NATIONAL OPEN UNIVERSITY OF NIGERIA

SCHOOL OF MANAGEMENT SCIENCES

COURSE CODE: ACC 320

COURSE TITLE: ECONOMICS AND BUSINESS ENVIRONMENT

NATIONAL OPEN UNIVERSITY OF NIGERIA

ACC 320: ECONOMICS AND BUSINESS ENVIRONMENT

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NATIONAL OPEN UNIVERSITY OF NIGERIA

ACC 320: ECONOMICS AND BUSINESS ENVIRONMENT

COURSE GUIDE

INTRODUCTION

For long, business managers have been borrowing aspects of economics to enable them take good and rational decisions. The success of an organization or business depends to a large extent on managerial decisions that are based on the external and internal environments indices. Businesses will need to obtain a clear understanding of their environment before they can set about making the right decisions. How sound the decisions are, is based on how knowledgeable the managers are of the surrounding environment. This does not in any way suggest that all good managers have sound knowledge of Economics and the Environment. There are some managers who are capable of taking right decision owing to their practical experience in the job. Others are able to do so because of the knowledge they acquired in school. All in all, academic knowledge is not a waste as it provides reasons for decisions taken.

Economics and Business Environment is that course that blends business decisions with economics and business realities. It brings out the economics management tools that could be used to enhance managerial decision-taking. Business flourishes most when managers are capable of taking good decisions. Their ability to take good decision can be enhance be enhanced by the knowledge they have of managerial economics.

This course guide briefly explains to you what the course is all about, the course material you will be using, and how you are expected to cover the course. It gives the advice on the amount of time you are required to spend on each unit of the course, to enable you complete the course successfully and in good time. The course also provides you some guidance on Tutor Marked Assignments, which will be made available in the assignment file. There will be regular tutorial classes that are linked to the course. You are advised to attend the sessions. However, the

student will be expected to take FOUR e-TMAs of 10 marks each our of which the best THREE shall be credited to the student.

WHAT YOU WILL LEARN IN THIS COURSE

During this course, you will be learning definition of economics concepts, their implications and their application to business. As a promising manager, you are expected to grasp these concepts and then try to apply them to your activities.

COURSE AIM AND OBJECTIVES

This course is aimed at:

i. Giving you an understanding of the concepts involve in economics and business environment.
ii. Making you to be able to define and explain the concepts.
iii. Enabling you understand the applicability of economic theories in the firms decision making processes.
iv. Making you appreciate the role of environment in analyzing and solving the practical problems facing modern firms, especially as it concerns investment decision.
v. Enabling you to understand the existing relationship between applied Economics and Business Management
vi. Enabling you discuss the strategic and operational importance of information technology to business.

When all the above aims are considered, we can conclude that the major aim of the course is to expose you to various tools, techniques and logic of solving business and economic problems of the firm.

WORKING THROUGH THIS COURSE

For you successfully complete this course, you are required to read the study units, reference books and other resources that are related to the unit. Each unit of the course contains Self Assessment and Tutor Marked Assignment. The self-assessments are to enhance your understanding of the course, and are not to be submitted.

The E-Tutor Marked Assignment (TMA) is to be done immediately every module is completed and sent to the course facilitators for assessment. The medium to be used and the time to submit the TMA will be specified to you later. This course is a 3-credit course. As such you are expected to spend a minimum of three hours every

week studying the course. You are expected to complete the entire course outlined within a period of 18-25 weeks.

COURSE EVALUATION

As stated before, every unit of this course has an assignment attached to it. However, the student shall be given four Tutor Marked Assignments(TMA). Each e-TMA shall carry 10 marks and only the best three shall be recorded for the student. At the end of the course, the evaluation shall be as follows:

e-Tutor Marked Assignments	- 30%
Examination	- 70%
Total	-100%

COURSE UNITS

In this course, Economy theory, techniques, logic and environmental analysis that could be helpful to you as a manager shall be considered under different topics. Based on this, the following units have been designed for the course.

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These units must be treated sequentially; as a logical link exists in the arrangement. Every previous unit lays a foundation for subsequent ones. A maximum period of one week is required for every unit.

REFERENCE MATERIAL AND OTHER RESOURCES

As was earlier mentioned, materials relevant to the course include, not only the ones below, but also others that you can lay your hands on. But for now, the following references are recommended:

1. Lipsey, R. G. and Crystal, K.A (1997): An introduction to positive economics, Oxford, Oxford press.
2. Lipsey R.G et al (1987): Economics. London Haper and Ron Publishers
3. Dwiredi D.N (1998): Managerial Economics. New Delhi, Vikas Publishing house PVT, Limited.
4. Koutsiyannis A. (1979): Micro-economics, London

PRESENTATION SCHEDULE

Specific dates for particular activities, such as submission of assignment, tutorial schedules and e-examination dates shall be made available to you on a later date. This will enable you plan your activities in the same line. The method of submitting your assignment and receiving other course materials shall be agreed upon on a later date.

You should endeavour not to be falling behind the schedule whenever it is given.

CONCLUSION

By the time you exhaust this course, you will find it useful not only in solving business problems, but also your day-to d-ay problems.

ACC 320: ECONOMICS AND BUSINESS ENVIRONMENT
COURSE DEVELOPMENT

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ACC 320: ECONOMICS & BUSINESS ENVIRONMENT

MODULE 1

1. Economic Environment
2. Measures of Economic Activity
3. Conceptual Framework of Nigerian Business Environment
4. Major Objectives of Firms
5. Nature and Theory of Management

Unit 1: ECONOMIC ENVIRONMENT

1.0 Introduction

Economics is the study of how individuals and societies choose to use the scarce resources that nature and previous generations have provided. Economics is behavioural science and, in large part, the study of how people make choices.

There are four main reasons to study economics: to learn a way of thinking, to understand society, to understand global affairs, and to be informed citizen (voter). Probably the most important reason for studying economics is to learn a particular way of thinking. Basic questions of economics are:

1. What is produced, and in what quantities?
2. How are these goods and services produced?
3. For whom they are produced?
4. Who takes economic decisions, and by what process?

In the process of learning economics, you will be aware of the fundamental problem from which all economic questions stem: that human being have limited resources but unlimited wants. When wants exceed the resources available to satisfy them, there is *scarcity*. Scarcity is everywhere. People want good health and long life, material comfort, security, physical and mental recreation, and knowledge. None of these wants is completely satisfied for everyone, and everyone has some wants that remain altogether unsatisfied. This last category is highly individual. However, it is safe to say that no one feels entirely satisfied with her or his state of health and expected length of life. And no one has enough time for sport, travel, vacations, movies, theatre, reading, and other leisure pursuits.

2.0 Objectives

After working through Unit One of this course, you should be able to:

i. *Summarize* some benefits of studying economic issues and describe what kinds of insights into society and international affairs can result from thinking in economic terms.
ii. *Distinguish* between the variables that are internal to the firm (or industry) and those that are external.
iii. *State* the distinction between macroeconomics and microeconomics.
iv. *Define* 'normative economy' versus 'positive economy'

3.0 Main Contents

3.1 COSTS

Faced with scarcity, people must make choices. When we cannot have everything we want, we choose among the available alternatives. The concepts of scarcity and choice give a definition of economics as the study of how people make choices to cope with scarcity. Because scarcity forces choice, economics is sometimes called the *science of choice* – the science that explains the choices that people make and predicts how choices change as circumstances change.

Choosing more of one thing means having less of something else. Expressed another way, in making choices, we face costs. Economists use the term *opportunity cost* to emphasize that making choices in the face of scarcity implies a cost. Perhaps it might be playing a round of golf or studying for a big economics test. The opportunity cost of the trip to the zoo is the value you attach to that one activity you would otherwise have chosen.

3.2 ECONOMIC ENVIRONMENT OF BUSINESS

Economic news is exchanged in public media every day because economics issues affect everyone, in business or not. Business conditions exist within an economic environment containing technological, institutional, cultural, and political factors. Reciprocally, the economic environment is affected by business decisions, in which economic principles are variously implicit, consciously applied, or present in the background, in the form of government policies towards business. Corresponding with the two sides of this reciprocal influence are the two branches of economics. *Macroeconomics* focuses on aggregate economic conditions – those conditions that set the environment within which a business operates – and *microeconomics* focuses on the economic forces that influence the decisions made by individual consumers, firms, and industries. These decisions are often made in an instinctive way, yet consistent economic forces underlie them. Thus, an explicit recognition and understanding of the forces that influence these decisions is a vital part of a manager's intellectual equipment.

Macroeconomics is concerned with the economy as a whole. It is thus concerned with aggregate demand and aggregate supply. By aggregate demand is meant the total amount of spending in the economy, whether by consumers, by overseas customers for our exports, by the government, or by firms when they buy capital equipment or stock up on raw materials. By aggregate supply is meant the total national output of goods and services.

Overall economic activity is measured in a variety of ways. These measurements- the number of people with jobs, the total income of

persons, the output of factories, and the amount of total goods services produced in the economy (GDP)- are regularly reported in newspapers, business periodicals, and televisions and radio news. These reports often fail to explain the importance of these and other economic indicator. A business manager should be able to put these announcements in perspective in regard to both the relationships among indicators and the manager's own business.

Microeconomics is concerned with the individual parts of the economy. It is concerned with the demand and supply of *particular* goods and services and resources: cars, butter, clothes and haircuts, electricians, secretaries, blast furnaces, computers and coal. The most basic economics forces a firm has to address are those that shape the supply and demand for the goods or services it produces. Even as business around the world are undergoing massive management changes. it is increasingly recognized that influences on business decision-making is the answer to the two-part question: how much should the firm produce, and how much should it charge for this output?

Self Assessment Question: '*Reciprocally, the economic environment is affected by business decisions, in which economic principles are variously implicit and consciously applied'*. Discuss.

MAKING ECONOMIC CHOICES IN BUSINESS

Firms will normally want to make as much profit as possible, or at the very least to avoid a decline in profits. In order to meet these and other objectives, managers must make choices: of what types of output to

produce, how much to produce and at what price; of what techniques of production to use, how many workers to employ and of what type, what suppliers to use for raw materials, equipment, etc. in each case, weighing the alternatives can be less onerous for a manager aware of the types of influences that cannot be avoided in business decision-making.

Then, having acquired knowledge of these external factors, how do firms decide on prices, output, inputs, marketing, investments etc.? Here the business economist can play a major role in helping firms achieved their business objectives.

The external influences largely outside the direct control of a firm are the competition in faces, the prices it pays for raw materials, the state of the economy (i.e., whether static, growing or in recession) and the level of interest rates. Businesses will need to obtain a clear understanding of their environment before they can set about making the right decisions.

3.4. GOVERNMENT INTERVENTION IN BUSINESS

Dealing with government policies towards business is a very important activity in the private sector and implementing such policies is a major function of the public sector. Most citizens of modern developed countries expect government policy to play an important role in their lives. We expect governments to provide law enforcement, education, and a variety of other goods and services, and we expect, or at least accept, that government will finance these activities by imposing taxes, along with other means. Most of us also recognized that government policy has some influence on unemployment, inflation, interest rates, and general business conditions. However, many people are surprised when they discover the

extent to which the business decisions of private sector firms are affected by government intervention.

3.4.1 Three Dominant Macroeconomic Principles

Recently, economic policies throughout the world have converged around three basic principles.

1. Increasing emphasis on *using market mechanisms* to achieved objectives rather than supplanting them with state intervention.
2. Macroeconomic policy formulated more to ensure a *stable economic framework* than to achieve proactive counter-cyclical targets or national planned growth rates and investment targets.
3. More *outward-looking* national policies, as evidenced by the steadily increasing membership of the World Trade Organization (WTO), the relaxation of controls on capital mobility and the globally more benign stance towards foreign investment.

3.5 TYPES OF ECONOMIC EVALUATION

You might wonder what all this government intervention is intended to achieve, and why governments choose the policies that they do. Economists are often called upon to make judgment on matters of public policy. Should government reduce the deficit? If so, how? In this type of public discussion, economists tend to disagree. They differ in their *description* of the economy and in their perditions of the consequences of certain actions. When they describe the economy, and construct models that predict either how the economy will change or be affected by different policies, they are engaged in what is called positive *economics*.

When they evaluate alternative policies, they are engaged in what is called *normative economics*.

Positive economics is concerned with what is, with describing how the economy functions. It is, therefore, 'descriptive' in that it tries to explain or describe why things are as they are. The positive approach to policy analysis focuses on the objectives, behaviour and interaction of individuals and group who influence policy decision. Instead of focusing on what policy should be, as normative analysis does, positive analysis examines the reasons why policy takes the form it does.

One important influence on policy decisions is voting. Another arises from special interest groups, including business lobbies, which spend time and energy trying to influence government policies. Public sector managers (or bureaucrats) themselves are an important influence, as are elected politicians.

Normative economics deals with what should be, with making judgements about the desirably of various courses of action. Normative economics is, therefore, 'prescriptive', because in answering it we are trying to suggest or prescribe what governments should do. The starting point in the analysis of this question is that government policy toward business should seek to promote the public interest. However, it is difficult to say exactly what the public interest is. One policy may benefit others. One policy is not unambiguously better than another. It depends on what you care about.

3.6 Accepted Government Objectives

Nevertheless, there is a well-established set of goal that is widely accepted as legitimate objects of government attention. These include:

- *Economic efficiency* that corresponds to trying to make the per capital benefits from the consumption of goods and services as high as possible.
- *macroeconomic stabilization and growth,* the objectives of which are to smooth the business cycle, to keep unemployment rates low and stable, to keep inflation rates low and stable, and to assist in promoting economic growth.
- *Fairness (equity),* seeking to make the overall size of the 'economic pie' as large as possible. Fairness or equity is concerned mainly with the distribution of that pie among different claimants and other social objectives.

It is possible that actual policies toward business will be just as normative analysis suggests that they should be. Frequently, however, actual policies coincide very poorly with normative analysis, and we are forced to conclude that the general public interest was not the major determinant of policy.

Self Assessment Question: *How would you explain government intervention in business?*

3.7 ECONOMIC DEBATE

Statements made by those engaged in *positive economics* are not necessarily true; they can be disproved by empirical verification. *Normative economics* , being theoretical, are not subjected to empirical

verification at all if their basis is that of value judgements. Hence the importance of debate: accuracy and reliability improve as different judgements are aired and considered by different individuals.

Economists are often called upon to make judgements on matters of public policy. They differ in their views of how the world works, for two kinds of reasons:

1. Different objective. In macroeconomics, for example, economists place different weights on such objectives as-
   i. To reduce wage inequality
   ii. To maintain (or increase) economic activity
   iii. To reduce the inflation rate
   iv. To reduce the unemployment rate.
2. Absence of controlled experiments. Actual economies are highly complex, consisting of many individuals, firms and markets. This complexity prevents macroeconomists from conducting controlled experiments to study, for example, the effects of monetary policy on the economy. As a result, different macroeconomists can look at the same event and reach different conclusions.

4.0 CONCLUSION

The economic environment of business is about the study of economic decisions made by business. Seen in terms of economic principles, the business environment has two dimensions: microeconomic and macroeconomic. Economists addressing the micro environment analyse the functioning of individual markets and industries and the behaviour of individual decision-making units. Economists observing the macro environment deal with the economic behaviour of aggregate factors, both

national and international, influencing all decision-makers. In analyses of government policy affecting business, two sets of question arise: 'What should the role of government be?' and 'What factors explain the actual conduct of government?' The first set is referred to as normative or prescriptive and the second as positive or descriptive. The former involves value judgment, whereas the latter is confined to factual observations.

5.0 SUMMARY

6.0 TUTOR MARKED ASSIGNMENTS

i. Differentiate between *positive* and *normative* economics.

ii. Discuss the two branches of economics known to you.

7.0 REFERENCES/FURTHER READING

1. Farouk Zandi (2002). *Economic Environment*. Commonwealth of learning, Vancouver, Canada.
2. Catherine Kerr (2002) *Economic Environment*. Book-thought Content Company, Commonwealth of learning, Vancouver, Canada

UNIT 2: MEASURES OF ECONOMIC ACTIVITY

CONTENT

1.0 INTRODUCTION

Unit Two is designed to increase the accuracy and power of your economic vocabulary by spelling out the strict meaning of economic measurement terms that you encounter often in business reading. Exercise and learning tips help you to grasp and remember distinctions between similar kinds of measures and indices. You will also have a chance to reflect on certain problems of aggregation such as those which arise in the measurement of a 'nation's productivity when many of its passport holders are employed outside its boundaries.

2.0 OBJECTIVES

After working through Block Two of this course, you should be able to:

1. Define Gross Domestic Product (GDP)
2. Account for the different approaches to measuring GDP.
3. Distinguish between nominal GDP and real GDP.
4. State how the unemployment rate is defined, and described how it is determined.
5. Explain the definition and construction of the GDP deflator and the Consumer Price Index.

3.0 MAIN CONTENT

3.1 Management and Measurement

Business managers normally make decisions specific to their department or part of the firm. These decisions usually take into account the

concerns of the company as a whole and, at times are subjected to wider industry or market conditions. But how do you describe and measure such conditions?

In this unit, we will focus on the main measures of economic activity. Fluctuations in economic activity set the condition within which the market, industry, and company must operate, and these measures reflect those fluctuations. There are many measures and indicators of overall (macroeconomic) activity such as the number of people with jobs, the total income of persons, the output of factories, the total quantity of goods and services produced in the economy, the unemployment rates, the consumer price index, retail sales, housing starts, etc. such measures are regularly reported in newspapers and television and radio news. At the least, well-equipped business and public sector managers must understand these economic indicators in order to be able to make informed business decisions. The following pages focus on the main measures of economic activity to provide you with a working knowledge of economic indicators.

3.2 Gross Domestic Product

GDP is the most comprehensive measure of economic activity and a broad measure of people's income and well-being. The growth in real GDP is hence a measure of the growth of people's real incomes and therefore the pace of improvement in living standards. Differences in its growth rates produce large differences in living standards between countries. Much of macro economics is about trying to understand the causes of growth and the reasons for persistent differences in growth rates and income levels between countries.

GDP can be viewed from either the demand side or the supply side. On the demand side, it provides insight into the interaction of the various decision-making sectors of the aggregate economy (households: business firms; government entities; and foreigners). A competent manager recognized that these elements constitute the market demand that a firm faces.

The supply of goods and services requires firms to bring together the factors of production, particularly labour and capital, and to employ the best available technology, in order to produce output that meets demand. As a manager, you need to be aware of these limits and any ongoing changes in them to manage your resources efficiently.

Sometimes economic growth is rapid and at other times it is slow. There are even occasions when the economy stops growing and actually shrinks for a period. A rapidly growing economy is one in which people enjoy rapidly rising living standards and in which good jobs are easy to find. In a slow-growing or shrinking economy, living standards decline and unemployment becomes a serious problem.

3.3 Unemployment Rate

The labour market performance is measured by a number of including the unemployment rate, the employment rate, and the participation rate. The unemployment rate is the key and the most watched indicator. At times when the unemployment rate is high, a person may take a long time to fine a job. Today, the rapid pace of technological changes and the onslaught of globalization are responsible for the widespread displacement of worker.

Although unemployment is a permanent feature of our economic life, it sometimes becomes an extremely serious problem. One such time was the period of high unemployment and rapid contraction that occurred in the late 1920s and the 1930s throughout the world known as the Great Depression, which was to a great extent the result of the collapse of the international financial system as well as mutual adoption by many countries in the West of high-tariff policies. In the West we also witnessed other periods of high unemployment and stagnation in the early 1980s and the early 1990s, although these were less severe than earlier in the century. The economic slump of the early 1980s was primarily caused by a combination of a second oil price increase from OPEC (the Organization of Petroleum Exporting Countries) and the anti-inflation policies of the central banks of the developed oil-importing nations. The slowdown of the early 1990s perpetuated itself in Japan for at least ten years with a widespread impact in Asia.

Recently, dating back to 1997, the economies of major economic power in Asia – Korea, China, and Indonesia – have suffered period financial and economic crises, as have many in Latin America and subsequently the economy of Russia as well.

Business decisions are increasingly made in an international context – the global economy is becoming increasingly borderless- so that macroeconomic thinking necessarily becoming broader to consider the international trade and finance flow that affect business. It is not enough for a manger to take into account the conditions that affect the domestic economy. Furthermore, attempts by governments to stimulate growth and employment have often resulted in inflation and balance of payments crises.

Even when societies do achieve growth, it is often short-lived. This is especially true in developing countries where – for historical, sociological, and economic reasons-governments take the central role not only in initiating stimulating economic packages but also in implementing them. In the absence of a reliable tax system, governments of developing countries often wind up financing their growth strategies by creating inflation.

In those nations that rely on the regular tax channels for financing their growth strategies, the outcome is typically high foreign and domestic debts and the ensuing current account crises. As discussed in Block One, these have prompted the governments of developed as well as the emerging economies such as India and Indonesia, Brazil etc. to reformulate their economic policies around the basic principles of greater emphasis on market mechanisms 9less government intervention) and a stable macroeconomic framework.

In light of the discussion above, it is no surprise that governments have set the following as goals of macroeconomic policy:

- Sustained income growth
- Low unemployment
- Mild fluctuations
- Price stability
- Exchange rate stability
- Balance of trade surplus

3.4 Measuring Economic Performance: Output and Income

The output of 'the economy" – our particular nation's productive capacity, exclusive of unpaid work-consists of millions of different goods. We could report how much of each good the economy produced: 1,400,362 computers, 1,650,562,382 meters of fibre-optic cable, 13,220,490 bottles of beer, and so forth. Such data may he useful for some purposes, but they do not provide us with the information we want. If next year the output of computers falls by 10 percent, the output of cable goes down by 2 percent, and the output of beer rises by 3 percent, has total output gone up or down? And by how much?

We need a single number that summarizes these outputs of the economy. But how do we add up the computers, cable, beer, and millions of other products produced in the economy? We do this by adding the money value of all the final goods and services produced (those that are not used to make other goods and services) to arrive at a single number that encapsulates the production of the economy.

The most common measures of production of the economy are Gross Domestic Product (GDP) and Gross National Product or income (GNP). GDP and GNP refer to production during a particular time period, which we usually take to be a year or a quarter of a year. They are the flow of new products during the year (or the quarter) and are measured in dollars or the currency of the local economy.

Self Assessment Question: *Discuss the major macroeconomic policies of the Federal Government of Nigeria.*

3.4.1 GDP versus GNP

GDP is total income earned domestically: all economic activity that takes place within the country. It includes income earned domestically by foreigners, but it excludes income earned by domestic residents on foreign by domestic residents on foreign ground. This total value of goods produced would also measure the total value of domestic residents' (nationals') incomes, but only if:

i. No domestic worker had a job another country,
ii. No foreigner had a job in our domestic economy
iii. All machines and factories used both here and elsewhere were owned by domestic residents or nationals (residents of a nation)

However, since some income is received from individuals owning capital equipment in other countries, GDP is not a perfect measure of total domestic income. Thus, statisticians also compute an alternative measure of aggregate economic activity, the gross national product (GNP). GNP is total income earned by national. It includes the income that national earn abroad, but it does not include the income earned within a country by foreigners. The different between GDP and GNP is, therefore, known as 'net investment income from non-residents.'

Most countries pay more attention to GDP than to GNP for measuring aggregate economic activity. For the purpose of stabilizing employment, we are interested in a broad measure of job-creating activity within the nation. GDP is that measure. For evaluating trends in the standard of living of many nations, including the OECD (Organization for Economic Cooperation and Development) nations, GNP is more appropriate. Despite a possible gap between GDP and GNP, possibly arising from

either foreigners owning some capital equipment operating within the nation or nationals being in debt to foreigners, we simplify by ignoring the difference between them (and focus only on GDP) for many discussions within this course.

There are three different ways to think about and measure GDP Statisticians can measure either:

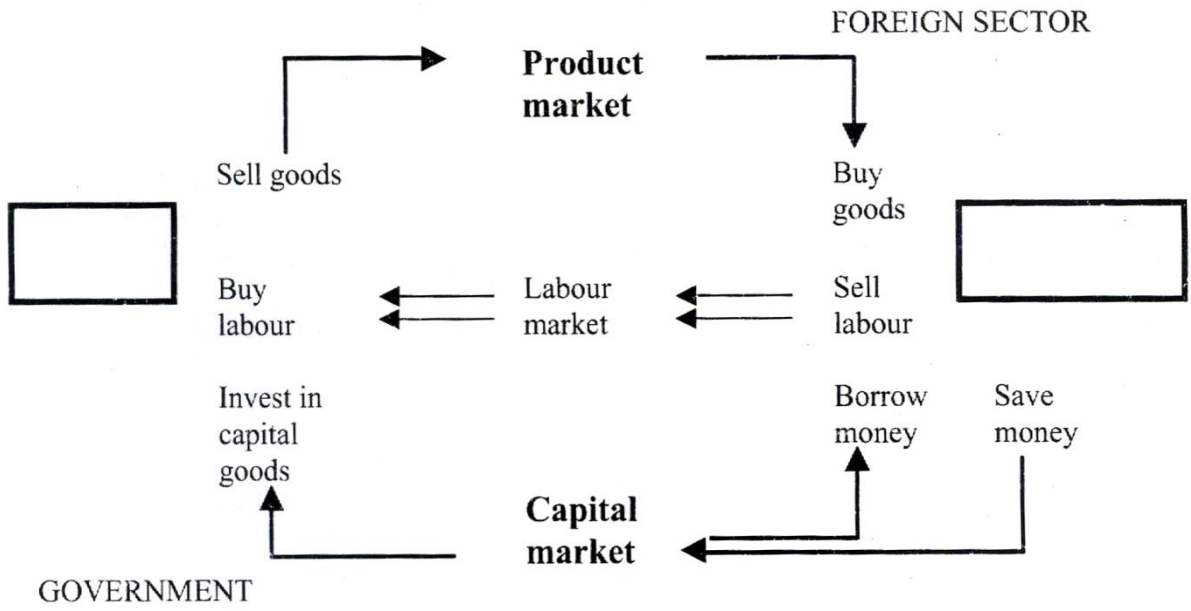
i. The production of each industry – agriculture, mining, manufacturing, and so on.
ii. The income that this production generates – wages, salaries, profits, and so on.
iii. The expenditure on the goods and services produced- spending by households, firms, governments and so on.

Aggregate economic activity can be measured in terms of aggregate expenditure. To see how GDP can measure all these things at once, we must discuss national accounting, the accounting system used to measure GDP and any related statistics.

3.4.2 Income, Expenditure, and the Circular Flow

Imagine an economy that produces a single good, bread, from a single input, labour. Figure 2-1 illustrates all the economic transition that occurs between household and firms in this economy.

Figure 2-1: An economy producing a single good with a single input



This figure illustrates the flows between firms and household in an economy that produces one good or product, bread, from one input, labour. The inner loop represents the flows of firms selling the bread they produce o households. The outer lop represent the corresponding flows of dollars: households pay the firms for the bread, and the firms pay wages and profit to the households. In this economy, GDP is both the total.

This figure illustrates the flows between firms and households in an economy that products one good or product, bread, from one input, labour. The inner loop represents the flows of firms selling the bread they produce to households. The outer loop represents the corresponding flows of dollars: households pay the firms for the bread, and the firms pay wages and profit to the households. In this economy, GDP is both the total expenditure on bread and the total income from the production of bread.

3.4.3 Value Added and Intermediate Goods

Several difficulties arise when output is measured. Let us explore two of them. Suppose a farmer produces ₦5 worth of wheat, which he sells to a baker. The baker exerts ₦20 worth of effort to turn the wheat into bread, which she sells for ₦25. At the end of the day, what has been produced? The answer is just ₦25 worth of bread. But if we ask the farmer and the baker to report their output for the, the farmer says, 'I produced ₦5 worth of wheat,' and the baker says, 'I produced ₦25 worth of bread."

A statistician who natively adds these numbers might think that there has been ₦30 of output in the economy. The statistician is led astray by counting the wheat, which is not a final good but rather an intermediate good that disappears after it is used to produce the bread. There are two ways to avoid this measurement pitfall:

1. Ask the farmer and the baker to report the value of their sales of final goods to consumers. The baker reports ₦25 and the farmer reports ₦0, because his wheat is not a final good.
2. Ask the farmer and the baker to report the contribution of each made to the total. The farmer reports ₦5 worth of wheat, and the baker reports ₦20 worth of effort, for a total value of ₦25 worth of output.

We call the baker's contribution to output her *value added*, which the baker calculates by subtracting her costs, ₦5, from her revenue, ₦25. The baker's value added is thus ₦20. The farmer's value added is N5: in our example, the farmer had no cost. When businesses report their output to the government, they subtract their cost, so they are reporting value

added. The government then sums the value added by all businesses to arrive at GDP.

There are many examples of intermediate goods- e.g., wheat-whose value should not be double-counted when output is computed. Other examples are oil, shipping and advertising.

1. For businesses to know what to report as their contributions or value added, they have to know how much of their costs they should subtract from their revenues. Thus, the government must define 'intermediate goods' quiet explicitly. Officially, an intermediate good or service is one that is used up in the production of other goods or services during the same period in which it was produced. The key phrases in this definition are 'used up' and 'same period'. Let us see how these concepts clarify which goods are intermediate and which are final.

3.4.4 Measures of Income

The national accounts include other measures of income that differ slightly in definition from GDP and GNP, and economists and the press often refer to them. You can see how the alternative measures of income relate to one another by starting with GDP and subtracting various quantities. First, to obtain GNP from GDP, we subtract the net income of foreigners who own factors of production employed in Canada:

$$\text{GNP} = \text{GDP} - \text{Net Income of Foreigners.}$$

GDP and GNP are gross measures of economic activity because of gross investment-firms' expenditure on new capital and additions to

inventories. The capital stock increases because of investment and decreases because of depreciation. The total additions to the capital stock in a given period of time are called gross investment. The change in the capital stock equals gross investment minus depreciation and is called net investment. To obtain net national product (NNP), we subtract the depreciation of capital, i.e., the amount of the economy's stock of plants, equipment, and residential structures that wear out during the year.

NNP = GNP – Depreciation.

In the national accounts, depreciation is called the capital consumption allowances, since the depreciation of capital is a cost in producing the output of the economy, subtracting depreciation shows the net result of economic activity. For this reason, some economists believe that NNP is a better measure of economic well-being.

