**LAGOS CITY POLYTECHNIC, IKEJA**

 **DEPARTMENT: ACCOUNTANCY**

**TO WHOM: ND 1**

**COURSE CODE: BFN 121**

**COURSE TITLE: ELEMENT OF BANKING 2**

**COURSE UNIT: 2**

**LESSON 1**

**LESSON OUTLINE:**

* Introduction to Money
* Importance of Money
* Features of Money

**MONEY**

Money, as defined in economics, is anything that is readily and widely accepted as a medium for the exchange for goods and services or in settlement of debts. Money plays a crucial role in the economic system of any country. It is a means for promoting specialization and exchange on which modern economic activity is based. Before the invention of modern money in the forms of currency notes and coins as we know today, trade had been conducted by barter, through the use of commodity monies such as cowries’ shells, cow, manilas, iron bars, etc. The barter system refers to a situation where goods are directly exchanged for goods. The problems associated with the system are:

1. Double coincidence of wants: It entails finding a person who has what you want and requires what you have. For example, a person who has a cow and needs a yam must search for another person who has a yam and needs a cow. This process is cumbersome and leads to a waste of time.
2. No common unit of measure: It is difficult to arrive at a uniform or an easily acceptable exchange rate between different commodities
3. The absence of a means of storing wealth or value: Under the barter system, it is difficult to store wealth because most articles of trade, especially agricultural products are easily perishable.
4. Difficulty in making deferred payment: As a result of exchange rate problem, the barter system makes deferred payment impossible.
5. Problem of bulkiness and indivisibility of most goods: The goods are often too bulky to be carried from one place to the other, and are not capable of being divided into similar units to facilitate transaction The introduction of money has enabled man to overcome the problem associated with the barter system.

**Importance of Money**

The main importance of money in every modern economy are:

1. A medium of exchange: Money facilitates the exchange of goods and services because people exchange the goods and services they produce for money and then use the money to buy other goods and services they want. This enabled man to overcome the problem of ‘double coincidence of wants’ associated with trade by barter.
2. A unit of account or a measure of value: Money serves as the unit of account in terms of which the values of goods and services are measured and recorded. The problem of barter with regards to the determination of exchange rate between different goods is solved.
3. A store of value: Money is a good store of value providing purchasing power in a general form that can be used to meet future needs for goods and services. Under the barter system, articles of trade are easily perishable and cannot be stored for future transactions.
4. A standard of deferred payment: Money makes it possible for people to enter into contracts, such as lending, borrowing, and enjoyment of services for fixed amount of money payable at a future date. The exchange rate problem makes this impossible under the barter system.

**Features of Money**

 For anything to perform the functions of money outlined above effectively, it must possess the following attributes or qualities:

1. General acceptability:- It must be acceptable by all economic agents in the country in which it is used as payment for goods and services, and in settling debts and obligations.
2. Divisibility: It should be available in units of a standard size sufficiently divisible to facilitate the purchase and sale of goods and services over a wide range of prices.
3. Durability: It should be able to last for a long time without losing its value. This is the reason why high quality papers are used to print paper currency and precious metals are used in minting coins.
4. Portability: Money should be convenient to carry about for easy transfer to other people during transactions.
5. Homogeneity: One unit of money must be the same in all respects (i.e. identical) everywhere throughout the country. This will promote general acceptability.
6. Relative Scarcity: It must be unique, not something that can be found easily anywhere. And it must not be supplied in excess so as not to lose its value whereby it will not be able to serve effectively as a store of value and a standard of deferred payment.

**QUIZ Questions**

1. An acceptable medium for the exchange of goods and services or in settlement of debts is called…………………….
2. 2. The desire to hold wealth in form of cash instead of interest-yielding assets is described as…………………………..

**ASSIGNMENT**

 Outline the attributes which anything that is money must possess to perform its function effectively and adequately

**LESSON 2**

**LESSON OUTLINE:**

* Types of Money
* The Nature of Money
* The Supply of Money

**TYPES OF MONEY**

The three main types of money are classified as:

 a. Paper money and coins: These are monies issued exclusively by the financial institutions, such as the Central Bank of Nigeria (CBN), Federal Reserve of the United States etc. They are backed by law and hence accepted in exchange for goods and services and in settlement of debt obligations.

 b. Bank deposits: These are money deposited with financial institutions, especially commercial banks which are withdrawable or transferable without prior notice by writing a cheque. Such deposits are held in current account of the customer, and a fee is charged for processing the cheque. The three types of bank deposits are:

 i. Demand deposits: It is deposit of funds (usually paper money and coins) with a bank which are withdrawable or transferable without prior notice by writing a cheque. Such deposits are held in current account of the customer, and a fee is charged for processing the cheque.

 ii. Saving deposit: It is a deposit of fund with a bank which can be withdrawn with or without a notice of withdrawal. Savings deposits are held in savings account and they yield interest for the depositor.

 iii. Time Deposit: It is a deposit of fund that cannot legally be withdrawn from the bank without at least 30 days notice of withdrawal. Time deposits are held in fixed deposit accounts opened for depositors and they yield interests.

 c. Quasi- money or near money: These are assets which adequately serve as a store of value but do not fulfil the medium of exchange function. Examples include saving and time deposits, stock and shares, postal and money orders, treasury bills etc. What constitute quasi – money varies from one country to another.

**THE NATURE OF MONEY**

 The nature of money is usually discussed under three headings:

 a. Legal tender: This refers to money which by nature must be accepted in payment for goods and in discharge of debt obligations. Currency notes and coins are legal tender in all modern economies.

 b. Fiat money: This is money that is not a commodity and it is not redeemable in any commodity. What gives such money value and acceptability is their being declared as legal tender by the government. Money in the form of currency notes fit into this description.

c. Token money: This refers to money whose face value is greater than the actual value of the material of which it is made. In most economies, coins are token money, whose value as metal is less than their monetary value.

**THE SUPPLY OF MONEY**

Money supply or money stock refers to the total amount of money in the economy for purposes of policy. Various definitions or variants of money supply exists (e.g. M1, M2, etc).

