COURSE GUIDE

ECO 444
MONEY AND BANKING

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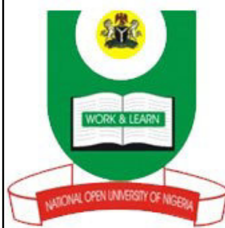

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INTRODUCTION

ECO 444 is a two credit unit course designed for final year economics students in the School of Art and Social Science at the National Open University of Nigeria. ECO 444 is a significant course to you in your academic pursuit as it will assist you to gain an in-depth understanding on how the banks and other financial institutions operate. More importantly, this course critically examined the relevant issues regarding money, credit and financial issue. It made some assumptions to serve as a guide to you for you to know the crucial role of the course in enhancing the stability of money in our economy.

Furthermore, this course will broaden your knowledge on how the economy is stabilized using the government monetary and fiscal policies. Subsequently, the course will inform you on what money and banking is and how money can be created in the banking industry.

Aside that, the course will also expose you to knowledge about different kinds of exchange rate in the exchange rate market. This course guide will provide you some guidance on your Tutor-Marked Assignment (TMA) as contained herein.

WHAT YOU WILL LEARN IN THIS COURSE

This course will detailed an in-depth knowledge on the theories of demand and supply, role of bank and international financial system in the economy. Also, you will be expose to knowing the difference between product, money and capital including their various functions and roles in the economy.

COURSE CONTENT

This course builds on the foundation of finance and economics on studying the role, function and significance of money and banking. Topics covered include; Theory of money, relevance of money in the economy, link between credit, money and interest rate, financial institutions and Nigerian financial system and its role in the economy etc.

COURSE AIMS

The overall aim of this course includes:

i. To introduce you to the basic concepts in money and banking .

ii. To teach you the major theories in demand for money and supply of money.
iii. To expose you to the mode of operation in the banking industries. And also to enhance your knowledge on activities of international monetary system and their operation.
iv. To broaden your knowledge on the roles and functions of the money and capital market in Nigeria.

COURSE OBJECTIVES

There are 12 study units in this course and each unit has its objective. You should read the objectives of each unit and bear them in mind as you go through the unit. Each unit of this course has its objectives unit. In addition to these, the course has its overall objectives. At the completion of this course, you should be able to:

- Explain the meaning and the origin of money
- Differentiate the different eras in the evolution of money
- Define the demand for money and explain the theories behind it.
- Differentiate between Classical Approach, the Keynesian Approach and the
- Post-Keynesian Approach.
- Define money, credit and interest.
- Explain the inverse relationship between interest rate, demand for money and investment.
- Understand the definition and evolution of banking system in Nigeria.
- Distinguish between banking financial institution and non banking financial institution.
- Identify the activities of the commercial bank from that of the merchant banks.
- Identify the organization structure of the commercial bank from that of the merchant banks.
- Understand the various non-bank financial institutions in Nigeria.
- Distinguish between non-bank financial institution and banks.
- Explain it significance to economic development Examines the financial reforms and it achievements .

WORKING THROUGH THIS COURSE

Each unit contains self-assessment exercises and tutor- marked assignment. At some points in this course, you will be required to submit assignments for assessment purposes. At the end of this course, there is a final examination. This course should take about 15 weeks to

complete. Some components of the course are outlined under the course material subsection.

To successfully complete this course, you are required to read the study units, referenced books and other materials on the course.

COURSE MATERIALS

Major components of this course are:

1. Course guide
2. Study units
3. Text books
4. Assignment file
5. Presentation schedule

STUDY UNITS

The breakdown of the four modules and 12 units are as follows.

Module 1 Basic Concepts Of Money And Credit

Unit 1: Meaning and relevance of money
Unit 2: Theory of money
Unit 3: A links between money, credit and interest rate

Module 2 Financial Institution and Its Relevance to the Economy

Unit 1: Meaning of financial institution and its classification.
Unit 2: Nigerian Money Deposit Bank (Commercial Bank)
Unit 3: Other financial institution and its relevance.

Module 3 The Nigerian Financial System

Unit 1 Nigerian financial system and its significance to economic development
Unit 2 The financial market and its role in economy acceleration
Unit 3 The capital market, structure and its achievement

Module 4 Monetary Policy Framework and its International Monetary System

Unit 1 Concepts of monetary policy, instruments and its operational framework.
Unit 2 Central bank in action and its economic significance
Unit 3 International monetary system.

REFERENCES AND TEXTBOOKS

Every unit contains a list of references and further reading. Try to get as many as possible of those textbooks and materials listed. The textbooks and materials are meant to deepen your knowledge of the course.

ASSIGNMENT FILE

In this file, you will find all the details of the work you must submit to your tutor for marking. The marks you obtain from these assignments will count towards the final mark you obtain for this course. Further information on assignments will be found in the assignment file itself and later in this Course Guide in the section on assessment.

PRESENTATION SCHEDULE

The presentation schedule included in your course materials gives you the important dates for the completion of tutor-marked assignments and attending tutorials. Remember, you are required to submit all your assignments by the due date. You should guard against lagging behind in your work.

ASSESSMENT

Your assessment will be based on tutor-marked assignments (TMAs) and a final examination, which you will write at the end of the course.

TUTOR-MARKED ASSIGNMENT

There are many tutor-marked assignments in this course. You will submit all the assignments. You are encouraged to work all the questions thoroughly. The TMAs constitute 30 per cent of the total score.

Assignment questions for the units in this course are contained in the Assignment File. You will be able to complete your assignments from the information and materials contained in your set books, reading and study units. However, it is desirable that you demonstrate that you have read and researched more widely than the required minimum. You should use other references to have a broad view point of the subject and also to give you a deeper understanding of the subject. When you have completed each assignment, send it, together with a TMA form, to your tutor. Make sure that each assignment reaches your tutor on or before the deadline given in the Presentation File. If for any reason, you cannot complete your work on time, contact your tutor.

FINAL EXAMINATION AND GRADING

The final examination will be of three hours' duration and have a value of 70% of the total course grade. The examination will consist of questions which reflect the types of self-assessment practice exercises and tutor-marked problems you have previously encountered. All areas of the course will be assessed. You are advised to use the time between finishing the last unit and sitting for the examination to revise the entire course material. You might find it useful to review your self- assessment exercises, tutor-marked assignments and comments on them before the examination. The final examination covers information from all parts of the course.

COURSE MARKING SCHEME

The table presented below indicates the total marks (100%) allocation.

ASSESSMENT MARKS

Tutor-marked assignment (best three assignment out of the four marked) 30% Final Examination 70% Total 100%

COURSE OVERVIEW

The Table presented below indicates the units, number of weeks and assignments to be taken by you in this course.

HOW TO GET THE MOST FROM THIS COURSE

One of the great advantages of distance learning is that; you can read and work through specially designed study materials at your own pace and at a time and place that suit you best. Think of it as reading the lecture instead of listening to a lecturer. In the same way that a lecturer might set you some reading to do, the study units tell you when to read your books or other material, and when to embark on discussion with your colleagues. Just as a lecturer might give you an in-class exercise, your study units provides exercises 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 integrated 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. If you make a habit of doing this you will significantly improve your chances of passing the course and getting the best grade. The main body of the unit guides you through the required reading from other sources. This will usually be either from your set books or from a readings section. Some units require you to undertake practical overview of historical events. You will be directed when you need to embark on discussion and guided through the tasks you must do. The purpose of the practical overview of some certain historical economic issues are in twofold. First, it will enhance your understanding of the material in the unit. Second, it will give you practical experience and skills to evaluate economic arguments, and understand the roles of history in guiding current economic policies and debates outside your studies. In any event, most of the critical thinking skills you will develop during studying are applicable in normal working practice, so it is important that you encounter them during your studies.

Self-assessments are interspersed throughout the units, and answers are given at the ends of the units. Working through these tests will help you to achieve the objectives of the unit and prepare you for the assignments and the examination. You should do each self-assessment exercises as you come to it in the study unit. Also, ensure to master some major historical dates and events during the course of studying the material. The following is a practical strategy for working through the course. If you run into any trouble, consult your tutor. Remember that your tutor's job is to help you. When you need help, don't hesitate to call and ask your tutor to provide it.

1. Read this Course Guide thoroughly.
2. Organize 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 units. Important information, e.g. details of your tutorials, and the date of the first day of the semester is available from study centre. You need to gather together all this information in one place, such as your dairy or a wall calendar. Whatever method you choose to use, you should decide on and write in your own dates for working breach 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 course work. If you get into difficulties with your schedule, please let your tutor 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 also 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 the unit you will be instructed to read sections from your set books or other articles. Use the unit to guide your reading.
7. Up-to-date course information will be continuously delivered to you at the study centre.
8. Work before the relevant due date (about 4 weeks before due dates), get the Assignment File for the 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 exam. Submit all assignments no later than the due date.
9. 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.
10. 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.
11. When you have submitted an assignment to your tutor for marking, do not wait for its return `before starting on the next units. Keep to your schedule. When the assignment is returned, pay particular attention to your tutor's comments, both on the tutor-marked assignment form and also written on the assignment. Consult your tutor as soon as possible if you have any questions or problems.
12. After completing the last unit, review the course and prepare yourself for the final examination. Check that you have achieved the unit objectives (listed at the beginning of each unit) and the course objectives (listed in this Course Guide).

FACILITATOR/TUTOR AND TUTORIALS

There are some hours of tutorials (2-hour session) provided in support of this course. You will be notified of the dates, times and location of these tutorials. Together with the name 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, and 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 tutor if:

- You do not understand any part of the study units or the assigned readings
- You have difficulty with the self -assessment exercises
- You have a question or problem with an assignment, with your tutor's comments on an assignment or with the grading of an assignment.

You should try your 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. 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

On successful completion of the course, you would have developed critical thinking skills with the material necessary for efficient and effective discussion of economic issues and integration of past events with the present. However, to gain a lot from the course please try to apply anything you learn in the course to term papers writing in other economic development courses. We wish you success with the course and hope that you will find it both interesting and useful.

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MODULE 1 BASIC CONCEPTS OF MONEY AND CREDIT

Unit 1: Meaning and relevance of money
Unit 2: Theory of money
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UNIT 1 MEANING AND RELEVANCE OF MONEY

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1.0 INTRODUCTION

In this unit, we will begin the course by introducing and further expatiating on the evolution of money, before explaining the meaning and relevance of money. We will also explain the various eras in the evolution of money such as era of spherical adventure, era of subsistence, era of Barter System, era of money exchange-commodity money, era of money exchange full bodied money, era of token or credit

money and era of e-money. Furthermore, we shall look at the significant of money in the economy and also the four major functions of money in the economy.

2.0 OBJECTIVE

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

- Explain the meaning and the origin of money
- Differentiate the different eras in the evolution of money
- Have broad understanding on the four major functions of money
- Explain the roles or significance of money in the economy

3.0 MAIN CONTENT

3.1 Evolution of Money

Before the evolution money, exchange was done on the basis of direct exchange of goods and services. This direct exchange is known as the barter system. Barter system involves the direct exchange of one good for some quantity of other goods, for instance, exchanging a horse for a cow. Consequently, this exchange at a time become more difficult in that people finds it very difficult to get someone that can exchange what they have to what they want. Apparently, this problem of search resulted to the problem of barter system. Consequently, in the quest to solving the problem of barter resulted to the means of exchange that requires no goods for goods rather money for goods, which is classified as monetary evolution of money . To further understand the monetary evolution of money, we will have to discuss each of the Era in the evolution of money, down to the credit money era.

3.1.1 The Era of Spherical Adventure (Anomalism)

This era was marked by the movement of man from one end of the earth to the other. At last, he discovered that most of the fruit seeds he had dropped in the past had geminated and grown into new fruit producing trees. Thus, this discovery marked the beginning of agriculture, which called for ownership, possession and control. The end of this era opened the door for a new era called the subsistence era.

3.1.2 The Era of Subsistence (Autarky or No Exchange)

Autarky is a Greek word from autarkeia meaning self-sufficient. According to investopedia it is both political and an economic term. Autos mean “self” and arkein means “to be strong enough or sufficient”.

Consequently, it define autarky as a state of independence and been functional without partaking in any international trade. The era of subsistence was marked by the simple ownership, possession and control of the natural resource. However, man discovered over time that whatever he personally owned possessed and controlled in expanding the family could not be enough for him. This development gave rise to the emergence of direct exchange.

3.1.3 The Era of Barter System (Direct Exchange)

This era of direct exchange was marked by the exchange of goods and services for goods and service within and among the expanding families. The system had no room for any medium of exchange as people exchanged the goods and services at their disposal with what the other party had for exchange. This simply means exchanging directly with your immediate or extended family person without necessarily looking distinct person before exchanging. For instance, if a man who had a goat needed a bag of orange, he could directly exchange his goat for the bag of orange without recourse to any medium of exchange.

3.1.4 The Era of money exchange-community money (indirect exchange)

This era actually came to resolve some of the problems posed by the barter system. Thus, unlike the barter system, the money exchange-commodity money era identified and designated few commodities to serve as medium of exchange, such commodities as oxen, clothes, slaves; salt, etc were all used as a medium of exchange. Consequently, some scholars argued that these commodities were acceptable as the medium of exchange at this era because they were the most priced and sought after by the buyers of goods and services (see Element of Banking by A.C.Onyia, 2007:6).

3.1.5 The Era of Money Exchange (Full bodied money)

The era of money exchange or full bodied money, provided solution to some of the persistent barter system problems. Money exchange or full bodied money era was the period when metals and subsequent papers were used as money. Iron was the first metal used, but with effluxion of time, gold, silver, copper were introduced to replace iron because the latter was prone to rusting and very bulky to convey from place to place. The gold metals were replaced by cheaper metals such as silver and copper. At this era, the face and intrinsic values of money were equal (see Element of Banking by A.C.Onyia, 2007:6).

3.1.6 The Era of Paper Money

This is the era of goldsmith. The development of paper money started with goldsmiths who kept strong safes to store their gold. As goldsmith was thought to be honest merchant, people started keeping their goldsmiths them for safe custody. Thus, in return, the goldsmiths gave the depositors a receipt promising to return the gold on demand. However, these receipts of the goldsmiths were given to the sellers of commodities by the buyers. Thus, the receipts of the goldsmiths were use as substitute for money. Such paper money was backed by gold and was convertible on demand into gold. This ultimately led to the development of bank notes (see Element of Banking by A.C.Onyia, 2007:6-7).

3.1.7 The Era of Credit Money

Another era in the evolution of money in the modern world is the use of the cheque as money. The cheque is like a bank note in that it performs the same function. It is a means of transferring money or obligation from one person to another. A cheque is made for a specific sum and is not a bank note, as it empires with a single transaction. Thus, cheque is simply a written order to transfer money (see Element of Banking by A.C.Onyia, 2007:7).

3.1.8 The Era of E-money (Electronic and Cashless)

This is the era were payment or withdrawal is done by the use of card. In Nigeria, the concept of e-money was introduced in 1996 when the C.B.N. granted approval to the then All State Trust Bank Plc to offer ESCA Smart Card product (Onyia and Egungwu, 2004:11). Consequently, E-money simply means the application of electronic devices to effect payments arising from business transactions without the use of cash. It is important to note that e-money era has not foreclosed the use of note and coins, cheques and other credit instruments in transaction, rather it strictly de-emphasizes the use of cash in making payments in both local and international transactions.

SELF ASSESSMENT EXERCISE

i. Describe the various stages in the evolution of money
ii. Explain what led to the emergence of money in the modern world

3.2 Meaning of Money

The world „money‟ is derived from the Latin word „Moneta‟ whic h was the surname of the Roman goddess of Juno in whose temple at Rome money was coined. Having said that, one can say that money is something that has value that is it is a measure of value. According to the traditional view which is also known as the currency school, money is defined as currency and demand deposits, and its most important function is to act as a medium of exchange. Keynes in view, defined money as currency and demand deposit. Furthermore, Friedman Milton, the head of the monetarist school, defined money as the sum of currency plus all adjusted deposits and commercial bank time deposit. More so, the Radcliffe Committee defined money as note plus bank deposits. That is, it includes money as only those assets which are commonly used as medium of exchange. Assets here refer to liquid assets by which it means the monetary quantity influencing total effective demand for goods and service.

In spite of all the definitions given, Crowther, 2011contribute to existing literature when he gave his definition as ”Anything that is generally acceptable as a means of exchange and which at the same time acts as a measure and store of value is regarded as money.

3.3 Functions of Money

Money performs a number of primary, secondary, contingent and other functions which not only remove the difficulties of barter but also oils the wheels of trade and industry in the present day world. The functions are discussed below:

3.3.1 Primary Functions of Money

The primary functions are subdivided into two they are medium of exchange and money as a unit of value

i. Money as a Medium of Exchange—
ii. Money as a medium of exchange, acts as an intermediary i.e. it facilitates exchange. The introduction of money as a medium of exchange decomposes the single transaction of barter into separate transactions of sale and purchase, thereby eliminating the double coincidence of want. Also money as a medium of exchange helps production indirectly through specialization and division of labour which in turn increase efficiency and output.
ii. Money as Unit of Value: Money as a unit of value means that money is the standard for measuring value just as the yard or

metre is the standard for measuring length. The use of money as a standard of value eliminates the necessity of quoting the price of apples in terms of oranges, the price of oranges in terms of nut etc. Thus, money as a unit of value facilitates accounting and also helps in calculation of economic importance such as the estimation of the costs and revenues of business firms, the relative costs and profitability of various public enterprises and projects under a planned economy.

3.3.2 Secondary Function of Money

The secondary functions money is subdivided into three, they are;

i. Money as a standard of deferred payment Money as a standard of deferred payment means that purchase can be made now and payment will take effect in the future. Thus, by acting as a standard of deferred payment, money helps in capital formation both by the government and businesses enterprise. The important thing about these functions is that it develops the financial and capital markets and also helps in the growth of the economy.

ii. Money as a store of value---- □ Money as a store of value is meant to meet unforeseen emergencies and to pay debt. In other words, one can store value for the future by holding short-term promissory notes, bonds, preferred stocks, e.t.c The disadvantages of these function is that they sometimes involve storage cost, depreciate in terms of money and are illiquid in varying degrees.

iii. Money as a transfer of value --- □ Since money is a generally acceptable means of payment and acts as a store of value, it keeps on transferring values from person to person and place to place. A person who holds money in cash or assets can transfer that to any other person.

3.3.3 Contingent Functions of Money

Money performs certain contingent or incidental functions, such as;

i. Money as the most liquid of all liquid assets: This means that money is the most liquid of all liquid assets in which wealth is held. Individuals or firms may hold wealth in various forms. They may decide to hold their wealth in currency, demand deposit, time deposit, treasure bills, short term government

securities etc. All these are liquid forms of wealth which can be converted into money.

ii. Basis of the credit system: Money is the basis of credit system, meaning that a commercial bank cannot create credit without having sufficient money in reserve.

iii. Equalizer of Marginal utilities and productivities: Money acts as an equalizer of marginal utilities for the consumer. The main aim of a consumer in this regard is to maximize his satisfaction by spending a given sum of money on various goods which he wants to purchase.

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

3.3.4 Other Functions of Money

Money performs other functions apart from the aforementioned ones such as;

i. Money is helpful in making decisions

This means that money is a means of store of value and the consumer can meet her daily requirement on the basis of money held by him. If the consumer has a scooter and in the near future he needs a car, he can buy a car by selling his scooter and money accumulated by him. In this way, money helps in taking decisions.

ii. Money as a basis of adjustment

To carry on trade in a proper manner, the adjustment between money market and capital market is done through money. Similarly, adjustment in foreign exchange rate and international payments are made through money.

SELF ASSESSMENT EXERCISE

i. Explain the various secondary functions of money

Distinguish between contingent functions of money and that of primary function of money

3.4 Role of Money in The Economy

Money is of vital importance to an economy due to its static and dynamic roles. Its static role emerges from its static or traditional functions. In its dynamic role, money plays an important part in the life of every citizen and in the economic system as a whole (M.L.Jhingan, 2010).

3.4.1 Static Role of Money

In its static role, the importance of money lies in removing the difficulties of barter in the following ways:

i. By serving as a medium of exchange, money removes the need for double coincidence of wants and the inconveniences and difficulties associated with barter. The introduction of money as a medium of exchange breaks up the single transactions of barter into separate transactions of sales and purchases, thereby eliminating the double coincidence of wants
ii. By acting as a unit of account, money becomes a common measure of value. The use of money as a standard of value eliminates the necessity of quoting prices.
iii. By acting as a store of value, money removes the problem of storing of commodities under barter. Money being the most liquid asset can be kept for long periods without deterioration or hostage.

iv. Money removes the difficulty of barter by facilitating the transfer of value form one place to another.
v. Money as a standard of deferred payment, simplified both taking and repayment of loans because the unit of account is durable. It also overcomes the difficulty of indivisibility of commodities.

3.4.2 Dynamic Role of Money

Money in its dynamic role plays an important part in the daily life of a person whether he is a consumer, producer, business man, politician etc. The Dynamic role of money influences the economy in number of ways:

i. Money possesses much significance for the consumer:

That is, consumer receives his income in the form of money rather than in goods and services. With money in his hand, he can get any commodity and services he likes, in whatever equalizer of marginal utilities for the consumer.

ii. Money is of equal importance to the producer. He keeps his account of the values of input and outputs in money.

iii. Money plays an important role in large scale specialization and division of labour in modern production i.e. it helps the capitalist to pay wages to a large number of workers engaged in specialized jobs on the basis of division of labour.

iv. By transforming savings into investment, money acts as a means to capital formation. Money in its form is a liquid asset which can be stored and storing of money implies savings and savings are kept in bank deposit to earn interest on them.

v. Money is also an index of economic growth. The various indicators of growths are national income, per capita income and economic welfare. These are calculated and measured in money terms. For instance, changes in the value of money or prices also reflect the growth of an economy.

vi. Money facilitates both national and international trade. The use of money as a medium of exchange, store of value and as a transfer of value has made

it possible to sell commodities not only within a country but also internationally.

vii. Money helps in solving the central problems of an economy; what to produce, for whom to produce, how to produce and in what quantities. This is because on the basis of its functions, money facilitates the flow of goods and services among consumers, producers and the government

viii. Money facilitates the buying and collection of taxes, fines fees, and prices of service rendered by the government to the people. It also simplifies the floating and management of public debt and government expenditure on development and non developmental activities.