The next adjustment in the national accounts is for indirect business taxes, such as sales taxes and subsidies. These taxes place a wedge between the price that consumers pay for a good and the price that firms receive. Because firms never receive this tax wedge, it is not part of their income. Once we subtract indirect business taxes from NNP, we obtain a measure called national income.

National Income = NNP – indirect Business Taxes.

National income is a measure of how much everyone in the economy has earned.

GDP data are, in practice, used not only as a measure of how much is being produced but also a measure of his welfare of the residents of a country. Economists and politicians talk as if an increase in real GDP

means that people are better off. In reality, however, GDP data are from perfect. Most of the difficulties of measuring GDP arise because some outputs do not go through the market. Examples are volunteer activities, housework, and do-it yourself home improvements. In the case of the government sector, we already noted that production is valued at cost. That is because much of government output is not sold in the market, nor is there a simple technique available that would make it possible to estimate the value of government output. How would we measure safety from criminals as the value of output that police expenditures are supposed to produce?

3.4.4.1 Potential GDP

You saw that GDP measures how much the economy actually produces. But the economy is generally capable of producing more than it actually does. Another measure, potential GDP, indicates what the economy could produce if labour and machines were fully used. Although it is true that actual GDP usually falls short of its potential, sometimes it could exceed it. This happens when the rate of utilization of the labour force and that of other factors of production exceeds their normal rates. Strong upward fluctuations are called booms, and downwards ones are called recessions. Severe downturns are referred to as depressions. The last depression, called the Great Depression because of its length and depth, began in 1929. The economy did not fully recover from it until four years later. There is no technical definition of a boom, hut there is one of a recession; a recession is said to have occurred when GDP falls for at least two consecutive quarters.

The economy's fluctuations are sometimes called business cycles but the term 'cycle' suggests a kind of regularity that cannot be found between one downturn and the next. Economists have seen patterns repeat often enough to have given a name to the bottom of a recession (a trough) and the top of a boom (a peak). However, we also know that as little as two years and as much as ten can elapse between one and the other.

3.4.4.2 Real versus Nominal GDP

Both GDP and GNP, discussed above, are valued at market prices, the prices paid by the final user. There is, however, one problem with using money as a measure of output: the value of a dollar changes over time. Chocolate bars, books, movie tickets and cars cost more today than they did ten years ago, whereas computers cost less. We use prices not only because they are a convenient way of making comparisons but also because prices reflect how consumers value different goods. If the price of an orange is twice that of an apple, it means an orange is worth twice as much at the margin as an apple. Another way of saying this is that a dollar does not buy as much as it did ten years ago. We do not want to be misled into believing that the output is higher when in fact only the price level changes in the average level of prices. Unadjusted GDP is known as nominal GDP (₦Yt). The term real GDP (Yt) is used for inflation-adjusted GDP figures, which are true year-to-year measurements of the nominal value of GD- the money value of all the goods and services produced in the economy- and divide it by a measure of the price level. Thus, real GDP is defined by the equation.

$$\text{Real GDP} = \text{Nominal GDP} / \text{Price Level}$$

If, for instance, nominal GDP has risen 5 percent in the past year but prices have also increased by 5 percent, then real GDP is unchanged. If nominal GDP has risen 5 percent in the past year but prices have increased by 6 percent, real GDP has actually decreased.

Self Assessment Question: *Explain the difference between nominal GDP and real GDP.*

3.4.5 PRICE INDEXES AND INFLATION.

In macroeconomics, the price level is the average level of prices measured by a *priceindex*. For example, in Canada, two main price indexes that are used today are the Consumer Price Index and the GDP Deflator.

3.4.5.1 The Consumer Price Index (CPI)

The CPI is a measure of the price level that considers the price of a list of specific goods and services purchase by a typical household at current prices. The nation's statistics agency typically starts with this 'basket' of purchases and calculates this year's CPI by expressing the cost of the basket in the current year as a percentage of the cost of that same basket in the base year. The CPI is the weighted average of price movements of several thousand goods and services grouped into several hundred categories. More precisely:

$$\text{CPI} = \frac{\text{value of fixed basket in current prices}}{\text{value of fixed basket at base year prices}} \times 100$$

Where the value of the basket represents total expenditure on (or the cost of) the basket in any period, month or year. The base year is an arbitrary year employed by the nation's statistics agency that, depending on the

agency's approach, its targets and its feasibility, normally changes once every five to ten years. Until 2000, the basket of goods and services in Canada was based on 1992 spending behaviour: therefore, 1992 represented the base year. In 2001 the base year was changed to 1997, reflecting a new spending behaviour.

3.4.5.2 Implicit GDP Deflator

Economists generally tend to prefer measures of the inflation rate that are broader than the CPI. The broadest such measure is the *implicit* GDP *deflator* (sometimes called just the GDP deflator for short). The GDP deflator is an average of the prices of all goods in the economy, weighted by the quantities of those goods that are actually purchased. The computation of the price deflator is simple. It is equal to nominal GDP (expressed in dollars) as a percentage of real GDP (expressed in the dollars of the base year):

$$\text{GDP Deflator} = \frac{\text{Nominal GDP}}{\text{Real DGP}} \times 100$$

The deflator, then, is highly inclusive. Another main difference between the CPI and the deflator is that the CPI is a fixed-basket index whereas is a variable-basket index.

Expressed in terms of a time period, the GDP deflator in year t (Pt) is defined as the ratio of nominal GDP to real GDP in year t: Pt = ~~N~~Yt / Yt. The GDP deflator gives the average price of all goods and services include in GDP.

3.4.5.3 Inflation Rate

The percent change in the price level is called the *inflation rate*. If the price level rises from ₦20 per good to ₦22 per good over a period of time, the inflation rate for the period is 10 percent. if the price level falls from N20 per good to ₦18 per good, the inflation rate is 10- percent; that is, there is a 10 percent deflation. The measure of inflation most frequently cited by media is the CPI:

$$\text{Inflation Rate} = \frac{CPI_t - CPI_{t-1}}{CPI_{t-1}} \text{ x } 100 \text{ x}$$

An alternative rate of inflation can be calculated by replacing the CPI with the deflator.

3.4.5.4 Unemployment Statistics

In most countries, unemployment data are collected by their respective statistics agencies, which survey a representative mix of households and ask each whether a member of the household is currently seeking employment. The unemployment rate is the ratio of the number seeking employment to the total *labour force*:

$$\text{Unemployment rate} = \frac{\text{Number of Unemployed}}{\text{Labour Force}} \text{ x } 100$$

$$\text{Labour force} = \text{Number Employed} + \text{Number Unemployed}$$

3.4.5.4.1 Problems with Unemployment Statistics

Some economists believe that the statistics agencies' unemployment surveys provide too high an estimate of the true unemployment rate. These statistics typically come from the labour force survey conducted by the agency in charge. Based on the survey questions, each working age individual is placed into one of three categories: employed, unemployed and not in the labour force. The main difference between an unemployed individual and one who is in the labour force is that the latter is deemed not actively looking for a job. Some workers who do not have jobs may have in fact abandoned hope of finding one. They are referred to as discouraged workers. Statistics will not count them as unemployed, thus will provide an underestimate of the number that would choose to work if a job were available.

The sharp focus on the unemployment rate by economists, policy makers, and the media is to a degree misguided. As discussed above, some of those classified as not in the labour force are in fact discouraged workers. These workers would typically take a job if offered it even though they are not looking for one. This is why economists sometimes focus on the employment rate. Employment rate is the ratio of employment to working age *(adult) population*:

$$\text{Employment Rate} = \frac{\text{Number of Employed}}{\text{Adult Population}} \times 100$$

Finally, the fraction of the working age population that is employed or seeking employment is called the labour force participation rate, which is

the ratio of labour force to population. Because of discouraged workers, the labour force participation tends to decline in recessions:

$$\text{Participation Rate} = \frac{\text{Labour Force}}{\text{Adult Population}} \times 100$$

Self Assessment Question: *Why should we be concerned with an increase in the unemployment rate? Briefly explain.*

4.0 CONCLUSION

In unit one, you were introduced to the basic concept of economic environment. We were exposed into some economic vocabulary and economic measures and indices. In the process, goals of government macroeconomic policy, unemployment, several measures of income were discussed.

5.0 SUMMARY

1. GDP and GNP are the two most widely used measures of performance of an economy.
2. GDP is the value of the final goods and services produced in the economy, by foreign or domestic firms, during a given year.
3. GNP is the value of final goods and services produced by that country's nationals regardless of their geographical location.
4. To obtain GNP, we first add to GNP receipts of factor income from the rest of the world and hen subtract from GDP payments of factor income to the rest of the world.
5. Nominal and real GDP differ in that the former incorporates changes in the price from the previous year, whereas the latter abstracts from it.

6. National income is the sum of wages and non-wage benefits, corporate profits, net interest income, proprietor's income, and rental income.
7. GDP deflator is defined as the ratio of nominal GDP to real GDP in a given year.
8. The consumer price index (CPI) measure the price of a given basket of goods and services consumed by household.
9. Unemployment represents the percentage of the labour force that is not employed.

To be counted as unemployed, an individual must not have a job and must have been looking for work actively.

6.0 Tutor Marked Assignment

i. Define Gross Domestic Product. Explain the three ways of measurement.
ii. What is the GDP deflator and how it calculated?
iii. What is the Consumer Price Index (CPI) and how is it calculated?

7.0 References/ Further Reading

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5. **UNIT 3: CONCEPTUAL FRAMEWORK OF NIGERIAN BUSINESS ENVIRONMENT**

1.0 INTRODUCTION:

Any activity, which has the objective of earning profit, is called business. Such activities are termed as economic activities. In performing economic activities, various decisions have to be taken. Decision-making involves a choice of the best alternative from among various alternatives. The choice is made and affected by various variables. Some of the variables are controllable and others uncontrollable. Controllable variables are those which are within the control of the individual business firms. Uncontrollable variables are those which are external to the business firms. Such uncontrollable factors are termed as environmental factors because they constitute part of the environment. The environment may be economic, social, political and legal. Each of these constituents may also be domestic or international and they affect the establishment of any business enterprise.

Business managers must realize that they are operating in a given environment. Thus, they must take into account the influence of the environmental forces that can affect the performance of their organizations. They must have sufficient knowledge to be able to identify, evaluate and cope with environmental forces that may affect the operations of their organizations. Therefore, any manager that wants to succeed must be mindful of the organization's environment. The study of business environment is important because

- ✓ It helps in understanding the social implications of any decisions taking by the business organization.
- ✓ It allows new business to analyze its strengths, weaknesses, opportunities, threats and constraints in terms of availability of trained manpower, political forces, potential market, competition etc**.**

2.0 LEARNING OBJECTIVE:

To be able to understand the meaning, importance, and the dynamic nature of the environment in which business operates. This chapter also aims at identifying the various environmental factors of business and their relative influence on the practice of business.

- Describe the relationship between Business and its environment.
- Discuss the characteristics of the environment of business organization.

- Explain the environmental factors that determines the success of a business organization

3.0 Main Content

3.1 FEATURES OF NIGERIAN BUSINESS ENVIRONMENT

Business is a social activity aimed at creating goods and services within the framework of a society or community. An activity that is legitimate in a society, city or state, may be illegitimate in another. For example, the sale of alcoholic drink is illegal in some states in Northern part of the country; so also is the consumption of pork is a taboo to Muslims. This implies that the type of business activity that takes place in a particular community, state or Nation, is largely determined by beliefs, needs and attitudes of that community. It is important to note that business makes demand on the society and vice versa, thus the interrelationship between the business and the community in which the business operates is known as the business environment. Business environment varies from one country, state or community. Some business environment may be favourable to the business growth while others may be hostile. The features of Nigerian business environment are:

3.1.1 PROXIMATE ENVIRONMENT

Proximate environment is the environment that is concerned with how and where to obtain the various resources which are employed in conversion processes and how the system output should be distributed. Such resources are labour, finance, materials and information. Apart from these resources, there are proximate bodies. Such proximate bodies are trade unions, competitors and local communities.

3.1.2 ECONOMIC ENVIRONMENT

Nigerian Economy is a developing one. As a result, there is low per capital income. When there is boom, the employment levels is always high and demand for goods and services is greater. Management is expected to keep such state for the benefit of the business. However, in a depressed economy consumer purchasing power is always low; the duty of management is to seek alternative market. Thus, the significant current economic environment that affects business includes the following:

(a) **Demand**: The purchasing power or the consumer demand level determines the average demand for the business.

(b) **Inflation**: Inflation has been defined as economic situation whereby too much money is chasing too few goods. Inflation affects the level of profitability. Then, management's duty entails the determination of a suitable selling prices, an encouraging reward system for labour and investors etc. There are a number of effects that relatively high rates of inflation might have on business and on consumer demand and confidence. For example, inflation leads to increase in business costs such as:

- Increase in wages and salaries of employees to keep pace with inflation
- Increase in the costs of components of raw materials
- Increase in energy costs
- Rising service costs such as the cost of technicians for repairs

(c) **Degree of Competition**: This involves how to counter the actions of the competitors.

(d) **Economic Growth**: This is an indication of the change in the goods and services produced by an economy. If economy growth is taking place, there are likely to be favourable trading conditions for business. Many businesses will be set up, and many will continue to grow. In periods of growth, business will find a healthy demand for their products. Businesses will tend to suffer when the growth is zero or negative

(e) **Exchange rates**. An exchange rate is the price of one country's currency in relation to that of another. For example, an exchange rate N1 = #150 while £1 = #255. Exchange rates are determined on foreign exchange markets throughout the world. The main reason why exchange rates are so important to businesses is because of their influence on the price of imports and exports. In Nigeria, all but very few small firm uses at least some goods and services imported from abroad. Also large number of businesses is finding that they have to export their products abroad in order to grow or survive. Thus, majority of firms are affected in some way by exchange

(f) **Monetary and Fiscal Policy Decisions**: Monetary policy means the various ways by which the monetary authorities i.e. (Central Bank of Nigeria and Ministry of Finance) influences the money supply, the general credit available as well as the rate of interest in order to achieve desired economic goals. Fiscal policy, on the other hand, consists of government decisions to influence the

country's economic activities using taxation and government expenditure. Finally, the management of an organization must keep in view the pattern, structure and even the rate of changes occurring on the economic scene.

(g) **Taxation**

This is the charges imposed or levied by the government on the earnings and income of business and individuals as well as goods and services produced and consumed by the people in the economy. An increase in price will raise the cost of business. A business might try to raise prices to cover this and maintain profit. However, higher prices can reduce sales hence profit would be affected if the revenue falls. This can affect the ability of the business to pay its debts, buy stocks and meet other expenses thereby affecting investments of the business.

(h) Interest Rates

Interest rates are the cost or price of borrowing. There are many interest rates in the economy. A change in the interest rates will affect the overhead costs of doing business. The interest that business has to pay on their borrowing is an overhead cost for business. For example, if the rates fall from 10% to 8% the overhead cost of the business will fall but if interest rate increases from 10% to15% the overhead cost will increase

(i) **Government Intervention**: In a bid to control economy, government intervenes by increasing taxes. This largely depends on the fiscal objectives of the government, whether to increase or reduce the purchasing power of workers.

Thus, a good manager should be concerned with economic environment He should be able to analyze changes in economy and predict how people will react to such changes. Above all, the manager must be able to determine the effect of such change on his business and take effective decision.

3.1.3 POLITICAL / LEGAL AND LEGAL ENVIRONMENT

The main components of this environment are the government and the system laws

(a) **Government:** This relates to the type of government in power, military or civilian; the levels of government – Federal, State and Local government. These are important variables to be considered. The Federal government influences management by imposing financial and legal controls, and

establishes institutions to achieve the overall goals of economic growth and prosperity e.g. Indigenization Act, Privatization and Commercialization decree, Industrial Policy of Nigeria, Company and Allied Matters decree of 1990 etc. Also, government divisions can also be influenced by various independent political pressure groups e.g. the NLC, the NANS, the NUPENG etc. All these groups can forward their aims by pressurizing government to legislate favourable policy that will promote their business.

(b) **Legal:** The legal framework is to protect the various public enterprises from being harmed. The legal controls could affect the following specific areas among others:

i. **Customers**: Protect customers from being supplied with, unusable, dangerous or unreliable goods;

ii. **Middlemen**: Threaten to withhold supplies to middlemen, who do not conform to its marketing requirements,

iii. **Local Communities:** protect communities from environmental pollution,

iv. **Personal**: Protect against unreasonable working conditions or terms of employment, minimum wage, activities of Trade Unions etc.

v. **Marketing:** Minimum and maximum prices, misleading advertisements, packaging of product etc. Thus, the legal structure is designed to prevent business from acting against all these categories of the public.

3.1.4 TECHNOLOGICAL ENVIRONMENT

Technological environment plays a significant role in determining the products and services that will be provided as the use of computer today is widely spread. Managers need to monitor new technology so that their business could enjoy the advantages of change that new technology can bring.

Technological development influence organizations in the following areas:

(a) **Method of Production, Sales and Distribution**: They enable the development of new product or different skills and productions process to take place.

New innovation in productions and transportation may impel management to acquire new skills.

(b) **Employees:** Organization requirements for staff in terms of numbers and level of skills also affected by technology. The development of electronic computers has enable management to handle, store and analyze easily the data on which decisions are based.

(c) **Communication**: Quality and speed at which decisions are taken has advance. Development of information technology such as micro-computers has helped. Also, improved technology has revolutionized communication. In the area of transport, innovation such as supersonic aircraft has reduced time spent on travelling. As well, development of telex system and video phones has made efficient personal contact possible even at long distances.

The importance of technology is that it can revolutionize operations so as to render obsolete either the product or the production process within a short time. However, it could be a strain on the financial resources of an organization in terms of the acquisition of experts and the training of personnel.

Self Assessment Question: *Discuss fully the technological environment of business and state how it influences the practice of business in Nigeria.*

3.1.5 SOCIO-CULTURAL ETHNIC ENVIRONMENT

The socio-cultural environment has social, cultural, demographic and educational characteristics.

(a) Social: This is the social structure, family patterns and occupational structure.

(b) Cultural ideologies, beliefs, values and norms

(c) Demographic characteristics include the age, sex and geographical structure of the population.

(d) Educational characteristics include the basic literacy and the extent to which higher education is provided.

Thus social environment represent a combination of attitudes, desires expectations, education, beliefs, and customs of people in a given society. Important also are culture, religion, age and the political beliefs of the social group. All these

factors may have impact on the operation of a business. They will manifest in the areas:

(i) of demand/pattern of consumer expenditure
(ii) channels of distribution
(iii) the nature of competition
(iv) the size of and skill of labour force
(v) attitude towards work and business etc.

Furthermore, the social- cultural environment is also important to business that engages in foreign production and sales. This is because the laws, customs, moral and ethics etc are important to the success of any business they engage in.

3.2 INTERNATIONAL BUSINESS ENVIRONMENT

Business is influenced as much by the events and conditions that obtained domestically as by what happens in the rest of the world. With the information technology revolution and the whole world gradually shrinking to become a global village, any event or change however small, leaves its impact worldwide. Hence, no business can remain immune to event happening elsewhere in the world. To prepare itself for any challenge or opportunity, a business firm has to undertake international environmental analysis. International environmental analysis again would rely on the same economic and non-economic components of the environment. One has to look at all these components from a global perspective and not from a region or a nation's perspective. International environmental scanning takes a broader view than the regional or national analysis. Nigerian businessmen look beyond the shores of this country for raw materials and component parts needed for production as well as foreign markets as outlets for their goods. Therefore, managers of internationally oriented enterprises will need to understand the different peoples and their cultures, philosophies and politics.

Nigerian companies are dependent on the foreign markets for the of raw materials, technology, machinery and equipment needed. Further more foreign investments account for the capital of multinationals and other large business organizations in Nigeria, particularly in the oil and gas sector such as Shell, Mobil Oil Plc. Trading firms like United African Company (UAC Plc), John Holt and so on.

Nigeria also belongs to many international economic institutions or organizations such as the Economic Community of West African States, International Monetary Fund (ILO) etc. Therefore the policy decisions of these international organizations must necessarily affect the business environment of the member countries, Nigeria inclusive.

Self Assessment Question: *Why is it important for a manager to analyze his business environment?*

3.3 CORRUPTION AND NIGERIAN BUSINESS

The word "corruption" is no longer strange in today's Nigerian business scene. It is a term that has acquired the status of a household recipe. It has eaten deep into the fabrics of the day-to-day business operations such that its presence is always known and felt. According to the Oxford Dictionary, the word "corruption" is used to mean dishonesty, illegal or immoral behaviour. But from a simple standpoint of view, corruption can be defined as the erosion of moral values and behaviour of a community/person in order to satisfy a need through illegal act.

The Nigerian business environment on the other hand, is large and is presumed to be dynamic, but the word business can simply be used to mean any human undertaken that conforms with the societal norms and values with the objective of making profit.

Business owners or business people engage in some acts that are basically contradictory to the customs and values of what their business stands for. These acts are in a nutshell referred to as "unethical behaviors or unethical acts" Therefore, every acts or practice of a business and/or person that contradicts the ethical behaviors could be said to be corruption. Nigeria just like every other or most other corrupt nations as listed by the United Nations is characterized by low per capita income, low consumption of calories, poor standard of living, more labour intensive approach to nation building among others. The countries in this category of corrupt nations are Nigeria, Bangladesh to mention a few. It should be noted that these corrupt countries also features among the list of poorest nations in the world. The paradox then remains worrisome for Nigeria in particular, because how could a country that is rich in mineral resources be so impoverished to have successfully acquired a status in the nomenclature of poorest nations in the world. One does not need a teacher to figure out that corruptions impoverished nations and the more corrupt a nation is, the poorer it becomes.

Nigeria is a country that is blessed with so many resources amongst which is human resources. Productive people who can sit and think, people who can channel their abstract thinking into not just a meaningful but also a visible, concrete and productive business drives. But a major setback lives within the people is corruption.

In a drive to curb corruption in Nigeria and promote Foreign Direct Investment (FDI), the government has inaugurated various bodies to deal with the problems from their roots. In this vein, the Economic and Financial Crime Commission (EFCC) was inaugurated in 2002, Independent Corrupt Practices Commission (ICPC) and others were also inaugurated.

Self Assessment Question: *What do you understand by the concept 'business environment'?*

3.4 ENVIROMENTAL FACTORS THAT DETERMINES THE SUCCESS OF A BUSINESS ORGANISATION

The environment of any organization is the aggregate of all conditions, events and influences that surround and affect it. Business environment can be classified into internal and external environment. The internal environment of business consists of factors that are under the control of the firm e.g. its resources while the external environment of business consists of business consists of uncontrollable factors which are independent of the firm e.g. the economic variable, technological variables, etc.

These are factors that have determined effects on the success of a business organization. These are internal environmental factors, that is, those factors within the organization and external environmental factors that are forces outside the organization.

3.4.1 INTERNAL ENVIROMENTAL FACTORS

These are situational factors within the organization namely:

(i) ***Objectives***:- These are specific end state or desired results the group wishes to attain by working together.

(ii) ***Structure***: - These are several levels of management and several sub units. Another term for this unit is functional areas. This refers to the work units performed for the organization as a whole such as marketing production, personnel, training, finance, planning.

(iii) ***Tasks:-*** This is the assigned job that is series of job or piece of work that is to be completed in specific manner within a specific period of time.

Technically tasks are assigned not to people but to positions each position is assigned a set of tasks intended to make a necessary contribution to the attainment of the organizational objectives.

(iv) ***Technology:*** **-** This is a means of transforming raw materials, people, information and physical materials in to desirable goods and services. It include combination of skills, equipment, facilities, tools and relevant technical knowledge needed to bring about desired transformation in materials, information and people in order to achieve its objectives.

(v) ***People:*** **-** These are the central figure in any model of management. No technology is useful and no task can be performed without the cooperation of people (Human Resources).

3.4.2 EXTERNAL ENVIRONMENT

This consists of those things outside an organization such as customers, competitors, Government units, suppliers, financial firms, labour pools that are relevant to organization operations. Forces external to the organization can either be direct or indirect. Direct action environment consists of those factors that directly affect the organization operations; these are suppliers, labour, laws, government regulating agencies, customers, and competitors. While indirect environments are those factors that may not have an immediate direct effect on operation but nevertheless influence them. These include general economic conditions, technology, socio-cultural and political development, indifferent groups and influence of foreign countries.

3.4.2.1 DIRECT ACTION ENVIRONMENT

(i) ***Supplier:*** Organization is a vehicle for transforming inputs into outputs. The major types of input are material, equipment, energy, capital and labour. There is a network of suppliers from which these inputs are obtained. This is one of the clearest examples of forces in the environment directly influencing the operation and success of an organization.

(ii) ***Laws:*** These are labour legislation. This affects the management of an organization. Organizations are subject not only to the federal and state laws but also to governmental regulatory agencies of Environmental protection Agency. State and local government require every business to be licensed; they also limit some business enterprises to certain locations.

(iii) ***Customers:*** An organization's survival and reason for existence depend on its ability to identify a customer for its input and output needs. The importance of customers to a business is obvious, non-profit and governmental organizations also have customers. Customers decide which goods and services are desirable at what price they determine almost everything related to its output the need to meet customers' requirements thereby affect interaction with supplier of both material and labour.

(iv) ***Competitors***: It is not customers but competitors who determine what price can be charged. It is important to realize that customers are not the areas of competition among organization. Organizations also compete for labour, materials, capital and the right to use certain technical innovations.

Self Assessment Question: *Discuss the term 'direct action environment'.*

3.4.2.2 INDIRECT ENVIRONMENT

These factors do not have marked effect on the organization's operations as those in the direct action environment. The indirect environment is usually more complex and uncertain than direct environment. Management is compelled to make assumptions about it based on incomplete information in order to predict what the impact on the organization will be.

(ii) ***Technology:*** This is both an internal and external factor. New technological development affects the efficiency with which products can be manufactured and sold. Computer laser, microwave integrated circuits, semi-conductors, robotic satellite communication, nuclear power, synthetic fuel have influence on the success of an organization. Organizations must be ready to respond quickly to new developments and create innovations of its own.

(iii) ***Economic conditions***: Economic conditions throughout the world affect the cost of all inputs and the ability of customers to buy certain goods and services. It is important to understand that a given change in economic conditions e.g. inflation may have a positive effect on some organizations and negative on others.

(iv) ***Socio-cultural factors***: All organizations operate within at least one culture. This includes prevailing attitudes, values, customs of that culture e.g. in Nigeria, paying bribes to obtain contracts or political favors or promotion instead of competence is the order. Such practices are seen as normal and accepted business practices.

(v) ***Political factors***: This is the influence of government action on such matters as corporate income tax, trade tariffs, privatization requirements, customer protection legislation, safety standards, pollution standards, waste and price control, political stability. Political change on the other hand can lead to policies that may favor or discourage foreign investors.

(vi) ***Local Community***: Every country has specific laws and attitudes towards business that determine where one can operate certain types of business. Some countries encourage establishment of industries, others fight in court for years to keep out a proposed manufacturing facility. So many organizations have good relations with the community they operate.

(vii) ***International Environment:*** Environmental factors described above affects all organizations to some degree, those operating internationally to some degree; those operating internationally face even more complexity. This is due to the unique set of environmental factors that characterized any country. Each country's economy, culture, quality of labor, material, laws, governmental agencies, political stability, customer, competitor's state of technological development varies. Management of organizations must take these differences into account when an organization begins to do business outside its domestic market, its practices must be modified to adapt to different environmental factors.

4.0 CONCLUSION

The environment of any business organization is the aggregate of all conditions, events and influences that surround and affect it. Critical factors tha affect the environment are economic, political/institutional, social and cultural and technological factors.

5.0 SUMMARY

Business environment can be classified into internal and external environment. The internal environment of business consists of factors that are under the control of the firm for example its resources. The external environment of business consists of uncontrollable factors which are independent of the firm for example prevailing economic variable, technological variables, etc. The understanding of business environment by managers is essential because it acts as a warning signal for adverse conditions; it sensitizes the management, provides a basis for strategy, supplies source of intellectual stimulation, helps in image building, and continuous learning.

6.0 TUTOR MARKED ASSIGNMENTS

1. Why is an organization's environment so important?

2. Discuss the Nigerian Business Environment pointing out the impacts on the performance of an organization.

7.0 REFERENCES

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Unit 4: THE MAJOY OBJECTIVES OF BUSINESS FIRMS

CONTENTS

1.0 INTRODUCTION

Business enterprises are formed with specific objectives in mind. These objectives differ depending upon the intention of the owners of the firm. In this unit of the work, we will pay particular attention to the objectives of business firms. The problems of these objectives will also be discussed in this unit. Suppose you are running a poultry farm and somebody ask you the objective of your business venture. What will you tell him? You may not be wrong if you say your objective is to make profit. The real answers to the above question will come out clearly when we understand this unit and the next one.

2.0 OBJECTIVES OF THE UNIT

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

- What a business firm is all about
- The basic objectives of business firms
- The meaning and theories of profit
- The problems associated with measurement of profit
- How business firms maximize profits and
- What level of profit is considered reasonable?

An understanding of all these will help you a lot in business decision taking.

3.0 MAIN OBJECTIVE OF FIRM

3.1 Definition of Business Firms:

A firm in economics is the smallest unit of a production outfit. A business firm therefore is any production entity that carries out activities for money e.g. poultry farm, bakery, shoe industry, tannery, an accounting firm etc.

3.2 Profit as a Business Objective Firm:

Profit has been upheld as the major objective of business firms. Profit means different things to different people. Businessmen, accountants, tax collectors, workers and economists see it to mean different things. In a general sense, profit is regarded as income accruing to the equity holders, in the same sense as wages accrue to the labor, rent accrue to the owners of the rentable assets, and interest accrues to the money lenders. To the layman, profit means all income that flow to the investors. To the accountant, profit means the excess of revenue over all paid out cost including both manufacturing and overhead expenses. It is the same as net profit. To the economist profit means a return over and above the opportunity cost i.e. the income which a businessman might expect from the second best alternative use of his resources. You can see the notion different people have about profit. It therefore depends on who is defining it. Let us look at it now more closely.

Accounting profit Vs. Economic profit.