 Generally, the narrow money or narrow definitions refers mainly to the money used as medium of exchange while the broad money or broad definitions include money being used as a store of value. In every country, the Central Bank always state which definitions of money it is adopting at any particular time and for which purpose. The quantity of money in an economy has direct effect on the price level and therefore on the value of money. Hence, to promote price stability and economic growth, the total money supply is subject to government control through the Central Bank in every modern economy.

**QUIZ**

1. Assets which serve as a store of value but do not perform the function of medium of exchange are called………………………

 2. Money whose face value is greater than the actual value of the material of which it is made is referred to as……………………….

 **ASSIGNMENT:**

 How does supply of money operate n Nigeria?

**LESSON 3**

**LESSON OUTLINE:**

* The Demand for Money
* The Quantity theory of Money
* Introduction to Financial Institution

**THE DEMAND FOR MONEY**

 Demand for money otherwise referred to as liquidity preference means the desire of people to hold their resources or wealth in the form of cash i.e. currency notes and coins, instead of interest – yielding assets. The British economist, John Maynard Keynes (1883 – 1946) identified three reasons for demand for cash balances or why people hold money. These are:

a. The Transactions Motive: This represents cash balances held in order to carry out ordinary, everyday transactions. For example, individual persons need to hold money to buy fares, and so on. Similarly, business organizations need money to pay wages and electricity bills, buy raw materials, vehicles and equipment, etc. The transactions demand for money is directly related to income.

 b. The Precautionary Motive: This refers to holding cash balances as a precaution against unexpected expenses. For instance, people hold money to provide them with some degree of security against sudden illness, accidents, fire or flood disaster, etc., while firms hold money against unpredictable occurrences such as sudden breakdown of vehicles, equipments and so on. The main factor influencing this motive is the level of income.

c. The Speculative Motive: This refers mostly to the desire to hold cash balances in order to make speculative dealing in the bond or securities (interest – yielding assets) markets. The demand for money for speculative purposes is interest – elastic. The higher the rate of interest, the lower the demand for speculative cash balances. Thus, there is an inverse relationship between the price of bond and interest rate.

This motive for holding money is a decreasing function of the rate of interest and it is also influenced by incomes. Lord Keynes refers to the money held for transactions and precautionary motive as active balances, and that which is held for speculative motive as idle balances. The total demand for money is found by the summation of transactions, precautionary, and speculative demands.

**THE QUANTITY THEORY OF MONEY**

 This theory suggests the existence of a direct relationship between money supply and the average price level in the macro economy. Specifically the quantity theory of money states that the price level is strictly proportional to the money supply. The quantity theory of money which was pioneered by the 18th century economists including Adam Smith and David Hume, was modified and popularized in 1911 by the American Economist, Irvin Fisher (1867 – 1947) in what is known as equation of exchange: MV = PQ (10.1) where M = Total money supply V = velocity of circulation of each unit of money P = average price level Q = real national output or real GNP The assumptions of the theory are that:

1. The velocity of money circulation (V) is fixed.
2. he real GNP denoted (Q) is fixed in the short – run.
3. The money stock (M) is determined from time to time by the country`s monetary authorities.
4. The economy is at full employment level. Given the above assumptions, the equilibrium price level (P) is determined by the money stock (M) as expressed in equation .1) P = MV (10.2) Q Equation .2) which also represents the quantity theory of money is obtained by making P the subject of the relation in equation .1. It follows, for example, that a 5 percent increase in money stock will cause average price level in the economy to rise by 5 percent. Thus, inflation is conceived as a monetary phenomenon. The major policy implication of the theory is that monetary policy of the restrictive type is most relevant for effective control of inflation. In other words, to curb the problem of inflation effectively requires the reduction of money stock through the use of monetary policy instruments such as open market operations (OMO), reserve requirements and bank rate. The weakness of the quantity theory of money lies in the underlying assumptions, especially the assumption of fixed output and fixed velocity of money circulations which are unrealistic. However, the theory provides a guide to the government to regulate money supply along the rate of changes in national output so as to avoid the problem of inflation.

 **FINANCIAL INSTITUTIONS**

Financial institutions are the main channel by which funds flow from the sectors of the economy with surplus funds to other sectors with insufficient funds to ensure efficient utilization of such resources in the promotion of economic growth and development. Financial institutions may be broadly divided into two groups – banking and non-banking financial institutions.

The banking institutions include commercial and merchant banks, development banks, and the Central Bank.

 On the other hand, the non-banking institutions include insurance companies, equipment – leasing companies, hire – purchase companies, building societies, discount houses, etc. However, it is important to note that the legal framework within which the financial institutions operate in an economy varies from one country to the other. Therefore, only the conventional activities of financial institutions in most developing economies are highlighted here.

**QUIZ.**

In the quantity theory of money, the equation of exchange approach shows that money supply is proportionately directly related to………………..

**ASSIGNMENT**

 (a)Distinguish between deposit money and quasi money

 (b) Advance any three arguments in favour of transforming your country into a cashless society.

(c) Explain the term legal tender

**LESSON 4**

**LESSON OUTLINE:**

* Commercial and Merchant Banking
* Functions of Commercial Banks
* Creation of Money by Commercial Banks

**COMMERCIAL AND MERCHANT BANKING**

 The commercial and merchant banks are profit – making enterprises, as well as the major financial intermediaries through which the monetary authorities facilitate effective distribution of money in the economy.

