COURSE GUIDE

BFN 740
REGULATION OF FINANCIAL INSTITUTIONS

Course Team Dr. Okoh, Johnson Ifeanyi (Course Writer) - NOUN
Prof. Steve Ibenta(Course Editor) - Nnamdi Azikiwe University, Awka
Dr. Okoh Johnson Ifeanyi(Programme Coordinator) - NOUN
Dr. Ofe. Inua (Course Coordinator) - NOUN

NATIONAL OPEN UNIVERSITY OF NIGERIA

National Open University of Nigeria
Headquarters
University Village
Plot 91, Cadastral Zone
Nnamdi Azikiwe Expressway
Jabi, Abuja

Lagos Office
14/16 Ahmadu Bello Way
Victoria Island, Lagos

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

Printed 2018

ISBN: 978-978-8521-80-8

CONTENTS **PAGE**

INTRODUCTION

BFN 740: Regulation of Financial Institutions is a second semester course, two credit unit, 700 level core courses. It is available for all students offering Postgraduate Diploma Programme in Banking and Finance in the Faculty of Management Sciences. The study covers an advanced treatment of fiscal and monetary policy issues; in respect of economic stabilization measures. The instruments and targets of fiscal and monetary policies and theory impacts on macroeconomic aggregates including unemployment, income levels, inflation etc. regulatory institutions in domestic and international economic environment such as the CBN, NDIC, IMF etc. as they effect national and international economic development.

COURSE GUIDE

The course guide tells you briefly what the course is about, what course material will be used, and how you can work your way through the study material. It suggest some general guidelines for the amount of time you are likely to spend on each unit of the course in order to complete it successfully.

The guide also gives you some guidance on your tutor-marked assignments, which will be made available to you in the Study Centre. There are regular tutorial classes that are linked to the course. You are advised to attend these sessions.

WHAT YOU WILL LEARN IN THIS COURSE

The BFN 740, course consists of 5 Modules with 19 units. Specifically, the course discusses the following:

- The Nigerian Financial System
- Sources of instability in the Banking System and Regulatory Authorities efforts at stabilizing the Financial System
- Emerging Issues, Challenges and possible remedial actions
- Objectives of Regulating the Financial Institutions and Major Regulations in the Financial system
- Regulatory Institution in the Nigeria Financial System (Domestic Environment) – CBN,
- Regulatory Institution in the Nigeria Financial System (Domestic Environment) –NDIC
- Regulatory Institution in the Nigeria Financial System (Domestic Environment) – SEC,
- Regulatory Institution in the Nigeria Financial System (Domestic Environment) –NAICOM

- International Financial market difficulties
- Regulatory Institutions in the International Environment-International Monetary Fund (IMF)
- The International Bank for Reconstruction and Development (IBRD) or the world bank
- The African Development Bank (ADB)
- Economic Stabilization and the Need for Regulation
- Monetary policy as Instrument of Economic Stabilization
- Fiscal Policy as an Instrument of Economic Stabilization
- Direct Controls as Instrument of Economic stabilization
- Overview of monetary policy framework
- Strategies of monetary targeting in Nigeria
- unemployment and inflation aggregate

COURSE AIMS

The aim of this course can be summarized as follows:

- To exposed you to the advanced treatment of fiscal and monetary policy issues in respect of economic stabilization measures.
- It also gives you in-depth knowledge about the instruments and targets of fiscal and monetary policies and theory impacts on macroeconomic aggregates including unemployment, income levels, and inflation etc. regulatory institutions in domestic and international economic environment.

COURSE OBJECTIVES

To achieve the aims set out, the course sets overall objectives. Each unit also has specific objectives. The unit objectives are always specified at the beginning of a unit, you should read them before you start working through the unit. You may want to refer to them during your study of the unit to check your progress.

You should always look at the unit objectives after completing a unit. When you do that, you will ensure that you have followed the instructions in the unit. Below are the overall objectives of the course. By meeting these objectives, you should have achieved the aims of the course as a whole. On successful completion of the course, you should be able to:

- give a brief overview of the banking sector
- trace the historical background of the banking sector
- state the nature of the financial system

- state the factors that account for the unhealthiness and instability in the banking sector
- discuss macroeconomic environment as a source of instability in the banking sector
- the emerging issues in the banking system
- the challenges in the banking system
- how globalization and financial openness constitute a challenge to the financial system
- clearly understand the monetary management mechanism
- understand the meaning of fiscal and monetary policies

WORKING THROUGH THIS COURSE

To complete this course, you are required to read the study units, read set books and read other materials provided by the National Open University of Nigeria (NOUN). Each unit contains assignments which you are required to attempt and submit for assessment purposes. At the end of the course, there will be a final examination. The course should take you a total of 16 **-** 17 weeks to complete.

Below, you will find listed all the components of the course. What you have to do and how you should allocate your time to each unit in order to complete the course successfully on time. The list of all the components of the course is as presented.

COURSE MATERIALS

Major components of the course are:

1. Course Guide
2. Study Units
3. Textbooks
4. Assignment
5. Presentation Schedule

STUDY UNITS

The study units in this course are as follows:

Module 1 Policy Study On Issues in the Nigerian Financial System

Unit 1 Nigerian Financial System
Unit 2 Sources of instability in the Banking System and Regulatory Authorities efforts at stabilizing the Financial System

TEXTBOOKS

At the end of each unit of the course, there are reference materials to which you can refer in order to increase the depth of your knowledge on the course. Please take this seriously.

ASSIGNMENT FILES

A number of assignments have been prepared to help you succeed in this course. They will guide you to have understanding and good grasp of the course.

PRESENTATION SCHEDULE

The presentation schedule included in your course materials also have important dates of the year for the completion of tutor-marked assignments (TMAs) and you attending to tutorials.

Remember, you are to submit all your assignments by the due date. You should guard against falling behind in your work.

ASSESSMENTS

There are two aspects to the assessment of the course: first are the tutor-marked assignments and a written examination.

In tackling the assignments, you are expected to apply information, knowledge and techniques gathered during the course. The assignments must be submitted to your tutor for formal assessment in accordance with the deadlines stated in the **Presentation Schedule** and the **Assignment File**. The work you submitted to your tutor will count for 30 percent of your total course mark.

At the end of the course, you will need to sit for a final written examination of three hour duration. This examination will also count for 70 percent of your total coursework.

TUTOR-MARKED ASSIGNMENTS (TMAs)

Each of the units in the course material has a tutor-marked assignment (TMA) in this course. You only need to submit five of the eight assignments. You are to answer all the TMAs and compare your answers with those of your course mates. However, you should ensure that you collect four (TMAs) from the Study Centre. It is compulsory for you to answer four (4) TMAs from the Study Centre. Each TMA is allocated a total of 10 marks. However, the best three (3) of the four marks shall be used as your continuous assessment score.

You will be able to complete your assignment from the information and materials contained in your reading, references and study units. However, it is desirable in all degree level education to demonstrate that you have read and researched more widely than the required minimum.

Using other references will give you a broader viewpoint and may provide a deeper understanding of the subject.

FINAL EXAMINATION AND GRADING

The final examination for BFN740 will not be more than three hours' duration and has a value of 70 percent of the total course grade. The examination will consist of questions, which reflect the types of practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed.

After going through the entire course material, ensure that you do a revision before sitting for the final examination. You may find it useful to review your tutor-marked assignments and comments on them before the examination. The final examination covers information from all parts of the course.

COURSE MARKING SCHEME

Table showing the total course marking scheme is shown below:

ASSESSMENT	MARKS
Assignment 4 (TMAs)	Best three marks of the 4 TMAs @ 10 marks is 30 marks of the course = 40%
Final Examination	60% of overall course marks
Total	**100% of course marks**

COURSE OVERVIEW

This table brings together the units and the number of weeks you should spread to complete them and the assignment that follow them are taken into account.

Unit	Title of Work	Week Activity	Assessment (end of unit
	Module 1		
1	The Nigerian Financial System	1	Assignment 1
2	Sources of instability in the Banking System and Regulatory Authorities efforts at stabilizing the Financial System	1	Assignment 2
3	Emerging Issues, Challenges and possible remedial actions	1	Assignment 3

	Module 2		
4	Objectives of Regulating the Financial Institutions and Major Regulations in the Financial system	1	Assignment 4
5	Regulatory Institution in the Nigeria Financial System (Domestic Environment) – CBN,		
6	Regulatory Institution in the Nigeria Financial System (Domestic Environment) –NDIC		
7	Regulatory Institution in the Nigeria Financial System (Domestic Environment) – SEC,		
8	Regulatory Institution in the Nigeria Financial System (Domestic Environment) –NAICOM		
	Module 3		
9	International Financial market difficulties	1	Assignment 5
10	Regulatory Institutions in the International Environment-International Monetary Fund (IMF)	1	Assignment 6
11	The International Bank for Reconstruction and Development (IBRD) or the world bank		
12	The African Development Bank (ADB	1	Assignment 7
	Module 4		
13	Economic Stabilization and the Need for Regulation		
14	Monetary policy as Instrument of Economic Stabilization		
15	Fiscal Policy as an Instrument of Economic Stabilization		
16	Direct Controls as Instrument of Economic stabilization		
	Module 5		
17	Overview of monetary policy framework	1	Assignment 8
18	Strategies of monetary targeting in Nigeria		
11817	unemployment and inflation aggregate		
	Revision		
	Total	**19**	

HOW TO GET THE MOST FROM THIS COURSE

In distance learning, the study units replace the university lecturer. This is one of the great advantages of distance education. You can read and work through the specially designed study materials at your own pace, and at a time and place that suits you best. Think of it as you read the lecture notes and that a lecturer might set you some readings to do.

The study unit will tell you when to read your other materials. Just as a lecturer might give you an in-class exercise, your study units also provide assignments for you to do at appropriate points.

Each of the study units follows a common format. The first item is an introduction to the subject matter of the unit, and how a particular unit is related with the other units and the course as a whole.

Next is a set of learning objectives. These objectives let you know what you should be able to do by the time you have completed the unit. You should use these objectives to guide your study. When you have finished the unit, you must go back and check whether you have achieved the objectives set. If you make a habit of doing this, you will significantly improve your chances of passing the course.

The main body of the unit guides you through the required reading from other sources. This will usually be either from **Reading Section** or some other sources.

Self-tests/assignments are interspersed throughout the end of units. Working through these tests will help you to achieve the objectives of the unit and prepare you for the examinations. You should do each of the assignments as you come to it in the study unit. There will also be numerous examples given in the study units, work through these when you come to them too.

The following is a practical strategy for working through the course. If you run into any trouble, call your tutor. When you need help, don’t hesitate to call and ask your tutor to provide it. In summary:

(1) Read this course guide.

(2) Organise a study schedule. Refer to the course overview for more details. Note the time you are expected to spend on each unit and how the assignments relate to the unit. Important information e.g. details of your tutorials and the date of the first day of the semester is available. You need to gather together all information in one place, such as your diary or a wall calendar. Whatever

method you choose to use, you should decide on and write in your own dates for working on each unit.

(3) Once you have created your own study schedule, do everything you can to stick to it. The major reason that students fail is that they get behind with their coursework. If you get into difficulty with your schedule, please let your facilitator know before it is too late for help.

(4) Turn to unit 1 and read the introduction and the objectives for the unit.

(5) Assemble the study materials. Information about what you need for a unit is given in the 'Overview' at the beginning of each unit. You will always need both the study unit you are working on and one of your set books, on your desk at the same time.

(6) Work through the unit. The content of the unit itself has been arranged to provide a sequence for you to follow. As you work through this unit, you will be instructed to read sections from your set books or other articles. Use the unit to guide your reading.

(7) Well before the relevant due dates (about 4 weeks before the dates) access the Assignment file on the web and download your next required assignment. Keep in mind that you will learn a lot by doing the assignments carefully. They have been designed to help you meet the objectives of the course and, therefore, will help you pass the examination. Submit all assignments not later than the due dates.

(8) Review the objectives for each study unit to confirm that you have achieved them. If you feel unsure about any of the objectives, review the study material or consult your tutor.

(9) When you are confident that you have achieved a unit's objectives, you can then start on the next unit. Proceed unit by unit through the course and try to pace your study so that you keep yourself on schedule.

(10) When you have submitted an assignment to your tutor for marking, do not wait for its return before starting on the next unit. Keep to your schedule. When the assignment is returned, pay particular attention to your facilitator's comments. Consult your tutor as soon as possible if you have any questions or problems.

(11) After completing the last unit, review the course and prepare yourself for the final examination. Check that you have achieved the unit objectives and the course objectives.

TUTORS AND TUTORIALS

There are eight (8) hours of tutorials provided in support of this course. You will be notified of the dates, times and location of these tutorials, together with the names and phone number of your tutor, as soon as you are allocated a tutorial group.

Your tutor will mark and comment on your assignments, keep a close watch on your progress and on any difficulties you might encounter as they would provide assistance to you during the course. You must mail your tutor-marked assignments to your tutor well before the due date (at least two working days are required). They will be marked by your tutor and returned to you as soon as possible. Do not hesitate to contact your tutor by telephone, e-mail, or discussion board if you need help. The following might be circumstances in which you would find help necessary.
Contact your tutorif you:

- do not understand any part of the study units or the assigned readings;
- have difficulty with the tutor-marked assignments;
- have a question or problem with an assignment or with your tutor's comments on an assignment or with the grading of an assignment.

You should try your possible best to attend the tutorials. This is the only chance to have face-to-face contact with your tutor and to ask questions which are answered instantly. You can raise any problem encountered in the course of your study during such contact. To gain the maximum benefit from course tutorials, prepare a question list before attending them. You will learn a lot from participating in discussions actively.

SUMMARY

As earlier stated, the course BFN 740, Regulations of Financial Institutions is designed for the advanced treatment of fiscal and monetary policy issues; in respect of economic stabilization measures. The instruments and targets of fiscal and monetary policies and theory impacts on macroeconomic aggregates including unemployment, income levels, inflation etc. regulatory institutions in domestic and international economic environment such as the CBN, NDIC, IMF etc.
We wish you great success at National Open University of Nigeria.

MAIN COURSE

CONTENTS **PAGE**

MODULE 1 POLICY STUDY ON ISSUES IN THE NIGERIAN FINANCIAL SYSTEM

UNIT 1 THE NIGERIAN FINANCIAL SYSTEM

CONTENTS

1.0 INTRODUCTION

Financial institutions sometimes referred to as financial intermediaries are establishments engaged in some form of borrowing and lending. The concept of financial institutions denotes the principal players in the financial system namely the commercial and merchant banks, specialized banks, including the Central Bank and Non-Bank Financial Institutions (NBFIS). These include insurance companies, stock broking firms and finance houses, mortgage firms and the rest. Financial systems are so-called because they engage in the core function of mobilizing and channeling financial resources for saving and investment purposes within the economy.

I should point out here that the banking industry as used in this context implies an icon of the entire financial system, but let me assure you that the interchange is not arbitrary. Besides, using the banking sector to substitute for other financial institutions in a generic sense is not only convenient, it also reflects the frontline role of banks in the financial system and indeed the financial intermediation process.

2.0 OBJECTIVES

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

- give a brief overview of the banking sector
- trace the historical background of the banking sector
- state the nature of the financial system
- state three factors that account for the unhealthiness and instability in the banking sector.

3.0 MAIN CONTENT

3.1 Overview of the Nigerian banking sector

If there is anything that all well-meaning stakeholders in the Nigerian banking industry look forward to, it is a banking sector that is healthy and stable. Banking sectors are where investors, depositors, operators, regulators, etc. can, after a hard day's work go to sleep with all eyes closed and without the anxiety that before dawn something amiss will happen. To a large extent, that used to be the nature of Nigeria banking industry from independence in 1960 to the deregulation and liberalization of the industry which started in the mid-1980s. Situations have drastically changed since the manifestation of rounds of bank distress that subsequently claimed the life of 37 banks from 1994 to 2003. Since then, the banking industry and its environment have been anything but sound and stable. And the consequences have been very grave for the economy, especially in the areas of loss of wealth, public confidence in the system and of course a monetary management that has become more challenging with large amount of currency in circulation outside the banking system.

We can easily point at a number of factors that may be contributing to the unhealthiness and instability in the banking sector. Such factors include:

1. Unstable macroeconomic and fiscal policies.
2. Unethical and unprofessional practices.
3. Inadequate supervisory activities rank high on the scale.

In spite of the causative factors, there is no gain saying that this economy deserves a sound and stable banking industry that can withstand the challenges from the global economy. Therefore, there is the need for deep reflection and search for strategic initiatives that will guarantee the attainment of our dream banking industry. Nigerian and indeed the global economy look forward to a banking sector that is sound and stable in Nigeria. To achieve this is a challenge to all stakeholders, the regulatory and supervisory authorities, bank owners, managers and employees, the government, bank customers, the general banking public, etc. It necessarily demands that stakeholders should henceforth eschew actions that go against this goal. They should also collaborate and co-operate as well as conduct the business of banking according to the laws, rules and customs.

3.2 Nature of Financial systems

i. **Risk and uncertainty**: First, more than other economic activities financial operations are concerned with the future, and hence are characterized by risk and uncertainty. The key services of the financial system in the process of allocating funds between savers and borrowers consist in trading risk and liquidity. As a consequence, expectations play a major role in the pricing of financial assets. However, given the often limited amount of information available price developments are difficult to predict. As new information becomes available market parties adjust suddenly and collectively (so-called herd behavior) their price expectations. Together with low transaction costs in financial markets, it explains the high volatility and inherent instability of financial markets.

ii. **Asymmetric information:** Problems arise when market parties have different information. Hence, one party may not have enough information about the other party to make accurate decisions. It certainly applies to financial markets where one party often has superior information about the risk being transacted than the other party, for example an investor knows more about the riskiness of his investment than the money lender.

Asymmetric information hampers the well-functioning of markets. It creates problems of adverse selection before the transaction is entered into, and of moral hazard after the transaction has taken place. Adverse selection arises as due to incomplete information the lender cannot accurately distinguish good risk applicants from bad-risk applicants before making an investment. Thereby a so-called lemon-premium' will increase the loan rate, so that only risky projects will be funded. Moral hazard costs, incurred by the lender in verifying that borrowers are using their funds as intended, further raise the loan rate.

In the process financial intermediaries arise as they specialize in information on borrowers and solve these asymmetric information problems. The key services provided by financial institutions then consist in collecting and communicating information on debtors and on financial assets.

The principal-agent relationship of creditors with financial institutions, however, involves similar information problems. How can the lender (the principal) make sure that the agent (the financial intermediary) acts in his interest? For example, depositors lack information regarding the riskiness of the bank's portfolio. Should these financial intermediaries which provide market solutions to market imperfections, in turn not be subject to government regulation and supervision?

iii. **Independence:** Financial markets and financial institutions tend to be more interdependent than is the case for other sectors of the economy. Events in one financial market or institution may have important external effects on the rest of the financial system and on the whole economy. Together with the important potential for 'herd behavior' it explains the occurrence of so-called system risks.

iv. **Money:** Finally, at the heart of the financial system lies a special commodity: money. The proper functioning of money depends upon price stability. As there is a link between prices and money in circulation, there is a need to keep money creation under control. Money creation, however, is profitable, so that it may not be taken for granted that an unregulated money supply will lead to a sufficient stable price level. As money is created by the banking sector a special need for controlling these specialized intermediaries may arise.

3.3 History of Banking in Nigeria

0rthodox banking business was introduced into Nigeria in 1892 by expatriates who also monopolized banking activities. The monopolizing of banking in the country also brought with it serious discriminatory attitude by the expatriates such that by 1927, indigenous banks had accumulated huge debts.

It is on record that before the banking ordinance of 1952, Nigeria's banking landscape was unregulated. This lack of regulation was later to be fingered as one of the principal factors that led to the first banking distress which by 1952, had claimed the life of 21 of the 25 indigenous banks in the country.

Since the banking ordinance of 1952, many more statutory and supervisory regulations have emerged to guide the conduct of banking business. Unfortunately, in spite of the existence of such regulations, the country was shocked to witness a second round of collapse of 34 banks between 1994 and the year 2000. Other financial institutions witnessed even more severe level of distress and collapse. Among the problems that facilitated the second bank collapse was definitely not unavailability of regulation.

In the aftermath of the banking problems experienced by many countries over the past two decades and the devastating effects on financial sector stability, concern over the health of banking system became widespread. Given our banking experience of the 1990s and current public apprehension about the health of a few banks in the country, it is clear that Nigeria is not insulated from the crisis phenomenon. This helps to create awareness that the opportunities initiated for banks by financial sector stabilization and globalization are not without their attendant risks. It is therefore expected that this will generate a lot of interest amongst us as major stakeholders in the economy, given our collective responsibility to ensure the soundness and stability of the banking system.

Regulation is very necessary in banking to ensure a high level of probity, integrity and responsibility. The above scenario was before the introduction of universal banking concept in 2001, with the broader definition of banking business to now include services in insurance, capital market and investment management.

Consequently, it becomes necessary to place on record the happenings in the global environment, particularly, in the United States, which one considers relevant to our situation. For a long time in the United States, capitalism was synonymous with market deregulation, free enterprise and ascendancy of private initiative. Government practically withdrew from running private enterprises. But with the recent unexpected bursting of the technology bubble, the unnerving terrorism of September 11, 2001 and the shocking revelation of corporate corruption, it appears the tide has changed and the era of regulation is gradually creeping back.

4.0 CONCLUSION

We have seen in this unit that regulation is very necessary in banking to ensure a high level of probity, integrity and responsibility.

5.0 SUMMARY

In this unit you have learnt a brief overview of the banking sector, the nature of the financial system, the historical background of the banking sector and the three factors that account for the unhealthiness and instability in the banking sector.

6.0 TUTOR-MARKED ASSIGNMENT

1. Trace the historical background of the Nigerian banking sector.
2. State the three reasons that account for theweakness and instability in the banking sector.

7.0 REFERENCES/FURTHER READINGS

Afifia-Oru, B. (2009). *Dynamics of credit economic system in Africa*. Lagos: Byolah concepts ltd.

Central Bank of Nigeria (2011). Understanding Monetary Policy series no 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy and direct controls, retrieved fromwww.yourarticlelibrary.com/eco

Dirk, H. (1999). Regulations of banking and financial market, Encyclopedia of Law and Economics.