SELF ASSESSMENT EXERCISE

- Briefly discuss the static role of money in the economy.
- Explain some of the dynamic significant of money in the economy.

4.0 CONCLUSION

In this unit, we extensively discussed the meaning and the relevance of money in the economy. Also, the major functions money has in the economy were not ignored. Money being what it is has helped in facilitating and making exchange easy, by putting to an end the problems barter system created.

5.0 SUMMARY

This unit treats the fundamentals of money by looking into the various eras in the evolution of money as well as explaining them in details. Also, different definition of money was given by different economists, ranging from the traditional definition down to the monetarist definition of money. In the course of writing, we found out that money plays significant role in the economy.

6.0 TUTOR-MARKED ASSIGNMENT

1. Differentiate between money as a medium of exchange and money as the most liquid of all liquid assets.
2. State the static roles of money in the economy.
3. Differentiate between era of subsistence and era of spherical adventure.

7.0 REFERENCES/FURTHER READING

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UNIT 2 THEORY OF MONEY

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1.0 INTRODUCTION

Having discussed extensively on the relevance and meaning of money in the previous unit, this current unit will further explain the theory of money, by focusing on the theory of demand for money only. Having said that, one can define the demand for money as the amount of wealth everyone in the society wishes to hold in the form of money balances. In other words, it is the desire of people to hold money balances either in cash or in demand deposit form. It is important to note that the demand for money is directly related to the level of income i.e. the higher the income level; the greater will be the demand for money. Consequently, in this unit, we will discuss in detail the classical approach to demand for money, the Keynesian and the post Keynesian demand for money.

2.0 OBJECTIVES

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

- Define the demand for money and explain the theories behind it.
- Differentiate between Classical Approach, the Keynesian Approach and the
- Post-Keynesian Approach.
- Explain the superiority over each and the criticisms of each.

3.0 MAIN CONTENT

3.1 The Classical Approach to Demand for Money

The Classical economists did not explicitly formulate demand for money theory but their views are inherent in the quantity theory of money. The Classical economist which has Irving Fisher and the Cambridge School has slightly different views on the demand for money theory. These two will be explained subsequently in detail.

3.1.1 Irving Fisher View to Demand for Money

Irving Fisher was the first classical economist to develop a theory on quantity theory of money, although he did not explicitly formulate demand for money. In his theory postulated in 1928, established the link between quantities of money and total amount of money spent on goods and services in the economy. In his equation of exchange he said that $MV = PT$ Where

M is Money stock

V is Velocity,

P is Price Level and

T is Average Transaction of goods in the economy.

According to his theory, holding velocity and average transaction constant, anything that happens to money stock will also happen to price, that is, if money stock doubles in the economy, price will also double. Consequently, the Fisher"s equation of exchange shows that the right hand side of the equation i.e. PT represent the demand for money, which depends upon the value of the transactions to be undertaken in the economy and is equal to constant fraction of those transaction while MV represents the supply of money.

Furthermore, the demand for money in Fisher"s approach is a constant proportion of the level of transaction which in turn bears a constant relationship to the level of national income. The theory of demand for money by fisher"s has faced severa l criticisms. It is said that the theory failed to incorporate or consider interest as a factor and also that there is no way velocity in economy can be held constant, just to mention a few. Lastly, one of the problems Fisher theory has among other problems is that he did not explain fully why people hold money and also he did not clarify whether to include money in such items as time deposit or saving deposit that are not immediately available to pay debts without first being converted into currency.

3.1.2 The Cambridge or Cash Balance Approach

The Cambridge economists are set of classical economists who are interested to know why people want to hold their assets in the form of money. Unlike Irving Fisher who dwelt so much on the transaction motive for demand for money and who also see money as a medium of exchange, the Cambridge economist view the demand for money from the precaution aspect and also see money not as a medium of exchange but as a stock of value. Also, just like Fisher, the Cambridge expresses the demand for money function as M d = KPY where M d is the demand for money K is the Constant of proportionality or the fraction of the real money income which people wish to hold in cash P is the price level and

Y is the aggregate real income.

The Cambridge approach to demand for money includes time and saving deposits and other convertible funds in the demand for money. They also stressed the importance of factors that make money more or less useful, such as the cost of holding it, uncertainty abou t the future etc. Just the way Fisher"s theory was criticized, the Cambridge theory was also criticized.

In a nutshell, the classical economist was subjected to criticism. One of the major criticisms of the classical approach to demand for moneys is that they emphasized only on medium of exchange and store of value function of money without considering other factors that affects demand for money such as interest rate.

Second, it failed to analyze variation in the price level due to saving-investment inequality in the economy.

Third, the theory is weak in that it ignores other influence such as the rate of interest which exerts a decisive and significant influence upon the price level.
Fourth, the theory neglected speculative demand for money. The neglect of the speculative demand for cash balance makes the demand for exclusively dependent on money income thereby neglecting the role of the rate interest and the store of value function of money.

Fifth, the cash balance approach does not tell about changes in the price level due to changes in the proportions in which deposits are held for income, business and saving purposes.

SELF ASSESSMENT EXERCISE

i. Distinguish between Fisher‟s demand for money and the Cambridge demand for money approach.

3.2 The Keynesian Approach to Demand for Money: Liquidity preference

The Keynesians are the set of British economists who believe in the efficiency of fiscal policies as opposed to the use of monetary policies to control economic activities. They hold the view that demand for money falls within the realm of liquidity preference. Lord Keynes in his theory of demand for money suggested three motives to demand for money. These motives are:

A. Transaction Demand for Money: This simply refers to the need to hold some money for daily business transaction. The transaction demand for money arises from the medium of exchange function of money in making regular payment for goods and services. Keynes in his theory of demand for money divided the transaction demand for money into two i.e. Income Motive which means to bridge the interval between the receipt of income and its disbursement and secondly Business Motive which means to bridge the interval between the time of incurring business cost and that of the receipt of the sale proceeds (see M.L.Jhingan, 2011:186). Consequently, Keynes in his theory further argued that the transactions demand for money is a stable function of the level of income and that the transaction demand for money has a direct proportional relationship with the level of income i.e. L T = f (KY), while L T of transaction demand for money while KY represent linear and proportional relationship between transaction demand for money and the level of income. Keynes in his transaction demand for money did not stress the role of interest rate.

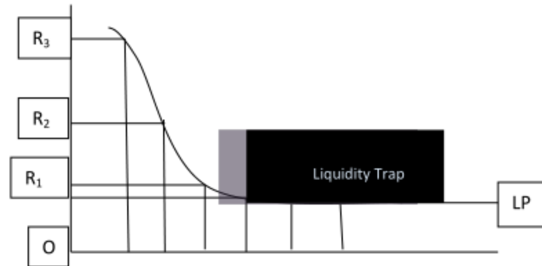
B. Precautionary Demand for Money: This is a situation where money is held for unforeseen circumstance and eventualities. Both individuals and businessmen keep money or cash to meet unexpected needs. The precautionary demand for money depends upon the level of income, and business activity, opportunities for unexpected profitable deals, availability of cash, the cost of holding liquid assets in bank reserve etc.

Keynes in his analysis held that the precautionary demand for money like transaction demand is a function of the level of income. But the Post- Keynesian economists believe that like transaction demand, it is inversely related to high interest rate. Note both the transaction and precautionary demand for money will be unstable, particularly if the economy is not at full employment level and transactions are therefore, less than the maximum and are liable to fluctuate up and down.

According to Keynesian, the precautionary demand for money is expressed as $L T = f (Y, r)$.

C. The Speculative Demand for Money: The speculative or asset or liquidity preference of demand for money is for securing profit from knowing better than the market what the future will bring forth. Also, it is a situation where people hold money not for transactions or precautionary purpose, but for the purpose of making more profit in the future or taking advantage of investment in the future. Thus, money held for speculative purposes is a liquidity store of value which can be invested at an opportune moment in interest bearing bonds or securities. According to Keynesian, in his liquidity preference theory, bond prices and the rate of interest are inversely related to each other. This is to say that low bond prices are indicative of high interest rate and high bond price reflect low interest rates. Note importantly that wealth holders go for capital gain so as to avoid capital loss. For instance, if the rate of interest is higher than normal and so is being expected to fall, wealth holders demand less money, that is, they hold more bonds in anticipation of capital gain i.e. they will buy bonds to sell them in future when their prices rise in order to gain. Conversely, if the rate of interest is low than normal and so being expected to rise, the demand for money will be high, this giving the wealth holders the opportunity to sell bonds in the present so as to avoid capital. Thus, it is important to note that the speculative demand for money is a decreasing function of the rate of interest. The higher

the rate of interest, the lower the speculative demand for money and vice versa. This is shown graphically below



Speculative demand for money according to Keynesian is expressed as L S = f (r). Also, he further explain liquidity trap as a situation where the real interest rate cannot be reduced by any action of the monetary authorities. This is likely to happen when the market interest rate is very low so that the yields on bonds, equities and other securities will also be low.

3.2.1 Criticisms of the Keynesian Theory of Demand for Money

The Keynesian theory of demand for money was undoubtedly a radical improvement over the classical and neoclassical theories of money. His theory has however been criticized on the following ground by post-Keynesian theorist;

Firstly, Keynes division of demand for money between precautionary and speculative motive is unrealistic, because people do not maintain a separate purse for each motive. They have one purse for all purposes. Besides, empirical evidence shows that, contrary to Keynes postulate, even the transaction demand for money is interest elastic.

Secondly, critics reflect the Keynesian postulate that there exists a normal rate of interest and the current rate of interest may not necessarily be the same as the normal rate: there may always be a difference between the two. According to Keynes, the speculative demand for money is governed by the difference between the normal and the current rate of interest, but the critics argues that if the current rate of interest remains stable over a long period of time, people tend to take it to be normal rate. Consequently, the difference between the current rate and the normal rate disappears.

Thirdly, Keynes assumed unrealistically that the people hold their financial assets in the form of either idle cash balance or bond. In fact, people hold their assets in a combination of both assets.

SELF-ASSESSMENT EXERCISE

i. Differentiate between the Transaction motive and the Speculative motive of
ii. demand for money.
iii. Explain the term liquidity trap using graph as a support.

3.3 The Post-Keynesian Approach To Demand For Money

The Post-Keynesian has their approaches to demand for money. According to Keynes in his approach to demand for money brought out three motives to demand for money. These motives have been extensively analyzed in the Keynes demand for money. Consequently, Keynes in his demand for money believed that the transactions demand was primarily interest inelastic. He analyzed speculative demand for money in relation to uncertainty in the market.

Basically, outside Keynes and the Keynesian approach to demand for money, we have others who have dealt immensely on the demand for money in recent time. These scholars are Baumol Williams (1952), who analyzed the interest elasticity of the transactions demand for money on the basis of his inventory theoretical approach, the second scholar is James Tobin (1956) who in his analysis explain liquidity preference as behavior toward risk and the third scholar is Friedman Milton (1959), who formulated that the demand for money is not merely a function of income and the rate of interest, but also of the total wealth. These three Post-Keynesian approaches to demand for money will be explained subsequently.

3.3.1 Williams Baumol Inventory Theoretic Approach

Baumol made an important addition on the Keynesian transaction demand for money. As Keynes regarded transaction demand for money as a function of level of income and that the relationship between transaction demand and income is linear and proportional. Baumol in his analysis show that the relation between transaction demand and income is neither linear nor proportional, rather changes in income lead to less than proportionate change in the transaction demand for money. Furthermore, as Keynes considers transaction demand as primarily interest inelastic, Baumol analyses the interest elasticity of transactions demand for money. Baumol‟s analysis on transaction demand for money is based on the holding of an optimum inventory of money for transaction purposes by a firm or an individual.

Thus, he further writes that a firm‟s cash balance can usually be interpreted as an inventory of money which its holder stands ready to exchange against purchases of labour, raw materials etc. In a nutshell, Baumol is saying that firms should try to keep minimum transaction balances in order to earn maximum interest from its asset i.e. the higher the interest rate on bonds, the lesser the transaction balance which a firm holds. Thus, the holding of cash balance consists of interest cost and non-interest cost. Interest cost are opportunity cost because when a firm holds cash balance for transaction purpose it forgoes interest income, while non-interest cost include such item s as brokerage fee, mailing expense etc. Lastly, Baumol‟s inventory theoretic approach to the transaction demand for money is an improvement over the classical and Keynesian in that:

i. The theory has the merit of demonstrating the interest elasticity of the transaction demand for money as against Keynes view of interest inelastic.
ii. The theory also analyses the transaction demand for real balances
iii. thereby emphasizing the absence of money illusion.
iv. The theory also integrate the transaction demand for money with the capital theory approach by taking assets, interest and non-interest cost into account.

3.3.2 James Tobin's Portfolio Selection Mode : The Risk Aversion theory of liquidity preference

James formulated the risk aversion theory of liquidity preference which is based on portfolio selection. His theory removed the two major defects of the Keynesian theory of liquidity preference. Firstly, that Keynes‟s liquidity preference function depends on the inelasticity of expectations of future interest rate and secondly, that individuals hold either money or bonds in wealth has been remove. Furthermore, Tobin‟s theory does not depend on the elasticity of expectation of future interest rate but he proceeds on the assumption that the expected value of capital gain or loss from holding interest bearing assets is always zero. James Tobin further in his portfolio selection model described the three categories of investors.

James Tobin starts his portfolio selection model liquidity preference with the presumption that an individual assets holder has portfolio of money and bonds. In other words, money neither brings any return nor imposes any risk on him, but bond tends to yield interest and also bring income. He further said that income from bonds is uncertain because it involves a risk of capital losses or gains i.e. the greater the investment in bonds, the greater is the risk of capital loss from them. For instance, if g

is the expected capital gain or loss, it is assumed that the investor bases his actions on his estimate of its probability distribution. He further assumed that this probability distribution has an expected value of zero and is independent of the level of the current rate of interest on bonds. It is important to note that Tobin‟s portfolio selection consis t of a proportion M of money and B of bond where both M and B add up 1 and has a return on portfolio R i.e. R = B (r + g).

Tobin‟s further described the three categories of investors.

i. The risk lover who enjoy putting all their wealth into bonds to maximize risk. They accept risk of loss in exchange for the income they expect from bonds.
ii. The risk plungers, they are investors who will either put all their wealth into bonds or will keep it in cash.
iii. The third category is the risk averters or diversifiers. These kind of investor prefer to avoid the risk of loss which is associated with holding bonds rather than money. In other words, they are prepare to bear some additional risk only if they expect to receive some additional return on bond.

3.3.3 Friedman Milton Theory of Demand for Money

Friedman Milton theory of demand for money is a capital or wealth theory because he regards money as an asset or capital good. He developed a model for money demand based on the general theory of asset demand. In his theory, he said that money demand like the demand for any other asset should be a function of wealth and the returns of other assets relative to money. According to his theory, wealth can be held in five different forms such as:

i. Wealth can be held in the form of money, meaning that money is taken in the broadcast sense to include currency, demand deposit and time deposit which yield interest on deposits.
ii. Wealth can be held in the form of Bonds, meaning that the yield on bonds, R b includes coupon interest rate or the expectation of capital profit or loss due to fall or rise in the expected market rate of interest.
iii. Wealth can be held in the form of equities, that is, the yield on equalities R e includes return on dividend rate, expected profit or loss due to changes in interest rate.
iv. Wealth can be held in the form of physical goods or non-human goods. Physical goods or non-human goods are inventories of producer and consumer durables. The returns are affected by expected rate of changes in price.

v. Wealth can be held in the form of Human Capital i.e. W = Y/r where W is the current value of total wealth, Y is the total flow of expected income and r is the interest rate.

Thus, the demand for money function in Friedman"s theory is given as Md/P = f

(Y, W, R m , R b , R e g p , N) where

Thus, the demand for money function in Friedman's theory is given as Md/P = f
(Y, W, R_m, R_b, R_e g_p, N) where

$M = total\ stock\ of\ money;$

$Y = is\ the\ real\ income;$

$P = price\ level;$

$W = fractions\ of\ wealth\ in\ non-human\ form;$

$Rm = Expected\ nominal\ rate\ of\ return\ on\ bond;$

$Rb = Expected\ nominal\ rate\ of\ return\ on\ bond;$

$Re = Expected\ nominal\ rate\ of\ return\ on\ equalities\ including\ expected\ changes\ in\ the\ prices;$

$g_p = {}^{1}\!/_{p} \cdot \frac{dp}{rr}$ *is the expected rate of changes of price of goods and hence the expected nominal rate of return on physical assets.*

N = Variables other than income that may affect the utility of service.

It is important to note that the relationship between demand for money and wealth is positive. This is to say that when wealth increases, the demand for money also increases because people hold more wealth. Thus, the empirical evidence is greater than unity which means that income demand for money function is stable and will be relatively interest inelastic.

3.3.4 Criticisms of the Friedman Milton Theory of Demand for Money

i. Frised Milton theory does not tell about timing and speed of adjustment or the length of time to which his theory applies
ii. The theory ignores the effect of prices, output or interest rates on the money supply, but there is considerable empirical evidence that the money supply can be expressed as function of the variables earlier given.
iii Friedman`s demand for money function, wealth variables are preferable to income and the operation of wealth and income variable simultaneously does not seem to be justified.

iv Friedman takes the supply of money to be unstable, thus, the supply of money is varied by the monetary authorities in an exogenous manner.

SELF ASSESSMENT EXERCISE

i. Briefly explain the superior of Baumol"s theory of demand for money over Keynes.
ii. Explain the three categories of investor in Tobin"s Risk Aversion of liquidity preference.

4.0 CONCLUSION

The unit extensively explains the various approaches to demand for money, ranging from the classical approach to demand for money down to the Post- Keynesian demand for money. Also, series criticisms were made. Although the classical approach to demand for money focuses on the transaction and precautionary demand for money, but they tend to neglect or consider interest rate as a factor. Keynes elaborated on what the classical approach did and more so incorporate interest rate by introducing speculative motive or Keynes liquidity preference which considered interest rate. Although Keynes theory was criticized by the Post-Keynesian monetary theorist because the theory has some faults.

5.0 SUMMARY

In this unit, we have succeeded in explaining the theories of demand for money, starting from the classical approach to demand for money, the Keynesian demand for money and the Post-Keynesian demand for money. Also, the unit immensively discussed the various criticisms and fault each of the approaches has apart from that of the Post-Keynesian approach to demand for money.

6.0 TUTOR-MARKED ASSIGNMENT

i. Distinguish between the Fishers equation of exchange and the Cambridge approach to demand for money.
ii. Explain James Tobins Risk Aversion theory of liquidity preference.
iii. When should a wealth holder make capital gain.
iv. Explain the three criticisms in the Keynesian demand for money theory.
v. Describe the five different forms of wealth in Friedman Milton theory of demand for money.

vi. Explain the Fisher‟s equation of exchange as regards the demand for money.

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UNIT 3 MONEY, CREDIT AND TERM STRUCTURE OF INTEREST RATE

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  - 3.2.4 Credit facilities available in Nigeria Banks
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- 3.3 The term structure of interest rate
  - 3.3.1 Factors that determines the term structure of interest rate

4.0 Conclusion
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1.0 INTRODUCTION

In this unit, you will learn more about money, credit and interest rate. Also, the unit will expose us more to 6 C‟s in borrowing and also explain the term structure of interest rate.

2.0 OBJECTIVES

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

- Define money, credit and interest.
- Explain the six (6) C‟s bank considers before borrowing.
- Explain the inverse relationship between interest rate, demand for money and investment.

3.0 MAIN CONTENT

3.1 Money and how it is created by Banks

Money since the inception has contributed so much as a medium of exchange and settle of debt in the economy. Before now, that is during the barter system, exchange has been so difficult since one has to look for some one that will exchange what he has before he can get what he need. But today, the introduction of money has solved the problem of double coincidence of wants. Having said that, one can say that money is a solution to a problem. Money is define as an item, income, wealth, credit, provision, sort of financial resources available as purchasing power in the society i.e. it serves as the guage, barometer to determine or measure the wealth of an individual organization and or government. Onyia and Egungun (2004) defined money as anything which is generally acceptable in a given society or locality as a means of exchange and for settlement of debts. Chandler and Adekanye both legal personnel have said from the legal view that money is what the law says it is.

3.1.1 How Banks create Money

The creation of money by banks is more of movement of currency in circulation to demand deposit. In actual sense, no new money is created by the banks in the process of money creation. The money creation process is a record of chain of events that results from the initial deposit of money into a current account in a bank by a customer dependent. The process of money creation is premised on the principle of fractional reserve system which posits that a bank need not keep all the deposit in the vault as idle cash, the bank is expected to keep part as reserve and invest the balance in business including lending. This is because a depositor will rarely demand his money all at a time. It is based on this principle that banks keep part of the deposit of customer as legal reserve requirement stipulated by monetary authorities and lend out the excess of the deposits. The process of money creation is based on the following assumptions.

i. There is a subsisting current account belonging to the depositor. There is a stipulated legal cash reserve requirement.
ii. There is no cash drain or leakage in the system. That is, withdrawals made by depositors are re-deposited by new depositors less the legal cash reserve.
iii. There is an efficient clearing system.

v. The commercial banks maintain the stipulated reserve in monetary
vi. The borrowing and lending processes are continuous, banks are willing to lend and borrowers are willing to take loans.

