# THE EFFICACY OF MONEY SUPPLY ON ECONOMIC GROWTH IN NIGERIA (1980 - 2014)


BY

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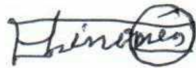
**CERTIFICATION**

This is to certify that this research was done by KUNLE-ONI TEMITOPE ATIUNKE, a student of Economics and Development Studies with matric number EDS/11/0179, Federal University Oye Ekiti, Ekiti State.



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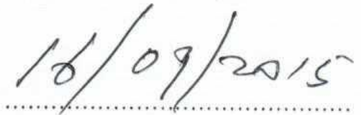


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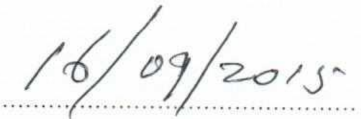


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## DEDICATION

I dedicate this project work to Almighty God, for his grace that was sufficient for me and also for granting me the knowledge to carry out this work. Also, to my parent and siblings who supported me in every aspect and for their unmeasured love towards me, I say a big thank u. Love you all.

## ABSTRACT

This research is carried out on the impact of money supply on economic growth in Nigeria (1980-2014). This study is necessitated by the existence of some major problems which include price instability, persistent inflationary rate and unemployment in the economy in spite of the adopted monetary policies used to combat the problems. The primary objective of this research is to investigate the efficiency and effectiveness of money supply on economic growth in Nigeria.The research employs quantitative methodological framework and specifically draws on econometric technique to find the relationship between economic growth (RGDP), exchange rate, money supply, inflation rate, and government expenditure. This work investigate the short and long run relationship between economic growth (RGDP), exchange rate, money supply, inflation rate, and government expenditure. E-view 7.2 was the statistical package used to carry out the analysis on Phillip Perron stationary unit root test, regression analysis, Pairwise Granger causality test, Johansen co-integration test and the Error Correction Model (ECM). The stationary test conducted using Phillip Perron reveals that the variables used are stationary at levels. The regression analysis shows that money supply and economic growth are positively related in the short run holding all other variables constant that is, an increase in money supply will increase economic growth by 0.026%, also it shows that exchange rate has positive impact on economic growth in the short run holding other variables constant. Pairwise Granger causality test also shows that it is economic growth that granger cause money supply. The Johansen Co-integration test suggest that at least two variables are co-integrated at 0.05% level of significance, it can also be noted that Johansen shows the long run relationship between money supply and economic growth

and its posit a negative relationship. The ECM reveals that it is paramount that the speed of adjustment be ascertained since the variable (money supply and RGDP) co-move in the long run and it will take nine (9) years for this disequilibrium to be cleared. it also shows that in the long run money supply and economic growth (RGDP) are negative related. Among the recommendation drawn is that government should adopt effective monetary policies to curb the problems stated above by implementing the right policies and putting in power transparent and accountable policy makers to achieve the objective stated above.

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# CHAPTER ONE

# INTODUCTION

## 1.1. BACKGROUND OF THE STUDY

Money is a legal tender generally acceptable by law as a medium of exchange. Money Supply implies the amount of cash and currencies available in economy insufficiently liquid and spendable forms at any point in time. It is on this notion that money forms a very important instrument which can be manipulated as a money stock variable in order to control money supply in the economy. The LM curve is a graph that shows all combination of interest rate(r) and income(y) that equates the supply and demand for money in the financial market when the money supply curve is fixed.

The relationship between money supply and economic growth has been receiving increasing attention than any subject matter in the field of monetary economics in recent years. Economists differ on the effect of money supply on economic growth. while some agreed that variations in the quantity of money is the most important determinant of economic growth and that countries that devote more time to studying the behaviour of aggregate money supply experiences much variations in their economic activities(Handle 1997),others are sceptical about the role of money on gross national income (Robinson 1950, 1952).

Kuznet (1955) supports the view that financial markets start growing as the economy approaches the intermediate stage of the growth process and develop once the economy becomes matured. This connotes that economic growth stimulates increased financial development. Steve (1997) and Domigo (2001),explain that there may not be possibility of economic growth without an appropriate level of money supply, credit and appropriate financial conditions in general.

Money supply can have both positive and negative effect on economic growth. Economic growth is a long term expansion of a country's productive potential. Nigeria has been controlling her economy through variation in her stock of money. Consequent upon the effect of the collapse of oil price in 1981 and the balance of payment (BOP) deficit experienced during this period, various methods of stabilization ranging from fiscal to monetary policy were used. Ikhide and Alwoda (1993) concluded that reducing money stock of money through increased interest rates would lower gross national product (GNP). Thus the notion that stock of money varies with economic activities applies to the Nigerian economy.

