- Avoid paying advances on purchase orders unless the sellers pays interest on the advances sufficient to cover the loss of purchasing power.
- Not have excess idle cash. Excess cash can be used to buy inventory or other real assets.
- Buy materials and supplies on credit in the country in which the foreign subsidiary is operating, extending the final payment date as long as possible.
- Avoid giving excessive trade credit. If accounts receivable balances are outstanding for an extended time period, interest should be changed to absorb the loss in purchasing power.
- Borrow local currency funds when the interest rate charged does not exceed US rate after taking into account expected devaluation in the foreign country.

3.6 Types Of Foreign Exchange Exposure (Risk)

Nations and companies with foreign operations are faced with the dilemma of three different types of foreign exchange risk. They are:

3.6.1 Translation exposure

It is often called accounting exposure, measures the impact of an exchange rate change on the firms financial statements.

An example would be the impact of an Euro devaluation on a US firms reported income statement and balance sheet. A major purpose of translation is to provide data of expected impacts of rate changes on cash flow and equity. In the translation of the foreign subsidiaries financial statement into the US parents' financial statements, the following steps are involved:

- The foreign financial statements are put into US generally accepted accounting principles.

- The foreign currency is translated into US dollars. Balance sheet accounts are translated using the current exchange rate at the balance sheet date. If a current exchange rate is not available at the balance sheet date, use the first exchange rate available after that date. Income statement accounts are translated using the weighted average exchange rate for the period.
- Translation gains and losses are only included in net income when there is a sale or liquidation of the entire investment in a foreign entity.

3.6.2 Transaction Exposure

This measures potential gains or losses on the future settlement of outstanding obligations that are denominated in a foreign currency. An example would be a US dollar loss after the Euro devaluates, on payments received for an export invoiced in franc before that devaluation. Foreign currency transactions may result in receivables or payables fixed in terms of the amount of foreign currency to be received or paid. Transaction gains and losses are reported in the income statement. Foreign currency transactions are those transactions whose terms are denominated in a currency other than the entities functional currency.

3.6.3 Operating Exposure

It is often called economic exposure. It is the potential for the change in the present value of future cash flows due to an unexpected change in the exchange rate. Operating or economic exposure is the possibility that an unexpected change in exchange rates will cause a change in the future cash flows of a firm and its market value. It differs from translation and transaction exposures in that it is subjective and does not easily quantified. Note the best strategy to control operation exposure is to diversify operations and financing internationally.

3.7 Foreign Exchange System Management

3.7.1 The Gold Standard

The gold standard is an international monetary system in which currencies were defined in terms of gold, balance of payment deficits were settled in gold and money suppliers were tied to gold.

The major countries of the world operated on gold standard between 1870s and 1914 and briefly again between the two world wars. Since gold has been considered money in most of the world for all the recorded history, trading nations agreed to exchange their currencies for gold at a fixed rate, that way, it provided a way of setting accounts between countries with different national currencies. Economic history has it that under the gold standard, the dollar price of an ounce of gold was $20.67, while the price of gold in British pounds was £4.25 and because every national currency was defined in terms of gold, that automatically determined the exchange rate as in the ease of the US and Britain the British pounds was worth.

$4.86 i.e. $\frac{\$20.67}{£4.25}$

This means that the monetary authorities of the two countries were willing to exchange a unit of pounds sterling for $4.86 at a fixed rate. Also, that the monetary authorities had to be willing to buy gold from anyone or sell gold to anyone at official prices. Gold standard main attractions were that it provide fixed exchange rates.

However, the slow growth of monetary gold supplied in the twentieth century and restrictions on monetary policy were problems that could not be handled within the rigid rules of the gold standard.

- Disciplines of the Gold standard are as follows:
- All currencies must maintain fixed parity with gold. Once the exchange rate is determined, it can't altered in either word.
- All currencies area freely convertible into gold both within and cross boarder.
- There was no trade restriction.
- There was no restriction in international movement.
- In all countries, the exchange rate equation = MV=PT.

3.7.2 The Bretton Woods's system and fixed exchange rates.

Fixed exchange rate is the second element of the Bretton Wood system after the dollar exchange standard. Under the dollar exchange standard dollar was assigned the role of key currency and then tied to gold at a fixed rate of $35 per ounce of gold. The other currencies were in turn tied to the dollar at a fixed rate. Because the United States agreed to exchange dollar for gold other currencies were tied to gold via what was known as the exchange standard.

The second element of the Bretton Woods was the agreement that nation would attempt to maintain fixed exchange rate by using their reserves of international currencies to finance temporary international deficits.

But in case of fundamental is equilibrium nations were allowed to adjust their exchange rate up to 10 percent. We define fundamental disequilibria as a long term continuous trade deficit that cannot be reversed by domestic Economic Policies. The policy of fixed exchange rate resulted however the balance of payment disequilibrium during the Bretton era.

This is because countries that were enjoying balance of payment surpluses and who were supposed to revalue their currency were unwilling to do so perhaps because it would make export dearer and import cheaper which may lead to recession at home. But here is general bias for devaluation particularly those having overvalued currency and balance of payment problems. So as to make their export cheaper and their import dearer. In summary, some national currencies were undervalued while some were overvalued resulting in trade surplus and trade deficit respectively.

3.8 Advantages of Fixed Exchange Rate

- It provided for stability in the value of foreign assets.
- The system makes planning international accounting and balance of payment accounting to be relatively easy.
- When combined with other disciplines of the gold standard, it provided automatic mechanism for balance of payment.
- Doesn’t encourage speculation.

3.9 Disadvantages of fixed exchange rate.

It is too rigid and ignores the fact that simply manipulating the exchange rate can solve the balance of payment problems.
It cannot be adjusted as a strategy to encourage export and discourage import.
The principle is based on the presumption that certain basic parameters in the economy like price, wages etc are flexible.

SELF ASSESSMENT EXERCISE

State any two steps you know about translation exposure

4.0 CONCLUSION

This unit has introduced you to the various types of foreign operations that we have, the issues of nations and organizations in foreign operating management. You have also learnt about the concept of currency risk management.

5.0 SUMMARY

The foreign exchange market (forex, or currency market) is a global, worldwide–decentralised financial market for trading currencies. Financial centres around the world function as anchors of trading between a wide range of different types of buyers and sellers around the clock with the exception of weekends. The foreign exchange market determines the relative values of the different currencies.
The foreign exchange market assists international trade and investment, by enabling currency conversion.

6.0 TUTOR MARKED ASSIGNMENT

Discuss the financial strategies that are involved in currency risk management.

Explain some of the advantages and disadvantages of Breton Woods's system and fixed exchange rates.

ANSWER TO SELF ASSESSMENT EXERCISE

Translation exposure has it that:

The foreign financial statements are put into US generally accepted accounting principles.

The translation gains and losses are only included in net income when there is a sale or liquidation of the entire investment in a foreign entity.

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