 **Functions of Commercial Banks**

The commercial banks offer a range of services which include the following:

1. Accepting deposits of money: Commercial banks, as savings institutions, provide facilities for the mobilization of savings by accepting deposits from households, firms and government. They use current account, saving account and fixed deposit account to accept demand deposits, saving deposits and time deposits respectively.
2. Granting loans and advances: The most profitable function of commercial banks is extending credits to worthy borrowers while charging interest rate higher than the rate they pay on deposits. Short – term credit facilities are extended to customers using special loan account or in the form of overdraft using current account. It may also take the form of loan syndication whereby two or more banks agree to finance a large project.
3. Acting as agents of payment: Commercial banks` customers keep current accounts from which they can draw for settlement of debt and for payments for goods and services. They also transfer funds on behalf of their customers through collection of standing orders and direct debiting.
4. Creating demand – deposit money: By lending out the money – i.e. deposit that they collected from some customers, commercial banks create additional purchasing power in the economy.
5. Providing international trade service: Commercial banks are involved in the financial aspects of international trade, especially by discounting bills of exchange for their customers who are exporters and opening letters of credit in favour of their customers who are importers. A letter of credit is an undertaking by the bank accepting to redeem the liability of its customers on an import contract.
6. Providing brokerage services: Commercial banks undertake to buy and sell stocks and shares on behalf of their customers.
7. Foreign exchange services: Commercial banks act as intermediaries between the Central Bank or authorized foreign exchange dealers and their corporate customers to process foreign exchange allocation. They also provide traveller’s cheque to their customers who are travelling out of the country.
8. Safekeeping of valuable items: Commercial banks undertake to keep, for their customers, valuable items such as government stock, share certificates, academic certificates, certificate of occupancy, jewelleries, insurance policies, etc.
9. Equipment leasing: This is the activity of banks in financing purchases of fixed assets by their customers (mostly business enterprises) and allowing repayment over an agreed period of time. The bank is the lessor, while the beneficiary is the lessee.

 **Creation of Money by Commercial Banks**

 Creation of money by commercial banks reflects the view that by granting loans and advances, an initial deposit with a commercial bank can yield a greater cumulative demand deposits in the entire commercial banking system. When a commercial bank advances a loan, it opens an account in the name of the customer creating a claim against itself and in favour of the customer (borrower). Note that the loan is made, not by physically handing over claims, but by creating a book - keeping entry. The same procedure is followed by other banks – each keeping small cash in reverse and lending the remaining amount. The entire commercial banking system thus creates demand deposit money and the economy is reflated. The maximum total demand deposit money (Mdep) that the entire commercial banking system will create given an initial deposit (A) and statutory cash reserve ratio (r) can be obtained using the formula:

 Mdep = r A or A r, the deposit multiplier (Kdep) is Kdep = r 1 , the deposit multiplier is the reciprocal of the cash reserve ratio maintained by the banking system. The higher the cash ratio, the lower the deposit multiplier and the lower the demand deposit expansion and vice versa. Multiple demand – deposit expansion occurs when an initial cash deposit causes an expansion of the money supply by a multiple of the initial deposit. The assumptions underlying the process of deposit money creation are:

1. The banking system is comprised of many banks.
2. There is no cash leakage in the system.
3. The statutory cash reserve ratio ( i.e . the percentage of the total deposit liabilities of the banks that they are legally required to keep with the Central Bank) is given.
4. All banks in the system are willing and able to make loans to the limit set by cash reserve requirements.
5. The initial deposit of a customer in his current account is given. The formula given in equation will change if we relax the assumption of no cash leakage so that there is vault cash (vc) and cash drain (cd). The vault cash is the amount of money kept

 ILLUSTRATION : Suppose a customer deposits N120,000 in a commercial bank, and the cash reserve ratio imposed by the Central Bank is 5 per cent. Required: a. Calculate the deposit multiplier. b. Determiner the maximum amount of deposits money that can be created by the entire commercial banking system of the economy. ILLUSTRATION 11.2 (Solution) a) To obtain demand deposit multiplier (Kdep) Kdep = 1 r = 1 0.05 = 20 b) The maximum deposit money that can be created.

Banks are engaged in issuing or floating of new securities for private and public companies and for government (state and local) seeking to raise long-term or permanent finance for their projects. For all services involved in the performance of this function, merchant banks receive a commission called brokerage. (ii) Accepting deposit: Merchant banks accept large deposits from their customers, mostly corporate bodies. Such deposits attract interest and can be withdrawn only with certificate of deposits (CD) and not with cheques as in the commercial banks transactions. (iii) Providing foreign exchange services: Merchant banks are authorized dealers in the foreign exchange market and as a result they are engaged in the buying and selling of foreign exchange (forex) for commercial and other purposes. They also provide services for both importers and exporters. (iv) Granting loans and advances: The banks provide medium and long-term loans and advances to manufacturers and big-time traders. They are also engage in loan syndication. (v) Project Financing: The merchant banks are engaged in the financing of new industrial and agricultural projects on the understanding that the repayment would be made from the revenue stream generated by the project. (vi) Providing advisory services: Merchant banks offer advice to their clients on project financing, joint ventures, mergers and acquisitions, debt financing, and on the rationalization of the company’s capital structure. (vii) Equipment Leasing: The business of equipment leasing, as described under commercial banking, is more popular with the merchant banks. Equipment leasing can be in the form of finance lease where a bank provides funds to a firm to purchase the equipment, or operation lease where a bank or lessor buys the equipment and rent it out to the firm – i.e (the leasee).

**QUIZ**

 Given the initial deposit of N 240,000 and cash reserve ratio of 5% in the commercial banking system, the maximum money that can be created is ……………………..

ASSIGNMENT

(a)Explain the motives why people hold cash balances

(b)Distinguish between deposit money and quasi money

**LESSON 5**

**LESSON OUTLINE:**

* Comparison between Commercial and Merchant Banks
* The Concepts of Universal Banking
* Central Bank

**Comparison between Commercial and Merchant Banks** The activities and functions of commercial and merchant banks in a typical developing economy can be compared and contrasted as follow:

1. Commercial banks are retail bankers accepting deposit from individuals, businesses and government, not considering the size. On the other hand, merchant bankers accept deposit not below a specified minimum, mostly from corporate bodies.
2. Commercial banks grant more of short-term loans and advances to their customers. Merchant banks, on the other hand, grant medium and long-term loans and advances to their customers .
3. Commercial banks operate with wider branch network, while merchant banks, as wholesale bankers, operate with limited branch network.
4. Commercial banks offer more of general banking services such as deposit taking and granting of loans and advances. Merchant banks offer mostly specialized banking services such as equipment leasing, debt factoring, project financing, etc.
5. Both commercial and merchant banks facilitate foreign trade by providing for their customers facilities for establishing letters of credit with overseas trading partners. Both also provide bills of exchange facility.