These two concepts of profit are the most important in business decisions. As such, an understanding of the difference between them is important.

From the accounting point of view, profit is surplus of revenue over and above all payment on cost. This can be calculated as:

Accounting profit = TR- (W+R+I+M).
Where TR = Total Revenue

W = wages and salaries, = rent, I = interest and M= Cost of materials. It should be noted that when calculating accounting profit, only explicit costs are considered i.e. Actual expenditure.

On the other hand, economic profit takes into account the implicit and imputed costs. This implies that economic cost takes into consideration the opportunity costs of factors of production. Opportunity cost is defined as the income forgone, which a businessman could expect from the second best alternative use of his resources. *E.g.* when an entrepreneur uses his labour in his own business, he forgoes the income, which he might have earned by working in another firm. This also applies to all productive resources and is called opportunity cost.

Economic profit or pure profit as it is also called, could therefore be defined as the residual left after all contractual costs have been met, including the transfer costs of management, insurable risks, depreciation and payments to shareholders sufficient to maintain

investment at its current level. The formula for calculating it is: Pure profit (economic profit) = Total Rev. - (Explicit + implicit cost).

The value that can be derived from the above formulae can be negative or positive. In a nutshell, the major difference between accounting profit and pure profit lies in the fact that while pure profit takes into consideration the opportunity cost of factors of production employed, account profit does not. By the time we treat the concept of cost, you will appreciate this aspect better.

3.2.1 Sources and Theories of Profit.

Economists do not agree on the sources of profit. As result of these disagreements, a number of theories are advanced to explain the sources of profit. We shall briefly consider a few of these theories here. You are required to pay particular attention to this for proper understanding. The following are advanced as sources of profit:

a) Profit as reward for Dynamic Entrepreneurship

According to this theory, profits are found not in a static economy, but in a dynamic economy. In a static economy, (i.e. economy with little or no changes) there are no changes in economic indices, in such a case, firms make only normal profit i.e. the wages of management). But in a dynamic economy there are constant changes in all economic indicators. Managers take advantage of these changes and promote their businesses, expand their sales and reduce their costs. A manager who takes successful advantage of

the changing conditions in a dynamic economy makes pure profit.

Pure profits exist only in the short-run, because in the long run, there is a rise in output, which causes a decline in product prices. This leads to the disappearance of pure profit. Managers with foresight continue to take advantage of these changes and make profit.

b) Profit as Reward for Risk-Bearing

This approach is also known as Hawley's Risk Theory of Profit. According to this approach, profit is simply the price paid by society for assuming business risks. As such, businessmen would not assume risk without expecting adequate compensation in excess of actual value. They would always look for a return in excess of the wages of management for bearing risk. Risk gives rise to trouble, anxiety and disabilities of various kinds and the entrepreneur bears all these. This gives him a claim to reward for taking these pains in excess of actuarial value of risk. According to this theory, profits consist of two parts:

- One part represents compensation for actuarial or average loss incidental to the various classes of risks necessarily assumed by the entrepreneurial adventures, and

- The remaining part represents an inducement to suffer the consequences of being exposed to risk in their entrepreneurial adventures.

Hence, profits arise from factor ownership only so long as ownership involves risk. This implies that an entrepreneur has to assume risk to qualify for profit. Accordingly, if an entrepreneur avoids risks by insuring against it, he ceases to be an entrepreneur and would not receive any profit, because profits arise out of uninsured risks.

c) Profit as reward for innovations

This theory is also called Schumpeter's Innovation Theory of profit: According to this theory, the payment of interest and profit, trade cycles and many others were only incidental to a distinct process of economic development. As such, this theory is embedded in Schumpeter's theory of economic development. According to this approach, a stationary economy, which is the starting point, is characterized by equilibrium in all the spheres, implying there is no profit. Profit can only be made by introducing innovations in manufacturing techniques and methods of supplying the goods. Innovations could take the form of:

- Introduction of new commodity,
- Introduction of a new method of production
- The opening of a new market

- Finding new sources of raw materials and
- organising the industry in an innovative manner

This may all give rise to profit, which over time will be competed away as early discussed. Where profits arise due to such factors as patent, trusts, cartel, etc., it would be in the nature of monopoly profit and not entrepreneurial profits.

3.2.2 Problems of Measuring Profit

The first problem of measuring profit arises from its definition, and the costs to be included. The problem that arises from the definition is solved by specifying the purpose for measuring profit. Accounting concept of profit is used when the purpose is to produce an interim profit figure for:

- Shareholders to inform them of progress of the firm,
- Financiers and creditors who are interested in firm's progress,
- Managers to assess their own performance and
- For computation of tax-liability.

Data to measure the profit for this purpose can be obtained from firm's books of account.

Accounting profit may exaggerate actual profits, if it is based on arbitrary allocation of revenue and costs to a given accounting period. If on the other hand, the objective is to

measure true profit, the concept of economic profit should be used. This can be achieved by viewing profit in terms of maximum amount that can be distributed in dividends, since the true profitability of any investment can be determined only when the ownership of that business has been terminated. This makes the concept of economic profit to be of little practical use. This notwithstanding, it serves as a guide to income measurement even from businessmen's point of view.

From the above discussion, it is clear that for all practical purposes, profits are measured on the bases of the accounting concept. This method too is not free from problems. The main problem with this method, is deciding the items that should be included in the cost. These problems include:

- Measurement of depreciation, which method to be used,
- Treatment of capital gains and losses and Method of valuation, i.e., current or historical costs
- These problems arise because:

Economists' view on these items differs from that of accountants and there is more than one accepted method of treating these items.

3.3 Profit Maximisation as the Major Business Objective

Economists have built price and production theories holding profit maximization as an important assumption. Conventional economic theory assumes profit maximization as the sole objective of business

enterprises. The advantage of this assumption is its predictive power. It helps predict the behaviour of business firms in the real world and the behaviour of price and output under different market conditions. To maximize profit under this approach, some conditions must be fulfilled. These conditions are:

- The necessary condition: which requires that Marginal Revenue (MR) must be equal to Marginal Cost (MC), i.e, MR=MC. This is Known as the first order condition of profit maximization

- The secondary condition also called the second order condition, requires that MR=MC at a point where MR is decreasing and MC rising.

When these two conditions are fulfilled, it makes it the sufficient condition. These could be expressed as follows:

$$\pi = TR - TC \text{----------} 3.1$$

Where n — total profit, TR = Total Revenue and TC= Total Cost. If Total Revenue (TR) and Total Cost (TC) functions are given, such that

$$TR = F(Q) \text{ and}$$
$$TC = F(Q)$$

Where Q = quantity produced and sold, the profit function is of the firm thus:

$$\pi = F(Q) - F(Q)$$

The first order condition of maximising a function is that its first derivative be equal to zero. This also holds true for the first order condition of profit maximization, i.e. *the first derivative of the profit function must be equal to zero*

Also $\frac{\Delta TC}{\Delta Q} = MC$

Which is the slope of total cost curve is the same as marginal Cost (MC). Thus, *we can state the first -order condition for profit maximization as MR =MC.*

This is the necessary condition, whose non-fulfilment results in the non-occurrence of an event. The second order condition requires thatits second derivative be negative. The implication of this that the total profit curve has turned downward after having reached the peak. The second derivative of the total profit function is:

$$\frac{d^2\Pi}{dQ^2} = \frac{d^2TR}{dQ^2} - \frac{d^2TC}{dQ^2} = O$$

This implies that $\frac{d^2TR}{dQ^2} > \frac{d^2TC}{dQ^2}$

Slope of MC, it can be expressed as:
Slope of MR > slope of MC

The above equation meets the second order condition for profit maximisation.

4.0 CONCLUSION

From what has been discussed so far, one can conclude that business enterprises have profit maximisation as their prime objectives, and profit maximisation plays a significant role in business decision. For profit to be maximized, the conditions of MR = MC and a rising slope of MC at the point where MR = MC provide the adequate condition for profit maximization.

5.0 SUMMARY

It has been observed from the foregoing discussion on this unit that business firms engage in production activities for the purpose of profit malting. Profit is given different explanation by different disciplines e.g. while accounting profits is surplus of revenue over and above all paid on cost economic profit is the residual left after all contractual costs have been met. Profit is maximised at a point where MR = MC.

6.0 TUTOR MARKED ASSIGNMENT

1. Explain how business firms maximise profit?

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MODULE 2

Unit 1: MARKET MECHANISM AND ANALYSES OF DEMAND AND SUPPLY

1.0 INTRODUCTION

Now that you perceive the essential economic problem as one of scarcity in its most objective sense, let's explore how different economic systems go about answering the following basic questions:

How does price work as a rationing device (allocating scarce resources)?

How efficient is a price system?

2.0 OBJECTIVE

After working through Unit One of this course, you should be able to:

i. *Describe* economic systems.
ii. *Describe* the overall market system.
iii. *Discuss* the role of price as a rationing device
iv. *Apply* the demand and supply model in a variety of situations.
v. *Describe* how the price system responds to such changes as the effect of taxes, price ceilings and price floors.
vi. *Discuss* the efficiency of free market competition.
vii. *Explain* conditions that determine the pattern of international

3.0 MAIN CONTENT

3.1 Command Economy

In a command economy, a central authority or agency draws up a plan that establishes what will be produced and when, sets production goals,

and makes rules for distribution. Even in a pure planned economy, the public exercises choices by setting the volume that it wished to consume.

3.2 Laissez-faire Economy

*Laissez-faire** is frim the French: 'allow to do.' This is an economy in which individual households and firms pursue their own self-interests without any central direction or regulation. In this environment (today called a market economy), no central direction or regulation co-ordinates the decisions of individual household and firms. Some markets are simple and others are complex, but they all involve buyers and sellers engaging in exchange. The behaviour of buyers and sellers in a laissez-faire economy determines what gets produced, how it is produced and who gets to buy the goods. This is not to deny that government involvement is absent. In every market economy today, governments produce many services, redistribute income thorough taxes and expenditures, and regulate many activities.

Prices in a free market act as a signalling device. A rise in the price of a product indicates that this product has become scarcer. The price increase signals to consumers the need to purchase less – by seeking cheaper substitutes, for instance – and it signals to business the need for more supply. If the free market system is to operate efficiently, it requires an adequate institutional framework of law, custom and behaviour. In long – established market economies this background tends to be taken for granted. Its absence can be costly, as the newly liberalized economies of Europe discovered.

3.2.1 The market System in Action

The free market consists of many interconnected markets which, for the purpose of this course, you can assume for now to be highly competitive and to operate free of government interference. In reality, many markets are subject to imperfectly competitive and monopolistic influences, and government intervention in the market system is a feature of even the most enthusiastically capitalist society. Indeed, in some circumstances, such intervention can be shown to be a necessary condition for achieving economic efficiency.

3.3 WHAT IS A MARKET?

There are many types of market, but the type of market structure truest to the traditional model of a physical marketplace is a *perfectly competitive* market with the following characteristics:

- Large numbers of sellers and buyers, each acting independently and exerting no individual monopolistic power.
- Full information: everyone knows what the going price is and can evaluate the quality of the good or service being produced.
- Consumers aim to maximize utility (i.e., personal satisfaction) and firms aim to maximize profits.
- Prices are flexible in all markets.

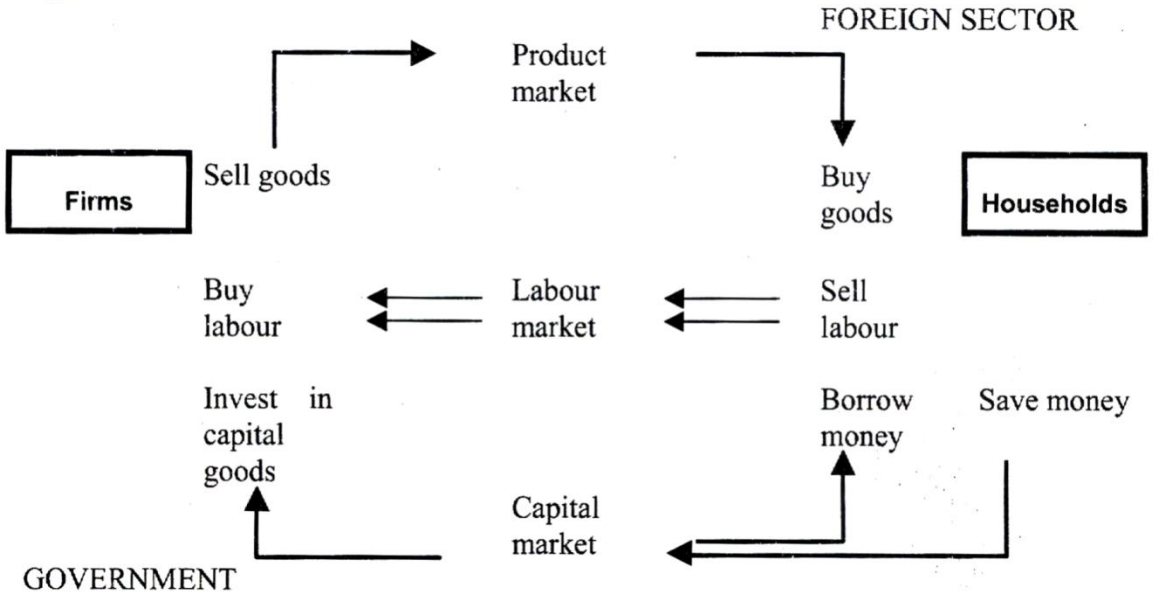
Given these conditions, the market system fulfils the function of allocating resources between different uses and among different people. It acts as an equilibrating mechanism between supply and demand. Prices

act as *signals*, and the price system is the coordinating mechanism that ensures that markets 'clear': i.e., that supply equals demand in each market.

3.4 The Market System

Your reading about economic measurements has already brought three key elements of the market system to your attention, one being the product market: the markets for individual goods and services. The others are the labour market – the buying and selling of labour – and the capital market – the lending and borrowing of capital. In each market the typical buyers and sellers are firms and households. Households sell their labour to firms, and, with the income earned this way, they buy goods and services from firms. Firms produce goods and services by hiring labour and capital form households (and other firms). Households and firms also interact on the capital market. If individuals choose not to spend all their income, their savings are channelled to firms by intermediaries such as banks and pension funds. If they choose to spend more than their income, loans will be supplied by the same intermediaries. This is a much simplified conceptualization of the market system as we know it in the real world, but it is sufficient to illustrate the strong interconnections between markets diagrammed in figure 3-1.

Figure 3-1



3.4.1 Foreign and Government sectors

Two other market participants must be considered: the *foreign sector* and *government sector*. Domestic firms do not have to sell their entire output to domestic consumers. They also have the option of exporting. Likewise, household can import goods and services instead of buying the output of domestic firms. Imports, exports and the foreign trade market are an integral part of an analysis of the market system. Factors of production such as capital and labour can also be traded internationally. The rise in global capital mobility, especially between developed countries, has meant that the domestic economy is no longer restricted to domestics savings for its supply of investment funds. Since the middle of the twentieth century, the foreign sector has been growing rapidly in relative importance.

The government is also an important participant in the market. The size of government spending as a percentage of the nation's aggregate spending varies from nation to the next, but in industrial countries, government spending amounts to about 40 per cent of total national

expenditure. Governments figure importantly in the labour market. They hire directly – civil servants – or indirectly in the form of contracts with the private sector to acquire services, supervise procurements, etc. Public intervention takes many forms in addition to government spending. All arrears of economic life are subject to official regulations: examples are planning requirements for new buildings, health and safety regulations, and environmental restrictions. State-owned commercial companies are another vehicle of government influence not reflected in the spending GDP ratio.

3.5 PRODUCT (OUTPUT) MARKET

3.5.1 Demand

In economics the concept of demand is employed to describe the quantity of a good or service that a household can, or a firm chooses, to buy at a given price.

3.5.2 Market Demand and Individual Demand

The market demand for a good or service is simply the total quantity that all the consumers in the economy are willing to demand per time period at a given price.

3.5.3 Determinants of Demand

The amount of a product that consumers wish to buy in a given time period is influenced by the following variables:

- Product's own price
- The price of related products
- Average income of households

- Tastes and preferences
- Income distribution
- Population

It is difficult to consider the impact of changes in all these variables at once. Studying each in isolation is only possible in theory, but theory still improves understanding. Therefore, this module will employ a convenient assumption called ceteris paribus to focus on the impact of a single variable at a time (ceteris paribus meaning 'everything else remaining constant')

3.5.4 Price and Quantity Demanded: the Law of Demand

How are prices determined, then? To develop a theory, we need to study the relationship between the quantity demanded of each product and that product's price. This requires that we hold all other influences constant and ask, 'How will the quantity of a product demanded change as its price changes?

The headlines announce a move by the Organization of Petroleum Exporting Countries with 'Major cutback in OPEC production and exports of crude oil.' Shortly afterwards you find that oil and gas prices – wherever not regulated by the government – have doubled at service stations. What do you do? If you have a fixed transportation budget but drive a car, you will cut back on your use of the car. Perhaps you will drive less and might substitute public transit for private transportation. Perhaps in time you will buy a smaller car.

Why might this be so? There is almost always more than one product that will satisfy any desire or need. For example, the desire for a new

automobile may be satisfied by variety of different automobiles of a certain category: imported, domestic, sedan, coupe, etc.

This is simply an illustration of the general relationship between price and consumption: when the price of a good rises, the quantity demanded will fall. This relationship is known as the law of demand. The *law of demand* states that there is a negative relationship between the price and the quantity demanded of a product. When the price of a movie theatre increases, we buy less.

There are two reasons for the predictable response to a price increase:

1. People will feel poorer. They will not be able to afford to buy so much of the good with their money. The purchasing power of their income (their *real income*) has fallen. This is called *income effect* of a price rise.
2. The good will now be dearer relative to other goods. People will thus switch to alternative or substitute goods. This is called the *substitution effect* of a price rise.

Similarly, when the price of a goods falls, the quantity demanded will rise. People can afford to buy more (the income effect), and they will switch away from consuming alternative goods (the substitution effect). The amount by which the quantity demanded falls will depend on the size of the income and substitution effects.

3.6 The Demand Schedule and Demand Curve

A demand schedule is one way of showing the relationship between quantity demanded and the price of a product, other things equal. It is numerical tabulation showing the quantity that is demanded at certain prices.

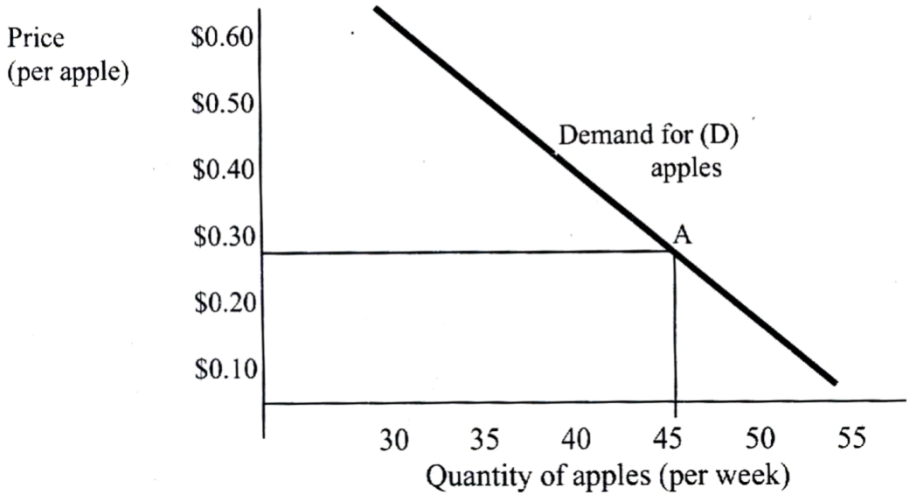
Table 3.1

Price per apple	Quantity demanded (per week)
₦.60	30
₦.50	35
₦.40	40
₦.30	45
₦.20	50
₦.10	55

A demand curve is a graphical representation of a demand schedule such as that of Table 3.1. A strict and regular relationship between the X and Y entries produces a straight slope, not the swoop you might expect in thinking about the 'learning curve' and similar graphs. When the word 'shape' is used about a curve, it refers to the direction of the curve – wither up or down, in the case of a simple slope.

The position and shape of the market demand curve depends on the position and shapes of the individual consumers' demand curves from which it is derived. But it also depends on the number of individual consumers who consume in that market. Figure 3-2 shows the demand curve for apples. The price – quantity combination shown in Table 3-1 are plotted on the graph shown in Figure 3-2. Price is plotted on the vertical axis, quantity on the horizontal.

Figure 3-2



The smooth curve drawn through these points is called a demand curve. It shows the quantity that purchasers would like to buy at each price. The negative slope of the curve indicates that the quantity demanded increases as the price fails. Each point on the demand curve indicates a single price – quantity combination. The demand curve represents the relationship between quantity demanded and price, other things being equal.

As you see, the term 'demand' refers to the entire relationship between the quantity demanded of a producer and the product (as shown, for example, by the demand schedule in Table 3-1 or the demand curve in Figure 3-2). In contrast, a single point on a demand schedule or curve is the *quantity demanded* at that point. This distinction between 'demand' and 'quantity demanded' is an extremely important one and will be examined more closely later in this study block.

3.6.1 Shifts in the Demand Curve

Now consider what happens if income, tastes, population, and the prices of all other products remain constant and the price of only one product

changes. As the price goes up, that product becomes an increasingly expensive way to satisfy a desire. Some consumers will stop buying it altogether; others will buy smaller amounts; still others may continue to buy the same quantity. Because many consumers will switch wholly or partly to other products to satisfy the same desire, less will be bought of the product whose price has risen. As meat becomes more expensive, for example, consumers may extent switch to meat substitutes; they may also forgo meat at some meals and eat less meat at others.

Conversely, as the price goes down, the product becomes a cheaper method of satisfying a desire. Households will buy more of it. Consequently, they will buy less of similar products whose prices have not fallen and as a result have become expensive *relative* to the product in question. When a bumper tomato harvest drives prices down, shoppers switch to tomatoes and cut their purchases of many other vegetables that now look relatively more expensive.

3.6.1.1 Average Income

A glance at any rack of magazines will tell you that tastes have an effect on people's desired purchases. A change in taste may be long-lasting, as has been the shift from fountain pens to ballpoint pens or from typewriters to computers; or it may be short-lived, like the fad for Hula Hoops or collapsible scooters. In either case, a change in tastes in favour of a product shifts the demand curve to the right. More will be demanded at each price.

3.6.1.2 Prices of Related Goods

You have seen that the negative slope of a product's demand curve occurs because the lower its price, the cheaper the product becomes relative to other products that can satisfy the same needs or desires. These other products are called substitutes, each being a good that can be used in place of another good. For example, a bus ride substitutes for a train ride; therefore, a bus ride can become cheap relative to a train ride either because the price of the bus ride falls or because the price of the train ride rises. Either change will increase the demand for (frequency of) bus rides that consumers wish to buy as consumers substitute away from train rides. Thus a rise in the price of substitute for a product shifts the demand curve for the product to the right. More will be demanded at each price.

Complements are products that tend to be used jointly. Cars and gasoline are complements; so are hamburgers and French fries, tapes and tape players. Because complements tend to be consumed together; a fall in the price of one will increase the demand for both products. Thus a fall in the price of a compliment for a product will shift that product's demand curve to the right. More will be demanded at each price. For example, a fall in the price of tape player will lead to a rise in demand for tapes, even though the price of tapes is unchanged.

3.6.1.3 Population

Demand also depends on the size as well as the composition of the population. The larger the population, all else being the same, the greater is the demand for all goods and services, and vice versa (that is, the smaller the population, the smaller the demand).

Population growth does not create new demand unless the additional people have the means to purchase goods: that is, unless they have purchasing power. If there is an increase in population with purchasing power – for example, the immigration of wealthy foreigners – the demands for all the products purchased by new people will rise. Thus we expect that an increase in population will shift the demand curves for most products to the right, indicating that more will be demanded at each price.

The composition or the age structure of population is rather important, too. Demand for certain products depend very much on the proportion of the pollution in a given age. For example, the older the population, the greater will be demand for nursing home spaces.

3.6.1.4 Distribution of Income

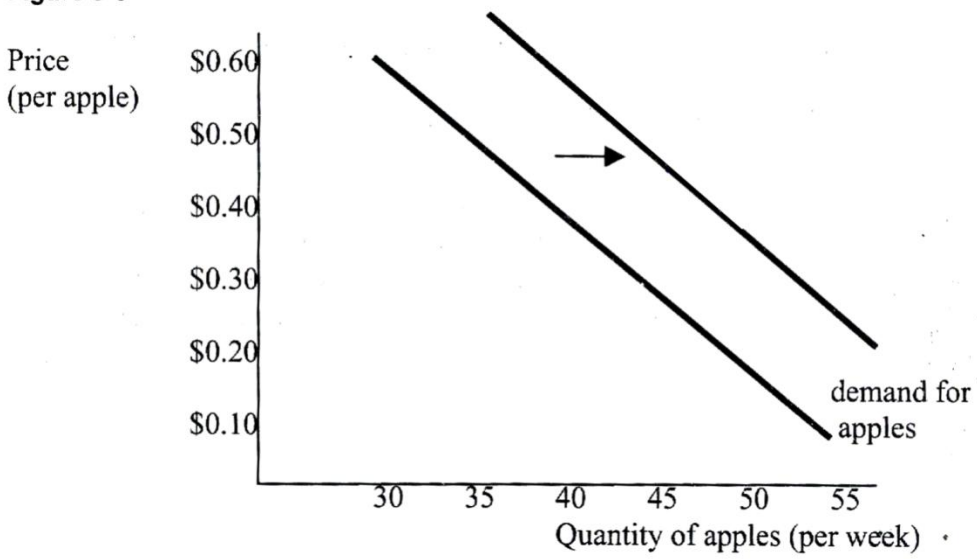
If a constant total of income is redistributed among the population, demands nay change. If, for example, the government increases the deductions that may be taken for children on income-tax returns and compensates by raising basic tax rates, income will be transferred from childless persons to households with large families. Demands for product more heavily bought by child-less persons will decline while demands for products more heavily bought by households with large families will increase. A change in the distribution of income will therefore cause an increase in the demand for products bought most by households whose incomes increase and a decrease in the demand for products bought most by households whose income decrease.

3.6.1.5 Tastes and Preferences of the Household.

Households' taste and preferences tend to change for time to time. For example, in societies such as Canada, anti-smoking campaigns have been so strong that demand for cigarettes has diminished for a large segment of the population.

Consider an increase in household income while price remains constant. If households increase their purchase of the product, the new quantity cannot be represented by a point on the original demand curve. It must be represented on a new demand curve that is to the right if the old curve. Thus the rise in consumer income shifts the demand curve to the right, as shown in Figure 3-3. This illustrates the operation of an important general rule.

Figure 3-3



You can study the influence of changes in variables other than price by determining how changes in each variable shift the demand curve. Any change will shift the demand curve to the right if it increases the amount that households wish to buy, other things remaining equal. It will shift

the demand curve to the left if it *decreases* the amount that households wish to buy, other things remaining equal. Note that changes in people's *expectations about future values* of variables such as income and prices can also influence the current demand. However, for simplicity, we consider only the influence of changes in the current values of these variables.

Self Assessment Question: *List and explain the determinants of demand of a product.*

3.6.2 Movements along the Curve versus Shifts of the Whole Curve

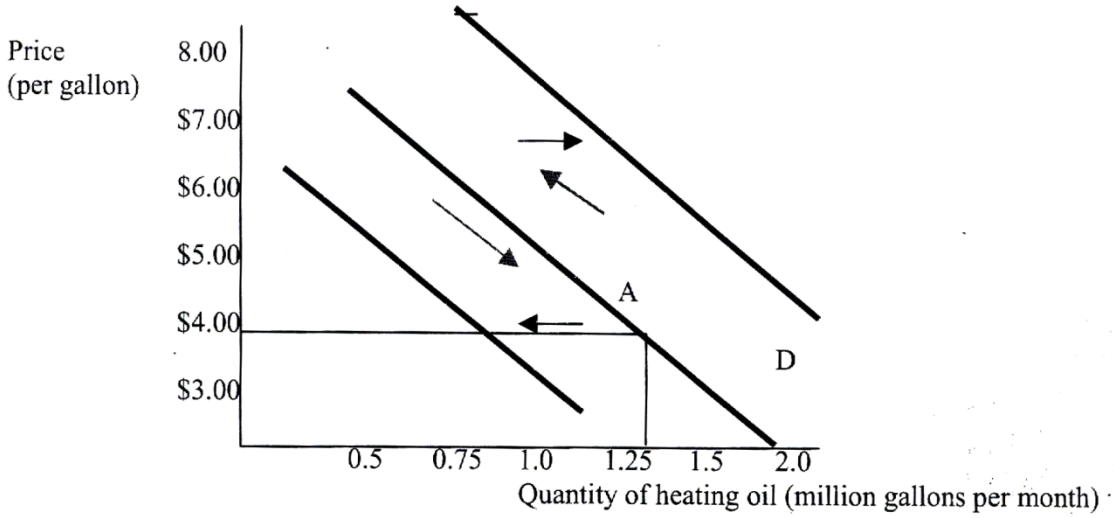
Suppose that you read in today's newspaper that the soaring of heating oil has been caused by a greatly increased demand for heating oil. Then tomorrow you read that the rising price of heating oil is greatly reducing the typical consumer's purchases of heating oil, as shoppers switch to burning natural gas, coal, and wood. The two stories appear to be in contradiction with each other. The first associates a rising price with a rising demand; the second associates a rising price with a declining demand. Can both statements be true? The answer is yes – because they refer to different things. The first describes a shift in the demand curve; the second refers to a movement along a demand curve in response to a change in price.

Consider first the statement that the increase in the price of heating oil has been caused by an increased demand for heating oil. This statement refers to a shift in the demand curve for heating oil. In this case, the demand curve must have shifted to the right, indicating more heating oil

demanded at each price. This shift, as we will see later in this chapter; will increase the price of heating oil, Figure 3-4.

Now consider the statement that less heating is being bought because heating oil has become more expensive. This refers to a movement along a given demand curve and reflects a change between two specific quantities being bought, one before the price rose and one afterward.

