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The Limitations of Monetary Tools in a Developing Economy like Nigeria

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Abstract

In the classical system, the classical and neo-classical economists under the assumption of perfect competition, wages and prices flexibility, belief that the economy of was self adjusting and equilibrium income always tend towards its full employment level when disturbed especially in the long-run. These concepts were accepted and formed the corpus of economic knowledge from which polices were drawn. Governments were not to intervene in the event of any dislocation arising say from inadequate demand. The events of the Great Depression of 1929-1932 shook the very foundation of World Economics so that the classical schools prescription of no government action was no longer a solution. The need for a change *in concept was therefore obvious. Economists like John Maynard Keynes succeeded in making a transition from old to new. In his demand management ideas, he identified the issue of the deflationary gap which is inconsistent with the classical full employment. He therefore advocated for governments intervention in the economy. He also advocated for the use of fiscal policy to address economic problems. This paper analyzed both the classical and Keynesian policy prescription and came to the conclusion that the Keynesians prescription of government's intervention in the economy is necessary. The use of fiscal policy as prescribed by the Keynesian is more relevant to a developing economy like Nigeria.*

Introduction

Before the great depression of 1929-1932 that shook the very foundation of the world economies, the classical thoughts and principles were the principles nearly all countries recognized. These principles had wide unquestionable unchallengeable acceptability for a long time.

The system reached an unprecedented height that other systems that came after it could not achieve. This school of thought was referred to as a liberal school of economics because they preach economics liberalism. They extol individual ability, individual liberty and property. That is, the doctrine believes in personal liberty, private property, individual initiative and individual control of enterprises.

Between the time of the publication of Adam Smiths, wealth of the nations in 1976 up to the end up the 1930's all economic analysis were based on the classical and Neo-classical theories which believe in full employment. That means the economy was self regulating such that money wages, income, interest rates were all assumed to be flexible both upwards and downwards as such there should be full employment of all resources. Since the economy was self regulating and always tending towards full employment there was no need for government intervention by way of fiscal or monetary policies. The period 1927 – 1933 was a decisive one in the economic history. That was the period of the Great Depression which was characterized by high unemployment, low private capital investment, massive bank failures just to mention a few. When these were happening, there was no rule to restore them back to normalcy because the classical analysis could not explain this as such there was need for a review of the classical theories. It was during that period that John Maynard Keynes came out with his policies that were revolutionary and the birth place of Macro-economic theory when he published his book titled "The General theory of employment, interest and money" in 1936 to address the problems. John Maynard Keynes advocated for government's intervention in the economy since the economy had failed to regulate itself.

Keynesian – Classical Differences

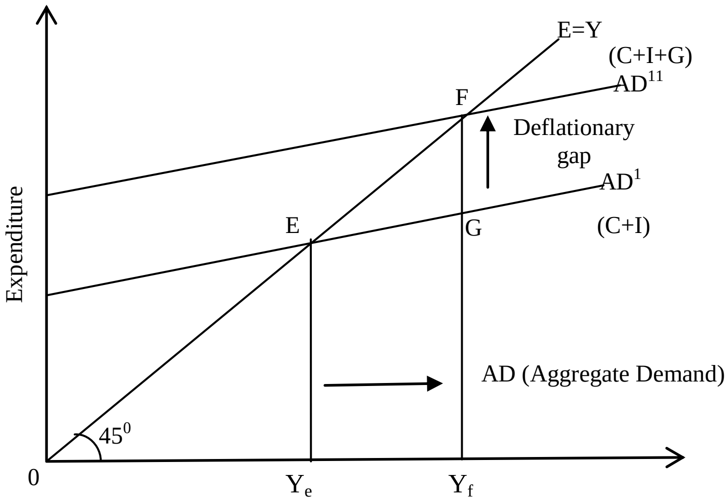
The following are some of the major differences between the two schools of thought:-

1. The classical economics emphasis only on the transactions and precautionary demand for money. The Keynesians added the speculations motive for liquidity preference.
2. In the classical system, the rate of interest is conceived to be the reward for waiting and so it is determined by the forces or interplay of the demand for and the supply of savings. The Keynesians also recognized the existence of the liquidity trap unlike the classical system.
3. The classical economics recognized savings as the function of the rate of interest $S = f(r)$. The Keynesians introduced the consumption function and argued that savings was not the function of the rate of interest. Savings is the function of the level of income $S = f(Y)$. That is $S \neq f(r)$ but $S = f(Y)$.
4. While money wages and product prices were assumed flexible both upwards and downwards in the classical system, they are not flexible downwards within the Keynesian system. This is

because of minimum wage laws, labour contracts regarding wages as well as the activities of trade unions.