**THE CONCEPT OF UNIVERSAL BANKING** Broadly defined, universal banking refers to an arrangement whereby a bank, that is, any deposit taking institution, could engage in a wide range of financial activities and could as well own and control non financial institutions. It should be noted, however, that there is no generally accepted definition of universal banking. Universal banking practice depends essentially on the definition of banking business which varies from one country to the other. But there seems to be an agreement on its salient features. For instance, Universal banking practice entails the removal of restriction between money, capital and insurance markets such that a banking institution can offer integrated financial services. These include deposit taking and lending, underwriting of new debt/equity issues, stock broking, insurance, investment management and so on.

 **Merits of Universal Banking** The following points are usually raised in favour of universal banking practice.

1. It promotes economic growth through supply of long-term financing for commerce and industry
2. It promotes efficiency through economies of scale and scope
3. It fosters competition by opening up various areas of financial and non-financial activities for entry by banks.

 **Demerits of Universal Banking** The following arguments are often advanced against universal banking practice.

1. It distorts credit allocation to various economic activities because of increased connected lending.
2. It promotes greater concentration of economic and political power
3. It leads to conflicts of interest with a bank engaging in more activities that could cope with or difficulty in how to patronize its activities
4. There is a great potential for banks to engaging in more risk activities which could destabilize the banking system. The adoption of universal banking practice in Nigeria commenced in the last quarter of 2000, following the CBN circular (Ref no: BSD/DO/CIR/VOL.1/10/2000), dated 22 December, 2000, which was addressed to all licensed banks.

 **CENTRAL BANK**: A Central Bank is the apex institution of the monetary and banking system of every country. It is owned by the government but the responsibility of its management is usually rested in the Board of Directors whose members are appointed by the government. The Bank of Ghana (BOG) and the Central Bank of Nigeria (CBN) are among the earliest Central Banks established in the West African sub-region.

**Traditional Functions of the Central Bank** In both developed and developing economies, the following are performed by the Central Bank.

1. Currency issue and distribution: The Central Bank is the only institution empowered by law to issue currency notes and coins that are used as a medium of exchange in the country. The monopoly power of issuing legal tender currency is important to control the supply of money in order to prevent inflation.
2. The bankers’ bank: The Central Bank provides facilities for other banks especially commercial banks to keep their cash reserve and clear their balance through the clearing house. It also grants loans to or discount the bills of commercial banks when they are short of fund; hence the Central Bank is referred to as ‘lender of last resort’.
3. Banker to the government: The Central Bank keeps the accounts of the government and of all its corporations and agencies. It receives all payments due to the government, as well as undertake borrowing on behalf of the government through the issuance of short-term and long-term securities e.g. treasury bills, treasury certificates and long term securities e.g. development stocks. The Central bank is also responsible for the management of domestic and external debts of the government.
4. Promotion of monetary stability: The Central Bank controls money supply in the economy to promote price stability. This involves the use of instruments of monetary policy such as open market operations (OMO), reserve requirements, discount rate, etc.
5. Foreign exchange management: To ensure that foreign exchange disbursement and allocation are consistent with economic priorities, the Central Bank acquires, allocates and monitors the use of scarce foreign exchange resources as well as maintains the country`s foreign exchange reserves.

 Supervision of finance houses: In every modern economy, the Central Bank is backed by law to monitor and supervise the activities and practices of financial houses in order to promote effective execution of monetary policy

**QUIZ**

The apex institution of the monetary and banking system in a country is known as …………………………

**ASSIGNMENT**

Explain the implication of Central Bank in Nigeria

**LESSON 6**

**LESSON OUTLINE:**

* Developmental Functions of The Central Bank
* **Development Banking**
* **Financial Institution Intermediaries**

**Developmental Functions of The Central Bank** These are activities of the Central Bank to promote growth in various sectors of the economy.

1. Promotion of the growth of financial markets: The Central Bank usually initiates instruments of mobilizing short-and long-term funds in both the money and capital markets.
2. Promotion of development of financial institutions: The Central Bank participates actively (morally and financially) in the establishment of development banks e.g. Bank of Industry (BOI) and Nigeria Agricultural Cooperative and Rural Development Bank (NACRDB) in Nigeria, as well as non bank financial institutions including the Stock Exchange.
3. Human capital development: The Central Bank participates directly and indirectly in the training of manpower for the banking industry. For example, in Nigeria, the CBN is involved in the activities of the Chartered Institute of Bankers of Nigeria (CIBN) and the Financial Institution-Training Centre (FITC).
4. Establishment of special schemes and funds: The Central Bank promotes special schemes and funds in the areas of agricultural finance, export development and small and medium scale enterprises so as to enhance economic development. Examples in Nigeria include the Agricultural Credit Guarantee Scheme Fund (ACGSF) and Small and Medium Industries Equity Investment Scheme (SMIEIS).
5. Sources of data for research: Through its regular publications, the Central Bank provides information on financial indices and indicators for use in research and development (R&D) efforts.

