MBF 833 MONEY AND BANKING

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CONTENTS PAGES

MODULE 1

Unit 1 Meaning and Evolution of Money
Unit 2 The Barter System and the Role of Money
Unit 3 Characteristics and Functions of Money
Unit 4 The Demand for Money
Unit 5 The Supply of Money

UNIT 1 MEANING AND EVOLUTION OF MONEY

CONTENTS

1.0 INTRODUCTION

There has been no precise definition of money, which has conveniently covered its functions. In this unit we shall discuss the meaning and evolution of money. In addition various types of money in use would also be explained.

2.0 OBJECTIVES

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

- Explain the meaning of money.
- Trace the evolution of money
- Discuss the various types of money in use.

3.0 MAIN CONTENT

3.1 The Meaning of Money

What is money? There has been no precise definition of money which has conveniently covered its functions.

It appears that there are many definitions of money as there are writers of economists. A number of definitions shall be examined here. One of such definitions is that of Paul Samuelson, who defined money "as the modern medium of exchange and the standard unit in which prices and debts are expressed".

Money has also been defined as an asset which is used as a medium of exchange, a store of value and a standard for deferred payment or value.

Money is looked at as any thing legally acceptable in the discharge of obligations within a political boundary, expressed as a multiple of some unit which is regarded as a measure or standard of the value of things in general. Money can also be defined as anything which passes freely from hand to hand and is generally acceptable in the settlement of a debt. Lewis E. Davids in his 'Dictionary of Banking and Finance' defined "money as any form of denomination of coin or paper currency of legal tender which passes freely as a medium of exchange" In banking operations, money refers to cash and this includes both currency notes (paper money) and coin (metallic money).

The word 'MONEY' according to Messrs. Pierce and Shaw, haf two definitions The first is an abstract meaning which refers to money as a unit of account or the measure of exchange value. By this definition, money is a common denominator in terms of which the exchange value of all goods and services can be expressed. It is a unit of measurement, just as kilometres measure distance. This gives money an abstract meaning.

The second meaning of money refers to its concrete form. Money in this form indicates possibility of ownership which is capable of changing hands and the supply of it is capable of measurement. By this definition money becomes a medium of exchange. It is this definition of money that is relevant to monetary theory and policy. Money could also be defined as a commodity chosen by common consent to be a medium of exchange, a store of value, a unit of account and a standard for deferred payments among all other commodities.

There has been lot of controversy and confusion over the meaning and nature of money. As pointed out by Scitovsky, "Money is a difficult concept to define, partly because it fulfils not one but three functions, each of them providing a criterion of moneyness, yet he gives a wide definition of money. Professor Coulborn defines money as "the means of valuation and of payment; as both the unit of account and the generally acceptable medium of exchange." Coulborn's definition is very wide He includes in it the 'concrete' money such as gold, cheques, coins, currency notes, bank draft, etc. and also abstract money which "is the

vehicle of our thoughts of value, price and worth," Such wide definitions have led Sir John Hicks to say that "Money is defined by its functions: anything is money which is used as money: 'money is what money does.' These are the functional definitions of money because they define money in terms of the functions it performs.

Some economists define money in legal terms saying that "anything which the state declares as money is money." Such money possesses general acceptability and has the legal power to discharge debts. But people may not accept legal money by refusing to sell goods and services against the payment of legal tender money On the other hand, they may accept some other things as money which are not legally defined as money in discharge of debts which may circulate freely. Such things are cheques and notes issued by commercial banks. Thus besides legality, there are other determinants which go to make a thing to serve as money.

3.2 The Evolution of Money

The word "money' is derived from the Latin word 'Moneta" which was the surname of the Roman Goddess of Juno in whose temple at Rome, money was coined. The origin of money is lost in antiquity. Even the primitive man had some sort of money. The type of money in every age depended on the nature of its livelihood. In a hunting society, the skins of wild animals were used as money. The pastoral society used livestock, whereas the agricultural society used grains and foodstuffs as money. The Greeks used coins as money.

Stages in the Evolution of Money

The evolution of money has passed through the following five stages depending upon the progress of human civilisation at different times and places.

1. **Commodity Money: Various types of commodities have been** used as money from the beginning of human civilisation. Stones, spears, skins, bows and arrows, and axes were used as money in the hunting society. The pastoral society used cattle as money. The agricultural society used grains as money. The Roman used cattle and salt as money at different times. The Mongolians used squirrel skins as money. Precious stones, tobacco, tea, shells, fishhooks, and many other commodities served as money depending upon time, place and economic standard of the society.

The use of commodities as money had the following defects. (1) All commodities were not uniform in quality, such as cattle, etc. Thus lack of standardisation made pricing difficult. (2) Difficult to store and prevent loss of value in the case of perishable commodities. (3) Supplies of such commodities were uncertain. (4) They lacked in portability and hence were difficult to transfer from one place to another. (5) There was the problem of indivisibility in the case of such commodities as cattle.

2. Metallic Money: With the spread of civilisation and trade relations by land and sea, metallic money took the place of commodity money. Many nations started using silver, gold, copper, tin, etc. as money.

Metal was an inconvenient thing to accept, weigh, divide and assess in quality. Accordingly, metal was made into coins of predetermined weight. This is attributed to King Midas of Lydia in the eight century B C. It is worthy of note that gold coins were in use in India many centuries earlier than in Lydia. Thus coins came to be accepted as convenient method of exchange.

But some ingenious persons started debasing the coins by clipping a thin slice off the edge of coins. This led to the hoarding of full-bodied coins with the result that debased coins were found in circulation. This led to the minting of coins with rough edge.

As the price of gold began to rise, gold coins were melted in order to earn more by selling them as metal. This led governments to mix copper or silver in gold coins so that their intrinsic value might be more than their face value. As gold became dearer and scarce, silver coins were used, first in their pure form and later on mixed with alloy or some other metal.

But metallic money had the following defects: (1) It was not possible to change its supply according to the requirements of the nation both for internal and external use. (2) Being heavy, it was not possible to carry large sums of money in the form of coins from one place to another by merchants. (3) It was unsafe and inconvenient to carry precious metals for trade purposes over long distances. (4) Metallic money was very expensive because the use of coins led to their debasement and their minting and exchange at the mint cost a lot to the government.

3. Paper Money: The development of paper money started with goldsmiths who kept strong safes to store their gold. As

Goldsmiths were thought to be honest merchants, people started keeping their gold with them for the safe custody. In return, the goldsmiths gave the depositor a receipt promising to return the gold on demand. These receipts of the goldsmiths were given to the sellers of commodities by the buyers. Thus receipts of the goldsmiths were a substitute for money. Such paper monies were backed by gold and were convertible on demand into gold. This ultimately led to the development of bank notes.

The bank notes are issued by the central bank of the country. We shall discuss the central bank in a latter unit. As the demand for gold and silver increased with the rise in their prices, the convertibility of bank notes into gold and silver was gradually given up during the beginning and after the First World War in all the countries of the world. Since then the bank money has ceased to be representative money and is simply fiat money which is inconvertible and is accepted as money because it is backed by law

4. Credit Money: Another stage 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 obligations from one person to another. But a cheque is different from a bank note. A cheque is made for a specific sum, and it expires with a single transaction. But a cheque is not money. It is simply a written order to transfer money. However, large transactions are made through cheques these days and bank notes are used only for small transactions.

5. Near Money: The final stage in the evolution of money has been the use of bills of exchange, treasury bills, bonds, debentures, savings certificates, etc. They are known as "near money". They are close substitutes for money and are liquid assets. Thus in the final stage of its evolution money has become intangible. Its ownership is now transferable simply by book entry.

Thus the origin of money has been through various stages: from commodity money to metallic money, and to paper money, and from credit money to near money.

3.3 Types of Money

Historically, such diverse items as brass rod, copper wire, cowries and manilas, etc, have functioned as money. In Nigeria, as in many other countries, the money supply is composed of only three items:

i. Coins
ii. Paper money, and
iii. Demand deposits

i. Coins

Coins are essentially 'convenience money' in that they permit us to rru'.e all kinds of very small purchases. The CBN has recently introduced new coins to the nation which comprise 50k, Nl and N2 that is in 2007.It should be noted that all coins in circulation are token money. This simply means that the intrinsic value, that is, the value of the bullion contained in the coin itself, is less than the face value of the coin. This is purposely done so as to avoid the melting of token money for profitable sale as bullion.

ii. Paper Money

These are notes issued by the Central Bank such as the N5, N10, N20, N50, N100, N200, N500 and N1000 notes in circulation today in Nigeria. The coin and paper money components of the money supply are frequently lumped together and simply labelled currency.

iii. Demand deposits

As banking habit in an economy, the safety and convenience of using cheques, or bank money (demand deposits) become rather too obvious. For instance, as the writing of cheque requires endorsement by the drawer, the theft or loss of one's cheque book is not nearly as devastating as would be the losing of an identical amount of currency. It is, furthermore, more convenient to write a cheque in many cases than it is to transport and count out a large sum of currency. For all these and many other reasons, cheque book money is becoming dominant as a form of money in Nigeria.

SELF ASSESSMENT EXERCIS

i. What do you understand by the concept of money?
ii. Trace the Evolution of money.

4.0 CONCLUSION

It can be concluded that there are various definitions of money and that today money has passed through various stages. We also conclude that there are three types of money in modern economy: coins, paper money and demand deposits.

5.0 SUMMARY

In this unit; we have treated the meaning and Evolution of money. We have also discussed the various types of money in use in Nigeria today.

6.0 TUTOR MARKED ASSIGNMENT

1. What are the various types of money in use in Nigeria today?

7.0 REFERENCES/FURTHER READINGS

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UNIT 2 THE BARTER SYSTEM AND THE ROLE OF MONEY

CONTENTS

1.0 INTRODUCTION

In this unit, we shall explain the meaning of barter system. The various difficulties associated with the barter system will also be discussed. In addition we shall discuss the static and dynamic roles of money.

2.0 OBJECTIVES

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

- Concept and nature of barter system and the difficulties associated with the system.
- Explain the concept of barter
- Explain the various difficulties associated with the barter system.
- Discuss both the static and the dynamic roles of money.

3.0 MAIN CONTENT

3.1 Barter System

Before the evolution of money, exchange was done on the basis of direct exchange of goods and services. This is known as barter. Barter involves the direct exchange of one good for some quantity of another good. For example, a horse may be exchanged for a cow, or 3 sheep or 4 goats. For a transaction to take place there must be a double coincidence of **wants. For instance, if the horse-owner wants a cow, he has to find out a** person who not only possesses the cow but wants to exchange it with the horse. In other cases, goods are exchanged for services A doctor may be

paid in kind as payment for his services. For example, he may be paid a cock, or some wheat or rice or fruit. Thus a barter economy is a moneyless economy. It is also a simple economy where people produce goods either for self-consumption or for exchange with other goods which they want. Bartering was found in primitive societies. But it is the practiced at places where the use of money has not spread much. Such non-monetised areas are to be found in many rural areas of underdeveloped countries.

The development of a system of exchange is one of the earliest contrivances of organised community. It is through the exchange of goods that communities can move away from primitive subsistence agriculture toward an economy where the members of the community can enjoy the advantages of division of labour and specialization in production.

The present system whereby we use notes and coins as money has been arrived at in three different stages. One of the earliest stages or the beginning stages involved the direct production of goods for self consumption. This was the primitive age when people lived in Africa right up to the end of the Old Stone Age around 3, 000 B.C. and a little beyond. Under this system each man and his nuclear family were completely independent of others. Everything needed by the family had to be produced by them or forgotten about.

The second stage which is indirect production and usually referred to as barter involves the production of goods for personal needs as well as for others. This develops when a man has more than enough goods for his own family and decides to barter or exchange his surplus with someone who has other goods. A typical example of this is where a man who produces yams exchanges them for maize from another person who produces maize. This arrangement known as barter economy was prevalent in Britain from the beginning of the New Stone Age (about 3, 000 B. C.) until the arrival of the Romans in A. D. 43. This system was later found to be inadequate, problematic and unprogressive.

3.2 Difficulties of the Barter System

But the barter system is the most inconvenient method of exchange. It involves loss of much time and effort on the part of people in trying to exchange goods and services. As a method of exchange, the barter system has the following difficulties and disadvantages:

1. **Lack of Double Coincidence of Wants: The functioning of the** barter system requires a double coincidence of wants on the part of those who want to exchange goods or services. It is necessary

for a person who wishes to trade his good or service to find some other person who is not only willing to buy his good or service, but also possesses that good which the former wants. For example suppose a person possesses a horse and wants to exchange it for a cow. In the barter system he has to find out a person who not only possesses a cow but also wants a horse. The existence of such a double coincidence of wants is a remote probability. For, it is a very laborious and time-consuming process to find out person who want each other's goods. Often the horse-owner would have to carry through a number of intermediary transactions He might have to trade his horse for some sheep, sheep for some goats and goats for the cow he wants. To be successful, the barter system involves multilateral transactions which are not matched exactly; no trade is possible under barter. This is the problem of finding someone who wants what you have to offer and who also has what you want. The yam farmer looking for a change of diet might try to find someone with plantains to offer, but having found such a person he might be disappointed to learn that he is not anxious to exchange his plantains for yam but instead wants some potatoes.

Thus a barter system is time-consuming and is a great hindrance to the development and expansion of trade.

2. Lack of a Common Measure of Value: Another difficulty under the barter system relates to the lack of a common unit in which the value of goods and services should be measured. Even if the two persons who want each other's goods meet by coincidence, the problem arises as to the proportion in which the two goods should be exchanged. There being no common measure of value, the rate of exchange will be arbitrarily fixed according to the intensity of demand for each other's goods. Consequently, one party is at a disadvantage in the terms of trade between the two goods. The problem here is in fixing the relative values of the two commodities being bartered. For example, how many tubers of yams are equivalent to a bunch of plantains?

Moreover, under a barer system the value of each good is required to be stated in as many quantities as there are types and quantities of other goods and services. The exchange rate formula given by Prof. Culberston is n(n-l)/2. For example, if there are 100 different types of good in a barter economy, then there would be 4950 exchange rates for it to function smoothly, i.e. 100(100-1)72 = 100x99/2 or 9900/2 = 4950. This makes accounting an impossibility because a balance sheet would consist of a long physical inventory of the various types and

qualities of goods owned and owed. Similarly, it is difficult to draw and interpret the profit and loss accounts of even a small shop. That is why the existence of the barter system is associated with a small primitive society confined to a local market.

3. Indivisibility of Certain Goods: The barter system is based on the exchange of goods with other goods. It is difficult to fix exchange rates for certain goods which are indivisible. Such indivisible goods pose a real problem under barter. A person may desire a horse and the other a sheep and both may be willing to trade The former may demand more than four sheep for a horse but the other is not prepared to give five sheep and thus there is no exchange. If a sheep had been divisible, a payment of four and a half sheep for a horse might have been mutually satisfactory. Similarly, if the man with the horse wants only two sheep, then how will he exchange his horse for two sheep. As it is possible to divide his horse, no trade will be possible between the two persons. This is another problem of the barter system economy. There is no bias on which to equate one person's product for another person's product. For instance, a man wanting to exchange his table for only one bunch of plantains will not obtain any change as it is apparent that a bunch of plantains cannot be of the same value with a table. The barter economy apart from the above-mentioned draw-backs, the system is a slow and an inefficient way of trading especially in a progressive economy.

The third stage is the indirect production system using money as a medium of exchange between all other commodities. This system overcomes the inherent problems in barter economy. The indirect production of goods and services has been carried to a higher degree which enables people to specialize in those jobs they are best suited for. As a reward for the job performed by each person, money is paid at the end of month. Thus indivisibility of certain goods makes the barter system inoperative.

4. Difficulty in Storing Value. Under the barter system it is difficult to store value. Anyone wanting to save real capital over a long period would be faced with the difficulty that during the intervening period the stored commodity may become obsolete or deteriorate in value. As people trade in cattle, grains, and other such perishable commodities, it is very expensive and often difficult to store and to prevent their deterioration and loss over the long period.

5. Difficulty in Making Deferred Payments: In a barter economy,

it is difficult to make payments in the future. As payments are made in goods and services, debt contracts are not possible due to disagreements on the part of the two parties on the following. It would often invite controversy as to the quality of the goods or services to be repaid. 2. The two parties would often be unable to agree on the specific commodity to be used for repayment. 3. Both parties would run the risk that the commodity to be repaid would increase or decease seriously in value over the duration of the contract. For example, wheat might rise markedly in value in terms of other commodities, to the debtor's regret, or decrease markedly in value, to the H creditor's regret." Thus it is not possible to make just payments involving future contracts under the barter system.

6. **Lack of Specialisation: Another difficulty of the barter system is** that it is associated with a production system where each person is a jack-of-all trade. In other words, a high degree of specialization is difficult to achieve under the barter system. Specialization and interdependence in production is only possible in an expanded market system based on the money economy. Thus no economic progress is possible in a barter economy due to lack of specialization.

3.3 The Role of Money

Money is of vital importance to the operation of the national and international economy Money plays an important role in the daily life of a person whether he is a consumer, a producer, a businessman, an academician, a politician or an administrator "An individual need not be an economist to be actually aware that money plays an important role in modern life: he needs to think only of his own experience " We study below the importance of money in a modern 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 In its dynamic role, money plays an important part of the life of every citizen and in the economic system as a whole.

3.3.1 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. Instead of exchanging commodities directly with commodities i.e. C4 **>C, commodities are exchanged for money and money, in turn,** buys other commodities as C M C; where C refers to commodities and M to money.

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 the price of apples in terms of oranges, the price of oranges in terms of nuts, and so on. Money is the standard of measuring value and value expressed in money is price. The price of different commodities is expressed in terms of so many units of dollars, Naira, pounds, etc. depending on the nature of monetary unit in a country. The measurement of the values of goods and services in the monetary unit facilitates the problem of measuring the exchange values of goods in the market.

iii. Money acts as a standard of deferred payments. Under barter, it was easy to take loans in goats or grains but difficult to make repayments in such perishable articles in the future Money has simplified both taking and repayment of loans because the unit of account is durable. It also overcomes the difficulty of indivisibility of commodities.

iv. 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 wastage.

v. Under barter, it was difficult to transfer value in the form of animals, grains, etc. from one place to another. Money removes this difficulty of barter by facilitating the transfer of value from one place to another. A person can transfer his money through draft, bill of exchange, etc. and his assets by selling them for cash at one place and buying them at another place. For example, a person can sell his assets in Lagos and in turn buy other assets in Abuja.

3.3.2 Dynamic Role of Money

In its dynamic role, money plays an important part in the daily life of a person whether he is a consumer, producer, a businessman, an academician, a politician or an administrator. Besides, it influences the

economy in a number of ways.

i. To the Consumer: Money possesses much significance for the consumer. The consumer receives his income in the form of money rather than in goods and services. With money in hands, he can buy any commodity and service he likes, in whatever quantities he needs, and at any time he requires. Not only this, money acts as an equalizer of marginal utilities for the consumer. The main aim of a consumer is to maximize his satisfaction by spending his limited income on different goods which he wants to purchase. Since prices of goods indicate their marginal utilities and are expressed in money, money helps in equalizing the marginal utilities of goods This is done by substituting goods with higher utilities for others having lower utilities Thus money enables a consumer to make a rational distribution of his income on various commodities of his choice.

ii. To the Producer: Money is of equal importance to the producer. He keeps his account of the values of inputs and outputs in money. The raw materials purchased, the wages paid to workers, the capital borrowed, the rent paid, the expenses on advertisements, etc. are all expenses of production which are entered in his account books. The sale of products in terms of money are his sale proceeds. The difference between the two gives him profit. Thus a producer easily calculates not only his costs of production and receipts but also profit with the help of money. Furthermore, money helps in the general flow of goods and services from agricultural, industrial and tertiary sectors of the economy because all these activities are performed in terms of money.

iii. In Specialization and Division of Labour: Money plays an important role in large scale specialization and division of labour in modern production. Money helps the capitalist to pay wages to a large number of workers engaged in specialised jobs on the basis of division of labour. Each worker is paid money wages in accordance with the nature of work done by him. This money facilitates specialization and division of labour in modern production. These, in turn, help in the growth of industries. It is, in fact, through money that production on a large scale is possible. All inputs like raw materials, labour, machinery, etc. are purchased with money and all output is sold in exchange for money. As rightly pointed out by Prof. Pigou, "In the modern world industry is closely enfolded in a garment of money."

iv. As the Basis of Credit: The entire modern business is based on

credit and credit is based on money. All monetary transactions consist of cheques, drafts, bills of exchange etc. These are credit instruments which are not money. It is the bank deposits that are money. Bank issue such credit instruments and create credit Credit creation, in turn, plays a major role in transferring funds from depositors to investors. Thus credit expands investment on the basis of public saving lying in bank deposits and helps in maintaining a circular flow of income within the economy.

v. As a Means to Capital Formation: By transforming savings

into investment, money acts as a means to capital formation. Money is a liquid asset which can be stored and storing of money implies savings, and savings are kept in bank deposits to earn interest on them. Banks, in turn, lend these savings to businessmen for investment in capital equipment, buying of raw materials, labour, etc. form different sources and place. This makes capital mobile and leads to capital formation and economic growth.

vi. As an Index of Economic Growth: Money is also an index of

economic growth. The various indicators of growth are national income, per capita income, and economic welfare. These are calculated and measured in money terms Changes in the value of money (or rise in prices) means that the economy is not progressing in real terms On the other hand, a continuous rise in the value of money (or fall in prices) reflects retardation of the economy. Somewhat stable prices imply a growing economy. Thus money is an index of economic growth.

vii. In the Distribution and Circulation of Income: The rewards to

the various factors of production in a modern economy are paid in money. A worker get his wages, capitalist his interest, a landlord his rent, and an entrepreneur his profit. But all are paid their rewards in money. An organiser is able to calculate the marginal productivity of each factor in terms of money and pay it accordingly. For this, he equalises the marginal productivity of each factor with its price. Its price is, in fact, its productivity expressed in terms of money. As payments are made to various factors of production in money, the calculation of national income becomes easy.

viii. In National and International Trade: Money facilitates both

nation? ' and international trade. The use of money as a medium of exchange, as a store of value and as transfer of value has made it possible to sell commodities not only within a country but also

internationally. To facilitate trade, money has helped in establishing money and capital markets. There are banks, financial institutions, stock exchanges, produce exchanges, international financial institutions, etc which operate on the basis of the money economy and they help in both national and international trade.

Further, trade relations among different countries have led to international cooperation. As a result, the developed countries have been helping the growth of underdeveloped countries by giving loans and technical assistance. This has been made possible because the value of foreign aid received and its repayment by the developing countries is measured in money.

ix. In solving the Central Problem of an Economy: 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.

ix. To the Government: Money is of immense importance to the government. Money facilitates the buying and collection of taxes, fines, fees, and prices of services rendered by the government to the people. It simplifies the floating and management of public-debt and government expenditure on development and non-developmental activities. It will be impossible for modern government to carry on their functions without the use of money. Not only this, modern government are welfare states which aim at improving the standard of living of the people by removing poverty, inequalities and unemployment, and achieving growth with stability. Money helps in achieving these goals of economic policy through its various instruments.

xi To the society: Money confers many social advantages It is on the basis of money that the superstructure of credit is built in the society which simplifies consumption, production, exchange and distribution. It promotes national unity when people use the same currency in every nook and corner of the country. It acts as a lubricant for the social life of the people, and oils the wheels of material progress. Money is at the back of social prestige and political power.

Thus money is the pivot round which the whole science of economics clusters.

SELF ASSESSMENT EXERCISE

"Money is of vital importance to an economy due to its static and dynamic roles". Elucidate

4.0 CONCLUSION

We conclude that there are various difficulties associated with barter system. In addition we see that money plays various roles in our society. These roles are made up of both static and dynamic roles.