UNIT 2 SOURCES OF INSTABILITY AND REGULATORY AUTHORITIES' EFFORTS AT STABILIZING THE FINANCIAL SYSTEM

CONTENTS

1.0 INTRODUCTION

There are a number of factors, both exogenous and endogenous, that can precipitate instability in the banking system. The exogenous factors, which include macroeconomic shocks emanate from negative effects of financial liberalization, globalization and rapid technological changes. The internal factors include inappropriate corporate governance and inadequate regulatory and supervisory capacity among others. Some of these factors are examined in details below.

2.0 OBJECTIVES

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

- discuss macroeconomic environment as a source of instability in the banking sector
- explain asymmetric information as a source of instability in the banking sector
- discuss weak management as a source of instability in the banking sector

- discuss inappropriate corporate governance structures as a source of instability in the banking sector
- analyseinadequate or poor regulatory and supervisory capacity as a source of instability in the banking sector.

3.0 MAIN CONTENT

3.1 Sources of instability in the banking sector

3.1.1 Macroeconomic Environment

The macroeconomic environment represents a combination of factors that impact on the banking system which could be either favourable or adverse to the system. When the impact is adverse, banks tend to embark on protective strategies, which may not augur well for both the banking system and the economy. For instance an economy experiencing sluggish growth or in recession poses formidable challenges to all economic agents, causing business opportunities to shrink. Under such circumstances, it is critical that bankers take actions which will not affect the health of the banking system adversely or further destabilize the economy.

Generally, it is easier to achieve sound banking system under a stable macroeconomic environment than an unstable one. On the other hand, an unsound banking system could trigger off macroeconomic instability, hence the symbiotic relationship between the banking system and macroeconomic environment.

3.1.2 Asymmetric Information

It is a fact that, information asymmetry results in mismatching of financial contracts, precipitating runs on banks. As we all know, depositors have little information about the soundness of banks and the safety of their deposits. Thus any misinformation, as was experienced in the country recently, can cause panic withdrawals, creating runs on the banks with potentials of contagion and loss of credit confidence. Similarly, poor loan selection due to information asymmetry leading to funding of unviable projects could lead to having very high volume of non-performing loans.

3.1.3 Weak Management

One of the major internal factors that have contributed to the observed weakness in some financial institutions is poor management. This is often reflected in poor asset quality, insider abuse, inadequate internal controls, and fraud, including unethical and unprofessional conduct, squabbles and high staff turnover rate.

Weak risk-control systems have been a major factor in the emergence of a number of crises, leading to a variety of balance sheet differences including large and undetected mismatches on the balance sheet or poor asset quality, leading to large unrealizable losses.

3.1.4 Inappropriate Corporate Governance Structures

Corporate governance refers to the extent to which companies are run in an open and honest manner. Thus, effective corporate governance practice incorporates transparency, openness, accurate reporting and compliance with statutory regulations, among others. Historical antecedents indicate that financial crisis is a direct consequence of lack of good corporate governance in banks. In particular, the need to implement good corporate governance in the banking sector became more apparent after the Asian financial crisis.

3.1.5 Inadequate or Poor Regulatory and Supervisory Capacity

Inadequate or poor regulatory and supervisory capacity can contribute to instability in the financial system. Consequently, regulatory and supervisory capacity must be adequate for effective monitoring of the system. Regulatory Supervisors must exhibit a high level of integrity, competence and be equipped with modern facilities, in order to meet the challenges of contemporary banking practices.

3.2 Regulatory Authorities' Efforts at Stabilizing The Financial System

3.2.1 Regulation

The focus of regulation has been to reduce the risk of bank insolvency and the potential cost of bank failure to depositors. This is the hallmark of the 1988 capital accord of the Basel committee on banking supervision. The major elements of the 1988 capital accord included the explicit linkage of capital requirements to a bank's quantum, degree of risks, and the establishment of internationally comparable minimum capital requirement. The need for more flexibility and risk sensitivity as well as provision of coverage for effective bank-level management, supervision and market discipline gave the fillip for the new capital accord which took effect from 2007. The bank also strengthened its regulatory framework, with emphasis on creating an environment for competitiveness, efficiency, financial soundness and sustainable growth.

3.2.2 Supervision

In the discharge of its statutory responsibility, the CBN has continued to undertake both off-site and on-site supervisory activities. Emerging issues from these supervisory efforts include poor/weak management structure, weak internal control systems, under-capitalization, inadequate collateralization of facilities granted and exceeding the single obligor limits are quite revealing, and are of great concern to the monetary authorities.

In addressing these weaknesses, the CBN introduced prudent guidelines encompassing capital adequate ratio, mandatory uniform accounting standards and strict enforcement of licenses which are issued to only those who are fit and proper to operate a bank.

The ability of the supervisory authorities to prevent, contain, manage and resolve the distress syndrome was severely handicapped by the absence of a comprehensive regulatory framework for distress/crisis management. Against this background the CBN and the NDIC put in place in July 2002 the framework on contingency planning for banking that would ensure the systemic management of crisis in Nigerian banks. The regulators have since then, been ensuring that banks adopt realistic accounting policies and standards, in generating financial statements that would facilitate the valuation of the assets and liabilities and classification in accordance with a uniform bank rating system. This apart, the bankers committee recently adopted the code of corporate governance for directors of banks, which is designed to inculcate good corporate governance in the banking industry in line with international regulations on best practices.

More so, the committee of ethics and professionalism was set up in 2001 and it has since issued the "code of ethics" which every banker in the country should not only possess but observe. The objective is to enforce the tenets of good ethics and professionalism in Nigerian banking system. The committee, which has so far performed satisfactorily, has entertained and adjudicated on complaints against banks from their customers and banks ag6inst other banks.

3.2.3 Emphasis on Good Corporate Governance

It will be recalled that the major causes of distress in the Nigerian banking sector in the 1990s were identified to include weak management, poor capital base, inadequate credit policy and fraudulent and corrupt practices. All these were reflections of unsound and inadequate corporate governance structures in the sector.

The CBN has, in recent times, placed emphasis on the enthronement of good corporate governance in the financial sector. For instance, the issue of multiple directorships in the banking system has been given regulatory attention by the CBN.

The restriction was designed to reduce or possibly eliminate conflict of interest, reduce sharp practices, reduce undue influence of one director on the others and guard against abridge practice by the banks with common directorship. Also, the banks have strengthened the requirement for appointment into board and top management positions, both in terms of minimum educational qualifications and requisite years of experience.

4.0 CONCLUSION

We have seen in this unit there are a number of factors, both exogenous and endogenous, that can precipitate instability in the banking system. Consequently, regulatory and supervisory capacity must be adequate for effective monitoring of the system.

5.0 SUMMARY

In this unit, you have learnt the various sources of instability in the banking sector ranging from Macroeconomic Environment, Asymmetric Information, Weak Management, Inappropriate Corporate Governance Structures, and Inadequate to Poor Regulatory and Supervisory Capacity

6.0 TUTOR-MARKED ASSIGNMENT

State the various sources of instability in the banking sector.

7.0 REFERENCES/FURTHER READING

Afifia-Oru, B. (2009). *Dynamics of Credit Economic System in Africa*. Lagos: Byolah Concepts Ltd.

Central Bank of Nigeria (2011). Understanding Monetary Policy series No 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy and Direct controls, retrieved fromwww.yourarticlelibrary.com/eco

Dirk, H. (1999). Regulations of banking and financial market, Encyclopedia of Law and Economics.

Osaze, E.B. (2007). *Capital markets,* Lagos: The Book house Company.

UNIT 3 EMERGING ISSUES, CHALLENGES AND POSSIBLE REMEDIAL ACTIONS IN THE FINANCIAL SYSTEM

CONTENTS

1.0 INTRODUCTION

The Nigerian financial system i.e. banking system has over the years witnessed some improvements in terms of stability in relative terms. However, some outstanding problems as earlier highlighted, pose serious challenges to the soundness and stability of the sector. These could be complicated by the challenges imposed by globalization and technological innovations, especially, in terms of competition and efficient service delivery.

2.0 OBJECTIVES

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

- discuss emerging issues in the banking system
- list the challenges in the banking system
- explain how globalization and financial openness constitute challenges to the financial system
- Highlight possible remedial actions.

3.0 MAIN CONTENT

The challenge of increasing sophistication of the consumers of financial services and the requirements for upgrading of financial services put a lot of pressure on the resources available to the operators. Some of the challenges are under listed below:

3.1 Globalization and Financial Openness

While increasing openness of the banking system to foreign influence to allow for transfer of technology that may benefit the sector, financial openness provided an easy way for systemic contagion, as was the case with the Asian financial crisis. With the Nigerian banking system responding to transactions with correspondent banks, the system is becoming more vulnerable to international systemic risks. There is also the challenge of insuring transparency in foreign financial transactions in order to discourage money laundering and other malpractices within the banking system. In this regard, the CBN has embarked on strengthening its regulatory and supervisory capacity and framework in order to avoid the contagious effect of adverse development similar to those that were inflicted on the East Asian financial markets.

3.2 Transparency Information Disclosure

Effective monitoring of the banking system under the New Capital Accord would rely on efficient, timely and accurate data. As indicated earlier, the supervisory role of the regulatory authorities suffers setbacks since some banks do not seem to be transparent in the rendition of the financial returns to the CBN. This lack of transparency undermines the ethics of good corporate governance and the prospect for effective contingency plan for managing systemic distress. It is expected that the introduction of the automated Bank Analysis System (BAS) will partly help to address this short-coming and enhance the efficiency of off-site supervision. In order to stem the persistent incidence of misreporting and violations of regulatory requirements, the CBN will, from now on, regard offending directors and chief executive officers as unfit to operate a bank and may be removed from the banking system.

3.3 Combating Money Laundering and Advance Free Fraud (419)

The CBN is concerned that despite the efforts being made and the strategies put in place to combat the problem of money laundering and the menace of **dynamics of credit economic system in Africa** advanced free fraud (otherwise known as 419) in the economy, the banking system is being used as a conduit pipe for perpetrating this monumental crime. The CBN has conducted various investigations into reported cases of advanced fee fraud, which involved the use of banks and other financial institutions under its supervisory purview. Consequently, the CBN has put in place measures and safeguards to ensure that the financial system is not used as a channel for laundering money or perpetrating other financial frauds. In this regards, the CBN has enhanced its internal structures as well as equipped staff in the sensitive operational areas with the relevant tools for identifying and tracking the activities of money launderers.

Besides, the CBN has beefed up its surveillance capacity to ensure that banks and other financial institutions observe the rules of the Financial Action Task Force (FATF). Deposit money banks are also required to appoint high-ranking officers as Chief Compliance Officers (CCOs) in each of their branches to complement such efforts, while reported cases of advance fee fraud are properly invested.

It is noteworthy that, following its oversight activities, the CBN has been able to track fake web sites used by fraudsters and with the collaboration of the police, contacted internet service providers hosting such web site and proceeded to shut down such service providers. In addition to this, the Economic and Financial Crime Commission (EFCC) and the Independent Corrupt Practices Commission (ICPC) are now tracking down those money launderers and other fraudulent people.

3.3.1 The Problem of De-Marketing and False Rumours of Distress

It has been observed that some banks have often capitalized on the problem of asymmetric information in the system to de-market other banks. This is a worrisome trend as it could engender loss of public confidence in the banking system and consequently precipitate instability in the financial sector.

It is very important that the banking industry should observe high ethical standards and professionalism in the provision of financial services to the nation. The industry must be insulated from abuses and criminal tendencies.

3.4 Competitiveness

The level of competition among financial institutions has been on the increase in recent times and following the post - distress shakeout, the need to reposition or to consolidate by surviving financial institutions has in some way become the driving force. The problem is that if the emerging pattern is anything to go by, then, a sound competitive strategy that would ensure the survival of the financial institution and guide the managers of these financial institutions is something paramount in the new millennium.

3.5 Superior Service Quality

In a service-based industry such as banking, the product can hardly be separated from the supplier, and since most bank products revolve around money, which is a commodity, there is little room for differentiation. The attitude that goes with the service, such as timeliness, courtesy, accuracy, etc. is therefore important.

3.6 Market Orientation

Market forces have become the great disciplinarians that whip any erring business into line. The market will be playing even more decisive roles in the new millennium, which has liberalization as one of its chief slogan. Any business manager that ignores the market cannot compete favourably and as such, can hardly survive for long. We must therefore, be permanently tuned to the market for vital information on customers' needs, market competitiveness and product pricing. The effective manager in the coming dispensation will be one that can provide high quality service efficiently and at the least price.

3.7 Product Innovation

The current age in which we live has been described not only as the information age but also the age of knowledge. It is an age that thrives on creativity and skill; therefore business managers who demonstrate these attributes shall continue to hold on to their customers. Effective financial institutions should be able to design appropriate products that comply with the emerging new ways of life in order to ensure customers' satisfaction and convenience.

3.8 Adequate Capitalization

The current age in which we live has been described not only as the information age but also the age of knowledge. It is an age that thrives on creativity and skill; therefore, business managers who demonstrate these attributes shall continue to hold on to their customers. Effective financial institutions should be able to design appropriate products that comply with the emerging new ways of life in order to ensure customers' satisfaction and convenience.

3.9 Investment in Technology

The banking industry is heavily dependent on the processing, storing and retrieving of information in the form of banking transactions. The efficiency and effectiveness of a financial institution can therefore be greatly enhanced through automation. More than a processing tool, however, the frontier advancement in information technology offers a vast scope of application to the financial industry that is too potent to ignore.

3.10 Capacity Building

The relevance of universal banking brings to the fore the need for capacity building in the financial industry. Many banks that are already well established into one or more areas of businesses are making efforts at developing their personnel. However, the efforts of these, banks are obviously not enough, which explains why the incidences of staff poaching and the use of inexperienced staff in highly sensitive jobs have remained unabated. This anomaly is expected to be minimized with the bank consolidation exercise going on right now. Experienced persons will now be employed to synergize and move the industry forward to a greater height.

3.11 Social Demand on Financial Institutions

We have witnessed clear signals from the society that financial institutions should play roles which were thought to be for the government. Some have called it social responsibility, while others say it is a measure of the sensitivity of financial institutions to their environment. Beside the presidential call on banks to fund and build hostel accommodations on university campuses, demands are also being made for the construction or rehabilitation of roads. There is also the issue of funding and supporting security outfits like the police.

3.12 Imposition of Sanctions

An element of most regulations is the provision of sanctions against banks that breach CBN stipulations. Following investigations on alleged forex malpractices, the CBN suspended for one year, the dealership licenses of 21 banks. This action jolted the financial markets and the vibrations caused are yet to get settled. Our experience with these sanctions has revealed the need for greater consultation and confidentiality between the operators and regulators of the banking system. Incidents of poor information management in the sanctioning process must be minimized and this is supported by the awareness that the core objective of sanction is to reform conduct with a view to restoring system integrity and stability.

3.13 Legal Tussle between CBN and other Banks

Until recently, it was unheard of for an operator to square up issues with the CBN at the law courts. But the environment has changed and is still changing. We have witnessed some operators dragging the CBN to the law court for various reasons aimed at avoiding actions taken by the regulator. What this means is that both regulators and operators should be prepared to account for their actions.

3.14 Possible Remedial Actions

Possible remedial actions to the identified emerging issues and challenges in the financial sector are as follows:

- good corporate governance
- leadership by good example
- transparent compliance with regulations and guidelines as well as - financial sector standards
- emplacement of corporate contingency plan and framework for risk management (including effective internal control systems)
- self-regulations by operators
- due customer diligence
- man power training and development (human capacity building).
- co-operation and where necessary dialogue with regulatory authorities
- collaborative competition
- policy stability with only needful fine-tuning
- ethics and professionalism
- respect for law, order and rights of others
- consumer care and sensitivity
- proactive supervisory and surveillance activities
- research and development

- use of modern technology
- good corporate citizenship
- e-banking regulation
- a new sanction execution regime.

4.0 CONCLUSION

We have seen in this unitthe challenges imposed by globalization and possible remedial actions in technological innovations, especially, in terms of competition and efficient service delivery.

5.0 SUMMARY

You have learnt in this unit **t**he emerging issues and the challenges in the banking system and how globalization and financial openness constitute a challenge to the financial system among other factors as well as possible remedial actions.

6.0 TUTOR-MARKED ASSIGNMENT

1. State 10 emerging issues and challenges of the Nigerian financial system.
2. Discuss briefly 5 of the emerging issues in the Nigerian financial system.

7.0 REFERENCES/FURTHER READING

Afifia-Oru, B. (2009). *Dynamics of Credit Economic System in Africa*, Lagos: Byolah Concepts Ltd.

Central Bank of Nigeria (2011). Understanding Monetary Policy Series No 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy and Direct controls, retrieved from www.yourarticlelibrary.com/eco

Dirk, H. (1999). Regulations of banking and financial Market, Encyclopedia of Law and Economics.

Osaze, E.B. (2007). *Capital Markets*, Lagos: The Book house Company.

MODULE 2 REGULATORY INSTITUTIONS IN DOMESTIC ENVIRONMENT

UNIT 1 OBJECTIVES OF REGULATING THE FINANCIAL INSTITUTIONS

CONTENTS

1.0 INTRODUCTION

Regulation of banks is meant to serve certain purposes and objectives which will be discussed in this unit.

2.0 OBJECTIVES

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

- discuss what regulation entails
- highlight the objectives of regulation.

3.0 MAIN CONTENT

3.1 What does Regulation Entails?

Narrowly described, financial institutions regulation is the body of laws, rules directives and guidelines which are put in place, by the state and regulatory institutions in the market, for compliance/adherence by financial institutions within the market. This involves statutory and/or supervisory regulation as well as self-regulation. Hence, regulation of banks is meant to serve certain purposes and objectives which are discussed in below.

3.2 Objectives of Regulation

A close study of banking regulations in Nigeria indicates that some of the intended objectives include:

- promotion of monetary and economic stability
- protection of depositors and investors
- prevention or minimization of systemic failure
- promotion of market integrity and discipline
- maintenance of uniformity and standardization of practice
- maintenance of responsible corporate governance
- maintenance/restoration of public confidence in the system
- encouragement of banking habit and culture
- instilling of competitive equity (level playing field)
- restrain in certain activities
- general consumer protection
- efficiency in the system and development of the economy
- better service delivery.

3.3 Overview of Regulatory System of Nigerian Economy

As evidenced by the composition of the membership of the Financial Services Regulation Co-coordinating Committee (FSRCC) established in May 1994, regulators of the financial system and the constituent institutions are:

i. Central bank of Nigeria (CBN)
ii. Federal Ministry of finance (FMF).
iii. Securities and Exchanges Commission (SEC)
iv. Corporate Affairs Commission (CAC)
v. National Insurance Commission (NAICOM)
vi. NDIC

In contemporary Nigeria, the CBN regulates and supervises all money deposits in banks, finance institutions, exchange bureau, community banks primary mortgage institutions. Going by the overseeing role of regulates institutions in an economy therefore, it will be worthwhile to pause at juncture and make a brief review of the following:

1. The current CBN monetary, credit, foreign trade and exchange policy guidelines.
2. BOFIA.
3. A credit manual of any bank.

Monetary policy refers to those measures that the government and the Centre Bank of Nigeria employ to control monetary aggregates. Monetary policy is very crucial because it propels macroeconomic tools in helping to attain the overall policy goals set out. The primary objective of the monetary policy of the immediate past government of President Obasanjo centers on the maintenance of price and exchange rate stability in order to sustain a single digit inflation rate during the period through the effective control of the growth of monetary aggregates. Hence:

- The CBN shall continue to ensure banking soundness and financial sector stability in order to enhance the efficiency of the payment system and effective transmission of monetary policy to the real sector.
- The National Credit Guarantee Scheme (NCGS) will be encouraged and empowered to mitigate risks associated with lending to the Small and Medium Scale Enterprises (SMES).
- The productive sector i.e. the real sector will now assess large credit from the banks after the bank consolidation exercise going on presently.
- The exchange rate has appreciated which keeps the non-food prices inflation stable. Non-food prices inflation is low at about 4%. SEC regulates and supervises the capital market where issuing houses, stockbrokers, registrars and the Nigerian Stock Exchange (NSE) operate. NAICOM takes regulatory and supervisory charge of insurance business, reinsurance companies as well as insurance brokers and loss adjusters. CAC regulates the registration/incorporation of all companies in Nigeria.
- The FMF is a regulator of regulators given that SEC, NAICOM and NDIC are responsible to it. Perhaps, it needs be emphasized that these regulatory institutions are in some respect aided/assisted in playing their roles by some other institutions. For example: The Nigeria Deposit Insurance Corporation (NDIC) plays a complementary role (to CBN) as the insurer of depositors' funds and liquidator/manager of distressed banks. The NDIC also

supervises money deposit banks, through off-site and on-site examination. Similarly, NSE assists in the proper functioning of the capital market. It is basically because of their supporting roles that NDIC, NSE and national board for community Banks are granted observer status in financial services regulation coordinating committee.

3.4 Major Regulations in the Nigerian Financial System

Some of the major legislations and regulations are highlighted are as follows:

Banking Sub-sector

- Central Bank of Nigeria Act 1991, as amended
- Banks and other financial institutions Act 1991, as amended
- Nigeria Deposit Insurance Corporation Act 1998, as amended
- Money Laundering Acts 1995
- Guidelines for the practice universal banking in Nigeria
- Guidelines for discount houses
- Monetary, credit, foreign trade and exchange policy guidelines

Capital market sub-sector

- Insurance and Securities Act, 1999
- NSE's Listing Requirements.

Insurance Sub-sector

- Insurance Act 1994
- National Insurance Commission Act 1997

Others which are more or less general within the financial system include:

1. Foreign exchange (monitoring and miscellaneous provisions) acts 1995
2. Monetary laundering acts 1995
3. The recently revised guidelines for the operation of the foreign exchange market: the Dutch auction system (DAS)
4. Various statements of accounting standards issued by the Nigerian - Accounting Standards Boards (NASB)
5. The practice of Treasury Single Account (TSA)

3.5 Further Reasons for Regulation of Banks

Over the years, Nigeria as a nation has suffered a lot of decadence in various aspects of her life. Whether by accident of history or by design, Nigeria witnessed the highest level of deterioration so far under various heads of state during the era of unnecessarily prolonged military rule in the country. The political and business climate became so bad that by 1999 when the nation returned to civil rule, the new administration inherited a pariah state noted to be among the most corrupt nations of the world. Most public corporations were either dead or simply drain pipes for public resources, while the business of government itself was becoming impossible, the few factories that were available were no longer booming; the banks with their unwholesome profits where collapsing in their numbers leaving a trial of woes for both investors, shareholders, suppliers, depositors, employees, etc. It, thus, became obvious that if the President Olusegun Obasanjo led federal government would make any impact, "Corporate Government Revolution" was imperative at the levels of both the public and the private sectors.