**DEVELOPMENT BANKING** Development banks or Development Financial Institutions (DFIs) are specialized financial institutions established to contribute to the development of specific sectors of the economy e.g. industrial, commerce, agricultural, rural, urban and housing sectors. The role of development banks, especially in low-income countries (LICs) include:

1. Provision of medium and long-term loans for investment in various sectors like agriculture, manufacturing and commerce.
2. Identification, promotion and development of viable projects for the private sector.
3. Advice and assistance to indigenous businesses. This includes financial, technical and managerial advice to ensure profitable outcomes.
4. Directly investing in agriculture, housing, and mining sectors of the economy
5. Supervising the implementation of projects they finance but requesting progress reports and visiting the project sites,
6. They commission and/or carry out studies into the social and economic needs of the economy with a view to making policy recommendations to the government.
7. They develop in the citizens, entrepreneurial ability and support their efforts with take-off loans. (viii) They serve as a channel for bringing into the local economy investible funds from international organisations.
8. Nominating technical and managerial partners to both local and especially foreign investors thereby promoting foreign direct investments (FDIs). Examples of DFIs in Nigeria include the Nigeria Agricultural Cooperative and Rural Development Bank (NACRDB), Bank of Industry (BOI) and Urban Development Bank (UDB)

**OTHER FINANCIAL INSTITUTIONS** Some of the other institutions that play intermediating roles within the financial system are discussed below.

 **Finance Companies:**  Finance companies are institutions that specialize in short-term non-bank financial intermediation. Their activities include:

1. Mobilising funds from the investing public in the form of borrowing and providing facilities for local purchase order (LPO), project financing, equipment leasing, hire purchase and debt factoring;
2. Helping companies to establish efficient management structures and controls;
3. Providing corporate finance advice such as on capital restructuring and project financing services.

 **Discount Houses:**  Discount houses are financial institutions which intermediate funds between the Central Bank, licensed banks and other financial institutions. Their activities include:

1. Mobilizing funds for investment in short-term securities, especially treasury securities and other short-term financial instruments by providing discounting/rediscounting facilities.
2. Assisting financial institutions to effectively manage their idle cash balances by bringing together surplus and deficit units in the money market.
3. Underwriting issues of treasury securities thereby promoting monetary policy objective

 **Insurance Companies:**  Insurance companies, consisting of life and non-life institutions, are also important financial intermediaries in any economy.

Their main functions are:

1. Mobilising relatively long-term funds in the form of premiums from policy holders thereby promoting savings in the economy.
2. Investing their funds in bonds, stocks, mortgages and government securities, in the process contributing to effective utilization of scarce investible resources.
3. Providing palliatives in the form of `claims` where a policy holder suffers a loss. Hence, they encourage asset acquisition and facilitate the growth of commerce and industry.

**QUIZ**

3. The non –banking financial institution which intermediates funds between the central bank, licensed banks and other financial institutions is called……………

4. The market for short term loans is …………………

 5. The policy designed to regulate the value, supply and cost of money in an economy is referred to as ………………………

**ASSIGNMENT**

If the monetary base increases by N4billion, and the quantity of money increases by N10billion, what is the money multiplier?

**Lesson 7**

Lesson Outline:

* + Money Market
	+ Capital Market
	+ Monetary Policy
	+ Monetary Policy and Inflation
	+ Monetary Policy and Full Employment

**MONEY AND CAPITAL MARKETS**: The money and capital markets are financial markets created and nurtured by a country`s monetary authorities to mobilize savings for economic growth.

**The Money Market**: The money market is a market for short-term loans. It consists of financial institutions having surplus funds to lend on short-term basis, and those wishing to borrow. The market allocates savings into investment thereby promoting rational allocation of resources. It also encourages savings and investment habits by promoting liquidity and safety of financial assets.

 Institutions that operate in the market include the Central Bank, commercial banks, and discount houses. The major short-term instruments associated with the Nigerian money market include treasury securities, commercial papers, call money, Bankers Unit Fund, Bankers` Acceptances, etc.

 **The Capital Market:** The Capital market is a market for mobilizing medium and long-term funds. It is a market for new issues of securities as well as for trading in existing securities. The major instruments for raising funds in the capital market include equities, debentures, bonds, and stocks.

 The main institutions in the market are the stock exchange, the issuing houses, and the stock broking firms.

**MONETARY POLICY:** In this section, we consider the meaning, instruments and targets of monetary policy.

Monetary Policy Defined Monetary policy refers to the combination of measures designed to regulate the value, supply and cost of money in the economy in consonance with the expected level of economic activity. An expansionary monetary policy is that which is designed to increase money supply, while a contractionary or restrictive monetary policy is that which is intended to reduce money supply.

 **Instruments of Monetary Policy:** The main instruments or tools of monetary policy vary between economies and over time. However, the main instruments of monetary policy are:

1. Open market operations (OMO): This refers to purchases and sales of securities in the open market by Central Bank in order to achieve the desired level of money stock in the economy. To reduce money supply, the Central Bank will sell securities in the open market. Conversely, to increase money supply, it will require the purchase of government secursecuritie
2. Reserve requirements: This refers to the proportion of the total deposit liabilities of the commercial and merchant banks which they are required by law to keep as reserve with the Central Bank. The reserve requirements (i.e cash reserve ratio and liquidity ratio) will be increased to reduce money supply or reduced to increase money supply.
3. Discount rate: It is the minimum lending rate of the Central Bank at which it rediscounts bills and government securities, or the rate charged by the Central Bank on its loans to the commercial and merchant banks as a lender of last resort. It is used to regulate credit conditions and availability in the economy because other rates depend on it.
4. Moral suasion: It is the use of persuasion rather than compulsion by the Central Bank to get other financial institutions to adopt a pattern of behaviour that is favourable to effective conduct of the monetary policy.
5. Special deposits: Sometimes, commercial and merchant banks are required by law to hold a non-interest bearing special deposit with the Central Bank to complement other contractionary monetary policy measures.
6. Selective credit control: It involves issuance of credit guidelines to commercial and merchant banks to direct their credit facilities to the so-called favoured or preferred sectors of the economy.
7. Credit ceiling: It is a directive by the Central Bank prescribing the growth rate of credit expansion by the commercial and merchant banks. This is to ensure stability in both the domestic and external sectors of the economy.

 Monetary Policy Targets The instruments of monetary policy can be manipulated in different ways by Central Bank to achieve macroeconomic objectives of full employment, economic growth, price stability, and balance of payment (BOP) equilibrium.

 **Monetary policy and inflation**: The problem of inflation will call for contractionary monetary policy measures such as:

1. Sales of government securities (under OMO).
2. Increase of reserve requirements.
3. Increase of discount rate.
4. Call for special deposit .