Figure 3-4



A indicated above, to prevent the type of confusion caused by our two newspaper stories, economists use a specialized vocabulary to distinguish between shifts of curves and movements along curves.

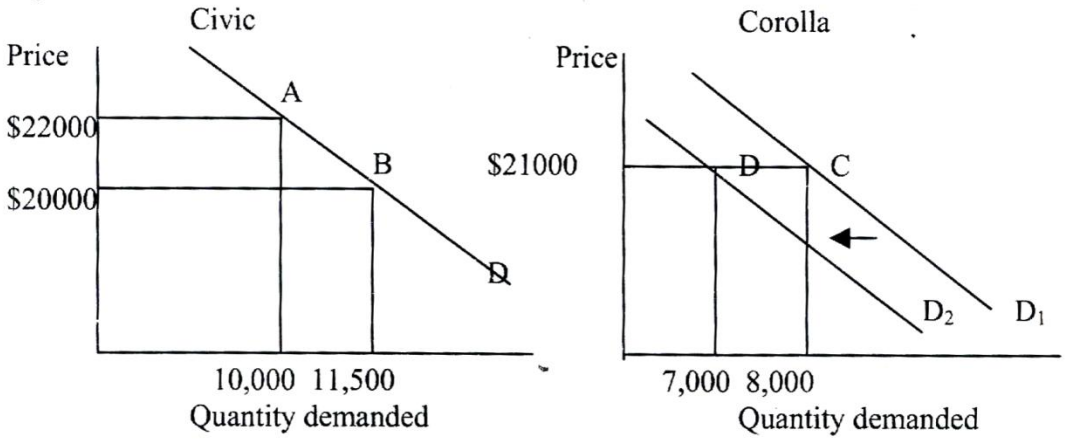
We have seen that demand refers to the *whole* demand curve, whereas quantity demanded refers to a specific quantity that is demanded at a specific price, as indicated by a particular point on the demand curve. In Figure 3-4, for example, demand is given by the curve *D*; at a price of ₦4.00, the quantity demanded is 1.25 million gallons of heating oil per month, as indicated by the point A.

3.6.3 Illustration of Change in Demand vs. Quantity Demanded

Here is an example that points out the difference between a 'change in quantity demanded' and 'a change in demand.'

In Figure 3-5 below, we have a demand curve for the Honda Civic automobile on the left and the competing Toyota Corolla on the right. Initially, the price of the Civic is ₦22,000 and 10,000 units are demanded per year. The Corolla sells for ₦21,000 and has a demand of 8,000 demanders at that price per year. (Note: it is irrelevant whether the Civic's price is above, below or equal to that of the Corolla.)

Figure 3-5



Suppose that the price of the Civic decreases to ₦20,000. MORE Civics will be purchased – and increase in quantity demanded as there is a movement along the demand curve for A to B. Some of the new Civic customers would have been Corolla drivers but now are not. At the same price (₦21,000) as before, the demand for Corolla has decreased, perhaps to 7,000. Note that the increased demand for Civic (by 1,500 units) rises partly from some of the existing Corolla customers who switch to Civic and partly from a bigger pool of potential

automobile buyers (not necessarily the existing drivers) who find the reduced price attractive.

3.7 SUPPLY

When we refer to the economy of our own country, we find that the economy, in the most recent year for which statistics are available, produced goods and services worth millions, or billions, or even perhaps trillions in the local currency. In studying the subject of production, there is a single question that economists attempt to answer: *What determines the quantities of products that will be produced and offered for sale?* Such an attempt requires an examination of the basic relationship between the price of a product and the quantity produced and offered for sale as well as an examination of the forces that lead to shifts in this relationship.

3.7.1 What is Quantity Supplied?

The amount of a product that firms wish to sell in some time period is called the quantity supplied of that product. Quantity supplied is a flow; it is so much per unit of time. Note also that quantity supplied is the amount that firms are willing to offer for sale; it is not necessarily the amount that they succeed in selling.

The amount of a product that firms are willing to produce and offer for sale is influenced by the following important variables:

- Product's own price
- Price of inputs
- Technology
- Number of suppliers

The situation with supply is the same as with demand: there are several influencing variables, and we will not get far if we try to discover what happens when they all change at the same time. So, again, we use the convenient *ceteris paribus* assumption (everything else remaining constant) to study the influence of the variables, one at a time.

3.7.2 Quantity Supplied and the Law of Supply

We begin by holding all other influences constant and ask how we expect the quantity of a product supplied to vary with its own price.

A basic hypothesis of economics is that for many products, the price of the product and the quantity supplied are related *positively*, other things being equal. That is to say, the higher the product's own price, the more its producers will supply; and the lower the price, the less its producers will supply.

Why might this be? It is true because the profits that can be earned from producing a product will increase if the price of that product rises while the costs of inputs used to produce it remain unchanged. This will make firms, which are in business to earn profits, wish to produce more of the product whose price has risen.

3.7.3 The Supply Schedule and the Supply Curve

The general relationship just discussed can be illustrated by a supply schedule which shows the relationship between quantities supplied of a product and the price of the product, other things being equal. A *supply schedule* is analogous to a demand schedule; the former shows what producers would be willing to sell, whereas the latter shows what

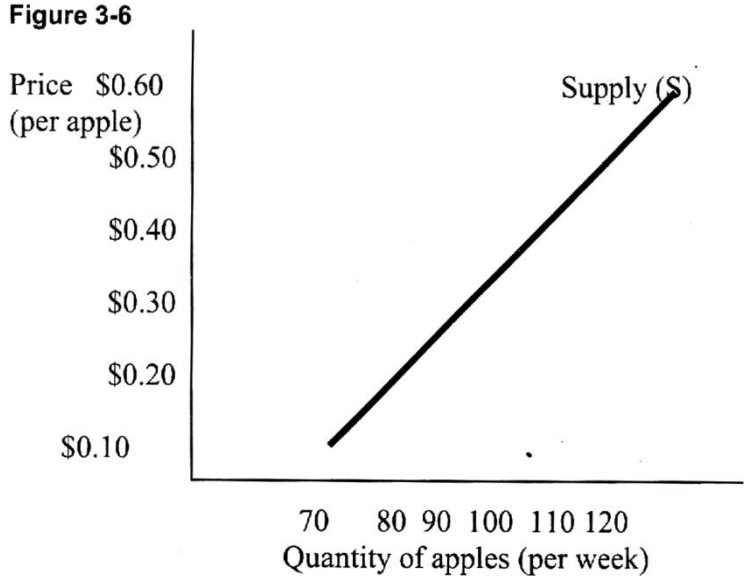
households would be willing to buy, at alternative prices of the product. Table 3-2 presents a hypothetical schedule for apples.

Table 3.1

Price per apple	Quantity demanded (per week)
₦.60	120
₦.50	110
₦.40	100
₦.30	90
₦.20	80
₦.10	70

A *supply curve,* the graphical representation of the supply schedule, is illustrated in figure 3-6. Each point on the supply curve represents a specific price-quantity combination; however, the whole curve shows something more.

Figure 3-6



The supply curve represents the relationship between quantity supplied and price, other things being equal; its positive slope indicates that

quantity supplied varies in the same direction as does price. When economists make statements about the conditions of supply, they are not referring just to the particular quantity being supplied at the moment, that is, not to just one point on the supply curve. Instead, they are referring to the entire supply curve, to the complete relationship between desired sales and all possible prices of the product.

Supply refers to the entire relationship between the quantity supplied of a product and the price of the product, other things being equal. A single point on the supply curve refers to the *quantity supplied* at the price.

The position and shape of the market supply curve depends on the positions and shapes of the individual firms which produce in that market.

3.7.4 Shifts in the Supply Curve

The supply curve will shift to a new position with a change in any of the variables (other than the product's own price) that affects the amount of a product which firms are willing to produce and sell. A shift in the supply curve means that at each price, the quantity supplied will be different from before. An increase in the quantity supplied at each price is shown in figure 3-7. This change appears as a rightward shift in the supply curve. In contrast, a decrease in the quantity supplied at each appears as a leftward shift. A shift in the supply curve must be the result of a change in one of the factors that influence the quantity supplied other than the product's own price.

3.7.5 Influence on Supply

As indicated before, supply depends on several factors other than a good's own price. Changes in these other factors are sources of shifts in market supply curves, just as happens with the market demand curves discussed above.

3.7.6 Price of Inputs (Changes in Costs of Production)

All things that a firm uses to produce its outputs, such as materials, labour, and machines, are called the firm's *inputs.* Other things being equal, the higher the price of any input used to make a product, the less will be the profit from making that product. We expect, therefore, that the higher the price of any input used by a firm, the lower will be the amount that the firm will produce and offer for sale at any given price of the product. A rise in the price of inputs therefore shifts the supply curve to the left, indicating that less will he supplied at any given price; a fall in the cost of inputs shifts the supply curve to the right.

3.7.7 Technology

At any time, what is produced and how it is produced depends on what is known. Over time, knowledge changes; so do the quantities of individual products supplied. The technological improvements in the computer industry over the past two decades have led to a rightward shift in the supply curve.

3.7.8 Number of Firms

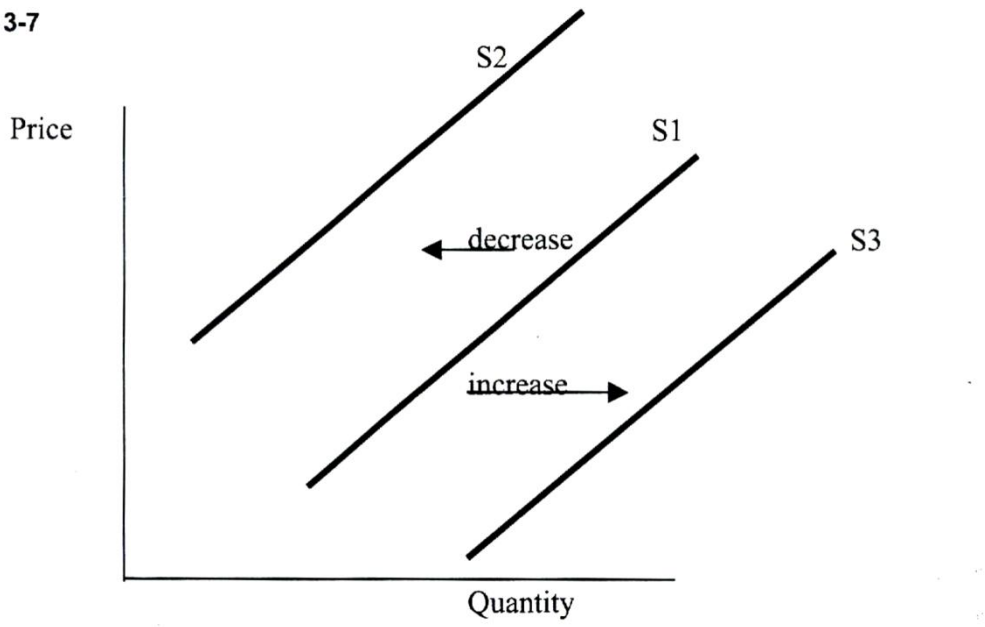
If firms that produce for a particular market are earning high profits, other firms may be tempted to go into that business. When the technology to produce computes for home use became available, literally hundreds of

new firms got into the act. The popularity and profitability of the internet has led to the formation of new service providers. When new firms enter an industry, the supply curve shifts to the right. When firms go out of business or exit the market, the supply curve shifts to the left.

Suppose that the price of sugar rises. How does this affect the demand for ice cream? Sugar is an input into ice cream production. An increase in the price of an input tends to raise the cost of production and hence to lower profitability. In response to this increased cost, the ice cream producers will cut back on their supply of ice cream. At any given price of ice cream, the suppliers are now less inclined to continue producing the same amount. As they produce less, the supply curve for ice cream shifts to the left.

Figure 3-7 exhibits the shift in the supply curve to the left for any change that reduces the quantity that suppliers wish to produce at any given price, including the above ice cream example, and to the right for any change that increases the suppliers' wish to produce at any given price.

Figure 3-7

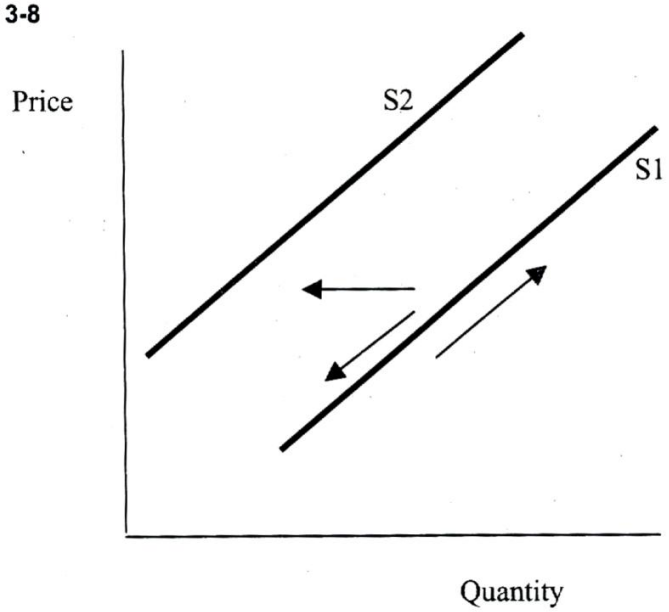


Self Assessment Question: *List and explain the factors that might lead to a shift in the supply of a product.*

3.8 Shifts in a supply Curve versus Movements along a Supply Curve

A **point on** the supply curve shows the quantity supplied at a given price. A **movement along** the supply curve shows a change in *quantity supplied.*

Figure 3-8



If the price of ice cream changes but everything else remains constant, there is a movement along the supply curve as the seller attempts to respond to a change in this market signal. If the price of ice cream remains the same but other factors that influence supply change, for example the price of inputs (sugar), supply changes and there will be a shift of the supply curve.

4.0 CONCLUSION

In this unit, we discussed market system and the ways firms react in a competitive market. We also examined product (output) market-market demand and individual demand, quantity supplied and the law of supply

and shifts in demand and supply. We then put demand and supply together by studying market equilibrium and the effect of changes in demand and supply.

5.0 SUMMARY

i. A supply curve shows how much of a product a firm would supply if it could sell all it wanted at the given price. A demand curve shows how much of a product a household would buy if it could buy all it wanted at the given price.

ii. Quantity demanded and quantities supplied are always per time period: that is per day per month, or per year.

iii. The supply of goods is determined by costs of production, availability of resources, and the price of related products. Costs of production are determined by available technologies of production and input prices.

iv. The demand for a goods or services is determined by household income, the prices of other goods and services, tastes and preferences, and expectations.

v. The market supply for a product is the sum of all the quantities of a product that various sellers wish to supply at alternative prices. It is, therefore, determined by the number of sellers in the market.

vi. The market demand curve is the sum of individuals' demand curves. Therefore, market supply is also a function of population and its composition.

vii. Take care to distinguish between movements along supply and demand curves and shifts of these curves. When the price of a good changes, the quantity of that good demanded or supplied changes –

that is, a movement occurs along the curve. When any other factor changes, the curves shift or change position.

viii. Market equilibrium exists only when quantity supplied equals demanded.

ix. The market system, also called the price system, performs two important and closely related functions in a society with unregulated markets. First, it provides an automatic mechanism for distributing scarce goods and services. That is, it serves as a price-rationing device for allocating goods and services to consumers when the quantity demanded exceeds the quantity supplied. Second, the price system ultimately determines both the allocation of resources among producers and the final mix of outputs.

x. To allocate scarce resources, alternative rationing devices can replace price rationing. The most common non-price rationing system is queuing, a term that simply means waiting in line. This is a form of quantity rationing.

xi. Attempts to bypass price rationing in the market and to use alternative rationing devices are much more difficult and costly than they would seem at first glance.

xii. Government price controls are policies that attempt to hold the price at some disequilibrium value that could not be maintained in the absence of the government's intervention. Two basic government policies are price ceilings, which impose a maximum price that can be charged for a product, and price floors, which impose a minimum price.

xiii. **TUTOR MARKED ASSIGNMENT**

a. Discuss the term 'price floor-the case of minimum wage laws'.

b. Define market equilibrium. Illustrate your answer with appropriate graph.

c. Discuss the preconditions necessary for the smooth functioning of the market system.

xiv. REFERENCES/FURTHER READING

1. Farouk Zandi (2002). *Economic Environment*. Commonwealth of learning, Vancouver, Canada.
2. Catherine Kerr (2002) *Economic Environment*. Bookthought Content Company, Commonwealth of learning, Vancouver, Canada

Unit 2: EQUILIBRIUM ANALYSIS OF DEMAND AND SUPPLY

CONTENTS

1.0 INTRODUCTION

In the last three units, we have devoted considerable attention to demand and supply analysis. In the course of the analysis, we have observed that I demand analysis are concern with individual(s) purchases, while the supply analysis are concerned with the amount of a product suppliers offer to the market for sale at any given time. Having understood these aspects, the next point of contact is to unite the two. It is this unity between demand and supply that is called equilibrium analysis. In a free market system, this equilibrium is determined by the invisible forces of demand and supply (market forces). But in other situations, the government

normally steps in to adjust the prices for one reason or the other. It is this government intervention in the market that is considered price control. All these shall form the backbone of our discussion in this unit.

2.0 OBJECTIVES

The objective of this unit is to see how we can bring the aspect of demand and supply together. Hence, at the end of this unit, it is expected that

- You should be able to unite demand and supply,
- Analyze different changes that may occur to the demand and supply conditions and how the equilibrium is restored.
- Know how the government intervenes in the market through price fixation.

A good knowledge of these aspects would pave the way for you to be able to take rationale and good decisions especially when it concerns production and supply of goods to the market.

3.0 EQUILIBRUIUM ANALYSIS

Economists use the term equilibrium to indicate state of balance in which there are no forces causing change in either direction. From our discussions on demand and supply we have established that as demand curve slopes downward, the supply curve slopes upward. This means that the behavior of sellers and buyers are inversely related. . As the seller supply more at a higher price, consumers on the other hand, buy more at a lower price and vice-versa. Hence

there is a need for a price that is both acceptable to sellers and buyers so that whatever is supplied will be automatically the quantity demanded. The equilibrium price clears the market, in which the quantity supplied equals the quantity demanded.

Possible Price (N per kg)	Demand	Supply	Pressure on Price
500	10	50	Downward
400	20	40	Downward
300	30	30	Neutral
200	40	20	Upward
100	50	20	Upward

Table 11.1: For Demand and Supply Schedule of Rice per Kg.

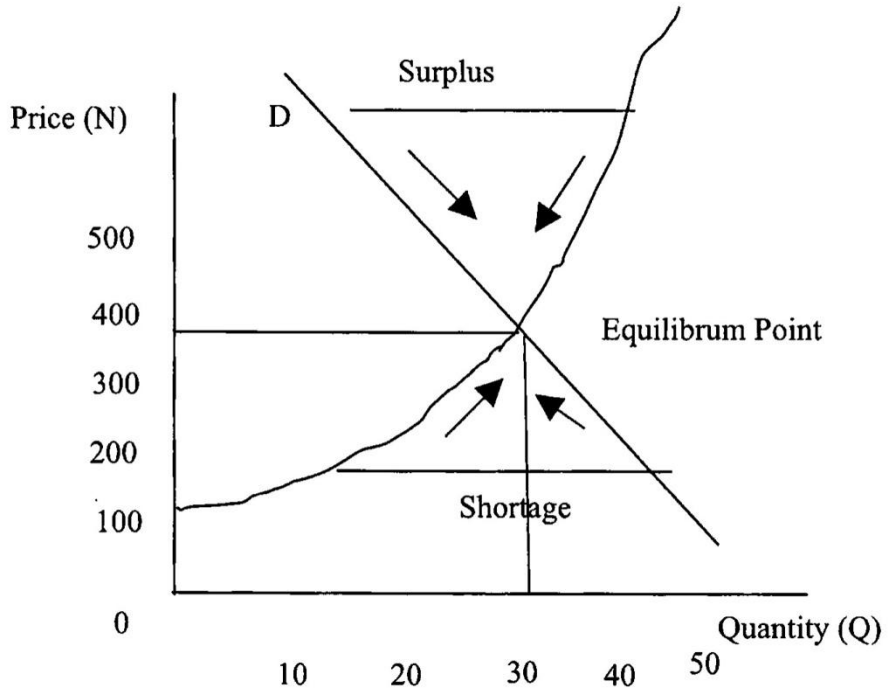


Figure 11.1: Showing Demand & Supply Curve for Rice and the equilibrium price

The Market equilibrium is shown by the intersection of the demand curve DD and the supply curve SS, at a price of N300 at which

30Kgs per month are transacted i.e. supplied and demanded. At any price above equilibrium, there will be a downward pressure on the price because quantity supplied exceeds quantity demanded. While at any price, below the equilibrium, there will be an upward pressure on the price. Here quantity demanded exceeds quantity supplied and price forced upwards. The buyers and sellers can trade as much as they wish, as there is no incentive for any further price change. When there is disequilibrium in the market, the market forces try to re-establish the equilibrium position. Look at the figures below.

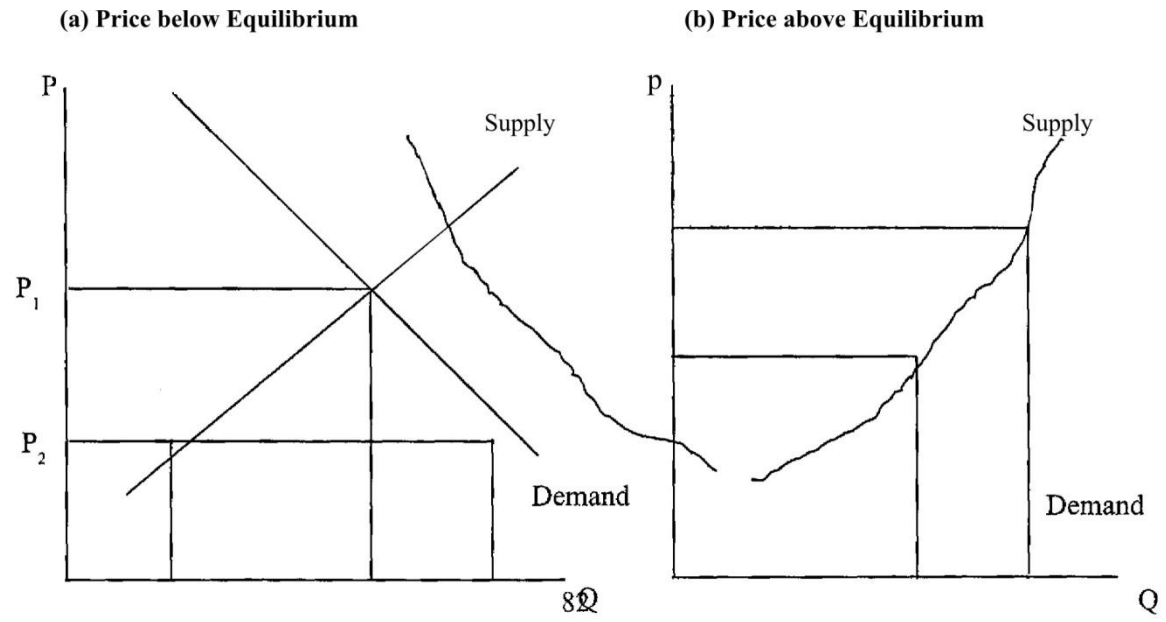


Figure 11.2: showing Movement to Equilibrium

In panel (a) of figure 11.2, the market price is below the equilibrium price. In this case:

- The quantity demanded (QD) exceeds the quantity supplied (AS);
- Shortages develop suppliers stock runs out, and queue may form.
- Sellers raise their prices

- As prices rise to equilibrium the quantity supplied expands and the quantity demanded contracts until equilibrium is attained.

In panel (b) the market price is above equilibrium price. Here,

- The quantity supplied (QS) exceeds the quantity demanded (QD)
- Surplus develops and seller's warehouse unsold stock.
- Sellers reduce their price
- As prices fall to equilibrium the quantity demanded expands and the quantity supplied contracts until equilibrium is attained.

3.1 Effects of Shift in Demand and Supply on The Equilibrium Price and Equilibrium

3.1.1 Shifts in Demand and its Effects on Equilibrium.

As we have seen earlier that a demand curve can shift either to the left or to the right due to non-price factors. Now let us consider what happens if the demand for product changes for any of the reasons given. Suppose that demand increased because of a basic change in peoples' income. The product is now bought in large quantities and this would occur at any price.

As we have seen earlier on our diagrams, a large quantity is always shown further to the right. Since people now buy more at any price level, each point on the demand curve moves to the right. The result is a general shift of the demand curve to the right. If demand decreased causing less to be bought at each price the demand curve as a whole would shift to the left.

(a) Increase (b) Decrease

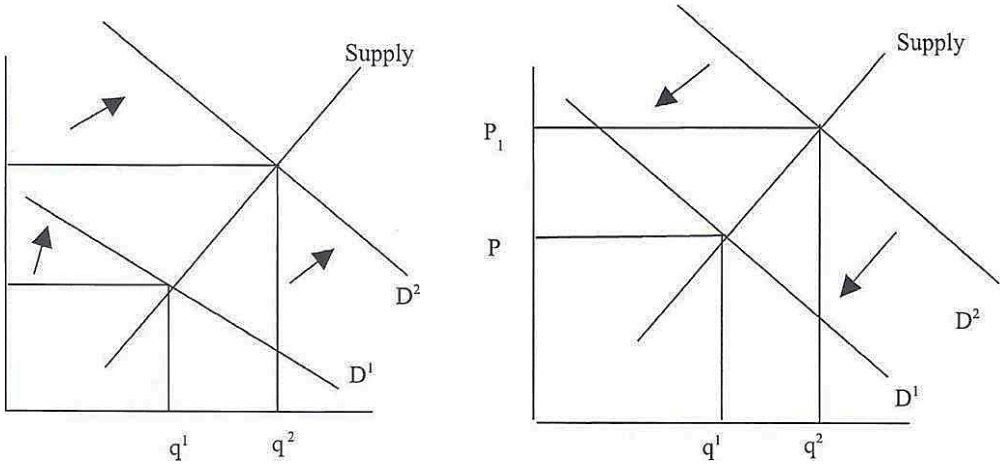


Figure 11.3: Effects of Shift in demand Curve

The effect of an increase in demand is illustrated in the fig above. The adjustment to a new equilibrium involved the following distinct movements:

1. The demand curve shifts to the right from Di to D_2
2. The increase in demand may cause the price to rise from Pi to P2 quantity demanded expands from Q_1, to, Q_2.

You should note that there is no shift in the supply curve but simply movements along the curve as firms respond to the higher price. Thus, through the rise in price, the quantity supplied adjusts to the extra demand and equilibrium is restored.

If demand decreases, the process of adjustment is the reverse of an increase in demand. Conclusion about the market equilibrium is sometimes called the "Law" of demand and supply. One such law can now be stated, an increase in demand normally causes the price to rise and the quantity supplied to expand to a new equilibrium. Conversely, a

decrease in demand causes the price to fall and the quantity supplied to contract to a new equilibrium.

3.2 Effect of Shift in Supply

A change in equilibrium may also be brought about by a shift in the supply curve. Such a shift could be caused by any of the given influences on the supply of the product. Thus, anything that improved the efficiency or reduced the costs of production would stimulate production and so increase supply at any given price. Conversely, a rise in costs would discourage production and decrease supply at any given price.

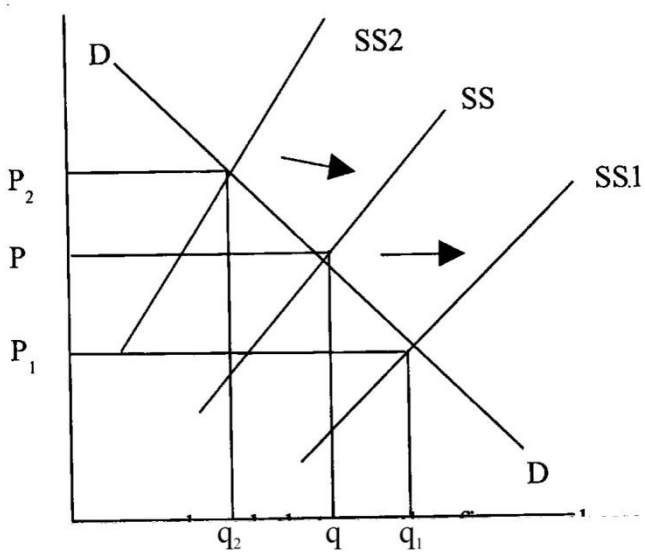


Figure 11.4. Effects of Shifts in Supply Curve

It should be remembered that, on the figures above an increase in quantity is shown by the movement to the right. An increase in supply would therefore shift supply curve to the right. A decrease would shift the supply curve to the left. The figure shows how equilibrium is restored in each case. The figure exposes the following:

a) A shift in the supply curve
b) A movement of price to the new equilibrium
c) An adjustment of the quantity demanded to the new equilibrium.

Another "Law of demand and supply" can now be noted. An increase in supply normally, causes the price to fall and the quantity demanded to expand to new equilibrium. Conversely, a decrease in supply causes the price to rise and the quantity demanded to contract to a new equilibrium.

3.3 Price Control

As we have already mentioned, there are times the government steps into the market to control prices. This could be done to protect the consumers or the producers as the case may be. Therefore, price control refers to the deliberate attempt by the government to adjust prices in the market rather than give the forces of demand and supply a free hand. There are two categories of price control. These categories are: Maximum Price and Minimum Price.

3.3.1 Maximum Price

This is also called price ceiling. This is that price below the equilibrium above which no producer is allowed to sell. This price is established below the equilibrium so as to protect the consumers from producer's exploitation. This is depicted by figure 11.5 below.