The process of money creation by banks may be explained through the use of formula. The formula approach is given as:

Total deposit =

1 ID

1

Where I = Constant

C = Excess Reserve (RE) ID = Initial Deposit TD = Total Deposit

Example:

Let us assume that Mr. Sunday made an initial deposit of N30, 000 into bank ABC, at a time the ratio was 20%. The excess reserve will be lent to another individual who is expected to deposit some into bank ABC 2 . The bank BCA will reserve 20% and lend the reserve, the process goes like that. Solution:

TD =

1 ID

1

=

1

1 □ (100 □ 20)%

×

30000

1

1

1 □ 0 . 8

□

30000

1

=

1

0 . 2

□ 30000 = 150,000

3.1.2 Limitation to Ability of Bank to create Money The limitations to the ability of banks to create money include:

i. Incidence of Cash Drain or Leakage □ If there is cash drain in the system, the bank‟s ability to create money is constrained. Cash drain or leakage occurs when the borrower decide to withdraw money from the banking system for whatever purpose.
ii. Legal Cash Ratio □ The level of the legal cash reserve affects the ability of banks to create money. A higher legal cash reserve will definitely result in the creation of less volume of money in the system.
iii. Savings ability of the people □ The more people deposit money into the banks, the more banks are disposed to create credit. If less deposits are made into banks, less money may be lent by the banks hence less credit is created.
iv. Interest Rate Structure □ The dynamics of interest rate affects the money creation ability of the banks. If the interest rate is excessively higher, less people will be willing to borrow from the banks. The incidence of fewer borrowers limits the money creation ability of banks.
v. Effective and Efficient Cheque Clearing System □ An effective and efficient cheque clearing system is a prerequisite for banks to create money. This is because such a system guarantees smooth clearing of cheques and settlement of claims that encourages the use of cheques.
vi. Condition attached to the loans □ The stiffer the conditionality attached to loans, the lesser the borrowers will be willing to borrow. This will reduce the money creation ability of the banks.

SELF ASSESSMENT EXERCISE

i. Explain the economist definition of money.
ii. Explain the limitation to ability of bank to create money.

3.2 Credit and Importance of Bank Credit to the Economy

Credit can be defined as the value of goods and services enjoyed or made use of by a business firm and on which payment is made sometimes thereafter. It also means transfer of goods and services from a seller to a buyer without any value being given immediately in return.

There are however two types of credit available and these are:

3.2.1 Trade Credit

This is a system whereby manufacturers collect money from wholesalers in advance in order to enable them raise money to produce goods and pay the wholesalers with goods produced with the money collected. Also, the wholesalers allow retailers to collect goods without making immediate payment but pay the old debt when the retailers come to buy new goods on credit. No interest is involved in trade credit. This source of finance is available to all business firms irrespective of size. It involves no cost if there is no cash discount or if the amount is paid within the discount period. The following sources of information are essential for granting trade credit by supplier firm:

i. The supplier past trading records of the customer.

ii. The customer‟s application request.

iii. The customer‟s bank(s) i.e. by making status enquiry.

iv. The industry to which customer belong.

v. The customer‟s business associates.

3.2.2 Bank Credit

No company operates as an island nor is there any business firm that is self- sufficient financially, there arises the need for businesses interacting with one another for different purposes especially for financial assistance for smooth operation of such businesses. The basis of credit financing in any economy is to ensure liquidity and solvency.

Thus, bank credit is loans and overdraft granted by banks to deserving customers on request.

A bank credit is usually a short-term loan, which requires adequate security, and it is one of the important sources of income to banks. Thus, Bank Credit is controlled by Central Bank through Credit Sectoral allocation and credit ceiling and depending on how reasonably liquid the bank is. Note it is a known fact that bank credit facilities are granted or extended only to deserving bank customer.

3.2.3 The Six C's in Credit

Before credit can be given, certain things need to be considered. These things are the six C""s that is involve d in credit. They are:

i. Character This is a situation where the character of is the customer is questioned. That is, the character of the customer is examined in detail by considering the following; the integrity of the customer, his social standing and the experience of the customer in the line of business he engages in. Thus, in assessing character, manager""s personal experience based on past dealings with the customer is very important. If the customer has been in the branch for sometimes, his account should be scrutinized to ascertain the nature of his business. The purpose of making these enquiries is to assess the customer and reduce the risk in lending to unknown person.

ii. Capital This refers to capital contributed by the owners of the business, its adequacy or not and the form or types of capital they are, since amount and size of company capital signifies degree of commitment of the owner of such business, their seriousness and one of the premises on which lending banker counts in determining the amount to be extended. The assessment of capital in the case of individual will include his salary and other sources of income and in the case of business firm through analysis of its financial statement.

iii. Capability This means that the lending banker must take into consideration the type of customer requesting for credit whether individual or business firm uses the credit for what is meant for. Also, it is the duty of the bank or the banker to assess the ability of the borrower to repay both principal and interest within a satisfactory future period.

iv. Collateral This is important because banks can easily recover that money back when they have an asset that has greater value than the amount they gave out. The purpose of taking collateral or security is to ensure that borrower does not default in the long run when the loan has been given out. Examples of securities requested are Real Estate, Documentary Credits, and Quoted Shares, Government Securities such as Treasury Bills etc and plants and equipment.

v. Condition This may include the cost of fund, that is at what interest rate and the term of repayment. Other condition could be submission of half-yearly management account to the borrowers company, statement of sources and application of funds, cash flow analysis statement i.e. cash budget and yearly audited accounts of the company etc.

vi. Connection Connection may be direct or indirect. In a direct connection, the customer is personally involved, for example

M.D of the company, which maintains valuable credit balance with a bank, if such a Director should request for a reasonable amount and his request is declined, the bank will run the risk of losing the account of his company. In the case of indirect connection, the customer is not directly involved but his relation.

3.2.4 Credit Facilities Available In Nigerian Banks

There are many avenues for raising credit from the bank as there are various types of banking services and banking institutions in the economy. The following are some of the credit facilities or instruments available in Nigerian Banks.

i. Bank Overdraft This is a short-term source of finance on which

interest is charged on outstanding balance by the bank and such interest charged are allowable for tax deduction. Bank overdrafts are largely repayable on demand; therefore, they should be applied on assets, which are readily realizable or disposable. It is generally unsecured but in some cases, banks coupled with provision of collateral.

ii. Bank Term Loan These are usually issued for a definite period of time unlike overdraft. They normally carry higher interest charges because of the period covered and the fact that bank might want to avoid problem of fluctuations in interest charged on loans.

iii. Inventory Financing Under this financing system only finished goods and raw material quality as a form of collateral as there is no market for work-in-progress. Lender will usually provide finance in the amount of one half of the collateral that qualifies.

iv. Lines of Credit This is not a loan but a favourable method of securing a loan. Company can go to the bank and arrange for a line of credit or borrow when she did not need it. Line of credit is an advance reservation that makes funds available to be used only when needed.

v. Credit Cards This is a convenient method of payment which affords holder enjoyment of credit and immediate payment on transaction. Thus, more and more customer orders are being placed by phone or by computer over the internet allowing the customer to pay with credit card. Credit card holders are allowed credit facilities by the concerned bank for a specified period of time without any security from them.

vi. Project Financing This source though relatively new is normally made available after consideration, analysis and assessment of the project has been carried out by the bank.

vii. Equipment Leasing This is an agreement whereby a person called the leasor conveys to another person called lessee in return for rent the right to use an asset for an agreed period of time.

viii. Bill Discounting This is a situation were a company in need of fund obtains credit from a bank against its bills. The bank purchases or discounts the borrower‟s bills by providing an amount less than the face value of the bill after assessment and consideration of credit worthiness of the borrower.

3.2.5 Importance of Bank Credit to the Economy

Credit is of vital importance for the working of an economy. It is the oil of the wheel of trade and industry and helps in the economic prosperity of a country in the following ways:

i. Mobilization and Intermediation of funds by banks from the surplus to the deficit units of the economy is no doubt has facilitated tremendous increase in investment activities by reducing incidence of idle funds and thereby promote growth of money market in the economy.

ii. Availability of Bank Credit enables firms to purchase raw materials needed for production at the right time, right source and right quality and at competitive prices and this is more pronounced with business that import substantial part of their raw materials from overseas.

iii. Bank Credit enables certain productive activities, which would have been impossible to be available locally, thus improving the economy.

iv. Bank Credit has made it possible for highly sophisticated equipment such as farm tractor, harvester etc to be readily available to the developing economy.

v. Bank Credit has not enable many firms to gain access into capital market, it has enable such firms to develop their research and development department which invariably lead to improvement in the quantity, quality and variety of goods and services made available by such companies.

SELF ASSESSMENT EXERCISE

i. Briefly explain the importance of bank credit to the economy.

3.3 The Term Structure of Interest Rate

The term structure of interest rate refers to the relationship between market rates of interest on the short-term and long-term securities. It is the interest rate difference on fixed income securities due to difference in time of maturity. It is also known as time structure or maturity structure of interest rates which exchanges the relationship between yields and maturities of the same type of security.

3.3.1 Factors that determines the term structure of interest rate The factors that determine the term structure of interest rates are:

i. Risk Preference

This means that long-term security prices are sensitive to changes in interest rate because the chances to default are higher on long-term securities as compared to short-term securities. Therefore, lenders prefer to lend for short-term, if short-term and long-term securities have identical yields. On the other hand, borrowers prefer to borrow for long

period because they will not have to worry about rising interest rate or to renew their loans frequently.

ii. Supply Demand Conditions

When the supply of short-term securities falls and that of long-term securities rise, the short-term interest comes down and the long-term interest rate is pushed up. Also, if the demand for securities is more in the short run market and the supply is more in the long-run market, this will lead to high short-term and low long term interest rates.

iii. Expectations and Uncertainty

The expectation of the rise in the longs-term interest rate explains that the short-term interest rate remains much below the long-term interest rate for any length of time. This produces an upward sloping yield curve. Further, certain risk and uncertainties may lead to the same results. For instance, if people expect war, social disturbances, political upheavals etc, they will not purchase long-term securities except at a low price or low current yield.

iv. Cost of funds

The alternative to which the fund could be used will affect interest rate. It may also be possible that the lender obtains the fund at a cost like the commercial banks using interest bearing deposit for lending.

v. Inflation rate

Where inflation rate is very high, the nominal rate of interest has to be high for real rate of interest to be maintained. Interest rate will therefore be high during inflation

vi. Financial Standing of Borrower

Where the borrower is of good financial and moral standing, lending rate will be low and interest rate will similarly be low. Thus, lending to government attracts low rate of interest because of the risk in default.

SELF ASSESSMENT EXERCISE

1. Briefly explain in detail the factors that determine the term structure of interest rate.

4.0 CONCLUSION

The unit explained the various factors that determine the term structure of interest rate and also when further in discussing the C`s in credit which is seen as an important factor to reckon with when banks is considering given out loans to their customers. However, we also explain money and credit can be created by banks.

5.0 SUMMARY

In this unit, we have succeeded in explaining extensively money, credit and term structure of interest rate. The unit also discussed the importance of credit in the economy and the six C`s of credit in bank.

6.0 TUTOR-MARKED ASSIGNMENT

i. Briefly list six assumptions involved in the process of money creation.
ii. Explain some of the credit facilities available in Nigerian banks.
iii. Explain the following; (a) cost of funds and (b) expectations and uncertainty. iv State five importance of credit to the economy.

7.0 REFERENCES/FURTHER READING

A .Adebayo (2013). Economics; A Simplified Approach (2 nd Ed) Vol 2, African international publishing limited, Lagos

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MODULE 2 FINANCIAL INSTITUTION AND ITS RELEVANCE TO THE ECONOMY

Unit 1 Meaning of financial institution and its classification.
Unit 2 Nigerian Money Deposit Bank (Commercial Bank)
Unit 3 Other financial institution and its relevance

UNIT 1 MEANING OF FINANCIAL INSTITUTION AND ITS CLASSIFICATION

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
 3.1 Evolution and definition financial institution in Nigeria
 3.2 Classification of financial institution
 3.3 Relevance of financial institution
4.0 Conclusion
5.0 Summary
6.0 Tutor-Marked Assignment
7.0 References/Further Reading

1.0 INTRODUCTION

In this unit, you will understand why financial institution is established as an intermediary between individuals with surplus funds and those with deficit funds. You will also understand the evolution of financial institution, its relevance and classification.

2.0 OBJECTIVES

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

- Understand the definition and evolution of banking system in Nigeria.
- Distinguish between banking financial institution and non banking financial
- institution.
- To state the relevance of financial institution.

3.0 Main Content

3.1 Evolution and Definition of Financial Institution In Nigeria

Banking which is also referred to as a financial institution had its origin with the goldsmith in London in the 17 th century. The goldsmiths had facilities for storing valuables; therefore, they accept money and other valuables from merchants for safekeeping. The first banking function was accepting deposits of cash from merchants who had no safe place to keep their money. The second stage came when receipt for these deposits began to be used as means of payment by merchants. This made the early bankers to issue bank notes of fixed denominations, which were more generally acceptable.

The next stage in the development of the banking system was the development of money lending to customers with interest charged on it. This provided a profitable business, hence bankers began to offer the inducement of interest to encourage merchants and others to increase their deposit. The ideology of goldsmith on banking has spread abroad and today practice banking in continent of the world including Nigeria. Nigeria banking system commenced in 1892, and they copied the London banking system since Goldsmith is a British citizen. Having said brief on the evolution of banking, one can now define financial institution.

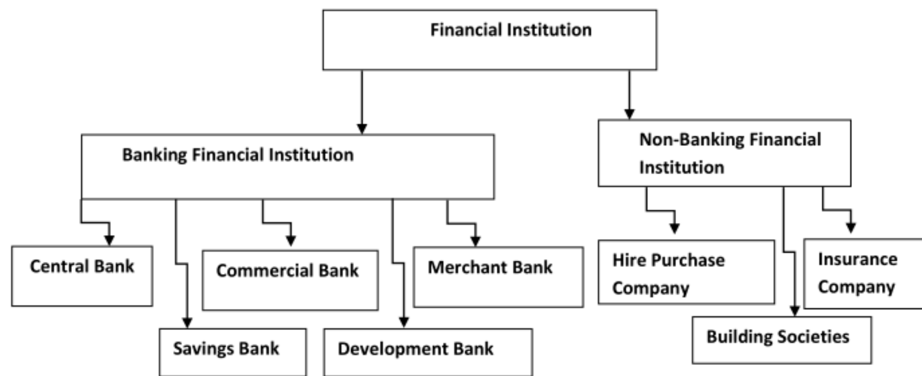
Financial Institution refers to all business organizations which hold money for individuals and institutions and may borrow from them in order to give loans or make other investments. Financial institutions are very important for economic development of a nation. They represent the main channel or medium by which funds can flow from lenders to borrowers.

SELF ASSESSMENT EXERCISE

In detail explain the various stages in the evolution of Banking

3.2 Classification Of Financial Institution

Financial Institutions may be divided into two major groups i.e. banking and non- banking financial institutions. The major difference between the banking and the non-banking financial institutions is that the liabilities of the banking institutions are counted as part of the total supply of money while those of the non-banking institutions are excluded from the money supply.



- Central Bank is the apex financial institution in the economy, that is empowered by the law to supervise and regulate the financial system. It also includes the formulation of policies that will influence the management of money and credits hence enhance the achievement of set government economic objective.
- Commercial Banks are financial institutions which accept deposits and other valuable from the public for safe keeping with the sole aim of making profit. In other words, they are financial institutions that perform the services of holding people"s money and accounts and using such money to make loans and other financial services available to customers.
- Merchant Banks are financial institutions which perform specialized
- functions, such as acceptance of bills of exchange, issuance of loans for foreign trade transactions, issuance of new shares and provision of medium and long-term loans. They are sometimes referred to as Acceptance houses .
- Development Banks are specialized financial institutions which provide long-term credit or loan to other enterprises for capital projects. They provide loans for projects in the area of agriculture, commerce and industry. Examples of development banks are Nigeria Industrial Development Bank (N.I.D.B), Nigerian Bank for Commerce and Industry (N.B.C.I) e.t.c.

Insurance Companies are financial institutions that are concerned with insurance. It can also be defined as a contract between an insurer and an insured, under which an insurer promises to indemnify (compensate) the insured against loss, which he may suffer in future, upon the payment of a premium.

SELF ASSESSMENT EXERCISE

1. Distinguish between Banking and Non-Banking Financial Institutions

3.3 Relevance Of Financial Institution

Financial Institutions provide consumer and commercial clients with a wide range of services and different types of banking products, like sale of treasury bills, treasury certificates e.t.c.

The importance of financial institutions to the wider economy is apparent during market booms and recession. During economic upturns, financial institutions provide the financing that drives economic growth and during recessions, banks curtail lending. Another thing is that, financial institutions are encouraged or even compelled to lend money loans small businesses, that is, the readily made available loans to prospective investors which will help in enhancing growth in the economy.

Thus, outside giving loans to small businesses, they also provide the liquidity needed for the economy to function and also offering important risk management services.

SELF ASSESSMENT EXERCISE

1. Briefly explain three relevance of Financial Institutions in Nigeria.

4.0 CONCLUSION

Financial institution is an institution established as an intermediary between individuals with surplus funds and those with deficit of funds. Consequently, financial institution which is classified as banks and non-bank financial institution play significant roles in economic growth and development, by giving loans and overdraft to individuals who are willing to invest in the economy. This unit has succeeded in explaining the relevance of financial institution in developing economy like Nigeria.

5.0 SUMMARY

Here you have learnt more about the evolution of financial institution, having explained in detail the stages of development of banking system in Nigeria. Also, you should have understood the different classification of financial institutions in Nigeria. The Central bank is seen as the apex bank that is empowered by law to regulate and supervise the financial

activities of the commercial banks and other financial institution. However, the commercial banks, merchant banks and other bank are seen as bank for receiving and giving out loans to prospective business individuals.

6.0 TUTOR-MARKED ASSIGNMENT

i. Distinguish between central bank and commercial bank in Nigeria
ii. State five instruments which the central bank can use to control the activities of the commercial banks.
iii. List some banking products that is provided by the banking sector in Nigeria.

7.0 REFERENCES/FURTHER READING

A .Adebayo (2013). Economics; A Simplified Approach (2 nd Ed) Vol 2, African international publishing limited, Lagos

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UNIT 2 NIGERIAN COMMERCIAL BANK

CONTENTS

1.0 Introduction
2.0 Objectives
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  3.1 Evolution of Commercial Bank in Nigeria
  3.2 Definition, Functions and the Organization Structure of the Commercial Bank
    3.2.1 Functions of Commercial Bank
    3.2.2 The balance sheet of a Commercial Bank
  3.3 Roles of Commercial in Nigeria
    3.3.1 Problem of Commercial Bank in Nigeria
  3.4 Merchant Bank and its functions
    3.4.1 Functions of Merchant Banks
    3.4.2 Sources of fund to Merchant Bank
4.0 Conclusion
5.0 Summary
6.0 Tutor Marked Assignment
7.0 References/ Further Reading

1.0 INTRODUCTION

This unit will focus on Nigerian Money Deposit Bank which is also known as the commercial banks. Also, the unit will also focus on the History or origin of commercial bank in Nigeria, their roles in the economy and the challenges and prospect in the economy.

2.0 OBJECTIVES

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

- Identify the activities of the commercial bank from that of the merchant banks.
- Identify the organization structure of the commercial bank from that of the merchant banks.

3.0 MAIN CONTENT

3.1 Evolution of Commercial Banks in Nigeria

(i) African Banking Corporation (Now First Bank of Nigeria Plc).

In 1892, the African Banking Corporation opened a branch office in the Lagos area of Nigeria. The British Bank for West African took over the operations of this bank in 1894 and changed its name to Bank of West Africa in 1957. The name was again changed to Standard Bank of Nigeria Limited in 1965. In 1977, the name was again changed to First Bank of Nigeria Limited following the government's acquisition of 60% of the equity as the marth of the indigenization policy. The bank has since become a publicly quoted company.

(ii) Barclays Bank of Nigeria Limited now Union Bank of Nigeria Plc.

The Barclays Bank of Nigeria Limited opened for banking business in Nigeria in 1917. In 1979, its name was changed to Union Bank of Nigeria Limited. The company is quoted on the Nigerian stock exchange as Union Bank of Nigeria Plc.

(iii) British and French Bank now United Bank of Africa Plc.

The British and French Bank opened for banking business in Nigeria in 1949. Its name was changed to United Bank for Africa Limited in 1961. The bank has since been publicly quoted on the Nigerian stock exchange as United Bank of Africa Plc.

The three banks discussed above owe their origin to colonial interest hence;

Nigerian indigenous banks were conspicuous by their absence till the early 1930‟s.

The high level of discrimination over employment and credit practiced by the then foreign banks was one of the reasons that fuelled the agitation for self rule by Nigerians. As a result of this unpleasant development, Nigerians were compelled to enter into banking business between 1933 and 1952.

The National Bank of Nigeria Limited was established in 1933 as the first indigenous commercial bank in Nigeria. The bank‟s inability to satisfy the stringent requirement of the 1952 banking ordinance almost

forced it to extinct but for the life line received from the then Western Regional Government. The regional government was able to raise money for that purpose from the cocoa sales. The bank later transformed into a universal bank in 2000 and merged with Wema Bank in 2005.

Another indigenous bank is Agbomagbe Bank Limited now Wema Bank of Nigeria Plc. the bank started as a private enterprise in 1945. With the effluxion of time, the then Western Nigerian Regional Government took over the bank and changes its name to Wema Bank of Nigeria Limited.

The last before the current establishing ones is African Continental Bank Limited then called Spring Bank Plc and now called Enterprise Bank Limited. The African Continental Bank Limited was an off shoot of the Tinubu Bank then part of Lagos 53 Properties Limited. It was acquired by the then Eastern Nigerian Regional Government in 1945 and subsequently had its name changed to African Continental Bank Limited. The name was later changed to ACB International Limited and merged with few other banks to form the Spring Bank Plc in 2005. In 2010, the name was changed from Spring Bank Plc to Enterprise Bank Limited, which is owned by Government.

SELF ASSESSMENT EXERCISE

i. Distinguish between the 1892 banking system and 1933 banking system.
ii. Briefly explain evolution of UBA

3.2 Definition, Functions and its Organizational Structure of the Commercial Bank

The Nigerian money deposit bank also known as commercial bank can be defined as a financial institution which carries out retail bank services, set up for keeping and lending money to people, owned by individuals ,organizations or governments, for the purpose of making profits.

Ozoani, G.C defines it as an institution that accepts deposits of money from the public withdrawal by cheque and used for lending. Also, John Paget defines commercial bank on the basis of functions perform by the bank.