All these measures will reduce money supply and aggregate demand in the economy and thereby operate to stem the inflationary pressure.

**Monetary Policy and full employment**: To raise the level of employment and output in the economy will require adoption of expansionary monetary policy measures i.e a reverse of the measures listed above for inflation.

**Quiz**:

 1. The market for short term loans is …………………

 5. The policy designed to regulate the value, supply and cost of money in an economy is referred to as ………………………

**Assignment**:

1. Distinguish clearly between the ‘money market’ and ‘capital market’

 2. Identify and discuss Four (4) instruments of monetary policy.

**Lesson 8**

Lesson Outline:

* + Introduction to Fiscal Policy
	+ Use of Fiscal Policy
	+ Use of Monetary Policy

**Fiscal Policy**

Fiscal Policy is the use of taxation and government expenditure to regulate economic activity. Fiscal Policy can be employed to achieve macroeconomic objectives of full employment, economic growth, external balance, price stability, and equitable distribution of income and wealth. For example, a period of economic recession or depression characterized by sluggish economic growth with rising unemployment would call for an increase in the level of government expenditure (especially to raise aggregate demand) as well as tax reliefs and concessions to local industries to stimulate domestic production. There measures are collectively referred to as expansionary fiscal Policy.

On the other hand, to control inflation pressure would require contractionary fiscal measures such as curtaining the growth of government spending, and raising taxes to reduce disposable income and aggregate demand.

**Use of Fiscal Policy**

Fiscal Policy is one of the two main macroeconomic policies used to control aggregate demand and thereby achieve price stability. Fiscal measures relate to taxation, government expenditure and public debt management, which seek to influence the level of aggregate demand in an economy.

There are three main tools of fiscal policy: government spending (G), the income tax rate (t) and government transfer payments(Tr).

In times of demand pull inflation these tools are used to reduce aggregate demand. All increase in tax rate, decrease in government expenditure and decline in government transfer payment will reduce aggregate expenditure in the economy. That is there is contractionary fiscal policy.

**Use of Monetary Policy**

Monetary policy is that part of macroeconomic policy which regulates the changes in money supply in order to maintain price stability.

Tools of monetary policy are changing discount rate (d); changing required reserve ratio (rr), reduces the extent to which commercial banks create credit hence reduces money supply. When the discount rate is increased, short term interest rates increase and this discourages borrowing to finance investment spending. This invariably reduces aggregate demand. Central bank selling of its own government securities to the general public reduces money supply which reduces aggregate demand. Generally, there will be contractionary monetary policy.

Quiz:

What is Fiscal Policy?

Assignment:

Give the importance of Fiscal Policy and Monetary Policy in Nigeria.

Lesson 9

Lesson Outline:

* + Introduction to International and Regional
	+ Balance of Payments
	+ World Bank Group
	+ IMF

**INTERNATIONAL AND REGIONAL ORGANISATIONS .**

Following the serious economic conditions encountered worldwide during the Great Depression of 1930s, political leaders in both developed and less developed countries recognised that “no country is free from poverty until every country is free from poverty”.

Therefore, the desire to promote economic well-being of their people coupled with the realization that trade and economic cooperation can be an important stimulus to rapid economic growth, has led to the establishment of a number of international and regional organizations immediately after the second World War (1939 – 1945).

**BALANCE OF PAYMENT**

Balance of payment is an account that summarizes a country’s total payments and total receipts from international economic transactions within a specific period usually one year.

The main reason for compiling the balance of payments is to inform the government authorities in a particular country of the international position of the country. It also helps policy makers in taking decisions on monetary and fiscal policies on one hand, trade and payment policies on the other.

**The Accounting Principle of the Balance of Payment**

Under the balance of payments, international transactions are classified as either credit (positive) or debits (negative). A credit transaction involves the receipt of payment from a foreigner. A debit transaction is a transaction that involves the making of payment to a foreigner.

The export of goods and services, unilateral transfers (gifts) received from foreigners and capital inflows are recorded as credits (+). On the other hand, the import of goods and services, unilateral transfers (gifts) made to foreigners and capital outflows are recorded as debits (-).

The Accounts of the Balance of Payments

The Balance of payments has three main parts namely: the Current Account, the Capital account and the Official Reserves Account.

 (a) **The Current Account**

The Current account is subdivided into three main items: merchandise imports and exports, services imports and exports and unilateral transfers. Merchandise imports and exports are also referred to as visible trade and services imports and exports and unilateral transfers dubbed invisible trade.

(i) Merchandise Account or Visible Trade: This records trade in merchandise, that is, export and import of goods. Visible goods are for example, crude oil, timber, cars, etc. The difference between merchandise exports and Merchandise imports is termed as the Balance of Trade. When merchandise exports exceed visible merchandise import, the country is said to have trade surplus. The country has a trade deficit if merchandise imports exceed merchandise exports.

(ii) Services Accounts or Invisible Trade

The second section consists of services. It records the services of shipping and civil aviation, insurance, dividends, profits, remittances, government services, travel and tourism, banking services, etc. This section also includes unilateral transfers (gifts), that is, money transferred to and from foreign countries without rendering any services.

Transactions on the current account except unilateral transfers are referred to as autonomous, meaning they are undertaken because of profit motive. The difference between invisible exports and invisible imports is called the balance of services. This is classified as favourable or unfavourable. When invisible exports exceed invisible imports we have favourable balance of services, other wise we have unfavourable balance of services.

The total of the current account is the sum of (1) merchandise trade account (2) services account and (3) unilateral transfers.

(b) **The Capital Account**

The capital account deals with long and short-term capital movement. These capital movements are referred to as autonomous because they take place for business or profit motive. Long-term capital movements are overseas investments in shares or long-term securities or from the establishment of factories in foreign countries or the reporting country. The short-term are usually portfolio investment.

The movement of capital to a country represents an inflow of foreign capital and there is a corresponding outflow when such funds are withdrawn. An inflow of funds represents credit while an outflow represents debit.