Money plays a fundamental role in an economy. This role has been vividly described by the quantity theory of money represented by Fisher's Equation of Exchange and the New Quantity Theory of Money as ascribed to a variant of the Chicago School tradition. According to Shepherd and Duck (1978), there is substantial and growing evidence that one of the necessary conditions for economic and financial stability is that the expansions of the money stock be adequately controlled. This has to be so because in the view of Laidler (1971), changes in the money stock influence economic activities after a time lag. This has led a number of economists, including Friedman (1968), to argue that the most sensible monetary policy involves the central bank's ensuring that the money stock be expanded annually in conformity with the economy's growth rate. Thus, given this strategic role of money, it is imperative to control its behavior.

Discussing the concept of money supply on economic growth two issues often come to mind and they are inflationary pressure and the unemployment rate. According to the monetarist, an increase in money supply in an economy causes an increase in general price level of commodities which brings about inflationary in the country (uzougu 1981). Also related to the issue of inflation is the issue of unemployment which is the primary goal of any economy so as to produce as many goods and services as possible while maintaining an acceptable level of price stability, but this

major goal will be very difficult to attain at high inflation rate and price instabilities due to excess money supply in the economy.

## 1.2. STATEMENT OF THE PROBLEM

This study is necessitated by the existence of some major problems which include price instability, persistent inflationary rate and unemployment in the economy in spite of the adopted monetary policies used to combat the problems. Money growth was often in excess of real economic growth. However, preceding the growth in money supply, some factors reflecting the structural characteristics of the economy are observable. Some of these are supply shocks, arising from factors such as famine, currency devaluation and changes in terms of trade.

There is also this problem of general feeling that a continuous annual rate of money increase will adversely increase the rate of price level which will directly lead to inflation, which may deny the intended effects of use of monetary policy measure to influence economic growth thus, requiring a policy response.

## 1.3. OBJECTIVES

The primary aim of this study is to investigate the efficiency and effectiveness of money supply on economic growth in Nigeria. As a result of the stated problem this study will focus on the following objectives;

- To examine the impact of money supply on economic growth in Nigeria.
- To examine the relationship between money supply and economic growth.
- To show the causality effect between money supply and economic growth.
- To use the Error Correction Model to determine the rate or speed of adjustment.

### 1.4. RESEARCH QUESTIONS

To achieve the stated objectives,the following research questions are examined.

- What is the impact of money supply on economic growth?
- What is the relationship between money supply and economic growth?
- What is the causality effect between money supply and economic growth?
- What is the speed of adjustment?

### 1.5. JUSTIFICATION OF THE STUDY

This project work will help in filling the gap of price instability by curb inflationary tendencies, persistent inflation rate by increasing tax on personal income and corporate firm profit to lower money in hand and to ensure a relative price level, also to fill the gap of unemployment by increasing money supply with a reduced interest rate to encourage investors to invest in the industry to create more job opportunity.

### 1.6. SCOPE OF THE STUDY

This study will rely on the secondary data for this study of which the sources are the Central bank of Nigeria (CBN) statistical bulletin 1980 to 2014 versions. The research work centers on the impact of money supply on economic growth in Nigeria from 1980 – 2014, It is expected in course of this study that the researcher will examine and appraise the stock of money supply and its impacts with regards to growth in the Nigerian economy.

### 1.7. ORGANISATION OF THE STUDY

This study will be divided into five chapters; chapter one will capture the introduction while chapter two will focus on the literature review; chapter three will be on the methodology utilisied

for the study; while, chapter four is focused on the data analysis and interpretation: chapter five gives the summary,conclusion and recommendation.

## 1.8. DEFINITION OF TERMS

**Real Gross Domestic Product:** is a macroeconomic measure of the value of economic output adjusted for price changes (i.e., inflation or deflation). This adjustment transforms the money-value measure, nominal GDP, into an index for quantity of total output. GDP is the sum of consumer spending, Investment made by industry, Excess of Exports over Imports and Government Spending. Due to inflation GDP increases and does not actually reflect the true growth in economy. That is why inflation rate must be subtracted from the GDP to get the real growth percentage called the real GDP.Since real GDP is adjusted for inflation throughout the year, it can be thought of in terms of purchasing power. As a result, individual purchasing power can be measured by real GDP per capita, i.e., real GDP divided by the size of the population.

**Exchange Rate:** an exchange rate between two currencies is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country's currency in terms of another currency

**Money supply:** The entire stock of currency and other liquid instruments in a country's economy as of a particular time. The money supply can include cash, coins and balances held in checking and savings accounts. Economists analyze the money supply and develop policies revolving around it through controlling interest rates and increasing or decreasing the amount of money flowing in the economy. Money supply data is collected, recorded and published periodically, typically by the country's government or central bank.