3.2.1 Functions of Commercial Banks

Commercial banks perform a variety of functions which can be divided as follows:

i. Accepting Deposit: Commercial banks accepts deposits from the public for safe-custody through three methods, viz savings, current and fixed deposit account. The depositors are allowed to draw their money by cheques for a current account or withdrawal slip or ATM for savings account and fixed account. For current account, banks do not pay any interest to it but little percentage of interest is paid into savings and fixed deposit account. Note importantly that current account is known as demand deposit while fixed deposit account is known as time deposits.

ii. Advancing Loan: One of the primary functions of a commercial bank is to advance loans to its customers. A bank lends a certain percentage of the cash lying in deposits on a higher interest rate than it pay on such deposit. The bank advances loans in the following ways:

   a. Through Cash Credit: This means that bank advances loan to businessman against certain specified securities. The amount of the loan is credited to the current account of the borrow, then the borrowers can withdraw money through cheques according to his requirement by paying interest on the full amount.
   b. Through Call Loan: These are very short-term loans advanced to the bill brokers for not more than fifteen days. They are advanced against first class bill or securities such loans can be recalled at a very short notice.
   c. Through Overdraft: This means that banks often permits a businessman who has been their old customer with good credit record to draw cheques for a sum greater than the balance lying in his current account. This is done by providing the overdraft facility up to a specific amount to the businessman.
   d. Through Discounting Bills of Exchange: This means that if a creditor holding a bill of exchange wants money immediately, the bank provides him the money by discounting the bill of exchange.

iii. Credit Creation: This another function of commercial banks like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping a small cash in reserve for day-to-day transactions.

iv. Financing Foreign Trade: Commercial bank finances foreign trade of its customer by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buy and sells foreign currency.

v. Agency Services: This means that banks acts as an agent of its customers in collecting and paying cheques, bills of exchange, draft, and dividend, e.t.c. it also buys and sells shares, securities, debentures etc. for its customers. Further, it pays subscriptions, insurance premium, rent, electric and water bills and other similar charges on behalf of its clients. Moreso, the bank acts as an income tax consultant to its clients.

3.2.2 The Balance Sheet of a Commercial Bank

The Balance Sheet of a Commercial Bank provides a picture of its functioning. It is a statement which shows its assets and liabilities on a particular date at the end of one year. The assets are shown on the right hand side and the liability is shown on the left hand side of the balance sheet.

The assets of a bank are those items from which it receives income and profit, while the liabilities of commercial banks are claims on it. These are the items which form the sources of its fund.

The assets and liabilities side of the commercial bank is shown below:

Commercial Banks Balance Sheet

Commercial Banks Balance Sheet

Liabilities		**Assets**	
Share Capital	xx	Cash	xx
Reserve Funds	xx	Balances with the central bank and others	xx
Deposit	xx	Money at Call and Short Notice	xx
Borrowing from other banks	xx	Bills Discount and Purchased Investment	xx
Bill is payable	xx	Liabilities of Customers for Acceptance, Endorsement and other obligation	xx
Acceptance, Endorsement and other obligations	xx	Property,furniture,fixtures less depreciation	x
Contingent Liabilities	xx	Profit & Loss	xx
Profit and Loss	xx		

Note, money at call means short term loans to bill brokers, discount houses and acceptance houses. Contingent liabilities relates to those claims on the bank which are unforeseen such as outstanding forward exchange contract, claims on acknowledge debt etc.

Acceptance, Endorsement and other obligations by the bank on behalf of its customers are the claims on the bank which it has to meet when the bills mature. Bills payable refer to the bills which the bank pays out of its resources. Bill for collection are the bills of exchange which the bank

collects on behalf of its customers and credits the amount to their accounts.

SELF ASSESSMENT EXERCISE

1. State five functions of Commercial Banks
2. Explain four ways in which Commercial Banks can advance loans

3.3 Roles of Commercial Banks in Nigeria

Besides performing the usual commercial banking functions, banks in developing countries play an effective role to economic development. These roles are:

i. Commercial Banks helps in mobilizing savings through network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing variety of deposit schemes to suit the needs of individual depositors.
ii. The Commercial Banks finance the industrial sector in a number of ways. They provide short term, medium term and long term loans to industry. They also underwrite the shares and debentures of large scale industries, and also help in developing the capital market which is undeveloped in such country.
iii. They help in financing both internal and external trade i.e. they provide loans to retailers and wholesalers to stock goods in which they deal on. They also keep in the movement of goods from one place to another by providing all types of facilities such as discounting and accepting bills of exchange.
iv. They help the large agricultural sector in developing countries in number of ways. They provide loans to traders in agricultural commodities and also open a network of branches in rural areas to provide agricultural credit.
v. The Commercial Banks finance employment generating activities in developing countries. They provide loans for the education of young person"s studying in engineering, medical, and other vocational institutes of higher learning.
vi. The Commercial Banks help in economic development of a country by faithfully following the monetary policy of the central bank. More so, the central bank depends on commercial banks for the success of its policy of monetary management in keeping with requirements of a developing economy.

3.3.1 Problems of Commercial Banks in Nigeria

Commercial banks in most developing countries, especially Nigeria are faced with problems. These are as follows:

i. Urban Concentration: Majority of the commercial banks are located in urban centers thereby denying the rural areas banking services.
ii. Corruption and Low Saving: There is high level of corruption in the banking industry as some bank managers and officials embezzle money and grant unauthorized loans to friends and relative because of their selfish interest. This odd attitude has discouraged so much from saving, since they believe their monies can be taken without been returned.
iii. Government's Frequent Interventions: Government‟s frequent intervention in the operation of banks sometimes make things difficult for commercial banks to operate smoothly and efficiently.
iv. Lack of Innovative Banking Practices: Most commercial banks are not innovative in their banking practices as customers are not given the prompt attention they desire.
v. Capital shortage and high interest rates: Most of the commercial banks have low capital base and this makes it impossible to grant loans to prospective customers. Inspite of low capital they have, they tend to charge high interest when loan is given out.
vi. Non-Repayment of Loans Some customers that took loans sometimes fail to repay the loans as a result of high interest rate charged and these has led to the collapse or failure of some commercial banks.

Importantly, some of the aforementioned challenges of the commercial has been solved through improve technology. Today, most of the rural areas has commercial banks in them and also withdrawal and depositing of cash has been made easier through ATM cards.

SELF ASSESSMENT EXERCISE

1. State the problems or challenges faced by commercial banks in Nigeria and identify one solution to it.

3.4 Merchant Bank and Its Functions

Merchant bank can be defined as a financial institution that provides medium and long-term loans, accepts large deposits, bills and deal in stocks. The under- developed nature of the banking system, money and

capital markets in West Africa brought about the delay in the establishment of merchant banks in this part of the world.

Philip Hill became the first merchant bank in Nigeria and has given rise to other similar banks like then NAL Merchant Bank; Indo-Nigerian Merchant bank etc. Merchant banks deal with companies or organizations, government and other financial institutions. They also carryout wholesale banking services with the primary aim of making profit.

3.4.1 Functions of Merchant Banks

The functions of merchant banks may be grouped into five as follows:

1. Portfolio Management Function: Merchant banks do undertake to manage the portfolio investments of some investors at a fee for such services.
2. Banking Function: The banking function include
   i. Mobilization of deposits from both the private and public sectors of the economy.
   ii. Granting of loans/advances to individuals, corporate bodies and the government.
   iii. Equipment leasing which involves the purchasing and leasing of equipment for rental fees to the banks.
   iv. Loan syndication (consortium lending) which involves the coming together of banks or group of banks to provide credit to a customers.
3. Corporate Finance Services: The corporate service include acting as issuing house to issuers, assisting in private placement, stock brokerage services, investment and advisory services.
4. Treasury Services: The merchant banks do invest in money market instruments such as treasury bills, treasury certificate etc. They also issue short-term instruments such as certificates of deposits, commercial papers etc.
5. Operational Services □ This includes the remittance and receipt of funds for their customers at both local and international levels. Merchant banks also open letters of credit and accepts bill on behalf of their customers in favour of foreign creditors and issued by the creditors respectively.

3.4.2 Sources of fund to Merchant Banks

The main sources of funds to merchant banks include:

i. Statutory Reserves: The funds statutorily required to be transferred from profit to reserve account is available for use by the bank.
ii. Share Capital: Funds are raised through the issuance of shares subscribed to, by the individuals, corporate bodies and government.
iii. Interest arising from credit facilities and other charges: The cost of funds provided to borrowers as well as various charges for services rendered from part of merchant bank"s funds.
iv. Retained Profit: This is the percentage of net profit retained for future expansion. Retained profit remains part of shareholder equity.
v. Debentures: Merchant banks raise money through the issuance of debentures.
vi. Mobilized Deposits: The huge deposits mobilized from the economy forms part of merchant banks funds.
vii. Borrowing: Merchants banks may borrow money from lending institutions including the central bank of Nigeria.

SELF ASSESSMENT EXERCISE

i. State five ways in which merchant banks can raise money.

4.0 CONCLUSION

Commercial banks as a financial institution play very important role in the development of any country, be it developing or developed. Their roles as a matter of fact cannot be neglected, in the sense that they are seen as the major back bone of the country. Despite the functions and roles they play, they still face series of challenges which was discussed in the unit.

5.0 SUMMARY

In this unit, we have succeeded in explaining the origin of commercial banks in Nigeria and also the different functions and roles it plays growth and development of the country. Also, some problems of commercial banks in Nigeria was also entrenched in the unit, not neglecting the ways in which they can source for funds.

6.0 TUTOR-MARKED ASSIGNMENT

i. Write short note on the following African Banking Corporation and Barclay Bank of Nigeria.
ii. Distinguish between Bill payable and Bill for collection. iii. Explain five roles of commercial banks in Nigeria.
iii. State four ways in which commercial banks can advance loans to customers.
iv. Discuss any three functions of a merchant bank.
v. Explain the challenges faced by commercial banks in developing countries.

7.0 REFERENCES/FURTHER READING

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UNIT 3 NON-BANK FINANCIAL INSTITUTION

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  3.1.5 Discount Houses
 3.2 Importance of the Institution by Funds mobilization and contribution to the economy
 3.3 Similarities between Banks and NBFIs
 3.4 Roles of Non-Financial Institutions
4.0 Conclusion
5.0 Summary
6.0 Tutor Marked Assignment
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1.0 INTRODUCTION

This unit focuses on non-bank financial institution in Nigeria. Non-Bank Financial Institutions are institutions created or established to provide long-term loans to individuals, government and prospective business individuals. Subsequently, the unit will explain the various classifications non-bank financial institutions such as insurance companies, pension scheme, traditional financial institutions, finance companies and discount houses etc.

2.0 OBJECTIVES

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

- Understand the various non-bank financial institutions in Nigeria. Identify their functions.
- Distinguish between each of them.
- Distinguish between non-bank financial institution and banks.

3.0 MAIN CONTENT

3.1 Classification of Non-Bank Financial Institution

Non-Bank Financial Institutions are institutions that provide medium and long- term loans to prospective business firm or government. These institutions pool funds from net savers and lend them to finance expenditure of business firms and local bodies. The non-bank financial institution outside the commercial banks has contributed immensely in enhancing growth and development in the nation. Consequently, they are classified as insurance, pension scheme (fund), traditional financial institution, finance companies etc. Subsequently, the aforementioned institutions will be explained in detail.

3.1.1 Insurance Companies

An insurance company may be defined as a financial institution involved in the protection of person and objects against risk. These companies as financial institution collect large sums of money called premium from individual and organization in order to insure lives and properties. Thus, people save money with the insurance companies in form of life assurance which is paid to them after a period of time if they do not die before then under endowment assurance policy. On the other hand, under the whole life assurance, bulk of money is paid to the beneficiaries of the assured after his death.

Insurance in Nigeria is both owned by Nigerians and foreigners. However, ownership had significantly remained more companies being controlled by indigenous interest while few have mixed ownership. In any case, a consolidator exercise could introduce a new ownership character as all the insurance companies may desire to be quoted on the Nigerian stock exchange.

Apparently, insurance companies in Nigeria tends to provide some functions in economy, such functions are as:

i. Protection of persons and objects under different types of insurance like motor vehicle, fire, burglary, marine, life insurance etc.

ii. They serve as pool of risks; that is they are an umbrella under which all forms of risks are covered.

iii. They offer both short and long-term loans to individuals, organization

iv. etc, from the money they collected from other clients as premiums.

v. Through the money and capital market, they make funds available to industry and commerce thereby contributing to the development of nations where they exist.

vi. They offer advice to individuals, organizations, government etc, on the best way to secure lives and properties.

3.1.2 Pension Scheme

Pension Scheme is an arrangement designed by the government through the constitution or other statue which guarantees an employee some financial benefits on leaving employment.

In Nigeria, the first pension Act was promulgated in 1951 and was later replaced by the 1979 Pension Act. The public sector had its own pension arrangement different from that of private sector.

The public sector pension scheme is a non-contributory scheme while the private sector pension scheme is contributory in nature. Employees are expected to contribute a certain percentage of their total emolument to pension scheme. The 2004 pension perform Act has brought in it numerous changes ranging from the introduction of pension regulators, administrators and managers in Nigeria.

3.1.3 Traditional Financial Institutions

These are non-bank financial institutions whose existence predates both the invasion of Africa by the colonialists and the emergence of conventional financial institutions. The traditional institutions have continued to thrive in most African countries especially Nigeria due to some Unique characteristics surrounding their activities. Their operations are in the secretive, require little amount of money and mutual trust exist between and among members. Some of the traditional financial institutions are Esusu, Local Money Lenders, Community Development Associations, Co-operative, Thrift and Credit Union, Social Club, and Town Union Monthly Associations.

The Modus Oprandii in the traditional financial institutions is that members are encouraged to save their money together, which all or part of it may be lent to any member that is in need.

Basically, the major advantage of traditional financial institution is that;

i. They encourage their members to form the habit of saving money.
ii. They encourage their members to invest the big sum of money they have saved.
iii. They lend money they have saved.
iv. They save their members the pains of going to banks to borrow money
v. with their embarrassing collateral securities.
vi. They inculcate the principles of democracy in their members.
vii. They discourage their members from being extravagant in their spending so that they can save money.

In spite all the enticing advantages, the traditional financial institution still face enormous problems which ranges from:

i. High embezzlement of cash
ii. Weak management i.e. they are managed by those who lack administrative and managerial acumen.
iii. The institution also lack effective means of recovering loan granted to their members, if they default in repayment.
iv. They have low financial resources at their disposal as a result of some of their members to make their contributions.
v. They use arbitrary means in fixing interest on loans.

3.1.4 Finance Companies

Finance Companies are non-bank financial institutions regulated and supervised by the Central Bank of Nigeria under the provision of the BOFIA 1991 (as amended). These institutions provide short-term financial services such as the local purchase order financing, project financing, leasing of equipment and debt factoring. The main sources of funds to finance companies include public offer of bonds, Issuance Commercial Paper, Issuance of equity shares, commercial bank credit facilities, insurance companies etc.

Finance Companies in the course of providing financial services, use to charge higher interest on their financial accommodation, discounts, loans fees and other services to average for high operating cost.

The greatest challenge to finance companies in Nigeria has remained the crisis of confidence question between the operators and the public. Fortunately, this appears to have been taken care of by the emergence of a vibrant post consolidation financial system in Nigeria.

3.1.5 Discount Houses

The discount house sub-sector is a very important part of the Nigeria financial system. The idea of discount houses was muted and nurtured by the Central Bank of Nigeria in the 1990"s to strengthen and sustain the ailing banking system.

Sections 28 of the Central Bank of Nigeria Act 1991 and section 59 of BOFIA 1991 charged the bank with the responsibilities of licensing, regulating and supervising of discount house business in Nigeria.

A discount house is a non-bank financial institution engaged in discount house business. The business of discount house includes the trading in and holding of money market instruments such as treasury bills, treasury certificates, commercial bills etc.

Discount Houses serve as conduit through which banks were able to channel excess liquidity to the Central Bank of Nigeria.

Discount houses also serve as secondary market for the trading of treasury bills and other commercial bills.

Currently, many of the discount houses have identified with corporate finance hence establish advisory services units in order to provide additional services to their clients.

Discount houses that are owned by group of financial institution can source for fund to finance the business in the following ways. They can source for funds through:

i. Paid up capital this is part of the called up capital which the

ii. shareholders have actually paid.

iii. ii. Income from advisory services. iii. Reserves in their vault. iv. Call money

iv. Short-term borrowing

v. Selling of short-term bills to the CBN

vi. Outright borrowing from the CBN through night advances.

SELF ASSESSMENT EXERCISE

i. Distinguish between finance houses and discount houses

3.2 Importance of the Institution by Funds Mobilization and Contribution to the Economy

i. Although the non-bank financial institutions are not legally mandated to act as the conventional banking institutions, they do mobilize funds from the private and public sectors of the economy. For instance, the insurance companies do mobilize funds arising from the payment of premium part of which they may lend to people and organizations on special arrangement. Similarly, the Traditional financial institutions do mobilize fund from members and in most case lend to them from the pool for overall economic growth and development of the country.

ii. The non-bank financial institutions offer greater accessibility in the borrowing of funds at the micro level to the members of the society. The provision of micro credit guarantees both grass root and even economic growth and stability necessary for meaningful economic development.

iii. The non-bank financial institutions offer specialist service in the economy. These services enhance the efficiency of the operation of both the banking and other sectors of the economy. For instance, the insurance companies reduce the risks associated with various businesses through underwriting, while the pension funds, scheme provide reassurance to the workers by promising them wonderful post-active days etc.

iv. The non-bank financial institutions have continued to provide employment for over twenty-one percent of the entire Nigeria workforce.

SELF ASSESSMENT EXERCISE

i. Explain the importance of Non-Bank Financial Institutions to the economy

3.3 Similarities between Banks and NBFIS

i. Commercial banks create demand deposit when they borrow from the central bank, and NBFIs create various forms of indirect debt when they borrow from commercial banks.

ii. Both commercial banks and NBFIs acts as intermediaries in bringing

iii. ultimate borrowers and ultimate lenders together and facilitate the transfer of currency balance from non-financial lenders to non-financial borrowers for the purpose of earning profits.

iv. Both commercial banks and NBFIs provide liquid funds. The bank deposits and other assets of commercial banks and the assets provided by NBFIs are liquid assets.

v. Both banks and NBFIs are important creator of loanable funds. The commercial banks by net creation of money and the NBFIs by mobilizing existing money balance to exchange for their own newly issued.

vi. Like NBFIs, commercial banks acquire the primary securities of borrowers, loans and deposits and in turn, they provide their own indirect securities and demand deposits to the lenders.

SELF ASSESSMENT EXERCISE

1. State the similarities between banks and NBFIs as financial institutions.

3.4 Roles of Non-Financial Institutions

The roles of non-bank financial institutions are as follows:

i. Reduce Hoarding This is done by bringing the ultimate lenders and ultimate borrowers together. Outside that they also reduce hoarding of cash by ensuring that they make funds available to people.

ii. They help both the Household sector and the business sector The household sector relies on NBFIs for making profitable use of its surplus funds and also to provide consumer credit loans, mortgage loans etc. On the other hand, they help the business sector by financing them so as to facilitate their investment in plant, equipment and inventories.

iii. Help the state and local government This means that NBFI help the state and local bodies financially by purchasing their bonds.

iv. NBFIs provide liquidity and safety to financial assets and help in transferring funds from ultimate lenders to ultimate borrowers for productive purposes.

v. NBFIs help in the growth process of the economy, that is, they intermediate between lenders and borrowers. By performing this function, they discourage hoarding by the people, mobilize their savings and lend them to investors.

vi. NBFIs are of immense help in the working of financial markets, in executing monetary and credit policies of the central bank and hence in promoting the growth of an economy, by transferring funds from surplus unit to deficit unit.

SELF ASSESSMENT EXERCISE

i. Briefly explain the major roles NBFIs plays in the economy

4.0 CONCLUSION

In this unit, we extensively discussed the meaning and relevance of non-banking financial institutions in the economy. Also, the major similarity between Banks and non-bank financial institutions were also explained in detail in the unit.

5.0 SUMMARY

This unit treats the fundamentals of non-bank financial institutions by looking into the different non-bank financial institution as well as explaining them in details. Also, the significant roles NBFIs plays in the country were also integrated into the unit including the roles NBFIs plays in the economy.

6.0 TUTOR-MARKED ASSIGNMENT

i. State five functions of insurance company in Nigeria

ii. Briefly explain the major advantages of traditional financial institution

iii. Discuss the major problems in traditional financial institution

iv. List five ways on which discount houses can raise funds.

v. Write short note on pension scheme

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MODULE 3 THE NIGERIAN FINANCIAL SYSTEM

Unit 1 Nigerian financial system and its significance to economic development
Unit 2 The financial market and its role in economy acceleration
Unit 3 The capital market, structure and its achievement

UNIT 1 NIGERIAN FINANCIAL SYSTEM AND ITS SIGNIFICANCE TO ECONOMIC DEVELOPMENT

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
 3.1 Meaning of Financial System
 3.2 Significance of the Financial System
 3.3 Elements of Financial Reform
 3.4 Objectives of Financial Reform
 3.5 Achievements of the Financial sector reforms
4.0 Conclusion
5.0 Summary
6.0 Tutor Marked Assignment
7.0 References/ Further Reading

1.0 INTRODUCTION

In recent past, the financial sector all over the world has witnessed remarkable changes, given the increasing depth of globalization, structural and technological changes, and integration of financial market. These have also been driven by the quest to implement strategies that engender sustainable economic development. These unit focus on the financial system and it crucial importance to economic development in Nigerian context.

2.0 OBJECTIVES

- Define the term financial system
- Explain it significance to economic development
- Examines the financial reforms and it achievements

3.0 MAIN CONTENTS

3.1 Meaning of Financial System

The financial system comprises the structure, institutions, markets, infrastructure, and mechanisms through which financial assets (loans, bond, stocks, and other securities) are sourced and channeled or traded, interest rates determined and financial delivered in the economy.

Typically, the financial system consists of the banking sector and non financial institutions. The financial sector play importance roles in economic development as economic activities cannot take efficiently without proper functioning of the financial system.

SELF ASSESSMENT EXERCISE

- Define the term financial system

3.2 Significance of The Financial System

The significance of capital market to a country‟s economy can be briefly discussed under the following broad outlines:

1. provision of market facilities and encouragement of investment
2. capital formation
3. capital mobilization
4. capital allocation
5. creation of employment opportunities
6. a measure of economy's performance
7. a safe depository for investors.