5. In the classical theory, equilibrium National Income is synonymous with equilibrium with full employment especially in the long run. That is, there could be disequilibrium only in the short-run but by the long run full equilibrium will be achieved. The Keynesians concentrated only on the short run because they believe that in the long run everything will be dead. To explain how full equilibrium could be restored in the short run by the Keynesian analysis, the paper will look at the deflationary gap and its elimination.

The Deflationary Gap and its Elimination



The deflationary gap is said to exist when aggregate demand by the economy's consumers as well as investors falls short of the full employment level of income.

On the graph FG is the deflationary gap. The existence of this gap is attributed to the inflexibility of product prices, money wages and the liquidity trap. According to Keynes this gap can be made up for by government spending of money (from G to F) to increase the level of equilibrium income to its full level. Government spending adjusts the deflationary gap.

Y_e = equilibrium income due to C + 1

Y_f = equilibrium income due to C + 1+G.

In the absence of government spending (G), full employment (Y_f) cannot be attained. From the graph, the aggregate demand occasioned by AD' which is consumption and investment (C+1) leaves us with the deflationary gap FG.

The interplay of the forces of demand and supply (classical) has failed to give Y_f as such under the Keynesian system the government should spend an amount yearly equal to FG without raising taxes to restore equilibrium income to Y_f (full employment).

The expenditure is shown on the graph by a shift from AD_I curve to AD_{II} curve and at this point Y_e is also equal to Y_f. The gap is the potential level of income and the actual level of income, that is, what the economy is capable of producing and the actual production.

From the above analysis it can be seen that the Keynesians advocated for government's intervention in the economy. The question now, is, to what extent government should intervene in the economy? This can be looked at from the capitalist economy, controlled economy and mixed economy.

There are three basic types of economic systems namely;

- Free enterprise or capitalist economy
- Centrally planned or socialist economy and
- Mixed economy.

Free Enterprise Economy or Capitalism: This is an economic system in which the means of production are predominantly owned by private individuals. These owners of productive resources take decisions on the use and deployment of these resources. Thus, there is freedom of use of factors of production by users and suppliers. In this economic system resource allocation is exclusively through the price mechanism. The prices of goods and services are determined by the forces of demand and supply. These prices also determine the quantities of goods and services that each user would purchase at any point in time. It must however be admitted that pure capitalism does not exist but some countries adopt economic policies that tend towards capitalism. These countries include Japan, Germany and United States of American (U.S.A.).

Centrally Planned Economy or Socialism: Centrally planned economy is an economic system characterized by public ownership of the means of production. Two types of socialism can be identified.

(a) Command Socialism: In this type of socialism means of production are owned by the government and decisions on the use and allocation are taken by the central planning committee comprising party leaders, administrators, technicians in various areas of specialization.

(b) Market socialism: In a market social economy means of production are owned by the government but allocation of resources is through the price system as in capitalist economy. Countries that practice socialism include Republic of China, former Yugoslavia and Russia.

Mixed Economy: Mixed economic system possesses some features of both capitalism and socialism. Economic decisions are not made by only private individuals or by the government; rather they are made by powerful economic groups such as businesses entrepreneurs, organized labour unions and the government. There exists the private sector controlled by private individuals and public sector controlled by the government all in the same state. The government can intervene in the activities of the private individuals where such activities are deemed unhealthy or exploitative. Thus, the government can control prices of goods and services and can set up minimum wages. France and Britain practice mixed economic system (Uguji et al 2004).

Nigeria is a mixed economy so this analysis will continue based on the Nigeria situation.

Basically, the macroeconomic objectives or goals of the government in any economy include.