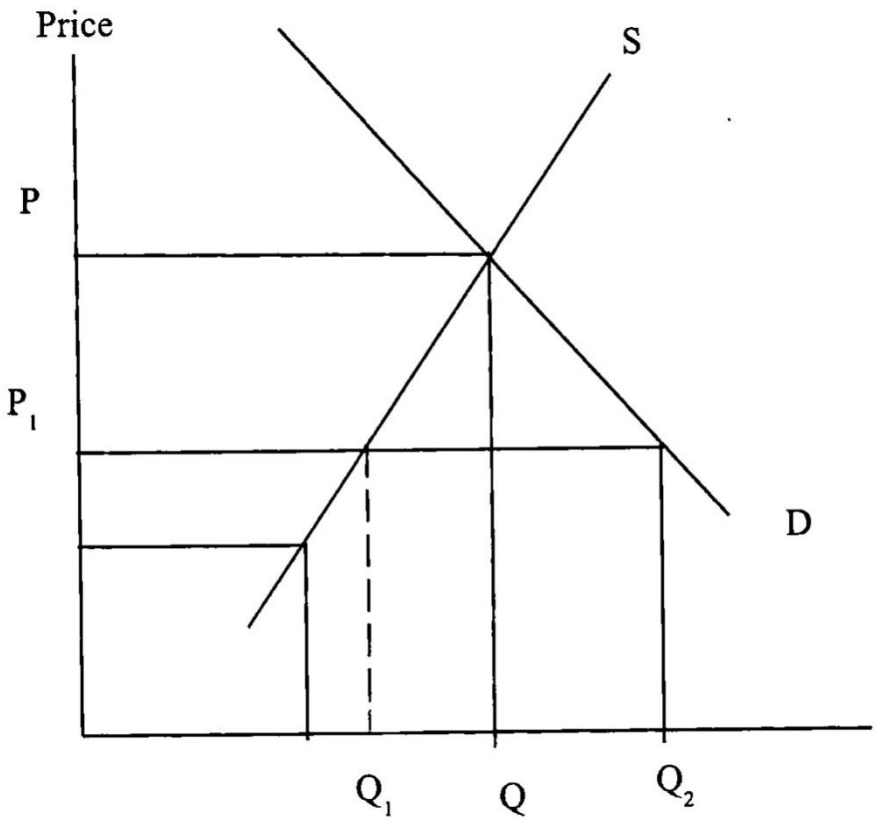


Figure 11.5: Price Ceiling.

In the Figure above the equilibrium price is P but the maximum price is PI as set by the government. Above this price, no producer is allowed to sale. Here Demand exceeds supply i.e. quantity demanded is q_2 while quantity supplied is qi. To meet up the excess demand, the government rations the few available goods to the needy consumers.

3.3.2 Minimum Price

The minimum price is also known as the floor price. This is the price above the equilibrium price established by the government, below which no producer is permitted to sale. This is a price higher than the equilibrium and is meant to protect the producers from low prices. These types of prices are

common in situations where government seeks to protect producers, especially in the areas of agriculture. The figure below depicts this type of price control. The minimum price is set for P_1. At the minimum price supply exceeds demand.

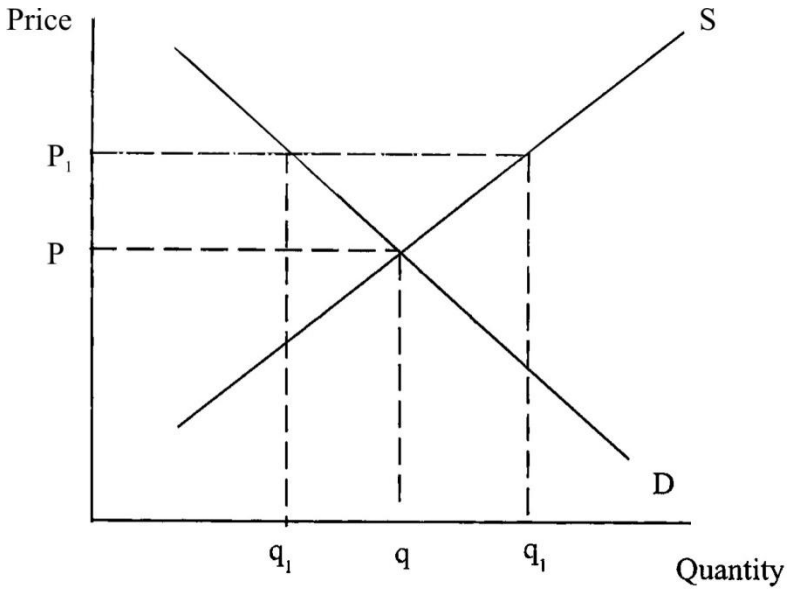


Figure 11.6: Price Flow

To prevent price from falling, the government buys the excess and stock-piles.

3.4 Interfering with the Law of Supply and Demand

On many occasions, governments and sometimes private firms may decide to use some mechanism other than the market system to ration an item for which there is excess demand at the current price. This was often the case in the former Soviet Union and other communist nations such as China. The rationale most often used is fairness. This is because the law of supply and demand, which governs the level at which prices are set, can produce results that some individuals or groups do

not like. For example, it is not 'fair' to let landlords charge high rents, not 'fair' for oil companies to run up the price of gasoline, etc.

The purpose of this section is to study how government policies control prices and hence market quantity supplied. Government *price controls* are policies that attempt to hold the price at some disequilibrium value that could not be maintained in the absence of the government's intervention. We begin by looking into two basic policies: price ceilings, which impose a maximum price that can be charged for a product, and price floors, which impose a minimum price. Rent control laws and agricultural support policies are examples of price ceilings and floors.

In the case of the ceilings, the control mechanism holds the market price below its equilibrium value; this creates a shortage, with quantity demanded exceeding quantity supplied at the controlled price. If the price ceiling is set above the equilibrium price, it has no effect because the equilibrium remains attainable. If, however, the price ceiling is set below the equilibrium price, the price ceiling lowers the price and is said to be binding or effective.

In the case of the floors, the control mechanism holds the price above the equilibrium price; this creates surplus, with quantity supplied exceeding quantity demanded at the controlled price. If the price floor is set below the equilibrium price, it has no effect because the equilibrium remains

attainable. If, however, the price floor is set above the equilibrium price, it raises the price floor and is said to be binding or effective.

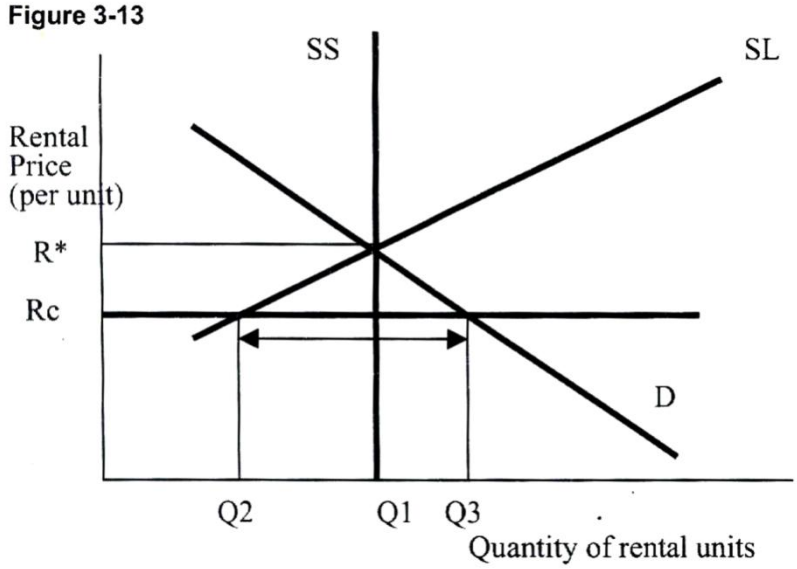
3.4.1 Price Ceilings: The Case of Rent Control

Rent controls are perhaps the most extensively studied form of price ceilings and provide a vivid illustration of the short- and long-term effects of this type of market intervention. Note, however, that the specifics of rent-control laws vary greatly and have changed significantly since they were first imposed many decades ago. In particular, current laws often permit exemptions for new buildings and allowances for maintenance costs and inflation. Moreover, in many countries rent controls have evolved into a second generation where they focus more on *regulating* the rental housing market rather than simply *controlling the price* of rental accommodation.

Figure 3-13 illustrates the effect of rent control laws as an example of a price ceiling. In panel A, R^* is the market equilibrium rental rate, at which the demand for housing equals the supply. However, the local government is concerned that at R^* many poor people cannot afford housing in the city, so it imposes a law that says that rents may be no higher than *Rc*. At *Rc*, there is an excess demand (shortage) for rental units that worsens as time passes. While the motives behind the government action may well have been praiseworthy, the government has created an artificial scarcity.

The short-run supply of housing is shown by the vertical curve *SS*. Thus quantity supplied remains at Q_1 in the short run, and the housing shortage is Q_1 Q_2. This is because in the short run, landlords have a fixed number of apartments to rent, and they cannot adjust their number quickly as market conditions change. Over time, the quantity supplied shrinks, as shown by the long-run supply curve *SL*. In the long run, there are only Q_3 units of rental accommodations, fewer than when controls were instituted. The housing shortage of Q_2 Q_3, which occurs after supply has fully adjusted, is larger than the initial shortage of Q_1 Q_2.

Figure 3-13



The long-run story is different from the short run in that neither side of the market is constrained by time and both can respond freely to market conditions. As the return from investing in new rental housing falls significantly below what can be earned on comparable investments, funds will go elsewhere. New construction will be halted, and old buildings

will be converted to other uses of will simple be left to deteriorate. This implies that the long-run supply curve for rental accommodations (which refers to the quantity supplied after all adjustments have been made) is very flat.

As with many government policies, there are some gainers and some losers. The gainers will be the households that happen to be lucky enough to have a rental unit. Their rent will be lower than it otherwise would have been. Among the losers will be the owners of rental accommodation, who will receive lower rents and incomes than in the absence of rent controls .There are also the potential landlords who would otherwise have supplied rental accommodation at the market price but are unable to cover costs at the controlled rent. Perhaps the most important losers are the households that are unable to find accommodation, given the limited supply. Among these will be low-income households that are presumably the ones that the policy was meant to benefit.

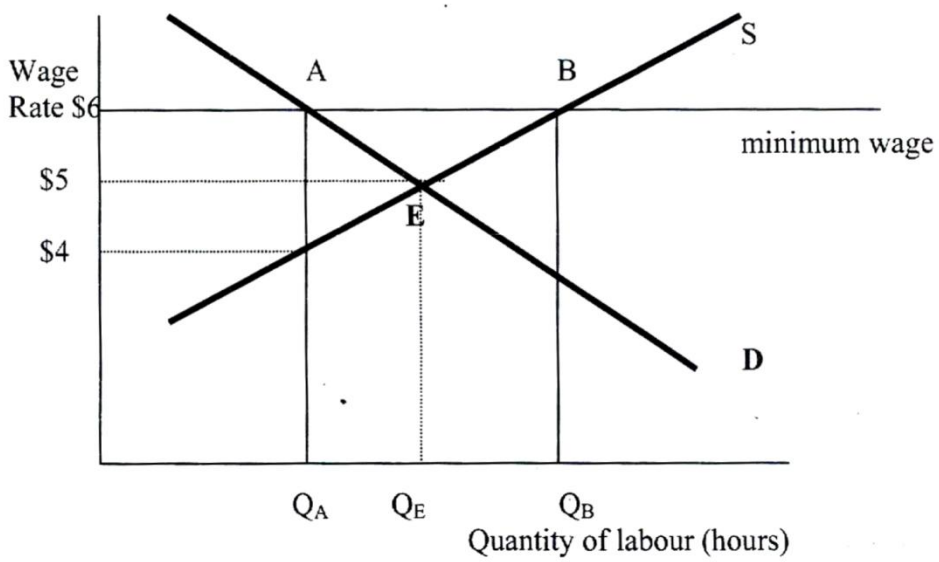
Price ceilings usually give rise to black markets. A *black market* is any market in which goods are sold at prices that violate a legal price control. Effective price ceilings create the potential for a black

market because a profit results from buying at the controlled price and selling at the black market price.

3.4.2 Price Floors: The Case of Minimum Wage Laws

Governments sometimes establish a price *floor*, which is the minimum permissible price that can be charged for a particular good or service. Price floors may be established by rules that make it illegal to sell the product below the prescribed price, as in the case of the minimum wage. Effective price floors lead to excess supply. Either an unsold surplus will exist, or someone must enter the market and buy the excess supply. The consequences of excess supply will, of course, differ from product to product. If the product is labour, subject to a minimum wage, excess supply translates into people without jobs. If the product is wheat, and more is produced that can be sold to consumers, the surplus wheat accumulate in grain elevators or government warehouses. Whereas price ceilings are meant to help demanders (buyers), price floors are meant to help suppliers (sellers). With a price floor such as the minimum wage, buyers (employers) cannot pay less than the government-set minimum wage. The effects of binding price floors are illustrated in Figure 3-14.

Figure 3-14



As indicate before, the short end of the market determines the quantity exchanged. In this case, the lesser of the market is demand. At the minimum wage (N6.00), only Q_A units (hours) of labour are demanded but Q_B units (hours) are supplied. Therefore, Q_A Q_B units are unemployed. Note that only Q_E – Q_A units of labour are displaced. The remaining part of unemployment (Q_B – Q_E) is due to the increased number of workers who have been drawn to the labour force in response to the higher wage (N6 versus the market rate, N5) in search of a job. With only Q_A employed, the remaining, Q_A Q_B, will continue to spend time and resources in search of a job. The diagram indicates that these unemployed individuals are willing to supply their labour services for as little as N4. (Why N4? This is a good test of your knowledge of supply and demand theory.)

As with minimum prices, agricultural price supports are designed with the purpose of making suppliers (farmers) better off. Note, however, that the excess supply, in the case of agricultural products, is pure waste from an efficiency point of view.

Alternatively, government can regulate quantities traded on markets, and thereby indirectly determine market prices. For example, if governments can restrict the quantity of a product supplied (perhaps to release resources for war production), this will artificially increase the market rice to producers per unit of their restricted production. This is the case since consumers will be willing to pay higher price for it.

4.0 CONCLUSION

From the foregoing discussion, it is evident that the equilibrium position is one in which quantity demanded is equal to the quantity supplied, i.e., Qd = Qs. When there is a disequilibrium either due to excess supply or excess demand, the market forces interacts and establishes a new equilibrium. All these we have seen how they work. At times, the government in an attempt to either protect the consumers or producers may step into the market to control prices. These prices are either maximum prices in favour of consumers or minimum prices in favour of producers. We now know what happens when the least change is introduced into the market. Any change in the market conditions can be adjusted by the market forces alone or with the help of the government through price control.

5.0 SUMMARY

The analysis of the equilibrium demand and supply, as shown above, is based on the background knowledge of our analysis of market demand on the one hand and market supply on the other hand. It is the unity between these two that is considered equilibrium. At equilibrium, demand must be equal to supply. How stable this equilibrium is a matter that can be considered elsewhere. When there is a disequilibrium, all is put on deck by the market forces to ensure that equilibrium is once more re-established. At other times, the government deliberately ignores the market forces and moves in to determine its own prices.

6.0 TUTOR MARKED ASSIGNMENTS

1. When a price floor is established above the equilibrium price, what happens?

2. Discuss the precondition necessary for the smooth functioning of the market place.

7.0 REFERENCES/ FURTHER READING

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Unit 3: THE CONCEPT OF ELASTICITY OF DEMAND

CONTENTS

1.0 INTRODUCTION

The concept of elasticity of demand plays a crucial role in business-decisions regarding maneuvering of prices with a view to making larger profits. For instance, when cost of production is increasing the firm would want to pass the rising cost on to the consumer by increasing the price of the goods in question. Firms may decide to change the price even without change in cost of production. But whether this action i.e. raising the price following the rise in cost or otherwise will be beneficial depends on:

(a) the price elasticity of demand for the product.

(b) Price Elasticity of demand for its substitutes.

Because of this central or strategic position which elasticity of demand holds in the production and consumption process, this unit is devoted to the study of what constitute the concept of elasticity, elasticity of demand and its practical applications. You are required to devote particular attention to this unit and understand the concepts involved right at this stage. Now, what do you think is the reason given for the possibility of some producers increasing the prices of their goods and demand remaining the same, while others cannot tamper with the price of their goods? The answer to this lies in your understanding of the concept of elasticity.

2.0 OBJECTIVES OF THE UNIT

The Unit is devoted to the analysis of elasticity as a concept as it affects demand and supply of commodities. At the end of the analysis it is expected that you will be able to:

1. Appreciate the concept of elasticity

2. Apply the concept to practice in the course of decision-making, and,

3. Appreciate the applicability of the concept to real life situations.

3.0 THE CONCEPT OF ELASTICITY

Elasticity of demand is a measure of the extent to which the quantity demanded of a good responds to changes in some factors that influence demand. Such f actors include price, income, and prices of other goods. The main measures therefore are price elasticity of demand, income elasticity of demand and cross elasticity demand. These measures that can be considered as types of elasticity of demand will be discussed in detail one after the other.

3.1 Price Elasticity of Demand

For any purposes, it is useful to have a numerical measure of just how quickly or slowly quantity demanded rises or falls as price changes. To this end, a distinguished economist by named Alfred Marshall has been able to formulate the concept of price elasticity of demand. In the way of definition, price elasticity of demand is the ratio of the percentage change in quantity demanded to the percentage change in the price that brings about the change in the quantity demanded. It can also be defined as the degree of responsiveness of quantity demanded to changes in price. Moreover, it can be viewed as the measure of the change in quantity resulting from a change in price.

The definition can be put in mathematical form as

$$Ep_{P} = \frac{\text{Percentage change in Quantity Demanded.}}{\text{Percentage change in price in P}} = \frac{\% \Delta \text{ in Qd}}{\% \Delta}$$

If the percentage changes for quantity and price are known the value of the elasticity coefficient Ep can be calculated. It is always negative because the demand curve is negatively sloped.

3.2 Interpretation of Numerical Values of Demand Elasticity

Price elasticity of demand may be unity, greater than unity, less than unity, zero or infinity. In other words, the numerical value of elasticity of demand can vary from zero to infinity. This can be expressed mathematically as $0<Ep<\alpha$, the above five cases are explained with the aid of diagrams below: It should be noted that the analysis has to do with elasticity and shape of demand curves.

a) Perfectly Inelastic Demand

Demand is said to be perfectly inelastic when quantity demanded does not react to changes in price. In this case elasticity of demand becomes zero. For example, a 20% rise in or fall in price leads to no change in the quantity demanded. For instance, if price falls from Pi to P_2 the expectations are that quantity demanded of that particular

good will rise. Unfortunately if the rise in price leaves quantity demanded unchanged, that is known as imperfect elasticity of demand.

Figure 10.1: Perfectly Inelastic Demand

It should be noted that this form of price elasticity of demand is unusual. It may be expected when the price range being considered involved very low prices. For instance more salt will not be demanded by the consumer if the price is lowered and vice versa. It can also occur when the affected item is considered absolutely essential and affordable by the consumer. An example here is medicine.

b) Perfectly Elastic Demand:

Demand is elastic when at a fixed price an unlimited quantity is demanded. In other words, demand is said to be perfectly elastic when any quantity be bought at the prevailing price. Any rise in price will cause quantity demanded to fall to zero. This may be expected to occur where a substitute commodity that is just as nice in the consumer's view is available at the going or prevailing price. It also occurs in case where no one will pay more than the going price, the seller will lose Iris entire customers if he raises his price even by one kobo. The demand curve of perfectly or infinitely elastic demand as it is also called is

shown below. The demand curve is a horizontal line and is parallel to the X axis.

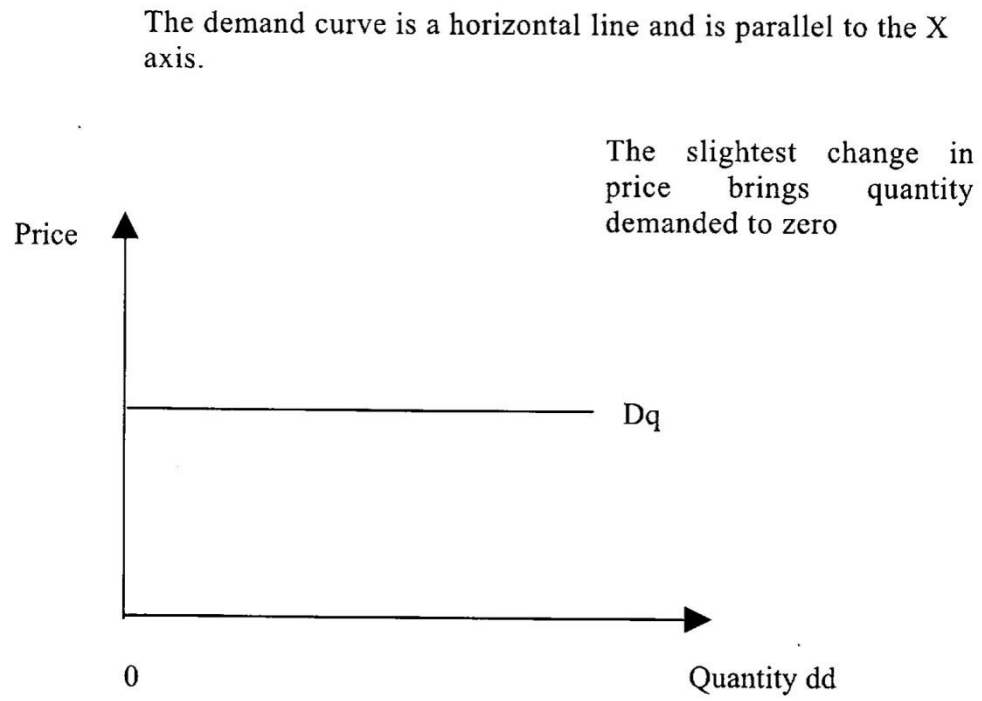

Figure 10.2: Perfectly Elastic Demand

c) Unity Elastic Demand:

Demand is said to be unit elastic when a given percentage change in price leads to a proportionately (equal percentage) change in quantity demanded. That is to say, the percentage change in quantity demanded is exactly equal to percentage change in price. For example, a 20% change in prices causes 20% change in quantity demanded.

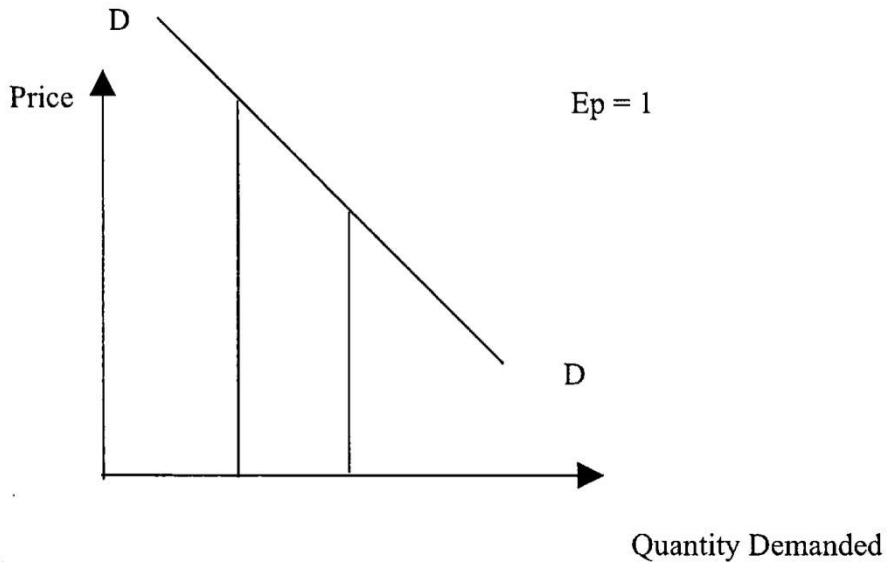

Figure 10.3: Unitary Elastic Demand

From the diagram any change in price causes a proportionate change in quantity demand, but to the opposite direction.

d) Inelastic Demand:

Demand is inelastic when a given percentage change in price induces a less proportionate change in quantity demanded. This means that the percentages change in price greater than the percentage change in quantity demanded. The diagram below depicts inelastic demand curve.

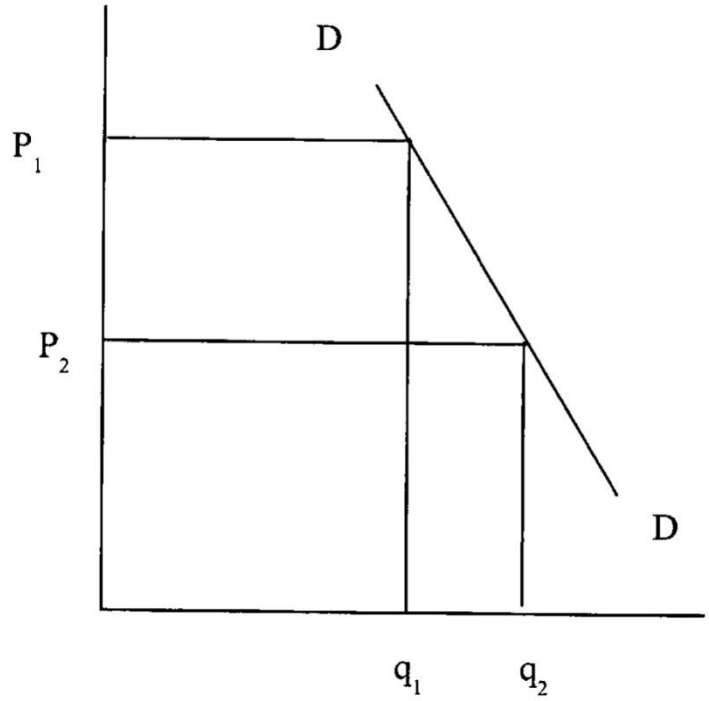

Figure 10.5: Inelastic Demand

It can be seen from the above figure that the inelastic demand curve tends to be steep. This implies that the steeper the demand curve the more inelastic the demand. In this case elasticity of demand is less than I ie Ep<1. From the figure above, a change from Pi to P2 brings about a change in quantity qi to q2 which is smaller. Hence demand is fairly inelastic.

3.3 Relationship between Elasticity and Total Expenditure or Total Revenue.

Money spent by purchasers of a commodity is received by the producer and is thus the gross revenue of the sellers. Economists are often interested in how total expenditure by purchasers of commodity, or total revenue of sellers of the

commodity reacts when the price changes. The elasticity of demand presents useful information about the effect of a price change on the buyer's total expenditure. The relationship between price elasticity and total expenditure is analyzed below.

1. When demand is elastic, a fall in price will increase total consumer expenditure and a rise in price will reduced total expenditure. It will be more profitable for the producer to reduce price than to increase it, if he intends to raise Total Revenue (TR).

2. If demand is inelastic, a fall in price will reduce total expenditure and a rise in price increase total expenditure. Therefore a producer whose good has an elastic demand will increase his TR, when he increases the price of Ills goods.

3. If demand is unit any elastic, a rise or a fall in price leaves total expenditure and Total Revenue unaffected.

In a nutshell for goods with elastic demand, a fall in its price will increase total revenue and for goods with inelastic demand a fall in its price reduces TR.

3.4 Income Elasticity of Demand

Income elasticity of demand can be defined as the degree of responsiveness of quantity demanded to changes in income. In other words, it measures the response of quantity demanded when there is a change in income. It may also be defined as the ratio of percentage change in the quantity demanded of a

good X to the percentage change in income. This can be expressed mathematically as shown below.

$$Ey = \frac{\text{Percentage change in quantity demanded of X}}{\text{Percentage change in income,}} \text{ or } \frac{\Delta Qdx}{\Delta Y}$$

The interpretation of the values is the same as we have seen in the price elasticity of demand. The value obtained here is used in determining the type of goods in question.

3.5 Cross Elasticity of Complementary Goods

This is the responsiveness of the quantity demanded of good y to changes in the price of good x. it is measured using the formula i.e.

$$\frac{\text{Percentage change in quantity demand of good v}}{\text{Percentage change in the price of good x}}$$

$$\frac{\Delta Qvx}{\Delta Px} * \frac{Px}{Qy}$$

If two goods are complementary (Jointly demanded), a rise in the price of one leads to fall in the demand for other. For example a rise in the price of cars will lead to a fall in the demand for petrol and vice versa. Cross elasticity of complementary goods is negative because price and demand vary in the opposite direction.

3.5.1 Some Factors Determining the Cross Elasticity of Demand

These factors are: Availability of close substitutes, Nature of the Commodity, Level of Income, Proportion of income spent,

Time Factor, Habit formation. These factors determine whether a good is elastic or inelastic. For instance if a good has close substitutes, such a good, must have an elastic demand, since a change in its price will cause substitutes to react, for example, if the price or demand for fish changes, the price and quantity demanded for meat will react.

4.0 CONCLUSION

Elasticity as a concept in managerial Economics is worth studying in a bid to determine those factors that are responsible for the change in the quantity demanded of certain commodities. In this unit we have attempted to analyse the different types of elasticity of demand as they form an important aspect of business decision-making. The types considered are the price, cross, and the income elasticity.

5.0 SUMMARY

This Unit discusses the main issues pertaining to elasticity of demand especially as it affects the decisions of the managers on how to determine prices of the commodities. Equally, elasticity in relation to the Revenue of the firm has been discussed in this unit and also a superficial explanation of income and Cross elasticity of demands has been made in this Unit. In this unit, focus is on the price elasticity of demand, income and cross elasticity of the commodities. The relationship between elasticity and the revenue of the firm has also been considered.

6.0 TUTOR MARKED ASSIGNMENT

1. Define the concept of Elasticity?

2. With the help of diagram explain : how a rise in the price of

   (i) A perfectly elastic good

   (ii) Fairly elastic good,

   Affects total revenue of a firm.

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Unit 4: NATURE AND THEORIES OF MANAGEMENT

CONTENTS

1.0 INTRODUCTION

Resources by their nature are generally scare, thus there is the compelling need of ensuring prudence in utilizing them. The act/process of exercising prudence is what organizational leaders (managers) are engage in. this process involves an efficient and effective coordination of the activities of organization's employees with a view to achieving a wide range of goals. Management as a human practice has evolved over time and in recent times has become of great concern to humanity. This has led to the development of a variety of theories to help explain the concept (management). Management is practiced at all levels- low, middle and top- of an organization.

2.0 OBJECTIVES

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

i. *Describe* the concept of management.
ii. *Analyse* the approaches to the study of management.
iii. *Identify* the various levels of management.