(c) **Official Reserve Account**

This part of the balance of payments informs us about how the balance of both current and capital accounts taken together is settled. Transaction in this section is called accommodating transactions. They are accommodating transaction because the funds are moved to make the balance of payments balance. When the net balance on the current and capital accounts is in deficit, the deficit must be settled with an equal net credit in the official reserve account. If on the other hand, a country has a surplus, the surplus must be used up to balance the balance of payments.

**World Bank**

World Bank is an international financial institutions that provides interest – free loans and grants to the governments of poorer countries for the purpose o pursuing capital projects.

**The World Bank Group** comprises of the following four institutions:

(i) International Bank for Reconstruction and Development (IBRD)

(ii) International Finance Corporation (IFC)

(iii) International Development Association (IDA)

(iv) The Multilateral Investment Guarantee Agency (MIGA)

 **International Bank for Reconstruction and Development (IBRD)**

The IBRD – the original organization of the World Bank group was established in 1945. The bank and the International Monetary Fund (IMF) were products of the articles of agreement signed by representatives of a group of 44 nations at the United Nations Monetary and Financial Conference held at Bretton Woods, New Hampshire, USA in July 1944. It was for this reason that both IBRD and IMF were usually referred to as Bretton Woods Institutions.

The membership of the IBRD which was 44 at its inception in 1945 reached 182 in 2000 including developing countries of the West African Sub-region. The main objectives of the IBRD, also called the World Bank are:

i. To assist the economic development of member countries by providing loans, on reasonable terms, for the development of productive facilities and resources. ii. To provide and coordinate staff training and technical assistance for member countries on investment projects in which they lack the requisite manpower and technical knowledge.

iii. To promote private foreign investment by guarantees or through participation in loans and other investments made in the private sector of the economies of member countries.

iv. To conduct project feasibility and evaluation studies and act as executing agency for development projects financed by the United Nations Development Programme (UNDP).

v. To promote balanced growth of international trade and the maintenance of viable balance of payments positions by member countries.

The IBRD derives its resources from capital subscribed by member countries, funds received in repayment of past loans, and borrowing in the world capital markets through the issuance and sales of bonds. Over the years, the IBRD has been more relevant in the development efforts of the developing member countries in the areas of: i. Staff training and technical assistance, and

ii. Loan financing of projects in agriculture and rural development, ene

**International Finance Corporation (IFC)**

The IFC is a member of the World Bank Group established in 1956 to promote the growth of productive private enterprises in the developing member countries. All member countries of World Bank are qualified to the membership of the IFC.

The objectives of the IFC are:

i. To provide loans and equity capital for private enterprises thereby complementing the resources of private investors.

ii. To bring together investment opportunities, by encouraging local and foreign private investors cooperate in joint ventures.

iii. To provide technical assistance for member countries on private investment projects so that their enterprises can be productive and financially sound. iv. To stimulate and help create conditions conducive to the flow of private domestic and foreign capital into productive investments in member countries.

Although the IFC has been promoting productive private investments in developing member countries in line with the objectives of its establishment, however, the foreign capital flow into these countries have not been sufficient to make for impressive private sector performance.

**The International Development Association (IDA)**

The IDA was established as the soft loan window of the World Bank in September 1960.

Its membership is open to all members of the World Bank. The main objectives of IDA are:

i. To provide long-term soft loans to the governments of the world’s poorest countries for poverty alleviation.

ii. To promote human capital development in the poorest countries.

To achieve these two objectives, the IDA has extended credits to the poorest member countries at concessional rates. Such loans, which are repayable over a period of 30 – 40 years and with a 10 year grace period, were meant for poverty-alleviation related projects e.g. population control, education and health, nutrition, social safety, environment security, etc.

**The Multilateral Investment Guarantee Agency (MIGA)**

MIGA was established in April 1988 to make the World Bank Group more relevant to the development aspirations of the member countries. The primary aim of MIGA is to encourage the flow of Foreign Direct Investment (FDI) into developing countries. The principal objectives of MIGA are:

i. To provide insurance covers for investors against political and non-commercial risks e.g. war and civil disturbance, breach of contract by government, the danger involved in currency transfer and expropriation.

ii. To insure new investment, including the expansion of existing ones, and promote financial restructuring.

iii. To provide promotional and advisory services to the governments of developing member countries in their efforts to create enabling environment for local and foreign private investments.

iv. To establish credibility among investors, and higher credit rating among global banking and financial markets of its members.

Many developing member countries have been able to attract more foreign direct investment as a result of the insurance guarantee provided by the MIGA.

**INTERNATIONAL MONETARY FUND (IMF)**

The IMF, also referred to as The Fund, is an autonomous international financial institution established in 1945 under the Bretton Woods Agreement of 1944. Thus, it is a sister institution of the International Bank for Reconstruction and Development (IBRD).

The main objectives of the IMF, set out in article 1 of its articles of Agreement are:

i. To promote international monetary co operations through a permanent institution that provides the machinery for consultation and collaboration on international monetary problems.

ii. To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income.

iii. To promote exchange rate stability, to maintain orderly exchange arrangement among members, and to discourage competitive currency devaluation.

iv. To assist in the establishment of a multilateral system of payment in respect of current transactions and in the elimination of foreign exchange restrictions which hamper the growth of world trade.

v. To help member countries overcome their balance of payment difficulties through the provision of short to medium term credit and technical guidance.

The IMF introduced the Special Drawing Rights (SDRs) in 1970 to facilitate the expansion and balanced growth of world trade. The SDRs is an international financial asset designed to supplement gold, dollars, and convertible currencies.

To applies for IMF loan is expected to meet certain stipulated conditions, known collectively as “IMF conditionalities”, before such facility is granted. The conditions stipulated for some developing member countries to be met to qualify them for the use of the Fund’s financial resources have included devaluation of currency, removal of government subsidy on some products, reduction of public expenditure, trade liberalization, strengthening of the operational efficiency of revenue collection agencies, and reduction of grants and subventions to government parastatals.