3.3 Provision of Market Facilities and Encouragement of Investment

Simple economics states that income, in whatever form, either spent, saved or both. The same simple economics states that investment is a function of savings i.e. an individual (a person or an institution) can invest only to the extent of the surplus income or savings that is available, all other things remaining equal.

The capital market offers veritable for a and facilities for people and institutions in the surplus sector of an economy i.e. savers who are suppliers of fund to pass their savings to other people and institutions in the deficit sector of the economy i.e. borrowers who are consumers of fund.

- Capital Formation

Once the capital market had been formalised, or organised, enterprises tend to take advantage of the opportunities therein. Companies occasionally do require, capital or funds to

1. augment working capital
2. finance expansion programmes In respect of product range, branch network etc
3. refurbish existing machineries or acquire new ones
4. construct head office blocks, factory buildings, staff residential buildings etc.

The company could create securities to be offered to the investing community for subscription. While the company-issuer is able to source funds to meet its operational requirements, the breadth of the capital market gets bigger in the sense that the number of tradable securities increases. The increase in the number of securities automatically brings an increase in the market capitalisation.

If the capital market had not been so organised, the company issuer's ability to create securities or capital would have been greatly restricted.

- Capital Mobilisation

A public company, as opposed to a private limited liability company, has the opportunity to raise funds from its local market and also from the international market. The market "has a- lot of facilities and a number of functionaries that make security issuance feasible while facilitating the success of such public offers. This is the reason it is possible to make a public offer, in a country like Nigeria, within 3O days. A rights offer i.e. a security that is issued to only existing shareholders or members of a particular company is concluded within 4O days.

In effect, the capital market makes it possible and easy for a company, a fund or a government to invite the public to subscribe money and for the money or capital to be successfully collected within a reasonable time frame.

The capital market is also a veritable tool for sourcing funds from foreign countries.

Foreign companies and individuals can invest directly through the establishment of companies in the country. Foreigners can also engage

in portfolio investment by buying securities of companies listed on the stock exchange or those not listed on the exchange

- Capital Allocation

This is the incidence of providing different sectors of the economy with part of or the entire funds they need for effective operations.

Both governments and companies have priority needs which they source funds to meet. For instance, a government may need funds to provide utilities or infrastructure for people i.e. water, electricity, roads etc. At the same time, companies may need funds for research, agriculture, manufacturing etc. there is no single institution or individual that can stay at a location, determine the capital needs of all those in the deficit sector of the economy, the total savings of all those in the surplus sector of the economy and allocate the savings to those in need of funds.

- Benefit To Government

The government benefits from two-tier taxation:

a. the companies in the capital market pay a certain percentage of their net profits as corporate tax
b. the investors in the companies also pay tax [on their dividends; in fact, the tax on dividend is deducted at source.

- Creation Of Employment Opportunities

First, the uniqueness of the capital market gives birth to unique services to be rendered by only trained and qualified personnel. The need for these services created employment opportunities for people-and institutions. Second, when the companies and governments utilise the funds they source from the market, they also provide things (e.g. infrastructure) that facilitate the establishment of some handicrafts, businesses etc which, in turn, provide employment for a number of people in the community. Some successful expansion programmes, of companies, had created employment opportunities for people in the environment.

- A measure of Economy's Performance

The capital market is a popular barometer for measuring the pulse of a country's economy. The operations in the market are closely monitored by the regulators, operators and informed investors. In this regard, the

trend in the all-share index and market capitalization are significant indices.

The macro or over-all performance of the capital market could signal improvement, stagnation or retrogression in the economy. Any of these signals poses some challenges not to only a country"s financial authorities but also the executive arm of government.

- Safe Depository For investors

The capital market acts as a safe-depository for investors whose money, if left at home, could have been under probable threat from robbers. As a corollary to a safe-depository above, the capital market is also a forum for hiding wealth from public glare. Unlike the positions with investments in transport, real estate and other assets, investment in the capital market is, to a large extent, invisible to or hidden from the public.

It is, therefore, not an overstatement to say that the formal existence of a functioning capital market is a catalyst to a country's economic growth and development. In effect, an active capital market can be regarded as a prerequisite for a country's economic survival.

- Rationale For Investment In the Capital Market

Different people and institutions invest in the capital market for different reasons. The following factors, among others, can be identified as motivating factors for investment in the capital market:

SELF ASSESSMENT EXERCISE

1. Examine the significance of financial system in Nigerian economy

3.3 Elements Of Financial Reforms

Following the prolonged use of direct controls, the pervasive government intervention in the financial system and the resultant stifling of competition and resource misallocation, a comprehensive economic restructuring programme was embarked upon in 1986 with increase reliance on market force.

In line with this orientation, financial sector reform was initiated to enhance competition, reduce distortion in investment decisions and evolve a sound and more efficient financial system.

The reforms which focuses on structural changes, monetary policy, interest rate administration and foreign exchange management, encompass both financial market liberalization and institutional building in the financial sector.

3.4 Objective of Financial Reforms

The broad objectives of financial reforms include:

a. Removal of controls on interest rate to increase the level of savings and improve allocation efficiency.
b. Elimination of non-price rationing of credit to reduce misdirected credit and increase competition.
c. Adoption of indirect monetary management in place of the imposition of credit ceiling on individual banks.
d. Enhancing of institutional structure and supervision
e. Strengthen the money and capital market through policy changes and distress resolution measures.
f. Improving the linkages between formal and informal financial sectors.

3.5 Achievements of the Financial Sector Reforms

A critical outlook of the financial reforms shows that the following achievement have been made

Increase in the Number of Operating Institutions- □ one of objectives of the liberalization policy was to encourage the establishment of new financial institutions through relaxed entry requirements.

Also, innovative institutions were encouraged to take advantage of the opportunities created through deregulation. The structural reform increase competition, strengthen supervisory. Role of the regulatory authorities and streamline public sector relationship with the financial sectors.

1. Improved Service Delivery and Product Development

Another positive effect of the reform efforts in the financial sector is the continuous drive by the institutions to improve service delivery through innovations and product development

2. Innovation and Competition

The need to excel in service delivery has resulted in increased competition. In the financial sector. Bank now open for longer hours and on Saturday in order to make their service available to their customer.

3. Improvement in the Speed and Quality of Information

The use of information technology in all aspects of banking operations has become popular among the bank in response to competition generated by financial reforms and globalization.

4. Improve Regulatory Surveillance

The regulatory environment for the institution with in the sector has also improved with the reforms. Apart from the restructuring of the surveillance section of CBN into Banking Supervision and Bank examination Departments and the establishment of Nigeria Deposit insurance corporation as the insurer of deposits in the banks in event of failures.

5. Improve Approach to Monetary Management

It would be recalled that the direct approach to monetary management constituted the main technique before the introduction of SAP. A major action taken as part of monetary reform was the initial rationalization and eventual elimination of credit ceilings for sound banks.

6. Enhanced Interest Rate Management

The reform has been able to remove all control on interest rate and has adopted the policy of fixating only it minimum rediscount rate to indicate the desire direction.

SELF ASSESSMENT EXERCISE

1. What are the achievements of this financial reform?

4.0 CONCLUSION

In this unit, we have been able to examine the nature, structure and background of Nigerian financial market and we have also check out the recent reform and its achievement.

5.0 SUMMARY

We hope you have clearly understood the content in Nigerian financial market and the recent reform coupled with the achievement. We hope you are enlightened about it.

6.0 TUTOR MARKED ASSIGNMENT

i. State the difference between capital formation and capital mobilization.
ii. What do you understand by understand by safe depository for investor.
iii. List and explain the objectives of financial reform in Nigeria.
iv. What are the achievements of this financial reform?
v. Briefly explain the enhanced interest management.

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UNIT 2 THE FINANCIAL MARKET AND ITS ROLE IN ECONOMY ACCELERATION

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
3.1 Objectives money market
3.2 Regulatory frame work of money market
3.3 Graphical and Algebraic analysis of money and product market
3.3.1 Money market
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3.3.6 Derivation of IS function: Algebraic method
3.3.7 General equilibrium of product and money market
3.3.8 Simultaneous shift in the real sector and money sector
3.3.9 Derivation of IS-LM function: Algebraic method
4.0 Conclusion
5.0 Summary
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1.0 INTRODUCTION

The financial markets comprises the money and capital Markets. The foundation for modern financial market in Nigeria was laid in the early 1960s. In the capital market, infrastructure and Institutions to facilities the money, mobilization of long terms capital were put in place. The money market which was meant to support in terms of short term financing was also established to enhance economic acceleration as well as allow liquidity flow from surplus to deficit. This unit focuses on the money market and it Institutions as well as its significance to economy development.

2.0 OBJECTIVES

- Explain the meaning of money markets
- Identify the objectives of money market
- Describes it economy importance

3.0 MAIN CONTENT

Money market is a market for short term finds, designed to channel resources from surplus sector to the deficits sector of the economy. Prior to the establishment of CBN, then was no a market. What existed then was a market for short terms borrowing based on commercial paper, which was an integral part of the London money market to Nigeria for the purpose of financing export produce. Following the establishment of CBN, there was a need to establish a local money market that would provide opportunities for investment in liquid domestic assets. This Head to the formation of money Market. After the establishment of money market in Nigeria certain instruments are used there. These instruments are : treasury bills, treasury certificates, C.B.N bills, C.B.N. certificates and commercial papers e.t.c.

3.1 Objectives Of Money Market

The money market was set up to provide achieve the following objectives.

1. The money market was set up to provide the channel for the management of bank portfolio of assets and liabilities.

2. It was meant to enhance and facil itates effective‟s monetary management in the economy.

3. It was also setup to prevent capital flight.

SELF ASSESSMENT EXERCISE

1. Define the term Money Market.
2. What are the instruments used in money market?

3.2 Regulatory Frame Work In Money Market

The following are the Regulatory Operation in the Money Market

- Central Bank Supervisory Frame Work

The apex bank maintains surveillance over the operation and improve operational standard, ensure adherence to the prudential regulations as well as compliance with legal provision to guide its operation.

- Deposit Money Bank (DMBS)

The deposit money banks are the major player in the Nigeria money market. They accept deposit from banking public and facilitate raising of short term funds for deficits sector of the economy through surplus sectors by trading in short terms securities.

- Discount Houses (DHS)

Discount houses were established to serves as financial intermediaries between CBN and the licensed bank. They mobilized finds for investment in securities by providing discounting and rediscounting facilities in government short terms securities.

- Foreign Exchange Market

The foreign exchange market as a segment of the financial market play an importance roles in the money market transaction in the

Market are generally short term nature as it s essentially a spot market.

SELF ASSESSMENT EXERCISE

- Differentiate between foreign exchange market and discount houses.

3.3 Graphically and Algebraic Analysis of Money and Product Market

3.3.1 Money Market

Money market is a market for short-term securities or funds. It consists of financial institutions having surplus funds to lend on short term basis and those wishing to borrow at short term purpose. The money market in a developing economy has several functions it performs. The functions are:

i). It allocates savings into investment and tends to obtain equilibrium between the demand for and supply of loanable funds, thereby promoting rational allocation of resources

ii) It promotes liquidity and safety of financial assets and thereby encourages savings and investment.

iii). Also, it promotes financial mobility by enabling the transfer of funds from one sector to the other. Such flow of funds is regarded as essential for the growth of the economy and commerce.

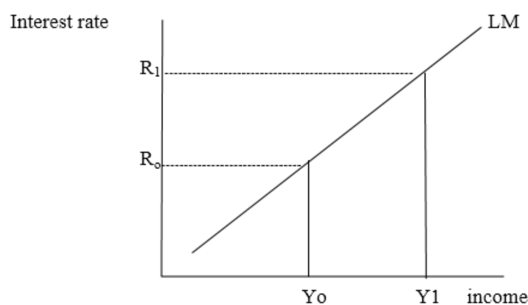
iv). A well developed money market is essential for the successful implementation of the monetary policy of the central bank. Consequently, the money market institutions in Nigeria comprises of the central bank of Nigeria, Commercial bank, Merchant bank and discount houses etc. the major instruments used in money are treasury bills, Call money, treasury certificates of deposit, commercial papers etc.

3.3.2 Money Market Equilibrium

Money market is in equilibrium when the demand for and supply of money are equal. This means that equilibrium is attained in a money when L=M i.e L= LT + Ls and M= LT(Y) + Ls(r)

The LM schedule or function in the money can be graphically and algebraically derived. Before deriving we need to define LM schedule. LM schedule or curve shows the combinations of interest rate and levels of income where the demand for money (L) and the supply of money (M) are equal such that the money market is in equilibrium.

The LM curve is derived from the Keynesian formulation of liquidity preference schedule and the schedule of supply of money. Assuming a fixed level of money supply, a change in income level would need to be accompanied by increase in transaction demand. This is not possible except interest rate is raised, to reduce speculative demand. On the other hand, when speculative demand falls, money is freed to meet increasing transaction demand. The relationship between interest rate (r) and national income (y) is given by the LM curve which is an upward sloping curve. Graphically the LM curve is shown as:

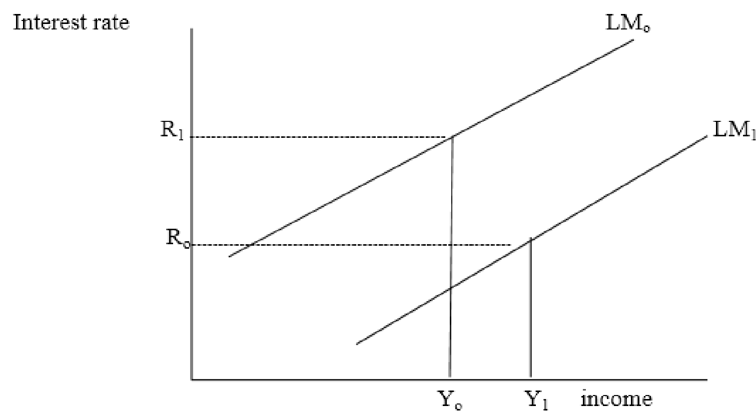


The graph above shows that an increase in interest rate is accompanied by increase in national income.

Shifts in the LM curve

The LM function shifts to the right with the increase in the money supply, given the demand for money or due to the decrease in the demand for money, given the supply of money. For instance, if the central bank decides to follow an expansionary monetary policy, by buying securities in the open market then the money supply with public will increase for both transaction and speculative purposes.

Consequently, a decrease in the demand for money means a reduction in the quantity demanded at each level of income and interest rate. Such a decrease in the demand for money balances creates an excess of the money supplied over the money demanded, which will cause the LM curve to shift to the right. This can be analyzed graphically.



The above graph shows that with an increase in the money supply, the LM o curve shifts to the as LM1 which moves the economy to a new equilibrium point E1. The increase in the money supply brings down the interest rate from R 1 to R 2 in the money market. This in turn increases investment thereby raising the level of income to Y 2 . Conversely, a decrease in the money supply or an increase in the demand for money will shift the LM function to the left such that a new equilibrium is established at a higher interest rate and lower income level.

3.3.3 Derivation Of Lm Function: Algebraic Method

The LM function can be derived by using algebraic method. The equilibrium condition in a money market is given as:

$Md = \overline{Ms}$

$Where\ Md = demand\ for\ money$

$\overline{Ms} = money\ supply\ which\ is\ constant$

$Md = Mt + Msp$

$Mt = Transaction\ demand\ for\ money$

$Msp = Speculative\ demand\ for\ money.$

$Mt = ky$

$Msp = I - L(r)$

$\overline{Ms} = KY + (L - l(r)$

$KY = \overline{Ms} - I - l(r)$

$Y = 1/\bar{k}\,[Ms - I - l(r)]$ this is the algebraic derivation of LM function in a money market

Example

Given that money market model is

$\overline{Ms} = 150million$

$Mt = 0.5y$

$Msp = 150 - 1500r$

$r = 8\%$

Calculate the national income level in the money market.

Solution

$Md = \overline{Ms}$

$Mt + Msp = \overline{Ms}$

$KY + L - lr \equiv Ms$

$KY = \overline{Ms} - L + lr$

$0.5y = 150 - 150 + 1500(8\%)$

$0.5y = 150 - 150 + 1500(0.08)$

$0.5y = 120$

$Y = 1/0.5 * 120$

$Y = 2(120)$

$Y = 240Million.$

3.3.4 Product Market

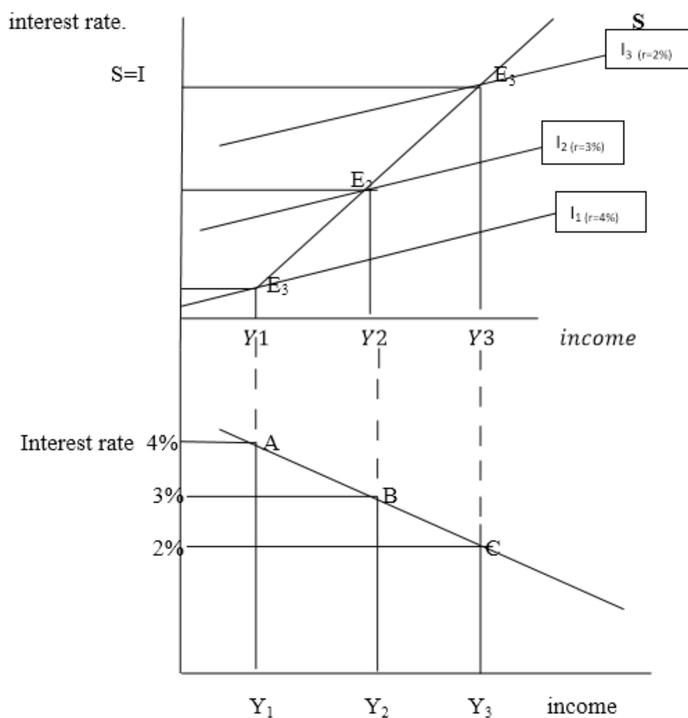
Product market is a market place where final good and service is bought and sold. A product market does not include trading in raw or other intermediate materials rather focuses on finished goods purchased by consumers, businesses, the public sector and foreign buyers.

3.3.5 The Product Market Equilibrium

The product market is in equilibrium when desired saving and investment are equal. Saving is a direct function of the level of income i.e S=f(y) and investment is a decreasing function of the interest rate i.e I=f(r).

The product market equilibrium is known as the real sector equilibrium.

The IS curve can be derived graphically, using savings, income, investment and interest rate. S



The graph above shows that saving increases as the level of income and investment increases as interest rate falls.

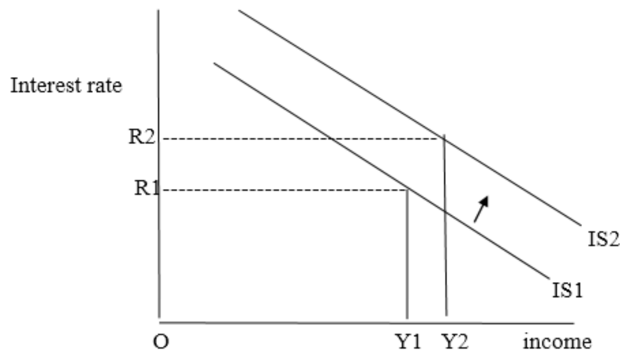
Given a level of interest rate, the level of investment rises with the level of income. At 3% rate of interest, the investment curve is I2. If the rate of interest is reduced to 2%, the investment curve will shift upward to I3. The rate of investment will have to be raised to reduce the marginal efficiency of capital (MEC) to be equal with the lower rate of interest.

SHIFT IN THE IS CURVE

The IS function shifts to the right with a reduction in saving. Also, the IS function shifts to the right by an autonomous increase in investment.

The increase in investment may result from expectation of higher profits in the future, or from innovation or from expectation concerning increase in the future demand for the product.

With the increase in the autonomous investment, the IS curve shifts from IS1 to IS2 and the new equilibrium is established at point E2 which indicate a higher level of income Y2 at a higher interest rate R2. In the opposite case, when investment falls or saving increases, the IS function will shift to the left and the equilibrium will be established at a lower level of income and interest rate.



3.3.6 Derivation Of IS Function: Algebraic Method

The IS function can be derived by using both the equilibrium condition of the product market. The equilibrium condition is given as AD=AS. To derive the IS function algebraically, we start by saying that:

$AD = Y = C(y) + L(i)$

$Where\ C(y) = a + bY$

$L(i) = I - hr$

$Y = a + by + I - hr$

$Y = 1/1 - b * (a + I - hr)$

$Let\ 1/1 - b = m$

$Y = m(a + I - hr)$

Example

Given C(y) = 10 + 0.5y and L(r) = 200 – 2000r, calculate the income level in the product market, given that rate of interest is 7%

Solution

$y = C(y) + L(r)$

$y = a + by + I - hr$

$y - by = a + I - hr$

$y = 1/1 - b * a + I - hr$

$y = 1/1 - 0.5[(10 + (200 - 2000(0.07)]$

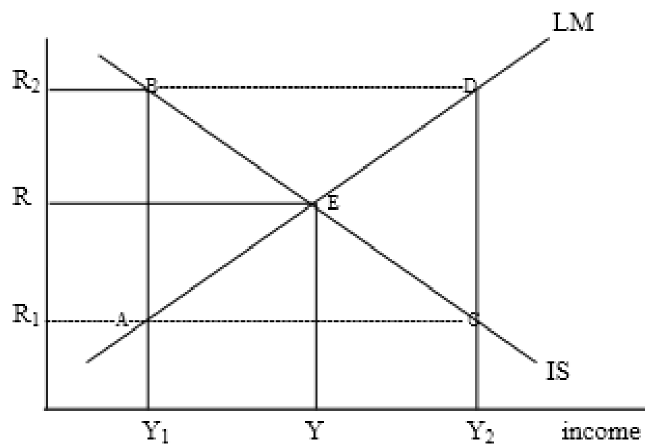
$y = 2[(10 + 60)]$

$y = 2(70)$

$y = 140 million.$

3.3.7 General Equilibrium of Product and Money Market

General equilibrium of product and money market is a solution where we have an intersection in the real sector of the economy (IS) and in the money sector of the economy (LM), at a sing interest rate and income. The money market equilibrium and the product market equilibrium are better explained using graph.