5.0 SUMMARY

In this unit we have discussed the meaning and difficulties associated with the barter system. We have also discussed both the static and the dynamic roles of money.

6.0 TUTOR -MARKED ASSIGNMENT

Outline and discuss the difficulties associated with the barter system

7.0 REFERENCES/FURTHER READINGS

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UNIT 3 CHARACTERISTICS AND FUNCTIONS OF MONEY

CONTENTS

1.0 INTRODUCTION

In unit one, we discussed the concept of money. In this unit, we shall discuss the characteristics of money. In addition, we shall discuss the various functions of money

2.0 OBJECTIVES

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

- Discuss the characteristics of money
- Explain the various functions of money

3.0 MAIN CONTENT

3.1 Characteristics of Money

The money in current use world wide has to have certain qualities or properties to be able to perform the functions mentioned below. Economists have pointed towards the following characteristics or qualities for a thing to be money.

i. General Acceptability: Everybody must be prepared to accept the money in use. This is the most important quality of money. People accept a thing as money which is used by everybody as a medium of exchange. Gold and silver are considered good money materials because they have alternative uses and are generally accepted. Paper notes are accepted as money when they are issued by the central bank and/or the government and are legal tender. Cheques and bills of exchange are not generally accepted Hence they are not money.

ii. Durability: Money in circulation must be durable, that is, it should last for a reasonable time without deterioration. Animals and perishable commodities are not good money materials because they do not possess durability. In this sense, gold, silver, alloy, brass etc. are the best materials which are used as money. Paper notes are less durable than these metals. But they are money because they are legal tender.

iii. Portability: Money should be easy to carry in both large and small amounts and should be easily carried and transferred from one place to another. It should contain large value in small bulk. Gold and silver possess this quality. Hence they are good money materials. But they involve risk in carrying or transferring then, from one place to another therefore, paper is considered as a better material and is used in the form of notes.

iv. Cognizability: Everybody must easily recognize it by sight or touch as it the money in use. Coins and currency notes dfferent denominations in different designs and sizes meet this quality of good money.

v. Divisibility. Money should be easily divisible into a range of denominations in order to ensure that goods of different prices can be purchased with the exact money or that change can easily be given where money of a higher denomination is offered.

vi. Scarcity: Money must be relatively scarce if it is to be acceptable

vii. Homogeneity: This means that every money note or coin has the same buying power and is identical in all respects to every other notes or coin of the same denomination. Similarly, paper notes of one denomination must have the same quality of paper, design and size.

viii. Stability: Money should be stable in value because it has to serve as a measure of value. Gold and silver possess this quality because they are not available in abundance. They are neither very scarce because being durable, they can be easily stocked. Their supplies can thus be increased or decreased when required. So they act as a store of value because their value is stable. But governments prefer paper money to gold and silver because it is cheap and easily available. Its value is kept stable by keeping control over its issue. It is another thing that the central bank of a country is seldom able to exercise complete control over its issue which makes paper money unstable in value.

3.2 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. We discuss these functions below.

a) Primary Functions

The two primary functions of money are to act as a medium of exchange and as a unit of value.

i. Money as a Medium of Exchange: This is the primary function of money because it is out of this function that its other functions developed. 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 decomposes the single transaction of barter into separate transactions of sale and purchase thereby eliminating the double coincidence of wants. This function of money also separates the transactions in time and place because the sellers and buyers of a commodity are not required to perform the transactions at the same time and place. This is because the seller of a commodity buys some money and money, in turn, buys the commodity over time and place.

When money acts a medium of exchange, it means that it is generally acceptable. It, therefore, affords the freedom of choice. With money, we can buy an assorted bundle of goods and services. At the same time, we can purchase the best and also bargain in the market. Thus money gives us a good deal of economic independence and also perfects the market mechanism by increasing competition and widening the market.

As a medium of exchange, money acts as an intermediary. It facilitates exchange. It helps production indirectly through specialization and division of labour which, in turn, increase efficiency and output. According to Prof. Walters, money, therefore, serves as a 'factor of production', enabling output to increase and diversify.

In the last analysis money facilitates trade. When acting as the intermediary, it helps one good or service to be traded indirectly for others

ii. Money as Unit of Value: The second primary function of money is to act as a unit of value. Under barter one would have to resort to some standard of measurement, such as a length of string or a piece of wood. Since one would have to use a standard to measure the length or height of any object, it is only sensible that one particular standard should be accepted as the standard Money is the standard for measuring value just as the yard or metre is the standard for measuring length. The monetary unit measures and expresses the value of all goods and services. In fact the monetary unit expresses the value of each good or service in terms of price. Money is the common denominator which determines the rate of exchange between goods and services which are priced in terms of the monetary unit. There can be no pricing process without a measure of value.

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 nuts, and so on. Unlike barter, the prices of such commodities are expressed in terms of so many units of dollars, Naira, francs, pounds, etc., depending on the nature of the monetary unit in a country. As a matter of fact, measuring the values of goods and services in the monetary unit facilities the problem of measuring the exchange values of goods in the market. When values are expressed in terms of money, the number of prices are reduced from n(n-l) in barter economy to *(n-1) in monetary economy.*

Money as a unit of value also facilitates accounting. "Assets of all kinds, liabilities of all kinds, income of all kinds, and expenses of all kinds can be stated in terms of common monetary units to be added or subtracted."

Further, money as a unit of account helps in calculations 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, and the gross national product. As pointed out by Coulbertson, "Prices quoted in terms of money become the focus of people's behaviour. Their calculations, plans, expectations, and contracts focus on money prices."

b) Secondary Functions

Money performs three secondary functions: (i) as a standard of deferred payments,(ii) as a store of value, (iii) as a transfer of value. They are discussed below.

i. **Money as a Standard of Deferred Payments: The third** function of money is that it acts as a standard of deferred payments. All debts are taken in money, thus was easy under barter to take loans in goats or grains but difficult to make repayments in such perishable articles in the future. Money has simplified both the taking and repayment of loans because the unit of account is durable. Money links the present values with those of the future. It simplifies credit transactions. It makes possible contracts for the supply of goods in the future for an agreed payment of money. It simplifies borrowing by consumers on hire-purchase and from house-building and cooperative societies. Money facilitates borrowing by firms and businessmen from banks and other non-bank financial institutions. The buying and selling of shares, debentures and securities is made possible by money. By acting as a standard of deferred payments, money helps in capital formation both by the government and business enterprises. In fact this function of money develops financial and capital markets and helps in the growth of the economy.

But there is the danger of changes in the value of money over time which harms or benefits the creditors and debtors. If the value of money increases over time, the creditors gain and debtors lose. On the other hand, a fall in the value of money over time brings losses to creditors and windfalls to debtors. To overcome this difficulty, some of the countries have fixed debt contracts in terms of a price index which measures changes in the value of money. Such a contract over time guarantees the future payment of debt by compensating the loser by the same amount of purchasing power when the contract was entered into.

ii. **Money as a Store of Value: Another important function of** money is that it acts as a store of value. "The good chosen as money is always something which can be kept for long periods without deterioration or wastage. It is a form in which wealth can be kept intact from one year to the next. Money is a bridge from the present to the future. It is therefore essential that the money commodity should always be one which can be easily and safely stored." Money as a store of value is meant to meet unforeseen emergencies and to pay debts. Newlyn calls this the asset function money. "Money is not, of course, the only store of value. This function can be served by any valuable asset. One can store value for future by holding short-term promissory notes, bonds, mortgages, preferred stocks, household furniture, houses, land, or any other kind of valuable goods. The principal advantages of these other assets as a store of value are that they, unlike money, ordinarily yield an income in the form of interest,

profits, rent or usefulness..., and they sometimes rise in value in terms of money. On the other hand, they have certain disadvantages as a store of value, among which are the following: (1) They sometimes involve storage costs; (2) They may depreciate in terms of money; and (3) They are "illiquid" in varying degrees, for they are not generally acceptable as money and it may be possible to convert them into money quickly only by suffering a loss of value."

Keynes placed much emphasis on this function of money. According to him, to hold money is to keep it as a reserve of liquid assets which can be converted into real goods. It is a matter of comparative indifference whether wealth is in money, money claims, or goods. In fact, money and money claims have certain advantages of security, convenience and adaptability over real goods. But the store of value function of money also suffers from changes in the value of money. This introduces considerable hazard in using money or assets as a store of value.

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. Moreover, he can sell his assets at Lagos and purchase fresh assets at Abuja. Thus money facilities transfer of value between persons and places.

(c) Contingence Functions

Money also performs certain contingent or incidental functions, according to Prof. David Kilney. They are:

i. Money as the Most Liquid of all Liquid Assets. Money is the most liquid of all assets in which wealth is held. Individuals and firms may hold wealth in infinitely varied forms. "They may, for example, choose between holding wealth in currency, demand deposits, time deposits, savings, bonds, Treasury Bills, short-term government securities, long-term government securities, debentures, preference shares, ordinary shares, stocks of consumer goods, and productive equipment." All these are liquid forms of wealth which can be converted into money, and vice-versa.

ii. Basis of the Credit System: Money is the basis of the credit system. Business transactions are either in cash or on credit. Credit enhances the use of money. But money is at the back of

all credit. A commercial bank cannot create credit without having sufficient money in reserve. The credit instruments drawn by businessmen have always cash guarantee supported by their bankers.

iii. Equaliser of Marginal Utilities and Productivities: Money acts as an equaliser of marginal utilities for the consumer. The main aim of a consumer is to maximise his satisfaction by spending a given sum of money on various goods which he wants to purchase. Since prices of goods indicate their marginal utilities and are expressed in money, money helps in equalising the marginal utilities of various goods. This happens when the ratios of the marginal utilities and prices of the various goods are equal. Similarly, money helps in equalising the marginal productivities of the various factors. The main aim of the producer is to maximise his profits. For this, he equalises the marginal productivity of each factor with its price. The price of each factor is nothing but the money he receives for his work.

iv. Measurement of National Income: It was not possible to measure the national income. Rewards of factors of production in the form of wages, rent, interest and profit are determined and paid in terms of money.

d) Other Functions

Money also performs such functions which affect the decisions of consumers and governments. These functions are:

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

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, adjustments in foreign exchange are also made through money. Further, international payments of various types are also adjusted and made through money.

It is on the basis of these functions that money guarantees the solvency of the payer and provides options to the holder of money to use it any way, he likes.

SELF- ASSESSMENT EXERCISE

Explain the various functions of money known to you

4.0 CONCLUSION

For any thing to serve as money,, it must possess certain features such as general acceptability, portability, durability, scarcity etc. Money also performs various functions in an economy such as medium of exchange, store of value, unit of account etc.

5.0 SUMMARY

In this unit, we have discussed the characteristics of money. We have also explained the various functions of money.

6.0 TUTOR-MARKED ASSIGNMENT

What are the characteristics of money?

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UNIT 4 THE DEMAND FOR MONEY

COTNENTS

1.0 INTRODUCTION

Money is an asset to be held by the public. As such, it has its demand and supply and also a market. The demand for money comes from the public (excluding the producers of money).The supply of money is made by its producers, i.e., the government and the banking system. The money market comprise of those who demand and supply money. The study of the nature and determinants of demand and supply functions is necessary because of the fact that changes in demand and supply of money tend to influence greatly the price level, the interest rate and the real income. The present unit makes a general survey of the various developments in theories of demand for money.

2.0 OBJECTIVES

At the end of the unit you are expected to:

- Explain the demand for money;
- Discuss classical theory of demand for money and the Keynes theory of demand for money.

3.0 MAIN CONTENT

3.1 The Classical Theory of Demand for Money

The classical theory of demand for money is presented in the classical quantity theory of money and has two approaches: the Fisherian approach and the Cambridge approach.

a) Fisherian Approach: To the classical economists, the demand for money is transactions demand for money. Money is

demanded by the people not for its own sake, but as a medium of exchange. Thus, the demand for money is essentially to spend or for carrying on transactions and thus is determined by the total quantity of goods and services to be transacted during a given period. Further, the demand for money also depends upon velocity of circulation of money. In Fisher's equation, PT = MV, the demand for money (Md) is the product of the volume of transactions over a period of time (T) and the price level (P). Thus,

M d = PT

In Fisherian approach, the demand for money is defined only in a mechanical sense and no attention is paid to various motives for which money is demanded.

(b) Cambridge Approach: While Fisher's transactions approach emphasized the medium of exchange function of money, the Cambridge cash-balance approach is based on the store of value function of money. According to the Cambridge economists, the demand for money comes from those who want to hold it for various motives and not from those who want to exchange it for goods and services. This amounts to the same thing as saying that the real demand for houses comes from those who want to live in them, and not from those who simply want to construct and sell them. Thus, in the Cambridge approach, the demand for money implies demand for cash balances. The Cambridge economists considered a number of factors which tend to influence the demand for holding money. They are as follows:

i. People tend to hold money for transactions motive. Money is generally acceptable in exchange for goods and services and thus holding of money avoids the inconveniences of barter transactions.

ii. Money is also demanded for precautionary motive since money holding provides a degree of security against future uncertainties.

iii. Given the transactions and precautionary motives for holding money, the amount of money which an individual will choose to hold depends upon income and wealth forming the budget constraints for the individual.

iv. Within the absolute constraints set by the wealth and income, the actual proportion held in money form depends, among other things, the opportunity cost of holding money as opposed to other assets. For Cambridge School, the opportunity cost of holding

money consists of rate of interest, the yield on real capital and the expected rate of inflation

v. Other factors influencing money demand according to the Cambridge Schools are habits of the individual, the system of payments in the community, the availability of money substitutes, the density of population, the system of communication, the general level of confidence, etc.

After recognizing the importance of the above factors, the Cambridge economists, however, simplified the demand for money function by assuming, that the demand for money holdings (Md) is a constraint proportion (K) of money income (PY) alone. Thus,

$$Md = KPY$$

The value of K has been assumed to be stable in the sense that the determinants of K do not change significantly in the long run. The purpose of this simplification of the demand for money function by the Cambridge economic was to show that K in the Cambridge equation was just the reciprocal of V in Fisner's equation (i.e., K = 1/V).

3.2 Keynes' Theory of Demand for Money

Keynes formulated his theory of demand for money in his well-known book, The General Theory of Employment, Interest and Money (1936) According to Keynes demand for money arises because of its liquidity. Liquidity means the convertibility of an asset into cash. The asset with more liquidity is desired more as compared to that with less liquidity. Money being most liquid asset is desired most. Thus, in the Keynesian sense, the demand for money is the desire for holding money balances or the desire for liquidity or, as described by Keynes, the liquidity preference

Keynes identified three motives for the demand for money or the liquidity preference: (a) the transactions motive, (b) the precautionary motive, and (c) the speculative motive. For Keynes, the total demand for money implies total cash balances and total cash balance may be classified into two categories: (a) active cash balances consisting of transactions demand for money and precautionary demand for money, and (b) idle cash balances-consisting of speculative demand for money.

Active Cash Balances

Transactions demand for money and precautionary demand for money together constitute active cash balances.

Transaction Motive

Money being a medium of exchange, the primary demand for money arises for making day-to-day transactions. In daily life, the individual or business income and expenditures are not perfectly synchronised. People receive income in periods that do not correspond to the times they want to spend it. Generally, income is received at discrete intervals (for example, once in a week or in a month), but expenditures are made more or less continuously. Thus certain amount of money is needed by the people in order to carry out their frequent transactions smoothly. In this way, transactions motives refer to the demand for money for bridging the gap between periodic receipts and payments.

While discussing the transactions demand for money, Keynes recognized both the income and the business motive:

1. **Income Motive: The income motive relates to the transactions** motive of the households. The households need to hold money to bridge the time gap between the receipt of their income and its spending in daily transactions.
2. **Business Motive: The business motive refers to the transactions** motive of the business community. The businessmen require cash balances to meet their business expenses, such as, payment of wages, salaries, payment for raw materials, etc.

Given society's basic institutional and technical customs and practices which govern the receipt of income and the flow of expenditures, the transactions demand for money depends upon *(a) the personal income and (b) the business turnover. The* demand for money for transactions motive, thus, varies in direct proportion to change in money income. The transaction demand for money is not influenced by the rate of interest, it is interest-inelastic.

Symbolically, the transaction demand for the money function can be stated as:

$$L_t = K_t (Y)$$

Where L_t :represents the transactions demand for money, K_t represents the fraction of money income society desires to hold as money because its income and expenditure are not synchronised, and Y represents money income. The transactions demand for money is assumed to be a constant and stable function of income because the proportion of income to be kept for transactions purpose is influenced by the institutional and technological arrangements influencing the payment and receipt of money and these arrangements do not change in the short period. Hence, the value of K_t is assumed to be constant in the short period.

Precautionary Motive

Apart from transactions motive, people hold some additional amount of cash in order to meet emergencies and unexpected contingencies, such as, sickness, accidents, unemployment, etc. For the households, unexpected economic circumstances affect their decision to keep money for precautionary motive. For businessmen, the expectations regarding the future and prosperity and depression influence the precautionary demand for money. The precautionary demand for money depends upon the uncertainty of the future.

According to Keynes, the precautionary demand for money (Lp), like the transactions demand, is also a constant (Kp) function of the level of money income (Y), and is insensitive to the change in the interest rate. Thus

$$LP = KP(Y)$$

Keynes lumps the transactions and the precautionary demands for money together on the ground that both are fairly stable and constant functions of income and both are interest inelastic. The combined sum of money balances held under the transactions and precautionary motives is referred to as 'active balances' by Keynes. Thus, the demand for active balances ($Lt = Lt + Lp$) is a constant ($K = Kt + Kp$) function of income (Y) and can be symbolically written as:

$$Li = Lt + Lp = K, (Y) + KP(Y) = K (Y)$$

The amount of money required to be kept as active balances varies with individuals and business firms depending upon the frequency of income, credit arrangements, ease with which other assets can be converted into money, the individuals' degree of insecurity, and so on. However an over all stable K has been assumed for the community as a whole. Or, in other words, the determinants of K do not change in the short period.

Idle Cash Balances or Speculative Demand for Money

The demand for idle cash balances relates to the demand of money for speculative motive. The speculative demand for holding money balances is the unique Keynesian contribution. According to the classical economists, people hold money only for transactions and precautionary motives In other words, people trade off interest earnings for the convenience of transactions and the security against future uncertainties that holding money gives. They do not hold money above the active balances (Li). Thus, hoarding (i.e. to hold money above active balances) is considered irrational by the classical economists.

Speculative demand for money refers to the demand for holding certain amount of cash in reserve to make speculative gains out of the purchase and sale of bonds and securities through future changes in the rate of interest. Demand for speculative motives is essentially related with the rate of interest and bond prices. There is an inverse relationship between the rate of interest and the bond prices. For example, a bond with the price of 100 Naira yields a fixed amount of 3 Naira at 3% rate of interest. If the rate of interest rises to 4%, the price of the bond must fall to 75 Naira to yield the same fixed income of 3 Naira.

People desire to have money in order to take advantages from knowing better than others about the future changes in the rate of interest (or bond prices). In deciding whether to hold wealth in money or a bond form, an individual compares the current rate of interest (ic) with the rate of interest expected to prevail in future (ie). The latter is called Keynes as the normal interest rate. If people feel that the current rate of interest is low (or bond prices are high) and it is expected to rise in future (or bond prices will fall in future), then they anticipate capital losses, and in order to avoid expected losses on bonds, they will borrow money at a lower rate of interest (or sell their already purchased bonds), and keep cash in hand with a view to lend it in future at a higher rate of interest (or to purchase the bonds at a cheaper rate in future). Thus, when the expected rate of interest is higher than the current rate of interest (ie > ic), the demand for money for speculative motive will rise. Similarly, if people feel the rate of interest is going to fall (or bond prices going to rise), they will reduce the demand for money meant for speculative purpose.

For example, if the current rate of interest (ic) is .02 and the expected rate of interest (ic) is .04 (that is, ie > ic), the market value of one Naira invested today in a bond yielding .02 per year would be expected to decline to .5 Naira and the bond holder would suffer a potential capital loss equal to one-half the value of the holding of bond The expected capital gain or loss (g) can be computed by subtracting the current investment of one rupee from the ratio of current rate of interest to the expected rate of interest, or g = ic/ ie-l = .02/.04-1 = 0.5 Naira - 1 Naira = -5 Naira.

While deciding whether to hold a bond or money, an individual requires the net yield from a bond. The net yield consists of the interest earning from the bond plus or minus the capital gain or loss (ic + g). So long as the net yield from bond is greater then zero, the individual will hold only bonds. If the net yield is exactly zero, the individual will be indifferent between bonds and money. The critical value of the current interest rate, at which the net yield is zero, can be solved in the following way:

$$Ic + g = 0$$

but $g = ic/ie - 1$

Therefore $ic/ie - 1 + ic = 0$

Or $= ic/ie + ic = 1$

Or $ic(l/ie+l)=l$

Or $ic\ (1 + ie/ie) = 1$

Or $ic=l/l+ie/ie$

Or $ic = \frac{ie}{1+ie}$

For example, if ie is .04, the critical value of the current rate, ic, will be 0.04/1+.04 = .0385. Thus, whenever the current market rate of interest is above the critical rate, .0385, the speculator, (whose i is .04) will hold bonds and if the current rate is below .0385, he will hold only money. Suppose ie = .04 and ic = .039. Then g = ic / ie - 1 = -.025 Naira, and, by holding bonds, the wealth owner will earn a net yield, ic + g = .039 Naira + (-.025) = .014 per Naira invested. Hence, net yield from bond is greater than zero (ic + g > 0) and the wealth owner will hold bonds rather than cash to realise a positive net capital gain.

Thus, to conclude, given the level of income, the speculative demand for money and the current rate of interest are inversely related. As the current rate of interest falls, the number of individuals whose critical current rate lies above the fallen rate decreases and thus the speculative demand money increases. Conversely, as the current rate of interest the speculative demand for money falls. Thus, the demand for money for speculative motive (L2) is highly sensitive to and is a negative function of the rate of interest

3.3 Demand for Money in Underdeveloped Countries

In the underdeveloped countries, there exist some special characteristics which render the nature and determinants of demand for money different from that in the developed countries. These special characteristics are given below:

i. Dualistic Economy: The economies in the underdeveloped countries are fundamentally dualistic in nature. In other words, the organised (or the monetised) and the unorganised (or the non-

monetised) markets exist side by side in these economies. Whereas the organised market is competitive, modern and sophisticated, the unorganised market is marked by barter trade With economic growth, however, the proportion of non-monetised transactions will decline. Thus, one would expect a rise in the transaction demand for money as a result of economic growth and a rise in the monetisation in the underdeveloped countries

ii. Financial Dualism. The underdeveloped countries are also marked by financial dualism, which implies the co-existence of heterogeneous interest rates in the organised money market and the un-organised money market In the organised money market, the speculative demand for money is responsive to the interest rate, whereas in the un-organised money market, the interest rates change with risk and returns on the real assets. Under these conditions, the supply of money may not affect the interest rate significantly. Hence, the Keynesian theory may not be applicable in the underdeveloped countries.

iii. Influence on Non-Economic Forces. It is argued that in most of the underdeveloped countries, the interest rate is administered rather than determined by the market forces of demand and supply of money in the organised sector. In the un-organised sector, the interest rate is determined by both economic and institutional factors. In the rural sector, the determination of interest rate is generally viewed from the supply side. And on the supply side, the rural interest rate is normally influenced by risk premium, administrative costs, opportunity cost, and the degree of monopoly power of the money lenders.

iv. Unstable Income Velocity. Some researchers observed short-run fluctuations in their estimates of income velocity of money for underdeveloped countries. In view of the unstable income velocity, the use of the quantity theory of money explains the demand for money will not be suitable. This is the reason that in majority of cases, the expected rate of inflation (indicating the opportunity cost of money holdings) is observed as an important variable influencing the demand for money in these economies.

v. Interest-Inelastic Demand. In the underdeveloped countries, rate of interest, in particular, is not regarded as an appropriate variable in the determination of demand for money due to a number of reasons: (a) limited size of the organised financial market; (b) the institutional pegging of interest rates; (c) limited array of financial assets; and (d) limited degree of substitution between money and financial assets.