3.0 MAIN CONTENT

3.1 Definition of Management

The term management is being loosely understood by a wide of people even those in business. This perhaps explains why Drucker (1989:7) posited that management is the least known and the least understood of our basic institutions. Even the

people in business often do not know what management does and what it is supposed to be doing, how it acts and why, whether it does a good job or not. He went on to attest that we will only understand management by analysing the functions of management. Thus, management is said to be the planning, organizing, directing and controlling of human and other resources to achieve organizational goals effectively and efficiently (Jones and George, 203:5). Drucker opined that management is the organization and coordination of the activities of an enterprise inaccordance with certain policies and in the attainment of clearly defined.

The term effectiveness relates mostly to goal attainment. For example, when managers accomplish set goals, we say they are effective. Effectiveness measures the degree and appropriateness of the attainment of organisational set goals, i.e. when appropriate goals are chosen and are attained. On the other hand, efficiency is concerned with the relationship between inputs and outputs. Because managers deal with scare resources, when a manager is able to get more outputs from given inputs 01 can get the same output from less input, the manager is efficient. Efficiency measures how well or how productive resources are used in the achievement of set goals. The concern of management is not with either of these concepts, but with both since it is possible to be effective and yet ineffective. This occurs where goals are achieved but at a higher cost

Self-assessment exercise:

Why is management concerned with both efficiency and effectiveness? Give concrete examples to buttress your position.

3.2 Basic Managerial Thoughts

The practice of management is not a recent phenomenon as there are quite a number of activities or events that indicate principles of management were employed m executing them For example, the Biblical story of Moses and his father-in-lawondelegation of authority to ease work, the building of the Egyptian Pyramids, the Chinese great walls, the early Cheek and Roman Army, etc. potent that management as a practice is an old phenomenon. However, the striking influence of management was perhaps the industrial revolution which began in Great Britain in the seventeenth and eighteenth centimes where machine power virtually replaced human power. This resulted into mass production and rapid expansions. These propelled the emergence of large corporations. These developments necessitated formal management practices to guide managers and perhaps this led to the emergence of what we call management theories. These management theories are:

i. Scientific Management Theory

ii. Administrative Management Theory

iii. Behavioural Management Theory

iv. Management Science Theory

v. Organisational Environment Theory

3.2.1 Scientific Management Theory

The scientific management theory is that winch seeks the use of scientific methods to fine the "best way"" of performing a task or job. Stoner, Freeman and Gilbert (1995:34) assert that this theory arosein part from the need to increase productivity since at the tune of the introduction of this theory; skilled labour was in short supply. Its proponents thought that the only way to expand productive capacity was to raise the efficiency of workers. The proponents of the theory are quite numerous. The notable ones include: Frederick Taylor (1856-1915). Taylor used time study as Ins base, broke each job down into its components and designed the quickest and best methods for performing, each component He strongly believed that if the amount of time and effort that each worker expended in producing a unit of output should be reduced by increasing specialization and division of labour, the production process would become more efficient. He opined that such best ways could be devised through scientific management techniques rather than intuition or other informal methods. His concern was with management at the shop level-supervisory job.

The application of the .scientific approach led to an unprecedented production 'miracle' i.e. taster than Taylor expected. In addition, workers feared that the dramatic increases in productivity and higher pay would exhaust

available work and cause layoffs. This made unions to become suspicious of the theory leading to mistrust and strained labour management relations for a long time.

Others include Henry L. Gant (1861-1919), Frank B and Lillian M. Gilbreth (1868-1924) and 1878-19~2), Scientific management theories centre on studying personal task mix to increase efficiency in organizations.

3.2.2 Administrative Management Theory

The proponents of this school of thought (theory) believe in studying the entire organisation by developing more general theories of what managers do and what constitutes good management (Robbing and Coulter, 1996:43). The theory grew out of the desire to find appropriate guidelines for managing large and complex enterprises. The two prominent proponents of this theory are:

(i) **Henri Fayol (1841 -1925)**

Unlike Taylor, Fayol's concern was directed at the activities of managers in general since management is an activity common to all humans; hi pursuance of this he postulated or identified 14 principles which he opined are essential to increase the efficiency of the management process. These principles and many others are the subject of unit 3. Fayol's concept of management is that it could be taught once the principles underlying it are understood since managerial tasks can be identified and analysed. Thisimplies that managerial skills are

learned just like any other. This disposition led to the overthrow of the hitherto posture that "managers are born, not made""

(ii) Max Weber (1864-1920).

Weber's concern was the development of carefully contracted regulations of the activities of organisations since they are composed of large number of people. According to Leavitt (1978), Weber developed a theory of bureaucratic management which stresses the need for a strictly defined hierarchy governed by clearly defined regulations and lines of authority This is so because, Weber considered an idea of organisation to be a bureaucracy whose activities and objectives are rationally thought out and explicitly spelled out.

The concern of Weber was to improve the performance of organisations by making predictable and productive operations. Thus he opined that technical competence be emphasised and that performance evaluations be made purely on the basis of merit Weber construct of bureaucracy characterised by divisions of labour explicitly defined hierarchies, detailed rules and regulations and formal relationships. An ideal bureaucracy does not exist in the real sense of it, but merely a basis for postulating a theory about work and how it could be performed in large organizations.

3.2.3 Behavioural Management Theory

Proponents of this theory opined that the best approach to work and productivity is through an understanding of the worker and the work place. It follows that managers need to be equipped with the knowledge of social sciences for better perception of the employee and job performance (Udoh and Akpa, 2007:54). Major contributors to this theory include Chester Bernard, Herbert Simon, Mary Parker Follett, Abraham, Maslow, etc. The behavioural theorists studied a vast array of characteristics or factors in the work setting with a view to finding ways of improving or increasing efficiency. One of such studies is the Hawthorne study which found out that a manager's behaviour or leadership approach can affect workers level of performance i.e. where managers are trained to behave in ways that would elicit cooperative behaviour from subordinates, productivity could increase. This shifted emphasis to managerial behaviour and leadership.

3.2.4 Management Science Theory

This theory to some extent is a contemporary extension of scientific management theory since it also has a quantitative approach to management in raising efficiency productivity. This school of management thought began when a mixed team of experts from relevant diverse disciplines was called upon to analyse a problem and propose a course of action to management (Jones and George, 2003:59). To solve this problem, the team would rely on mathematical models which showed in symbolic terms all the relevant factors in the problem and their interrelationships. By varying the values of

these factors and analysing the equations, the effects of each changed situations could be determined. This scenario helps present management with objective basis for making decisions. The use of mathematical modelling and IT or computers, forecasting became much easier than previous theories could handle.

It could be deduced that this theory paid no emphasis 011 people and relationships; rather it promotes emphasis 011 aspects of the organization that can be captured numerically. This school of thought is often times called operations research (OR). The quantitative technique applicable to management includes statistics, optimisation models, information models, computer simulation, linear programming, work scheduling analysis, etc. Management science was first initiated in solving warfare solutions during the World War II The military officers who joined business organisations after the war employed OR techniques in solving business problems to improve decision making.

3.2.5 Organisational Environment Theory

The theories described either looked at organisations' problems basically as how managers may influence behaviours within the organisation only. The organisation environment theory is an attempt to view how managers relate with the external environment. Two of the views that are important here are the systems and contingency theories.

(i) The Systems Theory

This theory holds that an organization is a diverse and unified system, composed of numerous interrelated parts Thus; an organization is looked at as a whole and as an integral part of the larger external environment. This situation means that the activity of any sub-system of the larger environment affects in diverse ways the activities of all other segments. The theory opines that managers of each segment must make decisions only after they have identified the impact of such decisions 011 other sub-systems and on the entire system. This presupposes that the various parts must work together to promote efficiency and effectiveness i.e. an organizational system must create synergy (the whole is greater than the sum of parts) and thus increase efficiency and effectiveness. Synergy implies that units or segments that work together are more productive than they would be if they operated independently.

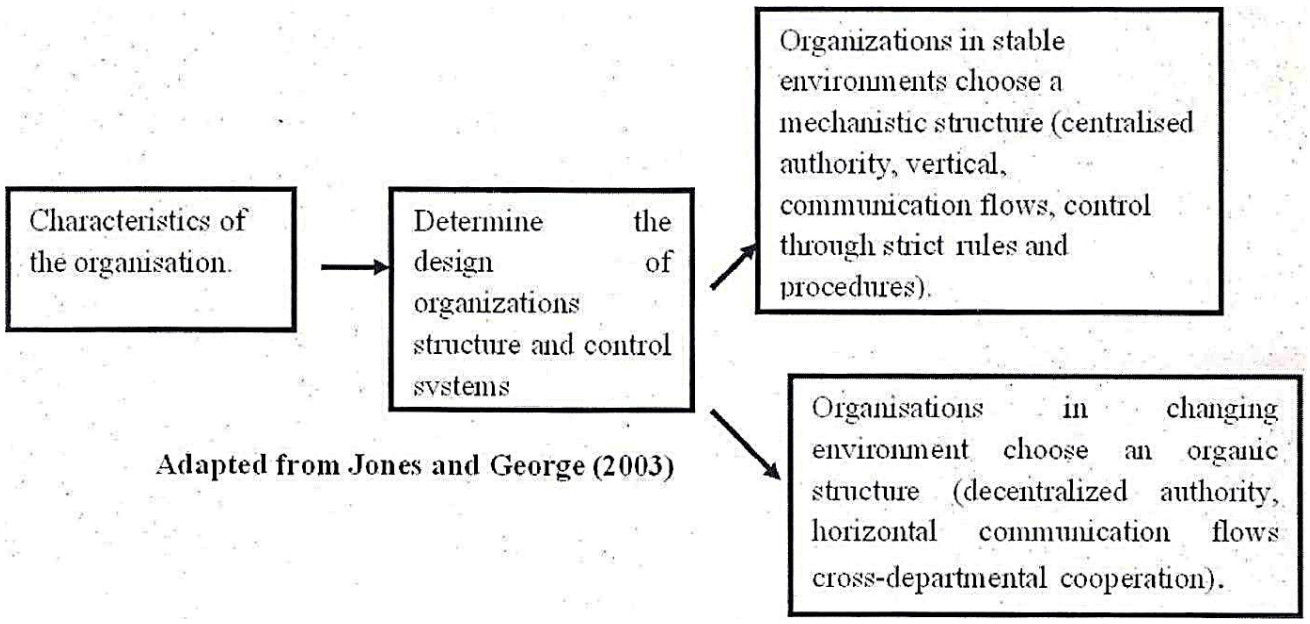
(ii) Contingency Theory

This theory is often called situational theory. It was developed when researchers tried to apply the concepts of the major theories to real life situations. It was discovered that certain methods were highly effective in certain settings but highly ineffective in others. Then logical conclusion was that results differ because situations differ (Stoner, freeman and Gilbert, 1995:48).

An effective and efficient manager is one who identifies which method will in a given situation, under a particular circumstance and at a given time will best contribute to the achievement of organisational goals In other words, the organizational structures and control systems that a manager chooses are contingent 011 the characteristic of the external environment in winch the enterprise is operating

It follows therefore that managers may either use a mechanistic structure where the environment is stable or an organic structure where the environment is rapidly changing. Figure 3 2 1 describes this vividly

Fig. 3. 2.1 **Contingency Theory of Organisational Design**



Adapted from Jones and George (2003)

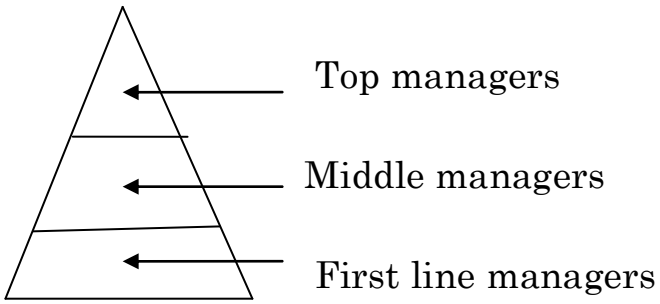
Self-Assessment Exercise

What are the pitfalls in Max Weber's concept of bureaucracy?

3.3 Classification of Managers

Managers generally are all those who are responsible for performing the functions of management. However, it is imperative to note that the practice of management is at different levels within an enterprise, with varying organisational activities. The various levels are represented using this diagram.

Fig. 3.3.1



First line managers are those who are at the lowest level in the organisation and are saddled with the task of being responsible for the work of others. They normally direct non- management employees and do not supervise other managers. This group of managers include production supervisors in a manufacturing concern, clerical supervisors in large offices, etc. They are also called first-level managers and direct the activities of operating employees.

Middle level managers are those in between first-line managers and top level managers. Then main task is to direct the tasks that will implement their organisations' polices and to have a balance between the demands of then supervisors (Managers) and the capabilities of their subordinates.

Top level Managers are those level of managers who are concerned with the establishment of operating polices and guidelines for the

organisation interactions with its environment. The top managers are basically responsible for the corporate management of an organisation. They are often referred to as chief executive officers, presidents, managing directors, etc. However, such titles vary from one enterprise to another.

A second mode of classification in not based on the level but on the scope of activities that they manage, namely:

i. **Functional Manager**: These are managers who are only responsible for one organisational activity (function) e.g. marketing or finance alone. Thus, using this approach, we can a have marketing manager, finance manager, production or human resources manager, etc.

ii. **General Managers**: These are group of managers who are responsible for all the functional areas of an organization or its subsidiary or unit Hence, all of its activities are the concern of that manager i.e. he or she is responsible for efficiency and effectiveness in finance, production, marketing, etc.

Self-Assessment Exercises

a. Why is classification necessary when looking at managers?

b. Discuss the quest for the development of management theories.

4.0 CONCLUSION

The above analyses show that management of organisations is inevitable and that explains the rationale or quest by numerous researchers,

authors and practitioners in developing appropriate theories that can ensure effectiveness, productivity and efficiency m organisations, .Also, the task of management becomes clearer and easier when managerial duties are fit into appropriate classes or levels. This grouping inevitably puts managers into different classes too.

5.0 SUMMARY

In this unit, the concept of management was discussed along with the mam theories that have been developed to help achieve increases m productivity. Each of these theories' view point was analysed and the merits/demands highlighted. Also, the different classes of managers were discussed.

6.0 TUTOR MARKED ASSIGNMENT

1. Clearly analyse the rationale behind the development of the behavioural management theory.
2. What is the main area of commonality between management science and scientific management theories?

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MODULE 3

1. **The Theory of Cost**
2. **Some basic Concept of Theory of Production**
3. **Pricing under Perfect Competition**
4. **Pure Monopoly**

Unit 1: THE THEORY OF COST

CONTENTS

1.0 INTRODUCTION

The last unit has been concerned with production. It has been dealing with cost in physical values. This is contrary to what is obtainable in the society as business managers take their decisions based on the money value of their goods. A consideration of factor value in monetary terms is what is called cost of production. Cost of production in plane terms can be defined as the monetary value of goods and services used in realizing a given output. When considered from technical position, the concept is given a deeper meaning. All these, we shall see in the course of our work. The concepts related to costs especially those that affect managerial decision making shall form part of this unit. These costs shall be analyzed and their implications on production drawn.

2.0 OBJECTIVES OF THE UNIT

Costs reflect on the price of a commodity and are translated into changing demand patterns. It is intended that at the end of this unit, you should be able to:

- Appreciate the concept of cost
- Understand explicit and implicit costs
- Calculate the various aspect of cost such as FC, VC, MC, AC
- Analyse short-run and long-run cost, and
- Take major decisions based on the cost concept.

3.0 COST CONCEPTS

The cost concepts that are relevant to business operation differ from those relevant to economics. Each of these groups shall be discussed below.

3.1 Accounting Cost Concepts

We had in an earlier unit defined opportunity cost as the next best alternative forgone. This is the same as defining it as the expected returns from the second best use of the resources forgone due to scarcity of resources. As such opportunity cost can also be called alternative cost. Tied to opportunity cost, is the concept of economic rent/profit. Economic rent/profit is excess earning over and above the employment of a factor of production in its next best alternative use. E.g. Given that Mr. X has N150, 000 to invest in either an Okada business or a tailoring shop, and he decides to invest in the Okada business because it will yield him a monthly profit of N 1,500, rather than investing in the sewing tailoring shop that will earn him only N 1,000 a month as profit.

His opportunity cost is the next best-forgone alternative i.e. the tailoring shop. On the other hand, his economic rent is the excess profit gotten by investing in the Okada business and not in the Tailoring shop i.e. Nl,500 (to be earned from the Okada business) minus N1,000 (the earnings that would have come from investing in the Tailoring shop.

Actual cost is a contrast to opportunity cost. It is the actual cost incurred during the process of production by making payments for labour, material, plants, machinery, equipment, etc., used.

a) Business Cost and Full Cost

Business cost includes all expenses incurred in carrying out a business. These types of cost are used for calculating business profit and losses, income tax returns and for legal purposes. This cost includes all the payments and contractual obligations made by the firm together with the book cost of depreciation on plant and equipment.

Full cost, on the other hand, incorporates opportunity cost and normal profit. It refers to the minimum earning which a firm must get to remain in its present occupation.

b) Explicit and Implicit Costs.

These are other accounting cost concepts. Explicit costs are those costs that fall under actual or business costs and are entered into the account books. This cost involves cash transaction, which are recorded. On the other hand, implicit cost also called imputed cost is the earnings expected from the second best alternative use of resources. There are costs forgone by other factors of production that goes unrecorded. E.g. If an entrepreneur is employed by another firm, he will be paid, but since he employs himself in his firm, he does not charge his pay as the explicit cost of his own business.

Implicit costs are not taken into account when calculating the profit of a firm, though they form an important consideration in whether or not a factor would remain in its present occupation. These two make up economic cost.

c) Out-of-Pocket and Book Costs

Out-of-pocket costs are those cash transfers made by a business, i.e. all explicit costs. On the other hand, those costs which do not involve cash payments but a provision is made for them in the account books are called book cost. This implies that book costs are payments by a firm to itself. E.g. depreciation and owner's own unpaid interest.

3.2 ECONOMIC COST CONCEPTS

a) Fixed cost and variable cost (FC and VC):

Fixed costs are the cost that do not change as output changes, i.e. it is the cost incurred as a result of using fixed factors of production. Example cost of managerial and administrative staff, depreciation of machinery, building cost, rents, etc. Variables cost, on the other hand, is that cost incurred as a result of employing a variable factor of production. It increases with an increase in output and falls with a fall in output, example cost of raw materials, and running cost of fuel, repairs, direct labour charges etc.

b) Total, Average and Marginal Costs:

- **Total Cost** represents the value of the total resource requirement for the production of goods and service. It refers to the total outlay of money expenditure on resources used to produce a given level of output.

  Algebraically,

  TC = FC + VC.

- **Average Cost**refers to per unit cost of a product. It is gotten by dividing TC by total output Q, i.e.

$$AC = \frac{TC}{Q}$$

- **Marginal cost**: Your knowledge of marginal can be applied here. Marginal cost is that additional cost to total cost incurred as a result of producing an extra unit of a particular product.

$$MC = \frac{\Delta TC}{\Delta Q}$$

  This concept of MC should be understood right at this point for it has extensive implications on both business and economic analysis.

3.3 Private Costs and Social Cost

Private Costs are those cost which are actually incurred or provided for by an individual or a firm on the purchase of goods and services from the market. These are an internalized cost incorporated in the firm's total cost of production.

On the other hand, social cost refers to the total cost to the society on account of production of a commodity. It includes both private cost and external cost. It is made up of:

- The cost of resources for which the firm is not compelled to pay a price example, rivers, lakes atmosphere public utilities etc.
- The cost in the form of disutility created through pollution.

3.4 Production Cost

This concept is concerned with the relationship between cost and output. This relationship is important in business decisions especially when profit levels and optimum levels are envisaged. This relationship is expressed through the cost function i.e.

TC = F (Q), i.e. Total cost (TC) is a function of output.

When this is interpreted, it means that the total amount to be incurred as cost of production depends on the quantity of that good that is produced.

You should note that production cost is divided into two time periods - the short-run and the long -run.

3.4.1 The Short-Run Cost

This is a period of production not long enough to allow all factors of production to be varied. In other words it is

that period of production in which some factors of production are fixed while others vary. Hence;

TC = TFC + TVC

No matter the level of output, TFC (total fixed cost) remains the same e.g., the cost of machines, building, etc.

By now we should already know that:

TFC = TC - TVC

TVC = TC– TFC

$$AC = \frac{TC}{Q}$$

$$MC = \frac{\Delta TC}{\Delta Q}$$

The law that governs cost of production in the short-run is the law of variable proportions, commonly called the law of diminishing returns to scale. This law states that "as more and more variable factors of production are added to the fixed factors of production out-put will be increased but at a rate that is decreasing"

This implies that to produce the same output a number of times, cost of production will be increasing as more variable factors will be needed each subsequent time due to the operation of diminishing returns.

It should be noted that for all the aggregated costs, the averages could be gotten except for the MC. Dividing that particular cost by the quantity, can give us this

$$\text{ATC or AC} = \frac{TC}{Q}$$

$$\text{AFC} = \frac{FC}{Q}$$

$$\text{AVC} = \frac{VC}{Q}$$

The following is the nature of cost curves in the short run.

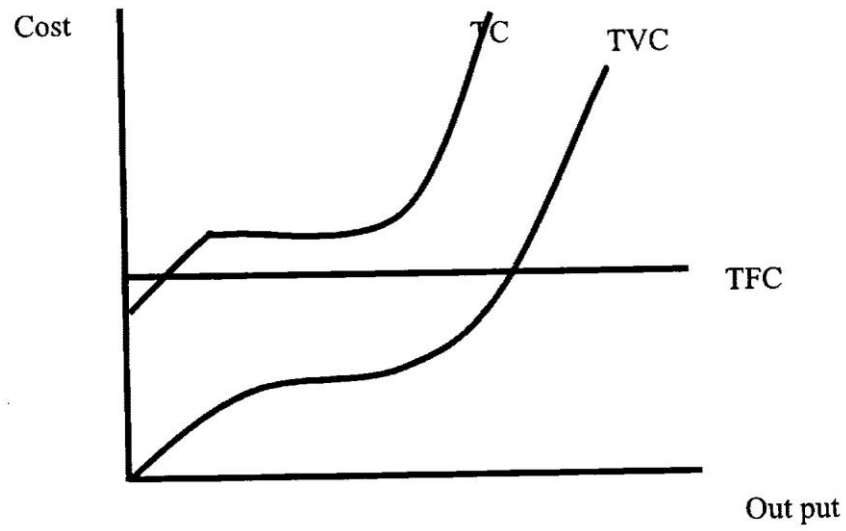

Fig. 14.1: Aggregate costs.

While TC and TVC are inversely S-shaped TFC is a horizontal straight line (Fixed) in the short-run.

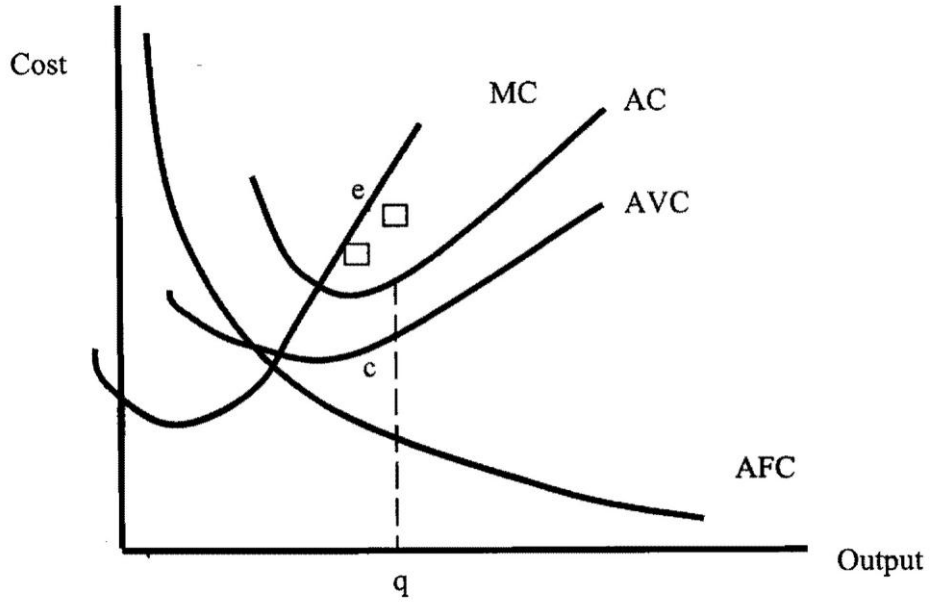

Figure 14.2: MC, AC, AVC and AFC cost curve.

AFC is an asymptomatically sloped, while MC, AC and AVC are all U- shaped owing to the law of diminishing returns to scale.

It should be noted that AVC reaches its minimum point before AC and the MC cuts across them, when each of them is at its minimum point i.e. e and e_1, respectively.

The optimum output in the short -run is that one which can be produced when MC = AC i.e. at point e, on the figure above. At this point the average cost is at its minimum, implying the least cost combination.

3.4.2 Long Run Cost Analysis

The long run is that period of production in which all factors of production are variable. This implies that all input in the long run are elastic. The firms can

therefore increase their scale of production by hiring a larger quantity of all inputs. Hence TC in the Long run is given by:

TC = VC or TC = TVC

An understanding of the long-run analysis will be enhanced when you understand that the long run comprises of a series of short run production plants. This implies that the long run cost curve is made up of so many short run costs curves.

The long -run cost curves of the traditional approach looks thus:

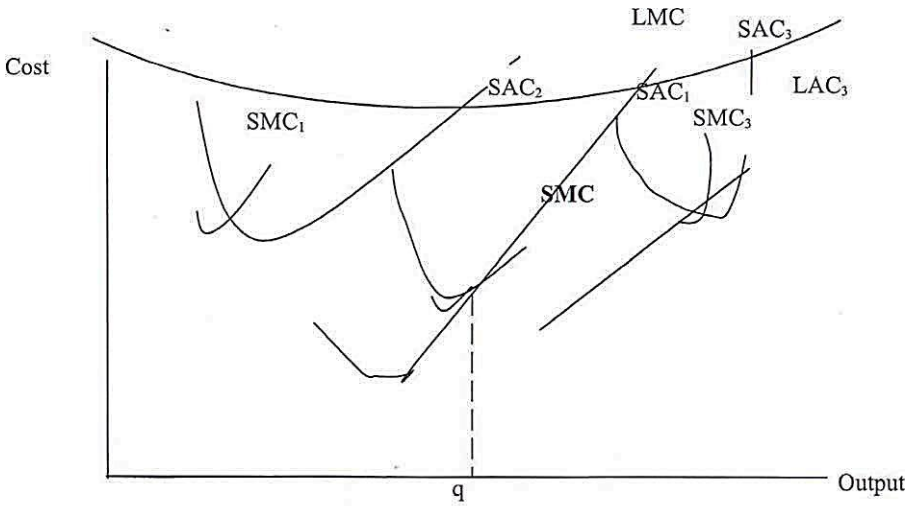

Figure 14.3: Long –run Average Cost Curve

The long run AC (LAC) is called a planning curve or an enveloped curve. The optimum point of production is at q where the LMC = LAC. The law that governs cost curves in the Long run is the law of return to scale. When the revenue of the firm is considered, the

firm will break even (make economic profit) when TR = TC i.e. no loss, no profit.

4.0 CONCLUSION

Having noted the importance of cost to business managers, a selected cost structure has been presented. Emphasis has been laid on aspects which can be of practical help to these managers. The rationale for the U-shape nature of the cost curves (Averages) both in the short run and long run, and the intersecting points of MC to AC and AVC should remain fresh in your minds.

5.0 SUMMARY

This work has examined the theory of cost from the traditional perspective. Accounting cost concepts have been distinguished from economic cost concept. In doing so, different types of costs have been discussed. Furthermore, production costs under the short run and long run has been analysed, and equilibrium cost positions established. This has been in a bid to exposing you to the theory of cost, which is a vital ingredient in business decisions that relates to output determination and profit.

6.0 TUTOR MARKED ASSIGNMENT

1. Why is it that the MC, AC, AVC are U-shaped in the short run and long run?

2. Explain and distinguish FC, VC, and TC from each other.

   a) Marginal cost and Average cost

b) Business cost and full cost

c) Actual cost and imputed cost

d) Short run and long run cost.

7.0 REFERENCES AND OTHER RESOURCES

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Unit 2: SOME BASIC CONCEPTS IN THE THEORY OF PRODUCTION

CONTENTS

1.0 INTRODUCTION

Business firms aim at achieving efficiency in their production process. The main concern of any manager is to see how he can minimize cost of producing a given level of output. In fact, the survival of a firm in a perfectly competitive environment depends on its ability to minimize its cost of production. This is because this cost of production is directly related to the profit level of the producer, which also determines his ability to compete favourably or otherwise. The theory of production tries to explain the ways and provides the tools and techniques to analyse the production conditions and to find solution to the practical business problems.

This unit is devoted to the discussion of some basic concepts in Jhe theory of production. It is equally worthy to note that production theory deals with input output relationship, production period, and production function.

Input-output relationship can be expressed in physical terms as well as in the monetary terms. Production theory deals with physical relationships i.e. technical and technological relations between inputs and outputs. In this unit, a discussion is made on production and its physical relationship i.e. an explanation of the relationship existing between the factor input and the factor output. With this background, let us assume that your firm is engaged in the production of a wide range of products. List all the inputs - output relation for a firm you know well for the past 10 months and tell us which inputs are fixed and which one can be varied. From your experience in the field I know you can do this. The theory below shades more light to what you have in mind.

2.0 OBJECTIVES OF THE UNIT

The theory of production deals with the relationship between the factor inputs and the factor output, in physical terms. The unit provides an explanation of this relationship between input and outputs in monetary terms. This unit examines the basic concept in the production theory, which will be of help in your understanding the subsequent units. At the end of this unit, you are expected to know the following:

- Define the meaning of production

- Discuss the production function
- Measure Input and output
- Distinguish between Fixed and variable input
- Calculate Fixed and variable costs

3.0 CONCEPTS IN THE PRODUCTION THEORY

As stated earlier, we are going to focus our attention on a few concepts of production.

3.1 Meaning of Production

In economics, the term "production" means a process by which a commodity or commodities are transformed into different usable commodities. In other words, production means transforming inputs (labour, machines, raw materials, etc.) into an output. The production process, however, does not necessarily involve physical conversion of raw materials into tangible goods. Some kind of production involves intangible inputs to produce intangible output. For example the productions of legal, medical, social and consulting services, hairdressers, musicians are all engaged in producing intangible goods.