In accepting this challenge the Obasanjo led administration spent several billions of naira not only on image laundering but also in putting into place, several institutional arrangements to ensure attitudinal change in our business and corporate life. The role of government in this matter is to properly delineate the functions/responsibilities of the various supervisory/regulatory and enforcement agencies and to strengthen them. The establishment by law, of the Independent Corrupt Practices Commission (ICPC) and the Economic and Financial Crimes Commission (EFCC) as enforcement agencies is considered a major push in the right direction. Another force in the revolution is the strengthening of Securities and Exchanges Commission (SEC), the Corporate Affairs Commission (CAC), and the Central Bank of Nigeria (CBN) all of which are major regulatory/supervisory agencies.

Also, strong and ethical corporate governance and regulations are of absolute necessity for the development of a resilient and vibrant capital market. This will go a long way to ensure that newer areas and avenues for the investment of funds evolve that will in turn encourage high returns. Thus, regulations are also necessary for the creation of competitive and efficient enterprises with particular emphasis on the need to:

- Enhance the accountability and performance of business enterprises as well as those entrusted to manage them
- Promote efficient and effective use of limited resources
- Ensure that there is transparency and accountability to the various stakeholders

- Ensure that legal and regulatory requirements are complied with
- Ensure that different stakeholders' interests are balanced with a view to ensuring convergence of interest
- Ensure that there is adequate disclosure of all pertinent information to stakeholders
- Ensure effective monitoring and management of risks, innovation and change
- Ensure that the viability and solvency of the banks are sustainable
- Ensure the safety and soundness of banks and the entire financial system
- Ensure that people have access to relevant and accurate information before they enter into financial contracts
- Ensure that the dealings in securities are fair
- Regulate dealings in markets and control commercial banking activities.

4.0 CONCLUSION

Regulation of banks is meant to serve certain purposes and objectives which include some of the following:

- maintenance/restoration of public confidence in the system
- encouragement of banking habit and culture
- instilling of competitive equity (level playing field)
- restrain in certain activities
- general consumer protection.

5.0 SUMMARY

Financial institutions regulation is the body of laws, rules directives and guidelines which are put in place, by the state and regulatory institutions in the market, for compliance/adherence by financial institutions within the market. Monetary policy refers to those measures that the government and the Centre Bank of Nigeria employ to control monetary aggregates. Nigeria as a nation has suffered a lot of decadence in various aspects of her life.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss what regulation entails.
2. Highlight the objectives of regulation.

7.0 REFRENCE/FURTHER READING

Osaze, E.B. (2007). *Capital Markets.* Lagos: The Book house Company.

UNIT 2 REGULATORY INSTITUTIONS IN THE NIGERIA FINANCIAL SYSTEM (DOMESTIC ENVIRONMENT) – CBN

CONTENTS

1.0 INTRODUCTION

The Nigerian financial institutions and indeed, the financial markets are not regulated by only one entity. Different institutions regulate different players in the various sub-sets of the financial markets. The Central Bank of Nigeria (CBN) is the apex regulatory authority in the Nigerian Banking Sector.

2.0 OBJECTIVES

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

- describe the historical background of Central Bank of Nigeria
- narrate the origin of Central Bank of Nigeria
- state the functions of Central Bank of Nigeria
- discuss the policy implementation and criticism of CBN.

3.0 MAIN CONTENT

3.1 Overview of the Background of Central Bank of Nigeria CBN)

The history of Central Bank of Nigeria includes its authorizing legislation and its origin which are discussed in the following subsections.

3.1.1 Authorizing Legislation

In 1948, an inquiry under the leadership of G.D. Paton was established by the colonial administration to investigate banking practices in Nigeria. Prior to the inquiry, the banking industry was largely uncontrolled. The G.D Paton's Report, an offshoot of the inquiry became the cornerstone of the first banking legislation in the country: the Banking Ordinance of 1952. The ordinance was designed to prevent non-viable banks from mushrooming, and to ensure orderly commercial banking. The banking ordinance triggered a rapid growth in the industry, with growth also came disappointment. By 1958, a few numbers of banks had failed. To curtail further failures and to prepare for indigenous control, in 1958, a bill for the establishment of Central Bank of Nigeria was presented to the House of Representatives of Nigeria. The Act was fully implemented on July 1, 1959, when the Central Bank of Nigeria came into full operation. In April 1960, the Bank issued its first treasury bills. In May 1961 the Bank launched the Lagos Bankers Clearing House, which provided licensed banks a framework in which to exchange and clear checks rapidly. By July 1, 1961 the Bank had completed issuing all denominations of new Nigerian notes and coins and redeemed all of the West African Currency Board's previous money.

3.1.2 The Origin of Central Bank of Nigeria

In 1892, Nigeria's first bank, the African Banking Corporation, was established. No banking legislation existed until 1952, at which point Nigeria had three foreign banks (the Bank of British West Africa, Barclays Bank, and the British and French Bank) and two indigenous banks (the National Bank of Nigeria and the African Continental Bank) with a collective total of forty branches. A 1952 ordinance set standards, required reserve funds, established bank examinations, and provided for assistance to indigenous banks. Yet for decades after 1952, the growth of demand deposits was slowed by the Nigerian propensity to prefer cash and to distrust checks for debt settlements.

British colonial officials established the West African Currency Board in 1912 to help finance the export trade of foreign firms in West Africa and to issue a West African currency convertible to British pounds sterling. But colonial policies barred local investment of reserves, discouraged deposit expansion, precluded discretion for monetary management, and did nothing to train Africans in developing indigenous financial institutions. In 1952, several Nigerian members of the Federal House of Assembly called for the establishment of a central bank to facilitate economic development. Although the motion was defeated, the colonial administration appointed a Bank of England official to study the issue. He advised against a central bank, questioning such a bank's effectiveness in an undeveloped capital market. In 1957, the Colonial Office sponsored another study that resulted in the establishment of a Nigerian central bank and the introduction of a Nigerian currency. The Nigerian pound on a par with the pound sterling until the British currency's devaluation in 1967, was converted in 1973 to a decimal currency, the naira (N), equivalent to two old Nigerian pounds. The smallest unit of the new currency was the kobo, 100 of which equaled 1 naira. The naira, which exchanged for US$1.52 in January 1973 and again in March 1982 (or N0.67=US$1), despite the floating exchange rate, depreciated relative to the United States dollar in the 1980s. The average exchange rate in 1990 was N8.004=US$1. Depreciation accelerated after the creation of a second-tier foreign exchange market under World Bank structural adjustment in September 1986. As 2014, the Naira further depreciated to N166 per $1.

The Central Bank of Nigeria, which was statutorily independent of the Federal Government until 1968, began operations on July 1, 1959. Following a decade of struggle over the relationship between the government and the Central Bank, a 1968 military decree granted authority over banking and monetary policy to the Federal Executive Council. The role of the Central Bank, similar to that of central banks in North America and Western Europe, was to establish the Nigerian currency, control and regulate the banking system, serve as banker to other banks in Nigeria, and carry out the government's economic policy in the monetary field. This policy included control of bank credit growth, credit distribution by sector, cash reserve requirements for commercial banks, discount rates and interest rates the Central Bank charged commercial and merchant banks and the ratio of banks' long-term assets to deposits. Changes in Central Bank’s restrictions on credit and monetary expansion affected total demand and income. For example, in 1988, as inflation accelerated, the Central Bank tried to restrain monetary growth. During the civil war, the government limited and later suspended repatriation of dividends and profits, reduced foreign travel allowances for Nigerian citizens, limited the size of allowances to overseas public offices, required official permission for all foreign payments, and, in January 1968, issued new currency notes to replace those in circulation. Although in 1970, the Central Bank advised against dismantling of import and financial constraints too soon after the war, the oil boom soon permitted Nigeria to relax restrictions. The three largest commercial banks held about one-third of total bank deposits. In 1973, the Federal Government undertook to acquire a 40-pe cent equity ownership of the three largest foreign banks. In 1976, under the second Nigerian Enterprises Promotion Decree requiring 60 percent indigenous holdings, the Federal Government acquired an additional 20 percent holding in the three largest foreign banks and 60 percent ownership in the other foreign banks. Yet, indigenization did not change the management, control, and lending orientation toward international trade, particularly of foreign companies and their Nigerian subsidiaries of foreign banks.

At the end of 1988, the banking system consisted of the Central Bank of Nigeria, forty-two commercial banks, and twenty-four merchant banks, a substantial increase since 1986. Merchant banks were allowed to open checking accounts for corporations only and could not accept deposits below N50, 000. Commercial and merchant banks together had 1,500 branches in 1988, up from 1,000 in 1984. In 1988, commercial banks had assets of N52.2 billion compared to N12.6 billion for merchant banks in early 1988. In 1990, the government put N503 million into establishing community banks to encourage community development associations, cooperative societies, farmers' groups, patriotic unions, trade groups, and other local organizations, especially in rural areas.

Other financial institutions included government-owned specialized development banks: the Nigerian Industrial Development Bank, the Nigerian Bank for Commerce and Industry, and the Nigerian Agricultural Bank, as well as the Federal Savings Banks and the Federal Mortgage Bank. Also active in Nigeria were numerous insurance companies, pension funds, and finance and leasing companies. Nigeria also had a stock exchange (established in Lagos in 1961) and a number of stockbrokerage firms. The Securities and Exchange Commission (SEC) Decree of 1988 gave the Nigerian SEC powers to regulate and supervise the capital market. These powers included the right to revoke stockbroker registrations and approve or disapprove any new stock exchange. Established in 1988, the Nigerian Deposit Insurance Corporation increased confidence in the banks by protecting depositors against bank failures in licensed banks up to N50,000 in return for an annual bank premium of nearly 1 per cent of total deposit liabilities.

Finance and insurance services represented more than 3 percent of Nigeria's GDP in 1988. Economists agree that services, consisting disproportionately of nonessential items, tend to expand as a share of national income as a national economy grows. However, Nigeria lacked comparable statistics over an extended period, preventing generalizations about the service sector. Statistics indicate, nevertheless, that services went from 28.9 percent of GDP in 1981 to 31.1 percent in 1988, a period of no economic growth. In 1988, services comprised the following percentages of GDP: wholesale and retail trade, 17.1 percent; hotels and restaurants, less than 1 percent; housing, 2.0 percent; government services, 6 per cent; real estate and business services, less than 1 per cent; and other services, less than 1 per cent. (Jhingan, 2004).

3.2 Functions of Central Bank of Nigeria

The functions of CBN are:

a. **Issuance of legal tender currency:** The Central Bank of Nigeria engages in currency issue and distribution within the economy. The Bank assumed these important functions since 1959 when it replaced the West African Currency Board (WACB) pound then in circulation with the Nigerian pound. The decimal currency denominations, Naira and Kobo, were introduced in 1973 in order to move to the metric system, which simplifies transactions. In 1976, a higher denomination note – N20 joined the currency profile. In 1984, a currency exchange was carried out whereby the colors of existing currencies were swapped in order to discourage currency hoarding and forestall counterfeiting. In 1991, a currency reform was carried out which brought about the phasing out of 2kobo and 5kobo coins, while the 1k, 10k and 25k coins were redesigned. In addition, the 50k and N1 notes were coined, while the N50 note was put in circulation. In the quest to enhance the payments system and substantially reduces the volume and cost of production of "legal tender notes", the N100 and N200 notes were issued in December 1999 and November 2000, respectively. Similarly, the N500 note was issued in 2001.

b. **Maintenance of Nigeria's external reserves:** In order to safeguard the international value of the legal tender currency, the CBN is actively involved in the management of the country's debt and foreign exchange.

c. **Debt management:** In addition to its function of mobilizing funds for the Federal Government, the CBN in the past managed its domestic debt and services external debt on the advice of the Federal Ministry of Finance. On the domestic front, the Bank advises the Federal Government as to the timing and size of new debt instruments, advertises for public subscription to new issues, redeems matured stocks, pays interest and principal as and when due, collects proceeds of issues for and on behalf of the Federal Government, and sensitizes the Government on the implications of the size of debt and budget deficit, among others. On external debt service, the CBN also cooperates with other agencies to manage the country's debt. In 2001, the responsibility of debt management was transferred to Debt Management Office (DMO).

d. **Foreign exchange management:** Foreign exchange management involves the acquisition and deployment of foreign exchange resources in order to reduce the destabilizing effects of short-term capital flows in the economy. The CBN monitors the use of scarce foreign exchange resources to ensure that foreign exchange disbursements and utilization are in line with economic priorities and within the annual foreign exchange budget in order to ensure available balance of payments position as well as the stability of the Naira.

e. **Promotion and maintenance of monetary stability and a sound and efficient financial system:** The effectiveness of any central bank in executing its functions hinges crucially on its ability to promote monetary stability. Price stability is indispensable for money to perform its role of medium of exchange, store of value, standard of deferred payments and unit of account. Attainment of monetary stability rests on a central bank's ability to evolve effective monetary policy and to implement it effectively. Since June 30, 1993 when the CBN adopted the market-based mechanism for the conduct of monetary policy, Open Market Operations (OMO) has constituted the pound. The decimal currency denominations, Naira and Kobo, were introduced in 1973 in order to move to the metric system, which simplifies transactions. In 1976, a higher denomination note – N20 joined the currency profile. In 1984, a currency exchange was carried out whereby, the colors of existing currencies were swapped in order to discourage currency hoarding and forestall counterfeiting. In 1991, a currency reform was carried out which brought about the phasing out of 2kobo and 5kobo coins, while the 1k, 10k and 25k coins were redesigned. In addition, the 50k and N1 notes were coined, while the N50 note was put in circulation. In the quest to enhance the payments system and substantially reduces the volume and cost of production of "legal tender notes", the N100 and N200 notes were issued in December 1999 and November 2000, respectively. Similarly, the N500 note was issued in 2001.

f. **Banker and financial adviser to the Federal Government:** The CBN as banker to the Federal government undertakes most of Federal Government banking businesses within and outside the country. The Bank also provides banking services to the State and Local Governments and may act as banker to institutions, funds or corporation set up by the Federal, State and Local Governments. The CBN also finances government in period of temporary budget shortfalls through Ways and Means Advances subject to limits imposed by law. As financial adviser to the Federal Government, the Bank advises on the nature and size of government debt instruments to be issued, while it acts as the issuing house on behalf of government for the short, medium and long-term debt instruments. The Bank coordinates the financial needs of government in collaboration with the treasury to determine appropriately the term, timing of issue and volume of instruments to raise funds for government financing.

g. **Banker and lender of last resort to banks:** The CBN maintains current account for deposit money banks. It also provides clearing house facilities through which instruments from the banks are processed and settled. Similarly, it undertakes trade finance functions on behalf of banks' customers. Finally, it provides temporary accommodation to banks in the performance of its functions as lender of last resort.

3.3 Policy Implementation and Criticism of the CBN

The CBN's early functions were mainly to act as the government's agency for the control and supervision of the banking sector, to monitor the balance of payments according to the demands of the Federal Government and to tailor monetary policy along the demands of the federal budget. The central bank's initial lack of financial competence over the finance ministry led to deferment of major economic decisions to the finance ministry. A key instrument of the bank was to initiate credit limit legislation for bank lending. The initiative was geared to make credit available to the neglected national areas such as agriculture and manufacturing. By the end of 1979, most of the banks did not adhere to their credit limits and favoured a loose interpretation of CBN's guidelines. The central bank did not effectively curtail the prevalence of short-term loan maturities. Most loans given out by commercial banks were usually set within a year. The major policy to balance this distortion in the credit market was to create a new Bank of Commerce and Industry, a universal bank. However, the new bank did not fulfill its mission.

Another policy of the bank in concert with the intentions of the government was direct involvement in the affairs of the three major expatriate commercial banks in order to forestall any bias against indigenous borrowers and consumers. By 1976, the Federal Government had acquired 40% of equity in the three largest commercial banks. The bank's slow reaction to curtail inflation by financing huge deficits of the Federal Government has been one of the sore points in the history of the central bank. Coupled with its failure to control the burgeoning trade arrears in 1983, the country was left with huge trade debts totaling $6 billion.

4.0 CONCLUSION

The Central Bank of Nigeria (CBN) plays a prominent role in economic growth and development. It plays a promotional, financial, operational, regulatory and participatory role in the money market and the capital market.

There is the need for close integration between the CBN's policies and those of the Federal Government in order to achieve macro-economic stability. There is also the need to guarantee CBN autonomy and should be insulated from interference by the government.

5.0 SUMMARY

In this unit, you learnt the history of Central Bank of Nigeria, its authorizing legislation andorigin. You also learnt the functions of Central Bank of Nigeria and its policy implementation and criticism.

6.0 TUTOR-MARKED ASSIGNMENT

Clearly state the functions of the Central Bank of Nigeria.

7.0 REFERENCES/FURTHER READING

Jhingan, M. L. (2004). *Monetary Economics.* Delhi: Vrinda Publications (P) Ltd.

Osaze, E. B. (2007). *Capital Markets.* Lagos: The Book house company.

UNIT 3 REGULATORY INSTITUTIONS IN THE NIGERIA FINANCIAL SYSTEM (DOMESTIC ENVIRONMENT) –NDIC

CONTENTS

1.0 INTRODUCTION

In this unit, we shall discuss the meaning, the historical development and functions of the Nigerian Deposit Insurance Corporation (NDIC).

2.0 OBJECTIVES

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

- trace the historical development of the NDIC
- discuss the roles of NDIC in the banking industry
- explain the essentials of banking regulation.

3.0 MAIN CONTENT

3.1 Meaning of NDIC

NDIC stands for Nigerian Deposit Insurance Corporation. The NDIC is an autonomous body which acts as a supervisory authority over licensed banks. The corporation not only provides financial guarantee to depositors but also ensures that banks comply with regulations and practices that foster safety and soundness in the market place.

3.2 Historical Background of the Nigeria Deposit Insurance Corporation (NDIC)

The history of Nigeria Deposit Insurance Corporation (NDIC) has its origin in the report of a committee set up in 1983 by the Board of Central Bank of Nigeria (CBN), to examine the operations of the banking system in Nigeria. The Committee in its report recommended the establishment of a depositors' protection fund. Consequently, the Nigeria Deposit Insurance Corporation was established through the promulgation of Decree No. 22 of 15th June 1988.

This was part of the economic reform measures taken by the then government, to strengthen the safety net for the banking sector following its liberalization policy and the introduction of the 1986 Structural Adjustment Programme (SAP) in Nigeria.

The phenomenal increase in the number of banks from 40 in 1986 to 120 in 1992 led to:

- Increased Competition amongst banks leading to sharp practices
- People of questionable integrity becoming bank owners and managers
- Inadequate Manpower
- The coming together of strange bedfellows due to the licensing requirement that banks maintain adequate geographical spread.

All these led to serious breakdown in corporate governance and boardroom squabbles. The unpredictable policy environment, downturn in the economy and political upheavals at the time, also exacerbated the difficult situation the Corporation found itself in. The banking industry was therefore, already in distress by the time the Corporation commenced operations in March 1989. NDIC operated under a difficult terrain at the time and was immediately saddled with the management of distress in the banking industry, to avert the impending systemic crises and its resultant consequences. Some of the measures undertaken by the Corporation at the time, to manage distress in the interest of the depositors and the system included:

i. Moral suasion; continuous interaction with bank managers/owners.
ii. Imposition of **holding actions** on distressed banks to restrict operations and encourage self-restructuring – about 52 distressed banks had holding actions imposed on them at that time.
iii. Rendering of financial assistance to banks; in 1989 alone, NDIC in collaboration with the CBN granted facilities to the tune of N2.3 billion to ten banks with serious liquidity problems.

iv. Takeover of management and control of 24 distressed banks between 1991 and 1996.
v. Acquisition and restructuring of seven (7) distressed banks which were handed over to new investors in 1999 and 2000
vi. Implementation of Failed Banks Decree No. 18 of 1994. At the end of 1995, about one out of every two banks in Nigeria was distressed. The Decree was intended to assist distressed banks recover their classified assets and punish the malpractices that contributed to the distress. As at June 1996, the Corporation had recovered about N3.3 billion.

3.3 Rationale for the Establishment of Deposit Insurance Scheme in Nigeria

The deposit insurance scheme was established in Nigeria in 1989 with the promulgation of an enabling legislation, Decree No. 22 of 1988.

i. There were at least four major reasons for establishing a formal bank deposit insurance scheme in Nigeria. The first was the lesson of history connected with the experience of prior bank failures in Nigeria. In the 1950s, many small depositors suffered untold hardship as twenty-one (21) out of the twenty-five (25) indigenous banks operating in Nigeria closed doors.
ii. The establishment of the Corporation was also informed by the approach which some other countries adopted to ensure banking stability. For example, Czechoslovakia which was the first country to establish a nation-wide deposit scheme in 1924 used the scheme to revitalize the country's banking system after ravages of the First World War. In addition, the scheme served to encourage saving, by increasing the safety of deposits and ensuring the best possible development of banking practice in that country. Similarly, the United States of America (USA) established the Federal Deposit Insurance Corporation (FDIC) in 1933 in response to a banking collapse and panic.
iii. Also, the Structural Adjustment Programme (SAP) embarked upon by government in 1986 was aimed at deregulating the economy in the direction of market-determined pricing. It was envisaged that since deregulation would involve the liberalisation of the bank licensing process, there would be a substantial increase in the number of licensed banks to be supervised by the CBN. The establishment of an explicit deposit insurance scheme with supervisory powers over insured institutions was expected to complement the supervisory efforts of the CBN. Indeed, since the establishment of the Corporation in 1989, it has been possible for both institutions (CBN and NDIC) to carry out routine and special examinations of licensed banks more frequently than

before, despite the increase in the number of banks. The banks are now examined more frequently prior to the establishment of the Corporation.

iv. Finally, prior to the establishment of the Corporation, government had been unwilling to let any bank fail, no matter a bank's financial condition and/or quality of management. Government feared the potential adverse effects on confidence in the banking system and in the economy following a bank failure. Consequently, government deliberately propped up a number of inefficient banks over the years, especially those banks in which state governments were the majority shareholders. Thus, government established the Corporation to administer the deposit protection scheme on its behalf and to serve as a vehicle for implementing failure resolution options for badly managed insolvent banks.