SELF-ASSESSMENT EXERCISE

The nature and determinants of demand for money in developed countries are different from those of underdeveloped countries. Do you agree?

4.0 CONCLUSION

There are various reasons for the demand for money which include precautionary, transactions and speculative reasons. There are also special characteristics which render the nature and determinant of demand for money in underdeveloped countries different from those of developed countries.

5.0 SUMMARY

In this unit, we have discussed the classical theory of demand for money made up of the fisherian approach and the Cambridge approach; The Keynes theory of demand for money made up of the active balances and the idle cash balance. We also discussed the demand for money in underdeveloped countries. The special characteristics that made the demand for money in underdeveloped countries different from those of developed countries are: Dualistic economy, financial dualism, Influence on non-economic forces, unstable income velocity and Interest inelastic demand.

Cash

6.0 TUTOR MARKED ASSIGNMENT

Discuss the Keynes theory of demand for money.

7.0 REFERENCES/FURTHER READINGS

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UNIT 5 THE SUPPLY OF MONEY

CONTENTS

1.0 INTRODUCTION

In this unit, we shall discuss the supply of money. Under the supply of money we shall look at the constituents of money supply, approaches to the definition of money supply, the velocity of money and the theory of money supply.

2.0 OBJECTIVES

At the end of the unit, you are expected to:

- Discuss the meaning of money supply. In addition,
- Discuss the constituents of money supply, the approaches to the definition of money supply, the velocity of money and the theory of money supply.

3.0 MAIN CONTENT

3.1 Supply of Money

Money may be regarded as something which is generally used as a means of payment and accepted for the settlement of debts. The term 'supply of money' means the total stock of money held by the public in expenditure form. The term 'public' refers to the individuals and the business firms in the economy, excluding the central government, the central bank and the commercial banks. Thus, the cash balances held by

the central government, the central bank and the commercial bank do not form money supply because they are not in actual circulation.

Money supply is a stock as well as a flow concept. When money supply is viewed at a point of time, it is a stock, and when viewed over a period of time, it is a flow Money supply at a particular moment of time is the stock of money held by the public at a moment of time. It refers to the total currency notes, coins and demand deposits with the banks held by the public. Over a period of time, money supply becomes a flow concept. It may be spent several times during a period of time. The average number of times a unit of money passes from one hand to another during a given period is called the velocity of circulation of money. Thus, the flow of money supply over the period of time can be known by multiplying a given stock of money held by the public by the velocity of circulation of money. In Fisher's equation, PT = MV, MV refers to the flow of money supply over a period of time, where M stands for the stock of money held by the public and V for the velocity of circulation of money.

3.2 Constituents of Money Supply

Monetary economists hold different views regarding the constituents of money supply. Broadly, there are two views: the traditional view and the modern view.

i. **Traditional View. According to the traditional view, money** supply is composed of (a) currency money and legal tender, i.e. coins and currency notes, and (b) bank money, i.e. demand deposits with the commercial banks.

ii. **Modern View. According to the modem view, the phenomenon** of money supply refers to the whole spectrum of liquidity in the asset portfolio of the individual. Thus, in the modem approach, money supply is a wider concept which includes (a) coins, (b) currency notes, (c) demand deposits with the banks, (d) time deposits with the banks, (e) financial assets, such as deposits with the non-banking financial intermediaries, like the post-office saving banks, building societies, etc., (f) treasury and exchange bills, (g) bonds and equities.

The basic difference between the traditional and modern views is due to their emphasis on the medium of exchange function of money and the store of value function of money respectively. While the acceptance of medium of exchange function of money supply gives a narrow view of money supply, the recognition of the store of value function of money provides a broader concept of money supply and allows for the

substitutability between money (which is traditionally defined as a medium of exchange) and the whole spectrum of financial assets.

3.2.1 Currency Money

Currency money is legal tender money and thus is called high-powered money. It includes the currency notes and coins issued by the central bank of a country. Generally the central bank possesses the monopoly of note issue. But, in certain countries, the treasury or the ministry of finance also issues notes or coins along with the central bank. In India, one rupee note and the coins are issued and managed by the Finance Ministry of the Government of India. All other notes are issued and managed by the Reserve Bank of India. In Nigeria all currency notes and coins are issued by the Central Bank.

The supply of notes and coins in a country are regulated by the system of note issue adopted in the country. According to the Reserve Bank of India Act, 1934, note less than 40 per cent of the total assets of the issue department should consist of gold coins, bullion and foreign securities with the provision that gold coins and bullion were not at any time to be less than Rs. 40 crores. This requirement was changed by the Reserve Bank of India Act, 1956, which provides for the substitution of the proportional reserve system by minimum reserve system. The minimum reserve system, fixes a minimum for the essential reserves in absolute amounts, namely, Rs. 400 crores in foreign securities, and Rs. 115 crores in gold coins and bullion However, in the second amendment to the Reserve Bank of India Act, in 1957, the provision was made that the total value of gold coins, gold bullion and foreign securities, held in the issue department at any time should not be less than Rs 200 crores and the gold value should not be less than Rs. 15 crores. Thus, in Indip, the minimum reserve method is the governing principle of note issue. In Nigeria the supply of notes and coins are regulated by the Central Bank.

Factors Influencing Currency Money

The monetary authority while determining the supply of currency and coins must be guided by the general requirements of the economy. The currency component of the money supply, i.e., coins and notes, is influenced by a number of factors as discussed below:

i. Volume of Transactions. The supply of currency must vary in accordance with the changes in the physical volume of trade and transactions of the economy. If the issue of the currency is more than what is required, it creates inflationary pressures. On the other hand, if the money supply is less than the requirements, it leads to deflationary trends.

ii. Nature of Trade. The nature of trade, whether wholesale or retail, determines the proportion of currency of different denominations. For the wholesale trade, the notes of higher denominations are required, while the retail trade requires larger proportion of note and coins of lower denominations.

iii. Method of Payment. The method of payment being used in the economy also determines the currency component of the money supply. If most of the payments are made in cash, greater proportion of currency to money supply is needed Tf the payments are generally made through cheques, the proportion of currency to money supply will be lowered.

iv. The Price level. Price level also affects the requirements of currency considerably. The higher the price level, the larger the amount of currency required, and the lower the price level, the smaller the amount of currency required to carry out the given volume of transactions.

v. Banking Habits. If the public has confidence in the bank money and has banking habits, the currency requirements will be less. But, if the people have less banking habits, the transactions will be conducted with currency and more currency is required.

vi. Distribution of Income. Distribution of income also influences the currency requirements. If the distribution of income is in favour of the rich, greater proportion of currency of higher denominations are required, on the other hand, if the distribution is in favour of the poor, a larger proportion of currency should be of low denominations.

vii. Other Factors. Other factors, like the volume of demand deposits with the banks, the taxation policy of the government, the extent of public loans, the volume of deficit financing, etc., also influence the amount of currency required in the economy significantly

3.2.2 Bank Money

The demand deposits held by the public in commercial banks also constitute the total money supply of the economy. The demand deposits are transferable by cheque for the settlement of debts. The creation of bank money depends upon the credit creation activities of the banks. Credit creation is based on the volume of cash, i.e., the high-powered money, held by the banks. The money created by the banks is known as secondary money. Thus, the total money supply in an economy is

composed of (a) the primary or high-powered money. And (b) the secondary or bank money

The relative proportions of the two constituents of money supply, i.e., currency money and bank money, depend upon the degree of monetisation of the economy, the development of the banking system and the banking habits of the people. In the economically advanced countries, like the U.S.A., the U.K., etc, chequable demand deposits constitute the major proportion of the total money supply In such countries, over 90 per cent, of the payments are made through cheques.

In less-developed countries, like India and Nigeria, on the contrary, the proportion of currency money to the total money supply with the public is much higher It is because in these countries, banking habits of the people have not yet fully developed and majority of the transactions are conducted through cash payments. In India and Nigeria, currency constitutes about 2/3rd of the total money supply, while the demand deposits are only l/3rd.

3.3 Definitions of Money Supply

Economists are not in agreement on the question of definition of money supply. There are four broad approaches of money supply. They are as follows:

i. Traditional Approach. The traditional approach emphasises the medium of exchange function of money. According to this approach, money supply is defined as currency with public and demand deposits with commercial banks. Demand deposits are the current accounts of depositors in a commercial bank. The traditional approach is analytically superior because it provides the most liquid and exact measure of money supply. The central bank can have better control over the money supply if it includes currency and demand deposits of banks alone. But, this approach limits money supply to a very narrow area.

ii. Monetarist Approach. The Chicago School led by Milton Friedman includes in money supply currency plus demand deposits plus time deposits. Time deposits are fixed deposits of the banks which earn a fixed rate of interest depending upon the period for which the amount is deposited. According to Friedman money is defined as "anything that serves the function of providing a temporary abode of purchasing power" Money can act as a temporary abode of purchasing power if it is kept in the form of cash, demand deposits or any other asset which is close to currency, i.e., time deposits. This approach lays emphasis on

the store of value function of money and provides a measure of money.

iii. Gurley and Shaw Approach. Gurley and Shaw further widened the scope of money supply by including in its constituents currency plus demand and time deposits of banks plus the liabilities of non-banking intermediaries The liabilities of non-banking intermediaries cover saving bank deposits, shares, bonds, etc. and are close substitutes to money.

iv. Redcliffe Committee Approach. Redcliffe Committee approach or liquidity approach provides much wider view of the concept of money supply. In this approach, the concept of money supply is viewed in terms of general liquidity of the economy. Money supply covers "the whole liquidity position that is relevant to spending decisions". The spending is not limited to the amount of money in existence It is related to the amount of money people think they can get hold of whether by receipts of income, by disposal of assets or by borrowing. Thus, according to this approach, money supply includes cash, all kinds of bank deposits, deposits with other institutions, near-money assets and the borrowing facilities available to the people. The practical difficulty with this liquidity approach is that the money supply in this wider sense cannot be successfully measured because the degree of liquidity of different constituents of money supply varies considerably. Moreover, most of the constituents remains outside the control of central bank and thus restrict the effective implementation of monetary policy.

3.4 Velocity of Money

In order to estimate total supply of money over a period of time, say. a year or so, the concept of velocity of money is necessary. Total supply of money over a period of time is equal to the total amount of money in circulation multiplied by its velocity of circulation during that period. If M stands for total amount of money in a given period of time, then the total supply of money during period of time is indicated by MY. While M gives the money supply at a particular moment of time, MV gives a measure of money supply over a period of time.

Velocity of money refers to the average number of times a unit of money changes hands or is transferred from one person to another during a given period of time. Total money supply is affected by the velocity of money, an increase in the velocity of money increases the money supply and a decrease in velocity of money decreases the money supply, other things remaining the same. Velocity of money is related

not only to metallic or paper money. Credit money also has its velocity of circulation. The quantity theory of money maintains that the velocity of money might change significantly in the short period. It is relatively stable in the long period because in the long run it is related to the institutional structure or the economy's payment system.

Transactions and Income Velocity

Two kinds of velocity of money may be distinguished, transactions velocity and income velocity:

i. **Transactions Velocity: Income velocity of money refers to the** average number of times a unit of money is used in making income transactions (i.e. in making payments for final goods and services). With the development of social accounting and with the growing importance of national income, a tendency has developed to express Fisher's equation of exchange in terms of real income (Y) rather than in terms of transactions (T). The difference between the transactions version (MV = PT) and the income version (MV - Py = Y) of Fisher's equation is that while the former includes T, that is, all goods, intermediate and final, the latter excludes the intermediate good;, and includes only final goods to avoid double counting. V in the income version of Fisher's equation is income velocity of money.
Income velocity is estimated as the ratio of market value of the final goods and services i.e. Py (= national income, i.e., Y) and the supply of money, i.e.,

$$V = Py/M = YM.$$

Income velocity of money is smaller than the transactions velocity of money because the former relates to the transactions of only final goods, the latter relates to the transactions of all goods, intermediate and final.

3.5 Theory of Money Supply

Historically, the analysis of supply of money has occupied a relatively less important place than the analysis of demand for money in the literature of monetary theory. Because of the prevalence of gold standard with full-bodied money as a monetary system throughout the history of the developed countries, the need for the development of a theory of supply of money explaining the behaviour of money supply over time was not felt, money supply depend upon the discoveries of gold mines and the activities of the miners. But, with the growth of demand deposit exchange, fractional reserve banking and the

development of central banks with the power to regulate the supply which the banking system can create, efforts began in the direction of developing the theory of money supply

Money Supply Model

Money supply is generally considered as a policy-determined phenomenon. But this view is not true. The modern theory of money supply maintains that the money supply is jointly determined by the central bank, the commercial banks and the public. Money supply (M) is the product of monetary base (B) and the money multiplier (m). Thus,

$$M = mB$$

3.6 Determinants of Money Supply

Main determinants of the supply of money are (a) monetary base and (b) the money multiplier. These two broad determinants of money supply are, in turn, influenced by a number of other factors. Various factors influencing the money supply are discussed below:

1. **Monetary Base. Magnitude of the monetary base (B) is the** significant determinant of the size of money supply. Money supply varies directly in relation to the changes in the monetary base. Monetary base refers to the supply of funds available for use either as cash or reserves of the central bank. Monetary base changes due to the policy of the government and is also influenced by the value of money.

2. **Money Multiplier. Money multiplier (m) has positive influence** upon the money supply An increase in the size of m will increase the money supply and vice versa

3. **Reserve Ratio. Reserve ratio (r) is also an important determinant** of money supply. The smaller cash-reserve ratio enables greater expansion in the credit by the banks and thus increases the money supply and vice versa. Reserve ratio is often broken down into its two component parts; (a) excess reserve ratio which is the ratio of excess reserves to the total deposits of the bank (re = ER/D); (b) required reserve ratio which is the ratio of required reserves to the total deposits of the bank (rr = RR/'D). Thus r = rc + rr. The rr ratio is legally fixed by the central bank and the re ratio depends on the market rate of interest

4. **Currency Ratio. Currency ratio (c) is a behavioural ratio** representing the ratio of currency demand to the demand deposits. The effect of the currency ratio on the money multiplier

(m) cannot be clearly recognised because c enters both as a numerator and a denominator in the money multiplier expression (l+c/r(l+t) + c). But, as long as the r ratio is less than unity, a rise in the c ratio must reduce the multiplier:

5. Confidence in Bank Money. General economic conditions affect

the confidence of the public in bank money and, thereby, influence the currency ratio (c) and the reserve ratio (r). During recession, confidence in bank money is low and, as a result, c and r ratios rise. Conversely, during prosperity, c and r ratios tend to be low when confidence in banks is high.

6. Time-Deposit Ratio. Time-deposit ratio (t), which represents the

ratio of time deposits to the demand deposits is a behavioural parameter having negative effect on the money multiplier (m) and thus on the money supply. A rise in t reduces m and thereby the supply of money decreases

7. Value of Money. The value of money (1/P) in terms of other

goods and services has positive influence on the monetary base (B) and hence on the money stock.

8. Real Income. Real income (Y) has a positive influence on the

money multiplier and hence on the money supply. A rise in real income will tend to increase the money multiplier and thus the money supply and vice versa.

9. Interest Rate. Interest rate has a positive effect on the money

multiplier and hence on the money supply. A rise in the interest rate will reduce the reserve ratio (r), which raises the money multiplier (m) and hence increases the money supply and vice versa.

10. 10. Monetary Policy. Monetary policy has positive or negative

influence on the money multiplier and hence on the money supply, depending upon whether reserve requirements are lowered or raised. If reserve requirements are raised, the value of reserve ratio (r) will rise reducing the money multiplier and thus the money supply and vice versa.

11. Seasonal Factors. Seasonal factors have negative effect on the

money multiplier, and hence on the money stock. During holiday periods, the currency ratio (c) will tend to rise, thus, reducing the money multiplier and, thereby, the money supply.

SELF-ASSESSMENT EXERCISE

Discuss the factors influencing currency money.

4.0 CONCLUSION

In conclusion, money supply is a stock as well as a flow concept. The term money supply means the total stock of money held by the public in a expenditure form. There are also various factors influencing currency money and there are also various determinants of money supply.

5.0 SUMMARY

In this unit, we have discussed the meaning of supply of money, constituents of money supply, currency money and factors influencing currency money. We have also discussed bank money, approaches to the definition of money supply, the velocity of money, the theory of money supply and determinants of money supply

6.0 TUTOR MARKED ASSIGNMENT

There are various determents of money supply. What are these determinants?

7.0 REFERENCES/FURTHER READINGS

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MODULE 2

Unit 1 Inflation – Meaning
Unit 2 Causes, Effects and Control of Inflation
Unit 3 Monetary Policy
Unit 4 Meaning and Evolution of Banking
Unit 5 The Central Bank

UNIT 1 INFLATION

CONTENTS

1.0 INTRODUCTION

For a layman, inflation means a substantial and rapid increase in the general price level which causes a decline in the purchasing power of money. Inflation is statistically measured in terms of percentage increase in the price index per unit of time (usually a year or a month). In this unit, we shall discuss the meaning of inflation, the features of inflation and types of inflation.

2.0 OBJECTIVES

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

• Define inflation/discuss the features of inflation
• Discuss the types of inflation

3.0 MAIN CONTENT

3.1 Inflation - Meaning

There is no generally accepted definition of inflation and different Economists define it differently. Broadly, the phenomenon of inflation has been understood in three ways: (a) in the popular sense, (b) in the Keynesian sense, (c) in the modern sense

Common View

Generally, inflation has been defined either (a) as a phenomenon of rising prices, or (b) as a monetary phenomenon:

1. **As a phenomenon of rising Prices: Definitions given by the** economists like Crowther, Gardner Ackley, H. G. Johnson regard inflation as a phenomenon of rising prices. According to Crowther, inflation is a "state in which the value of money is falling, i.e. the prices are rising." In the words of Gardner Ackley, "Inflation is a persistent and appreciable rise in the general level or average of prices." Harry G. Johnson states, "I define inflation as substantial rise in prices."

2. **As a Monetary Phenomenon: Economists like Friedman** Coulborn, Hawtrey, Kemmerer, define inflation as a monetary phenomenon According to Friedman, "inflation is always and everywhere a monetary phenomenon." Coulbron defines inflation a "too much money chasing too few goods." Hawtrey defines inflation as the "issue of too much currency." According to Kemmerer, inflation is too much money and deposit currency, that is, too much currency in relation to the physical volume of business being done."

Keynesian View

Keynes defined inflation as a phenomenon of full employment. According to him, inflation is the result of the excess of aggregate demand over the available aggregate supply and true inflation starts only after full employment. So long there is unemployment, employment will change in the same proportion as the quantity of money and when there is full employment then price will change in the same proportion as the quantity of money. Keynes does not deny that prices may rise even before full employment, mainly due to the existence of certain bottlenecks in the expansion of output. But, he termed such a rise in prices as semi-inflation. It is the true inflation (after full employment), which poses a real threat to the economy and is to be worried about.

Modern View

Modern economist analyses inflation in a comprehensive and unified manner. The modern view of inflation can be summarized in the following way:

i. Generally two types of inflation are distinguished: demand pull inflation and cost push inflation. In the demand pull inflation, inflation and falling unemployment are supposed to go together, while in cost push inflation, inflation and rising unemployment are supposed to occur simultaneously,
ii. During late 1950's A. W. Phillips empirically supported the idea that there existed a permanent long-run trade off between inflation and unemployment which implied that less inflation meant more unemployment and less unemployment would coexist with a higher rate of inflation.
iii. In the late 1960's the monetarists held the view that the trade off between inflation and unemployment existed only in the short-run and not in the long-run In the long-run when anticipated inflation is equal to actual inflation, inflation and unemployment will simultaneously increase.
vi. The monetarists, like Friedman, Phelps, Leijonhufvud, also combined demand-pull and cost-push inflation as one integrated whole. According to them, inflation is a unified phenomenon in which demand and cost elements appear as a part of one integrated cycle and in which expectations of future price level movements play a prominent role.

3.2 Features of Inflation

The main features of inflation are as follows:

i. Inflation is always accompanied by a rise in the price level. It is a process of uninterrupted increase in prices,
ii. Inflation is a monetary phenomenon and it is generally caused by excessive money supply,
iii. Inflation is essentially an economic phenomenon as it originates in the economic system and is the result of action and interaction of economic forces,
iv. Inflation is a dynamic process as observed over the period.
v. A cyclical movement of prices is not inflation,
vi. Pure inflation starts after full employment.
vii. Inflation may be demand-pull or cost-push.
viii. Excess demand in relation to the supply of everything is the essence of inflation.

3.3 Types of Inflation

There are different types of inflation which can be classified as under:

A. On the Basis of Speed

On the basis of speed, inflation can be classified as (a) creeping inflation (b) walking inflation, (c) running inflation and (d) galloping or hyperinflation.

1. **Creeping Inflation: It is the mildest form of inflation. It is** generally regarded as conducive to economic development because it keeps the economy away from stagnation. But, some economists consider creeping inflation as potentially dangerous They are of the view that, if not properly controlled in time, creeping inflation may assume alarming proportions Under creeping inflation, price;, rise about 2 percent annually.

2. **Walking Inflation: When the price rise becomes more marked** as compared to creeping inflation. Under walking inflation, prices rise approximately by 5 percent annually.

3. **Running Inflation: Under running inflation, the prices increase** at a still faster rate. The price rise may be about 10 percent annually.

4. **Galloping or Hyper-Inflation: This is the last stage of inflation** which starts after the level of full employment is reached. Keynes considers this type of inflation as the true inflation under galloping inflation, the prices rise every moment and there is no upper limit to the price rise. The classical examples of hyper-inflation are (a) the Great Inflation of Germany after the First World War and (b) the Great Inflation of China after Second World War.

B. On the Basis of Inducement

Inflation may be classified on the basis of factors inducing or causing rise in prices, such as, (a) wage-induced, (b) profit-induced, (c) scarcity-induced, (d) deficit-induced, (e) currency-induced, (f) credit-induced, and (g) foreign trade-induced inflation.

1. **Wage-Induced Inflation. When inflation rises due to a rise in** wages, it is called wage-induced inflation. In modern times, trade unions are able to secure higher wages for workers unaccompanied by a simultaneous increase in labour productivity. This increases the cost of production, and in turn, the price level.

2. **Profit-Induced Inflation. If the producers, due to their** monopoly position, tend to mark-up their profit margin, it will lead to profit-induced inflation and higher profits raise the cost of production which, in turn, pushes up the prices.

3. **Scarcity-Induced Inflation. When the supply of goods does not** increase on account of natural calamities, the prices tend to rise. This may be called scarcity-induced inflation.

4. **Deficit-Induced Inflation.**

When a government covers the deficit in its budget, through creating new money (a method known as deficit financing) the purchasing power of the community increases without a simultaneous increase in production. This leads to a rise in the price level which is referred to as deficit-induced inflation. Deficit-induced inflation is more common in less developed countries, where, due to lack of adequate resources, the government resorts to deficit financing to finance its development plans.

5. **Currency-Induced Inflation. When the supply of money** exceeds the available output of goods and services, it leads to an inflationary increase in prices. This is a case of currency-induced inflation.

6. **Credit-Induced Inflation. When prices increase on account of** an expansion of credit without increasing the quantity of money it is known as credit-induced inflation

7. **Foreign Trade-Induced Inflation, (a) When a country** experiences a sudden rise in the demand for its exportables against the inelastic supply of exportables in the domestic market, this increases the demand and price level at home, (b) Trade gains and sudden inflow of exchange remittances increase the demand and prices in the domestic market. Both these factors lead to foreign trade-induced inflation.