In economic sense, production process may take a variety of forms other than manufacturing. For example transporting a commodity from one place to another where it can be used in production. If a dealer collects and transfers the sand from the

riverbank to the construction site, he is engaged in production. A man who transports fish to the market place is considered to be producing. Their activities are all considered production. Suffice it to say that production is the creation of anything that satisfies a human want or need.

3.2 Input and Output

Input is a good or service that goes into the production process. In other words, an input constitutes the components of materials used to produce an output. An input is simply anything which the firm buys for use in its production or other processes for sale.

The term "inputs" needs some more explanations. Production processes require a wide variety of inputs depending on the nature of product. But, economists have classified inputs into:

- Labour
- Capital
- Raw materials and
- Time

All these variables are 'flow' variables, since they are measured per unit of time. An output is any good or service that comes out of production process. The outputs represent the value created out of the combination of inputs used by the producer.

3.3 Fixed and Variable Inputs

Inputs are classified as (1) Fixed inputs or fixed factors and (ii) variable inputs or variable factors.

Fixed and variable inputs are defined in economic sense and in technical sense. In economic sense, a fixed input is one whose supply is inelastic in the short run. Therefore, all of its users cannot buy more of it in the short-run. Conceptually all its users cannot employ more of it in the short run. If one user buys more of it, some other users will get less of it. A variable input is defined as one whose supply in the short run is elastic e.g. labour and raw materials. All of the users of such factors can employ a larger quantity in the short run.

In technical sense, a fixed input remains fixed (constant) up to certain level of output whereas a variable inputs changes with change in output.

3.4 Short Run and Long Run

The short run refers to a period of time in which the supply of certain inputs (e.g. plant, building, and machines.) is fixed or is inelastic. In the short run therefore, production of commodity can be increased only through an increase in variable inputs, like labour and raw materials. It is important to note that short-run and long-run are economic jargons. They do not refer to any fixed time period. While in some industries short run may be a matter of few weeks or few months, in others (e.g. electric and power industry), it may mean three or

more years. The long run refers to a period of time in which supply of all the inputs is variable. Therefore in the long run employing more of both variables and fixed inputs can be possible.

The economists use another term, i.e. very long period which refers to a period in which the technology of production is supposed to change. In a very long run, the production function also changes. The technological advancement means that a larger output can be produced with a given quantity of inputs.

3.5 Production Function

In this unit, we will be concerned with the laws of production i.e. the relationship between inputs and output. Production function is a tool of analysis used to explain the input-output relationship. A production function describes the technological relationship between inputs and outputs in physical terms. In its general form, it tells us that production of a commodity depends on certain specific inputs. In its specific form, it presents the quantitative relationships between inputs and outputs.

Besides, the production function represents the technology of a firm, of an industry or of the economy as a whole.

A production function may take the form of a schedule or table, a graphed line or Curve, an algebraic equation or a

mathematical model. But each of these forms of production function can be converted into the other forms.

Before we illustrate the various forms of a production let us note how a complex production function is simplified and the number of inputs in the production function, i.e. the dependent variables are reduced to manageable number, especially in theoretical analysis or models.

A real life production function is generally very complex. It includes a wide range of inputs. The economists have however classified the input as (1) land (ii) labour (iii) capital (iv) raw material (v) time and (vi) space.

All these variables enter the actual production function of a firm, the economist have however reduced the number of variables used in a production function to only two, viz, capital and labour, for the sake of convenience and simplicity in the analysis of input-output relations. The reasons for ignoring other inputs are as following:

Land as an input, is constant for the economy as a whole and hence it does not enter into the aggregate production function. However, land is not a constant variable of an individual firm or industry. In the case of an individual firm, land is lumped together with "capital." In case of raw materials it has been observed that this input bears a constant relation to output at all levels of production. For example, cloth bears a constant relation to the number of garments since the same number of garments can be gotten from the cloth. Similarly, for a given

size of a house, the quantity of bricks, cement, steel, etc. remains constant irrespective of number of houses constructed. This consistency of input - output relation leaves the methods of production unaffected. So is the case generally, with time and space. That is why, in most production function only two inputs - labour and capital are included.

We will illustrate the tabular and graphic form of a production when we move on to explain the laws of production. Here, let us illustrate the algebraic or mathematical form of a production function. This is the form of production function, which is most commonly used in production analysis.

To illustrate the algebraic form of production function, let us suppose a coal-mining firm employs only two inputs - capital (K) and labour (L) - in its coal production activity. As such, the general form of its production function may be algebraically expressed as;

$Q = f(L, K)$

Where $Q =$ the quantity of coal produced per time unit
$K =$ capital and $L =$ labour

The production function implies that output of coal depends on the quantity of capital, K, and labour, L, employed to produce coal. Increasing coal production will require increasing K and L. Whether the firm can increase both K and L or only L depends on the time period it takes into account for increasing

production, i.e. whether the firm considers a short run or long run.

By definition, supply of capital is inelastic in the short run and elastic in the long run. In the short run, therefore, the firm can increase coal production by increasing labour only, since the supply of capital in the short run is fixed. In the long run, however, the firm can employ more of both capital and labour. Accordingly, the firm would have two types of production functions.

- Short-run production function
- Long-run production function

The short run production function or what may also be termed as single variable production function,' can be expressed as,

$$Q = f(L)$$

the form: In the long-term production function, both K and L are included and the function takes the form:

$$Q = f(K,L)$$

Assumptions

A production function is based on certain assumptions, which include:

- perfect divisibility of both inputs and output
- limited substitution of one factor for the other

- constant technology, and
- inelastic supply of fixed factors in the short run

If there is a change in these assumptions, the production function will have to be modified accordingly. The most important functions used in economic literature to analyse input- output relationships is Cobb-Douglas Production function.

4.0 CONCLUSION

This unit reviewed quite a number of issues, which are of important to every business organization. It is recommended that managers should understand some of these concepts as a key to decision making. An understanding of the production conceptions will therefore give you a base in your managerial decision-making.

5.0 SUMMARY

Some basic concepts of production that are considered to be of some importance to business managers have been considered above. These concepts are quite useful when decisions on techniques of production are being considered. The concepts considered cover the meaning of production, the explanation of input-output relationship, nature of variables, the different production periods and the production function.

6.0 TUTOR MARKED ASSIGNMENTS

1. Analyse the short run and long run period of production?

2. What are fixed factors and variable factors of production?

7.0 REFERENCES AND OTHER RESOURCES

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Unit 3: PRICING UNDER PERFECT COMPETITION

CONTENTS

1.0 INTRODUCTION

The market in which a firm operates is quite crucial in deciding the achievement of the Firm's objective. Under market structure, the perfectly competitive market structure stands out unique as a theoretical base for competition. In this unit, we are going to consider what this market stands for by looking at its assumptions and its output and profit levels. Managers with knowledge on this, stand a better chance of making better business decisions.

When one hears the concept "perfect competition", the expectation is that, the rivalry in the market is quite intense, but practically it is not so. What do you need to convince a person on this? When you will go through this unit carefully, you will understand the situation better.

2.0 OBJECTIVES

The objectives of this unit are to ensure that you are equipped with knowledge on parallel markets. The intention here is to expose you to market realities. Hence it is expected that at the end you show know:

(a) The realities about perfect competition as a theoretical market, and

(b) When profit and output are maximized under this market.

3.0 CHARACTERISTICS (ASSUMPTIONS) OF PERFECT COMPETITION

The term perfect competition denotes a market structure in which there is the absence of rivalry among individual firms. Firms do not compete among themselves since they cannot influence market activities. A perfect competitive market is one which has the following characteristics:

1. **Large number of buyers and sellers:** Under perfect competition, the number of sellers and buyers is very large. The number of buyers and sellers is so large that the share of each seller in total supply and the share of each buyer in total demand are so small that no single seller can influence the market price by changing his supply, nor can a single buyer influence price by changing his demand. With such large number of buyers and sellers, individual quantities in the market are quite insignificant.

2. **Homogeneity of products:** products supplied by all firms are approximately homogeneous: Homogeneity of product does not mean that products supplied by various firms are so identical in appearance and use, that buyers do not differentiate between them

nor do they prefer the product of one firm to that of another. Product of each firm is regarded as a perfect substitute of the product of other firms. Hence, no firm can gain any competitive advantage over other firms. Nor do the firms have preference for particular buyers. All the buyers are treated the same. Buyer for example of wheat and vegetables produced by all the farmers in today's world can fit into this situation. Other things given, they are therefore treated as homogeneous.

3. **Price Takers:** since there are a large number of buyers and sellers in the market, and this individual buyer or seller has the power of influencing the market price, firms in such a market are seen as price takers. They are therefore to do exchange at a market determined price of quit the market. The price in the market. The forces of demand and supply establish the price in the market. The products in the market are perfectly homogenous. This implies that the products are identical to one another. This makes it impossible for anyone to have preference for a particular firm's product. Consumers and producers are to trade at that price or quit the market

4. **Perfect mobility of factors of production:** For a market to be perfectly competitive there should be perfect mobility of resources. It means that factors of production must be in a position to move freely into or out of an industry and from one firm to another.

5. **Free entry and free exit of firms:** There is no restriction legal or otherwise on the firm's entry into or exit from the industry. Hence when profits are available in the market, firms are free to join and

free to quit the market when profits have been competed away. This also suggests that there is no government intervention in any form.

6. **Perfect knowledge:** There is perfect dissemination of the information about the market condition. Both buyers and sellers are fully aware of the nature of the product, its availability, suitability, and of the price prevailing in the market. This information is available free of charge.

7. **Absence of collusion or artificial restraint:** There is no seller's Union or other kind of collusion between the sellers like cartels or guilds, nor is there any kind of collusion between the buyers, like consumers' association or consumers' forum. Each seller or buyer acts independently. The firms enjoy the freedom of independent decisions.

The perfect competition, as characterized above is considered as unrealistic phenomenon in the real business world. However, the actual market approximate to the condition of perfectly competitive model includes; the share markets, security and bonds markets, and the agricultural product market, e.g. Local vegetable markets. Although perfectly competitive markets are uncommon phenomena, perfect competition model has been the most popularly used in economic theories due to its analytical value.

Some economists make distinction between perfect competition and pure competition. The difference between the two is only a matter of degree. Perfect competition, less perfect mobility of factors, and perfect knowledge is regarded as a pure competition. In this unit, we shall use these two terms interchangeably.

3.1 PRICE DETERMINATION UNDER PERFECT COMPETITION

By definition, perfect competition is a market setting in which there are many sellers of homogeneous product. Each seller supplies a very small fraction of the total supply. No single seller is powerful enough to influence the market price not' can a single buyer influence the market price. Market price in a perfectly competitive market is determined by the market forces -market demand and supply. Market demand refers to the demand for the industry as a whole. It is the sum of the quantity demanded by each individual firm at different prices. Similarly, market supply is the sum of quantities supplied by the individual firms in the industry. The market price is therefore determined for the industry, and is given for each individual firm and for each buyer. Thus, a seller in a perfectly competitive market is a price-taker not a price maker.

In a perfectly competitive market, therefore, the main problem for a profit maximizing firm is not to determine the price of its product but to adjust its output to the market prices so that profit is at maximum.

The mode of price determination- price level and its variation - depend on the time taken by supply position to adjust itself to the changing demand conditions. Price determination is analysed under three different time periods;

- Market period or very short run
- Short run and

- Long run

The short run and the long-run have already been defined as regards the market period. But the very short run refers to a time period in which quantity supplied is absolutely fixed or in other words supply response to price is nil. Price determination in three types of markets is described below.

- **Pricing in market period:** In a market period, the total output ofa product is fixed. Each firm has a stock of commodity to be sold. The stock of good with all the firms makes the total supply.

  Since the stock is fixed, the supply curve is perfectly inelastic. In the very short run, supply is fixed as shown by the supply curve SS below.

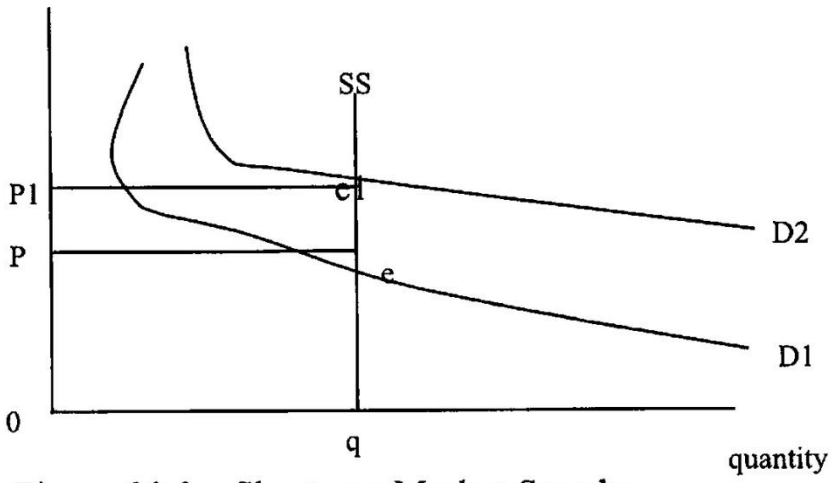


Figure 20.2: Short-run Market Supply

The quantity supplied to the market during this period is Oq. The demand curve is at D_1. Suppose due to a sudden rise in the demand for the product as a result of a rise in income, (temporal income), i.e. a movement from Dl to D2, supply will not change during this period to meet up the change in demand. As such

there will be a rise in price from P to Pi. The point of equilibrium will move from e to el, This C: scenario is common in the stock market, diary market and in situations of calamities-when medicines and coffins may witness a drastic change in demand.

3.1.2 PRICING AND QUANTITY DETERMINATION IN THE SHORT- RUN

The short run is by definition a period in which firms can neither change their size nor quit nor can new firms enter the industry. This is shown by the figure sector from the diagram it is clear that when demand changes from D to Dl, the quantity supplied also increase from q to ql.

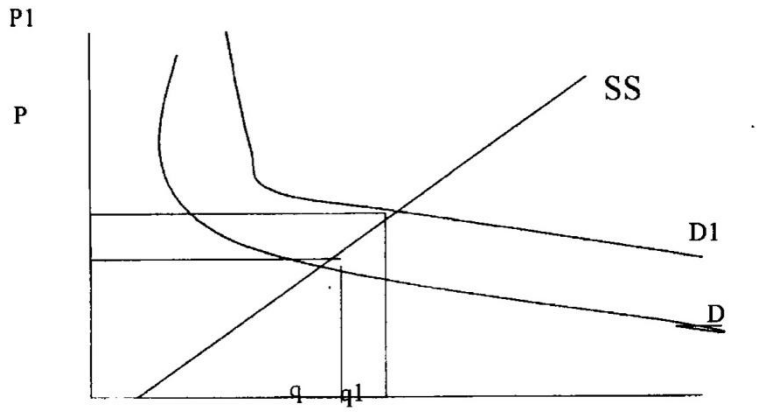
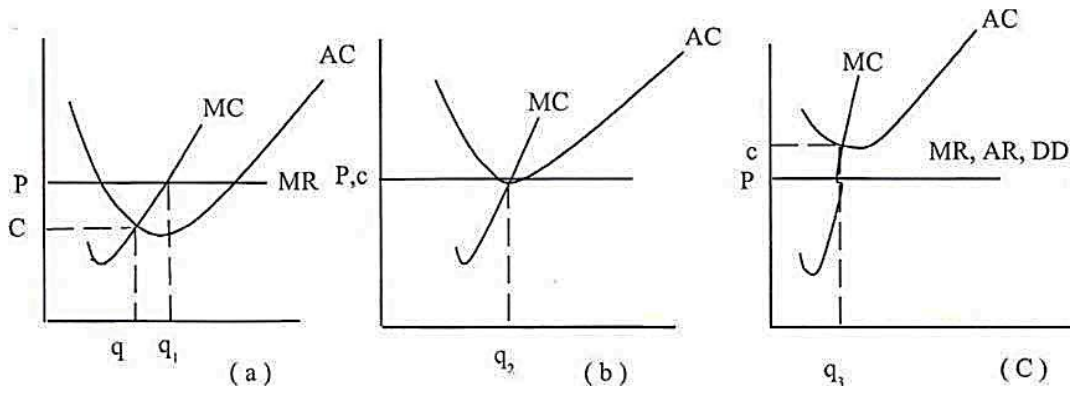


Figure 20.3: Price and quantity Determination in he Short-Run

This is followed by an increase in price from P to PI. This movement tallies with the second law of demand, which states that, at higher prices, a higher quantity is supplied and at lower prices, a lower quantity is supplied.

In the short run, a firm in the perfectly "competitive market can make, losses, breakeven, (economic profit) or make abnormal profit.

The assumptions of the perfect competitive market are brought into play at this period. The figures a, b, and c below illustrates the 3 different situation of competitive firms



Profit Break-even

Losses

Figure 20.4: Competitive Firms In the short Run

In figure 20.4 (C), the firm experiences a loss. The price in the market is fixed (given) at P, which is the same as the AR, MR and the industry's demand curve. The cost of production c, which is given by the minimums point of AC curve, is higher than the market price. As such Ac >AR and since the firm cannot influence the market price, it is forced to incur losses. Here, at equilibrium, firms can offer for sale the quantity q3, where MC = MR. This quantity minimizes the losses the firm can incur.

In figure 20.4 (b), the firm in the short run is making economic profit, i.e. it is breaking even. Here the cost of production and the market prices are the same at P hence the firm experiences a situation of no losses, no profit. The equilibrium quantity supplied

to the market is q2. At this quantity MC = MR. Also AR = AC =MC = MR=P=DD at this same quantity.

As we already mentioned, a short run firm can also make profit. This is illustrated by figure 20.4 (C). In this situation, price P is higher than the cost of production denoted by c. This is because AC is below AR. Profit is shown on the diagram by the shaded area. At this profit level, the equilibrium output is - qi. This implies that firms in the market can produce output at the cost of C and sale it at a price P which records profit for the firm.

We should note at this point that the Price line also denotes the demand curve. This suggests that the demand curve is perfectly elastic. Hence, the slightest change in price will bring about a zero demand for the good. If price increases no matter how small, quantity demanded will fall to zero. Also note that, no individual firm is large enough to influence the market price even downward. Any attempt to do this will lead to a loss position for the firm.

It is important to note here that in the short run, a firm in the perfectly competitive market may be in a position to earn economic profit.

3.1.2 OUTPUT AND PRICE DETERMINATION IN THE LONG RUN

As we already know, the long run is that period of production which allows fundamental changes in production to occur. In this period, firms are free to join the market, just as they are free to quit.

In the long run, any change in demand causes a change in supply in the opposite direction. The figure below illustrates this very clearly.

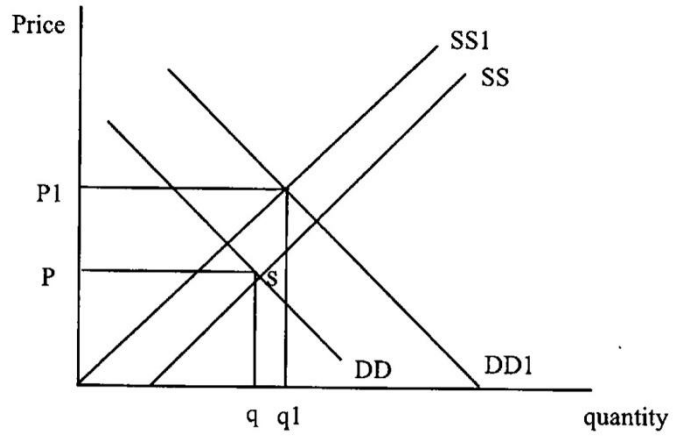


Figure 20.5: Output and Price Determination in the Long Run

When price is at P, the demand is DD, which is the same as price. The supply at this point is S. This leaves an equilibrium quantity of q. When price and demand increases the quantity moves from q to q 1.

As we clearly know, prices are given in the perfectly competitive market. This helps us to get optimum output and prices for the firm's **products in the short run.**

In the determination of output and prices, firms operating in the perfect competitive market can only break even make economic profit in the long run.

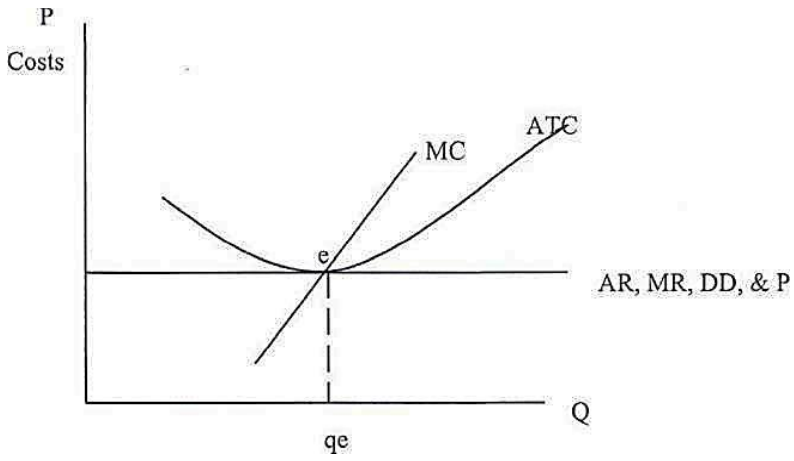


Figure 20.6: Price and Output Determination in the long Run

In the long run, when there are profits in the market, new firms are motivated to enter the market. This increases output and depresses prices such that they can no longer be profitable. Firms that find such low prices not profitable are forced to quit the market. This results in a fall in the market output and prices are pushed upwards again. New firms and others that had left the market may join the line of production again. This will pushed down prices again and unprofitable firm may leave the market and prices may rise once more. This movement continues throughout the period. As such Firms that can stay in the business do so by covering their cost of production, i.e., breaking even.

Hence, in the long run all perfectly competitive firms must only break, even as shown by point e on the figure above.

4,0 CONCLUSION

The conclusions reached here are that the assumptions of the perfect competitive market structure are quite elaborate and help shed light to

the market. Firms in the perfectly competitively market can make profit, losses, or break even in the short run.

In the long run it is only the breakeven condition that holds. An understanding of this market may enable managers striving in competitive environment to make better decision for their firm.

5.0 SUMMARY

We have examined different characteristics of firms under perfect competition. The assumptions of the market have been highlighted and the output and profit level indicated. It is observed that this aspect will be of importance to practical business managers.

6.0 TUTOR MARKED ASSIGNMENT

What are the assumptions of the perfectly competitive market?

7.0 REFERENCES AND OTHER RESOURCES

Lipsey R.G. and Crytal K.A. (1997) An Introduction to Positive Economics, Oxford, oxford press.

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Pedro I.A.(2005); Managerial Economics, NOUN Course Material

Unit 4: THE MONOPOLY

CONTENTS

1.0 INTRODUCTION

Monopoly is the extreme case of the imperfect market. It is a market under the imperfect market structure. It is often criticized by many as a source of inefficiency and exploitation. Yet its existence poses a challenge to many businesses as well as individuals. In tatting business decisions managers always attempt to appreciate the market condition in which their competitors are operating. In this unit, issues relating to the monopoly as a form of market will be considered. Such issue shall include; the meaning, reason for their existence, and their pricing condition.

2.0 OBJECTIVES

In this unit you are exposed to another form of market. As such, at the end of the unit you are expected to be able to:

- Define clearly who a monopolist is,
- Differentiate a monopoly from other market forms.
- Give reasons why monopolies exist and
- Determine the price and output conditions of a monopoly, both in the short run and long run.

3.0 ANALYSIS OF A MONOPOLY

The term pure monopoly signifies an absolute power to produce and sell products, which have no close substitutes. In other words, a monopoly market is one in which there is only one seller of a product having no close substitute. The cross elasticity of demand for a monopolized product is either zero or negative. A monopolized industry is a single firm industry. Firm and industry are identical in a monopoly setting. In a monopolized industry, equilibrium of the monopoly firm signifies the equilibrium of the industry.

It should be noted at this point that the monopolist is faced with two crucial production decisions at any point in time. These decisions are those of output determination and price determination. The monopolist can only take one of these decisions at a time. If it chooses to determine the output of the good, it allows the forces of the market to determine the prices. On the contrary, if a monopolist chooses to determine the price, it leaves the market forces to

determine the prices of the products. From all these, we can therefore define monopoly as a market in which a single seller dominates the sales of a particular product that lacks close substitutes. Initially a monopoly was seen as a market situation in which there is only one supplier of a product. This has changed today as market share has been given consideration. The case of Microsoft in America in which Bill Gates was seen as a monopolist merely because he dominated the production of computer soft wares is a good example.

3.1 CAUSES AND KINDS OF MONOPOLIES

The emergence and survival of monopoly is attributed to the factors which prevent the entry of other firms into the industry. *The barriers to entry are the success of monopoly power*. The major sources of barriers to entry are:

i. Legal restriction or barrier to entry of new firms.

ii. Sole control over the supply of scarce and key raw materials.

iii. Efficiency and economics of scale.

iv. Patent right.

v. Market Franchise

vi. Huge capital Outlay

1. **Legal restrictions:** Law in the interest of the public creates some monopolies. Most of the state monopolies in the public

utility sector are evident here. e.g. Postal, telegraph and telephone services, Radio and TV Services, Generation and distribution of Electricity, Nigerian Railways. The state may create monopolies in the private sector also through license or parent.

2. **Control over key Raw Material:** Some firms acquire monopoly power because of their traditional control over certain scarce and key raw materials, which are essential for the production of certain goods, e.g. bauxite, graphite, diamond. The monopolies of this kind emerge also because of the monopoly over certain specific knowledge or techniques of production. Firms that possess exclusive ownership of production techniques are automatically monopolies as entry is barred by lack of production knowledge.

3. **Efficiency:** A primary and technical reason for monopolies is the economy of scale. If a firm's long-run minimum cost of production of its most efficient scale of production almost coincides with the size of the market, then the large size firm finds it profitable in the long run to estimate competition through price-cutting. In the short-run, Once a monopoly is established, it becomes almost impossible for new firms to enter the industry and survive. Monopolies created on account of this factor are known as natural monopolies. A natural monopoly may emerge out of the technical conditions of efficiency or may be created by law on efficiency grounds.

4. **Patent Right:** when a firm discovers a product, it is given a period of grace to be the Sole producer of the product. This is to enable it re-coup its cost of research and Development. This is what is called Patent Right. Once the Paten right covers a firm, the firm becomes a monopoly. As such the firm faces limited competition in the market. Drug producing firms are good examples.

5. **Market Franchise:** Monopolies may come into existence when some particular firms dominate the market. Instances of this may occur when the firm wins government patronage. Such firms are able to whirl the market to their favour. By so doing, other firms becomes less privileged in the market. Minting and Government press are good examples of monopolies that come into existence through this means.

6. **Huge capital Outlay:** When the capital required to set up a business firm is too large, very few individual firms will be able to raise such huge amounts. As a result of this, any firm that is able to invest in such a business becomes a monopoly. Hence, we can say that huge amount of capital requirement repels small- scale investors, while the firm that is capable of raising such capital for investment, assumes the monopoly status. Good examples of such firms in Nigeria Included NITEL, NEPA etc.

Self Assessment Question: *What are the barriers to entry in a monopolist industry?*

3.2 PRICING AND OUTPUT DECISION: SHORT RUN

As under perfect competition, pricing and output decision under monopoly are based on revenue and cost conditions, i.e. MR and MC curves in a competitive and monopoly market are generally identical but the revenue conditions differ. Revenue conditions, i.e. AR and MR curve are different under monopoly because, unlike a competitive firm, a monopoly firm faces a downward sloping demand curve. A monopolist can reduce the price and sell more and can raise the price and still retain some customers. The revenue and cost conditions faced by a monopolist firm are presented in the figure below. The AR and MR curves show the firm's average and marginal revenue curves respectively. At its short-run, average and marginal cost curves are shown by SAC and SMC curve respectively. The price and output decision rule for profit maximizing monopoly is the same as for a firm in the competitive industry. A profit maximising monopoly firm chooses a price -output combinations at which MR = SMC. Given the firm's cost and revenue curve in figure 22.1 below, its MR and SMC intersect each other at point N. An ordinate drawn from point N to X axis determines the profit maximizing output for the firm at Oq. At this output, the firms MR=SMC. Given the demand curve AR =D, output Oq can be sold per-time Unit at only one price, i.e., Pq (=OPi). Thus the determination of output simultaneously determines the price for the monopolist firm. Once price is fixed, the output and total profits are also simultaneously determined. Hence the monopolist firm is in state of equilibrium.