3.4 NDIC's Mandates

Deposit Guarantee: This is the most significant and distinct mandate of the Corporation. Deposit Guarantee ensures Depositors are protected against loss of their insured deposits in the event of a bank unable to meet its obligations to the depositors**.**

Bank Supervision:

- The Corporation supervises banks in order to protect depositors and to ensure safety and soundness of the banking system
- Ensures potential risk of failure is reduced
- Ensures the unsafe and unsound banking practices do not go unchecked

Failure Resolution:

- One of the primary roles of the NDIC is to ensure that failing and failed institutions are resolved in a timely and efficient manner

Bank Liquidation

- Liquidation process involves orderly and efficient closure of the failed institutions with minimum disruption to the banking system
- Cost-effective realization of assets
- Settlement of claims to Depositors, Creditors and where possible, Shareholders

3.5 Functions of NDIC

Section 2 of the NDIC Act 2006 stipulates the functions for the Corporation as follows**:**

- Insuring all deposit liabilities of licensed banks and such other financial institutions operating in Nigeria to engender confidence in the Nigerian banking system.
- Giving financial and technical assistance to eligible insured institutions in the interest of depositors.
- Guaranteeing payments to depositors, in case of imminent or actual suspension of payments by Insured Institutions up to the maximum provided for in section 20 of NDIC Act;
- Assisting monetary authorities in the formulation and implementation of policies so as to ensure sound banking practice and fair competition among insured institutions in the country;
- Pursuing any other measures necessary to achieve the functions of the Corporation provided such measures and actions are not repugnant to the objects of the Corporation.

4.0 CONCLUSION

We therefore conclude that the NDIC was established to prevent theincidence of bank failure in Nigeria,

5.0 SUMMARY

We have learnt the meaning, historical development and functions of the NDIC. In addition we have also learnt the essentials of banking regulation.

6.0 TUTOR-MARKED ASSIGNMENT

1. Outline the functions of the NDIC in the banking sector.
2. Trace the historical development of the NDIC.

7.0 REFERENCES/FURTHER READING

Alhassan, H. A. (2004): Banking Regulation as a Panacea forBank failure in Nigeria.-A Research Project submitted to theDepartment of Business Administration, University of Abuja.(un-published).

CBN /NDIC (1995).Distress in the Nigeria Financial Services Industry.A Collaborative Study.

Nwankwo, G. O. (1993). *Prudential Regulation of Nigeria Banking*.Lagos: University Press.

Osaze, E.B. (2007). *Capital Markets.* Lagos: The Book house Company.

UNIT 4 REGULATORY INSTITUTIONS IN THE NIGERIA FINANCIAL SYSTEM (DOMESTIC ENVIRONMENT) – SEC

1.0 INTRODUCTION

The Securities and Exchange Commission (SEC) is the apex regulatory institution of the Nigerian capital market. Since inception, SEC has been playing within the capital market a similar role played by the Central Bank of Nigeria in the money market.

2.0 OBJECTIVES

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

- descibe the historical development of the Security and Exchange Commission (SEC)
- State the objectives of the Securities and Exchange Commission (SEC)
- highlight the Functions of the Commission
- discuss the Composition of Membership of SEC
- narrate how Securities and Exchange Commission protects the investing public
- explain what prospectus is all about.

3.0 MAIN CONTENT

3.1 Historical Development of the Security and Exchange Commission (SEC)

The Securities and Exchange Commission (SEC) is a federal government agency established by the Securities and Exchange Commission act 71 of 1979 which was re-enacted as Decree Number 29 of 1988. Before attaining its present status, the commission had undergone a number of changes from the initial days of its progenitor, the Capital Issues Committee that had ad-hoc powers 'to Capital Issues Commission that was statutorily established by the Capital Issues Decree of 1973. As would be expected, its role with each change continued to vary over the years with the changing objective carved for its evolving structure. The policy determination of the commission is the responsibility of its board of directors, which includes the director-general of the commission as a member. The director-general in turn oversees the day-to-day administration of the commission on behalf of the board.

Generally, members of the board are chosen in consideration of their ability, experience, specialized knowledge and professional attainments in securities business in particular and the national economy in general.

At inception, the staff of the commission was drawn from the Central Bank, (an inevitable fact of its history). But since attaining separate existence, it has recruited more professionals in the accountancy, economics, finance, statistics and law, in addition to administrative, clerical and secretarial staff. Administratively, the commission is divided into departments headed by departmental directors and divisions under divisional heads, who must be at least of managerial status. In broad terms, the main functions of the commission are to regulate and develop the Nigerian capital market in order to achieve its wider objectives of investor protection and capital market development toward enhanced socio-economic development. The pursuit of these broad objectives involves:

- Full disclosure requirements by operators and issuers in the market.
- Regulation of trading in securities through market surveillance activities. Registration of securities and institutions in the market.
- Public enlightenment, research and general education about securities industry.
- Creating the necessary atmosphere for the orderly growth and development of the capital market.

- Investigation of complaints and suspected breaches of the securities laws and,
- Making of rules to direct the market towards a desired course.

Apart from the Securities and Exchange Commission decree of 1988, which the commission administers, it also operates within the provisions of other statutory enactment's that relate to securities business, corporate finance and investments in Nigeria. Significant among these are the companies and allied matters decree, 1990 which vests the administration of unit trust schemes in the SEC, the trustee investments acts of 1957 and 1962, and the technical committee and privatization and commercialization decree of 1988.

As a statutory corporation under the supervision of the federal finance ministry, the commission submits reports of its activities annually to the ministry. Despite its now familiar public enlightenment strategy for broadening awareness, a certain level of ignorance still exists about the commission, its functions, roles and place in the Nigerian socio-economic set-up.

3.2 Objectives of the Security and Exchange Commission (SEC)

The basic objectives of the commission are:

- Investor protection, and
- Capital market development towards enhanced socio-economic growth and development.

The need for investor protection emanates from the nature of financial assets and financial services industry itself. The former, for instance, cannot have their worth determined by ordinary physical examination, like most other products do. Financial services on the other hand, are perceived to be terse and intricate. It is therefore more difficult for investors to evaluate with any degree of confidence, the quality of the services and products that are offered. It is equally not easy for a single investor to gain access to all the relevant information he may need in order to make an informed and rational investment decision.

The objective of investor protection is to ensure that issuers of financial instruments provide investors with relevant, timely and adequate information about securities and institutions that are subject of public issues. Secondly, such protection is pursued to prevent fraudulent practices such as false claims, deceit, price manipulation and unfair use of undisclosed price sensitive information that could dent public confidence in the securities business.

By and large, the rules and regulations of the commission have been formulated to guide all market operations and operators with the aim of offering far-reaching protection to all investors, whether local or foreign.

Capital market development on the other hand, involves creating general awareness about the market as an important source of investment finance and therefore, a catalyst for rapid socio-economic advancement. Capital market development has involved research activities aimed at improving market efficiency and competitiveness as well as introducing new instruments and initiating policies with positive implications for the market. The commission ensures that it balances regulation with development and progressive ideas.

As the apex regulatory body for the capital market, the SEC is the principal adviser to the Nigerian government on capital market issues and is in this regard, called upon to give from time to time opinions on related subjects.

3.3 Composition of Membership of SEC

(a) A Chairman
(b) One person not below the rank of Director to represent the Federal Ministry of Finance.
(c) One person not below the rank of Director to represent the Central Bank of Nigeria.
(d) Two full time Commissioners who shall be persons with ability, experience and specialized knowledge in capital market matters.
(e) The Director-General of the Commission; and
(f) Five other Commissioners who shall be persons with proven ability and expertise in corporate matters generally.

3.4 Functions of Securities and Exchange Commission

(a) Determining the price at which Securities are to be sold, the amount to be sold as well as the appropriate time to issue the securities either through offer for sale or offer for subscription.
(b) Registration of Securities proposed for offer for sale or offer for subscription.
(c) Maintaining surveillance over the securities market to ensure orderly, fair and equitable dealings in securities.
(d) Registering stock exchange or their branches, registrars, securities dealers and other capital market operators with a view to maintaining proper standards of and professionalism in the securities business.
(e) Protect the integrity of the securities market against any abuse

arising from the practice of insider trading.

(f) Acting as regulatory apex organisation for the Nigerian Stock exchange and its branches to which it would be at liberty to delegate power.

(g) Reviewing, appointing and regulating of business combination.

(h) Creating the necessary atmosphere for the orderly growth and development of the capital market.

3.5 How Does Securities and Exchange Commission Protect The investing Public?

The Securities and Exchange Commission protects the investing public by ensuring that companies make:

(a) Full disclosure in prospectus.
(b) Adequate and timely financial reporting.
(c) Fair and equitable issuance of securities.
(d) Fair trading practice.

3.6 Prospectus

A company issuing securities either through offer for sale or offer for Subscription is expected to submit a prospectus to Securities and Exchange Commission (through its issuing house) detailing information about the offer.

The prospectus often shows the following information:

(a) Summary of the offer:

a. Name of the company
b. Number of shares being offered
c. Nominal price and offer price
d. Market capitalization of the company (at offer price)
e. Market capitalization of the offer (at offer price)
f. Share capital (authorized issued)
g. Forecast EPS, Earnings Yield, dividend and dividend yield.

(b) Parties to the offer:

- Names of directors
- Company Secretary
- issuing houses
- stockbrokers
- Solicitors
- reporting accountants
- auditors and registrar.

(c) Chairman's Letter:

- Purposes of the offer
- History and business of the company
- Company's management staff
- Staff training, industrial relations and welfare
- Staff pensions
- Future expansion programmes.

(d) The Profit Forecast:

- Forecast PBT, PAT, Reserves, Dividend and Retained profit.
- Assumptions on which the forecast is based
- Reporting Accountant's letter relating to the following.
  - (i) Review of accounting policies used for the forecast.
  - (ii) Review of the calculations of the forecast
  - (iii) Review of the reasonableness of the assumptions
  - (iv) Review of the consistency in the application of accounting policies.
- Issuing House letter with respect to:
  - (i) Discussion with the directors of the company and reporting accountant with respect to assumptions, calculations and accounting policies used for the forecast.
  - (ii) Acceptance of responsibility by the Directors for the forecast.

(e) Accountant's Report (content):

- A letter expressing opinion on the following:
  - (i) Examination of audited accounts for five years
  - (ii) Financial statements are prepared from audited accounts after making necessary adjustments.
  - (iii) Whether the financial statements show true and fair view and comply with CAMD and accounting standards.
  - (iv) Name of company auditor.
- Five-year financial summary of P & L, Balance sheet, Statements of sources and applications of funds.
- Schedule of adjustments (e.g with respect to Extra-ordinary items, prior year adjustments etc.).

(f) Statutory and General Information:

- Incorporations and capital history
- Extract from Memorandum and Articles of Association
- Company's borrowing power
- Material contracts.
- Claims and pending litigations.

4.0 CONCLUSION

We have seen in this unit the historical background of SEC, the functions of SEC, how SEC protects the investors as well as what Prospectus Document is all about.

5.0 SUMMARY

In this unit, you have learnt the historical development of the Security and Exchange Commission (SEC), its objectives, the functions of the Commission and the composition of membership of SEC. We have also explained how Securities and Exchange Commission protects the investing public and what prospectus is all about.

6.0 TUTOR MARKED ASSIGNMENT

1. State five functions of SEC.
2. Explain how SEC protects the investing public.

7.0 REFERENCE/FURTHER READING

Osaze, E. B. (2007). *Capital markets.* Lagos: The Book housecompany.

UNIT 5 NATIONAL INSURANCE COMMISSION (NAICOM)

CONTENTS

3.0 MAIN CONTENT

3.1 Historical Background of NAICOM

The National Insurance Commission was established in 1997 by NAICOM Act Number 1 of 1997 with the main objective of enhancing the effective administration, supervision, regulation and control of insurance business in Nigeria.

3.2 Services Rendered by NAICOM

NAICOMwas established to render the following services:

i. Establish standards for the conduct of insurance business in Nigeria.
ii. Approve rates of insurance premiums to be paid in respect of all classes of Insurance business.
iii. Approve rates of commissions to be paid in respect of all classes of insurance business.
iv. Ensure adequate protection of strategic government assets and other properties.
v. Regulate transactions between insurers and reinsurers in Nigeria and those outside Nigeria.
vi. Act as adviser to the Federal Government on all insurance related matters.
vii. Approve standards, conditions and warranties applicable to all classes of insurance business.
viii. Protect insurance policy-holders and beneficiaries and third parties to insurance contracts.
ix. Publish for sale and distribution to the public, annual reports and statistics on the insurance industry.

x. Liaise with and advise Federal Ministries, Extra Ministerial Departments, statutory bodies and other government agencies on all matters relating to insurance contained in any technical agreement to which Nigeria is a signatory.

xi. Contribute to the educational programmes of the Chartered Insurance Institute of Nigeria and the West African Insurance Institute.

Services Rendered to Customers by the Commission

NAICOM rendersservice to the insurance industry, i.e. insurance and re-insurance companies, insurance brokers, insurance loss adjusters and agents. It also renders service to the insuring public at large, government (federal, state and local).

3.3 Performance Target and Customer Expectations

i. To work towards peaceful, orderly and well-regulated insurance industry. Claim payment within three (3) months or ninety (90) days.

ii. Registration of companies within two (2) months or sixty (60) days.

4.0 CONCLUSION

We have seen in this unitthe brief origin of NAICOM, the array of services rendered by the Commission as well as the performance targets and the customer expectations especially, in terms of competition and efficient service delivery.

5.0 SUMMARY

You have learnt in this unitthe brief origin of NAICOM, the array of services rendered by the Commission as well as the performance targets and the customer expectations especially, in terms of competition and efficient service delivery.

6.0 TUTOR-MARKED ASSIGNMENT

State five services rendered by NAICOM.

7.0 REFERENCE/FURTHER READING

Osaze, E.B. (2007). *Capital Markets.* Lagos: The Book house Company

MODULE 3 INTERNATIONAL DIMENSIONS OF FINANCIAL REGULATION

UNIT 1 INTERNATIONAL FINANCIAL MARKET DIFFICULTIES

CONTENTS

1.0 INTRODUCTION

The globalization of financial markets constitutes a major challenge to the regulation of financial activities and institutions which continues to be carried out by national governments. It creates several problems for which solutions are not easy to implement.

2.0 OBJECTIVES

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

- state international financial market difficulties
- explain possible remedial actions for the identified issues.

3.0 MAIN CONTENT

3.1 International Financial Market Difficulties

i. First, due to the growing interdependence in international financial markets financial difficulties experienced in one country can easily spill over to other countries. A systemic crisis in one country and the failure of its authorities to deal with it appropriately may lead to a global banking crisis.

ii. Second, regulation can be considered as a tax and can have an impact on the international competitiveness of financial institutions. Different regulatory regimes may also create barriers for firms in cross-border trade in financial services. For instance, different capital requirements create an unleveled playing field between financial institutions of different countries.

iii. Third, financial institutions may attempt to avoid more stringent domestic regulation by locating abroad. Regulatory arbitrage impairs the effectiveness of regulation and the ability of different countries to maintain their own regulatory framework. Regulatory competition may eventually lead to a downward regulatory spiral. As is demonstrated in a game-theoretic framework by taking into account the special informational characteristics of financial products and the role of reputation in the banking industry there may, however, be limits to this process. In particular in retail markets where financial integration is far less complete there remain upward regulatory pressures. Countries will be able to maintain regulatory measures as a signal of quality differentiation provided that they are valued by customers.

3.2 Possible Remedies

The concern for the distortion of international competition certainly has been a major driving force behind attempts towards worldwide solutions for financial regulation. Recent international financial crises are increasing the urge for an international approach. International market integration also helps to explain the recent shift of emphasis from structural towards prudential regulation.

Through efforts of international coordination an answer is sought for the questions of what should be the right of access to foreign markets, and whose rules should apply in international financial services. In this respect a tendency is observed to give branches and subsidiaries of foreign banks the same treatment as domestic banks. For cross-border transactions of financial intermediaries it is proposed that they should be monitored by the home country. Regulation and coordination can be limited as banks should be allowed to develop their own risk-assessment procedures which should only be subject to regulatory review.

Taking into account the concern for the threat of complete deregulation, however, stronger forms of international harmonization are also being envisaged. The European Union has linked policies of mutual recognition and home country control rules with agreements on minimum standards of conduct. The Basel Committee on Banking Supervision has laid down common bank capital rules. These minimum standards continue to be enforced by individual countries. They are, however, being criticized for their arbitrariness and potential inflexibility.

Finally, faced with the increasing need for worldwide regulation, an agreement that extends beyond the Basle countries on a set of minimum capital standards, as Goldstein (1997) has argued for may be eventually attained. But international cooperation beyond these minimal standards remains a difficult issue. In particular, faced with the fragmented supervision by many agencies to be multiplied by the number of countries, the prospects for international cooperation to reinforce supervision remain bleak. These difficulties to agree on the international dimension of financial regulation and supervision are enhancing the overall trend towards greater emphasis on discipline by the market rather than by regulators.

4.0 CONCLUSION

In the face of the possibility of a worldwide systemic crisis the lender of last resort function still remains largely the endeavor of national central banks. Whether emergency liquidity assistance should be provided not only for banks but also for other financial intermediaries, and whether the lender of last resort function should be provided at the international level, remain heavily debated issues.

5.0 SUMMARY

You have learnt in this unit that the major International financial market difficulties as well possible remedial actions for the identified issues.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss briefly three international financial difficulties.

7.0 REFERENCES/FURTHER READING

Afifia-Oru, B. (2009). *Dynamics of credit economic system in Africa*. Lagos: Byolah Concepts ltd.

Central Bank of Nigeria (2011). Understanding Monetary Policy Series No 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy andDirect controls, retrieved from www.yourarticlelibrary.com/eco

Dirk, H. (1999). Regulations of banking and financialmarket, Encyclopedia of Law & Economics.

Osaze, E.B. (2007). *Capital Markets.* Lagos: The Book house Company.

UNIT 2 REGULATORY INSTITUTIONS IN THE INTERNATIONAL ENVIRONMENT-INTERNATIONAL MONETARY FUND (IMF)

CONTENTS

1.0 INTRODUCTION

In this unit, you will learn the meaning of international monetary fund (IMF), its functions and its surveillance of the global economy. You will also study the structural adjustment, the benefits of IMF loan conditions, a critique of IMF conditionality and the qualifications for IMF membership.

2.0 OBJECTIVES

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

- explain the Meaning of International Monetary Fund (IMF)
- list the Functions of International Monetary Fund (IMF)
- analyse the Criticisms of IMF Conditionality
- understand the Benefits of MF Loan Conditions.

3.0 MAIN CONTENT

3.1 Meaning of International Monetary Fund (IMF)

The International Monetary Fund (IMF) is an international organization that was initiated in 1944 at the Bretton Woods Conference and formally created in 1945 by 29 member countries. The IMF's stated goal was to assist in the reconstruction of the world's international payment system post-World War II. Countries contribute money to a pool through a quota system from which countries with payment imbalances can borrow funds temporarily. Through this activity and others such as surveillance of its members' economies and the demand for self-correcting policies, the IMF works to improve the economies of its member countries (Escobar, 1980).

The IMF describes itself as “an organization of 188 countries, working to foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world” (IMF, 2012). The organization's stated objectives are to promote international economic co-operation, international trade, employment, and exchange rate stability, including by making financial resources available to member countries to meet balance of payments needs. Its headquarters are in Washington, D.C., United States.

3.2 Functions of International Monetary Fund (IMF)

The IMF works to foster global growth and economic stability. It provides policy advice and financing to members in economic difficulties and also works with developing nations to help them achieve macroeconomic stability and reduce poverty. The rationale for this is that private international capital markets function imperfectly and many countries have limited access to financial markets. Such market imperfections, together with balance of payments financing, provide the justification for official financing, without which many countries could only correct large external payment imbalances through measures with adverse effects on both national and international economic prosperity (Isard, 2005).The IMF can provide other sources of financing to countries in need that would not be available in the absence of an economic stabilization program supported by the fund.

Upon initial IMF formation, its two primary functions were: to oversee the fixed exchange rate arrangements between countries, thus helping national governments manage their exchange rates and allowing these governments to prioritize economic growth, and to provide short-term capital to aid balance of payments. This assistance was meant to prevent the spread of international economic crises. The Fund was also intended to help mend the pieces of the international economy post the great depression and World War II.

The IMF’s role was fundamentally altered after the floating exchange rates post 1971. It shifted to examining the economic policies of countries with IMF loan agreements to determine if a shortage of capital was due to economic fluctuations or economic policy. The IMF also researched what types of government policy would ensure economic recovery (Jensen, April 2004). The new challenge is to promote and implement policy that reduces the frequency of crises among the emerging market countries, especially the middle income countries that are open to massive capital outflows. Rather than maintaining a positive of oversight of only exchange rates, their function became one of “surveillance” of the overall macroeconomic performance of its member countries. Their role became a lot more active because the IMF now manages economic policy instead of just exchange rates.

In addition, the IMF negotiates conditions on lending and loans under their policy of conditionality, which was established in the 1950s. Low-income countries can borrow on concessional terms, which mean there is a period of time with no interest rates, through the Extended Credit Facility (ECF), the Standby Credit Facility (SCF) and the Rapid Credit Facility (RCF). Non-concessional loans, which include interest rates, are provided mainly through Stand-By Arrangements (SBA), the Flexible Credit Line (FCL), the Precautionary and Liquidity Line (PLL), and the Extended Fund Facility. The IMF provides emergency assistance via the newly introduced Rapid Financing instrument (RFI) to all its members facing urgent balance of payments needs.

3.3 Surveillance of the Global Economy

The IMF is mandated to oversee the international monetary and financial system and monitor the economic and financial policies of its 188 member countries. This activity is known as surveillance and facilitates international co-operation. Since the demise of the Bretton Woods system of fixed exchange rates in the early 1970s, surveillance has evolved largely by way of changes in procedures rather than through the adoption of new obligations. The responsibilities of the Fund changed from those of guardian to those of overseer of members' policies.

The Fund typically analyses the appropriateness of each member country's economic and financial policies for achieving orderly economic growth, and assesses consequences of these policies for other countries and for the global economy.