**Inflation Rate:** In economics, inflation is a sustained increase in the general price level of goods and services in an economy over a period of time. When the price level rises, each unit of

currency buys fewer goods and services. Consequently, inflation reflects a reduction in the purchasing power per unit of money – a loss of real value in the medium of exchange and unit of account within the economy. Inflation affects an economy in various ways, both positive and negative. Negative effects of inflation include an increase in the opportunity cost of holding money, uncertainty over future inflation which may discourage investment and savings, and if inflation were rapid enough, shortages of goods as consumers begin hoarding out of concern that prices will increase in the future. Some of the Positive effects include; inflation gives everyone an incentive to spend and invest, because if they don't, their money will be worth less in the future. This spending and investment can benefit the economy, Inflation reduces the real burden of debt, both public and private

**Government expenditure:** these includes all government consumption, investment, and transfer payments. In national income accounting the acquisition by governments, of goods and services for current use, to directly satisfy the individual or collective needs of the community, is classed as government final consumption expenditure. Government acquisition of goods and services intended to create future benefits, such as infrastructure investment or research spending, is classed as government investment (government gross capital formation). These two types of government spending, on final consumption and on gross capital formation, together constitute one of the major components of gross domestic product.

Government spending can be financed by government borrowing, seigniorage, or taxes. Changes in government spending is a major component of fiscal policy used to stabilize the macroeconomic business cycle

# CHAPTER TWO

# REVIEW OF LITERATURE

## 2.1 INTRODUCTION

This chapter focuses on explaining the topic of this research which is The efficacy of money supply on economic growth in Nigeria(1980-2014) and can be done in three aspect; the conceptual framework that explains the two major terms in this project work which are; money supply and economic growth, its also looks at the theories and finally it discuses the empirical review, that is the previous information gotten on the project work.

## 2.2 CONCEPTUAL FRAMEWORK

### 2.2.1 DEFINITION OF MONEY SUPPLY

Although, in case of difficulties in finding much of existing literatures on money supply, policy makers have agreed on that the reason could be the inaccessibility of various channels through which money is supplied. These channels are shared by the federal government fiscal policies via tax cuts and budget spending and the central bank of Nigeria's monetary options.

The first known attempt to define the concept of money supply in Nigeria economy was done by Roman and Newlyn, both monetarists agreed that the definition of money supply should base on the stage of development of the financial system and the concept of money adopted which serves as a working rule for measurement purposes and guided by the institutional framework of this economy. Meanwhile, the supply of money implies the amount of cash and currencies available in economy insufficiently liquid and spendable forms at any point in time. It is on this notion that money forms a very important instrument which can be manipulated as a money stock variable in order to control money supply in the economy.'

Money supply can also be defined as the sum of all the money holdings of all the members of the society. This could be either M1 or M2, M1, M2 and M3 in United Kingdom (UK) or M1, M2, M3 and M4 in United States of America (USA). The M1 is a narrow measure of money supply, it focuses on the role of money as a medium of exchange and defines money as "currencies in circulation outside the banks plus demand deposits held in banks" = C+DD.

The central bank of Nigeria defines M1 as currencies outside banks plus positively held demand deposits. M2 is a broad measure of money supply. It includes savings and time deposits =C + DD for M1 +SD+TD for M2. The argument for including time and savings deposits of commercial banks is that they can be converted into cash in short notice and used to carry out financial transactions.

Money supply is the amount of money that is available to the economy at any point in time. Money supply could be defined both in narrow and broad terms, depending on the ease with which it could be converted into cash. A narrow definition of money supply comprises currency in circulation and demand deposit, while a broader definition would include balances in other deposit accounts. In Nigeria, narrow money (M1) consists of the currency in circulation plus demand deposits while broad money (M2) is made up of narrow money plus savings, time and foreign currency deposits. The definition of what constitutes narrow or broad money depends to a large extent on the level of development of financial infrastructure and its deployment.

The supply of money is a stock at a particular point in time, though it conveys the idea of a flow over time. The term Money supply refers to the amount of money in the hands of the non-bank public at a point in time and the some balances in commercial banks (Okeowo, 2008). The Central Bank of Nigeria (CBN) as well as public and private analysts shows interest in the growth of money supply because of the impact it is believed to have on real economic activities and the general price level. The growth in money supply will lead to inflation if demand for money is stable if increase in money supply is not met by equal increase in demand (Umeora,

2010).

Money supply is the amount of money within a specific economy available for purchasing goods or services. The broad definition of money supply (M2+) is adopted which includes currency in circulation, demand deposits, quasi-money and foreign currency deposits (WAMA, 2009)

Money supply is defined differently in different countries depending on the level of development of their financial system. In Nigeria, this level is low. Savings and Time deposits first have to be converted into cash or demand deposits before they can be used as medium of exchange. Consequently, the official definition of money supply in Nigeria is M1 which comprises notes and coins in circulations and demand deposits in commercial and central bank. Other wider definitions of money merely add to M1. For instance, M1 is obtained by adding savings and time deposits at commercial banks to M1. The supply of money is the stock of money at a particular point in time. The supply of money at any moment is the total amount of money in the economy (Jhingan, 2006). According to Anyanwu and Oaikhenan (1995), money supply is the assets which represent immediate purchasing power in the economy and which as a result function as a medium of exchange.In Nigeria, the narrow money supply (M1) is defined as currency outside bank plus demand deposits of commercial banks plus domestic deposits with the central banks less Federal Government deposits at commercial banks. In simple terms, M1 is defined as;

$M1 = C + D$

Where:

M1 = Narrow money supply

C = Currency outside banks

D = Demand deposits.