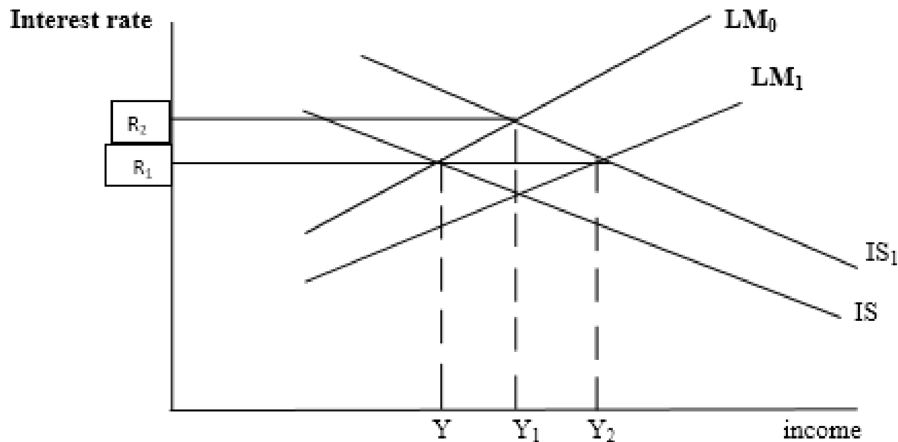


From the above graph at point A, there is excess of investment over saving since point A lies to the left of the IS curve. The excess of I over S indicates excess demand for goods which raises the level of income. As the level of income rises, the need for transaction purposes increases. In order to have more money for transaction purposes, people sell bonds. This tends to raise the interest rate. This moves the LM curve from point

A upward to point E where a combination of higher interest rate R and higher income level Y exist. On the other hand, rising interest rate reduces investment and increase income and saving. At point C, where the product market is at equilibrium at R 1 interest rate and Y 2 income level, the reduction in interest rate shows that the demand for money (L) is greater than the supply of money (M), because point C reflects lower rate of interest R 1 than is required for the equality of L and M. The excess demand for money as a result of reduction in interest rate, leads people to sell bonds but there is less demand for bonds which tends to raise the interest rate. When the rate of interest begins to rise, the product market is thrown into disequilibrium because investment falls. Falling investment leads to falling income which in turn reduce saving.

3.3.8 Simultaneous Shift in The Real Sector And Money Sector

The simultaneous shift in IS and LM function can be properly analyzed graphically. Suppose both the IS and LM curve shift to the right simultaneously as a result of the increase in investment and money supply respectively, how will these expansionary fiscal and monetary policies affect the level of income and the rate of interest?. This can be explain using a graph.



From the graph above, an increase in investment shifts the IS curve from IS 0 to IS 1 and an increase in the money supply, shifts the LM curve from LM 0 to LM 1 . Thus, the simultaneous shift in the IS and LM curve, will move the equilibrium point E 0 to a new equilibrium point E 1 where IS 1 intersect LM 1 at R 1 interest rate. The rate of interest remains at the old level R 1 , but the income increases from Y 0 to Y 2 . Thus, given the money supply with no change in the LM curve, an increase in investment would raise both income and the rate of interest. A shift in IS curve from IS 0 to IS 1 , holding the LM curve constant, will cause the interest to move R 1 to R 2 thus, reduce the level of income to Y 1 and new equilibrium level will be formed i.e E 2 . Conversely, if the money supply increases by so much as to prevent the

rise in the interest rate, the increase in income will be equal to the full expansionary effect of the rise in investment, thus moving LM curve to shift to the right, to intersect with IS, at an equilibrium E 1 which will have a positive effect on income by increasing the level of income.

3.3.9 Derivation of IS-LM Function: Algebraic Method

Having derived the IS and LM function, we may now combine the two functions and find the

From already derived IS function and LM function above, we have that IS=LM, is generally given as:

$1/1\text{-}b\ (a+I+hr) = 1/k(M\ s - L + lr)$

Where $1/1\text{-}b = m$

$1/k = m$

Therefore:

$m(a+I+hr) = m(M\ s - L + lr)$
Example

From the derived functions, IS function = 420-4000r, LM function = 300r, calculate the interest rate; use the result of the interest to determine income level.

Solution

is the equilibrium rate of interest

We can get equilibrium income by using either IS function or LM function

$Y = 420 - 4000r$ IS function $Y = 420 - 4000(0.06)$

$Y = 420 - 240$

$Y = 180$ million

4.0 CONCLUSION

In this unit, we have examined the money market and its role in supporting businesses by raising fund on a short-term basis and we have

also shed light on the regulatory framework behind the money market. Also, we have analyzed the product market and the money market. We hope you understand the analysis behind the derivations.

5.0 SUMMARY

We have cross the road on the first level of the financial market which is the money market and we have explained the regulatory framework coupled with the market operators. We do hope students find it interesting as well as enlighten enough.

6.0 TUTOR-MARKED ASSIGNMENT

1. What are the objectives of establishing a money market in Nigeria.
2. Explain four regulatory operations in the money market.
3. State four functions in the money market.
4. Distinguish between the product market and money market.
5. $C(y) = 9 + 0.35y$ and $L(r) = 300 - 2500r$, calculate the income level in the product market, given that the rate of interest is 6%.
6. Derive the LM function from the following money sector model

$Mt=0.5y$ $Msp = 100 -1500r$ $M s = 150$ 7.0

7.0 REFERENCES/FURTHER READINGS

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UNIT 3 THE CAPITAL MARKET, STRUCTURE AND ITS ACHIEVEMENTS

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
  3.1 Background of Nigeria Capital
  3.2 Structure of the Nigerian Capital Market
  3.3 Institutions in Nigeria Capital Market
    3.3.1 Segments of the Nigerian Stock Exchange
  3.4 Factors militating against the success of the market
  3.5 Consequences of the factor on Nigerian Capital Market
4.0 Conclusion
5.0 Summary
6.0 Tutor Marked Assignment
7.0 References/ Further Reading

1.0 INTRODUCTION

The primary aim of the Nigerian Capital Market is to mobilize long term funds. The Nigerian stock Exchange (NSE) is the centre-point of the market. It evolved from the Lagos Stock Exchange which commenced business 1961. Following government adoption of the recommendation of financial system review committee of 1976; the Nigeria stock exchange was set up in 1977; to provide a mechanism for mobilizing private and public savings and making such fund available for productive purpose. The exchange also provides a means for trading in existing securities and encourages small as well as large scale business gain access to the public investors.

This unit thrown light on the nature, structures and relevance regulatory framework of the market, its prospect and challenges.

2.0 OBJECTIVES

- Examine nature and structure of the market.
- Explain relevance institutions in the market.
- Examine its prospects and challenges.

3.0 MAIN CONTENTS

3.1 Background Of Nigeria Capital Market

The capital market is the long-terms end of the financial market. It is made up of institution, which facilitate the issuance and secondary trading of long terms financial instrument. Unlike the Money Market, which functions basically to provide short term funds, the Capital Market provides funds to industries and government to meet their long term requirements, such as financial of fixed investment-building, plants bridge etc. in Nigeria, the capital market first came into existence with establishment of the Lagos stock exchange in 1961. In December 1977 it becomes known as the Nigerian stock exchange, with branches established in some of the major commercial cities of the country. There are now eight branches of the Nigerian stock exchange each branches have a trade floor, some of the electronic. The head office is in Lagos was opened 1961 Kaduna in 1978, port court, 1980, Kano 1989, Onitsha 1990, Ibadan 1990, Abuja area office 1999, Yola, 2002; and Benin ,2005. The exchange started operations in Lagos 1961 with 19 securities listed for trade, currently, there are288 securities on the exchange made up of 33 government stocks, 47industrial loan (debentures/preference) stocks and 204 equity/ordinary share of companies with total market capitalization of N3.7trillion.many of the listed companies have foreign/ malfunctioned afflictions and represent a cross section of the economy, ranging from agriculture through manufacturing of services.

SELF ASSESSMENT EXERCISE

1. Trace the origin of the Nigerian Capital Market and its objective

3.2 Structure Of The Nigerian Capital Market

The Nigerian capital market consists of the following institutions: Securities and Exchange Commission (SEC)-the apex regulator: the Nigerian stock exchange (LSSE): the Abuja securities and commodity exchange (ASCE) and the facilitating institutions. The facilities institution include; the stock broking firms, the issuing houses investment advisers, portfolio funds managers, trusts solicitors, auditors reporting accountant ; receiving agency or registration.

There are two men segment of the market; these are primary and secondary markets. The major instruments used to raise fund at Nigerian capital market include: reunites (ordinary and preference share); government bonds (federal, states and social governments) and industrial loans, stock and bonds.

SELF ASSESSMENT EXERCISE

1. Briefly explain the two major structures of the Nigerian capital market

3.3 Institutions In Nigerian Capital Market

a. Securities and Exchange Commission

The man function and exchange commission are to regulate and develop the Nigerian capital market in order to achieve its wider objectives of investors protection and capital market development include regulation, registration, enforcement, mergers and acquisition and development functions.

b. The Nigerian Stock Exchange (NSE)

The NSE evolved from Lagos stock exchange as earlier mention. The functions the exchange includes: providing facilities to the public for purchase and sales of stock and share of any kind; and controlling the granting of quotation on the any exchange in respect of shares and stock. In the bid to reach out to the grassroots and bring the services of the stock exchange nearer to investing public a lot of branches have been created by the Institution. Also in recognition of the crucial role of small and medium scale enterprises in the overall industrial employment of the country, the NSE introduce second-tier security market (SSM) for listing small and medium scale enterprises that were unable to meet the stringent requirements of the main market.

3.3.1 Segments of the Nigerian Stock Exchange

The NSE can be classified into two broad categories namely;

1. The Primary Market

This is the market for new issues of securities. The mode for the securities traded in the market include offer for subscription, right issue, offer for sales and private placements. It is important to note that the fund raised through the primary segment of the capital market goes to the companies as equity capitals.

2. The Secondary Market

This is the market for trading in existing securities. It consists of the stock exchange and over-the-counter markets. Money raised through the segment of the market goes to the investors. Activities in the secondary

market have increased substantially over the years. This has been facilitated by the opening of trading floor in some parts of the country by the NSE.

SELF ASSESSMENT EXERCISE

Differentiate between the primary market and the secondary market

3.4 Factors Militating against the Success of the Markets

1. Pull-out of various Foreign Investors

To start with, many foreign investors that already have troubles in their home economics have pulled out of the Nigerian capital market leading to dumping of shares beyond the abilities of domestic investors to contain

1. Lack of Infrastructure and High Costs of Production

The cost of doing business is high in Nigeria. Basic infrastructures like good roads, power supply are lacking, lead to high of doing business. Many quoted and unquoted companies like Dunlop Nigeria Plc and Michelin Nigeria have close shops.

2. Impacts of Commercial Banks

Following the forced capitalization and reform in the Nigerian financial system, almost all banks utilized and access the capital market to raise funds. Within two years plus, many of the bank besieged the capital market more than once. These banks finally compete to suck every liquidity in the market leading to overheating. Inability of the Federal Government to Plot a Bailout Option. More so, government lacked wisdom to examine the socio-economic implications and chain effects of a failed capital market. It therefore, became impotent of hatching a bailout plan.

3. Structural Deficiencies

There appears to be some inadequacies of the Nigerian capital market, especially the absence of market makers. Thus, there are no functional market makers that can provide exit windows for investor who wish to check out.

4. Regulating Inconsistencies

The apex regulator of the Nigerian capital market, the Securities and Exchange Commission, prior to the crash of the market alleged publicity that stock market prices were being manipulated and it announced that it was probing some quoted companies, such as Dunlop Nig, Eternal Oil Plc, Capital Oil Plc and so on. Following the publication, investors became afraid that there evidence that investment gambling exist in the market.

5. Opportunities of Meltdown and Fall in Oil Price

The recent meltdown and fall in oil price has provided excellent opportunities both local and foreign investors to grab the shares at rock-bottom prices with greed of a hungry lion.

SELF ASSESSMENT EXERCISE

State five factors militating against the success of capital market in Nigeria

3.5 Consequences of the Factor on Nigerian Capital Markets

i. Loss of confidence in the Nigeria economy, as man investor‟s proffer to convert their naira to foreign currencies, worth the country exchange rate. ii. Trillion of naira-what remains of capitalization ate tied down in ensile-able stocks.

iii. Over exposure of investors and stock broking firms to banks. iv. Credit crunch in the economy as back do not have enough to lend.

v. Loss of depositor‟s fund.

vi. Loss of confidence on bank.

vii. Loss of value of pension assets.

viii. Inability of stock broking firms to settle their client for securities sold.

SELF ASSESSMENT EXERCISE 4

Explain the consequences capital market

4.0 CONCLUSION

In this unit, we examined the Nigerian Capital Market with special emphasis to Nigerian Stock Exchange Market. We further check out the factors militating the market and the consequence of these factors on Nigerian economy.

5.0 SUMMARY

Following our analysis, you must have understood the challenges militating against the Nigerian capital market and its reverse consequence on Nigeria economy

6.0 TUTOR MARKED

1. Describes the meaning of capital market in the Nigerian context
2. Write short note on the followings; Securities and Exchange Commission and the Nigerian Stock Exchange.

7.0 REFERENCES/FURTHER READINGS

Freidman, M. (1959). The Role of Monetary Policy, New York University Press, 1969.

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MODULE 4 MONETARY POLICY FRAMEWORK AND ITS INTERNATIONAL MONETARY SYSTEM.

Unit 1 Concepts of Monetary Policy, Instruments and its Operational Framework.
Unit 2 Central Bank in action and its Economic Significance
Unit 3 International Monetary System.

UNIT 1 CONCEPTS OF MONETARY POLICY, INSTRUMENTS AND ITS OPERATIONAL FRAMEWORK

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
    3.1 Definition of Monetary
    3.2 Definition, Functions and the Organization Structure of the Commercial Bank
        3.2.1 Functions of Commercial Bank
        3.2.2 The balance sheet of a Commercial Bank
    3.3 Roles of Commercial in Nigeria
        3.3.1 Problem of Commercial Bank in Nigeria
    3.4 Merchant Bank and its functions
        3.4.1 Functions of Merchant Banks
        3.4.2 Sources of fund to Merchant Bank
4.0 Conclusion
5.0 Summary
6.0 Tutor Marked Assignment
7.0 References/ Further Reading

1.0 INTRODUCTION

One of the principal functions of the Central Bank of Nigeria (CBN) is to formulate and execute monetary policy to promote monetary. Stability and sound financial system in Nigeria. These functions are carried out in line with CBN Decree of 1991 and the Bank and Financial Institutions Decree of 1991. Usually, the monetary policy to be pursued is detail out in the form of guidelines to all banks and financial institutions.

This chapter spell-out and enlighten readers on framework, concepts and operational focus of monetary policy in Nigeria.

2.0 OBJECTIVES

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

- Explain the term monetary policy
- Identify monetary policy instrument
- Analyze framework of high powered money iv. Explain and discusses roles of monetary policy

3.0 MAIN CONTENT

3.1 Definition Of Monetary Policy

Monetary policy refers to the combinations of measures designed to regulate the value, supply and cost of money in an economy, with regard to the current level of economic activity.

Objectives of monetary policy

1. Full employment

Full employment has been ranked among the foremost objectives of monetary policy. It"s an important goal not only because unemployment lead to wastage of output, but loss of social standing.

2. Price stability

One of the policy objectives of monetary policy is to enhance stability in price level in other control inflationary and deflationary pressure.

3. Economic growth

This is an increase in real output per capita income of a country overtime and its can only be achieve through appropriate monetary appropriate monetary policy strategy.

4. Balance of Payment

Monetary balance of payments in an economy is not an easy task, considering the level of economic activities and change in economic phenomenon. However, the framework of monetary policy helps to formulate policy that will bring equilibrium in this regard.

SELF ASSESSMENT EXERCISE

Define and explain the objectives of monetary policy in Nigeria

3.2 Instruments of Monetary Policy

The instruments of monetary policy used by the CBN depend on the level of development of the economy, especially its financial sectors the commonly used instruments are discussed below:

- Reserve Requirements

The central bank may require deposit money banks to hold a fraction (or a combination of their deposit abilities (reserves as) vault cash or deposits with it. Fraction reserve limit the amount of loan banks can make to the domestic economy and this limit the supply of money. The assumption is that deposit money banks generally maintain a stable relationship between their reserves holdings and the amount of credit of credit extends to extend to public.

- Open Market Operation

The Central Bank buys and sells (on behalf of the fiscal authority (the treasury) securities to the banking and non banking public. Those activities increases and reduces supply of money in the circulation.

- Interest Rate

The Central Bank Nigeria lends to financially sound deposits money banks at a most favourable rate of interest, called Monetary Policy Rate (MPR). The MPR sets the floor for interest rate regime in the money market, thereby affecting supply of credit.

- Direct Credit Control

The Central Bank Nigeria can direct deposit money bank on the measurement percentage or amount of loans to different economic sectors or activities, interest rate caps, liquid asset ratio and issue credit guarantee to preferred loan.

- Moral Suasion

The Central Bank Nigeria issue licenses or operating permit to deposit money banks and also regulates the operation of the banking system.

- Exchange Rate

The balance of payments can be in deficit or surplus and each of these affect monetary base, and hence, the money supply in one direction or other. By selling and buying of foreign exchange, Central Bank Nigeria ensure equilibrium or equal balance of domestic currency in terms of value with foreign currencies.

- Prudential Guidelines

The Central Bank Nigeria may in writing require deposit money banks to exercise particular care in their operations in order that specified outcomes are realized.

SELF ASSESSMENT EXERCISE

Generally discuss the monetary policy instruments used by CBN to checkmate the excess money in circulation.

3.3 Theory of Money Supply and Multipliers Analysis.

Money supply simply means the available stock in the economy. It is important to note that the total money that serves as medium of exchange and store of value is supplied mainly by two sources; the central bank and the commercial banks. Banks as it is called does not create their own money rather they add to the money supply through their system of borrowing and lending. Thus, the money supply from both sources is interlinked. The analysis of how money supplied by the central bank multiplies itself in the process of monetary transactions results into the theory of money supply.

The theory of money supply makes a distinction between the two concepts of money supply i.e the ordinary money or the stock of money (M) and high-power

money (H) which is also called "base money" . The ordinary money includes the currency held by the public and the demand deposits, both used as medium of exchange and store of value.

The ordinary money (M) is given as $M = C + DD$, where C = Currency with the public and DD = Demand deposit with banks.

High-Power money is define as the net liabilities of the central bank that is jointly held by the public as currency and as a reserve by the commercial banks. The high– power money multiplies the process of

monetary transactions between the people and the banks. It is however given as H = C + R, where C = Currency with the public and R = cash reserve with the central bank and with other banks.

3.3.1 Factors that determines Money Supply in an Economy .

i. Public desire to hold currency and deposit:

This determines the money supply. For instance, if people are in the habit of keeping less in cash and more in deposit with the commercial banks, the money supply will be large. This is because banks can create more money with larger deposit.

ii. High power money

This is the net monetary liabilities of the central bank that is held jointly by the commercial bank in the form of reserve and by the public in form of currency. Also, it is the base for the expansion of bank deposit and creation of money supply.

iii. The level of bank reserves:

This determines the money supply. Commercial banks reserves consist of reserve on deposits with the central bank and currency in their vault. The central bank is the only authorized entity that can influence the reserves of other banks so as to determine the supply of money. Note, the central bank requires all commercial bank to hold reserves equal to a fixed percentage of both time and demand deposit.

3.3.2 The Money Multipliers

Money multiplier is the rate at which high power money or reserve money gets multiplied to make the supply of total ordinary or broad money.

3.3.3 Factors that Determines Money Multiplier

The determinants of money multiplier (M) can be grouped under two categories:

A) THE PROXIMATE OR IMMEDIATE FACTORS

The proximate determinants of the money multiplier are merely the numerical ratios that appear in the multiplier formula. i.e it shows the factors that are included in money multiplier. These factors are:

i. Currency – deposit ratio (c) and money multiplier:

The higher the currency – deposit ratio (c), the smaller the money multiplier (m). This means that if public prefers to hold a high proportion of (H) in the form of cash (c) and a smaller proportion of it as deposit (D),then the ability of the bank to create secondary deposits and credit will be reduced to the extent that it reduces the value of „M".

ii. Reserve – deposit ratio (r) and money multiplier:

The role of reserve-deposit ratio (r) is more obvious, i.e the higher the

reserve – deposit ratio (r), the lower the value of money multiplier. For instance, if banks reserve requirement (RR) increases, their ability to create deposit and credit decreases and therefore, the value of (m) decreases.

iii. Time – deposit ratio (t) and money multiplier:

The ratio of time deposit to demand deposit, in the determination of

money multiplier is like that of the reserve – deposit ratio (r), i.e the

higher value of t, the smaller the value of (m).That is, if public decides to increase the ratio of time deposit (TD) to demand deposit (DD), then the value of (m) decreases.

B) THE ULTIMATE FACTORS:

The factors that determine the value of c, r, and t are the ultimate factors. They are ultimate in the sense that they arise out of the working of the economic system and the decision taken by the Central Bank, the public and the commercial banks.

3.3.4 Derivation of Money Multiplier with Demand Deposit (DD)

The derivation of this will require two determinants of money multiplier which are currency – deposit ratio (cr) and reserve deposit ratio (rr).

Given the ordinary money (M) ie M = C + DD and the base money (H) i.e H = C + R , following the mankiw"s approach, we can d erive the money multiplier as follows.

$M = C + DD$ - - - - - (1)

$H = C + R$ - - - - - - (2)

Divide equation 1 and 2

$\frac{M}{H} = \frac{C+DD}{C+R}$ - - - - - - - (3)

Divide equitation 3 by Demand deposit (DD)

$\frac{M}{H} = \frac{C/DD+DD/DD}{C/DD+R/DD}$ - - - - (4)

$\frac{M}{H} = \frac{C/DD+1}{C/DD+R/DD}$ - - - - - - (5)

Where $^{C}/_{DD}$ = Cr

$^{R}/_{DD}$ = rr

$\frac{M}{H} = \frac{Cr+1}{Cr+rr}$

Cross multiply

M(Cr + rr) = (Cr + 1)H.

$M = \left(\frac{Cr+1}{Cr+rr}\right) H$

Where $\frac{Cr+1}{Cr+rr}$ = m i.e multiplier.