3.4 Conditionality of loans

IMF conditionality is a set of policies or conditions that the IMF requires in exchange for financial resources. The IMF does not require collateral from collateral economic but rather requires the government seeking assistance to correct its macroeconomic imbalances in the in the form of policy reform. If the conditions are not met, the funds are withheld. Conditionality is perhaps the most controversial aspect of IMF policies. The concept of conditionality was introduced in an Executive Board decision in 1952 and later incorporated in the Articles of Agreement.

Conditionality is associated with economic theory as well as an enforcement mechanism for repayment. Stemming primarily from the work of Jacques Polak in the Fund's research department, the theoretical underpinning of conditionality was the “monetary approach to the balance of payments" (Chorev and Babb, June 2009).

3.5 Structural Adjustment

Some of the conditions for structural adjustment include:

- Cutting expenditures, also known as austerity measure.
- Focusing economic output on direct export and resource extraction.
- Devaluation of currencies.
- Trade liberalization, or lifting import and export restrictions.
- Increasing the stability of investment (by supplementing foreign direct investment with the opening of domestic stock markets).
- Balancing budgets and not overspending.
- Removing price controls and state subsidies.
- Privatization or divestiture of all or part of state-owned enterprises.
- Enhancing the rights of foreign investor’s vis-a-vis national laws.
- Improving governance and fighting corruption.

These conditions have also been sometimes labeled as the Washington Consensus.

3.6 Benefits of MF Loan Conditions

These loan conditions ensure that the borrowing country will be able to repay the Fund and that the country won't attempt to solve their balance of payment problems in a way that would negatively impact the international economy. The incentive problem of moral hazard which is the actions of economic agents maximizing their own utility to the detriment of others when they do not bear the full consequences of their actions, is mitigated through conditions rather than providing collateral; countries in need of IMF loans do not generally possess internationally valuable collateral anyway.

Conditionality also reassures the IMF that the funds lent to them will be used for the purposes defined by the Articles of Agreement and provides safeguards that country will be able to rectify its macroeconomic and structural imbalances. In the judgment of the Fund, the adoption by the member of certain corrective measures or policies will allow it to repay the Fund, thereby ensuring that the same resources will be available to support other members.

Why did Nigeria opt for structural adjustment instead of IMF loan during regime?

3.7 Criticisms of IMF Conditionality

In some quarters, the IMF has been criticized for being 'out of touch' with local economic conditions, cultures, and environments in the countries they are requiring policy reform. The Fund knows very little about what public spending on programs like public health and education actually means especially in African countries; they have no feel for the impact that their proposed national budget will have on people. The economic advice the IMF gives might not always take into consideration the difference between what spending means on paper and how it is felt by citizens.

It has been said that the IMF's role as a generalist institution specializing in macroeconomic issues needs reform. Conditionality has also been criticized because a country can pledge collateral of "acceptable assets" to obtain waivers on certain conditions. However, that assumes that all countries have the capability and choice to provide acceptable collateral.

One view is that conditionality undermines domestic political institutions. The recipient governments are sacrificing policy autonomy in exchange for funds, which can lead to public resentment of the local leadership for accepting and enforcing the IMF conditions. Political instability can result from more leadership turnover as political leaders are replaced in electoral backlashes. IMF conditions are often criticized for their bias against economic growth and reduce government services, thus increasing unemployment.

Another criticism is that IMF programs are only designed to address poor governance, excessive government spending, excessive government intervention in markets, and too much state ownership. This assumes that this narrow range of issues represents the only possible problems; everything is standardized and differing contexts are ignored A country may also be compelled to accept conditions it would not normally accept had they not been in a financial crisis in need of assistance.

It is claimed that conditionality inhibit the stated goals of the IMF, while Structural Adjustment Programs lead to an increase in poverty in recipient countries. The IMF sometimes advocates "austerity Programmes", cutting public spending and taxes even when the economy is weak, to bring budgets closer to a balance, thus reducing budget deficits. Countries are often advised to lower their corporate tax rate. In *Globalization and its Discontents*, Joseph E. Stiglitz, former chief economist and senior Vice president at the World Bank, criticizes approach, the purpose of the fund is no longer valid, as it was designed to provide funds for countries to carry out Keynesian reflections, and that the IMF "was not participating in a conspiracy, but it was reflecting the interests and ideology of the western financial community" (Friedman 2002).

3.8 Qualifications for Membership

Any country may apply to be a part of IMF. In the early postwar period, rules for IMF membership were left relatively loose, Members needed to make periodic membership payments towards their quota, to refrain from currency restrictions unless granted IMF permission, to abide by the Code of Conduct in the IMF Articles of Agreement, and to provide national economic information. However, stricter rules were imposed on governments that applied to the IMF for funding.

The countries that joined the IMF between 1945 and 1971 agreed to keep their exchange rates secured at rates that could be adjusted only to correct a fundamental disequilibrium in the balance of payments, and only with the IMF's agreement. Some members have a very difficult relationship with the IMF and even when they are still members they do not allow themselves to be monitored, Argentina for example refuses to participate in an Article IV Consultation with the IMF.

In terms of benefit, member countries of the IMF have access to information on the economic policies of all member countries, the opportunity to influence other members' economic policies, technical assistance in banking, fiscal affairs, andexchange matters, financial support in times of payment difficulties, and increased opportunities for trade and investment.

3.9 Leadership of IMF

IMF organs consist of Board of Governors, Executive Board and the Managing director.

3.9.1 Board of Governors

The Board of Governors consists of one governor and one alternate governor for each member country. Each member country appoints its two governors. The Board normally meets once a year and is responsible for electing or appointing executive directors to the Executive Board. While the Board of Governors is officially responsible for approving quota increases, Special drawing right allocations, the admittance of new members, compulsory withdrawal of members, and amendments to the Articles of Agreement and By-Laws, in practice it has delegated most of its powers to the IMF's Executive Board.

The Board of Governors is advised by the International Monetary and Financial Committee and the Development Committee. The International Monetary and Financial Committee have 24 members and monitors developments in global liquidity and the transfer of resources to developing countries. The Development Committee has 25 members and advises on critical development issues and on financial resourcesrequired to promote economic development in developing countries, they also advise on trade and global environmental issues.

3.9.2 Executive Directors

24 Executive Directors make up Executive Board. The Executive Directors represent all 188 member-countries. Countries with large economies have their own Executive Director, but most countries are grouped in constituencies representing four or more countries.

Following the 2008 Amendment on Voice and Participation, eight countries each appoint an Executive Director: the United States, Japan, Germany, France, the United Kingdom, China, the Russian Federation, and Saudi Arabia. The remaining 16 directors represent constituencies consisting of 4 to 22 countries. The Executive Director representing the largest constituency of 22 countries accounts for 1.55% of the vote.

3.9.3 Managing Director

The IMF is led by a managing director, who is head of the staff and serves as Chairman of the Executive Board. The managing director is assisted by a first deputy managing director and three other deputy managing directors. Historically the IMF's managing director has been European and the president of the World Bank has been from the United States. However, this standard is increasingly being questioned and competition for these two posts may soon open up to include other qualified candidates from any part of the world.

In 2011 the world's largest developing countries, the BRIC nations, issued a Statement declaring that the tradition of appointing a European as managing director undermined the legitimacy of the IMF and called for the appointment to be merit-based. The head of the IMF's European department is António Borges of Portugal, former deputy governor of the Bank of Portugal. He was elected in October 2010.

3.10 Voting Power

You should note that voting power in the IMF is based on a quota system. Each member has a number of "basic votes" (each member's number of basic votes equals 5.502% of the total votes), plus one additional vote for each Special Drawing Right (SDR) of 100,000 of a member country's quota. The Special Drawing Right is the unit of account of the IMF and represents a claim to currency. It is based on a basket of key international currencies. The basic votes generate a slight bias in favor of small countries, but the additional votes determined by SDR outweigh this bias.

3.10.1 Effects of the Quota System

The IMF's quota system was created to raise funds for loans. Each IMF member country is assigned a quota, or contribution, that reflects the country's relative size in the global economy. Each member’s quota also determines its relative voting power. Thus, financial contributions from member governments are linked to voting power in the organization. This system follows the logic of a shareholder controlled organization: wealthy countries have more say in the making and revision of rules. Since decision making at the IMF reflects each member's relative economic position in the world, wealthier countries that provide more money to the fund have more influence in the IMF than poorer members that contribute less; nonetheless, the IMF focuses on redistribution.

4.0 CONCLUSION

The IMF is only one of many international organizations and it is a generalist institution for macroeconomic issues only; its core areas of concern in developing countries are very narrow. One proposed reform is a movement towards close partnership with other specialist agencies to better productivity. The IMF has little to no communication with other international organizations such as UN specialist agencies like UNICEF, the Food and Agriculture Organization (FAO), and the United Nations Development Program (UNDP).

International institutions like the International Monetary Fund (IMF) and the World Bank have the brightest economists and the lead in advising poor countries on how to break out of poverty, but the problem is development economics. Development economics needs the reform, not the IMF. It should also be noted that IMF loan conditions need to be partnered with other reforms such as trade reform in developed nations, debt cancellation, and increased financial assistance for investments in basic infrastructure to be effective. IMF loan conditions cannot stand alone and produce change; they need to be partnered with other reforms or other conditions as applicable.

5.0 SUMMARY

In this unit, you learnt the meaning of international monetary fund (IMF), its functions and its surveillance of the global economy. You also studied the structural adjustment, the benefits of IMF loan conditions, a critique of IMF conditionality and the qualifications for IMF membership. Other sub-topics covered by you in this unit were the leadership of IMF, its Board of Governors, and the voting power of IMF members and effects of the quota system.

With the discussion of IMF in this unit, the study of the African Development Bank will be the focus of the next unit.

6.0 TUTOR-MARKED ASSIGNMENT

1. Why does IMF provides policy advice and financing to members in economic difficulties and also works with developing nations to help them achieve macroeconomic stability and reduce poverty?
2. IMF conditions are often criticized for their bias against economic growth. Discuss.

7.0 REFERENCES/FURTHER READING

Chorev, N. & Babb, S. (2009). “The crisis of neoliberalism and the future of international institutions: a comparison of the IMF and the WTO”. *Springer Science and Business Media*.

Escobar, A. (1980).Power and visibility: Development and the invention and management of the third world. *Cultural Anthropology* 3 (4), 428-443.

IMF (2012). About the IMF". International Monetary Fund Home Page. Retrieved on 14 October 2012 from https://www.imf.org/external/about.htm.

lsard, P. (2005). Globalization and the International Financial System: What's Wrong and What Can be Done. New York: Cambridge University Press.

Jensen, N. (April 2004). "Crisis, Conditions, and Capital: The Effect of the IMF on Foreign Direct Foreign Investment". *Journal of Conflict Resolution* 48 (48): 194.

Osaze, E.B. (2007). *Capital Markets.* Lagos: The Book house Company.

Stiglitz, J. (2002). *Globalization and its Discontents*. New York: WW Norton & Company.

Friedman, B. M. (15 August 2002). "Globalization: Stiglitz's Case". Nybooks.com. Retrieved 30 May 2010.

UNIT 3 THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT (IBRD) OR THE WORLD BANK

CONTENTS

1.0 INTRODUCTION

In the preceding unit**,** we learnt the African Development Bank Group (ADB), its history, entities, functions, management and control, status, and membership. You also learnt the recent trends and directions of the African Development Bank (ADB) and its support of Regional Member Countries (RMCs) through the fight against HIV/AIDS.

In this unit, we shall discuss the International Bank for Reconstruction and Development otherwise called the World Bank. You should note that the World Bank is different from the World Bank Group which we shall discuss in the last unit of this course, that is, Unit 5.

2.0 OBJECTIVES

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

- discuss the formation of the World Bank or the IBRD
- analyze the functions of the World Bank
- state the purposes of the World Bank
- describe the resources of the World Bank
- describe the lending procedure of the World Bank
- highlight the general provisions regarding World Bank loans and guarantees

- describe the World Bank structural adjustment loans
- undertake a critique against the World Bank policies.

3.0 MAIN CONTENT

3.1 The Formation of the World Bank or the IBRD

Like the International Monetary fund (IMF), the International Bank for Reconstruction and Development (IBRD) or simply the World Bank was also formed at the United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire, U.S.A. 1-22 July 1944. The Bank was meant to take care of the long-term economic problems of member-nations. Such aims for its creations are to:

- help the war-torn nations in the reconstruction of their economies
- help the vast underdeveloped world in accelerating the pace of economic growth.

By 1988, the Bank's membership stood at 151 countries. Its headquarters is in Washington D.C. and maintains 40 offices throughout the world.

The five institutions of the World Bank are the International Bank for Reconstruction and Development (IBRD), International Development Association (IDA), International Finance Corporation (IFC), Multilateral Guarantee Agency (MIGA), and International Centre for the Settlement of Investment Disputes (ICSID).

The World Bank's projects and operations are designed to support low-income and middle-income countries' poverty reduction strategies. The Bank provides low-interest loans, interest-free credits and grants to developing countries for a wide array of purposes that include investments in disaster recovery and risk mitigation, education, health, infrastructure, financial and private sector development, and environmental and natural resource management. Although the World Bank has traditionally played a key role in post-disaster recovery and reconstruction, it has been increasing its involvement in longer term disaster risk reduction. The overarching objective is to mainstream disaster risk reduction and climate change adaptation in country development strategies.

The World Bank supports country development strategies, such as Poverty Reduction Strategies (PRSP), Country Assistance Strategies (CAS), United Nations Development Assistance Frameworks (UNDAFs), and National Adaptation Programmes of Action (NAPAs), to reduce vulnerabilities to natural hazards. This is done through providing analytical, technical and operational support to countries for disaster risk reduction.

3.2 The Functions of the World Bank

The functions of the World Bank are:

i. Reconstruction of the war-devastated economies and development of economically backward countries through investment and capital accumulation and through use ofproductive capacity for production of civilian goods and services.
ii. To achieve the above objective through promotion of foreign private investment by means of guarantees or participation in loans and other investments made by private investors; and in case of non-availability of private capital at reasonable terms, to supplement private investment by providing, on suitable conditions, finance for productive purposes out of its own resources.
iii. To promote long-term balanced growth of international trade and maintenance of equilibrium in balance of payments by encouraging international investment for the development of productive resources of the members, thereby assisting in raising the standard of living.
iv. To assist in bringing about a smooth transition from a war-time to a peace-time economy.
v. To encourage that the more useful and urgent projects are dealt with first.
vi. To underwrite loans to developing nations.
vii. Renders technical assistance to LDCs.
viii. To comment on the financial buoyancy and credit-worthiness of a borrowing nations through its expertise and understanding of financial matters. It issues certificates of credit-worthiness and these are acceptable and respectable the world-over.
ix. It can also borrow money from member nations (advanced, rich nations) to finance its own loans.

3.3 The Purposes of the World Bank

It is important to note that the Bank has certain regional offices to serve the following purposes:

i. To help the Bank in maintaining and improving the effectiveness of its development assistance.
ii. To bring the ‘sectors experts’ and ‘country experts’ closer to each other thus helping the Bank in better understanding of the needs, opportunities and problems of the member countries.

iii. To permit an optimum utilization of the Bank staff in preparing, appraising and implementing projects. Its loans are medium- and long-term in nature.

3.4 Resources of the World Bank

The World Bank has three main sources of funds viz:

a. **Its own capital (i.e. authorized capital):** This is made up of subscribed capital, paid-in capital, and amounts subject to call. Thus, it is divided into three parts:
   (i) 2 per cent of the subscribed capital is payable by the subscriber in the form of U.S. dollars or gold and is available to the Bank for lending other uses.
   (ii) 18 per cent of subscription is payable in member's own currency and is available to the Bank for lending with the consent of the member whose currency is involved.
   (iii) The remainder (80 per cent) is not payable for lending, rather it can be called only for meeting the obligations of the Bank arising out of its borrowing or guaranteeing of loans.
b. **Retained Earnings:** A proportion of the Bank's retained earnings (net) are transferred in the form of grants to one of its affiliates, IDA, and the balance transferred to the General and Special Resources.
c. **Borrowings:** This forms the largest sources of the Bank's funds for lending and the major sources of borrowing are the international capital markets of the capital-rich members (through the issue of AAA rating bonds).

3.5 Lending Procedure of the World Bank

Loans rather than grants are given to needy member-nations at rates close to the market interest rates. Such loans come in the following forms:

a. The IBRD may give loans out of its own paid-in capital and retained earnings.
b. The Bank can guarantee in whole or in part loans made by private investors through the usual investment channels. Such guarantees attract a guarantee commission to the Bank.
c. The Bank may borrow from the capital markets of the world on the strength of its own credit-worthiness and in turn give loans to its borrowers. In this way, it acts as a bridge between the capital-surplus and capital-deficit areas of the world.

3.6 General Provisions Regarding Loans and Guarantees

The Bank can make loans or can guarantee them subject to the following conditions:

i. With the exception of loans given to the IFC, every loan must be made to or guaranteed by the member-government (or other competent authority) on its behalf acceptable to the World Bank, in whose territory the project to be financed is located.
ii. The World Bank ensures that the borrower and the guarantor have the paying capacity.
iii. It lends only for productive purposes and in non-military projects.
iv. It must ensure that the project to be financed will be able to provide a return commensurate with the amount of investment, i.e., its return must be enough to service its debt obligations and show a surplus thereafter.
v. Except in special circumstances, the World Bank loans are for specific projects.
vi. A loan made for a project cannot be diverted to any other use.
vii. Only economic considerations inform the Bank's decision to give loans.
viii. The World Bank satisfies itself that in the prevailing market conditions the borrower would be unable otherwise to obtain loans under conditions which in the opinion of the Bank are reasonable for the borrower.
ix. There must be a written report, prepared by a competent committee after careful study of the merits of the proposal, recommending the project.
x. The World Bank normally gives a loan only to cover the foreign exchange component of the project, though in special circumstances a part of the local cost may also be financed by the Bank's loan.
xi. The World Bank deals only with member governments, their Central Banks or some other competent agency.
xii. The loan must be spent in the economies of member-nations.
xiii. A project slated for financing must be able to contribute to the economic development of the borrowing member- nation.
xiv. The Bank has the right to determine the loan amount and conditions though it has to satisfy itself that the interest rate and other charges are reasonable and appropriate to the project.
xv. The loan amount or guarantee is not limited by the member's subscribed capital.
xvi. Amortization and interest must be paid in currencies in which the loan was made.

3.7 The World Bank Structural Adjustment Loans

The World Bank began a policy of structural adjustment lending in 1979-80 in response to the markedly deteriorating prospects that were then foreseen for developing nations in the 1980s. Such structural adjustment lending was designed within the staff and financing levels available to the Bank and within its mandate, to those governments that had requested such support and that had recognized the need to formulate and introduce, as a matter of urgency, a set of comprehensive measures designed to adjust the structure of productive activities of their economies to the markedly deteriorating external situation (World Bank, 1982). The objective here is to provide quick disbursing finance to support measures, specifically designed to strengthen country balance of payments within 5-10 years without restricting imports in a manner that would adversely affect its economic and social development. Such loans which are generally medium-term in nature are in the Bank's view directed to achieve the following:

a. To support a programme to specific policy changes and and institutional reforms so that the productive resources of the economy can be put to a better use in the sense of improving the balance of payments in medium and long-run, and to simultaneously help in the maintenance of economic growth.
b. To act as a catalyst for the inflow of other external capital to ease the balance of payments situation.

To extend such loans, the Bank insists on a high degree of conditionality, imposed upon LDCs only, leading to their bearing the cost resource-reallocation and consequent hardships.

Such conditionality imposed includes:
a. A set of pricing policies including tariff reforms, fiscal incentives, budget subsidies, and interest rate charges;
b. Revised public investment priorities;
c. Improved budget and debt management and
d. A policy for strengthening institutions particularly public enterprises.

Nigeria has benefitted from this scheme in her SAP which began in July 1986.

The world Bank has long been criticized by non-governmental organizations, such as the indigenous rights group survival international, and academics, including its former Chief Economist Joseph Stiglitz, Henry Hazlitt and Ludwig Von Mises (Stigliz, 2003, 2007). Henry Hazlitt argued that the World Bank along with the monetary system it was designed within, would promote world inflation and “a world in which international trade is state dominated” when they were being advocated (Hazlitt, 1984). Stiglitz argued that the so called free market reform policies which the Bank advocates are often harmful to economic development if implemented badly, too quickly (“shock therapy”), in the wrong sequence or in weak, uncompetitive economies (Stiglitz, 2003; Schneider, 2002).

One of the strongest criticisms of the World Bank has been the way in which it is governed. While the World Bank represents 188 countries, it is run by a small number of economically powerful countries. These countries (which also provide most of the institution's funding) choose the leadership and senior management of the World Bank, and so their interests dominate the bank. Titus Alexander argues that the unequal voting power of western countries and the World Bank's role in developing countries makes it similar to the South African Development Bank under apartheid, and therefore a pillar of global apartheid (Alexander, 1996). In the 1990s, the World Bank and the IMF forged the Washington Consensus, policies which included deregulation and liberalization of markets, privatization and the downscaling of government. Though the Washington Consensus was conceived as a policy that would best promote development, it was criticized for ignoring equity, employment and how reforms like privatization were carried out. Joseph Stiglitz argued that the Washington Consensus placed too much emphasis on the growth of GDP, and not enough on the permanence of growth or on whether growth contributed to better living standards (Stiglitz, 2007).

The United States Senate Committee on Foreign Relations report criticized the World Bank and other international financial institutions for focusing too much "on issuing loans rather than on achieving concrete development results within a finite period of time" and called on the institution to "strengthen anti-corruption efforts".

Criticism of the World Bank often takes the form of protesting as seen in recent events such as the World Bank Oslo 2002 Protests, the October Rebellion, and the Battle of Seattle. Such demonstrations have occurred all over the world, even amongst the Brazilian Kayapo people.

Another source of criticism has been the tradition of having an American head the Bank, because the United States provides the majority of World Bank funding. "When economists from the World Bank visit poor countries to dispense cash and advice," observed The Economist in 2012, "they routinely tell governments to reject cronyism and fill each important job with the best candidate available. It is good advice. The World Bank should take it." (The Economist, Mar 31st

2012). You should note that Jim Yong Kim was the most recently appointed president of the World Bank.