Ajayi (1978) contends that M2 is the appropriate definition of money in Nigeria. In the UK narrow money includes M0, M1 andM2. M0 includes only notes and coins in circulation and in bank tills, m1 includes notes and coins in circulation and sight deposits with banks, M2 includes not only notes and coin and bank current accounts, but also 7-days bank deposits and some building society deposits. In the Nigerian context board money (M2) is defined as M1 plus quasi money. Quasi-money as used here is defined as the sum of savings and time deposits with commercial banks.Symbolically shown as;

$$M2 = C + D + T + S$$

Where:

M2 = Board money

C = Currency outside banks

D = Demand deposits.

T = Time deposit

S = Savings deposits

### 2.2.2 WHY IS THE MONEY SUPPLY IMPORTANT?

Money is used in virtually all economic transactions, it has a powerful effect on economic activity. An increase in the supply of money works both through lowering interest rates which spurs investment and through putting more money in the hands of consumers, making them feel wealthier and thus stimulating spending. Business firms respond to increased sales by ordering more raw materials and increasing production. The spread of business activity increases the demand for labour and raises the demand for capital goods.

Also in a buoyant economy, stock market prices rise and firms issue equity and debt. If the money supply continues to expand and prices begin to rise, especially if output growth reaches capacity limits. As the public begins to expect inflation, lenders insist on higher interest rates to offset on expected decline in purchasing power over the life of their loans. Opposite effects occurs when the supply of money falls or when its rate of growth declines. Economic activity declines either disinflation (reduced inflation) or deflation (falling prices) results.

### 2.2.3 MEANING OF MONETARY POLICY

Generally, monetary policy is a tool of general macroeconomic management, under the control of the monetary authorities, designed to achieve government economic objectives. Monetary policy aims at achieving certain national goals which have historically included full employment (or a low unemployment rate), high output (or a high output growth), a stable price level (or a low inflation rate), and a stable exchange rate (or a desirable balance of payments). These are often referred to as the "ultimate goals" of monetary policy. These goals are usually achieved indirectly by the monetary authorities (central banks) through its use of monetary policy instruments. These instruments, though different from country to country, usually include open market operations (OMO), changes in discount/bank rate (both of which determine the monetary base), and required reserves (the minimum reserves the commercial banks must hold against the public's deposit with them).

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

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

- **Structural differences:** This includes the structure of the financial sector, types and level of debt, openness to trade, commodity dependence, fiscal discipline, etc.
- **Degree of Indexation:** This is very common with countries within various levels of economic integration which requires different types of indexation. In addition, there are other nominal rigidities that affect the speed of transmission from monetary policy instruments to inflation.
- **Institutional arrangements:** This refers to the number of institutions making up the monetary authorities, the enabling laws, data availability and related factors that may influence the way in which monetary policy responds to macroeconomic developments.

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

### 2.2.4 DERTERMINANTS OF MONEY SUPLY IN NIGERIA

The supply of money in Nigeria based on its composition appears to be determined basically by the behaviour of two main economic factors. First, is the behaviour of the banks concerning the amount of reserves that they decide to keep at any point in time. This amount given the fact that banks maximize profits in the long run is influenced by the banks foresight and their perception of the economic activities surrounding them. Secondly, the behaviour of the non-bank public in dividing their money between currency and demand deposits, The larger the non-bank public's marginal currency deposits and money supply resulting from it, the larger the monetary base or high-powered money.

### 2.2.5 CONTROL OF MONEY SUPPLY IN NIGERIA

To effectively put a curb on supply of credit in Nigeria, the following measures are necessary:

- The expansionary measures
- The contractionary measures

The expansionary measures deals the with government policy to increase the volume of money stock in the economy given that the situation at that point in time. This motive of increasing the money credit makes the government to increase its expenditure and effect a proper regulation of the CBN on the commercial Bank which in turn increases the economic productivity, output investment and generally raises the economic growth of the country.

On the other hand, the contractionary measures are just the opposite. It refers to the government policy to decrease the volume of money stock in the economy.

They have the motive of reducing the credit supply by reducing its expenditure and adopting the reduction regulation of the CBN on the commercial banks which now decreases the economic productivity, output and investment. This in turn stabilizes the amount of money stock in the country.