C. On the Basis of Time

On the basis of time, inflation may be classified into (a) peacetime inflation, (b) war-time inflation and (c) post-war inflation

1. **Peace-Time Inflation. By peace-time inflation we mean the rise** in prices during normal period of peace. This type of inflation occurs when, in a less-developed economy, the government

increases expenditure on development projects which normally have longer gestation periods. It means a gap arises between the generation of money income and the final availability of goods. This leads to a rise in prices.

2. **War-Time Inflation. War-time inflation occurs during a period** of war. During war time, unproductive government expenditure increases and the prices rise because the increase in output does not keep pace with the expansion of expenditure.

3. **Post-War Inflation. Post-war inflation occurs after the end of** the war when the pent-up demand finds open expression. Heavy taxes, which were imposed on the people during war time, are withdrawn during post-war period. As a result the disposable income of the people abruptly increases without increase in the output. Hence the prices shoot up.

D. On the Basis of Scope

On the basis of scope, inflation can be comprehensive or sporadic.

1. **Comprehensive Inflation. When the prices of all goods and** services increase throughout the economy, it is the case of comprehensive inflation. This leads to a rise in the general price level.

2. **Sporadic Inflation. Sporadic inflation is sectoral inflation, since,** instead of affecting whole economy, it affects a few sectors. In this case, the prices of some goods increase due to certain physical bottlenecks which adversely affect the production of these goods Sporadic or sectoral inflation can be checked by resorting to direct price control on the sale of the affected goods.

E. On the Basis of Government Reaction

On the basis of Government reaction, inflation can be open or suppressed.

1. **Open Inflation. If the government takes no steps to check the** price and the market mechanism is allowed to function without any interference, it is called open inflation. Under open inflation, market mechanism performs the function of allocating scarce resources among competing industries. If there is shortage of any particular resource, the market mechanism would raise its price and allocate it to those industries which can afford to pay a higher price for it. The hyper-inflation in Germany after the First World War is an example of open inflation.

2. Suppressed Inflation. If the government actively makes efforts to check the price rise through price control and rationing, it is called suppressed inflation. These measures can check inflation as long as their effect continues. Once these measures are withdrawn, the demand for goods increases and the suppressed inflation becomes open inflation. Thus, suppressed inflation means to defer current demand or to divert demand from controlled goods to uncontrolled goods. Suppressed inflation results in many evils, such as profiteering, black marketing, hoarding, corruption, etc. It also leads to the diversion of economic resources from more essential goods to less essential goods.

F. On the Basis of Employment Level

On the basis of employment level, inflation can be Partial or full inflation.

1. Partial Inflation. The price rise is as a result of expansion of money supply in the pre-full employment stage is called partial inflation. The increase in the money supply before full employment tends to mobilise the idle resources of the economy and thus leads to the expansion of output and employment. There is only a slight rise in price level under partial inflation.

2. Full Inflation. The increase in the money supply after the full employment level leads to full inflation. In this case, output and employment will not increase and there will be an uninterrupted rise in prices.

G. Other types

1. Ratchet Inflation. Under ratchet inflation, the prices in certain sectors are not allowed to fall even though there is every reason for the price to fall. Sometimes, it so happen that in certain the aggregate demand is excessive and in others, it is quite low In the excess-demand sectors, the prices will rise, while in the deficient-demand sectors, the prices should decline. But the prices are not allowed to fall in the deficient-demand sectors, due to the resistance from industrialists and trade unions. Thus while the prices rise in excess-demand sectors, they are not allowed to fall in the deficient-demand sectors. The net result is a general rise in prices. This is known as ratchet inflation.

2. Stagflation. The simultaneous existence of high rates of inflation and of high unemployment is called stagflation. After World War II, in those countries which pursued stabilisation policies with an

objective to achieve full employment, unemployment remained relatively high while inflation rate increased. This new phenomenon of stagflation which started in the developed countries towards the close of 1960's, has now become a world wide problem. This has also caused a serious crisis in the Keynesian and the Phillips curve theories of inflation.

SELF-ASSESSMENT EXERCISE

Discuss the different types of inflation you know.

4.0 CONCLUSION

In conclusion, the phenomenon of inflation has been understood in three ways:

i. In the popular sense
ii. In the Keynesian sense and
iii. In the modern sense

There are also various types of inflation which can be classified as under: on the basis of speed, on the basis of inducement, on the basis of time, on the basis of scope, on the basis of government reaction, on the basis of employment level and other types.

5.0 SUMMARY

In this unit, we have discussed the meaning of inflation made up of the common view, the Keynesian view and the modern view. In addition we have discussed the features and types of inflation.

6.0 TUTOR MARKED ASSIGNMENT

Outline and discuss the main features of inflation.

7.0 REFERENCES/FURTHER READINGS

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UNIT 2 CAUSES, EFFECTS AND CONTROL OF INFLATION

CONTENTS

1.0 INTRODUCTION

To layman inflation is the continuous and persistent rise in the general level of prices without a corresponding increase in the supply of commodities. In this unit we shall discuss the causes of inflation, effects of inflation and control of inflation.

2.0 OBJECTIVES

At the end of the unit it should be able to:

- Discuss the causes of inflation/Identify the effects of inflation.
- Discuss the control of inflations.

3.0 MAIN CONTENT

3.1 Causes of Inflation

Inflation is the result of disequilibrium between demand and supply forces and is attributed to (a) an increase in the demand for goods and services in the country, and (b) a decrease in the supply of goods in the economy.

Factors Causing Increase in Demand

Various factors responsible for increase in aggregate demand for goods and services are as follows.

1. **Increase in Money Supply. An increase in the money supply** leads to an increase in money income. The increase in money income raises the monetary demand for goods and services. The supply of money increases when (a) the government resorts to deficit financing i.e. printing of more currency or (b) the banks expand credit.

2. **Increase in Government Expenditure. An increase in the** government expenditure as a result of the outbreak of war, development and welfare activities causes an increase in the aggregate demand for goods and services in the economy.

3. **Increase in Private Expenditure. An expansion of private** expenditure (both consumption and investment) increases the aggregate demand in the economy. During the period of good business expectations, the businessmen start investing more and more funds in new enterprises, thus increasing the demand for factors of production. This results in an increase in factor prices. The increased factor incomes raise the expenditure on consumption goods.

4. **Reduction in Taxation. Reduction in taxation can also be an** important cause for the generation of excess demand in economy. When the government reduces taxes, it increases the disposable income of the people, which, in turn, raises the demand for goods and services.

5. **Increase in Exports. When the foreign demand for domestically** produced goods increases, it raises the earnings of exporting industries. This, in turn, will increase demand for goods and services within the economy.

6. **Increase in Population. A rapid growth of population raises** level of aggregate demand in the economy because of the increase in consumption, investment, government expenditure and net foreign expenditure. This leads to an inflationary rise in prices due to excessive demand.

7. **Paying off Debts. When the government pays off its old debts to** the public it results in an increase of purchasing power with the public. This will be used to buy more goods and services for consumption purposes, thus increasing the aggregate demand in the economy.

8. **Black Money. Black money means the money earned through** illegal transactions and tax evasion. Such money is generally spent on conspicuous consumption, while raising the aggregate demand and hence the price level.

Factors Causing Decrease in Supply

Various factors responsible for reducing the supply of goods and services
in the economy are given below:

1. Scarcity of Factors of Production. On the supply side, inflation may occur due to the scarcity of factors of production, such as, labour capital equipment, raw materials, etc these shortages are bound to reduce the production of goods and services for consumption purposes and thereby the price level.

2. Hoarding. At a time of shortages and rising prices, there is a tendency on the part of the traders and businessmen to hoard essential goods for earning profits in future. This causes scarcity and rise in prices of these goods in the market

3. Trade Union Activities. Trade union activities are responsible for inflationary pressures in two ways (a) Trade union activities (i.e. strikes) often lead to stoppage of work, decline in production, and rise in prices (b) If trade unions succeed in raising wages of the workers more than their productivity, this will push up the cost of production, and lead the producers to raise the prices of their products.

4. Natural Calamities. Natural calamities also create inflationary conditions by reducing the production in the economy. Floods and draughts adversely affect the supply of products and raise their prices.

5. Increase in Exports. An increase in exports reduces the stock of goods available for domestic consumption. This creates a situation of shortages in the economy giving rise to inflationary pressures.

6. Law of Diminishing Returns. The law of diminishing returns operates when production is increased by employing more and more variable factors with fixed factors and given technology. As a result of this law, the cost per unit of production increases, thus leading to a rise in the prices of production.

7. War. During the war period, economic resources are diverted to the production of war materials. This reduces the normal supply of goods and services for civilian consumption and this leads to the rise in price level.

8. International Causes. In modern times, a major cause of inflationary rise in prices in most of the countries is the international rise in the prices of basic materials (e.g. petrol) used in almost all the industrial materials.

3.2 Effects of Inflation

Inflation is good so long as it is well under control and increases output and employment. It becomes harmful once it goes out of control because then it robs Peter to pay Paul and takes not account of the basic principle of social equality. According to C.N. Vakil, "Inflation may be compared to robber. Both deprive the victim of some possession with the difference that robber is visible, inflation in invisible; the robber's victim may be one or few at a time, the victim of inflation is the whole nation, the robber may be dragged to a court of law, inflation is legal". Inflation has wide-ranging influence on economic, social, moral and political life of the country. Its various effects are discussed below.

A) Effects on Product

According to Keynes, moderate or creeping inflation has favourable effect on production particularly when there are unemployed resources in the country Rising prices increase the profit expectations of the entrepreneurs because the prices increase more rapidly than the cost of production. They are induced to step up investment, and, as a result, output and employment increase. Hyper or galloping inflation, on the other hand, creates the uncertainty which is inimical to production. Thus, while mild inflation is favourable to production and employment particularly before full employment, hyper inflation is generally harmful for the economy. The adverse effects of inflation or production are stated below:

1. Disrupt Price System. Inflation disrupts the smooth working of the price mechanism, creates rigidities and results in wrong allocation of resources

2. Reduces Saving. Inflation adversely affects saving and capital accumulation. When prices increase, the purchasing power of money fall which means more money is required to buy the same quantity of goods. This reduces saving.

3. Discourages Foreign Capital. Inflation not only reduces domestic saving, it also discourages the inflow of foreign capital into the country. If the value of money falls considerably, it may even drive out the foreign capital invested in the country

4. Encourages Hoarding. When prices increase, hoarding of larger stocks of goods become profitable. As a consequence of hoarding, available supply of goods in relation to increasing monetary demand decreases. This results in black marketing and causes further price-spiral.

5. Encourages Speculation Activities. Inflation promotes speculative activities on account of uncertainty created by a continually rising prices. Instead of earning profits though genuine productive activity, the businessmen find it easier to make quick profits through speculative activities.

6. Reduces Volume of production. Inflation reduces the volume of production because (a) capital accumulation has slowed down and (b) business uncertainty discourages entrepreneurs from taking business risks in production.

7. Affects Pattern of Production. Inflation adversely affects the pattern of production by diverting the resources from the production of essential goods to that of non-essential goods or luxuries because the rich, whose incomes increase more rapidly demand luxury goods.

8. Quality Fall. Inflation creates a sellers market in which sellers have command on prices because of excessive demand. In such a market, any thing can be sold. Since the producer's interest is only higher profits, they will not care for the quality.

B) Effects on Distribution

Inflation results in redistribution of income and wealth because the prices of all the factors of production do not increase in the same proportion. Generally, the flexible income groups, such as businessmen, traders, merchants, speculators gain during inflation due to wind-fall profits that arise because prices rise faster than the cost of production. On the other hand, the fixed income groups, such as workers, salaried persons, teachers, pensioners, interest and rent earners, are always the losers during inflation because their incomes do not increase as fast as the prices. Inflation is unjust because it puts economic burden on those sections of the society who are least able to bear it. The effects of inflation on different groups of society are as follows.

1. Debtors and Creditors. During inflation, the debtors are the gainers and the creditors are the losers. The debtors stand to gain because they had borrowed when the purchasing power of money was high and now return the loans when the purchasing power of

money is low due to inflation. The creditors, on the other hand, stand to lose because they get back less in terms of goods and services than what they had lent.

2. Wage and Salary Earners. Wage and salary earners usually suffer during inflation because (a) wages and salaries do not rise in the same proportion in which the prices or the cost of living rises and (b) there is a lag between a rise in the price level and a rise in wage and salary. Among workers, those who have formed trade unions, stand to lose less than those who are unorganized

3. Fixed Income Groups. The fixed-income groups are the worst sufferers during inflation. Persons who live on past saving, pensioners, interest and rent earners suffer during periods of rising prices because their incomes remain fixed.

4. Business Community. The business community, i.e., the producers, traders, entrepreneurs, speculators, etc., stand to gain during inflation, (a) They earn windfall profits because prices rise at a faster rate than the cost of production (b) They gain because the prices of their inventories go up, thus increasing their profits, (c) They also gain because they are normally borrowers of money for business purposes.

5. Investors. The effect of inflation on investors depends on in which asset the money is invested. If the investors invest their money in equities, they are gainers because of rise in profit. If the investors invest their money in debentures and fixed income bearing securities bonds, etc, they are the loser because income remains fixed.

6. Farmers. Farmers generally gain during inflation because the prices of the farm products increase faster than the cost of production, thus, leading to higher profits during inflation.

Thus inflation redistributes income and wealth in such a way as to harm the interests of the consumers, creditors, small investors, labourers, middle class and fixed income groups and to favour the businessmen, traders, debtors, farmer etc. Inflation, is society unjust because it makes the rich richer and the poor poorer; it transfers wealth from those who have less of it to those who have already too much of it.

C) Non-Economic Consequences

Inflation has far reaching social, moral and political consequences:

1. **Social Effects. Inflation is socially unjust and unequitable** because it leads to redistribution of income and wealth in favour of the rich. This widens the gap between haves and have-nots and creates conflict and tension in the society.

2. **Moral Effects. Inflation adversely affects business morality and** ethics. It encourages black marketing and enables the businessmen to reap wind-fall gains by undesirable means In order to increase the profit margin the producers reduce the quality by introduction of adulteration in their products.

3. **Political Effect. Inflation also disrupts the political life of a** country. It corrupts the politicians and weakens the political discipline. Again, social inequality and moral degradation resulting from inflationary pressures lead to general discontentment in the public which may result in the loss of faith in the government. General dissatisfaction among masses may sometimes result in political revolution or toppling of the government. It was the hyperinflation in Germany during 1920s that made Hitler a dictator. It is correctly remarked: "Hitler is the foster-child of inflation".

   In short, inflation is undesirable because of its all-round harmful consequences. It is "economically unsound, politically dangerous and morally indefensible" It should be avoidable if possible, and if it occurs, should be checked before it is too late.

3.3 Control of Inflation

The cumulative nature of the inflationary process and its socio-economic effects clearly indicate that appropriate measures should be taken to control inflation in its early stage. If it is not checked in the beginning, it may develop into hyper-inflation with its dangerous effects on the economy. Since inflation is mainly caused by an excess of effective demand for goods and services at the full employment level as compared to the available supply of goods and services, measures to control inflation involve reduction in the total demand on the one hand and increasing output on the other hand. Broadly, the measures against inflation can be divide into: (a) Monetary policy, (b) Fiscal policy, (c) Direct controls, and (d) Other measures.

A) Monetary Policy

Monetary policy is adopted, by the monetary authority or the central bank of a country to influence the supply of money and credit by changing interest rate structure and availability of credit. Various monetary measures to control inflation are explained below:

1. Increasing Bank Rate. Bank rate is the rate at which central bank lends money to the commercial banks. An increase in the bank rate leads to an increase in the interest rate charged by commercial banks which, in turn, discourages borrowing by businessmen and consumers. This will reduce money supply with public and thus control the inflationary pressure.

2. Sale of Government Securities. By selling government securities in the open market, the central bank directly reduces the cash reserves of the commercial banks because the central bank must be paid from these cash reserves. The fall in the cash reserves compels the banks to reduce their lending activities. This will reduce the money supply and hence the inflationary pressures in the economy

3. Higher Reserve Ratio. Another monetary measure to check inflation is to increase the minimum reserve ratio. An increase in the minimum reserve ratio means that the member banks are required to keep larger reserves with the central bank this reduces the deposits of the banks and thus limits their power to create credit Restrictions on credit expansion will control inflation.

4. Selective Credit Control. The purpose of selective credit control measures is to influence specific type of credit while leaving other types of credit unaffected. Such selective measures are particularly important for developing economies in which, on the one hand, there is an increasing need for credit expansion for growth purposes, and, on the other hand, there is also need for checking inflationary tendencies. In such a situation, selective credit control measures can direct the flow of credit from unproductive and inflation-prone sectors towards the productive and growth oriented sectors. The main selective credit control measures to control inflation are:

i. Consumer Credit Control. This method is adopted during inflation to curb excessive spending by consumers. In advanced countries, most of the durable consumer goods, such as, radio, Television, refrigerator, etc.; are purchased by the consumers on instalment credit. During inflation, loan facilities for instalment buying are reduced to minimum to check consumption spending. This is done by (a) raising the initial payment, (b) covering the large number of goods, and (c) reducing the length of the payment period.

ii. Higher Margin Requirements. Margin requirement is the different between the market value of the security and its

maximum loan value. A bank does not advance loan equal to the market value of the security, but less. For example, it may lend 600 Naira against the security worth 1000 Naira; thus the margin requirement in this case is 40%. During inflation, the margin requirement can be raised to reduce the loan one can get on a security.

Limitations of Monetary Policy: During inflation, a dear money policy is recommended which aims at restricting the credit creation activities of the commercial banks. But such an anti-inflationary policy suffers from many limitations:

i. Prof. Galbraith mentions three reasons for the ineffectiveness of the dear money policy during inflation: (a) In times of high earning, i.e., when the marginal efficiency of capital is high, both long as well as short period investments become relatively incentive to changes in interest rates, (b) The government fails to come to grips with real investment, (c), Very often, the monetary policy applied is so soft that it has little impact on inflation.

ii. Excess reserves possessed by the commercial banks can make the monetary measures of the central bank to control inflation ineffective. Excess reserves enable the bank to lend more credit even when the credit control measures have been adopted by the central bank.

iii. Monetary measures alone will not be sufficient when there are cost-push inflationary pressures. Along with monetary policy, the fiscal policy and income policy are also needed.

iv. If the inflationary price rise is due to scarcity of output, then the monetary policy will not be of much use. In this case, appropriate output policy is required.

v. Monetary policy will also not help in controlling inflation if the inflation is due to deficit financing

vi. In the modern economies, large amounts of near moneys (in the form of securities, bonds, etc) are in existence, which are highly liquid in nature. In such circumstances, it is not so easy to control the rate of spending merely by controlling the money supply. There is no direct relationship between money supply and the price level.

In short, however, judicious use of monetary policy as a secondary measure has an important role in checking inflationary pressures. The greatest merit of monetary policy is its flexibility. Monetary restrictions, along with other measures, are necessary to quickly and efficiently control inflation.

B) Fiscal Policy

Fiscal policy is the budgetary policy of the government relating to taxes, public expenditure, public borrowing and deficit financing. The major anti-inflationary fiscal measures include (a) increase in taxation, (b) reduction in public expenditure, (c) increase in public borrowing, and (d) control of deficit financing

1. **Increase in Taxation. Anti-inflationary tax policy should be** directed towards restricting demand without restricting production. Excise duties and sales tax on various goods, for example, take away the buying power from the consumer goods market without discouraging the expanding productive capacity of the economy. Some economists, therefore, prefer progressive direct taxes because such taxes on the one hand, reduce the disposable income of the people and, on the other hand, are justified on the basis of social equity.

2. **Reduction in Public Expenditure. During inflation, effective** demand is very high due to expansion of public and private spending. In order to check unregulated private spending, the government should first of all reduce its unproductive expenditure." In fact, during inflation, at the full employment level, the effective demand in relation to the available supply of goods and services is reduced to the extent that government expenditure is curtailed. Public expenditure being autonomous, an initial reduction in it will lead to a multiple reduction in the total expenditure of the economy. But for certain limitations of this measure: (a) It is not possible to reduce public expenditure related to defence needs particularly during war times, (b) Heavy reduction in government expenditure may come into clash with the planned long-run investment programmes in a developing economy.

3. **Public Borrowing. Public borrowing is another method of** controlling inflation. Through public borrowing, the government takes away from public excess purchasing power. This will reduce aggregate demand and hence the price level. Ordinarily public borrowing is voluntary, left to the free will of individuals. Voluntary public borrowing may not bring to the government sufficient funds to effectively control the inflationary pressures. In such conditions, compulsory public borrowing is necessary. Through compulsory public borrowing a certain percentage of wages or salaries is compulsorily deducted in exchange for saving bonds which become redeemable after a few years. In this way, purchasing power can be curtailed for a definite period to

curb inflation. Compulsory public borrowing has certain limitations, (a) It involves the element of compulsion on the public, (b) It results in frustration if the government borrows from the poorer sections of the public who cannot contribute to this scheme, (b) The government should avoid paying back the past loans during inflationary period, otherwise it will generate further inflation.

4. Control of Deficit Financing. Deficit financing means financing the deficit budget (i.e. excess of government expenditure over its revenue) through printing

Limitation of Fiscal Policy: Fiscal policy, as an anti-inflationary policy, also has certain limitations: (a) Through fiscal measures, various welfare schemes are curtailed to control inflation which adversely affect the poor people, (b) For the proper implementation of the fiscal policy, efficient administration is needed which is normally found lacking, (c) For fiscal measures to become effective, stable political set up, political will of the government and public cooperation are required, (d) Even if these limitations are removed, fiscal policy alone is not sufficient. What is, in fact, needed is the proper coordination of fiscal and monetary measures for controlling inflation.

C) Direct Controls

Direct controls refer to the regulatory measures undertaken with an objective of converting an open inflation into a suppressed one. Direct control on prices and
rationing of scarce goods are the two such regulatory measures.

1. Direct Controls on Prices. The purpose of price control is to fix an upper limit beyond which the price of particular commodity is not allowed and to that extent inflation is suppressed.

2. Rationing. When the government fixes the quota of certain goods so that each person gets only a limited quantity of the goods, it is called rationing. Rationing becomes necessary when the essential consumer goods are relatively scarce. The purpose of rationing is to divert consumption from those goods whose supply needs to be restricted for some special reason, e.g. to make such commodities available to a large number of people. According to Kurihara, "rationing should aim at diverting consumption from particular articles whose supply is below normal rather than at controlling aggregate consumption". Thus, rationing aims at achieving the twin objectives of price stability and distributive justice.

Limitations of Direct Controls: Various limitations of direct controls are mentioned below:

i. Direct controls suppress individual initiative and enterprise:
ii. They discourage innovations, i.e., new techniques and new products.
iii. They encourage speculative tendencies and create artificial scarcity through large-scale hoardings. If it is expected that a particular commodity is going to be rationed due to scarcity, people tend to hoard large stocks of it, thus making it scarce.
iv. The implementation of direct control requires efficient and honest administrative machinery. Generally, direct controls lead to evils like black marketing, corruption, etc
v. As soon as direct controls are removed, great economic disturbance appears.
vi. Direct controls have limited applicability. They are considered useful when applied to specific scarcity areas and in extraordinary emergency situations. Serious objections are raised against direct controls during peace time.
vii. According to Keynes, "rationing involves great deal of waste, both of resources and of employment."