4.0 CONCLUSION

The World Bank is a United Nations international financial institution that provides the loans to developing countries for capital programs. The World Bank's official goal is the reduction of poverty. According to its Articles to its Articles of Agreement, all its decisions must be guided by a commitment to the promotion of foreign investment and international trade and to the facilitation of capital investment.

The World Bank is the world's premier development institution. For almost 70 years, the leader of the IMF and World Bank has been subject to an indefensible carve-up. The head of the IMF is European; the World Bank, American. This shabby tradition has persisted because it has not been worth picking a fight over. It is long overdue for the headship of the World Bank and the IMF is opened to candidates from the rest of the world.

5.0 SUMMARY

In this unit, you learnt how the World Bank or the IBRD was formed as well as its functions, purposes, resources and lending procedure. You also learnt the generalprovisions regarding the World Bank loans and guarantees, the Bank's structural adjustment loans and a critique of its operation.

In the next unit, that is, Unit 4, which is the last of our Module 3, we shall conclude the study with a discussion about the World Bank Group, which as stated in the introductory section of this unit, is different from the World Bank or IBRD.

6.0 TUTOR-MARKED ASSIGNMENT

1. Analyze the functions of the World Bank.
2. Undertake a critique of the policies of IBRD.

7.0 REFERENCES/FURTHER READING

Alexander, T. (1996). *Unraveling Global Apartheid. an Overview of World Politics.* Cambridge, UK: Polity.

Hazlitt, H. (1984). *From Bretton Woods to World Inflation: A Study of the Causes and Consequences.* Washington, D.C.: Regnery Publishing.

Schneider, J. (2002). "World Markets: Anthropological Perspectives". In MacClancy, Jeremy. *Exotic No More: Anthropology on the Front Lines.* Chicago, IL: University of Chicago Press.

Stiglitz, J. E. (2003). The Roaring Nineties: A New History of the World's Most Prosperous Decade. New York: W. W. Norton and Company.

Stiglitz J. E. (2003). *Globalization and Its Discontents*. New York: W. W. Norton & Company.

Stiglitz, J. E. (2007). *Making Globalization Work*. New York: W. W. Norton

The Economist, (Mar 31st 2012). Hats off to Ngozi. The Economist 2012-03-31. Retrieved on 2012-04-02 from http://www.economist.com/node/21551490

UNIT 4 THE AFRICAN DEVELOPMENT BANK (ADB)

CONTENTS

1.0 INTRODUCTION

In the preceding unit, we learnt the meaning of international monetary fund (IMF), its functions and its surveillance of the global economy. We also studied the structural adjustment, the benefits of IMF loan conditions, a critique of IMF conditionality and the qualifications for IMF membership. Other sub-topics covered by us were the leadership of IMF, its Board of Governors, and the voting power of IMF members and effects of the quota system;

In this unit, we shall discuss the African Development Bank.

2.0 OBJECTIVES

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

- discuss the African Development Bank Group (ADB)
- trace the history of the African Development Bank (ADB)

- describe the group entities of the African Development Bank Group (ADB)
- explain the African Development Fund
- explain the Nigeria Trust Fund;
- analyze management and control of the African Development Bank (ADB)
- analyze functions of the African Development Bank (ADB)
- examine the status of the African Development Bank (ADB)
- trace the recent trends and directions of the African Development Bank (ADB)
- discuss the ADB’s support of RMCs through the fight against HIV/ AIDS
- list the membership of ADB.

3.0 MAIN CONTENT

3.1 The African Development Bank (ADB)

The African Development Bank (ADB) Group is a regional multilateral development finance institution established to contribute to the economic development and social progress of African countries that are the institution’s Regional Member Countries (RMCs). The ADB was founded following an agreement signed by member states on August 14, 1963, in Khartoum, Sudan, which became effective on September 10, 1964. The ADB comprises three entities: the African Development Bank (ADB), the African Development Fund (ADF) and the Nigeria Trust Fund (NTF).

As the premier development finance institution on the continent, the ADB’s mission is to help reduce poverty, improve living conditions for Africans and mobilize resources for the continent’s economic and social development. The ADB headquarters is officially in Abidjan, Côte d’Ivoire. However, due to recent events in Côte d’Ivoire, the institution’s activities have temporarily been relocated to Tunis, Tunisia (AFDB, 2014).

3.2 History of the African Development Bank (ADB)

At the end of the colonial period in Africa, growing desire for more unity within the continent led to the establishment of two draft charters, one for the establishment of the Organization of African Unity (OAU) established in 1963, later replaced by the African Union, and for a regional development bank.

A draft agreement was submitted to top African officials, then to African Ministers, before being cosigned by 23 African governments on

August 4, 1963 in the form of an agreement establishing the African Development Bank. The agreement came into force on 10 September 1964. Although established officially in under the auspices of the Economic Commission for Africa, the ADB began operation in 1966. Although originally only African countries were able to join the bank, since 1982 it has allowed the entry of non-African countries as well. During its forty years of operations, ADB has financed 2,885 operations, for a total of $47.5 billion. In 2003, it received an AAA rating from the major financial rating agencies and had a capital of $32.043 billion.

A development bank's mission is to promote the investment of public and private capital in projects and programmes that are likely to contribute to the economic development of its stakeholders. The bank therefore finances projects run either by the government or the private sector. The ADB is one of the five major multilateral development banks in the world that provides assistance to its regional member countries with a view to helping them achieve their development goals.
The ADB's primary objective is to assist African countries – individually and collectively - in their efforts to achieve economic development and social progress. To this end, the institution's main challenge is to reduce poverty on the continent.

Combating poverty is at the heart of the continent's efforts to attain sustainable economic growth. The Bank therefore seeks to stimulate and mobilize internal and external resources to promote investments as well as provide RMCs with technical and practical assistance. In partnership with various international and development organizations, including the United Nations, the World Bank, and the International Monetary Fund, the ADB has, since 2000, undertaken to support RMCs in their efforts to attain the Millennium Development Goals (MDGs).

3.3 Group entities the African Development Bank Group (ADB)

The African Development Bank Group has two other entities: the African Development Fund (ADF) and the Nigeria Trust Fund (NTF).

3.3.1 The African Development Fund

Established in 1972, the African Development Fund started operations in 1974. It provides development finance on concessional terms to low-income RMCs which are unable to borrow on the non-concessional terms of the ADB. In harmony with its lending strategy, poverty reduction is the main aim of ADF activities. Twenty-four non-African countries along with the ADB constitute its current membership. The largest ADF shareholder is the United States with approximately 6.5 percent of the total voting shares, followed by Japan with approximately

5.4 percent. The Federal Reserve Bank of New York was designated as the depositor bank for the fund according to telegraphs sent from the U.S. Embassy in Abidjan in 1976.

The ADF's general operations are decided by a Board of Directors, six of which are appointed by the non-African member states and six designated by the AFDB from among the bank's regional Executive Directors. The ADF's sources are mainly contributions and periodic replacements by non-African member states. The fund is usually replenished every three years, unless member states decide otherwise. The total donations, at the end of 1996, amounted to $12.58 billion. The ADF lends at no interest rate, with an annual service charge of 0.75%, a commitment fee of 0.5%, and a 50-year repayment period including a 10-yeargrace period. The tenth United Kingdom replenishment of the ADF was in 2006.

3.3.2 The Nigeria Trust Fund (NTF)

The Nigeria Trust Fund (NTF) was established in 1976 by the Nigerian Government with an initial capital of $80 million. The NTF is aimed at assisting in the development efforts of the poorest ADB members. The NTF uses its resources to provide financing for projects of national or regional importance which further the economic and social development of the low-income RMCs whose economic and social conditions require financing on non-conventional terms. In 1996, the NTF had a total resource base of $432 million. It lends at a 4% interest rate with a 25-year repayment period, including a five-year grace period.

3.4 Management and Control of the African Development Bank (ADB)

The ADB is controlled by a Board of Executive Directors, made up of representatives of its member countries. The voting power on the Board is split according to the size of each member's share, currently 60%-40% between African (or "regional") countries and "non-regional" member countries ("donors"). The largest African Development Bank shareholder is Nigeria with nearly 9 percent of the vote. All member countries of the ADB are represented on the ADB Board of Executive Directors.

Member governments are officially represented at the ADB by their Minister of Finance, Planning or Cooperation who sits on the ADB Board of Governors. The ADB Governors meet once a year (at the Annual Meetings of the ADB each May) to take major decisions about the institution's leadership, strategic directions and governing bodies.

The Governors typically appoint a representative from their country to serve in the offices of the ADB's Board of Executive Directors.

Day-to-day decisions about which loans and grants should be approved and what policies should guide the ADB's work are taken by the Board of Executive Directors. Each member country is represented on the Board, but their voting power and influence differs depending on the amount of money they contribute to the ADB.

3.5 Functions of the African Development Bank (ADB)

The primary function of ADB is making loans and equity investments for the socio-economic advancement of the RMC. Second, the bank provides technical assistance for development projects and programs. Third, it promotes investment of public and private capital for development. Fourth, the bank assists in organizing the development policies of RMCs. The ADB is also required to give special attention to national and multinational projects which are needed to promote regional integration.

3.6 Status of the African Development Bank (ADB)

The ADB promotes economic development and social progress of its RMCs in Africa and the bank commits approximately 3 billion dollars annually to African countries. Its relatively small lending and tendency to follow in the footsteps of more prominent public institutions like the World Bank implies that the African Development Bank has been receiving little interest from civil society organizations as well as academia.

ADB emphasizes the role of women along with education reforms, and lent its support to key initiatives such as debt alleviation for Heavily Indebted poor Countries and the New partnership for African's Development (NEPAD).The Bank is currently based in Tunis, Tunisia following the relocation of its headquarters from Abidjan, Cote d' lvoire . It employs approximately 1,020 employees as of 2007, and has 78 members: 53 countries in Africa and 25 American, European, and Asian countries.

3.7 Recent Trends and Directions of the African Development Bank (ADB)

One of emerging views, repeatedly cited by the ADB's Board of Directors and management, is that the ADB should be more "selective"and "country-focused" in its operations. Though this policy

has still to be clearly defined, it appears to be driving certain lending priorities.
The infrastructure sector, including power supply, water and sanitation, transport and communications has traditionally received the largest share of ADB lending. This focus was re-affirmed in the ADB's 2003-2007 Strategic Plan, which identified infrastructure as a priority area for ADB lending. In 2005, the ADB approved 23 infrastructure projects for approximately $982 million, which totaled 40 percent of ADB approvals that year. Given the increased attention to infrastructure development in Africa from donors and borrowers, it is likely that ADB's infrastructure lending will increase significantly in the coming years. In 2007, infrastructure operations accounted for approximately 60 percent of the bank's portfolio.

Regional integration infrastructure projects will also be a key part of the ADB's future business. According to the ADB's 2005 Annual Report, regional economic blocs will make Africa "more competitive in the global market", while transport and power interconnections between smaller African economies will help create larger markets within the continent. The ADB's member countries claim that ADB, as a multilateral institution, is particularly suited to support regional integration projects.

The ADB has also been designated the lead agency to facilitate "NEPAD infrastructure initiatives", which are regional integration projects led by African Regional Economic Communities (RECs). Additionally, the ADB hosts the Infrastructure Consortium for Africa (ICA). The ICA was established by G8 countries to coordinate and encourage infrastructure development in Africa, focusing on regional infrastructure development in particular. The ADB also helps to prepare projects so they may obtain financing from others sources through an initiative called the Infrastructure Project Preparation Facility (IPPF). So even if the ADB is not directly involved in financing a particular infrastructure project, it may have helped to make that project possible.

3.7.1 The ADB's Support of RMCs through the Fight against HIV/AIDS

Another key area of concentration of the ADB's support of RMCs is the fight against HIV/AIDS. The ADB has five policies towards securing Africa's future through health funding:

- Institutional capacity building through assistance of policy/strategy formulation and implementation
- Human capital development to create an environment for the operation of national AIDS strategies through training and technical assistance support

- HIV/AIDS multi-sectoral responses with emphasis on prevention and control interventions that include IEC (Information, Education and Communication), STI,(sexually Transmitted Infection) VCT (Voluntary Counseling and Testing), infrastructure support for the establishment of laboratories and blood transfusion facilities, and provision of equipment and supplies, including antiretroviral drugs
- Advocacy through participation in international and regional forums to raise political commitment and leadership towards a collaborative effort in the fight against the pandemic among RMCs and development partners
- Partnership development with a view of forging new alliances and revitalizing existing collaboration to cover critical development concerns such as HIV/AIDS and to bringing partnership activities within the framework of the bank's vision·

To date, the bank's contribution in the fight against HIV/AIDS is estimated at over 500 million Dollars. The bank is also among the initiating partners of AIDS in Africa – Scenarios for the future, a project whose outcome will enable governments and development partners alike to make strategic choices of current and future development paths and define their activities accordingly in order to face the challenges posed by HIV/AIDS.

Energy projects are likely to become a more important area of the AFDB’s infrastructure work, given the lack of access to energy services across Africa and continued high oil prices affecting oil-importing countries. It is not clear if the ADB’s role in the energy sector will prioritize energy projects for domestic consumption or for export, although the ADB has supported both in the past. The ADB is currently drafting an energy policy and developing its contribution to the G8-mandated Clean Energy Investment Framework.

Although there is no official statement or consensus to this effect, ADB lending for agriculture, (non-infrastructure) rural development and social sectors, such as health and education, is reportedly likely to decrease over the coming years.

4.0 CONCLUSION

The ADB's financial standing has been restored from the near collapse of 1995, but its operational credibility remains a work-in-progress. ADB is still a relatively small source of development finance for Africa. The ADB management and shareholders should address the urgent task of reforming Africa’s development bank to enable it deliver on its mandate especially a strong focus on infrastructure.

5.0 SUMMARY

In this unit**,** you learnt the African Development Bank Group (ADB), its history, entities, functions, management and control, status, and membership. You also learnt the recent trends and directions of the African Development Bank (ADB) and its support of Regional Member Countries (RMCs) through the fight against HIV/AIDS.

In the next unit, we shall discuss the International Bank for Reconstruction and Development otherwise called the World Bank.

6.0 TUTOR MARKED ASSIGNMENT

1. Trace the history of the African Development Bank (ADB).
2. State the functions of the African Development Bank (ADB).

7.0 REFERENCES/FURTHER READING

AFDB (2014). about-us/frequently-asked-questions. African Development Bank (ADB) Home Page. Retrieved on 05/03/2017 from http://www.afdb.org/en/about-us/frequently-asked-questions/

Osaze, E.B. (2007). *Capital markets.* Lagos: The Book house Company.

Wathne, C. & Hedger, E. (2010). *What does an Effective Multilateral Donor Look Like?*London: Overseas Development Institute.

MODULE 4 ECONOMIC STABILIZATION MEASURES

UNIT 1 ECONOMIC STABILIZATION AND THE NEED FOR REGULATION

CONTENTS

1.0 INTRODUCTION

Stabilization measure (policy) is a package or set of measures introduced to stabilize a financial system or the economy. This policy guidance represents the stability measures which may be the fiscal policy or monetary policy or both.

2.0 OBJECTIVES

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

- state the objectives of economic stabilization programme
- discuss economic Stability vis a vis the Need for Regulation
- explain the asymmetric information problem in the banking sector.

3.0 MAIN CONTENT

3.1 Objectives of Economic Stabilization Programme

Economic stabilization is one of the main remedies to effectively control or eliminate the periodic trade cycles which plague capitalist economy.

Economic stabilization, it should be noted, is not merely confined to a single individual sector of an economy but embraces all its facts. In order to ensure economic stability, a number of economic measures have to be devised and implemented.

In modem times, a programme of economic stabilization is usually directed towards the attainment of three objectives: (i) controlling or moderating cyclical fluctuations; (ii) encouraging and sustaining economic growth at full employment level; and (iii) maintaining the value of money through price stabilization. Thus, the goal of economic stability can be easily resolved into the twin objectives of sustained full employment and the achievement of a degree of price stability.

3.2 Need for Economic Stability and Regulation

Stability is traditionally an important concern in the financial sector. The characteristics of the financial sector are such that individual problems may easily will over and endanger the whole financial system. Hence failure in the investors and savers but stock market crashes, bank failures and other financial disasters may endanger the health of the whole economy.

Financial operations are characterized by risk and uncertainty. In particular information problems arise as explained before. As a result financial decision making depends heavily upon expectations. It is also characterized by herd behavior. Market parties adjust suddenly and collectively their expectations leading to high volatility in financial markets. Moreover, compared to other sectors of the economy, financial markets are much more interdependent. This is witnessed by very tight interconnections in the interbank market. Events in one financial market or institution may then have important effects on the rest of the financial system. Failure in one market or institution may create a financial panic and end up in a systemic crisis. Due to ever increasing international capital mobility it may become a worldwide financial crisis.

3.3 Asymmetric Information

Banks specifically are faced with a two-sided asymmetric information problem. On the asset side borrowers may fail on their repayment obligations. Depositors, however, cannot observe these credit risks. The quality of the loan portfolio is private information acquired while evaluating and monitoring borrowers. On the liabilities side savers and depositors may withdraw their funds on short notice. Banks, however, cannot observe the true liquidity needs of depositors. This is private information. A true liquidity risk arises when depositors collectively decide to withdraw more funds than the bank has immediately available.

It will force the bank to liquidate relatively illiquid assets probably at a loss. A liquidity crisis may then endanger also the solvability of the bank and eventually lead to bankruptcy.

As Dewatripont and Tirole (1994) observe, the providers of funds are not able to assess the value of the bank's underlying assets. As a result bad news, whether true or false, may provoke a withdrawal of funds. Moreover, as deposits are repaid in full on a first-come-first-served basis until the liquid assets are exhausted, depositors have an incentive to act quickly. A 'bank run' may occur when enough savers lose confidence in the soundness of a bank.

Moreover, bad news about one bank can snowball and have a contagious effect on other banks. A bank failure could eventually trigger a signal on the solvency of other banks. Even if these banks are financially healthy the information about the quality of the loan portfolio underlying the deposits is private, so that depositors may also lose confidence and withdraw their funds.

As is documented by Paroush (1988) domino effects lead to a widespread loss of confidence in the banking system and create a 'financial panic'.

Financial market failures and instability eventually leading to a systemic crisis not only affect individual savers and depositors, but the health of the whole economy. Public policy intervention then is not only a microeconomic question of protecting individual savers and investors, but becomes a macroeconomic issue.

Government concern about the health of the financial system is mainly motivated by the negative macroeconomic externalities from bank failures and financial panics. These impair the ability of the financial markets and intermediaries to provide the key services of risk sharing, liquidity and information when faced with economic disturbances. Financial crises undermine the efficiency with which resources in the economy are allocated as, for example, companies have difficulty raising capital for investment and job creation. The collapse of financial institutions in general may have important costs of debt deflation on effective aggregate demand in the economy, as is extensively documented by Hubbard (1991).

Because of the banks' importance it is in particular important to maintain the health of the banking industry. The severity of the Great Depression of the 1930s is often linked to the breakdown of the banking system's ability to provide financial services. As explained before, banks are very important in reducing information costs in the economy. Insolvency of banks is costly because information on borrowers is then lost. It hurts in particular the ability of less well known borrowers to obtain loans. Moreover, banks play an essential role in the payments system and in the creation of money. As argue by Mishkin (1997) bank failures could cause large and uncontrollable fluctuations in the quantity of money in circulation. The negative impact of banking problems on economic growth, the government budgets, the balance of payments and foreign exchange rates are further documented in an IMF study by Lindgren, Garcia and Saal (1996).

Systemic risks are more difficult to deal with than the previous individual risks for depositors and savers. Of course government intervention aiming at the protection of depositors and investors by reducing information costs will also stabilize their behavior and reduce the danger of major financial instability. Also at the international level the timely dissemination of accurate financial information may be in order. The question arises whether additional government intervention may be necessary. This applies especially to ex post interventions when a financial crisis has occurred.

Liquidity crisis may be overcome by monetary authorities acting as a lender of last resort and providing additional liquidity. However, this may lead in turn to a moral hazard problem. Financial institutions anticipating the bail-out possibility by monetary authorities may behave in a riskier way. Hence, the lender of last resort certainly does not have to intervene for financial problems that do not contain the danger of leading to a systems crisis. For an international financial crisis the question arises as to the need of an international lender of last resort.

Finally, ensuring a stable payments system has been a principal concern of public policy. Therefore financial regulation in a wider perspective contains also a whole framework for controlling the volume of money in circulation, that is a whole set of monetary policy instruments. Normally a stable and sound financial system is a condition for an efficient monetary policy. Therefore in financial law specific regulations determine for instance which institutions can offer deposit accounts.

However, in the short run conflicts may also arise between money supply control and the provision of additional liquidity under the lender of last resort function.

4.0 CONCLUSION

There is need for a robust financial regulation as a stable and sound financial system is a condition for an efficient monetary policy.

Therefore in financial law, specific regulations determine for instance which institutions can offer deposit accounts.

5.0 SUMMARY

You have further learnt the need for a stable and sound financial system is as a precondition for an efficient monetary policy while exposing you to the concept of asymmetric information.

6.0 TUTOR-MARKED ASSIGNMENT

What do you understand by asymmetric information problem?

7.0 REFERENCES/FURTHER READING

Afifia-Oru, B. (2009). *Dynamics of Credit Economic System in Africa*. Lagos: Byolah Concepts Ltd.

Central Bank of Nigeria (2011). Understanding Monetary Policy Series No 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy and Direct controls, retrieved from www.yourarticlelibrary.com/eco

Dirk, H. (1999). *Regulations of banking and financialMarket.* Encyclopedia of Law and Economics.

UNIT 2 MONETARY POLICY AS INSTRUMENT OF ECONOMIC STABILIZATION

CONTENTS

1.0 INTRODUCTION

Monetary policy is how central banks manage liquidity to create economic growth. Liquidity is how much there is in the money supply. That includes credit, cash, checks and money market mutual funds. The most important of these is credit. It includes loans, bonds and mortgages.

Monetary policy guides the central bank's supply of money in order to achieve the objectives of price stability (or low inflation rate), full employment, and growth in aggregate income. This is necessary because money is a medium of exchange and changes in its demand relative to supply, necessitate spending adjustments. Fiduciary or paper money is issued by the central bank based on an estimate of the demand for cash.

The most commonly advocated policy of solving the problem of fluctuations is monetary policy. Monetary policy pertains to banking and credit, availability of loans to firms and households, interest rates, public debt and its management, and monetary management.