M = mH

∴ making small m the subject of the formula. Then $m = \frac{M}{H}$.

Example

If in a country, cr = 0.4 and rr = 0.05 then what is m

Solution

$m = \frac{Cr+1}{Cr+rr}$

$m = \frac{0.4+1}{0.4+0.05} = \frac{1.4}{0.45}$

m = 3.11

3.3.5 Money Multiplier with Demand Deposit and Time Deposit.

In solving for money multiplier, it does involve the incorporation of time deposit (t) into it. Thus given

$C + DD = (C + R)m$

Where $R = r\,(DD + TD)$

$T = t.DD$

$C = C.DD$

$\therefore\ C + DD = [(C + r\,(DD + t\,.\,DD)]m$

$C.DD + DD = [(C.DD + r\,(DD + t.\,DD)]m$

Divide both sides by DD

$c.\ {DD}/{DD} + {DD}/{DD} = \left(c.\ {DD}/{DD} + r\,({DD}/{DD} + t\ {DD}/{DD})\right)m$

$c + 1 = \left((c + r\,(1 + t)\right)$

$m\,(c + r\,(1 + t)) = c + 1$

$m = \frac{C+1}{C+r\,(1+t)}$ money multiplier.

$\therefore$ Having derived this, it is important we incorporate money supply and high – power money so that money supply is equal to multiplier times high power money

$M = \left(\frac{C+1}{C+R\,(1+t)}\right) H.$

Substitute the values of money supply and high-power money

C +DD = (C +R)m

Where R = r (DD +TD)

T = t.DD

C = C.DD

C + DD = [(C + r (DD + t . DD)]m

C.DD +DD = [(C.DD + r (DD +t. DD)]m

Divide both sides by DD

/ + / = (/ / /) m

c+1= ( )

m =c+1

m= money multiplier.

Having derived this, it is important we incorporate money supply and high – power money so that money supply is equal to multiplier times high power money
M= ( ) H.

The above equation shows that the total money supply i.e ordinary money (M) is the function of the high – power money (H). Thus c, r and t are assumed to be constant, which shows that H is the key factor in the determination of ordinary money supply.

Example:

Given the immediate factors c, r, and t, where c = 0.3 r = 0.1 and t = 0.2, (i) calculate the money multiplier (ii) Determine what happens to money multiplier if the public decide hold large part of H as cash i.e if C = 0.5.

Solution

(a) $$m = \frac{C+1}{C+r\ (1+t)}$$

$$m = \frac{0.3+1}{-.3+0.1\ (1+0.2)}$$

$$m = \frac{1.3}{0.3+0.1+0.02}$$

$$m = \frac{1.3}{0.43}$$

$$m = 3.1$$

(ii) If the public decides to increase the currency deposit – ratio (c) say to 0.5 then.

$$m = \frac{0.5+1}{0.5+0.1\ (1+0.2)}$$

$$m = \frac{1.5}{0.5+0.1+0.02}$$

$$m = \frac{1.5}{0.62} = 2.42$$

This means that as the public holds more currency as cash, the multiplier (m) will decrease as against holding small part of H as cash.

3.4 Conflicts Or Trade Off In Monetary Policy Objectives

The objectives discussed above are not complementary to each other. Rather they conflict with one another. Below is conflict between different monetary policy objectives.

1. Full Employment and Economic Growth

The relationship between full employment and economic growth boil down to trade off as both cannot be achieved simultaneously.

2. Economic Growth and Price Stability

There is conflict between goals of growth and price stability. The rise in prices is inherent in the growth process. The demand for goods and services arises as a result of stepping up investments on a large scale and consequent increase in income. This often leads to inflation.

3. Full Employment and Price Stability

They have been extensive study is in the regard. The work of Philips, Samuelson, Solow and others in 1960s established a conflict between the two objectives as they cannot be achieved simultaneously. This finding explained in forms of Philips curve, suggests that full employment can be attained with high inflationary pressure.

3.5 The Economics of Financial Intermediation

The efficiency of an economy is tied to the effectiveness of its financial intermediation.

A financial intermediately is a form whose assets and liabilities are mainly financial instruments. The goal of financial intermediation is to pool resources from savers and lend to people and forms who need to borrow. The institutions also gather and relay information about the financial conditions of firms and individual.

Role of financial intermediaries

Financial intermediation is a huge part of the market economy. In terms of size other activity associated with indirect finance through intermediation can and does not exceed the GDP. The following are their roles:

1. Pooling of resources from small savers
2. Providing safekeeping and services and access to the payment system
3. Supplying liquidity
4. Providing method of diversification
5. Collecting and processing of information costs.

- Pooling of Savings

The most obvious function of financial intermediary is to pool resources of a large number of small savers. By pooling the resources the bank can then make large loan to firms.

- Safekeeping and Effective Access to Payment System

Financial intermediaries provide security. For instances, banks used to construct large, heavy safe locked imposing. The safekeeping of valuable assets is an essential function of financial intermediaries.

- Providing Liquidity

Financial intermediaries provide liquidity to their customers. Liquidity is simply the ease at which assets can turned into means of payments and thus consumption. Bank allows their depositor to quickly and easily turn benefit from easier liquidity.

- Banks mitigate several types of risk.

First, they take depositors from many people and make thousands of loans with these deposits. Thus each depositor face only small risk associated with loan. That will go default. Banks also provide a low cost of diversification of investment.

- Collecting and processing information

One of the biggest problems that savers face is who to lend their assets to. The fact is that the borrower. Could he about their true state and the lender have little ability to verify the truth? Finding out the truth can be a costly venture. By collecting and processing information financial intermediaries reduce problems associated with information asymmetric.

4.0 CONCLUSION

It is crystal clear at this junction that we have been able to explain relevant framework of monetary policy in Nigeria context. We do hope that you understand that some monetary goals have conflicts with one another. This implies that objectives of monetary policy cannot be achieved simultaneously.

5.0 SUMMARY

In this unit we have learnt that for a sound macro-economic stability monetary policy serve as a valid tool for achieving it.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain the objectives of monetary policy.
2. State the monetary instruments the monetary authorities can use in controlling money supply in the economy.
3. State the factors that determine money supply in the economy.
4. State five roles of financial intermediaries in Nigeria.
5. Given the immediate factors c, r, and t where c = 0.5, r = 0.2 and t = 0.3, calculate the money multiplier.

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UNIT 2 CENTRAL BANK IN ACTION AND ITS ECONOMIC SIGNIFICANCE

CONTENTS

1.0 Introduction
2.0 Objectives
3.0 Main Content
  3.1 Meaning of Central Bank
  3.2 Objectives of Central Bank of Nigeria
  3.3 Operational Strategies of Central Bank
  3.4 Evolution of Central Bank of Nigeria
    3.4.1 Challenges faced by Central Bank of Nigeria
    3.4.2 Solution to the above challenges
    3.4.3 Functions Central Bank
  3.5 Objectives of credit control by Central Bank of Nigeria
4.0 Conclusion
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1.0 INTRODUCTION

In Nigeria central bank was set up by the government to perform the traditional function of promoting economic development and enhancing sound and strong financial system in the country. However, for a central bank to succeed in its desire there are need to improve its sources of information and use effectively monetary instrument to facilitate economy activities. This unit explains the concept of central bank, operational strategies and its significance in the economy coupled with the prospects and challenges.

2.0 OBJECTIVE(S)

- Meaning and Objectives of Central Bank
- Describes Evolution of the Central Bank
- Identify and explain the operational strategies and it functions.

3.0 MAIN CONTENT

3.1 Meaning Of Central Bank

Central bank is the open, national financial institution that posses the monopoly of the issuance of a legal tender money and entrusted with the custody of cash reserve and out as lender of last resort.

3.2 Objectives Of Central Bank Of Nigeria

According to the CBN ordinance of 1958 which spell out the objectives of CBN as:

1. To issues legal tender currency in Nigeria.
2. To maintain external reserve in order to safeguard the international value of the currency.
3. To promote monetary stability and strong financial structure.
4. To out as banker and financial adviser to the federal government.

3.3 Operational Strategies Of Central Bank

The central bank is charge with the responsibility for promoting a sound financial system in Nigeria: to this end, these are some of its operational strategies.

1. Bank Clearance

The bank act as a banker to all commercial merchant, development banks and other financial institutions for operational regulatory purpose the C.B.N under the frame work of laws act as inter-link between inter-bank to day operation s of the clearing houses.

2. Bank Examination

The CBN exercise surveillance over the operations of the banks with a view to ensuring sound banking practices. The CBN Implement periodic examination of financial statement to ensure they are financial prudent enough to operate in the economy.

3. Monetary of Foreign

The Central Bank of Nigeria conduct routine examinations into the foreign exchange operations of the authorized dealers by investigating and certainly. The activities of Bureau De change. This routine allows Central Bank of Nigeria to monitor the exchange rate and its activities.

4. Act as lender of the last resort

By granting accommodation in form of re-discounts and collateral advance to commercial banks and other financial institutions the Central Bank of Nigeria act as a lender of last resort.

3.4 Evolution Of Central Bank Of Nigeria

The Central Bank of Nigeria is the apex regularly authority of the Nigeria banking act of 1958- the act conferred on the bank a number of functions and power to control the operations of banks. The act has undergone amendments at different times to reflect changes in economic circumstances and to reposition the bank to face the challenges of the changing economy. For instance, amendments introduce in 1962, 1967, 1997, 1999 and 2002 were made to restructure and foster the development of modern financial structure.

3.4.1 Challenges Faced by Central Bank of Nigeria

1. Globalization

The current picture of the Nigeria financial system clearly showed that it lacks improvement in sophistication of financial market and risk management.

2. Governance Structure

Experiences in different economics of the world show that efficient operation of the financial sector requires good governance. In its current form, the present structure need to provide incentive for portfolio risk management and avoid political interference in management decision of the institutions.

3. Financial Reform

The Nigerian financial sector reforms are not exceptions; they have their short coming which needs to be addressed as a challenge to the economy. For instance, capacity constraints, knowledge gap and lack of manpower.

3.4.2 Solution to the Above Challenges

1. A well improved economy structure should be put in place to enhance strong financial system
2. Real commitment with international monetary group who are ready to contribute to the financial reform should be encouraged.

3.4.3 Functions of Central Bank

1. Currency Regulator:

The Central Bank Acts as monopoly of currency issuance. It has its issue department which issues note and coins to the public

2. Bankers, Fiscal Agent and Adviser

Central Bank act as banker to the government, keep deposit of federal and state governments and makes payment on behalf of government. 3. Custodian of Cash Reserves of Commercial Banks Commercial banks are required by law to keep reserves equal to certain percentage of both time and demand deposit liabilities with central bank. Its on basis of this reserves that C.B.N transfer funds from one bank to another to facilitate change clearing.

4. Custody and Management of Foreign Reserve

The Central Bank keeps and manages foreign exchange reserve of the country. It is an official reservoir of naira and foreign currencies. It sell dollar at fixed prices to the monetary authorities of other countries.

5. Controller of Credit

The most important function of central bank is to control the credit creation power of commercial bank in other to control inflationary and deflationary pressures within the economy.

3.5 Objectives Of Credit Control By Cbn

Credit control is the mean to control lending policy of commercial bank by the central bank. The following are objectives of credit control.

1. Stabilization of Internal Price Pressure

One of the objectives of credit is to stabilities the price level in the economy. Since economist policy agreed that fragment change in price might lead to inflationary or deflationary pressure, it become mandatory for CBN to control lending policy.

2. Stabilization of Exchange Rate

A change in internal price affects the import and export of a country. Consequently, the demand for domestic currency increases foreign

market lead an increase in foreign exchange. Therefore, the CBN most ensure that the lending policy is favourable to price level in the economy.

3. To control Business Cycles

Business fluctuation is "Common phenomena in the economic activities that can lead to unfavourable swing in price lead to inflationary or deflationary pressure. To control this, lending policy is essential.

SELF ASSESSMENT EXERCISE

1. To what extent can business cycle be controlled?

4.0 CONCLUSION

We hope you understand that Central Bank is the apex bank that issued currency to the circulation and as well as control other banks using a instrument known as monetary policy. We have examined relevant issues and its operations and we hope we have an insight to the bank guidelines.

5.0 SUMMARY

In this unit, we have enlightened you on the operational background as well as the function of the Central Bank of Nigeria. We hope that you understand the guidelines and its objectives.

6.0 TUTOR MARKED ASSIGNMENT

i. Discuss the challenges faced by CBN and hence proffer solutions to the challenges.
ii. State at least four operational strategies of the central bank of Nigeria.
iii List and explain the functions of CBN
iv State four objectives of CBN according to the CBN ordinance of 1958.

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Freidman, M. (1959). The Role of Monetary Policy, New York University Press, 1969.

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UNIT 3 INTERNATIONAL MONETARY SYSTEM

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1.0 INTRODUCTION

International monetary system refers to the system and rules that govern the use and exchange of money around the world and between countries. Each country has its own currency as money but international monetary system governs the rules for valuing and exchanging these currencies among countries. However, the international monetary system consists of

- Exchange rate arrangements
- Capital flows and

A collection of institution, rule and contention that governors its operation.

To the effective, the international monetary system must deliver both sufficient nominal stability in exchange rates and domestic process, and timely adjustment to shocks and structural changes. In this unit, efforts will be made to explain the brain behind the international monetary systems, institutions as well as the challenges and possible way forward.

2.0 OBJECTIVES

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

- Examine the framework of international monetary system.
- Trace the origin as well as the institution behind the formation of international monetary system.
- Identify challenges and possible solutions of international monetary system

3.0 MAIN CONTENT

3.1 The Evolution Of The International Monetary System

3.1.1 The Gold Standard

Under the classical gold standard; from 1870 to 1914 the International Monetary System was largely decentralized and market based. There was minimal institutional support; apart from the commitment of the major economies to maintain the gold price of their currencies. Although the adjustment to external imbalances should, in theory, have been relatively smooth, in practice it was not problem free. Surplus countries did not always abide by the convention of the system and tried to frustrate gold flows. Deficit countries find the adjustment wage and price stickiness. Once the shocks were large and persistence enough, the consequences of forfeiting monetary independent and asymmetric adjustment ultimately undermined the system.

The gold standard did not survive world intact. Widespread of inflation caused by money financed war expenditures and major shift in the composition of global economic power undermined the pre-war gold parities.

Crucially, the was no mechanism to coordinate an orderly return to inflation adjusted exchange.

3.1.2 Bretton Woods

The Breton Wood system of pegged, but adjustable, exchange rate was direct response to the instability of the interwar period.

Breton wood was very difficult from gold standard: It was more administered than market based; adjustment was coordinated through international monetary fund (IMF). There were rules rather than conventions; and capital controls were widespread.

Despite these institutional changes; surplus countries still resisted adjustment. Fore shade owing present problems, countries often sterilized the impact of surpluses on domestic money supply and prices.

Like today, these interventions were justified by arguing that imbalances were temporary and that in any event, surpluses were evidence more of virtue than disequalitora. The Bretton wood system finally collapsed in the early 1970 after U.S. policy became very conpassionary its trade deficit unstable, and the loosening of capital control began to put pressure on fixed exchange rates. Once again, all countries suffered from the aftershocks.

3.1.3 Current Hybrid System

After breakdown of the Breton woods system, the international monetary system reverted to a more decentralized, market based model. Major countries floated their exchange rate, made their currencies convertible, and gradually liberalized capital flows.

In recent years, several major emerging markets adopted similar policies after experiencing the difficulties of managed rate regimes with increasing open capital accounts. The more to more market determined exchange rates has increase control fo domestic monetary policy and inflation, accelerated the development of financial sectors, and ultimately boosted economic growth. Intimately the trend has been far from universal.

SELF ASSIGNMENT EXERCISE

Briefly discuss the evolution of international monetary system.

3.2 International Monetary Institution

3.2.1 The International Monetary Fund

The international monetary fund (IMF) based in Washington, D.C., was established in 1945. The IMF was established in order to oversee the gold exchange standard system of fixed exchange rates, and provide advice and financing to countries experiencing acute balance of payments crises. When the Bretton Woods system of fixed exchange rates broke down in 1971-73, the IMF evolved into a lender of last resort to countries facing macroeconomic and financial crises, and has been involved in many episodes including those of the Latin American debt crisis of 1980s, the Mexican Peso crisis of 1994, The South East Asian and Russian crises of 1997 and1998, the Turkish crisis in 2001 and the Argentinean collapse of 2002. More recently, it has become increasingly involved with debt problems of developing countries. The IMF has often come under criticism for the conditionality of its support to member countries. Although it has not always been prefect in its recommendations, the problems it has been called upon to solve originated with unsound economic but populist entitlement policies that governments have offered their population to buy their vote. When these policies fail, governments are powerless to go back on their word and solve the problems they have created and they blame the international investment community and capitalists for their ills. When their financial systems collapse, then they carry out the necessary reforms under the excuse that they are imposed on them from the IMF in exchange for the badly needed financing.

3.2.2 The World Bank

The world bank (WB), based in Washington, D.C, established in 1946. The World Bank has three main branches: the International Bank for Reconstruction and Development (IBRD), the International Development Agency (IDA) and the International Finance Corporation (IFC). It aims to promote economic development in the world's poorer countries through technical advice, project financing, long-term lending at rates below market interest rates averaging around $30 billion a year and spread over 100 countries.

3.2.3 The World Trade Organization

The world trade Organization (WTO), based in Geneva, established in 1995, that has succeeded the General Agreement on Tariffs and Trade (GAAT), based in Geneva, established in 1995. The WTO was established following the Uruguay Round of multilateral trade

negotiations that were concluded in 1993. This organization should have come to life in the 1940s along with the other two, under the name International Trade Organization (ITO). The US Congress failed to ratify the agreement so the organization never came to life; rather the less formal Secretariat of the GATT was created instead. The WTO is the institution that governs international trade, setting international standards and the rules of trade. Started with 132 members it now has 150 following the admission of Vietnam in January 2006.

3.2.4 The Bank for International Settlements

Bank for international settlement was established in 1930, is based in Basel, Switzerland and serves as a bank for central banks and international organizations. The BIS is the oldest international financial organization established originally following the end of the First World War to facilitate the war reparations payments of Germany. In addition to being a clearing house for central banks, the BIS conduct research and facilitate the coordination of central bank policies and standards. The BIS is the author of the 1988 Basel Capital Accord and the Basel II revision. These accords establish minimum risk adjusted capital adequacy requirements (Tier I and Tier II capital) that internationally active banks should follow to reduce the risk of bank Failures and enhance the resilience of the global banking system.

SELF ASSIGNMENT EXERCISE

Discuss the establishment of the bank for international settlements

3.3 Current Challenges And Future Prospects

There are numerous challenges facing the international monetary system today. Two of the most important challenges today are the following:

The integration in the international monetary system of major emerging economies such as Brazil, Russia, India, and China (BRIG). Today's international monetary system is not that homogenous. The leading industrial countries such as the United States, the European Union, Japan, Canada, and Australia among others have adopted flexible exchange rate regimes. Other countries, most notably China, have maintained a fixed exchange rate system whereby they have fixed the value of their currency against major currencies, principally the U.S. dollar. North African countries link their currencies to the euro. Still others maintain a managed float that is they allow their currencies to fluctuate within a target range set by a basket of currencies of countries with which they conduct most of their trade. For example, India and

Turkey follow such an approach. For the international monetary system to function properly you need a large degree of uniformity were all countries -at least the major players- follow the same approach and play by the same rules. A measure of how well the system functions, for example, is the avoidance of major imbalances which can create stress that can lead to a break up of monetary crises like the ones experienced during the Asian crisis, the Mexican or the Argentinean crisis.

Some of the problems, therefore are that a) not all countries rely on floating exchange rate regimes, the principal example here being China and the Gulf Cooperation Council; b) not all countries' central banks have become independent from the executive branch of their government, the principle examples here are the central banks of China, Russia, Brazil, Argentina and Turkey, among others; c) the financial markets of different countries do not have the same degree of development, breadth and depth, market instruments and degree of openness required to allow their currency markets to function properly. For example, it is only recently that China has set up futures and derivatives markets and they are still inexperienced and untested; d} economic information on reserves, capita! flows, asset prices, budget and trade balances are not always publicly available and when they are it is with considerable delay and sometimes concealed from the public. To function properly, markets need timely information and data if they are to perform their policing and adjustment role effectively. When governments conceal crucial bits of information from markets, problems are allowed to simmer until it is too late and then markets are caught by surprise and they over react, resulting in financial crises.

Another problem is that not all countries play by the same rules. Some countries use the guise of fixed exchange rates and even floating exchange rates to pursue neo-mercantilist policies. The chief examples here are the Asian economies, mainly Japan and China. Japan has been on flexible exchange rates since 1971. However, instead of allowing their currency to trade freely and find its own level (a clean float) they have been very active in manipulating the value of their currency (a dirty float) in order to maintain its value at a competitive level vis a vis the U.S. dollar. The objective of this manipulation, of course, is to give their exporters a trading advantage in the huge US market. This way they have maintained large chronic trade surpluses against the United States. As a consequence they have accumulated huge US dollar reserves that they lend back to the USA. This is not how the system is supposed to work. When you experience trade surpluses, the value of your currency should rise until the trade surpluses have become reduced and vice versa when you experience a trade deficit. Another example is China. By maintaining the Chinese Yuan at an artificially low fixed

parity against the US dollar (1 USD = 8.28 Yuan), China makes its exports competitive against US products and ensures a trading advantage. As long as China was small and developing you could afford to overlook such mercantilist practices. Now that China has emerged into the world's third biggest economy, (behind the USA and the EU and ahead of Japan), the continuation of such currency manipulation creates instability in the international financial system. Since 2005 China has been facing increasing pressure from other countries to adjust its currency higher, either by outright revaluation, or by floating it and letting market forces push its price higher. Responding to this pressure, China has ended the fixed parity with the US dollar and has announced that it will tie the value of the yuan to a basket of currencies of countries with which it conducts most of its trade. However, the composition of this basket has not been disclosed so markets do not know on what basis the currency is supposed to move. Moreover, the appreciation of the yuan has been so minimal (around 5% so far) that it undermines the credibility of Chinese government authorities. What matters most here is that sooner than later China allows its currency to start floating more, and to let its currency appreciate at least by a reasonable degree to reduce the stress that is building up in the international monetary system. Such a move does not only benefit the countries that are suffering trade deficits against China, like the USA, but it also benefits China. A stronger yuan will act as a check against inflation in China and reduce the risk of a housing bubble, and the need to raise interest rates, but also expand the global buying power of Chinese consumers and producers who will be able to buy finished goods and resources (e.g. oil) more cheaply from the rest of the world! Some flexibility can go a long way to the benefit of all players.