Despite these shortcomings, direct controls are considered superior to monetary and fiscal measures. They seem inevitable in modern times to contain inflationary pressures in the economy because of the following reasons: (a) They can be applied easily and quickly and hence they produce rapid effects, (b) They are more selective and discriminatory than monetary and fiscal controls, (c) there can be variations in the intensity of operations of direct controls from time to time and in different sectors.

D) Other Measures

Besides monetary, fiscal and direct measures, there are some other measures which can be taken to control inflation:

1. Expansion of Output. Inflation arises partly due to inadequacy of output. But, it is difficult to increase output during inflationary period because the productive resources have already been fully utilised. Under such condition when output as a whole cannot be increased, steps should be taken to increase output of those goods which are sensitive to inflationary pressures. This requires reallocation of resources from the production of less inflation-sensitive goods (i.e., luxury goods) to the production of more inflation-sensitive goods (i.e. food, clothing and other essential consumer goods) Such reallocation of resources will keep the

prices of essential consumer goods under check by raising their output.

2. Proper Wage Policy. In order to check inflation, it is necessary to control wages and profits and to adopt appropriate wage and income policy. Wage increase should be allowed to the workers only if their productivity increases; in this way, higher wages will not lead to higher costs and hence higher prices.

3. Encouragement to Saving. Increase in private savings has dis- inflationary impact on the economy. Private saving lead to the reduction of expenditure income of the people, which in turn, curtail inflationary pressures. The government should therefore take steps to encourage private savings.

4. Overvaluation. Overvaluation of domestic currency in terms of foreign currencies also serves to control inflation in three ways: (a) It will discourage exports and thus increase the availability of goods and services in the domestic market (b) It will encourage imports from abroad and thus add to the domestic stock of goods and services, (b) by reducing the prices of foreign materials which are needed in domestic production, it will control the upward cost-price spiral.

5. Population Control. In an overpopulated country, like India, the measures to check the growth of population also produce anit-inflationary effects. Effective family planning programmes ultimately reduce the increasing pressures on general demand for goods and services, thus helping to keep the rising prices under control.

6. Indexing. Economists also suggest indexing as an anti- inflationary measure. Indexing refers to monetary corrections by periodic adjustments in money incomes of the people and in the value of financial assets, saving deposits, etc., held by the public in accordance with changes in the prices. For example, if the annual price rise is 10% the money incomes and the value of financial assets should be increased by 10% under the system of indexing.

SELF-ASSESSMENT EXERCISE

What are the various measures that can be adopted to control inflation?

4.0 CONCLUSION

The above discussion leads to the conclusion that a proper anti-inflationary policy should be comprehensive It should involve all types of measures and should not exclusively depend upon one measure or the other. The problem of inflation must be attacked from all sides with determined efforts.

You have identified the various causes and effects of inflation. You have also seen that there are various strategies towards which inflation can be controlled.

5.0 SUMMARY

In this unit, we have discussed the causes and effects of inflation, and the various measures of controlling inflation.

6.0 TUTOR – MARKED ASSIGNMENT

Discuss the various causes of inflation you know.

7.0 REFERENCES/FURTHER READINGS

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UNIT 3 MONETARY POLICY

CONTENTS

1.0 INTRODUCTION

In this unit we shall discuss the meaning and objectives of monetary policy. We shall also discuss the role of monetary policy in developing countries.

2.0 OBJECTIVES

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

- Define monetary policy
- Identify the objectives of monetary policy.
- Discuss the role of monetary policy in developing countries.

3.0 MAIN CONTENT

3.1 Monetary Policy

Monetary policy is concerned with the changes in the supply of money and credit it refers to the policy measures undertaken by the government or the central bank to influence the availability, cost and use of money and credit with the help of monetary techniques to achieve specific objectives. Monetary policy aims at influencing the economic activity in the economy mainly through two major variables, i.e., (a) money or credit supply, and (b) the rate of interest.

The techniques of monetary policy are the same as the techniques of credit control at the disposal of the central bank. Various techniques of monetary policy, thus, include bank rate, open market operations, variable cash reserve requirements, selective credit controls. R. P. Kent

defines monetary policy as "the management of the expansion and contraction of the volume of money in circulation for the purpose of attaining a specific objective such as full employment. According to A. J Shapiro, "Monetary Policy is the exercise of the central bank's control over the money supply as an instrument for achieving the objectives of economic police" In the words of D. C. Rowan, "The monetary policy is defined as discretionary action undertaken by the authorities designed to influence (a) the supply of money, (b) cost of money or rate of interest and (c) availability of money."

Monetary policy is not an end in itself, but a means to an end It involves the management of money and credit for the furtherance of the general economic policy of the government to achieve the predetermined objectives. There have been varying objectives of monetary policy in different countries in different times and in different economic conditions. Different objectives clash with each other and there is a problem of selecting a right objective for the monetary policy of a country. The proper objective of the monetary policy is to be selected by the monetary authority keeping in view the specific conditions and requirements of the economy.

3.2 OBJECTIVES OF MONETARY POLICY

Various objectives or goals of monetary policy are:

i. Neutrality of Money
ii. Exchange Stability
Price Stability
iii. Full Employment
Economic growth

These objectives are discussed in detail as follows.

Neutrality of Money

Economists like Wicksteed, Hayek, Robertson, advocated that the main objective of the monetary policy is to maintain complete neutrality of money. The policy of neutrality of money seeks to do away with the distributing effect of changes in the quantity of money on important economic variables, like income, output, employment and prices. According to this policy, money supply should be controlled in such a way that money should be neutral in its effects. In other words, the changes in money supply should not change the total volume of output and total transactions of goods and services in the economy.

The policy of neutrality of money is based on the assumption that money is purely a passive factor It functions only as a medium of exchange In the absence of money, barter (i.e., direct exchange of goods for goods) determines the relative values of goods. The function of money is only to reflect these relative values and not to distort them. On the basis of the assumption of the passive or neutral role of money, the advocates of the neutrality of money hold the view that money should not be allowed to interfere in the neutral functioning of the economic forces both on the supply and demand sides, such as productive efficiency, cost of production, consumer preferences.

The exponents of the neutral money policy believe that monetary changes are the root cause of all economic ills. They cause disturbances in the smooth working of the economic system. They are responsible for the occurrence of trade cycles. They bring changes in the real variables like income, output, employment and relative prices. They cause imbalance between demand and supply, consumption and production. Thus, economic fluctuations (inflation and deflation) are the result of non-neutral money (involving changes in money supply) and stability in the economic system with no inflation and deflation requires the adoption of neutral money policy (involving constant money supply).

Thus, according to the policy of neutral money, if the money is made neutral and the money supply is kept constant, there will be no disturbances in the economic system. In such a situation, relative prices will change according to the changes in the demand and supply of goods and services, economic resources will be allocated according to the wants of the society, and there will be no inflation and deflation.

However, this does not mean that the money supply should be kept constant under all circumstances:

i. The supply of money will have to be changed from time to time to provide for the changes in the velocity of money, in the periods of a fall in the velocity of money, the supply of money has to be increased and in periods of a rise in the velocity of money, the supply of money has to be reduced. It is, in fact, the volume of effective money supply (including both the volume of standard and bank money as well as the velocity of circulation of the money) which should be kept constant.
ii. The money supply will also be changed to neutralise the basic changes in the economic structure of the country. Such basic changes are changes in population, changes in the techniques of production, innovations, etc.

Exchange Stability

Exchange rate stability has been the traditional objective of monetary policy under gold standard. It was considered the primary objective, while stability of prices was considered secondary because of the great importance of international trade among the leading countries of the world. Main arguments made in favour of exchange stability and against exchange instability are given below:

i. Stable exchange rates are essential for the promotion of smooth international trade,
ii. Fluctuation in the exchange rates lead to lack of confidence in a particular currency and might result in the flight of capital from the country whose currency is unstable in value,
iii. Frequent changes in the exchange rates encourage speculation in the exchange markets.
iv. Fluctuations in exchange rates also lead to fluctuations in the internal price level,
v. Fluctuations in the exchange rates adversely affect the economic and political relationship among the countries.
vi. International lending and investment is seriously affected as a result of fluctuating exchange rates.

The objective of exchange stability is achieved through establishing equilibrium in the balance of payments. Monetary policy plays an important role in bringing balance of payments equilibrium in the without disturbing the stable exchange rate. A country with a deficit in balance of payments, for example, adopts a restrictive monetary policy. Contraction of currency and credit as a result of the restrictive monetary policy brings down the price level within the country. This will encourage exports and discourage imports. Increase in exports and decrease in imports will, in turn, correct the disequilibrium in the balance of payments position

Exchange rate stability as an objective of monetary policy has been criticised on two grounds: (a) Exchange rate stability is generally achieved at the expense of internal price stability But, fluctuations in the internal price level cause serious disturbances in the economy and adversely affect its smooth working and progress, (b) With stable exchange rates, the inflationary and deflationary conditions of some countries are passed on to other countries. This puts the country with stable exchange rates at the mercy of the other countries, seriously affecting the economy of that country.

In the modern times, when International Monetary Fund has been established to deal with the problem of maintaining exchange rate

stability among the member countries and most of the countries of the world are members of this institution, the exchange stability as an objective of monetary policy of a country has lost much rather than maintaining exchange stability.

Price Stability

With the abandonment of gold standard after the World War II, exchange stability was replaced by price stability as an objective of monetary policy Greater attention was paid to the problem of removing violent fluctuations in the domestic fluctuations in the prices through various monetary controls and regulations. Price stability refers to the absence of any market trend or sharp short-run movements in the general price level. Price stability does not mean that each and every price should be kept fixed; it means that the average of prices or the general price level, as measured by the wholesale price index, should not be allowed to fluctuate beyond certain minimum limit. Stable price level does not mean fixed or frozen price level. Economists generally regard 2 to 4% annual rise in prices as the stable price level.

Arguments in favour of Price Stability: The price stabilization is advocated on the basis of the following arguments:

i. Price Stability leads to great disturbances in the economy and price stability ensures smooth functioning of the economy and creates conditions for stable economic growth.
ii. Inflation and deflation representing cumulative rise and fall in prices respectively are both economically disturbing and socially undesirable. They create problems of production and distribution,
iii. Inflation is socially unjust because it redistributes income and wealth in favour of the rich.
iv. Deflation leads to the reduction of income and output and cause widespread unemployment.
v. Periods of price and business fluctuations, such as the hyper-inflation of 1923-24 and the Great Depression of 1929-33 have been the periods of great international upheavals, leading to World War II.
vi. Price stability eliminates cyclical fluctuations and helps to promote business activity It results in active and stable prosperity,
vii. Periods of price stability enable money to perform its functions of (a) store of value and (b) standard of deferred payments smoothly.
viii. Price stability leads to equitable distribution of income and wealth among various sections of the society.
ix. Stability of price level promotes economic progress and economic welfare in the country

Full Employment

With the publication of Keynes' General Theory of Employment, **Interest and Money (1936), full employment became the ideal goal of** monetary policy. Keynes emphasised the role of monetary policy in promoting full employment of human and natural resources in the country. He advocated cheap money policy, i.e. expansion of currency and credit and reduction in rate of interest, to achieve the goal of full employment Full employment of labour and full utilization of other productive resources are important from the point of view of maximising economic welfare in the country.

Meaning of Full Employment: The concept of full employment is vague and ambiguous It has been differently interpreted by different economists. However, one thing is clear that full employment does not mean complete absence of unemployment. In other words, full employment does not mean that each and every person in the country who is fit and free is employed productively. In fact, full employment is compatible with some amount (i.e. 3 to 4 %) of seasonal and frictional unemployment. According to Beveridge, full employment means that "unemployment is reduced to short intervals of stand by, with certainty that very soon one will be wanted in one's old job again or will be wanted in a new job within one's power."

Full Employment in Developed and Underdeveloped Countries: The problem of full employment is different for developed and underdeveloped countries. The developed countries, like England and America, may already have achieved the level of full employment and the problem in these countries is to maintain this level by avoiding all kinds of fluctuations. On the other hand, the underdeveloped countries, like India and Nigeria, are characterised by wide-spread unemployment and underemployment. So the problem in these countries is to remove unemployment by providing job to all those who are willing to work. Thus, the problem in an underdeveloped country is to achieve full employment, whereas that, in a developed country is to maintain full employment:

Achievement and Maintenance of Full Employment Level: Monetary policy can help the economy to achieve full employment. According to Kcynes, unemployment is mainly due to deficiency of investment and the level of full employment can be achieved by increasing investment and making it equal to the saving at the full employment level. The main task of monetary policy is to expand money supply and reduce rate of interest to that optimum level which raises the investment and ultimately achieving full employment is commonly called cheap money p'olicy. Cheap money policy stimulates investment by expanding money supply and reducing the interest rate.

Economic Growth

Traditionally, monetary policy has been regarded as a short-run policy primarily aiming at achieving the objectives of price stability and full employment. But quite recently, the emphasis has been shifted from full employment or price stability to economic growth as the main objective of monetary policy. The monetary policy is now no longer considered as a short-run policy of securing full-employment level free from cyclical fluctuations.

On the other hand the main objective of monetary policy now is to achieve the long-run goal of ever-increasing rate of economic growth.

The USA Employment Act of 1946 made it obligatory on the federal government to take all possible measures not only to promote maximum employment, but also maximum production in the country. The objective of economic growth is also important from the point of view of the underdeveloped countries. The real problem in these countries is not the short-run cyclical fluctuations in production and employment, but is one of long run structural changes aiming at creating conditions necessary for economic development. Thus, the main objective of monetary policy in an underdeveloped country should be to play an active part in the process of economic development.

In fact, economic growth has been aptly made the primary objective of monetary policy. The following arguments can be advanced in favour of economic growth:

i. The objective of full employment cannot possibly be achieved without raising the rate of economic growth,
ii. Increasing the rate of economic growth is necessary if the people are to be provided with ever-rising living standards,
iii. Rapid economic growth is essential for the survival of the developing countries in the present competitive world.
iv. The objective of economic growth takes into consideration the broader long-term perspective. It is concerned with economic and technological progress of the country.
v. According to Woodworth, the objective of economic growth deserves priority because of two reasons: (a) Despite the enormous improvement in the living standards in the western world, poverty still remains the world's burning economic problem (b) Economic growth is an essential ingredient of the economic and political institutions.

Some economists have opposed the growth objective of monetary

policy in underdeveloped countries. According to Howard Ellis, for example, any monetary policy promoting economic growth in an underdeveloped country is doomed to frustration because such countries are highly susceptible to inflationary pressures. But, the most of the economist are in favour of the monetary policy having economic growth and are of the view that monetary policy should explicitly adopt economic growth as its primary objectives.

Economic growth has been defined as the process whereby the real national income of a country increases over a long period of time. In this process, money can play an important role as a mobilising agent. Most of the countries, particularly the less developed countries, possess the physical and human resources necessary for economic growth, but their resources remain un-utilized largely due to lack of necessary finances. Under such conditions, an expansionary monetary policy, by providing necessary monetary resources, will be able to mobilise the unutilized resources and thus will activate and accelerate the process of economic growth.

The monetary policy aiming at promoting economic growth must satisfy two conditions:

i. The monetary policy must be flexible. In other words, it must be able to establish equilibrium between aggregate demand for money and aggregate supply of goods and services. When aggregate demand for money exceeds the aggregate supply of goods a restrictive monetary policy shorJd be adopted. On the contrary, when aggregate supply of goods and services exceeds aggregate monetary demands, an expansionary monetary policy should be adopted. Thus, a flexible monetary policy ensures price stabilization which is necessary for economic growth.

ii. The monetary policy should be able to promote capital formation. In other words, it should create favourable atmosphere for promoting saving and investment in the country. For this, the aim of the monetary policy should be to remove price fluctuations and establish reasonable price stability.

3.3 Role of Monetary Policy in Developing Countries

The monetary policy in a developing economy will have to be quite different from that of a developed economy mainly due to different economic conditions and requirements of the two types of economies. A developed country may adopt full employment or price stabilisation or exchange stability as a goal of the monetary policy. But in a developing or underdeveloped country, economic growth is the primary and basic necessity. Thus, in a developing economy, the monetary policy should

aim at promoting economic growth. The monetary authority of a developing economy can play a vital role by adopting such a monetary policy which creates conditions necessary for rapid economic growth. Monetary policy can serve the following developmental requirements of developing economies.

1. **Developmental Role. In a developing economy, the monetary** policy can play a significant role in accelerating economic development by influencing the supply and uses of credit, controlling inflation, and maintaining balance of payment. Once development gains momentum, effective monetary policy can help in meeting the requirements of expanding trade and population by providing elastic supply of credit.

2. **Creation and Expansion of Financial Institutions. The** primary aim of the monetary policy in a developing economy must be to improve its currency and credit system. More banks and financial institutions should be set up, particularly in those areas which lack these facilities. The extension of commercial banks and setting up of other financial institutions like saving banks, cooperative saving societies-, mutual societies, etc. will help in increasing credit facilities, mobilising voluntary savings of the people, and channelising them into productive uses. It is also the responsibility of the monetary authority to ensure that the funds of the institutions are diverted into priority sectors or industries as per requirements of the development plan of the country.

3. **Effective Central Banking. To meet the developmental needs,** the central bank of an underdeveloped country must function effectively to control and regulate the volume of credit through various monetary instruments, like bank rate, open market operations, cash-reserve ratio etc. Greater and more effective credit controls will influence the allocation of resources by diverting savings from speculative and unproductive activities to productive uses.

4. **Integration of Organised and Unorganised Money Market.** Most underdeveloped countries are characterised by dual monetary system in which a small but highly organised money market on the one hand and large". But unorganised money market operates simultaneously. The un-organised money market remains outside the control of the central bank. By adopting effective measures, the monetary authority should integrate the un-organised and organised sectors of the money market.

5. **Developing Banking Habit. The monetary authority of a less**

developed country should take appropriate measures to increase the proportion of bank money in the total money supply of the country. This requires increase in the bank deposits by developing the banking habits of the people and popularising the use of credit instruments (e.g. cheques, drafts, etc).

6. Monetisation of Economy. An underdeveloped country is also marked by the existence of large non-monetised sector. In this sector, all transactions are made through barter system and changes in money supply and the rate of interest do not influence the economic activity at all. The monetary authority should take measures to monetise this non-monetised sector and bring it under its control.

7. Integrated Interest Rate Structure. In an underdeveloped economy, there is absence of an integrated interest rate structure. There is wide disparity of interest rates prevailing in the different sectors of the economy and these rates do not respond to the changes in the bank rate, thus making the monetary policy ineffective. The monetary authority should take effective steps to integrate the interest rate structure of the-economy. Moreover, a suitable interest rate structure should be developed which not only encourages savings and investment in the country but also discourages speculative and unproductive loans.

8. Debt Management. Debt management is another function of monetary policy in a developing country. Debt management aims at (a) deciding proper timing and issuing of government bonds, (b) stabilising their prices and (c) minimising the cost of servicing public debt. The monetary authority should conduct the debt management in such a manner that conditions are created "in which public borrowing can increase from year to year and on a big scale without giving any jolt to the system. And this must be on cheap rates to keep the burden of the debt low. However, the success of debt management requires the existence of a well-developed money and capital market along with a variety of short-term and long-term securities.

9. Maintaining Equilibrium in Balance of Payments: The monetary policy in a developing economy should also solve balance of payments problems. Such a problem generally arises in the initial stages of economic development when the import of machinery, raw material, etc., increase considerably, but the export may not increase to the same extent. The monetary authority should adopt direct foreign exchange controls and other

measures to correct the adverse balance of payments.

10. Controlling Inflationary Pressures. Developing economies are highly sensitive to inflationary pressures. Large expenditures on developmental schemes increase aggregate demand. But output of consumers does not increase in the same proportion. This leads to inflationary rise in prices. Thus, the monetary policy in a developing economy should serve to control inflationary tendencies by increasing savings by the people, checking expansion of credit by the banking system, and discouraging deficit financing by the government.

11. Long-Term Loans for Industrial Development. Monetary policy can promote industrial development in the underdeveloped countries by promoting facilities of medium-term and long-term loans to the manufacturing units. The monetary authority should induce these banks to grant long-term loans to the industrial units by providing rediscounting facilities. Other development financial institutions also provide long-term productive loans.

12. Reforming Rural Credit System. Rural credit system is defective and rural credit facilities are deficient in the underdeveloped countries. Small cultivators are poor, have no finance of their own, and are largely dependent on loans from village money lenders and traders who generally exploit the helplessness, ignorance and necessity of these poor borrowers. The monetary authority can play an important role in providing both short-term and long term credit to the small arrangements, such as the establishment of cooperative credit societies, agricultural banks etc.

SELF ASSESSMENT EXERCISE

Outline and discuss the role of monetary policy in developing countries.

4.0 CONCLUSION

It is true that monetary policy in a developing economy can play a positive role in facilitating the process of economic development by influencing the supply and use of credit through well-developed credit institutions, checking inflation, maintaining balance of payments equilibrium, providing loan facilities to industrial and agricultural sectors, and so on. But it must be clearly borne in mind that the role of monetary policy in economic development is secondary and indirect, and not primary and direct. The fundamental problem of underdeveloped countries is that of inadequate saving which cannot be

solved merely by creating financial institutions. The growth of saving basically depends upon the increase in productive capacity and income of the country. Financial institutions only provide facilities to encourage savings to enhance the process of economic development. They are not the primary movers of economic development. AS Meier and Baldwin put it, "The currency and credit system must be responsive to the stimuli of development, but monetary and financial institutions in themselves cannot be expected to be the primary and active movers of development in a direct sense."

5.0 SUMMARY

In this unit, we have learnt the meaning and objectives of monetary policy. We have also learnt the role of monetary policy in developing countries.

6.0 TUTOR-MARKED ASSIGNMENT

Define the term monetary policy.

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UNIT 4 MEANING AND EVOLUTION OF BANKING

CONTENTS

1.0 INTRODUCTION

Various attempts have been made to define the term bank or banker. In this unit, we shall define the term bank or banker. We shall also trace the origin of banking.

2.0 OBJECTIVES

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

- Explain the meaning of a Bank, Banking or Banker
- Trace the evolution of Banking in Nigeria.

3.0 MAIN CONTENT

3.1 Meaning of Bank

As a result of different kinds of banks in existence nowadays, it would be difficult, or at least cumbersome, to formulate a definition of banking which connotes the diverse activities of all kinds of banks. We shall therefore consider the definition under three view points:

a) Definitions of bank or banker by Text-Book Writers
b) Definitions of bank or banker by Status
c) Definitions of bank or banker as expressed by the Courts

a) Definitions of bank or banker by Text-Book Writers: A bank has been defined by Dr. Hart as " a person or company carrying on the business of receiving moneys, and collecting drafts, for customers subject to the obligation of honouring cheques drawn upon them from time to time by the customers Lo the extent of the amounts available on the current accounts".

In his 8th edition, published in 1972 Paget defined "a bank or banker as a corporation or person (or group of persons) who accept moneys on current accounts, pay cheques drawn upon such account on demand and collect cheques for customers, that if such minimum services are afforded to al and sundry without restriction of any kind, the business is a banking business, whether or not other business is undertaken at the same time; that providing the banking business as so understood is not a mere for other business, the person or corporation is a banker or bank for the purposes of statutes relating to banking, other than those where the sole criterion is the satisfaction of some government department".