However, the fundamental problem of monetary policy in relation to trade cycles is to control and regulate the volume of credit in such a way as to attain economic stability. During a depression, credit must be expanded and during an inflationary boom, its flow must be checked.
Monetary management is the function of the commercial banking system, and through it, its effects are primarily exerted the economy as a whole. Monetary management directly affects the volume of cash reserves of banks, regulates the supply of money and credit in the

economy, thereby influencing the structure of interest rates and availability of credit.

Both these factors affect the components of aggregate demand (consumption plus investment) and the flow of expenditures in the economy. It is obvious that an expansion in bank credit causes an increasing flow of expenditure (in terms of money) and contraction in bank credit reduces it.

In the armoury of the central bank, there are quantitative as well as qualitative weapons to control the credit- creating activity of the banking system. They are bank rate, open market operations and reserve ratios. These are interrelated to tools which operate on the reserves of member banks which influence the ability and willingness of the banks to expand credit. Selective credit controls are applied to regulate the extension of credit for particular purposes.

We shall now briefly discuss the implications of these weapons (monetary policy instruments).

2.0 OBJECTIVES

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

- explain the monetary management mechanism
- discuss the effectiveness of various monetary policy weapons
- highlight the objectives of monetary policy
- state the direct and indirect instruments of monetary policy
- List different types of monetary policy regimes.

3.0 MAIN CONTENT

3.1 What is Monetary Policy?

Monetary Policy refers to the specific actions taken by the Central Bank (Monetary Authority) to regulate the value; supply and cost of money in the economy with a view to achieving predetermine macroeconomic goals. The Central Bank of Nigeria, like other central banks in developing countries, seeks to achieve price stability through the management of money supply. Money supply comprises narrow and broad money. Narrow money (Ml) is defined as currency in circulation with non-bank public and demand deposits or current accounts in the banks. The broad money (M2) includes narrow money plus savings and time deposits, as well as foreign currency denominated deposits. Broad money measures the total volume of money supply in the economy. Thus, excess money supply (or liquidity) may arise when the amount of broad money is higher than the level required to sustain non-inflationary output growth in the economy.

The need to regulate money supply is based on the knowledge that there is a relatively stable relationship between the quantity of money supply and economic activity and that if the supply of money is not limited to what is required to support productive activities, it will result in undesirable effects such as inflation or deflation.

Several factors influence the supply of money, some of which are within the control of the central bank, while others are outside its control. The specific objectives and focus of monetary policy may change from time to time, depending on the level of economic development and economic fortunes of the country.

3.2 Objectives of Monetary Policy

In Nigeria, the major objectives of monetary policy include the attainment of price stability and sustainable economic growth. In pursuing these objectives, the CBN recognizes the existence of conflicts among objectives necessitating some sort of trade-offs. The targets of monetary policy are the operational target, the intermediate target and the ultimate targets. The Bank manipulates the operating target (reserve money) over which it has substantial direct control to influence the intermediate target (broad money supply, M2) which has impact on the ultimate objective of monetary policy, i.e., inflation and output.

The stance of monetary policy refers to either expansion or contraction actions of the central bank to control money supply.

- Expansion monetary policy is a set of actions by the monetary authority to increase money supply in the economy. It is conventionally used to stimulate economic activity, usually in a recession.

Contraction monetary policy on the other hand seeks to reduce the level of money supply in the economy. It is conventionally used to reduce inflationary pressures in the economy.

3.3 Direct and Indirect Instruments of Monetary Policy

Direct Credit Control

The central bank can direct Deposit Money Banks on the maximum percentage or amount of loans (credit ceilings) to different economic sectors or activities, interest rate caps, liquid asset ratio and issue credit guarantee to preferred loans. In this way the available savings is allocated and investment directed in particular directions as desired by the authorities.

Selective controls or qualitative credit control is used to divert the flow of credit into and out of particular segments of the credit market. Selective controls aim at influencing the purpose of borrowing. They regulate the extension of credit for particular purposes. The rationale for the use of selective controls is that credit may be deemed excessive in some sectors at a time when a general credit control would be contrary to the maintenance of economic stability.

It goes without saying that these various means of credit controls are to be co-ordinated to achieve the goal of economic stability.

Indirect Instruments of Monetary Policy

- **Reserve Requirements**

This instrument is used by the central bank to influence the level of bank reserves and hence, their ability to grant loans. Reserve requirements are lowered in order to free reserves for banks to grant loans and thereby increase money supply in the economy. On the other hand, they are raised in order to reduce the capacity of banks to provide loans thereby reducing money supply in the economy. The monetary authorities have at their disposal another most effective way of influencing reserves and activities of commercial banks and that weapon is a change in cash reserve ratios. Changes in the reserve ratios become effective at a pre-announced date.

Their immediate effect is to alter the liquidity position in the banking system. When the cash reserve ratio is raised commercial banks find their existing level of cash reserves inadequate to cover deposits and have to raise funds by disposing liquid assets in the monetary market. The reverse will be the case when the reserve ratio is lowered. Thus, changes in the reserve ratios can influence directly the cash volume and the lending capacity of the banks.

It appears that the bank rate policy, open market operations and changes in reserve ratios exert their influence on the cost, volume and availability of bank reserves through reserves, on the money supply

- **Open Market Operations (OMO)**

The most important and flexible tool of monetary policy is open market operations. It is the buying and selling of government securities in the open market (primary or secondary) in order to expand or contract the amount of money in the banking system. By purchasing securities, the central bank injects money into the banking system and stimulates growth whereas by selling securities it absorbs excess money. Thus, if there is excess liquidity in the system, the central bank will in a bid to reduce the money supply sell the government securities such as Treasury Bills. On the other hand, in periods of liquidity shortages, the central bank buys government securities so as to increase money supply. Instruments commonly used for this purpose include treasury bills, central bank bills, or prime commercial paper.

OMO enables the central bank to influence the cost and availability of reserves and bring about desired changes in bank credit and money supply. This important instrument of monetary policy has a number of advantages because it is flexible and precise, it is implemented quickly and easily reversed and the central bank has complete control. The effectiveness of OMO, however, depends on the existence of well-developed financial markets that are sensitive to interest rate movements.

The technique of open market operations refers to the purchase and sale of securities by the central bank. A selling operation reduces commercial banks' reserves and their lending power.

However, because of the need to maintain the government securities market, the central bank is completely free to sell government securities when and in what amounts it wishes in order to influence commercial banks' reserve position. Thus, when a large public debt is outstanding, by expanding the securities market, monetary policy and management of the public debt become inseparably intertwined.

- **Discount Window Operations**

This instrument is a facility provided by the central bank which enables the DMBs to borrow reserves against collaterals in form of government or other acceptable securities. The central bank operates this facility in accordance with its role as lender of last resort and transactions are conducted in form of short term (usually overnight) loans. The central bank lends to financially sound DMBs at the policy rate. This rate sets the floor for the interest rate regime in the money market (the nominal anchor rate) and thereby affects the supply of credit, the supply of savings (which affects the supply of reserves and monetary aggregate) and the supply of investment (which affects employment and GDP).

- **Other Instruments**

Exchange Rate

The balance of payments can be in deficit or in surplus and this can affect the monetary base, hence the money supply, in one direction or the other. By selling or buying foreign exchange, the central bank ensures that the exchange rate is at an optimal level. The real exchange rate when misaligned affects the current account balance because of its impact on external competitiveness.

Prudential Guidelines

The central bank may require DMBs to exercise particular care in their credit operations in order to achieve specified outcomes. Key elements of prudential guidelines remove some discretion from bank management and replace them with rules.

Moral Suasion

The central bank issues licenses to DMBs and regulates the operation of the banking system. Thus, it can persuade banks to follow certain policies such as credit restraint or expansion, increase sayings mobilization and promote exports through financial support, which otherwise they may not do, on the basis of their risk/return assessment.

Bank Rate Policy

Due to various reasons, the bank rate policy is relatively an ineffective weapon of credit control.

However, from the viewpoint of contra cyclical monetary policy, bank rate policy is usually interpreted as an evidence of monetary authority's judgment regarding the contribution of the current flow of money and bank credit to general economic stability.

That is to say, a rise in the bank rate indicates that the central bank considers that liquidity in the banking system possesses an inflationary potential. It implies that the flow of money and credit is very much in excess of the actual productive capacity of the economy and therefore, a restraint on the expansion of money supply through dear money policy is desirable.

On the other hand, a reduction in the bank rate is generally interpreted as an evidence of a shift in the direction of monetary policy towards a cheap and expansive money policy. A reduction in bank rate then is more significant as a symbol of an easy money policy than anything else. However, the bank rate is most effective as an instrument of restraint.

According to Estey, the following difficulties usually arise in the way of an effective discount policy in expansion:

i. During high prosperity, the demand for credit by businessmen may be interest-inelastic.
ii. The rising of bank rate and a consequent rise in the market rates of interest may attract loanable funds from the financial intermediaries in the money market and assist in counteracting undesired effects.
iii. Though the quantity of money may be controlled by the banking system, the velocity of its circulation is not directly under the influence of banks. Banking policy may determine how much credit there should be but it is the trade which decides how much and how fast it will be used. Thus, if the velocity of the movement is contrary to the volume of credit, banking policy will be rendered ineffective.
iv. There is also the difficulty of proper timing in the application of banking policy. Brakes must be applied at the right time and in the right quarter. If they are applied too soon, they must bring expansion to an end with factors of production not fully employed. And when applied too late, there might be a runaway monetary expansion and inflation, completely out of control.

Effectiveness of Monetary Control

Monetary policy is much more effective in curbing a boom than in helping to bring the economy out of a depression state. It has long been recognized that monetary management can always contract the money supply sufficiently to end any boom, but it has little capacity to end a contraction.

This is because the actions of monetary management do not directly enter the income-expenditure stream as the most effective contra-cyclical weapon, for their first impact is on the asset structure of financial institutions, and in this process of altering the assets structure, rate of interest, volume of credit and the income-expenditure flow may be altered.

All these operate more significantly in restraining the income stream during expansion than in inducing an increase during contraction. However, the greatest advantage of monetary policy is its flexibility. Monetary management makes decisions about the rate of change in the money supplies that are consistent with economic stability and growth on a judgment of given quantitative and qualitative evidences.

But, whether this point of monetary policy will prove its effectiveness or not depends on its exact timing. Manipulation of bank rate and open market dealings by the central bank should be reasonably effective if applied quickly and continuously in preventing booms from developing and consequently, into a depression.

To sum up, monetary policy is a necessary part of the stabilization programme but it alone is not sufficient to achieve the desired goal. Monetary policy, if used as a tool of economic stabilization, in many ways, serves as a complement of fiscal policy.

It is strong, whereas fiscal policy is weak. It is flexible and capable of quick alternations to suit the measure of pressures of the time and needs. However, it is to be co-ordinated with fiscal policy.

3.4 Different types of Monetary policy Regimes

Central banks use contraction monetary policy to reduce inflation. They have many tools to do this. The most common are raising interest rates and selling securities through open market operations.

They use expansionary monetary policy to lower unemployment and avoid recession. They lower interest rates, buy securities from member banks and use other tools to increase liquidity.

Monetary regimes	**Target Market Variable**	**Long Term Objective**
Inflation Targeting	Interest rate on overnight debt	A given rate of change in the CPI
Price Level Targeting	Interest rate on overnight debt	A specific CPI number
Monetary Aggregates	The growth in money supply	A given rate of change in the CPI
Fixed Exchange Rate	The spot price of the currency	The spot price of the currency
Gold Standard	The spot price of gold	Low inflation as measured by the gold price
Mixed Policy	Usually interest rates	Usually unemployment + CPI change

The different types of policy are also called **monetary regimes,** in parallel to exchange-rate regimes. A fixed exchange rate is also an exchange-rate regime; The Gold standard results in a relatively fixed regime towards the currency of other countries on the gold standard and a floating regime towards those that are not. Targeting inflation, the price level or other monetary aggregates implies floating exchange rate unless the management of the relevant foreign currencies is tracking exactly the same variables (such as a harmonized consumer price index).

Expansion versus Contraction Monetary Policy

In economics, an expansionary fiscal policy includes higher spending and tax cuts that encourage economic growth. In turn, an expansionary monetary policy is one that seeks to increase the size of the money supply. As usual, inciting of money supply is aimed at lowering the interest rates on purpose to achieve economic growth by increase of economic activity. Conversely, contraction monetary policy seeks to reduce the size of the money supply. In most nations, monetary policy is controlled by either a central bank or a finance ministry. Neoclassical and Keynesian economics significantly differ on the effects and effectiveness of monetary policy on influencing the real economy; there is no clear consensus on how monetary policy affects real economic variables (aggregate output or income, employment). Both economic schools accept that monetary policy affects monetary variables (price levels, interest rates).

4.0 CONCLUSION

It should be understood that a wrong monetary policy may seriously endanger and even destroy the effectiveness of fiscal policy. Thus, monetary policy and fiscal policy, each reinforcing and supplementing the other, are the essential elements in devising an economic stabilization programme. We have also seen in this unit the different monetary regimes and how they differ from each other. The Gold standard results in a relatively fixed regime towards the currency of other countries on the gold standard and a floating regime towards those that are not

5.0 SUMMARY

In this unit, you have learnt the various monetary policy instruments and regimes as used in stabilizing the economy as well as the effectiveness of monetary control mechanism.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss briefly the effectiveness of monetary control mechanism.
2. What do you understand by monetary policy?

3. In tabular form show the different monetary regimes and their long term objectives.

7.0 REFERENCES/FURTHER READING

Afifia-Oru, B. (2009). *Dynamics of Credit Economic System in Africa*. Lagos: Byolah Concepts Ltd.

Central Bank of Nigeria (2011). Understanding Monetary Policy series No 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy and Direct controls, retrieved from www.yourarticlelibrary.com/eco

Dirk, H. (1999). Regulations of banking and financialMarket. Encyclopedia of Law and Economics.

Osaze, E. B. (2007). *Capital Markets.* Lagos: The Bookhouse Company.

UNIT 3 FISCAL POLICY AS AN INSTRUMENT OF ECONOMIC STABILIZATION

CONTENTS

1.0 INTRODUCTION

In this unit we shall discuss fiscal policy as a tool of economic stability. Fiscal policy has received its due importance under the influence of Keynesian economies since the depression years of the 1930s.

2.0 OBJECTIVES

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

- explain the meaning of fiscal policy
- discuss inbuilt flexibility as it affects fiscal policy
- analyse discretion action as it affects fiscal policy.

3.0 MAIN CONTENT

3.1 What is Fiscal policy?

The term "fiscal policy" embraces the tax and expenditure policies of the government. Thus, fiscal policy operates through the control of government expenditures and tax receipts. It encompasses two separate but related decisions: public expenditures and level and structure of taxes. The amount of public outlay, the inducement and effects of taxation and the relation between expenditure and revenue exert a significant impact upon the free enterprise economy.

Broadly speaking, the taxation policy of the government relates to the programme of curbing private spending. The expenditure policy, on the other hand, deals with the channels by which government spending on new goods and services directly add to aggregate demand and indirectly income through the secondary spending which takes place on account of the multiplier effect.

Taxation, on the other hand, operates to reduce the level of private spending (on both consumption and investment) by reducing the disposable income and the resulting savings in the community. Hence, under the budgetary phenomenon, public expenditure and revenue can be combined in various ways to achieve the desired stimulating or deflationary effect on aggregate demand.

Thus, fiscal policy has quantitative as well as qualitative aspect changes in tax rates, the structure of taxation and its incidence influence the volume and direction or private spending in economy. Similarly, changes in government's expenditures and its structure of allocations will also have quantitative and redistributive effects on time, consumption and aggregate demand of the community.

As a matter of fact, all government spending is an inducement to increase the aggregate demand (both volume and components) and has an inflationary bias in the sense that it releases funds for the private economy which are then available for use in trade and business.

Similarly, a reduction in government spending has a deflationary bias and it reduces the aggregate demand (its volume and relative components in which the expenditure is curtailed). Thus, the composition of public expenditures and public revenue not only help to mold the economic structure of the country but also exert certain effects on the economy.

For maximum effectiveness, fiscal policy should be planned on both long-run and short-run basis. Long- run fiscal policy obviously is concerned with the long- run trends in government income and spending. Within the framework of such a long-range plan of fiscal operations, the budget can be made to vary cyclically in order to moderate the short-run economic fluctuations.

Basically two sets of techniques can be employed for planning the desired flexibility in the relation between tax revenue and expenditure: (1) built-in flexibility or automatic stabilizers, and (2) discretionary action.

3.2 Built-in Flexibility

The operation of a fiscal policy is always confronted with the problem of timing and forecast. A fiscal policy administrator has always to face the question: When to do what? But it is a very difficult and complex question to answer. Thus, in order to minimize the difficulties that arise from uncertainties of forecasting and timing of fiscal operations, an automatic stabilizer programme is often advocated.

Automatic stabilizer programme implies that in a given framework of expenditure and revenue relation in a budgetary policy, there exist factors which provide automatically corrective influences on movements in national income, employment, etc. This is what is called built-in flexibility. It refers to a passive budgetary policy.

The essence of built-in flexibility is that (i) with a given set of tax rates tax yields will vary directly with national income, and (ii) there are certain lines of government expenditures which tend to vary inversely with movements in national income.

Thus, when the national income rises, the existing structure of taxes and expenditures tend to automatically increase public revenue relative to expenditure, and to increase expenditures relative to revenue when the national income falls. These changes tend to mitigate or offset inflation or depression at least partially. Thus, a progressive tax structure seems to be the best automatic stabilizer.

Likewise, certain kinds of government expenditure schemes like unemployment compensation programmes, government subsidies or price-support programmes also offset changes in income by varying inversely with movements in national income.

However, automatic stabilizers are not a panacea for economic fluctuations, since they operate only as a partial offset to changes in national income, but provide a force to reverse the direction of the change in the income.

They slow down the rate of decline in aggregate income but contain no provision for restoring income to its former level. Thus, they should be recognised as a very useful device of fiscal operations but not the only device. Simultaneously, there should be scope for discretionary policies as the circumstances will call for.

3.3 Discretionary Action

Quite often, it becomes absolutely necessary to have fiscal operations with a tool kit of discretionary policies consisting of measures for putting into effect with a minimum delay, the changes in government expenditures. This calls for a skeleton of public works projects providing for administrative discretion to employ them and the funds to put them into effect.

It calls for a budgetary manipulation an active budget policy constituting flexible tax rates and expenditures. There can be three ways of discretionary changes in tax rates and expenditures: changing expenditure with constant tax rates; changing tax rates and constant expenditure; and a combination of changing tax rates and changing expenditures.

In general, the first method is probably superior to the second during a depression. That is to say, to increase expenditures with the level of taxes remaining unchanged is useful in pushing up the aggregate spending and effective demand in the economy. However, the second method will prove to be superior to the first during inflation.

That is to say, inflation could be checked effectively by increasing the tax rates with a given expenditure programme. But it is easy to see that the third method is much more effective during inflation as well as deflation than the other two.

Inflation would, of course, be more effectively curbed when taxes are enhanced and public expenditure is also simultaneously reduced. Similarly, during a depression, the spending rate of private economy will be quickly lifted up if taxes are reduced simultaneously with the increasing public expenditure.

However, the main difficulty with most discretionary policies is their proper timing. Delay in discretion and implementation will aggravate the problem and the programme may not prove to be effective in solving the problems.

Thus, many economists fear that discretionary government actions are likely to do more harm than good, owing to the uncertainty of government actions and the political pressures to favour vested interests. That is why reliance on built-in stabilizers, as far as possible, has been advocated.

4.0 CONCLUSION

It should be noted that many economists and public financial experts fear that discretionary government actions are likely to do more harm than good, owing to the uncertainty of government actions and the political pressures to favour vested interests. That is why reliance on built-in stabilizers, as far as possible, has been advocated.

5.0 SUMMARY

You have learnt in this unit the meaning and application of fiscal policy as well as the implications of the flexibility mode and in built in stabilizers to guide government actions.

6.0 TUTOR-MARKED ASSIGNMENT

1. Explain the meaning of fiscal policy.
2. Discuss inbuilt flexibility as it affects fiscal policy.

7.0 REFERENCES/FURTHER READING

Afifia-Oru, B. (2009). *Dynamics of Credit Economic System in Africa*, Lagos: Byolah Concepts Ltd.

Central Bank of Nigeria (2011). Understanding Monetary Policy Series No 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy and Direct controls, retrieved from www.yourarticlelibrary.com/eco

Dirk, H. (1999). *Regulations of banking and financial Market.* Encyclopedia of Law and Economics.

UNIT 4 DIRECT CONTROLS AS INSTRUMENT OF ECONOMIC STABILIZATION

CONTENTS

1.0 INTRODUCTION

During World War II, price-wage controls were employed in conjunction with consumer rationing and materials allocation to curb generalized total excess demand and to direct productive resources into channels desired by the government.

2.0 OBJECTIVES

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

- explain the meaning of direct controls
- list the advantages of direct controls
- identify the objections to the application of direct controls.

3.0 MAIN CONTENT

3.1 Meaning of Direct Controls

Broadly speaking, direct controls are imposed by government which expressly forbid or restricts certain kinds of investment or economic activity. Sometimes, direct government controls over prices and wages as a measure against inflation have been advocated and implemented.

Monetary-fiscal controls may be used to curb excess demand in general but direct controls can be more useful when they are applied to specific scarcity areas.

3.2 Advantages of Direct Controls

1. They can be introduced or changed quickly and easily: hence the effects of these can be rapid.
2. Direct controls can be more discriminatory than monetary and fiscal controls.
3. There can be variation in the intensity of the operations of controls from time to time in different sectors.

3.3 Objections to the application of Direct controls

In a peace-time economy, however, there are serious philosophical and political objections to direct economic controls as a stabilization device Objections have been raised to such controls on the following counts:

1. Direct controls suppress individual initiative and enterprise.
2. They tend to inhibit innovations, such as new techniques of production, new products etc.
3. Direct controls may breed or induce speculation which may have destabilizing effects. For instance, if it is expected that a commodity X, say steel, is to be rationed because of scarcity, people may try to hoard large stocks of it, which aggravates its shortage. It, thus, encourages the creation of artificial scarcity through large-scale hoarding.
4. Direct controls need a cumbersome, honest and efficient administrative organization if they are to work effectively.
5. Gross disturbances reappear as soon as controls are removed.