The benefits derived by developing member countries, including West African countries, from their membership of the IMF include:

i. The signing of agreement with the Fund for stand-by facilities worth millions of dollars which boosted their credit worthiness in international trade.

ii. The use of SDRs allocation to solve their balance of payments and reserve problems.

iii. Manpower development efforts of member countries have been complemented by the Fund through training courses provided on economic and financial management.

iv. The Fund, on a regular basis, conducts studies on member countries economies and recommends necessary reform measures to improve growth performance.

**THE AFRICAN DEVELOPMENT BANK (ADB) GROUP**

The ADB Group is made up of the following institutions:

(i) African Development Bank (ADB)

(ii) African Development Fund (ADF)

(iii) Nigerian Trust Fund (NTF)

**African Development Bank (ADB)**

The ADB was established by the articles of Agreement signed in Khartoum, Sudan, by the Finance Ministers of 30 independent African countries on 4 August, 1963. It started business at its headquarters in Abidjan, Ivory coast (now Cote D’Ivore) in July, 1966. The member nations of the ADB include all independent African states and the non African members such as USA, Canada, Britain, France, Japan, etc. who were admitted following an amendment to its Charter in 1982.

The objectives of ADB are:

i. To finance investment projects and programmes of its members using its resources.

ii. To mobilize resources from outside Africa, especially from developed countries, for the financing of such investment projects and programmes.

iii. To undertake or participate in the selection, study and preparation of projects, enterprises and activities contributing to the development of its members.

iv. To provide technical assistance required in the selection, study, preparation and execution of development projects or programmes.

1. To promote investment in Africa of public and private capital projects or programmes designed to boost economic development or social progress of its members.
2. In pursuit of its policies of poverty alleviation and promotion of equitable growth in the continent, the ADB has granted loans to its African members, especially for projects and programmes which foster regional cooperation and integrated development within the member countries.
3. The problems of the bank in recent times have been identified as including:

i. The rapid decline in its financial resources due to increasing arrears on loan repayments from member countries.

ii. The continued concentration of its lending to a few member countries.

iii. Failure of member countries to pay their subscriptions timely and regularly

 **The African Development Fund (ADF)**

The ADF was established in 1972 as an affiliate of the African Development Bank (ADB) to provide development finance on easier repayment and interest terms than the ADB. The loans of the ADF are granted at no interest, a service charge of 0.7 per cent, a 10-year moratorium and repayment period spanning another 40 years. Thus, the ADF can be described as the ‘soft loan window’ of the ADB group.

However, the ADF facility is specifically meant for poorer countries with per capita GNP of less than $510. About 34 African countries have qualified under that category in the past 20 years. The primary objective of the ADF is to promote the economic development and integration of its members.

**The Nigerian Trust Fund (NTF)**

The NTF was established by the federal government of Nigeria in April 1976 to assist the development efforts of the poorest and most indebted member countries of the ADB. The NTF is therefore a member of the ADB group – it is administered by the ADB in consultation with the Nigerian government.

The NTF started with an initial capital of $80 million which grew to about $350 million in 1988. The NTF loans are granted at a 4 per cent interest, grace period is 5 years, and the repayment period ranges between 15 and 25 years. Not less than 18 member countries of the ADB benefited from the NTF loan commitment. The loans were granted to finance projects in the social/educational, industrial and agricultural sectors in those countries.

**THE EUROPEAN UNION (EU)**

What is today known as the European union (EU) was originally established as the European Economic Community (EEC) on 25 March, 1957 by the Treaty of Rome agreed to by the governments of Belgium, France, the Federal Republic of Germany, Italy, Luxemburg and the Netherlands. The EEC came into operation on January 1958, and was renamed the EU in November 1993. By 2006, the membership has increased to 25 including the United Kingdom, Denmark, Ireland, Greece, Spain, Portugal, Sweden, Austria and Finland that joined between 1973 and 1995.

The economic objectives of the EU include the following:

i. To promote free trade between member countries through the removal of tariffs and other non-tariff barriers to free trade.

ii. To harmonize trade policies of members by ensuring that members impose tariffs on import from non member countries at the same rate.

iii. To guarantee common internal price levels and promote stabilizations of farmers’ incomes by penalizing imported food items through a Common Agricultural Policies (CAP).

iv. To encourage free movement of factors of production, especially labour and capital, within the community.

v. To harmonize the tax systems of member countries with a view to removing any hidden barriers to trade.

vi. To integrate the monetary systems of member countries so as to facilitate the expansion of bilateral trades between member countries.

Vii To promote common regional policy through the establishment of a regional development fund. The EU is to ensure that no member nation is left to suffer economic depression.

viii. To develop common transport policy. ix. To create new world economic order and agreement with developing countries. A number of institutions, organizations and funds were established as well as common economic policies adopted to promote the realization of the above objectives.

Ix The major achievements of the EU from the standpoint of the impact of the various actions taken, on the economies of the member countries include:

i. The EU promotes specialization among member countries such that each member tends to specialize in their line of comparative cost advantage. This leads to efficient utilization of productive resources, greater output and improved standards of living within the sub-region.

ii. The EU provides a large market for the products of member countries. This encourages large-scale production with its concomitant economies of scale and increased employment opportunities.

III The removal of quotas and tariffs leads to keener competition in the larger market. This leads to effective resources allocation as a result of which factors of production receive higher incomes.

The EU has been relevant to the development aspirations of countries in West African sub-region under the Yaounde and Lome Conventions in the following ways:

 i. Financing rural-electrification projects.

ii. Providing grants to improve health facilities.

iii. Encouraging industrial cooperation through the transfer of technology, and funding research programmes to boost industrial activities.

Note that the Lome Convention is a series of trade and economic co-operations and agreements between the EU and countries from the African, Caribbean and Pacific states (ACP).

Quiz:

\_\_\_\_\_\_\_\_\_\_\_\_was the first country to received loan from World Bank

Assignment:

What are the significant impact of African Development Bank (ADB) on the African continent?