Chamber's Twentieth Century Dictionary defines a bank as an "institution for the keeping, lending and exchanging, etc of money. Economists have also defined a bank highlighting its various functions. According to Crowther, "The banker's business is to take the debts of other people to offer his own in exchange, and thereby create money." A similar definition has been given by Kent who defines a bank as "an organisation whose principal operations are concerned with the accumulation of the temporarily idle money of the general public for the purpose of advancing to others for expenditure." Sayets, on the other hand, gives a still more detailed definition of a bank thus: "Ordinary banking business consists of changing cash for bank deposits and band deposits for cash; transferring bank deposits from one person or corporation (one 'depositor') to another; giving bank deposit in exchange for bills of exchange, government bonds, the secured or unsecured promises of businessmen to repay, etc. Thus a bank is an institution, which accepts deposits from the public and in turn advances loans by creating credit. It is different from other financial institutions in that they cannot create credit though they may be accepting deposits and making advances.

b) Definitions by Statutes: There are no definitions by statute that are of more value. All we can see from the statutes are that both the Bills of Exchange Act 1882 and the Stamp Act, 1891 attempted to define a banker as any person carrying on the business of banking. In fact, section 2 of the Bills of Exchange Act, 1882 provides that "in this Act, unless the context otherwise requires ..... a 'banker' includes a body of persons, whether incorporated or not, who carry on the business of banking".

A Bank is "a company which carries on as its principal business the accepting of deposits of money on current account or otherwise, subject to withdrawal by cheque, draft or order".

> The 1958 Banking Ordinance defined banking as "the business of receiving money on current account, of paying and collecting cheques drawn by or paid in by customers, and of making advances to customer".

Section 2 of the bills of exchange Act 1958 defines a banker as follows:

Banker includes a body of persons whether incorporated or not who carry on the business of banking. But section 2 of the Coins Act 1958 state that bankers means any corporation carrying on the business of banker or financial agents. Again section 2.1 of the Nigerian Evidence Act 1958 provides that a bank and banker means any persons, partnership or company carrying on the business of bankers and also include any savings established under the savings bank ordinance and also any banking company incorporated under any ordinance hereto or hereinafter passed relating to such incorporation. Also under section 4.1 of the banking Act 1969 the term bank is defined as follows: Bank means any person who carries on banking business and include a commercial bank, an acceptance house, a discount house and financial institution

c) Definitions as expressed by the Courts: There are a number of

> decided cases where the definition of a banker has been made. For example, there was a traditionally expressed view that no one may be considered a banker unless he pays cheques drawn on self. This was re-affirmed by Justice J. Mocatta (1965) and was supported by the Court of Appeal in the celebrated case of United Dominions Trust Ltd. Versus Kirwood (1966).

3.2 Evolution of Banking

Banking is generally known to have started by the Italian goldsmiths who settled down into business in London in about the seventeenth century. They began by accepting deposits of gold coins and other valuables from their customers for safekeeping As the volume of this business grew they had to build large strong rooms where these customers' valuable items were kept until demands were made on them by the depositors. But from empirical observations, they found out that not all that were deposited were needed at any particular time. And so they began giving out part of the money deposited to interested borrowers by way of loans. They charged some amount of interest. The acceptance of deposits and granting of loans are still some of the basic banking functions all over the world today.

It must be borne in mind that the forerunner of the modern banking started and performed virtually all the present functions of modern

banking. The acceptance of their customers' letter of instruction to transfer funds from his or her holding to another represents the present day cheque system. After all a cheque is merely an instruction on a legalised paper from one customer to the banker requesting him (the banker) to pay money written on the cheque to a named beneficiary.

The Goldsmiths' receipts to their clients became the first known issue of notes, though they were not legal tender. These receipts later became transferable instruments.

As the individual goldsmith's business expanded, it became necessary for them to organise themselves into groups to form Merchant and private banks. As a result of the fast expanding activities of these goldsmiths and the huge financial involvement by individual citizens, it became necessary to protect both the depositors and the goldsmiths. In consequence, therefore, the British Government in 1694 established the Bank of England to regulate the control these merchant and private banks amongst other functions.

In Nigeria, banking came with the advent of colonial masters - the British colonists. The introduction of the first modern banking dated back to 1892, when the African Banking Corporation was established in Lagos at the invitation of Elder Dempster and Company. African Banking Corporation was based in South Africa but merely opened a branch office in Lagos to finance the shipping business of Elder Dempster and Company who was operating steamship services between Liverpool and the West Coast of Africa. Probably as a result of the good performances of the African banking Corporation, another bank opened its branch office in Lagos in 1894. The bank was The Bank of British West Africa (now known as First Bank of Nig. Pic), which was registered in London in 1892 with an authorised capital of £100,000 (or N200,000). This bank enjoyed the monopoly over banking business in Nigeria until 1916. Until this date, however, the bank (B.B.W.A.) was the sole agent for the custody and distribution of British silver currency in West Africa as issued by the West African Currency Board, which was established in 1912.

The Bank of British West Africa remained dominant in the field until 1916 when the Colonial Bank, which was established. As a result of its dynamism, the bank opened fifteen branches within four years it was established in West Africa. In 1925, the assets and liabilities of this bank were taken over by a consortium of banks comprising Barclays Bank, Anglo-Egyptian Bank and the National Bank of South Africa to form a new bank named Barclays Banks, D.C.O. (Dominion, Colonial and Overseas). This new bank had to change its name to Barclays Bank of Nigeria Ltd., and later to Union Bank of Nigeria Limited. Other

expatriate banks such as United Bank for Africa, Arab Bank, International Bank for West Africa, Bank of India, Bank of America later Savannah Bank and Chase Manhattan Bank were later introduced into Nigeria.

These banks were established by the colonial government and businessmen and as such they were mainly catering for the interest of expatriates. The indigenous men and women and their enterprises were severally discriminated against. This discriminatory attitude of these foreign banks led to the first known protest by the Nigerian business community in 1892. This was followed by an appeal from the native traders of Lagos to the Financiers from Great Britain when they visited Lagos in 1912. The height of these protests was the establishment in Lagos of the first indigenous financial institution known as the Industrial and Commercial bank in 1929. This protest "motivated" bank which was established primarily to moderate the effects of the discriminatory credit and investment policies of the expatriate banks against the indigenous enterprises went into liquidation 1930.

In 1931 another indigenous banking institution; the Nigerian Mercantile Bank was formed with an initial paid-up capital of N3,400. Its total deposits did not exceed N5,000 before it voluntarily liquidated in 1936. This bank had the same Managing Director with first indigenous bank (the Industrial and Commercial bank) that liquidated in 1930. The failures of these banks were largely due to inadequate capital, inexperience management and inefficient and crude accounting method, as well as the prevailing depressed economic conditions at the time.

In spite of these woeful failures the determination of Nigerians to own, control and manage their own banks continued. However, successful indigenous banking efforts in Nigeria thus began with the establishment of the National Bank of Nigeria Ltd., in 1933. The bank started with a nominal capital of N20,000 and the paid-up capital grew from N2,046 in 1936 to N29,108 in 1946. The deposits liabilities grew from N7,830 in 1936 to N345,930 in 1946 and Loans/Advances grew from N9,486 to N220,000 during the same period.

The favourable outcome of the effort the then Western Region of Nigeria Government in establishing the National Bank of Nigeria; the continuing need to provide banking credits to the indigenous enterprises and the buoyancy of the economic conditions during the post-world war years encouraged others to establish indigenous banks. In any case, between 1945 and 1960 a total of twenty three indigenous banks were established and twenty of them had either failed or surrendered their licences and three survived. The historical development of commercial banking in Nigeria is well documented. Detailed analysis can be found in various books.

Nigeria appears to be unique among the African Colonial territories in having an early experience of active indigenous commercial banking, although this sector had constantly been dwarfed by the expatriate sector in terms of percentage and absolute shares of assets and liabilities. Indeed, the development of the commercial banking system in Nigeria has been along oligopolistic lines in which a few expatriate banks control the market. This is to be expected, given the fact that banking services were established to serve the needs of the modern sectors (that is, the government, foreign trade, commerce and industries), which were entirely dominated by the expatriates. For the experiences of other developing economies, see E. Nevin.

Between 1951 and 1954 many indigenous banks tottered, faltered, limped and died. In fact these failures were of great magnitude. Various governments in Nigeria have come up with different measures in order to tackle the problem of bank failure. Some of these measures have contributed to strengthening the banking sector of the economy. We shall discuss some of these measures in a latter unit under regulation. Nigeria as at today (2007) has twenty-five commercial banks as a result of the recapitalization policy introduced by the Central Bank of Nigeria.

SELF-ASSESSMENT EXERCISE

Trace the evolution of banking in Nigeria.

4.0 CONCLUSION

In conclusion, there are various definitions of banker or banking. You have seen that both banker and, bank means one and the same thing. We know that banking has undergone some evolution.

5.0 SUMMARY

In this unit, we have discussed the meaning of a Bank or Banker where in we explained that they all mean one and the something. We have also traced the evolution of Banking in Nigeria where we mention that it started with the British colonialists before the indigenous banks were later established.

6.0 TUTOR-MARKED QUESTION

Banking has been defined in various ways. Give some of these definitions.

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UNIT 5 THE CENTRAL BANK

CONTENTS

1.0 INTRODUCTION

In this unit, we shall explain the meaning of a central bank and trace its origin in Nigeria. We shall in addition discuss the functions of the central bank.

2.0 OBJECTIVES

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

- Explain what is meant by the central bank,
- Trace its origin in Nigeria.
- Discuss the functions of the Central Bank.

3.0 MAIN CONTENT

3.1 The Central Bank

The central bank is the apex bank in a country. It is called by different names in different countries. It is the Reserve Bank of India in India, the Bank of England in England, the Federal Reserve System in USA, the Bank of France in France in Nigeria it is called the Central Bank of Nigeria.

DIFFERENCES BETWEEN CENTRAL BANK AND COMMERCIAL BANKS

1. The central bank is the apex institution of the monetary and banking structure of the country. The commercial bank is one of the organs of the money market.
2. The central bank is a no-profit institution which implements the economic policies of the government. But the commercial bank is a profit-making institution.

3. The central bank is owned by the government, whereas the commercial bank is owned by shareholders.
4. The central bank is a banker to the government and does not engage itself in ordinary banking activities. The commercial is a banker to the general public.
5. The central bank has the monopoly of notes issue. They are legal tender while the commercial bank can issue only cheques. But the cheques are in the nature of near-money.
6. The central bank is the banker's bank. As such, it grants accommodations to other banks in the form of rediscount facilities, keeps their cash reserves, and clears their balances. On the other hand, the commercial bank advances loans to and accepts deposits from the public.
7. The central bank controls credit in accordance with the needs of business and economy. The commercial bank creates credit to meet the requirements of business.
8. The central bank helps in establishing financial institutions so as to strengthen money and capital markets in a country. On the other hand, the commercial bank helps industry by underwriting shares and debentures, and agriculture by meeting its financial requirements through cooperatives or individually.
9. Every country has only one central bank with its offices at important centres of the country. On the other hand, there are many commercial banks with hundreds of branches within and outside the country.
10. The central bank is the custodian of the foreign currency reserves of the country. While the commercial bank is the dealer of foreign currencies.
11. The chief executive of the central bank is designated as "Governor", whereas the chief executive of the commercial bank is called 'Chairman'.

A central bank has been defined in terms of its functions. According to Vera Smith, "The primary definition of central bank is a banking system in which a single bank has either complete control or a residuary monopoly of note issue." W. A. Shaw defines a central bank as a bank which controls credit. To Hawtrey, a central bank is the lender of the last resort. According to A. C. L. Day, a central bank is "to help control and stabilise the monetary and banking system"-according to Sayers. The central bank "is the organ of government that undertakes the major financial operations of the government and by its conduct of these operations and by other means, influences the behaviour of financial institutions so as to support the economic policy of the Government." Sayers refers only to the nature of the central bank as the government's bank. All these definitions are narrow because they refer only to one particular function of a central bank.

On the other hand, Samuelson's definition is wide. According to him, a central bank "is a bank of bankers. Its duty is to control the monetary base and through control of this 'high-powered money' to control the community's supply of money". But the broadest definition has been given by De Kock. In his word, a central bank is "a bank which constitutes the apex of the monetary and banking structure of its country and which performs as best as it can in the national economic interest, the following functions: (i) The regulation of currency in accordance with the requirements of business and the general public for which purpose it is granted either the sole right of note issue or at least a monopoly thereof, (ii) The performance of general banking agency for the state. (Hi) The custody of the cash reserves of the commercial banks, (iv) The custody and management of the nation's reserves of the international currency, (v) The granting of accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions and the general acceptance of the responsibility of lender >f the last resort.(vi) The settlement of clearance balances between the banks. (vii) The control of credit is in accordance with the needs of business and with a view to carrying out the broad monetary policy adopted by the state."

3.2 Functions of the Central Bank

A central bank performs the following functions, as given by De Kock and accepted by the majority of economists.

1. Regulator of Currency

The central bank is the bank of issue. It has the monopoly of note issue. Notes issued by it circulate as legal tender money. It has its issue department which issues notes and coins to commercial banks. Coins are manufactured in the government mint but they are put into circulation through the central bank.

Central banks have been following different methods of note issue in different countries. The central bank is required by law to keep a certain amount of gold and foreign securities against the issue of notes. In some countries, the amount of gold and foreign securities bears a fixed proportion, between 25 to 40 percent of the total notes issued. In other countries, a minimum fixed amount of gold and foreign currencies is required to be kept against note issue by the central bank. This system is operative in India whereby the Reserves Bank of India is required to keep Rs 115 crores in gold and Rs 85 crores in foreign securities. There is no limit to the issue of notes after keeping this minimum amount of Rs 200 crores in gold and foreign securities.

The monopoly of issuing notes vested in the central bank ensure uniformity in the notes issued which helps in facilitating exchange and trade within the country. It brings stability in the monetary system and creates confidence among the public. The central bank can resist or expand the supply of cash according to the requirements of the economy. Thus it provides elasticity to the monetary system. By having a monopoly of note issue, the central bank also controls the banking system by being the ultimate source of cash. Last but not the least, by entrusting the monopoly of note issue to the central bank, the government is able to earn profits from printing notes whose cost is very low as compared with their face value.

2. Banker, Fiscal Agent and Adviser to the Government

Central banks everywhere act as bankers, fiscal agents and advisers to their respective governments. As banker to the government, the central bank keeps the deposits of the central and state governments and makes payments on behalf of governments. But it does not pay interest on government deposits. It buys and sells foreign currencies on behalf of the government. It keeps the stock of gold of the government. Thus it is the custodian of government money and wealth. As a fiscal agent, the central bank makes short-term loans to the government for a period not exceeding 90 days. It floats loans, pays interest on them, and finally repays them on behalf of the government. Thus it manages the entire public debt. The central bank also advises the government on such economic and money matters as controlling inflation or deflation, devaluation or revaluation of the currency, deficit financing, balance of payments, etc. As pointed out by De Kock, "Central banks everywhere operates as bankers to the state not only because it may by more convenient and economical to the state, but also because of the intimate connection between public finance an monetary affairs."

3. Custodian of Cash Reserves of Commercial Banks

Commercial banks are required by law to keep reserves equal to a certain percentage of both time and demand deposits liabilities with the central banks It is on the basis of these reserves that the central bank transfers funds from one bank to another to facilitate the clearing of cheques. Thus the central bank acts as the custodian of the cash reserves of commercial banks and helps in facilitating their transactions. There are many advantages of keeping the cash reserves of the commercial banks with the central bank, according to De Kock. In the first place the centralization of cash reserves in the central bank is a source of great strength to the banking system of a country. Secondly, centralised cash reserves can serve as the basis of a large and more elastic structure than if the same amount were scattered among the individual credit

banks. Thirdly, centralised cash reserves can be utilised fully and most effectively during periods of seasonal strains and in financial crises or emergencies. Fourthly, by varying these cash reserves the central bank can provide additional funds on a temporary and short term basis to commercial banks to overcome their financial difficulties.

4. Custodian and Management of Foreign Exchange Reserves

The central bank keeps and manages the foreign exchange reserves of the country. It is an official reservoir of gold and foreign currencies It sells gold at fixed prices to the monetary authorities of other countries. It also buys and sells foreign currencies at international prices. Further, it fixes the exchange rates of the domestic currency in terms of foreign currencies. It holds these rates within narrow limits in keeping with its obligations as a member of the International Monetary Fund and tries to bring stability in foreign exchange rates. Further, it manages exchange control operations by supplying foreign currencies to importers and persons visiting foreign countries on business, studies, etc. in keeping with the rules laid down by the government.

5. Lender of the Last Resort

De Kock regards this function as a sine qua non of central banking. By granting accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions, the commercial bank acts as the lender of the last resort. The central bank lends to such institutions in order to help them in times of stress so as to save the financial structure of the country from collapse. It acts as lender of the last resort through discount house on the basis of treasury bills, government securities and bonds at "the front door" The other method is to give temporary accommodation to the commercial banks or discount houses directly through the "back door". The difference between the two methods is that lending at the front door is at the bank rate and in the second case at the market rate. Thus the central bank as lender of the last resort is a big source of cash and also influences prices and market rates.

6. Clearing House for Transfer and Settlement

As banker's bank, the central bank acts as a clearing house for transfer and settlement of mutual claims of commercial banks. Since the central bank holds reserves of commercial banks, it transfers funds from one bank to other banks to facilitate clearing of cheques. This is done by making transfer entries in their accounts on the principle of book-keeping. To transfer and settle claims of one bank upon others, the central bank operates a separate department in big cities and trade

centres. This department is known as the "clearing house" and it renders the service free to commercial banks.

When the central bank acts as a clearing agency, it is time-saving and convenient for the commercial banks to settle their claims at one place. It also economizes the use of money. "It is not only a means of economizing cash and capital but is also a means of testing at any time the degree of liquidity which the community is maintaining."

7. Controller of Credit

The most important function of the central bank is to control the credit creation power of commercial bank in order to control inflationary and deflationary pressures within this economy. For this purpose, it adopts quantitative methods and qualitative methods. Quantitative methods aim at controlling the cost and quantity of credit by adopting bank rate policy, open market operations, and by variations in reserve ratios of commercial banks. Qualitative methods control the use and direction of credit. These involve selective credit controls and direct action. By adopting such methods the central bank tries to influence and control credit creation by commercial banks in order to stabilize economic activity in the country.

Besides the above noted functions, the central banks in a number of developing countries have been entrusted with the responsibility of developing a strong banking system to meet the expanding requirements of agriculture, industry, trade and commerce. Accordingly, the central banks possess some additional powers of supervision and control over the commercial banks. They are the issuing of licences, the regulation of branch expansion; to see that every bank maintains the minimum paid up capital and reserves as provided by law; inspecting or auditing the accounts of banks; to approve the appointment of chairmen and directors of such banks in accordance with the rules and qualifications; to control and recommend merger of weak banks in order to avoid their failures and to protect the interest of depositors; to recommend nationalisation of certain banks to the government in public interest; to publish periodical reports relating to different aspects of monetary and economic policies for the benefit of banks and the public; and to engage in research and train banking personnel etc.

SELF-ASSESSMENT EXERCISE

Discuss the functions of a central bank.

4.0 CONCLUSION

We can conclude that the Central Bank performs a lot of functions which helps in the monetary system of the economy.

5.0 SUMMARY

We have explained the meaning of the central bank and that there is only one Central, bank with different names in different countries for example In Nigeria it is called the Central Bank of Nigeria and in England it is the Bank of England. The various functions of the central bank have also been discussed.

6.0 TUTOR-MARKED ASSIGNMENT

Explain what you understand by the term central bank.

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MODULE 3

Unit 1 The Role of Central Bank
Unit 2 The Commercial Bank
Unit 3 Credit Creation by Commercial Bank
Unit 4 Merchant and Development Banks
Unit 5 The Nigerian Deposit Insurance Corporation

UNIT 1 THE ROLE OF CENTRAL BANK

CONTENTS

1.0 INTRODUCTION

In this unit we shall discuss the role of the Central Bank towards the development of an economy. The central bank in a developing economy performs both traditional and non-traditional functions. The principal traditional function performed by it are the monopoly of note issue, banker to the government, bankers' bank, lender of the last resort controller of credit and maintaining stable exchange rate. But all these functions are related to the foremost function of helping in the economic development of the country. The credit control measure of the central bank is also vital towards the development of an economy.

2.0 OBJECTIVES

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

- Discuss the role which a central bank can play towards the development of an economy.
- Discuss the credit control measure of the central bank.

3.0 MAIN CONTENT

3.1 Role of Central Bank (In a Developing Economy)

The central bank in a developing" country aims at the promotion and maintenance of a rising level of production, employment and income in the country. The central banks in the majority of underdeveloped countries have bee given wide powers to promote the growth of such economies. They, therefore, perform the following functions towards this end.

Creation and Expansion of Financial Institutions: One of the aims of a central bank in an underdeveloped country is to improve its currency and credit system. More banks and financial institutions are required to be set up to provide larger credit facilities and to divert voluntary savings into productive channels. Financial institutions are localized in big cities in underdeveloped countries and provide credit facilities to estates, plantations, big industrial and commercial houses. In order to remedy this, the central bank should extend branch banking to rural areas to make credit available to peasants, small businessmen and traders. In underdeveloped countries, the commercial banks provide only short-term loans. Credit facilities in rural areas are mostly non-existent. The only source is the village moneylender who charges exorbitant interest rates. The hold of the village moneylender in rural areas can be slackened if new institutional arrangements are made by the central bank in providing short-term, medium term and long-term credit at lower interest rates to the cultivators. A network of co-operative credit societies with apex banks financed b the central bank can help solve the problem. Similarly, it can help the establishment of lead banks and through them regional rural banks for providing credit facilities to marginal farmers, landless agricultural workers and other weaker sections. With the vast resources at its command, the central bank can also help in establishing industrial banks and financial corporations in order to finance large and small industries.

Proper Adjustment between Demands for and Supply of Money: The central bank plays an important role in bringing about a proper adjustment between demand for and supply of money. An imbalance between the two is reflected in the price level. A shortage of money supply will inhibit growth while an excess of it will lead to inflation. As the economy develops, the demand for money is likely to go up due to gradual monetization of the non-monetized sector and the increase in agricultural and industrial production and prices. The demand for money for transactions and speculative motives will also rise. So the increase in money supply will have to be more than proportionate to the increase in

the demand for money in order to avoid inflation. There is, however, the likelihood of increased money supply being used for speculative purpose, thereby inhibiting growth and causing inflation. The central bank controls the uses of money and credit by an appropriate monetary policy. Thus in an underdeveloped economy, the central bank should control the supply of money in such a way that the price level is prevented from rising without affecting investment and production adversely.

A Suitable Interest Rate Policy: In an underdeveloped country the interest rate structure stands at a very high level. There are also vast disparities between long-term and short-term interest rates and between interest rates in different sectors of the economy. The existence of high interest rates acts as an obstacle to the growth of both private and public investment, in an underdeveloped economy. A low interest rate is, therefore, essential for encouraging private investment in agriculture and industry. Since in an underdeveloped country businessmen have little savings cut of undistributed profiles, they have to borrow from the banks or from the capital market for purposes of investment and they would borrow only if the interest rate is low A low interest rate policy is also essential for encouraging public investment. A low interest rate policy a cheap money policy. It make public borrowing cheap, keeps the cost of serving public debt low, and thus helps in financing economic development.

In order to discourage the flow of resources into speculative borrowing and investment, the central bank should follow a policy of discriminatory interest rates, charging high rates for non-essential and unproductive loans and low rates for productive loans. But this does not imply that savings are interest-elastic in an underdeveloped economy. Since the level of income is low in such economies, a high rate of interest is not likely to raise the propensity to save. In the context of economic growth, as the economy develops, a progressive rise in the price level is inevitable. The value of money falls and the propensity to save declines further. Money conditions become tight and there is a tendency for the rate of interest to rise automatically. This would result in inflation. In such a situation any effort to control inflation by raising the rate of interest would be disastrous. A stable price level is, therefore, essential for the success of a low interest rate policy which can be maintained by following a judicious monetary policy by the central bank.