In short, direct controls are to be used only in extraordinary circumstances like emergencies, but not in a peace-time economy.

4.0 CONCLUSION

However useful direct controls are, they are to be used only in extraordinary circumstances like emergencies, but not in a peace-time economy.

5.0 SUMMARY

You have learnt in this unit the meaning of direct controls, its advantages and shortcomings.

6.0 TUTOR-MARKED ASSIGNMENT

State three advantages of direct controls.

7.0 REFERENCES/FURTHER READING

Afifia-Oru, B. (2009). *Dynamics of Credit Economic System in Africa*. Lagos: Byolah Concepts Ltd

Central Bank of Nigeria (2011). Understanding Monetary Policy Series No 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy and direct controls, retrieved from www.yourarticlelibrary.com/eco

Dirk, H. (1999). *Regulations of Banking and Financial Market.* Encyclopedia of Law and Economics.

MODULE 5 MONETARY AND FISCAL POLICY GOALS AND TARGETS

UNIT 1 OVERVIEW OF MONETARY POLICY FRAMEWORK

CONTENTS

1.0 INTRODUCTION

Generally, monetary policy is a tool of general macroeconomic management, under the control of the monetary authorities, designed to achieve government economic objectives. The monetary policy instruments, though different from country to country, usually include open market operations (OMO), changes in discount/bank rate (both of which determine the monetary base), and required reserves (the minimum reserves the commercial banks must hold against the public's deposit with them).

2.0 OBJECTIVES

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

- explain the meaning of monetary policy framework
- state the factors that influence the CBN choice of monetary framework
- discussthe relationship between monetary policy tools targets and goals.

3.0 MAIN CONTENT

3.1 What is Monetary Policy Framework?

The monetary policy framework generally refers to the institutional arrangements under which monetary policy decisions are made and executed. In view of this, an analysis of any monetary policy framework extends considerably beyond the confines of the central bank. Indeed, only in a few countries is much of the monetary policy framework decided by the central bank itself.

3.2 Factors that Influence the CBN Choice of Monetary Framework

Some of the factors that influence the choice of monetary policy framework by a central bank include:

Structural differences: This includes the structure of the financial sector, types and level of debt, openness to trade, commodity dependence, fiscal discipline, etc.

Degree of Indexation: This is very common with countries within various levels of economic integration which requires different types of indexation. In addition, there are other nominal rigidities that affect the speed of transmission from monetary policy instruments to inflation.

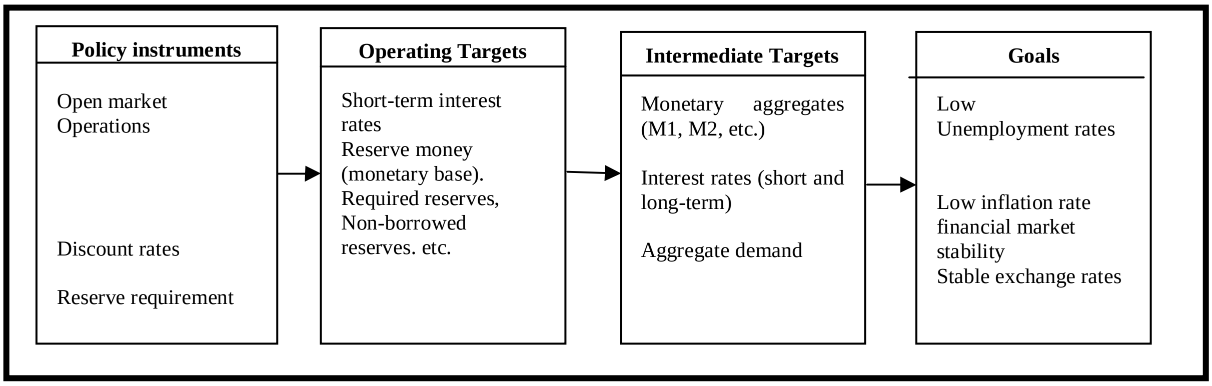
Institutional arrangements: This refers to the number of institutions making up the monetary authorities, the enabling laws, data availability andrelated factors that may influence the way in which monetary policy responds to macroeconomic developments.

3.3 Monetary policy tools targets and goals

In formulating monetary policy, the monetary authorities usually set targets whose values the policy maker wants to change. The targets could be ultimate (final goals, such as output/its deviation from the full-employment level, inflation rate (or the price level) or its deviation from a desired level, and employment; intermediate (variables that the central bank seeks to influence such as money supply or interest rate), or operating (variables the central bank can influence directly using the instruments at its disposal). However, since a given variable can fall in any of these categories, there is no hard and clear-cut separation between these categories. In addition, variables that provide information on the current and future state of the economy have to be identified.

At least three issues arise in the selection and use of the goals, intermediate variables, operating targets and instruments by the monetary authorities. The first concerns the existence or otherwise of stable and predictable relationships between the ultimate goal variables, intermediate variables and operating targets. The second has to do with whether the monetary authorities can actually achieve the desired level of the operating targets with the instruments at their disposal. The third deals with the lag structure (short or long) of the relationships with the implication that prediction of the future course of the economy will be increasingly less precise in the presence of long lags.

Figure 2.1 Monetary Policy Tools, Targets and Goals



There is also the issue of which of the two main intermediate targets (monetary aggregates and interest rates) monetary authorities should adopt. Generally, the choice between monetary aggregates and the interest rate depends on the policy objective of the monetary authorities, the structure of the economy and, to a lesser extent, the source of exogenous shocks to the economy.

4.0 CONCLUSION

In this unit we have seen thatmonetary policy aims at achieving certain national goals which have historically included full employment (or a low unemployment rate), high output (or a high output growth), a stable price level (or a low inflation rate), and a stable exchange rate (or a desirable balance of payments). These are often referred to as the "ultimate goals" of monetary policy. These goals are usually achieved indirectly by the monetary authorities (central banks) through its use of monetary policy instruments.

5.0 SUMMARY

In this unit, you have learnt themeaning of monetary policy framework, the factors that influence the CBN choice of monetary framework and examined the relationship between monetary policy tools targets and goals.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the factors that influence the CBN choice of monetary framework.

7.0 REFERENCES/FURTHER READINGS

Afifia-Oru, B. (2009). *Dynamics of Credit Economic System in Africa*. Lagos: ByolahConcepts Ltd.

Central Bank of Nigeria (2011). Understanding MonetaryPolicy Series No 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy and directcontrols, retrievedfrom www.yourarticlelibrary.com/eco

Dirk, H. (1999). *Regulations of Banking and Financial Market.*Encyclopedia of Law and Economics.

UNIT 2 STRATEGIES OF MONETARY TARGETING IN NIGERIA

CONTENTS

1.0 INTRODUCTION

The strategy of monetary policy involves modifying the amount of base money (M1) in circulation. This process of changing base money through the sale and purchase of government securities is called open market operations. Continuous market transactions by the monetary authorities modify the supply of money which affects other market variables such as short term interest and exchange rates.

2.0 OBJECTIVES

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

- explainthe different strategies of monetary policy with the set instruments, targets and long term objectives
- discuss price level targeting
- analyse the concept of Inflation targeting
- discuss the concept of exchange rate targeting.

3.0 MAIN CONTENT

3.1 The Distinction between the Various Strategies of Monetary Policy

The distinction between the various strategies of monetary policy lies primarily with the set of instruments, targets and variables that are used by the monetary authorities to achieve the desired goals (Table 3.1). The strategies of monetary policy could be classified as; monetary targeting, price level targeting, inflation targeting and exchange rate targeting. Under the monetary targeting approach, the target variable is the growth in money supply designed to achieve the long-term objective of price stability. This is currently used by CBN. Under this framework, the central bank watches very closely growth in the monetary aggregates in order to predict the future size of money supply. If the monetary aggregates were growing too quickly, it could trigger inflationary pressures (more money chasing after the same amount of goods and services leads to rising prices) and cause the central bank to raise interest rates or otherwise halt growth in moneysupply. While other monetary policy strategies focus on a price signal of one form or another, this approach is focused on monetary quantities.

Table 3.1

Monetary Policy	**Target Variable**	**Long Term Objective**
Monetary Targeting	Growth in money supply	A given rate of change in CPI
Price Level Targeting	Interest rate on	A specific CPI
Inflation Targeting	Interest rate on overnight debt	A given rate/band of inflation
Fixed Exchange Rate	Spot price of the currency	A given rate of change in CPI

3.2 Price Level Targeting

Price level targeting is similar to inflation targeting in that both establish targets for a price index like the CPI. However, where inflation targeting only looks forward (i.e., a 2% inflation target per year), price level targeting actually takes past years into account when conducting open market operations. So, if the price level rose by 2% in the previous year (from a theoretical base of 100 to 102), the price level would have to drop the next year in order to bring the price level back down to the 100 target level. This could mean more forceful action needs to be taken than would be required if inflation targeting were used.

Price level targeting is generally considered a risky policy stance, and one not used by many central banks. It is believed to bring more variability in inflation and employment in the short run compared to inflation targeting. Most economies feel that a small amount of annual inflation is (up to about 2% per year) actually good for the economy.

3.3 Inflation Targeting

Inflation targeting is a monetary policy framework, in which a central bank estimates and makes public a projected, or "target", inflation rate and then attempts to steer actual inflation towards the target through the use of interest rate changes and other monetary tools. The likely actions of the central bank to raise or reduce the policy rate become more transparent under inflation targeting. If inflation is above the target, the central bank is likely to raise the policy rate. This usually (but not always) has the effect over time of cooling the economy and bringing down inflation. If inflation is below the target, the central bank is likely to lower the policy rate. This usually (again, not always) has an effect over time of accelerating the growth rate of the economy and raising inflation.

Under the framework, investors know the target inflation rate and therefore can more easily anticipate interest rate changes and factor these into their investment decisions. This is regarded by proponents of inflation targeting as leading to increased economic stability.

3.4 Exchange Rate Targeting

Under exchange rate targeting, the value of a currency is fixed in relation to another currency or a basket of currencies. This facilitates trade and investment between the two countries, and is especially useful for small economies where external trade forms a large part of their GDP. It can also be used as a means to control inflation. However, as the reference value rises and falls, so does the currency pegged to it.

4.0 CONCLUSION

We have seen that continuous market transactions by the monetary authorities modify the supply of money which affects other market variables such as short term interest and exchange rates.

5.0 SUMMARY

You have learnt the different strategies of monetary policy with the set instruments, targets and long term objectives.

6.0 TUTOR-MARKED ASSIGNMENT

Attempt to match diagrammatically, the different monetary policies with their target variables and long term objectives.

7.0 REFERENCES/FURTHER READING

Afifia-Oru, B. (2009). *Dynamics of Credit Economic System in Africa*. Lagos: ByolahConcepts Ltd.

Central Bank of Nigeria (2011). Understanding MonetaryPolicy Series No 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy and directcontrols, retrievedfrom www.yourarticlelibrary.com/eco

Dirk, H. (1999). *Regulations of Banking and Financial Market*. Encyclopedia of Law and Economics.

UNIT 3 UNEMPLOYMENT ANDINFLATION AGGREGATE

CONTENTS

1.0 INTRODUCTION

The attempt to develop a more convincing framework for explaining high unemployment as an equilibrium phenomenon has led to at least three major trends in macroeconomics since the mid-eighties. First the micro-foundation of macroeconomic theory has been strengthened. The modern analysis of the behaviour of firms, households and unions is based on rational decisions. Second, the theoretical model increasingly leaves behind partial analysis and move on to a general equilibrium framework. Third, Walrasian-type models which assume perfect markets have become more and more obsolete.

2.0 OBJECTIVES

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

- explain the concept of unemployment
- discuss the structuralist approach of unemployment
- analyse unemployment as a structural labour market problem
- explain the income distribution theory of inflation
- discuss the conventional economist view of inflation and unemployment.

3.0 MAIN CONTENT

3.1 The Concept of Unemployment

The International Labour Organization (ILO) defines the unemployed as members of the economically active population who are without work but available for and seeking work, including people who have lost their jobs or who have voluntarily left work (IBRD, 2009). Morio and Zoctizoum (1980) define unemployment as works available for employment whose contract of employment has terminated or been temporarily suspended and who are without a job and seeking paid employment; persons never previously employed whose most recent status was other than that of employee, together with persons who had been in retirement, who were available for work during the specified period and were seeking paid employment; persons without a job and currently available for work who have made arrangements to start a new job at a date subsequent to the specified period; and persons temporarily or indefinitely laid off without pay. The impression of these definitions is that persons who are without paid jobs to earn decent living are unemployed. In Nigeria's unemployment scenario, the young school leavers of all categories are the worst hit. This cream of jobless youths belongs to the major workforce of the economy but being wasted as they seek for job endlessly without success. One of the greatest challenges facing the Nigeria economy is unemployment which has maintained a rising trend over the years. The total labour force in Nigeria is made up of all persons aged 15-64 years excluding students, home keepers, retired persons and stay-at-home to work or not interested.

Unemployment is a very serious issue in Africa and particularly in Nigeria. The need to avert the negative effects of unemployment on poverty has made the tackling of unemployment problems to feature very prominently in the development objectives of many developing countries.

3.2 "Structuralist"Approach of Unemployment

Today, the dominant explanation of aggregate unemployment, the so-called"structuralist" approach', starts with imperfect competition oflabour and goodsmarkets. In the basic scenario firms exert some influence on the prices for theirproducts and wages are determined in a bargaining process between unions andemployers or by efficiency wage considerations. This implies that the interdependenceof wage and price formation is explicitly taken into account. The unemploymentrate is the key variable that equilibrates the conflicting claims of wageand price-setting agents. This approach allows the influence of a variety of factors determining changes in equilibrium unemployment to be studied.

We do not intend to summarize all theoretical developments since the mid-80s,our contribution starts with a description of the standard “structuralist”model. Although several reviews of this approach exist in the literatures, the basicframework is recapitulated in section 2. It is well known that in this model, equilibriumunemployment is not affected by stabilization policies, but rather onlydepends on the institutional setup. Since this implication does not correspond withthe empirical facts, we consider two extensions of the basic model. The firststresses the importance of persistence and hysteresis effects on unemployment, thesecond focuses on open-economy aspects. It can be shown that through both extensionsthe demand side once again comes into play.

Building on the “structuralist” framework, we then turn to a two-sector economydifferentiated by the skill intensity of their products in section 4. By using such anapproach it is possible to create a link between macroeconomic theory and therecent literature dealing with the impacts of globalization and biased technicalchange on the employment performance of different skill groups. Our aim is tointroduce some new aspects to this important debate.

3.3 Unemployment as a Structural Labour MarketProblem

The “structuralist” model takes the assumption of imperfect competition on goods and labour marketsas a starting point. The different variants of this approach can, in principle,be condensed into two central equations for real wages and unemployment whichserve as substitutes for the supply and demand relationships in traditional labormarket analysis.

The first relationship, called the price-setting equation, stems from firm behaviouron the goods markets and is usually derived under the assumption of monopolisticcompetition using a variant of the influential model.

This approach offers the great advantage that strategic interactions among firmscan be neglected as the single firm is small compared to the economy. A sensible,but rarely used, alternative to this type of modeling rests on the assumption of"conditional monopolies" whose market power is constrained by the (higher)marginal costs of potential competitors. However, both approachesshare the assumption of identical films and individuals and of a symmetricdemand for commodities, which, in principle, leads to the same price-settingequation in the correct-expectation equilibrium.

Profit maximizing firms set prices as a mark-up p on marginal costs, the latterdepending on wages and employment This price-setting equation can be solvedfor real wages, thus determining the real wage the rums are willing to pay at eachlevel of employment We use the term 'price-setting equation" for this transformedexpression as well. Assuming the labor force, L,to be given, the level of employment, N, can also be expressed as $(l - u)$L, where $u$is the unemployment rate.

3.4 The Income Distribution Theory of Inflation and Unemployment versus the Conventional Economic Theories

What went wrong? Where were the conventional mainstream economic theories, the economic analysis and forecasts and the policies based on them mistaken?

All the developments described above , the great success of Germany and Japan and later of the U.S. in fending off the adverse effects of the energy crisis on their economies by economic-stimulus policies; the instant stagflation following the implementation of the "inflation fighting" monetarist economic policy; the existence of the inflation, unemployment and "inflation-fighting" policy triangle in the long term and the recent large liquidity of the Western economies in times of recession contradict the notion of a trade-off between inflation and unemployment. These developments are not marginal events, but they are all central to the recent economic history of the West, they are its turning points. They also certainly do not demonstrate the anti-inflationary and anti-unemployment potential of the "inflation fighting" and "unemployment fighting" monetarist economic policies, which are both focused on wage cutting, deficit cutting and raising interest rates.
It we look at these monetarist economic policy measures, it becomes apparent that each of them separately and all of them together, immediately and first and foremost redistribute incomes in an inequitable way, long before they can have any effect — if they have such an effect at all — on inflation or on unemployment.

We claim that the adverse effects on income distribution of these policy measures are what neutralize their ability to fight both inflation and also unemployment, separately or together. We assume — and our theory is built on this assumption — that both inflation and unemployment redistribute income in an un-egalitarian way. They do this by themselves along their course, and we shall show that they also accelerate themselves through this income redistribution effect. If this assumption is true — as we will describe below — it must also be true that an economic policy which works in the same direction of income redistribution as inflation and unemployment do, only aggravates them. Our policy conclusion is that only a policy which offsets this distribution effect of inflation and unemployment, a policy which redistributes income in a more equitable way, can fight inflation and unemployment.

3.5 The Conventional Economic Theories

These theories completely ignore the income redistribution process as an active economic factor which can determine the price level and the level of employment. They completely disregard the distribution effects, both of the economic crisis itself and of the "crisis fighting" austerity policies. Because the analytical tools of the conventional theories are the aggregates, only the aggregate (total) income, demand and consumption are the variables, the active economic factors in the theory — income distribution slips through, and is omitted from the theory. We claim that this omission of the income redistribution process from the mainstream theories, especially from the theory of inflation, leads them into contradictions with themselves and with the real world — as happens to every theory which does not incorporate into its theoretical framework a potent component of the real world. This omission prevents them from getting to the source of stagflation and so they still see inflation and unemployment as contradictory phenomena. While inflation is clearly a process of continuous price rise, in the eyes of the conventional theories it is a sequence of completely independent price jumps caused by exogenous supply shocks and has no demand side at all. We will show an intrinsic, built-in mechanism, through which inflation — as well as stagflation — fuels itself. We will show that inflation does have a demand side, but it is not the aggregate demand.

Because conventional theories deal only with the aggregate income and demand, they have no theoretical guide which could tell us which incomes to cut in order to fight inflation. We attribute to this the failure of Aggregate Demand Management, the only known policy for fighting inflation and unemployment on the national level. Aggregate Demand Management does not take into account the income redistribution effect of inflation and unemployment (IREIU) — which our Income Redistribution Theory of Inflation and Unemployment (IRTIU) does, thereby enabling it to serve as a reliable policy guide on the national level. If government policies — instead of cutting incomes which gain in inflation, and for this reason can buy anything at any price — raise the axes on incomes which shrink in inflation anyway and, for this reason, cannot be the cause of it, inflation will not recede.

Worse, because conventional economics disregards the role of profits as a component of the aggregate demand and also of the aggregate cost in the economy, it incorrectly identifies these aggregates with wages. It follows that cutting wages seems like the universal remedy for both inflation and unemployment. Conventional economics is focused around this central thesis. But if this was true, inflation and also unemployment would long ago have converged by themselves through their unquestionable effect of eroding wages — even without government intervention, and certainly with government intervention in the same direction. But this never happens.

We intend to show in our theory that it is not the increase, but the de-crease of wages that stands behind inflation and unemployment. The double effect of wage erosion means that decreasing wages on the one hand cause demand deficiencies in the wage goods market, and thus unemployment, and on the other hand, the profits which are made at its expense accelerate inflation. It makes no difference whether inflation, unemployment or government economic policy triggers this inequitable redistribution of income. We will show that above a certain rate inflation has an "unemployment effect", and within a certain range unemployment has an "inflationary effect".

When conventional economic theories do acknowledge the existence of the redistribution effect, it is considered more as a moral issue, subject to value judgment, than as an economically meaningful force, and it hardly affects pure economic thought. It is often mentioned as a possible outcome of the interaction between different economic forces, but not as an active force in its own right. In those cases when economists do deal with the income distribution as an economic factor, it is considered only in a static way, and in connection with its effect on the aggregate consumption function. Namely, they try to determine whose marginal propensity of consumption (MPC) is larger, that of the poor or that of the rich, and accordingly, how the aggregate consumption is affected by the state of the income distribution in the economy. In either direction only slight effects were found. There is also work on the effect of taxation on the GNP. Instead, we deal with income distribution in its dynamics, with the income re-distribution process and its effect on the demand structure of the economy. We find that income redistribution plays a major role in influencing employment and the price-level.

4.0 CONCLUSION

We have seen in this unit thatthe attempt to develop a more convincing framework for explaining high unemployment as an equilibrium phenomenon has led to at least three major trends in macroeconomics since the mid-eighties.

5.0 SUMMARY

You have learnt in this unit the concept of unemployment, the "structuralist"approach ofunemployment as well as unemployment as a structural labour market problem. You have also learnt about the income distribution theory of inflation and unemployment versus the conventional economic theories. Also, that because conventional economists disregard the role of profits as a component of the aggregate demand and also of the aggregate cost in the economy, it incorrectly identifies these aggregates with wages. It follows that cutting wages seems like the universal remedy for both inflation and unemployment.

6.0 TUTOR-MARKED ASSIGNMENT

1. Discuss briefly what you understand by unemployment as a structural market problem.
2. Discuss briefly the views of conventional economists as regards inflation and unemployment targets.

7.0 REFERENCES/FURTHER READING

Afifia-Oru, B. (2009). *Dynamics of Credit Economic System in Africa*. Lagos: ByolahConcepts Ltd.

Central Bank of Nigeria (2011). Understanding MonetaryPolicy Series No 3, CBN Monetary Policy Framework.

Chand, S. (Undated). Economic stabilization: Monetary policy and Directcontrols, retrievedfrom www.yourarticlelibrary.com/eco

Dirk, H. (1999). *Regulations of Banking and FinancialMarket.* Encyclopedia of Law and Economics.

Okoh, J.I. &Okoh, J.O. (2013). Banking reforms and unemployment Implications in Nigeria.*Nigerian Journal of Public Administration*, 17(1), 113-129.