The chronic US balance of payments deficit. The USA is experiencing a persistent and growing balance of payments (trade) deficit that has now risen to nearly 6% of its GDP, a level that would have caused a violent currency collapse and deflation in any other nation. There are a number of reasons for this problem. First, the undervaluation of the Chinese yuan is one of the factors, as we saw above, but it is not the only factor. Other Asian countries such as Japan, Korea, Taiwan, Hong Kong, Malaysia, Thailand and Indonesia are doing the same on the excuse that they cannot allow their currencies to appreciate too much against the Chinese yuan because it will damage their trade with China itself. What is needed here is that the entire South East Asian block of currencies appreciate their currencies vis a vis the US dollar and to a lesser extent the euro, the pound, the Canadian and other world currencies. To the extent that they revalue as a block, the smaller the percentage increase that will be required from China or any individual country to make, and

the less disruptive such a move ends up being on the international monetary system.

3.3.1 The Way Forward

To enhance a stable exchange rate as well as avoid outcomes of the challenges discussed earlier. There are several options.

1. The first is to reduce overall demand for reserves. Alternatively. Include regional reserve pooling mechanisms and lending and insurance facilities at the international monetary fund.

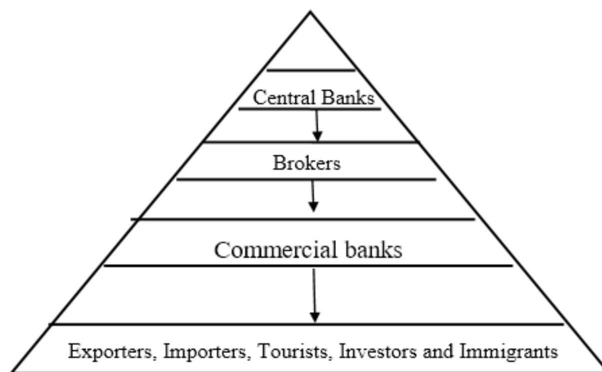
2. The common lesson of the gold standard, the Breton woods system and the current hydride system is that it is the adjustment mechanism;; not the choice of reserve asset, that ultimately matters.

3. The G-20 framework moves in the right direction, it stressed countries shared responsibility to ensure that their policies support strong, sustainable as balanced growth.

3.4 The Foreign Exchange Market

The foreign exchange market refers to the organizational setup under which foreign currencies are bought and sold by the buyers and sellers. The buyers and sellers include central banks, commercial banks, foreign exchange brokers, business firms, exporters, importers, and individuals. Also, it is a system i.e a market system which works and provides facilities to the market.

The key players in the foreign exchange market are shown below.



i. The central banks hold the top position in the foreign exchange market. They work as custodian of foreign exchange of the

country and lender of the last resort. They also have power to control and regulate the domestic foreign exchange market to ensure that it works in an orderly manner. One of their main functions is to prevent by direct intervention, if necessary, the violent fluctuations in the exchange rate. The main form of intervention is by buying and selling of foreign currency i.e selling a foreign currency when it is overvalued in terms of domestic currency and buying it back when it tends to be undervalued against domestic currency.

ii. The foreign exchange brokers hold the second most important place in the foreign exchange market. Brokers work as a link between the central bank and the commercial banks and between the banks. They are the major source of market information. Their main function is to liason the foreign exchange transactions between the actual buyers and the banks and the sellers.

iii. The commercial banks make the third important organ of the foreign exchange market. Banks dealing in foreign exchange play the role of market makers in the sense that they quote the exchange rate for buying and selling a foreign currency. Thus, they clear the market by buying the foreign currency in demand from the brokers and selling it to the buyers.

iv. The exporters, importer, tourist, investors and immigrants are the actual users of the foreign exchange. Those who need a foreign currency approach the commercial banks to buy and those who want to sell go the exchange dealers.

3.4.1 Functions of Foreign Exchange Market

The major functions of foreign exchange market are:

i. Transferring foreign currency from one country to another where it is needed in the settlement of payments.

ii. Providing short-term credit to the importer and thereby facilitating smooth flow of goods and services between the countries.

iii. Stabilizing the foreign exchange rate by spot and forward sale and purchase of foreign currencies.

3.4.2 Kinds of Foreign Exchange Market

The foreign exchange market is classified on the basis of whether foreign exchange transactions are spot or forward.

Accordingly, there are two kinds of foreign exchange markets spot market and forward market.
Spot Market:

This refers to that segment of the foreign exchange market in which sale and purchase of foreign currency are settled within two days of the deal. The rate at which foreign currency is bought and sold in the spot market is called spot exchange rate. The spot rate is treated as the current exchange rate.

Forward Market:

The forward exchange market refers to the deals for sale and purchase of a foreign currency at some future date at a pre settled exchange rate. When buyers and sellers enter an agreement to buy and sell a foreign currency after 90 days of deal, it is called forward transaction. The forward transactions in foreign exchange make the forward market. The exchange rate settled between the buyers and sellers for forward sale and purchase of currency is called forward exchange rate.

SELF ASSESSMENT EXERCISE

1. Distinguish between spot market and forward market.

3.5 EXCHANGE RATE

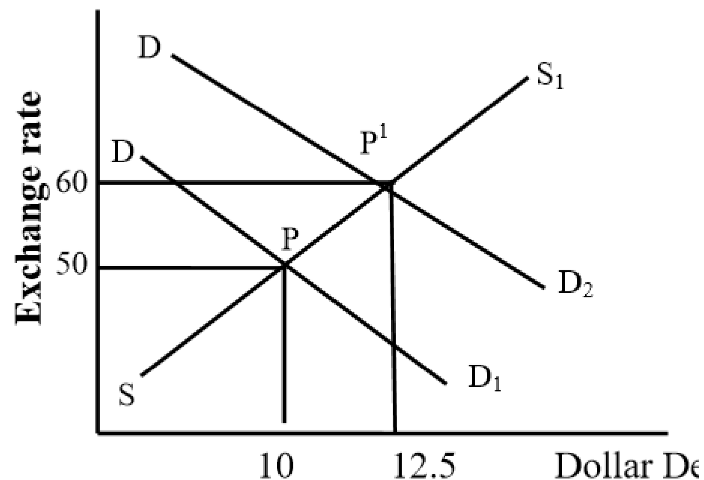
Exchange rate is the rate at which currency of a country is bought and sold against the currency of another country in the foreign exchange market.

Most economist have attempted to explain the exchange rate determination resulting in different kinds of theories, i.e the market theory, the purchasing power parity theory, the monetary theory and the portfolio balance theory. As a matter fact, this unit will only consider two that are used in general practice. They are market theory of exchange rate determination and the purchasing power parity theory.

3.5.1 The Market Theory of Exchange Rate

The market theory of exchange rate determination is also called demand and supply theory which applies to the conditions of a free market.

A free foreign exchange market is one in which there is no government intervention and no restriction on holding and transacting foreign currency. In a free foreign exchange market, the rate of foreign exchange is determined like the price of a commodity, by the demand for and supply of foreign exchange. The exchange rate determination in a free foreign exchange market is illustrated using graph.



The graph above shows that the demand for foreign exchange is a derive demand for foreign goods, services and securities. On the other hand, it is a composite demand. As, a composite demand, it means that there is an inverse relationship between the demand for foreign exchange and the exchange rate. The inverse relationship here means that a higher exchange rate implies higher of foreign goods. A higher price reduces the demand foreign goods and reduces imports. Lower import signifies lower demand for foreign exchange. Conversely, when exchange rate decreases, foreign goods becomes cheaper and therefore imports increases. Increase in imports lead to a greater demand for foreign exchange. That is why foreign exchange demand curve show an inverse relationship between the exchange rate and the demand for foreign exchange.

On the supply side, the supply curve of foreign exchange is derived from a composite supply of foreign exchange by the speculators, foreign exchange dealers and the monetary authorities providing foreign exchange for foreign payments or trying to get rid of their excess foreign exchange reserves.

Another way of looking at the supply curve of foreign exchange, is by looking at the supply schedule of a country`s currency. The supply schedule of a country's currency is an inverted image of its demand for foreign exchange.

This means that when a country demands foreign currency, it offers its own currency in payment and in the process; it supplies its own currency, which makes the supply curve to have a positive slope.

To further analyze the above graph, in the graph DD and SS intersect at point P determining the exchange rate at N50 per dollar. At this exchange rate, the total demand for dollar equals at $10 it means that the dollar naira exchange market is cleared. Therefore the exchange rate ($1 = N50) is the equilibrium exchange rate in the free foreign exchange market. In case demand for dollar increases for some reasons, say due to the increase in demand for U.S.A goods, the demand curve will shift to DD 2 and a new equilibrium exchange rate will be determined at $1 = N60 and market will be clear at $12.5 million.

3.5.2 Change in Equilibrium Exchange Rate

The foreign exchange market condition are however not static, thus they are subject to change due to changing domestic and external economic conditions. The market determined exchange rate is subject to frequent variations due to the following factors.

(i) Change in domestic prices:

A change in domestic prices, foreign prices remaining constant, changes the demand and supply conditions of foreign exchange. For example, a rise in domestic prices, all other things remaining the same, reduces foreign demand for goods and increase demand for foreign goods.

(ii) Change in the real income:

A change in real income of a country, other factors remaining the same, increases its demand for both domestic and foreign goods. Demand for foreign goods increase because, in general, imports are income elastic. Increase in imports increases demand for foreign exchange and therefore the exchange rate.

(iii) Change in the rate of interest:

Change in the interest rate in different countries affects the capital flows between the nations and the demand and supply conditions. Capital

tends to flow from low – interest rate countries to the high interest rate countries. The change in the pattern of capital flow leads to a change in demand and supply conditions for foreign exchange which changes the exchange rate.

(iv) Structural change:

The structural change in an economy for exchange, change in the composition of GNP and technological and industrial innovations, change the cost structure of a country which in turn changes the relative price structure.

(v) The speculative demand for and supply of foreign exchange: The speculative demand for and supply of foreign exchange too, change the position of the demand and supply curves and therefore the exchange rate.

3.5.3 The Purchasing Power Parity Theory

The PPP theory developed by Gustav Cassel, asserts that the relative value of different currencies correspond to the relation between the real purchasing power of each currency in its own country.

The purchasing power parity theory can be stated in the form of the following two statements.

(i) Under inconvertible paper standard, the absolute rate of exchange between any two currencies is determined on the basis of their purchasing power in their respective countries.

(ii) The relative change in exchange rate between any two currencies is proportional to the change in the relative prices.

3.5.4 Drawback of the PPP Theory

The purchasing parity theory has been criticized on the following grounds.

(a) That the whole sale price index number (WPI) used in PPP theory does not give an accurate and relevant measure of purchasing power of a currency in the context of foreign trade. For determining the purchasing power of a currency, prices of only internationally traded goods are relevant, not the domestic price of all goods and services. Therefore, it does not give a realistic exchange rate.

(b) Beside a large amount of capital transfers which take place between the nations, such transactions do affect purchasing power of a currency, but WPI does not take this transaction into account.

(c) The change in the exchange rate depends, by and large on the elasticity of reciprocal demand for imports and exports, but ppp theory does not take this factor into account

(d) The PPP theory assumes that relative price is the sole determinant of international transactions. This is not true because changes in the exchange rate take place also due to disequilibrium caused by capital transfers, service payment and changes in the real income.

3.5.5 The Fixed Exchange Rate and Its Determination

Under fixed or pegged exchange rates all exchange transactions take place at an exchange rate that is determined by the monetary authority. It may fix the exchange rate by legislation or intervention in currency markets. It may buy or sell currencies according to the need of the country or may take policy decision to appreciate or depreciate the national currency. The monetary authority holds foreign currency reserves in order to intervene in the foreign exchange market when the demand and supply of foreign exchange are not equal at the fixed rate. The main argument in support of this system is that it stabilizes international prices of goods and services and thus encourages international trade.

Advantages of Fixed Exchange Rates

(i) Based on common currency:

A fixed exchange rate encourages international trade by making prices of goods involved in trade more predictable. For instance, a country having a common currency with a fixed value facilities trade increases production and leads to faster growth of the economy. Similarly, a country would benefit if it has a fixed value of its currency in relation to other countries.

(ii) Encourages long term capital flows:

Fixed exchange rate encourages long-term capital flows in an orderly and smooth manner.

(iii) No fear of currency fluctuation:

There is no fear of currency depreciation or appreciation under a system of fixed exchange rates. For instance, it removes fear that holding large quantities of fo reign currency might lead to losses, if a currency‟s value drops.

(iv) No Adverse effect of speculation:

There is no fear of any adverse effect of speculation on the exchange rate, as speculative activities are controlled and prevented by the monetary authorities under a regime of fixed exchange rate.

(v) Less inflationary:

It leads to greater monetary discipline and so to less inflationary pressures.

(vi) Certainty:

Fixed exchange rates create certainty about foreign payment among exporters and importers of goods because they know what they have to receive or pay in foreign exchanges.

(vii) Suitable for common currency Areas:

This system is suitable for common currency areas such as Euro, Dollar, etc where fixed exchange rates promote growth of world trade.

Disadvantages of Fixed Exchange Rate

(i) Unexpected disturbances:

Under this system, the effects of unexpected disturbances in the domestic economy are transmuted abroad. While a country may be protected by fixed exchange rates from the full consequences of domestic disturbance and policy mistakes, it has to bear a share of the burden of the disturbances and mistakes of others.

(ii) Heavy Burden:

Under this system, large reserves of foreign currencies are required to be maintained. Countries with balance of payment deficits must have large reserves if they want to avoid devaluation.

(iii) Misallocation of Resources:

This system requires complicated exchange control measures which lead to misallocation of the economy‟s resources.

(iv) Complex system:

This system is very complex because it requires highly skilled administrator to operate it. It is also time consuming and may lead to uncertain results.

(v) Comparative advantage unclear:

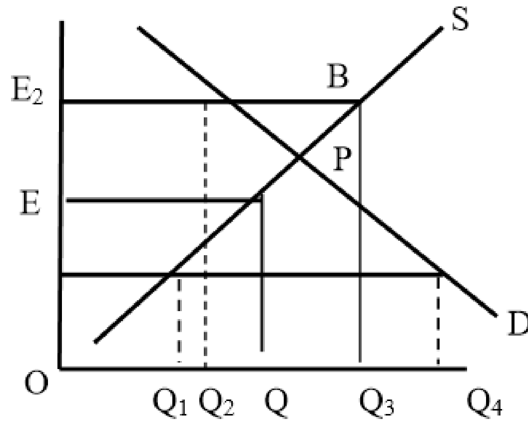
Under this system, the comparative advantage of a country is not clear. For instance, the exchange may be so low that a product may seen very cheap to the other country.

(vi) Balance of payment disequilibrium persist:

This system fails to solve the problem of balance of payments disequilibrium. It can be tackled only temporarily because its permanent solution lies in monetary, fiscal and other measures.

3.5.6 Flexible Exchange Rates

Under this system, exchange rates are determined by the market forces of demand and supply. In other words, the monetary authority does not intervene for the purpose of influencing the exchange rate. Under a regime of freely fluctuating exchange rates, if there is an excess supply of a currency, the value of that currency in foreign exchange markets will fall. It will lead to depreciation of the exchange rate. Consequently, equilibrium will be restored in the exchange market. On the other hand, shortage of a currency will lead to appreciation of exchange rate thereby leading to restoration of equilibrium in the exchange market.



Given that the initial exchange rate demand and supply intersect at point P and the equilibrium exchange rate E is determined. Suppose the exchange rate rises to E 2 , the quantity of pounds supplied OQ 3 is more than the quantity demanded OQ 2 , meaning that there is excess supply of pound, which means that the price of pounds will fall in the foreign exchange market and the value will also depreciates. The same will happen when there is shortage in the supply of pound, the price of pounds will rise since there is excess demand for pounds in the foreign market which will lead to appreciation of pounds

Advantages of Flexible Exchange Rate

(i) Removes problem of international liquidity:

A system of flexible exchange rates removes the problem of international liquidity. The shortage of international liquidity is the result of pegged exchange rates and intervention by monetary authorities to prevent fluctuation beyond narrow limit.

(ii) Autonomy of Economic policies:

Under this system, autonomy of the domestic economic policies is preserved. Modern governments are committed to maintain full employment and promote stability with growth.

(iii) Disequilibrium in the balance of payment automatically corrected: Since under a system of flexible exchange rates, disequilibrium in the balance of payment is automatically corrected, there is no need to accommodate gold movements and capital flows in and out of counties.

(iv) No need of foreign exchange reserve:

There is no need for foreign exchange reserves where exchange rates are moving freely. A deficit country will simply allow its currency to depreciate in relation to foreign currency instead of intervening by supplying foreign exchange reserve to the other country to maintain a stable exchange rate.

(v) Effective monetary policy:

The system of flexible exchange rates reinforces the effectiveness of monetary policy. If a country wants to increase output, it lower interest rate under a regime of flexible exchange rates, the lowering of interest rates will result in an outflow of capital, a rise in the spot rate for the currency which will, in turn, cause exports to rise and imports to fall.

(vi) Does not require complicated trade restriction:

A system of flexible exchange rate does not require the introduction of complicated and expansive trade restrictions and exchange controls.

(vii) Economical:

This system is very economical because it does not require idle holding of foreign currencies.

(viii) This system promotes international trade:

This system promotes international trade because it maintains the exchange rates at their natural level through continuous market adjustments.

Disadvantages of Flexible Exchange Rate

(i) Misallocation of Resources:

The equilibrium exchange rate in the foreign exchange market at a point of time may not give correct signals to concerned parties in the country. This may lead to wrong decisions and misallocation of resources with the country.

(ii) Official intervention:

It is not possible to have an exchange rate where there is absolutely no official intervention. Government may not intervene directly in the

foreign exchange market, but domestic monetary and fiscal measure do influence foreign exchange rate.

(iii) No justification:

As a corollary, there is no justification for a government to leave the determination of exchange rates to international market forces when prices, rents, wages, interest rates etc are often controlled by the government

(iv) Encouragement to inflation:

This system has inflationary bias. Critics argue that under a system of flexible exchange rates, a depreciation of the exchange rate leads to a vicious circle of inflation.

3.5.7 Other Kinds of Exchange Rate System

Because of the problem of illiquidity associated with a completely fixed exchange rate system, specifically the gold standard due to scarcity of gold, and the problems of instability and uncertainty of completely flexible exchange rate, most modern governments are now opting from other kinds of exchange rate system like.

i. Managed Floating Exchange Rate System

This is an exchange rate system in which exchange rate between currencies are usually determined by the market forces of demand and supply, but in which monetary authorities intervene at times to stabilize the rate or to achieve other specific economic goals

ii. Clean Float System

Under this system, the exchange rate is determined by the free market forces of demand and supply of foreign exchange. The exchange rate moves up and down freely without any intervention by the monetary authority. It is also known as free floating exchange rate.

iii. Dirty Float System

Under this system, the exchange rate is basically determined by the free market forces of demand and supply of foreign exchange. But the monetary authority intervenes form time to time to control excessive fluctuations in exchange rate. Thus, the monetary authority allows an orderly exchange rate adjustment when there are major changes in

demand and supply of foreign exchange. But at the same time, it prevents violent fluctuations that may occur under free floating of exchange rate. The monetary authority intervenes through the sale and purchase of foreign exchange in the market.

iv. Filthy Float System

Under this system, the monetary authority is compelled to intervene heavily under frequent and high fluctuation.

v. Joint Float System

Under the system of joint float, a group of countries have an adjustable peg system between their own currencies but they have a joint float against other countries. This system is in use under the European monetary system where its exchange rate mechanism has an adjustably pegged exchange rate band with member countries but a joint float against other currencies of the world.

3.5.6 Factors Affecting Changes in Exchange Rate

i . Inflation rate:

When domestic inflation rate is more rapid than those of the rest of the world, it would lead to implicit over valuation of the Naira and Occasion an excessive demand – supply gap which would in turn put exchange rate under pressure below the equilibrium position. This is because rapid domestic inflation rate makes domestic goods expensive relative to imported ones so that foreign demand for exports becomes discouraged while imports become more attractive.

ii Fall in Export Earning:

If world prices of major export commodities fall, the foreign exchange earning or supply falls. This widens the gap between demand and supply of foreign exchange given a constant or rising demand.

iii Rising incomes in industrial sectors excluding the export sector:

When incomes rise for industrial sectors but exclude agricultural and mining sector which earn the foreign exchange, imports will rise while exports remain stagnant. This is because imports are dependent positively on rising incomes particularly industrial urban incomes

iv Government Regulations and Policies:

Regulations that curb unscrupulous foreign exchange dealings will arrest the pace of domestic currency depreciation or rising exchange rate Expansionary fiscal policy that fails to encourage exports in the same why will increase import demand without a corresponding increase in foreign exchange supply.

v Political Instability:

Political Instability encourages capital flight and discourages capital inflow. This depresses supply but enhances demand for foreign exchange, thus precipitating changes in exchange rate.

SELF ASSESSMENT EXERCISE

1. State five advantages of fixed exchange rate.
2. What do you understand by free foreign exchange market.

4.0 CONCLUSION

In the unit, we have extensively explained the meaning, nature and component of international monetary systems and its relevance institution. We shed light on its challenges and historical landmark by looking at the fundamental of gold standard Breton woods system its been operated. We do hope you learn their common lessons and way forward.

5.0 SUMMARY

At this junction, we have succeeded in explain all relevant issue forwarding the international monetary system and do hope you put them analysis in your future ready

6.0 TUTOR MARKED ASSIGNMENT

i. Distinguish between clean float and dirty float exchange rate.
ii. Explain five factors affecting changes in exchange rate.
iii Explain the advantages in adopting flexible exchange rate system.
iv State the difference between world Trade Organization and International Monetary Fund.

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