Debt Management: Debt management is on of the important functions of the central bank in an underdeveloped country. It should aim at proper timing and issuing of government bonds, stabilizing their prices and minimizing the cost of servicing public debt. It is the central bank

which undertakes the selling and buying of government bonds and making timely changes in the structure and composition of public debt

In order to strengthen and stabilize the market for government bonds, the policy of low interest rates is essential. For, a low rate of interest raises the price of government bonds, thereby making them more attractive to the public and giving an impetus to the public borrowing programmes of the government. The maintenance of structure of low interest rates is" also called for minimizing the cost of servicing the national debt. Further, it encourages funding of debt by private firms. However, the success of debt management would depend upon the existence of well-developed money and capital markets in which wide range of securities exist both for short and long periods. It is the central bank which can help in the development of these markets.

Credit Control: Central Bank should also aim at controlling credit in order to influence the patterns of investment and production in a developing economy. Its main objective is to control inflationary pressures arising in the process of development. This requires the use of both quantitative and qualitative methods of credit control

Open market operations are not successful in controlling inflation in underdeveloped countries because the bill market is small and undeveloped. Commercial banks keep an elastic cash-deposit ratio because the central bank's control over them is not complete. They are also reluctant to invest in government securities due to their relatively low interest rates. Moreover, instead of investing in government securities, they prefer to keep their reserves in liquid form such as gold, foreign exchange and cash. Commercial banks are also not in the habit of rediscounting or borrowing form the central bank.

The bank rate policy is also not so effective in controlling credit in Less Developed Countries due to:

a) The lack of bills of discount;
b) The narrow size of the bill market;
c) A large non-monetised sector where barter transactions take place.
d) The existence of a large unorganized money market;
e) The existence of indigenous banks which do not discount bills with the central bank; and
f) The habit of commercial banks to keep large cash reserves.

The use of variable reserve ratio as method of credit control is more effective than open market operations and bank rate policy in LDCs. Since the market for securities is very small, open market operations are not successful. But a rise or fall in the reserve ratio by the central bank

reduces or increases the cash available with the commercial banks without affecting adversely the prices of securities. Again, the commercial banks keep large cash reserves which cannot be reduced by a raise in the bank rate or sale of securities by the central bank. But raising then cash-reserve ratio reduces liquidity with the banks. However, the use of variable reserve ratio has certain limitations in LDCs. First, the non-banking financial intermediaries do not keep deposits with the central bank so they are not affected by it. Second, banks which do not maintain excess liquidity are not affected than those who maintain it.

The qualitative credit control measures are, however, more effective than the quantitative measurers in influencing the allocation of credit, and thereby the pattern of investment. In underdeveloped countries, there is a strong tendency to invest in gold, inventories, real estate, etc., instead of in alternative productive channels available in agriculture, mining, plantations and industry. The selective credit controls are more appropriate for controlling and limiting credit facilitates for such unproductive purposes. They are beneficial in controlling speculative activities in food grains and raw materials. They prove more useful in controlling 'sectional inflations' in the economy. They curtail the demand for imports by making it obligatory on importers to deposit in advance an amount equal to the value of foreign currency. This has also the affect of reducing the reserves of the banks in so far as their deposits are transferred to the central banks in the process. The selective credit control measures may take the form of changing the margin requirements against certain types of collateral, the regulation of consumer credit and the rationing of credit.

Solving the Balance of Payments Problem: The central bank should also aim at preventing and solving the balance of payments problem in a developing economy. Such economies face serious balance of payments difficulties to fulfill the targets of development plans. An imbalance is created between imports and exports which continue to widen with development. The central bank manages and controls the foreign exchange of the country and also acts as the technical adviser to the government on foreign exchange policy. It is the function of the central bank to avoid fluctuations in the foreign exchange rates and to maintain stability. It does so through exchange controls and variations in the bank rate. For instance, if the value of the national currency continues to fall, it may raise the bank rate and thus encourage the inflow of foreign currencies.

3.2 Credit Control

Credit control is the regulation of credit by the central bank for achieving some definite objectives. Modern economy is a credit economy because credit has come to play a major role in setting all kinds of monetary and business transactions in the modern economic system. Changes in the volume of credit influence the level of business activity and the price level in the economy. Unrestricted credit creation by the commercial banks, by causing wide fluctuations in the purchasing power of money, may pose a serious threat to the national economy. Hence, it becomes necessary for the central bank to keep the creation of credit under control in order to maintain stability in the economic system.

3.3 Objectives of Credit Control

The important objectives of credit control are as follows.

i. Price stability. Violent price fluctuations cause disturbances and poor adjustment in the economic system and have serious social consequences. Hence, price stability is an important objective of credit control policy. The central bank, by regulating the supply of credit in accordance with the commercial needs of the people, can bring about price stability in the country.

ii. Economic stability. Operation of the business circle brings instability in a capitalist economy. The objective of the credit control policy of the central bank should be to eliminate cyclical fluctuations and ensure economic stability in the economy.

iii. Employment maximization: Unemployment is economically wasteful and socially undesirable. Therefore economic stability with full employment and high per capita income has been considered as an important objective of credit control policy of a country.

iv. Economic Growth: The main objective of credit control policy in the underdeveloped countries should be the promotion of economy growths within the shortest possible time. These countries generally suffer from the deficiency of financial resources. Hence, the central banks in these countries should solve the problem of financial scarcity through planned expansion of bank credit.

v. Stabilisation of Money Market. Another objective of the central bank's credit control policy is the stabilisation of the money market so as to i <; duce the fluctuations in the interest rates to the minimum. Credit control should be exercised in such a way that the equilibrium in the demand and supply of money should be achieved at all times.

vi. Change rate Stability. Exchange rate stability can also be an objective of credit control policy. Instability in the exchange rates is harmful for the foreign trade of the country. Thus, the central bank, in the countries largely dependent upon foreign trade, should attempt to eliminate the fluctuations in the foreign exchange rates through its credit control policy.

3.4 Methods of Credit Control

The various methods or instrument of credit control used by the central bank can broadly be classified into two categories: quantitative or general methods, and qualitative or selective methods.

a) Quantitative or General Methods

The methods used by the central bank to influence the total volume of credit in the banking system, without any regard for the use to which it is put, are called quantitative or general methods of credit control. These methods regulate the lending ability of the financial sector of the whole economy and do not discriminate among the various sectors of the economy. The important quantitative methods of credit control are (a) bank rates (b) open market operations and (c) cash-reserve ratio.

b) Qualitative or Selective Methods

The methods used by the central bank to regulate the flows of credit into particular directions of the economy are called qualitative or selective methods of credit control. Unlike the quantitative methods, which affect the volume of credit, the qualitative methods affect the types of credit extended by the commercial banks; they affect the composition rather than the size of credit in the economy. The important qualitative or selective methods of credit control are; (a) marginal requirements, (b) regulation of consumer credit (c) control through directives (d) credit rationing (e) moral suasion and publicity and (f) direct action.

SELF-ASSESSMENT EXERCISE

Outline and discuss the role of central bank towards the economic development of a nation.

4.0 CONCLUSION

Thus the central bank plays an important role in achieving economic growth of a developing country through the various measures discussed above. It promotes; economic growth with stability, helps in attaining

full employment of resources, overcomes balance of payments disequilibrium and stabilizes; exchange rates. Credit control is the regulation of credit by the central bank for achieving some definite objectives namely, price stability, economic stability, maximization of employment, economic growth, stabilisation of money market and exchange rate stability. The various methods of credit control used by the central bank are the quantitative or general methods and qualitative or selective methods.

5.0 SUMMARY

In this unit we have discussed the roles of central bank towards the development of an economy. We have also discussed the credit control policy of the central bank, the objectives of credit control and the methods of credit control policy of the central bank.

6.0 TUTOR-MARKED ASSIGNMENT

What are the objectives of credit control?

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UNIT 2 THE COMMERCIAL BANKS

1.0 INTRODUCTION

In this unit, we shall explain the meaning of commercial banks and the functions of commercial banks. We shall also explain the roles of commercial banks towards the development of an economy.

2.0 OBJECTIVES

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

- Explain the meaning of commercial banks.
- Discuss the various functions performed by commercial banks and discuss the roles of commercial banks.

3.0 MAIN CONTENT

3.1 Commercial Banks

Commercial banks are those banks which perform all kinds of banking functions such as accepting deposits, advancing loans, credit creation and agency functions. They are also called joint stock banks because they are organised in the same manner as joint stock companies. They usually advance short-term loans to customers. Of late, they have started giving medium-term and long-term loans also. Nigeria as a result of the re-capitalisation policy of the Central Bank, there are about 20 major commercial banks as at the end of December 31st 2005 deadline of the Central Bank. Some of the commercial banks in Nigeria are: First Bank Nigeria Pic., UBA Pic., GTB Pic. Zenith Bank Pic, Unity Bank Pic., Intercontinental Bank Pic. etc.

3.2 Functions of Commercial Banks

Commercial banks perform a variety of functions which can be divided

as: (1) accepting deposits, (2) advancing loans; (3) credit creation; (4) financing foreign trade; (5) agency services, (6) miscellaneous services to customers. These functions are discussed as follows:

i) Accepting Deposits

This is the oldest function of a bank. The banker charges commission for money in its custody when banking was developing as an institution. Nowadays a bank accepts three kinds of deposits form its customers. The first is the savings deposits on which the bank pays small interest to the depositors who are usually small savers. The depositors are allowed to draw their money by cheques up to a limited amount during a week or year. Businessmen keep their deposits in *current accounts. They can withdraw any amount standing to their credit* in current deposits by cheques without notice. The bank does no pay interest on such accounts but instead charges a normal sum for services rendered to its customers. Current accounts are known as demand deposits. Deposits are also accepted by a bank in fixed or time deposits. Savers who do not need money for a stipulated period from 6 months to longer periods ranging up to 10 years or more are encouraged to keep it in fixed deposit accounts. The bank pays a higher rate of interest on such deposit. But there is always the maximum limit of the interest rate which can be paid.

ii) Advancing Loans

One of the primary functions of a commercial bank is to advance loans to customers. A bank lends a certain percentage of the cash lying in deposits on a higher interest rate than it pays on such deposits. This is how it earns profits and carries on its business. The bank advances loans in the following ways:

a) Cash Credit. The bank advances loans to businessmen against certain specified securities. The amount of the loan is credited to the current account of the borrower. In case of a new customer a loan account for the sum is opened the borrower can withdraw money through cheques according to his requirements but pays interest on the full amount.

b) Call Loans. These are very short-term loans advanced to bill brokers for not more than fifteen days. They are advanced against first calls bill or securities. Such loans can be recalled at a very short notice. In normal times they can also be renewed.

c) Overdraft. A bank often permits a businessman 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. But he is charged interest only on the

amount by which his current account is actually overdrawn and not by the full amount of the overdraft sanctioned to him by the bank.

d) Discounting bills of Exchange. If a creditor holding a bill of exchange wants money immediately, the bank provides him the money by discounting the bill of exchange. It deposits the amount of the bill in the current account of the bill-holder after deducting its rate of interest for the period of the loan which is not more than 90 days. When the bill of exchange matures, the bank gets its payment from the banker of the debtor who accepted the bill.

iii) Credit Creation

Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping some cash in reserve for day-today transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

iv) Financing Foreign Trade

A commercial bank finances foreign trade of its customers by accepting foreign bills of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency.

v) Agency Services

A bank acts as an agent of its customers in collecting and paying cheques, bills of exchange, drafts, dividends, etc. It also buys and sells shares, securities, debentures, etc. for its customers. Further, it pays subscriptions, insurance premia, rent; electric and water bills, and other similar charges on behalf of its clients. It also acts as a trustee and executor of the property and will of its customers. Moreover, the bank acts as an income tax consultant to its clients. For some of these services, the bank charges a nominal fee while it renders others free of charge.

vi) Miscellaneous Services

Besides the above noted services, the commercial bank performs a number of other services. It acts as the custodian of the valuables of its customers by providing them lockers where they can keep their

jewellery and valuable documents. It issues various forms of credit instruments, such as cheques, drafts, travellers' cheques, etc. which facilitate transactions the bank also issues letters of credit and acts as a referee to its clients. It underwrites shares and debentures of companies and helps in the collection of funds from the public. Some commercial banks also publish journals which provide statistical information about the money market and business trends of the economy.

3.3 Role of Commercial Banks in a Developing Country

Besides performing the usual commercial banking functions, banks in developing countries play an effective role in their economic development The majority of people in such countries are poor, unemployed and engaged in traditional agriculture There is acute shortage of capital. People lack initiative and enterprise. Means of transport are undeveloped. Industry is depressed. The commercial banks help in overcoming these obstacles and promoting economic development. The role of commercial bank in a developing country is discussed as under.

1. **Mobilising Savings for Capital Formation: The commercial** banks help in mobilizing savings through a 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. They also mobilize idle savings of the few rich. By mobilizing savings, the banks channelise them into productive investments. Thus they help in the capital formation of a developing country.

2. **Financing Industry: The commercial banks finance the** industrial sector in a number of ways. They provide short-term, medium-term and long-term loans to industry in India they provide short-term loans and in some of the Latin American countries like Guatemala they advance medium-term loans for one to three years. But in Korea, the commercial banks also advance long-term and medium-term loans to industry. In India. The commercial banks undertake short-term and medium-term financing of small scale industries, and also provide hire-purchase finance. Besides, they underwrite the shares and debentures of large scale industries. Thus they not only provide finance for industry but also help in developing the capital market which is undeveloped in such countries.

3. **Financing Trade: The commercial banks help in financing both** internal and external trade. The banks provide loans to retailers and wholesalers to stock goods in which they deal. They also

help in the movement of goods from one place to another by proving all types of facilities such as discounting and accepting bills of exchange, providing overdraft facilities, issuing drafts etc. Moreover, they finance both exports and imports of developing countries by providing foreign exchange facilities to importers and exporters of goods.

4. **Financing Agriculture: The commercial banks help the large** agricultural see, or in developing countries in a number of ways. They provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provide agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for the modernization and mechanisation of their farms, for providing, irrigation facilities, for developing land, etc. They also finance poultry farming, pisci- culture and horti-culture. The small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through the regional rural banks in India. These regional rural banks operate under a commercial bank. Thus the commercial banks meet the credit requirements of all types of rural people.

5. **Financing Consumer Activities: People in underdeveloped** countries being poor and having low incomes do not possess sufficient financial resources to buy durable consumer goods. The commercial banks advance loans to consumers for the purchase of such items as house, scooters, fans, refrigerators, etc. In this way, they also help in raising the standard of living of the people in developing countries by providing loans for consumptive activities.

6. **Financing Employment Generating Activities: The** commercial banks finance employment generating person studying in engineering, medical and other vocational institutes of higher learning. They advance loans to young entrepreneurs, medical and engineering graduates, and other technically trained persons in establishing their own business. Such loan facilities are being provided by a number of commercial banks in India. Thus the banks not only help in human capital formation but also in increasing entrepreneurial activities in developing countries.

7. **Help in Monetary Policy: The commercial banks help the** economic development of a country by faithfully following the monetary policy of the central bank. In fact, the central bank depends upon the commercial banks for the success of its policy of monetary management in keeping with requirements of a

developing economy. Thus the commercial banks contribute much to the growth of a developing economy by granting loans to agriculture, trade and industry, by helping in physical and human capital formation and by following the monetary policy of the country.

SELF-ASSESSMENT EXERCISE

i. Discuss the various functions performed by commercial banks.
ii. Outline and discuss various roles performed by the Commercial Bank.

4.0 CONCLUSION

We conclude that commercial banks are those banks which perform all kinds of banking functions such as accepting deposits, advancing loans, credit creation and agency functions. Commercial banks perform varieties of function in an economy.

Commercial banks also perform various roles towards the development of an economy.

5.0 SUMMARY

In this unit, we have learnt the meaning and functions of commercial banks. We have also learnt that these banks play so many roles towards the development of an economy.

6.0 TUTOR-MARKED ASSIGNMENT

What is a commercial bank?

7.0 REFERENCES/FURTHER READINGS

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UNIT 3 CREDIT CREATION BY COMMERCIAL BANKS

CONTENTS

1.0 INTRODUCTION

In this Unit, we shall look at how commercial banks create money deposits otherwise known as credit creation by commercial banks.

2.0 OBJECTIVES

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

- Discuss credit creation otherwise known as money creation by commercial banks,

3.0 MAIN CONTENT

3.1 Credit Creation by Commercial Banks

The creation of credit or deposits is one of the most important functions of commercial banks. Like other corporations, banks aim at earning profits. For this purpose, they accept cash in demand deposits, and advance loans on credit to customers.' When a bank advances a loan, it does not pay the amount in cash. But it opens a current account in his name and allows him to withdraw the required sum by cheques. In this way, the bank creates credit or deposits.

Demand deposits arise in two ways: one, when customers deposit currency with commercial banks, and two, when banks advances loans, discount bills, provide overdraft facilities, and make investment through bonds and securities. The first type of demand deposits is called 'primary deposits'. Banks play a passive role in opening them. The second type of demand deposits are called 'derivative deposits"

Banks actively create such deposits.
Do banks really create credit or deposits?

There have been two views on this subject: one held by certain economists like Hartley Withers, and the other held by practical bankers like Walter Leaf.

According to Withers, banks can create credit by opening a deposit, every time they advance a loan. This is because every time a loan is sanctioned, payment is made through cheques by the customers. All such payments are adjusted through the clearing house. So long as a loan is due, a deposit of that amount remains outstanding in the books of the bank. Thus every loan creates a deposit. But this is an exaggerated and extreme view.

Dr Leaf and practical bankers do not agree with this view. They go to the opposite extreme. They hold that banks cannot create money out of thin air. They can lend only what they have in cash. Therefore, they cannot and do not create money.

This view is also wrong because it is based on arguments relating to a single bank.

As appointed out by Prof. Samuelson, "The banking system as a whole can do what each small bank cannot do: it can expand its loans and investments many times the new reserves of cash created for it, even though each small bank is lending out only a fraction of its deposits.

In fact, a bank is not a cloak room where one can keep currency notes and claim those very notes when one desires. Banks know by experience that all depositors do not withdraw their money simultaneously. Some withdraw while others deposit on the same day. So by keeping a small cash in reserve for day-to-day transactions, the bank is able to advance loans on the basis of excess reserves. When the bank advances a loan it opens an account in the name of the customer. The bank knows by experience that the customer will withdraw money by cheques which will be deposited by his creditors in this bank or some other banks, with whom they have their accounts. Settlements of all such cheques are made in the clearing house. The same procedure is followed in other banks. The banks are able to create credit or deposits by keeping small cash in reserves and lending the remaining amount.

In granting a loan, a bank actively creates a claim against itself and in favour of the borrower "The Claim the banks take from its customers, in exchange for the deposit entered in the books are the bank's assets. The standard assets of a commercial bank are overdrafts and loans, bill

discounted, investments and cash".

The bank provides overdraft facility to a customer on the basis of some security. It enters the amount of the overdraft in the existing account of the customer and allows him to draw cheques for the overdraft amount agreed upon. It thus creates a deposit. When a bank discounts a bill of exchange, it in fact, buys the bills from the customer for a short period of 90 days or less. The amount of the bills is credited in the account of the customer who withdraws it through a cheque. Or, it pays the sum through a cheque on itself. In both cases, the bank creates a deposit equal to the amount of the bill of exchange less the discount charged.

A commercial bank also creates a deposit by making investments by buying government bonds and securities. The bank pays for the bonds through a cheque on itself to the central bank. If it buys a bond from the stock exchange, it credits the amount in the account of the seller, if he happens to be its customer. Otherwise, it pays a cheque on itself which is deposited in some other bank. In any case, a deposit is created either in this bank or some other bank. In all such cases, liabilities and assets in the banking system on the whole are increased. Thus loans by banks create deposits. It is in this sense that credit is created by commercial banks.

3.2 The Process of Credit Creation

Let us explain the actual process of credit creation. We have seen above that the ability of banks to create credit depends on the fact that banks need only a small percentage of cash to deposits. If banks keep 100 percent cash against deposits, there would be no credit creation. Modern banks do not keep 100 percent cash reserve. They are legally required to keep a fixed percentage of their deposits in cash, say 10, 15 or 20percent. They lend and/or invest the remaining amount which is called excess reserves. The deposit multiplier depends upon the required reserve ratio which is the basis of credit creation. Symbolically, the required reserve ratio:

$$RRr = \frac{RR}{D}$$

Or $RR = RRr \times D$

Where RR are the required cash reserves with banks, RRr is the required reserve ratio and D is the demand deposits of banks. To show that D depends on RR and RRr, divide both sides of the above equation by RRr:

$$\frac{RR}{RRr} = \frac{RRr \times D}{RRr}$$

$$\text{Or} \quad RR = D \cdot RRr$$

$$\text{Or} \quad \frac{1}{RRr} = \frac{D}{RR}$$

$$\text{Or } D = \frac{1}{RRr} \times RR$$

Where 1/RRr, the reciprocal of the percentage reserve ratio, is called the deposit (or credit) expansion multiplier. It determines the limits to the deposit expansion of a bank. The maximum amount of demand deposits which the banking system can support with any given amount of RR is by applying the multiplier to RR. Taking the initial change in volume of deposits (D) and in cash reserves (RR), it follows from any given percentage of RRr that

$$D = RR \times \frac{I}{RRr}$$

To understand it, suppose the RRr for the banks is fixed at 10 percent and the initial change in cash reserves is N1000. By applying the above formula the maximum increase in demand deposits will be

$$AD = 1000 \times \frac{1}{0.10} - = N\ 10000$$

This is the extent to which the banking system can create credit, equation can also be expressed as follows:

$$D = RR[1 + (1\text{-}RRr) + (1 - RRr)2 + ... + (1 - RRr)n]$$

The sum of the geometric progression within brackets gives:

$$\frac{1}{l\text{-}(l\text{-}RRr)} = \frac{1}{RRr}$$

$$D = RR \times \frac{1}{RRr}$$

The deposit expansion multiplier rests on the assumptions that banks lend out all their excess reserves and RRr remains constant. To explain the process of credit creation, we make the following assumptions:

1. There are many banks, say, A, B, C, etc in the banking system.
2. Each bank has to keep 10 percent of its deposits in reserves.
   In other words: 10 percent is the required reserve ratio, fixed by Law.

3. The first bank has N 1000 as deposits.
4. The loan amount drawn by the customer of one bank is deposited in full in the second bank, and that of the second bank into the third bank, and so on.
5. Each bank starts with the initial deposits deposited by the debtor of the other bank.

Given these assumptions, suppose that Bank A receives a cash deposit of N 1000 to begin with. This is the cash in hand with the bank which is its assets and this amount is also the liability of the bank by way of deposits it holds. Given the reserve ratio of 10 percent, the bank keeps N100 in reserve and lends N 900 to one of its customers who, in turn, gives a cheque to some person from whom he borrows or bys something. The net changes in Bank A's balance sheet are + N100 in reserve and + N900 in loans in the assets side and N1000 in demand deposit on the liabilities side as shown in table 1. Before these changes Bank A had zero excess reserves.

Table 1: Balance Sheet of Bank A

	Assets Liabilities		
Reserves	N 1000	Deposits	N 1000
	net changes		**net changes**
Reserves	N 100	Deposits	N 1000
Loans	N900		

This loan of N 900 is deposited by the customer in Bank B whose balance sheet is shown in Table II. Bank B starts with a deposit of N900, keep 10 percent of it or N 90 as cash in reserve. Bank B has N810 as excess reserves which it lends thereby creating new deposits.

Table 11: Balance Sheet of Bank B

	Assets Liabilities		
Reserves	N 900	Deposits	N900
	net changes		*net changes*
Reserves	N90	Deposits	N900
Loans	N810		

This loan of N810 is deposited by the customer of Bank B into Bank C. The balance sheet of Bank C is shown in Table III. Bank C keeps N81 or 10 percent of N810 in cash reserves and lends N. 729.