(i) Promotion of steady economic growth and development. Policy measures are put in place to promote the growth of the Gross Domestic Product (GDP) at a very fast rate.

(ii) Maintenance of relatively stable price level in the economy. This is done in such a manner that the economy will neither experience inflationary or deflationary situation.

(iii) Promoting the full employment of resources in the economy or at least a reasonable percentage of resources.

(iv) Ensuring equitable distribution or redistribution of income in the economy.

(v) Maintenance of a healthy balance of payment and equilibrium balance in the external sector.

(vi) Ensuring economic independence and self-reliance

(vii) Alleviation of poverty.

Instruments of Achieving Macroeconomic Objectives

The instruments or tools used by government to achieve these objectives are either fiscal or monetary policy measures or both. Depending on the direction of economic policy and the prevailing economic conditions in the economy, government can use contractionary fiscal and monetary policy measures or expansionary fiscal and monetary policy measures to achieve macroeconomic objectives. These instruments are usually embedded in the annual budget of the government.

Fiscal policy instruments used by the government, include government expenditure, tax policy (direct and indirect taxes) transfer payments etc. These instruments can be used to influence fiscal policy in order to achieve allocation function, stabilization function and the distribution functions.

Monetary policy employs instruments of direct and indirect measures. These include open market operation; cash reserve ratio, liquidity ratio, interest rate policy, stabilization securities and foreign exchange rate policy. Both fiscal and monetary policy measures could be expansionary or contractionary depending on the prevailing economic conditions so as to achieve desirable macroeconomic goals.

There is also the use of exchange rate policy to manipulate and influence the external sector so as to achieve the desired macroeconomic objectives. This involves the use of appropriate exchange rate management policy such as fixed or floating exchange rate regime. By fixed exchange rate, the government decides administratively how much its currency should exchange for other currencies. The government may devalue or revalue its currency depending on what the economy wants to achieve at a particular point in time. On the other, hand under a freely floating exchange rate regime the value of the domestic currency is allowed to be freely determined on the foreign exchange market with its value fluctuating daily.

Another tool is the use of incomes policy to influence the distribution and redistribution of income in the economy. One way of achieving this is through the review of wages and salaries and setting of minimum wage.

Conflict of Target in the Implementation of Monetary and Fiscal Policy Measures

The realization of desirable macroeconomic goals and objectives involves an appropriate mix of both fiscal and monetary policy measures. This is done in such a manner that the pursuit of one macroeconomic goal should not be at variance with one another. For example, contractionary fiscal policy measures put in place to control inflation should be complemented with an appropriate monetary policy measure so that in pursuing that goal the economy will not stagnate. On the other hand expansionary monetary policy put in place to boast economic growth should not experience inflation. In practice however, economic policy is a mixture of both fiscal and monetary policies except that the Keynesians lay more emphasize on fiscal rather than monetary policies.

Why should the Keynesian lay more emphasis on fiscal rather than monetary policies? The Keynesian model offered ample scope for illustrating the significant role that the government can play in influencing the level of overall economic activity. The role of government in developing economies goes beyond short-term regulatory activities and beyond that of being just one of several agents within the economy, to that of a dominant agent whose activities are aimed at medium and long-term structural transformation of the economy.

Before Keynesian macroeconomics gained wide acceptability, that is, when classical macroeconomics was still dominant, the debate as to whether an economy should be left to itself, that is, to operate under laissez faire conditions, as opposed to allowing government intervention was quite fashionable. According to Olofin (2001), there are still some circles of contemporary economists, particularly those taking after Milton Friedman of the Chicago School where this debate is being kept alive. This notwithstanding, there is hardly any contemporary economy today, be it a capitalist or a centrally planned economy in which the role of government in influencing the level of economic activity can be brushed aside. The choice is no longer intervention, but rather as to what extent and in what areas of the economy the government can and ought to intervene. The question pertaining to the scope and degree of government intervention continues to be an issue in developed and developing countries alike.

Within the context of market economies or the so-called mixed economies, the government seeks to influence the economy through direct and indirect means of control.