Table III: Balance Sheet of Bank C

	Assets Liabilities		
Reserves	N810	Deposits	N810
	net changes		*net changes*
Reserves	N81	Deposits	N810
Loans	N729		

This process goes on to other banks. Each bank in the sequence gets excess reserves, lends and creates new demand deposits equal to 90% of the preceding banks. In this way, new deposits are created to the tune of N10000 in the banking system, as shown in table IV.

Table IV: Multiple Credit Creation

Banks Required Reserves	Net Loans	New Deposits	
A	N 100	N900	N1000
B	N90	N810	N900
C	N81	N729	N810
All other banks	N729	N6561	N7290
Total for the banking system	N 1000	N9000	N10000

The multiple credit creation shown in the last column of the above Table can also be worked out algebraically as:

N 1000 [1 +(9/10) + (9/10)2+(9/10)3+ ... +(9/IO)n]
= N1000 (1/1 - 9/10) = N1000 (1/1/10) = N1000 x 10 = N 10000.

3.3 Limitations of the Power of Banks to Create Credit

We have seen above how the banking system as a whole can create credit. But is does not mean that the banks have unlimited powers to create credit. In fact, they have to function under certain restrictions. The following are the limitations on the power of commercial banks to create credit.

1. **Amount of Cash: The credit creation power of banks depends** upon the amount of cash they possess. The larger the cash, the larger the amount of credit that can be created by banks. The amount of cash that a bank has in its vault cannot be determined by it. It depends upon the primary deposits with the bank. The bank's power of creating credit is thus limited by the cash it possesses.

2. Proper Securities: An important factor that limits the power of a bank to create credit is the availability of adequate securities. A bank advances loans to its customers on the basis of a security, or a bill, or a share, or a stock or a building, or some other types of assets. It turns ill-liquid forms of wealth into liquid wealth and thus creates credit. If proper securities are not available with the public, a bank cannot create credit. As pointed out by Crowther, "Thus the bank does not create money out of thin air it transmutes other forms of wealth into money".

3. Banking habits of the people: The banking habits of the people also govern the power of credit creation on the part of the banks. If people are not in the habit of using cheques, the grant of loans will lead to the withdrawal of cash from the credit creation stream of the banking system. This reduces the power of banks to create credit to the desired level.

4. Minimum Legal Reserve Ratio: The minimum legal reserve ratio of cash to deposits fixed by the Central Bank is an important factor which determines the power of banks to create credit the higher this ratio (RRr) the lower the power of banks to create credit, and the lower the ratio, the higher the power of banks to create credit.

5. Excess Reserves: The process of credit creation is based on the assumption that banks sticks to the required ratio fixed by the central bank. If banks keep more cash in reserve than the legal reserve requirements, their power to create credit is limited to the extent. If Bank A of our example keeps 25 percent of N 1000 instead of 20 percent. It will lend N 750 instead of N800. Consequently, the amount of credit creation will be reduced even if the other banks in the system stick to the legal reserve ratio o 20 percent

6. Leakages: If there are leakages in the credit creation stream of the banking system, credit expansion will not reach the required level, given the legal reserve ratio. It is possible that some person who receives cheques does not deposit them in their bank accounts, but withdraw the money in cash for spending or for hoarding at home. The extent to which the amount of cash is withdrawn from the chain of credit expansion, the power of the banking system to create credit is limited.

7. Cheque Clearances: The process of credit expansion is based on the assumption that cheques drawn by commercial banks are cleared immediately and reserves of commercial banks expand

and contract uniformly by cheque transactions. But it is not possible for banks to receive and draw cheques of exactly equal amount. Often some banks have their reserves increased and others reduced through cheque clearance. This expands and contracts credit creation on the part of banks. Accordingly, the credit creation stream is disturbed.

8 Behaviour of other banks: The power of credit creation is further limited by the behaviour of other banks. If some of the banks do not advance loans to the extent required of the banking system, the chain of credit expansion will be broken. Consequently, the banking system will not be 'loaned up'.

9. Economic Climate: Banks cannot continue to create credit limitlessly. Their power to create credit depends upon the economic climate in the country. If there are boom times there is optimism. Investment opportunities increased and businessmen take more loans from banks. So credit expands. But in depressed times when the business activity is at a low level, banks cannot force the business community to take loans from them. Thus the economic climate in a country determines the power of banks to create credit.

10. Credit Control Policy of the Central Bank: The power of commercial banks to create credit is also limited by the credit control policy of the Central Bank The central bank influences the amount of cash reserve with banks by open market operations, discount rate policy and varying margin requirements. Accordingly, it affects the credit expansion or contraction by commercial banks.

11. Contagion Effect. If a bank fails to remain solvent due to huge loan losses, a credit panic is created among banks. The fear of failure of a particular bank may lead to a 'run' and depositors demand to make huge withdrawals. This may spread to other banks and is called the "Contagion effect" whereby credit creation stops altogether.

SELF-ASSESSMENT EXERCISE

Discuss how commercial banks can create credit.

4.0 CONCLUSION

We conclude that commercial banks do not possess unlimited powers to create credit.

5.0 SUMMARY

In this unit, we have learnt how commercial banks create credits, otherwise known as money creation. We have also learnt the limitations of commercial banks to create credit.

6.0 TUTOR MARKED ASSIGNMENT

Outline the limitations of commercial banks to create credit.

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UNIT 4 MERCHANT AND DEVELOPMENT BANKS

CONTENTS

1.0 INTRODUCTION

In this unit, we shall discuss the merchant banks and their functions We shall also discuss development banks and their functions.

2.0 OBJECTIVES

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

- Discuss the meaning of merchant banks and their functions.
- Discuss the meaning of development banks in Nigeria

3.0 MAIN CONTENT

3.1 The Merchant Bank

In contrast to a commercial bank which operate on retail basis, a Merchant Bank is a wholesale Bank, accepting deposits only in large blocks and providing mainly medium and long term loans, with public and private corporations being its customers (Magaji 1995).

Merchant Banks, otherwise known as acceptance Houses or Investment banks, began operation in Nigeria in 1960 when the Philiph Hill (Nig) Ltd and the Nigerian Acceptances Limited (NAL) were registered. These two Banks merged in 1969 to form NAL. In 1974, first National

Bank of Chicago (Nig) Ltd, first National City Bank of New York (Nig) Ltd, and Chase Merchant Bank Ltd. were established. In 1975, ICON Ltd. Merchant Bankers began operation. The Nigerian American Merchant Bank Ltd was established in 1979, and in 1982 both the Merchant Banking

Corporation Nigeria Ltd and the Indo Nigeria Merchant Bank Ltd were established. Now the number of Merchant Bank is large.

3.2 Functions of Merchant Banks

a) Corporate Finance Services: These include management of public and private equity shares and debt securities issues, company floatation, mergers and reconstruction, financial planning and portfolio management.

i. Issuing House Services: Merchant Banks undertakes the sales of shares to their client. They act as issuing Houses in the capital market by, among other things, offering financial services to corporate entities desiring to raise long-term finance for their operations, given advices on type of capital structure, appropriate time of issues, and advise on relevant government regulations. Merchant Banks also gives backing to an issue in the form of underwriting.

ii. Project Financing: This term is used to describe how Merchant Banks in particular finance new project on the agreement that repayment is expected from the revenues or cash flow to be generated by the project.

iii. Advisory Services: These include advice on project financing and joint ownership, arrangement of mergers and acquisitions, advices on corporate financial structure, etc.

b) Banking Services: These services include loans and advances, deposits, acceptances, foreign exchange transactions, international trade service and equipment leasing.

i. Loans and Advances: These are provided by Merchant Banks mainly to industry and commerce. CBN stipulates the percentage of loans and advances of these type of Banks to be made to various sectors of the economy at the beginning of each financial year. Although Merchant Banks also do lend on short term for working capital requirement, plant expansion, agricultural development, trade finance, etc., but they mainly championed the course of medium and long term loans disbursements.

ii. Acceptance of Deposit: Deposits in Merchant Banks are made in the form of fixed term, usually by corporate and non corporate customers, in large amount,

iii. Acceptances: Acceptance business is mainly used for the finance of international trade. A customer or client can draw a bill on his merchant Bank. By accepting this bill, his Merchant Bank becomes responsible for its payment at due date.

iv. Foreign Exchange Service: Upon authorization by CBN for a Merchant Bank to provide foreign exchange services, the later can act as a correspondent Bank to assist international trade settlement and to act as intermediary between CBN and its clients in obtaining foreign exchange.

(c) Equipment Leasing: Most Merchant Banks are members of equipment leasing.

They execute leasing in return for fee. Leasing is the hiring of an asset foe the duration of its economic life or up to a specific time (Adekanye 1986).

(d) Portfolio Management: Merchant Banks manages their clients' portfolios through Investment Departments. Portfolio Management includes "arranging purchases and sales of securities and offering advice on when and what to buy and sell, as well as attending to right or bonus issues and registrations" (Adekanye 1986).

(e) Money Market Services: Merchant Banks mobilises deposits on time and call from commercial banks, larger corporations, institutions, etc. at very attractive interest rates. They are also authorised dealers and users of Negotiable Certificates

3.3 Development Banks

This category of banking institutions sprang up in response to the clamour for establishment of specialized financial institutions for the interests of investors in need for medium and long term finance for accelerated development of the Nigerian economy. Okigbo (1981:129) recognizes the need to create institutions that could undertake or promote investment where the private sector inspired by private gain, might for the moment be reluctant to go. He finds the answer in the creation of development institutions to provide funds for direct investment on medium and long term basis, or for assisting private initiative or providing technical assistance and supporting services in

any sector of the economy.
In Nigeria, a number of financial institutions have been set up based on these principles. We shall briefly examine some of them, notably NIDB, NBCI, and NACRDB

3.4 Rationale or Basis for Establishing Development Banks

a) To plug the gaps in the financial system of inadequacy of commercial banks services that rarely concerns with long term capital financing, and the determination or involvement of CBN to bridge this gap through establishment of Development banks.
b) As a recognition at the domestic level, the importance of International Development banks, such as World Bank and International Development Association. Development Banks at National level are therefore, established to investigate, undertake or finance projects which required more local knowledge and patronage than international finance.
c) As a catalyst to development by financing small, independent manufacturing and industrial enterprises etc. in order to promote speedy industrial expansion (Nwankwo 1980).

Development Banks are creature of government and do not emerge on their own. They are finance by government through CBN, but also do obtain loans from institutional lenders such as Banks and Insurance companies.

3.5 The Nigerian Industrial Development Bank (NIDB)

NIDB was established in 1964 in place of the investment corporation of Nigeria established since 1959. This Bank is owned by the Federal Government and the Central Bank.

FUNCTIONS

a) It provides medium and long term finance to industrial establishments both in private and public sectors and to render technical, financial and managerial assistance to industry.
b) Identifies investment bottlenecks in the economy with a view to determine investment priorities
c) Promotes project developments.
d) Provides technical, financial and managerial advices to indigenous enterprises.
e) Supervises the implementation of projects financed by it through requesting project reports and visiting project sites.
f) Nominates technical and managerial advisers to industrial organizations.
g) Fosters the development of capital market in Nigeria by

encouraging borrowers to list their shares in the stock exchange

h) Serves as channel for bringing into Nigeria investible funds from international organizations.

3.6 The Nigerian Bank for Commerce and Industry (NBCI)

Partly in reaction to the criticism against NIDB for favouring foreign dominated enterprises in its loan policy and partly for cater for needs of the newly indigenised business for medium and long term funds, the NBCI came on board by the decree No 22 of 1973. Unlike the NIDB which started off with foreign and Nigerian equity interests, the NBCI too off as a wholly owned Nigerian public sector organization to attend chiefly to the interests of Nigerian indigenous investors.

The principal functions and powers of the bank as defined by section 2 of the NIDB decree are follows:

i. To provide equity and funds by way of loans to indigenous persons, organizations, institutions for medium and long term investment in industry and commerce at such rates and upon such terms as may be determined by the Board in accordance with the policy directed by the Federal Executive Council.

ii. To engage in all aspects of merchant banking, particularly confirmation of bills and obligation to third parties, acceptance and discounting bills.

iii. To underwrite stocks, shares and debentures issued in furtherance of the policy of the government.

iv. To purchase and sell stocks quoted on the Lagos Stock Exchange.

v. To provide guarantees including letters of credit.

vi. To accept term deposits from the public, financial institutions, trust funds, post office and other bodies.

vii. To provide chequing facilities for its customers.

With time, the scope of the bank's functions was widened to take on in addition to those outlined above the provision of venture capital and funds for acquisition and investment in basic development (shopping centres, warehouses, grain silos etc)

As with NIDB, to attract NBCI financing, there must be evidence of viability, sound management, good prospects for profit, among other criteria.

3.7 The Nigerian Agricultural Cooperative and Rural Development Bank (NACRDB) Ltd

The birth of the Nigerian Agricultural, Cooperative and Rural Development Bank (NACRDB) Limited as the single largest development finance institution in Nigeria followed the successful merger of the former People's Bank of Nigeria (PBN), the defunct Nigerian Agricultural and Co-operative Bank (NACB) Ltd. and the risk assets of the Family Economic Advancement programme (FEAP) in October, 2000. Thus, NACRDB is dedicated primarily to agricultural financing at both the micro and macro levels, as well as micro financing of small and medium scale enterprises The Bank is a registered limited liability company that is wholly owned by the Government of the Federal Republic of Nigeria with the share capital fully subscribed by the Federal ministry of Finance Incorporated 60% and the Central Bank I of Nigeria 40%. The Bank's broad mandate encompasses savings mobilization and the timely delivery of affordable credit to meet the funding requirements of the teeming Nigerian population in the agricultural sectors of the national economy.

FUNCTIONS OF NACRDB

- Providing all classes of agricultural loans for fanning, livestock, poultry and fisheries etc:
- Developing the economic base of the low income groups through the provision of loans to small scale enterprises, such as bakers, hair dressers, petty traders etc;
- Accepting savings from individuals and co-operative societies and make repayment of such savings together with appropriate interest;
- Encourage the formation of co-operatives;
- Engendering good banking habits amongst Nigerians, especially the target group,
- Encouraging capacity building through the training of beneficiaries on proper loan utilization, repayment, savings and the formulation of strategies for the profitable marketing of products.

SELF-ASSESSMENT EXERCISE

Define the term development bank and discuss the functions of NIDB, NBCI and NACRDB.

4.0 CONCLUSION

We conclude that a merchant bank is a whole sale bank , accepting deposits only in large blocks and providing mainly medium and long term loans with public and private corporations being its customers. Development banks are established specifically to aid the development of some specific sectors of the economy such as agriculture, industry etc.

5.0 SUMMARY

In this unit, we have learnt the meaning of merchant and development banks. We have also learnt the functions of merchant banks and also the functions of some development banks in

6.0 TUTOR-MARKED ASSIGNMENT

Define the term merchant bank.

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UNIT 5 THE NIGERIAN DEPOSIT INSURANCE CORPORATION

1.0 INTRODUCTION

In this unit, we shall discuss the historical development of the Nigerian Deposit Insurance Corporation (NDIC) and its in the banking industry. We shall also discuss the essentials of banking regulation.

2.0 OBJECTIVES

At the end of unit you should be able to:

- Trace the historical development of the NDIC
- Discuss the roles of NDIC in the banking industry
- Discuss the essentials of banking regulation,

3.0 MAIN CONTENT

3.1 The Nigerian Deposit Insurance Corporation (NDIC)

The modalities for the establishment of an explicit deposit insurance scheme in Nigeria was necessitated by the CBN, having been convinced of the need f.--r the scheme, and after going into necessary consultations with the federal ministry of finance. The federal government gave approval to a memorandum for establishing the scheme in December, 1987, following which Decree 22, establishing the NDIC was promulgated in June, 1988. The NDIC Decree sets forth the rule and procedure guiding its operations. The law specifies eligible financial institutions, average funding, clear and unambiguous procedures for risk assessment and management containment.

The NIDC was an autonomous body which acts as an supervisory authority over licensed banks. The corporation not only provides financial guarantee to depositors but also ensures that banks comply with regulations and practices that foster safety and soundness in the market place.

The corporation successfully commenced operation in March, 1988after being guided and expertly advised by the United States Federal Deposit Insurance Corporation (FDIC), immediately before and after take off. The FDIC not only offered the corporation attachment training facilitates, but also paid an assessment mission to Nigeria to assess where the NDIC would need technical assistance without cost.

Its authorized share capital was One Hundred Million Naira (NIOOm) out of which fifty million naira (N50m) has already been called up and paid up by the subscribers. The CBN and Federal Government have ownership of 60% and 40% respectively.

To further boost the activities of the corporation as well as its independence, the Government in its 1997 budget announced the independence of the NDIC from the CBN To that effect, where the corporation recommends to the CBN the revocation of a license of a bank and no response is received within thirty (30) days from the date of recommendation the NDIC can liquidate the bank, (section 23c (2) NDIC (amendments) Decree 1997).

However the relationship between the CBN and NDIC still remains that of a principal and its agent.

3.2 The Role of NDIC in the Banking Industry

Section 5.of the NDIC Decree No 22 of 1988 states its functions. These functions therefore, form the core of the role of NDIC and its activities in the Nigerian Financial System.

The major concerns of the NDIC are protection of depositors and the safety of the banking system. These derive from its core function of "insuring all deposit liabilities of licensed banks and such other financial institutions operating in Nigeria" The other functions of NDIC include "guaranteeing payment to depositors in case of imminent or actual suspension of payments by insured banks or financial institutions fl up to the maximum amount of N50, 000 as provided in the Act" and "assisting monetary authorities in the formulation and implementation of banking policy so as to ensure sound banking practice and fair competition among banks in the country".

It is important to observe that although the NDIC interacts with banks in one form or the other, it is difficult to state in strict terms that it is involved in the direct regulation of banks. Indeed, Umoh (1996:6) admits that "as an insurer, the administrator of a deposit insurance scheme necessarily become a supervisor but not a regulator as it does not directly stipulate rules guiding the operations of insured institutions."

3.3 Functions of NDIC

In the exercise of its functions, the NDIC implements the following against banks in accordance with statutory provisions.

i **Insurance of Deposit Liabilities of all Licensed Banks in Nigeria. In return for this insurance, all insured banks pay** mandatory annual premium which is calculated as 15/16 of 1% of a bank's total deposit liabilities excluding, insider deposits, counter claims from persons who maintain both deposits as may be specified from time to time by the board of the NDIC.

ii. **Financial and Technical Assistance to Insured Banks: The** corporation is expected to render assistance in the interest of depositors of banks faced with actual financial difficulties, as liquidity deficiencies and accumulated loss, which has nearly or completely eroded the shareholders funds, may approach the NDIC for assistance. So NDIC can render any or all of the following as assistance to a failing bank,

a) Grant Loans
b) Give guarantee for loans taken by the bank
c) Subject to the approval of the CBN, take over the management of a bank until its financial position improves or
d) Arrange merger with other banks etc.

iii. **Guaranteeing Payment to Depositors. It is the job of the NDIC** to play the role of undertaker when a bank fails. Incidental to this job is the payment of insured amount up to a maximum of N50, 000 to depositors. In any circumstance where the corporation is liable to make payment, it will require proof of claims from all depositors by the courts of competent jurisdiction before making any payment of such claims. If the corporation fined it advisable in the interest of the depositors or the public, it shall appoint another insured bank to assume the insured deposits of the failed bank not later than three months after failure.

iv. Assisting Monetary Authorities: This function is demonstrated through assisting monetary authorities in formulation and implementation of banking policies so as to ensure safe and sound banking practices and fair competition. In this respect, NDIC is required to ensure that the insured banks comply with the provisions of all banking laws and regulations.

v. Bank Supervisory Activities: Supervision of insured banks remains an integral part of the mechanism of reinsuring safe and sound banking practice. In this regard, the corporation carries out off-site surveillance and on-site examination both of which are mutually re-inforcing. The on-site supervision or examination provides opportunity for the organization to appreciate the financial health of, and inherent risks it has undertaken in insuring a particular bank or the entire banking system. This is ascertained through an analysis and evaluation of the banks' finances under such international parameters as, the capital adequacy, asset quality, management, earnings and liquidity (CAMEL). Indeed, it is through on site examinations that the NDIC verifies the authenticity of data it received via returns rendered by banks. The off-site supervision also monitors the soundness (i.e. financial condition and performance of a bank through statutory and prudential returns rendered to the NDIC from time to time. Using the returns, the NDIC may be able to discover areas of potential problems and thus take immediate steps to cause the bank to remedy the situation. Both on site and off-site supervision examinations are geared towards ensuring banks' compliance with regulations and laws.

vi. Bank Receivership and Liquidation: In 1994 and 1995, the corporation, under the appointment of the CBN, liquidated five (5) distress banks. The corporation also successfully undertook the closing of the twenty six (26) distressed banks pursuant to its appointment as a provisional liquidator by the Central Bank of Nigeria in 1998. This brings the total number of banks liquidated to 31.

vii. Claims Settlement and Administration: This involves the processing, verification and settlement of claims filed by the proven depositors of the failed banks. This function also involve payment of liquidation dividends to uninjured depositor as well as the creditors of the closed banks consistent with the provision of the NDIC Decree 22 of 1988 (as amended), the corporation only provides funds for the payment of insured depositors from the insurance fund while the liquidation dividend is paid from the sales of fixed (net proceeds) assets of the failed banks.

3.4 Essentials of Banking Regulation

In virtually all countries of the world, the banking industry is regulated than any other sector. Banking is regulated from the cradle to the grave; indeed from pre-cradle since regulation commence with the processing of application precedent to licensing. Why is this so? What makes banking different from other activities?

One explanation is the uniqueness of banking. A bank is a financial institution that differs from other financial institutions in two crucial product areas. It offers demand or transaction deposits with commercial lending rates. It is central to a nation's payments system and savings / investment process. This centrally in the economic system singles banking out for much heavier regulation than any other activity (Johnson and Johnson 1987)

In performing their traditional functions, banks are expected to ensure prudent management of assets and guarantee the safety of depositors' fund. They are expected to adhere strictly to safe and sound banking practices to prevent incidence of fraud, forgeries and other financial malpractices to ensure stability and public confidence in the system. Here lies the concern of the regulatory bodies and hence the need for bank regulation by the regulatory and supervisory authorities.
In brief, regulation of banking evolved to serve many goals which include the
following:

i. PROTECTION OF DEPOSITORS

The most basic reason for bank regulation is depositors' protection. Bank depositors have difficulties in protecting their interest when compared to bank creditors or investors. Given the increased number of banks in the system, the shift in government bank support policy and the bitter experience of prior bank failures in the country, the need for regulation to protect depositor becomes rather imperative.

ii. MONETARY STABILITY

Bank regulation promotes financial stability by encouraging a flexible banking system that can always meet the public's transaction needs and by discouraging banking practice that stability could lessen or prevent the occurrence of banking panics and their disruptive effects on the economy and thus be linked with goals of depositor protection.

iii. EFFICIENT AND COMPETITIVE FINANCIAL SYSTEM

One aspect of good banking is that customers are provided with equity services at competitive price. One of the purposes of banking regulation therefore is to create regulatory framework that encourages efficiency and competition. Competition is a vehicle for achieving efficiency since in a competitive banking system banks are forced to operate efficiently if they are to keep their customers and to remain in business

iv. CONSUMER PROTECTION

Another goal of regulation of banking is to protect consumer interests in certain aspects of banking relationship, Broadly interpreted, these objectives, could encompass most banking regulation as well as legal protection generally given to all customers. It could thus include regulations designed to protect depositors.

SELF-ASSESSMENT EXERCISE

Trace the historical development of the NDIC

4.0 CONCLUSION

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

5.0 SUMMARY

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

6.0 TUTOR-MARKED ASSIGNMENT

Outline the functions of the NDIC in the banking sector.

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