Most of the developing countries' economies are tied to the business cycles of the advanced industrialized economies over which they have very little, if any control. To achieve their economic goals, most developing economies sometime find themselves pursuing short-term goals of monetary or fiscal policy, usually out of necessity to imitate the activities of government in their former metropolitan countries regardless of whether any degree of effectiveness can be expected from such measure of not. This is often due to the fact that most of the government institutions in these countries are a direct copy of the institutions in the former metropolitan country, with little or no modifications by way of structure and defined functions. For example in Nigeria the capital market is not quite developed hence few instruments and most of the monies in Nigeria lay outside the banking system as a result the use of monetary tools to influence the economy is limited. Monetary tools are more effective in a developed economy because most of their monies lie within the banking system. Fiscal tools as suggested by the Keynesian are a better option in a developing economy than a developed one.

The two most important fiscal policy tools of government are government expenditure and taxation.

Government expenditure can be used when the economy is in a depression and undesirable consequences such as increased unemployment sets in. To pull the economy out of depression government can either increase government expenditure or reduce taxes or apply a combination of both. On the other hand, when the economy is in a boom and inflation among other ills threatens, the government can apply necessary breaks on the economy by either reducing direct government expenditure or increasing taxes. This in a nutshell sums up the basic principle involved in conventional government fiscal policy control and how they are expected to work.

In contrast, the classical/monetarist school often identified with Milton Friedman of the University of Chicago argument that boils down to favouring minimal government intervention in seeking to influence the level and direction of economic activity.

From the view point of developing economies the long-term goal envisaged in the monetarist approach may not be consistent with the inevitability of government massive spending programmes aimed at the long-term structural transformation of otherwise backward and dualistic economies with large under-monetised traditional sectors. There is yet to be a systematic study so far, undertaking to determine the impact of this kind of policy on a typical developing economy. Given the various supply constraints in an average developing economy, a policy aimed at steady increases in the stock of money is likely to be highly inflationary (Olofin 2001).

In summary, issues surrounding what monetary policy entails, how it may be pursued, and how to measure its effectiveness remain highly controversial. For most of the developing world, the problem as to the relevance or effectiveness of monetary policy remains a circumstantial one in which there is little choice to make other than relying on fiscal policy, and that by way of direct public spending as opposed to taxation.

Summary

The events of the great depression of 1929 – 1932 shook the very foundation of the world economies so that the classical schools prescription of no government action was no longer a solution. The need for a change in concepts was therefore obvious hence the "Keynesian Revolution." Some of the main highlights have been discussed, particularly the issue of the deflationary gap which is inconsistent with the classical full employment. Based on this, the Keynesians advocated for governments intervention in the economy. They advocated for the use of fiscal policy to address economic problems.

The use of any particular policy depends on the convictions of the government in power. In practice however, economic policy is a mixture of both fiscal and monetary policies, except that the Keynesians lay more emphasis on fiscal rather than monetary policies.

Conclusion

The effectiveness of monetary policy measures hinges on a number of factors namely:

(i) The institution of the Central Bank and what roles it performs in a given economy

(ii) The degree of monetization of a given economy – in Nigeria most of the currency lies outside the banking system hence the limitations of the monetary tools to affect money supply in a developing economy.

(iii) The level of development of the economy’s financial sector and its institutions such as commercial banks, financial intermediaries and other monetary institution. In majority of developing economies, the Central Bank is essentially a banker to government. Rather than being an independent monetary authority capable of instituting independent monetary policies as it is the case in most developed economies, it is often tied to the Ministry of Finance. Furthermore these economies are by nature dualistic economies in which a large sector, the traditional sector carries out its transaction with little or no recourse to money as a medium of exchange. Financial institutions such as Commercial banks and financial intermediaries and other financial institutions often operate in a rudimentary monetary sector, performing very limited functions. Given these very restrictive circumstances, the set of tools which constitute traditional tools of monetary policy can be expected to be of little (limited) or no relevance in most developing economies.

Monetary tools are more effective in developed countries where the banking system is very efficient and the currency is more within the banking sector. This write up recommends with the Keynesian economies the use of fiscal policy by way of direct public spending as opposed to taxation in a developing economy like Nigeria.

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