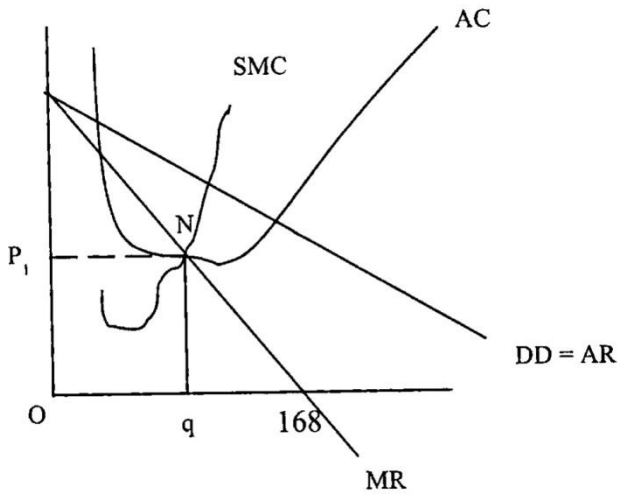

Figure 22.1: Price Determination Under Monopoly in the short run

The curve below shows how a monopolist can make abnormal profit in the short run. We must state at this point that in the short run, a monopolist can make profit, break even or even incur losses. The two Figures below shows such a trend:

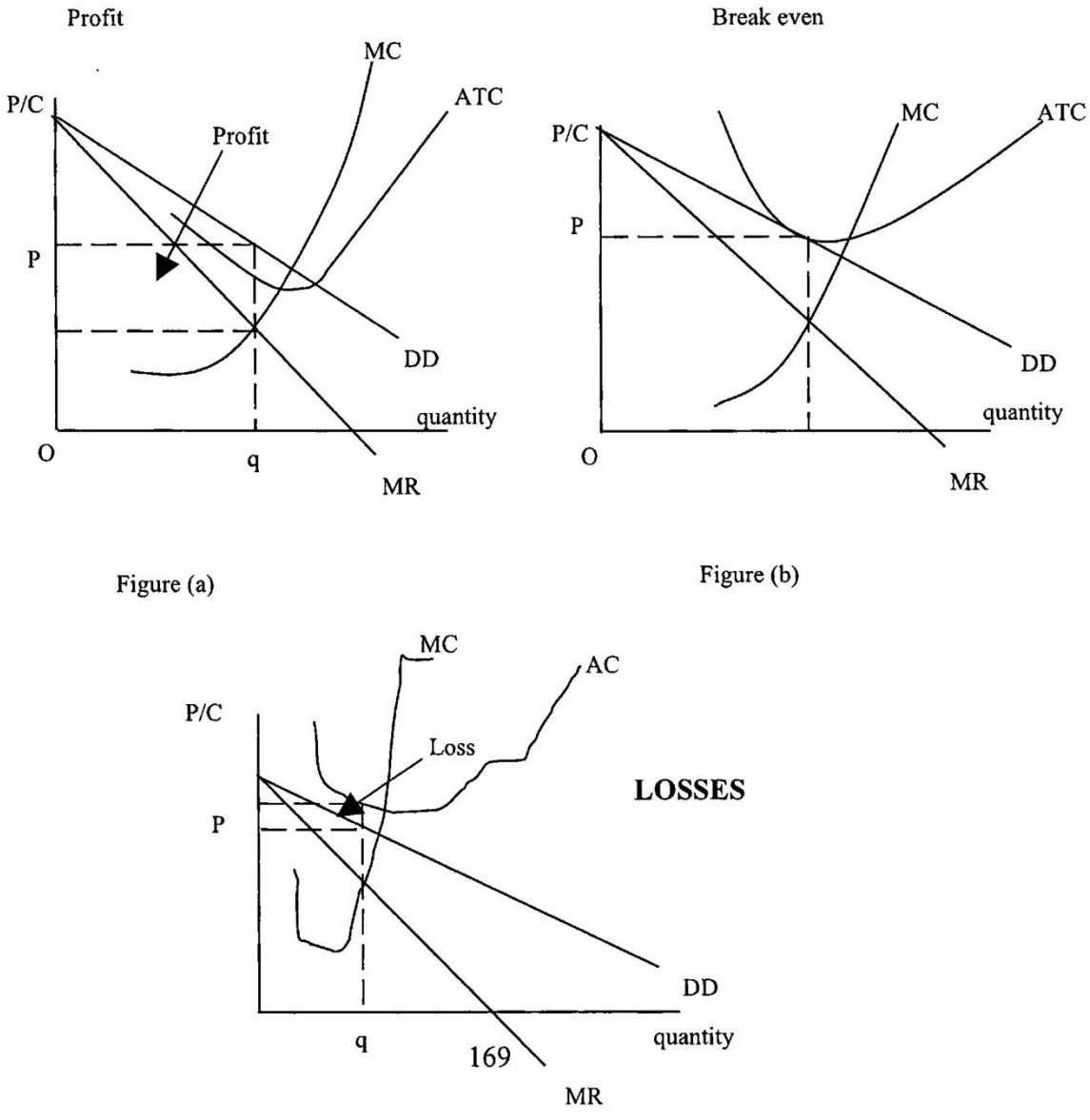

Figure 22.2: Short-run Equilibrium condition of the Monopolist

In fig a, the monopolist is malting only profit. Here P > AC.

In fig b, the monopolist is making only economic profit i.e. it breaks-even only. Its AC is the same as its price. AC=P, showing that there is no profit and no loser.

In fig c, the firm is incurring losses. The AC of production in fig c is above the market price P. In this case, the firm produces at a loss. Since it cannot cover its cost of production.

3.3 PRICING AND OUTPUT DECSIONS IN THE LONG RUN

In the long run, all monopolist must make abnormal profit. This is justified by the fact that in the short run, a monopoly still testing the techniques of production can incur losses break-even or profit. But in the long-run only firms capable of making abnormal profits should stay in the market.

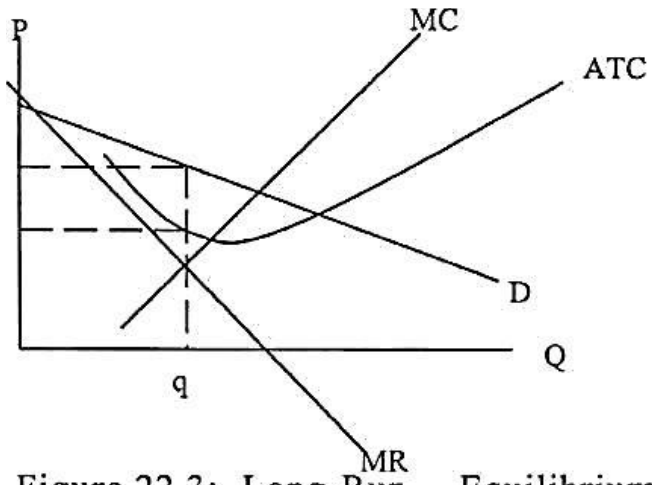

Figure 22.3: Long-Run Equilibrium Condition

Monopolist

4.0 CONCLUSION

The monopoly like other markets operate at an optimum when MR = MC. But they are likely to make losses, profit and economic profit. Losses can be incurred only in the short run when the monopoly is adjusting his techniques of production. Curves of different types have been used to buttress the scenario.

5.0 SUMMARY

This unit has examined the various aspects of the monopoly. It has established the reasons why monopolies exist and the optimum level of profit and output has been considered. Profit and output are maximized when MR = MC. Business managers need such information in designing the production and sales decisions.

6.0 TUTOR MARKED ASSIGNMENT

1. Who is a monopolist?

2. Why do monopolists exist?

7.0 REFERENCES AND OTHER RESOURCES

Lipsey R.G. and Crytal K.A. (1997) An introduction to positive economics, Oxford, oxford press.

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MODULE 4

1. The Nigerian Money Market
2. The Nigerian Capital Market
3. Commercial Banking in Nigeria The Nigerian Money Market
4. Central Banking and the Monetary Policy Guidelines

Unit 1: THE NIGERIAN MONEY MARKET

CONTENTS

1.0 INTRODUCTION

Money market refers to a collection, or group of financial institutions or exchange system, set up for dealing in short-term credit instructions of high quality, such as treasury bills, treasury certificates, call money, commercial paper, bankers' unit fund, certificates, ways and means advances, as well as the dealing in gold and foreign exchange. These short-term instruments involve a small risk due to loss, because they are issued by obligors of the highest credit rating and they mature within one year.

While denoting trading in money and other-term financial assets, the money market comprises all the facilities of the country for the purchase and sale of money for intermediate and deferred delivery, and for the borrowing and lending of money for short periods of time. It is a manifestation of dealing in short-term financial instruments (their sale and purchase, and also, borrowing and lending for short period) on the one hand, and a collection of the dealers in these assets on the other. It is thus a collection of financial institutions set up for the granting of short-term loans and dealing in short-term securities, gold and foreign exchange.

2.0 OBJECTIVES

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

- Identify the rational for establishing money market

- Discuss the instruments of Nigerian money market.

3.0 MAIN CONTENT

3.1 Reasons For The Establishment of The Nigerian Money Market

1. To provide the machinery needed for government's short-term financing requirements.

2. As an essential step on the path to independent nationhood, hence, it is part of a modern financial and monetary system to enable the nation to establish the monetary autonomy, which is part and parcel of the workings of an independent, modern state.

3. To Nigerianize the credit base by providing local investment outlets for the retention of funds in Nigeria, and for the investment of funds repatriated from abroad, as a result of government persuasions to that effect.

3.2 The Instruments of the Nigeria Money Market

3.2.1 Treasury Bills (TBs)

TBs are money-market (short-term) securities issued by the Federal Government of Nigeria. They are sold at discount (rather than paying coupon interest), mature within 90 days of the date of issue, and are default-free. These instruments are promissory notes to pay the bearer, 90 days from the date of issue. They provide the government with a highly flexible and relatively cheap means of borrowing cash. They also provide a sound security for dealings in the money market, and the

Central Bank of Nigeria in particular, can operate on that market by dealing on treasury bills.

TB rates were fixed prior to the deregulation of interest rates in Nigeria, but since 1989, they have been offered on auction basis and hence, market determined.

Thus TBs, mere IOUs are used by the federal government to borrow for short periods of about three months, pending the collection of its revenues. Their issue for the first time in Nigeria in April 1960, was provided for under the Treasury Bill Ordinance of 1959. Among other things, the ordinance stipulated: That treasury bills would be issued in Nigeria in multiples of 2,000 (later reduced to 100 in order to expand the coverage of holders) for 91 days and at fixed discount; that subscription would be accepted from the general public, and only through licensed banks in Lagos (later spread throughout the country), that the issues would be monthly (later made fortnightly, and weekly) and that the total outstanding at any time should not exceed 10 per cent of the federal government estimated revenue for that financial year (the 1970 amendment-Treasury Bill Act, 1970, raised the maximum to 150 per cent of the estimated revenue retained by the federal government, and the gross revenues of all the state governments). The CBN absorbed those not taken up by other institutions-providing for rediscount at par.

The main investor in TBs is the commercial banking system and this is partly related to the fact these bills form part of the

assets statutorily specified for liquidity ratio purposes. In April 1960, TBs were first issued to the tune of 18 million. By the end of 1995 total issues amounted to 88,103.3265 million.

3.2.2 Treasury Certificates (TCs)

These are similar to TBs but are issued at par or face value and pay fixed interest rates. These fixed interest rates are called coupon rates. Thus, each issue promises to pay a coupon rate of interest and the investor collects this interest income by tearing coupons off the edge of the certificate and cashing the coupons at a bank, post office, or other specified federal offices. Each coupon is imprinted with its naira value and the date it is eligible to be cashed. They mature within a year from the date of issue. In the Nigerian context, their rates became market-determined like TB rates following interest rates deregulation.

Thus, treasury certificates are medium-term government securities which mature after a period of one to two years and are intended to bridge the gap between the Treasury bill and long-term government securities. They were first issued in 1968, at a discount of 4 per cent for one-year certificates, and 41/4 percent for two-year certificates. Like treasury bills, treasury certificates are eligible for rediscounting at the CBN. It is popular with banks which use the opportunity of their use to diversity their asset holdings. Because of its buoyant oil revenues, the government declared in the 1975-76 budget speech that no new certificates would be issued and that

outstanding issues would be retired as they mature. Due to dwindling oil revenue of the 1980s, the decision had to be reversed. The maiden issue of the instrument amounting to ₦29 million was over-subscribed by the commercial banks by ₦24.0 million. At the end of 1987, treasury certificates outstanding had risen to ₦654.1 million (and only ₦639.1 million issues) but reaching ₦6.944 million in 1989. By 1990, it stood at ₦34,214.6 million, rising to ₦36,584.32 in 1993, ₦37,342.7 million in 1994, but declined to ₦23,596.5 million. In 1995, it averaged ₦392302 million. The main holders of treasury certificates are the commercial banks with CBN ranking second.

Assessment Question: *What is the function of call money fund scheme?*

3.2.3 Call Money Fund Scheme: Money at Call or Short Notice

This refers to money lent by the banks on the understanding that it is repayable at the bank's demand, or at short notice (eg. 24 hours or overnight). It used to be lent at relatively low rates of interest to financial firms and institutions that use it to finance their everyday business.

Overnight loans between commercial banks arise when banks hold reserves in excess of the minimum amount that the Central Bank requires all banks to hold. They are simply bank reserves that are loaned from banks with excess reserves to banks with insufficient reserves. One bank borrows money and pays the overnight interest rate to another bank in order to

obtain the lending bank's excess reserves to hold as one day deposit. The borrowing bank needs these one day deposits in order to acquire the legal reserves the CBN examiners require banks to maintain.

They act as a cushion which absorbs the immediate shock of liquidity pursuers in the market. In 1962, the call money fund scheme was introduced in Naira. Under the scheme, a call money fund was created at the CBN and the participating banks had to agree to maintain a minimum balance at the CBN. And surplus above the minimum balance was then lent to the fund. The CBN administered the fund on behalf of the banks and paid interest at a rate fixed somewhere below the treasury bill rate. The CBN then invested the funds in treasury bills.

Initially limited to the banks, but later extended to other financial institutions, the call money scheme proved very popular. In addition to earning interest for the banks, it acted as a cushion absorbing immediate liquidity pressures on the marker. A noticeable feature is that the funds employed in the market exhibited a definite pattern, usually rising during the first half of the month and peaks around mid-month, but reducing thereafter at month ends. This follows the monthly salary and wage payments cycles. Thus banks pressed for cash balances towards month's ends for salary and wage payments, drew down their balances in the fund, and began to build them up from early in the month as the cash payments travel back to the banking system. The scheme was abolished in 1974, due

to buoyant oil revenue of the federal government, consequent upon the oil boom. By 1970, investments in treasury bills under the call money fund scheme had averaged ₦12.7 million monthly, but in 1973, outstanding investment in the fund averaged ₦15 million monthly compared with ₦5 million in 1963, the first full year of its operation.

3.2.4 Commercial Paper or Commercial Bill

These are short-term promissory notes issued by the Central Bank of Nigeria, and their maturity vary from 50 to 270 days, with varying denominations (sometimes ₦50,000 or more). They are debts that arise in the course of commerce.

Commercial papers may also be sold by major companies (blue-chip, well-known, national companies) to obtain a loan. Here, such notes are not backed by any collateral; rather, they rely on the high credit rating of the issuing companies. Customarily, issuers of commercial papers maintain open lines of credit (i.e. unused borrowing power at banks) sufficient to pay back all of their commercial papers outstanding. Issuers operate in this form since this type of credit can be obtained more quickly and easily than bank loans.

In the Nigerian context, there were two forms of commercial bills the Ordinary Trade Bill and Marketing Board Bills. The ordinary trade was drawn by ordinary reputable commercial firms and accepted by a bank or acceptance house and secured on stocks of manufactured goods or other stocks in trade. But these were note eligible for rediscount at the CBN and hence,

not popular with banks, except when secured on export produce. The Marketing Board Bills originated with the inception of the Bill Market Scheme in 1962. Under that scheme, the Marketing Board met its requirements forecast by drawing a 90- day commercial bill of exchange, supported by a sales contract on the Nigerian Produce Marketing Company Limited, the then sole exporter for all the Marketing Boards (now disbanded). Upon acceptance by the company, the Board then rediscounted the bills with the participating commercial banks and accepting houses, which, if they chose, could rediscount the bills with the CBN. Three separate consortia of banks and other financial institutions operated the scheme for the three marketing boards; and at the height of the scheme, nearly all the commercial banks were involved.

The scheme provided adequate credit for the marketing of the crops concerned and provided a vehicle for short-term investment. However, the scheme began to crack in 1964/65 cocoa crop season and other members of the Cocoa Producers Alliance withdrew from the World Cocoa Market, in an effort to get the cocoa produce manufacturers to raise the price of cocoa to at least ₦380 per ton. With the withdrawal of sale contract, finance was no longer available. In 1968 the CBN took over the responsibility for Marketing Board crop finance and hence, the demise of the bill market. What remains today of the commercial paper market, following the disappearance of produce bills, are import and domestic trade bills.

By 1968, commercial paper outstanding was ₦5.1 million, from ₦36.4 million in 1967. However in 1989, commercial paper outstanding averaged ₦868.8 million. Between 1990 and 1995, it averaged ₦2219.05 million with a high of ₦5,252.5 million in 1993, and a low of ₦953.4 million recorded in 1990.

3.2.5 Certificates of Deposits (CDs)

These are inter-bank debt instrument meant to provide outlet for the commercial bank's surplus funds. It was introduced in Nigeria by the CBN in 1975. it was also meant to open up anew source of funds for the merchant banks who are the major issuers. Two types of certificates of deposit are the negotiable and the non-negotiable certificate of deposit. Negotiable Certificate of Deposits (NCDs) has a maturity range of between 3 and 36 months, and wholesale unit issue of not less ₦50,000. Those maturing within 18 months are classified as liquid assets, and are eligible for the purpose of satisfying the liquidity ratio requirements. They are also rediscount able at the CBN.

In addition, they are claims to specified sums of money deposited with a merchant bank named on them, i.e., they are receipts from merchant banks for a deposit of 50,000 or more, with certain provisions attached. The banks issuing the NCDs are said to have bought deposit' by selling CDs' with high interest rates ,in order to induce large depositors to make cash

deposits not to be withdrawn from the banks before some specific date. Usually 3 to 36 months.

In Nigeria, in most cases, they are issued to fellow-bankers within that maturity period, as one of the deposits they accept. The non-negotiable certificates of deposits (NNCDs) on the other hand, are issued in denominations ranging between ₦1,000 and ₦50,000, and are normally held till maturity.

Whereas interest charges on NCDs were by negotiation, rates on NNCDs complied with the rate of interest of deposits as stipulated from time to time by the CBN (before August 1987 when interest rates were deregulated). The CDs outstanding by 1989 averaged ₦2,079.2 million while it averaged 590.15 million between 1990 and 1995. The decline in average is due to the steep decline in the value of this money market instrument between1992 and 1995 when it declined to a mere ₦15.2 million in 1994.

3.2.6 Bankers Unit Fund (BUF)

This was introduced by the CBN in 1975. Initially, it was meant to mop up excess liquidity in the banking system. It was also designed to smoothen the. market for federal government stock. To this end, commercial banks' holdings of the stocks are accepted as a part of their specified liquid assets and are repayable on demand. Under the BUF, federal government stocks of not more than 3 years to maturity were thus designated "Eligible Development Stocks" (EDS), for the purpose of meeting the banks' specified liquid assets

requirements. This placed banks in a position to earn long-term rates of interest on what is essentially a short-term investment. Though, initially designed to mop up excess liquidity in the banking system, by conferring on instruments cash-substitute status repayable on demand or acceptable in meeting reserve requirements, the capability of the banks for credit expansion was unaffected.

In effect, the BUF was intended to provide avenue for the commercial and merchant banks and other financial institutions to invest part of their liquid funds in a money market asset linked to federal government stocks. Participants in the scheme invest in multiples of ₦10,000, and the fund is in turn, invested in available government stocks of various maturity periods. The operation of the scheme was subject to the availability of stocks. Interest is payable every twelve months, from the date of initial investment of funds in the scheme (Onyido, 1986). At the end of 1975, total CDs BUF and EDS outstanding stood at ₦49.8 million, constituting only 5.1 per cent of total money market assets then. This went up to ₦258.2 million in 1985. However, in 1989, BUF alone outstanding averaged ₦3.9 million, while EDS outstanding averaged 23 million. However, by September 1988, BUF ceased to be used as a money market instrument, following divestment by the investing banks in the instrument, in the wake of the squeeze on their liquidity, occasioned by the transfer of government accounts from these banks to the central bank. While EDS (government development stock of

not more than three years to maturity designed for purposes of meeting specified liquid asset requirement) were dropped out of the portfolios of the merchant banks that invested in them in April, 1991.

3.2.7 Stabilization Securities

These were issued since 1976 by the CBN, ideally to mop up idle cash balance of participating banks. Participation was mandatory for banks with saving deposits of ₦50 million and above. The amount they are required to invest in stabilization securities is fixed at 50 per cent of the increase in savings deposits over the level of the preceding year. The savings deposits relate to individual accounts not exceeding ₦20,000 each. In 1976, when the scheme was introduced, interest rate paid was 4 per cent per annum and revised to 5 per cent by 1979.

Assessment Question 2: *In what ways and means does the federal government grant advances?*

3.2.8 Ways and Means Advances:

Section 34 of the CBN Act 1958 (Cap. 30 as amended 1962-1969),empowers the CBN to grant temporary advances in the form of ways and means to the federal government up to 25 percent of estimated recurrent budget revenue. Ways and means advances averaged about ₦i million yearly between 1960 and 1962. The federal government did not use this facility from 1963 to 1966, except on two occasions only, in

December 1963, and January 1966, when relatively small amounts of ₦400,000 and ₦240,000 respectively were borrowed.

However, the financial pressures arising from the prosecution of the civil war led to increased use of the instrument by the government. Therefore, from ₦1.9 million in 1967 ways and means advances rose to a monthly average of ₦44.5 million at the end of the war in 1970. The instrument was not use between 1971 and 1976, following government's unprecedented revenue from oil. However, the reemergence of financial pressures in 1977 led to the rise in ways and means to a hard-core level of over ₦1 billion in 1977, and 1978. By 1979, way and means advances outstanding was ₦65.4 million, while the average monthly amount outstanding in 1987 was ₦739.9 million, rising to ₦5,278.0 million in 1988, and to ₦5,794.4 in 1989. It rose again to a monthly average of ₦17,791.4 million in 1991, ₦21,701.2 million in 1992, 43,065.3 million in 1993, but declined to ₦3,925.2 million, and further to ₦24,970 million in 1994 and 1995 respectively, reflecting an average of ₦29,355.96 million between 1991 and 1995.

4.0 CONCLUSION

The performance of the money market in Nigeria can better be assessed within the framework of the objectives for its establishment, or the functions it is expected to perform on the Nigerian economy. In this regard, the achievement of the Nigerian money market is not too impressive. This is because there still exist much idle funds in the

economy, although chief among its functions is that of borrowing and lending money of short-term funds and, hence promote an efficient allocation and utilization.

5.0 SUMMARY

The money market is a market where money instruments are bought and sold. It is a market where short-term securities are important. The market is, therefore, important for governments and institutions in need of short-term funds and suppliers of short-term funds, who, because of the character, maintain part of their assets in relatively liquid form. To carry out its functions successfully, the money market in Nigeria employs four major instruments. These are: treasury bills, call monies, treasury certificates, and commercial bills.

The Nigerian money market has grown both in the number and value as a result of money market instruments that were introduced during the period 1960-1998. The commercial banks and the other providers of short-term funds now have a local investment outlet for their funds, and this has helped them to check the outflow of funds to foreign banks.

6.0 TUTOR-MARKED ASSIGNMENT

Does the money-market play any significant role in the economic development of Nigeria?

7.0 REFERENCES/FURTHER READING

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Unit 2: THE NIGERIAN CAPITAL MARKET

CONTENTS

1.0 INTRODUCTION

The capital market is a market for the mobilization and utilization of long-term funds for development. The instruments traded in the market include: government securities, corporate bonds and shares (stocks) and mortgage loans. The market consists of an inner capital market (market for new securities) and the outer capital market (not directly concerned with the issue of new securities, but engaged in the business of long-term borrowing and lending, upon which the issue of new securities depends). The capital market embraces therefore, both the new issues (primary) market and the secondary (seasoned securities) market. Participants in the Nigerian capital market include: the Nigerian Stock Exchange (NSE), discount houses, development banks, investment banks, building societies, stock broking firms, insurance and pension organizations,

quoted companies, the government, individuals and the Nigerian Securities and Exchange Commission (NSEC).

2.0 OBJECTIVES

After going through this unit, the student should be able to:

a. Explain the functions of the Nigerian Stock Exchange

b. Differentiate the primary market from the secondary market

c. Analyze the development of the Nigerian Capital Market

d. Explain the functions of the Securities and Exchange Commission.

3.0 MAIN CONTENT

3.1 The Nigerian Stock Exchange (NSE)

The stock exchange is a market where those who want to buy or sell shares, stocks, government bonds, debentures, and other approved securities, can do so (though only through its members (stockbrokers). The NSE thus provides the essential facilities for companies and government, to raise money for business expansion and development projects (through investors who own shares in the companies), for the ultimate economic benefit of the society. Such securities traded openly at the SE, refer to documentary evidence of ownership of entitlement to claim upon the assets of the issuing organization, which may be a government, quasi-government institution or agency, or a business firm.

The Nigerian Stock Exchange (NSE) earlier called the Lagos Stock Exchange (LSE), was registered on 1 March, 1959, incorporated on 15th September 1960, and started business on 5th June, 1961. In December 1977, its name was changed firm the Lagos Stock Exchange to the Nigerian Stock Exchange (NSE), and additional branches were opened in Kaduna and Port-Harcourt, in order to meet the aspirations of the users of its services.

The major functions of the NSE include:

- providing appropriate machinery to facilitate further offerings of stock and shares to the general public;
- Promoting increasing participation by the public in the private sector of the economy; and
- Encouraging the investment of savings, as soon as its is clear that stocks and shares are readily available.

Like all stock exchanges, the NSE is made up of many markets, including a market for new issues (primary market), market for existing securities (secondary market), and markets for debt securities and equities. There are in fact, markets for each of the sectors of the economy.

3.1.1 The Primary Market

The market is concerned with the offering of new issues or the initial insurance and sale of securities in the NSE. Previously quoted companies can seek expansion funds through the issuance of supplementary securities in this market while 'new' companies (companies not hitherto quoted on the exchange) will have to go

public before they can issue sell securities to the public through the market. Types of instruments/securities issued in the primary market include: debt instruments (comprising federal government development stocks (FDSs), and industrial loans, preference stocks and bonds issued by corporate concerns), and equity capital (ordinary share of corporate entities which confer upon the holder some ownership rights to the business concern).

3.1.2 The Secondary Market

The existing issues or secondary market, in a strict sense, constitute the stock exchange, since it is the mechanism which gives liquidity to the securities listed on the exchange.

The Second-Tier Securities Market (SSM)

The Second-Tier Securities Market was established on 30th April, 1985, to assist small and medium-sized companies that are unable to meet the requirements of the first-tier market (NSE) in raising long-term capital. To encourage the development of the SSM, the stringent conditions for enlistment in the first-tier market were relaxed for indigenous enterprises seeking to raise funds through the SSM. The simplified listing requirements, which constituted the basic distinguishing features of the SSM, were that prospective companies should:

- Have a three-year trading record, instead of the five years required for full listing at the NSE;

- Thereafter, submit audited half-year and annual statements, without the quarterly statement required for listing in the first-tier market;

- Make at least 10% of their equity available for public subscription as against the 25% minimum required for full listing;

- Have not less than 100 shareholders, compared with the 500 prescribed minimum for full listing in the NSE;

- Make flat annual subscription of 2,000 to the stock exchange, instead of the graduated annual quotation fees based on the company's share capital in the NSE; and

- Raise a maximum sum of 5 million in the market, whereas there is no limit to the amount that could be raised in the NSE.

Assessment Question 1: *Discuss the role of the Nigerian Stock Exchange?*

The Nigerian Securities and Exchange Commission (NSEC)

It is the responsibility of the Nigerian Securities and Exchange Commission to determine, among others:

- The price at which shares or debentures of a company are to be sold to the public, either through offer for sale, or direct issue;

- The timing and amount of sale; and

- In the case of a quoted company, the price, amount and time any subsequent or supplementary offer of shares or debentures are to be sold.

However, only public companies (quoted or unquoted) fell within the sphere of the NSEC. In other words, private companies were not obliged to seek the approval of the NSEC before raising funds through the securities market.

In 1976, following the realization of the need for an apex capital market regulatory body, the Financial System Review Committee recommended the establishment of the Securities and Exchange Commission. The commission was later established by the Securities and Exchange Commission Act of 27 September,, 1979 (effective retrospectively from April 1978), with an autonomous and legal status. As an apex regulatory body, the NSEC was legally empowered to ensure:

- That resources are allocated into their most efficient and profitable uses, That is, to accelerate the use of capital by helping to increase the amount of domestic savings flowing into productive investments;

- That, investors are protected from fraud and deceit and hence instill the confidence needed for orderly growth and development of the market. This implies the regulation of the Nigerian Stock Exchange, stock brokers, issuing houses, and employees;

- The easy transfer of securities by removing bottlenecks which may breed inefficiencies and impair impair the possibility of adequate liquidity, so that funds may freely find their way into productive channel vital for economic and industrial development; and

A wider spread distribution of equities by discouraging the concentration of securities in a few, but powerful hands.

These are in addition to the usual functions of the commission such as, determining the amount of and time at which securities of a company are to be sold to the public, and registering all securities proposed to be offered by the public, etc.

Self Assessment 2: *Outline the development that has taken place in the Nigerian capital market.*

3.2 Developments In The Nigerian Capital Market

The finance and insurance sector is one that has experienced about the highest growth in the Nigerian economy, especially after the introduction of the Structural Adjustment Programme (SAP). This has had positive and far reaching implications on the activities of the capital market in Nigeria.

The total number of securities transacted in the capital market (both first and second-tier) was 334 in 1961. Of this, government securities was 92, while industrial securities was 242 (72.5% of the total). In 1965, the total number of transaction had increased to 1,018 (204.79% over the 1961 figure). Of this, industrial securities still dominate with a percentage share of 61.6.

The number of transactions, however, dropped in 1970 to 643 (47.8% of which were government securities). Again, the value of total transaction in the year was N16.6 million (with government though more in number were valued at only (98.78%). Industrial securities though more in number, were valued at only 0.2 million.

Developments in the markets in the 1970s, however, witnessed a steady growth in the number of value of industrial securities traded vis-a-vis government securities. In 1974 for example, the number of industrial securities was ₦2,807, as compared to 256 for government securities. Although these still had a relatively small value of ₦1.3 million compared to ₦49.4 million for the latter. From 1976, however, the share of industrial security in both number and value of transactions, increased tremendously, (from 97.0% and 2.03% for 1990, to 97.31% and 3.29% for 1985, and 98.85% and 11.11% respectively in 1987). Also, the total number of transaction in the capital market increased steadily, growing by 91.6% in 1980 and 97.7% in 1995.

4.0 SUMMARY

The capital market is seen as the institutions and mechanisms whereby intermediate and long-term funds (loans of longest maturity, government and company stocks), are pooled together and made available to businesses, governments and the individuals, and also through which instruments already outstanding are transferred through the capital market.. Funds raised by businesses and individuals are invested in fixed assts and inventories. It is also through the market that new capital, by offer of new securities, is made available to the public.

5.0 CONCLUSION

With the present move at sanitizing the Nigerian financial system, given the rate of growth of the financial and insurance sector, it is obvious that the capital market in Nigeria has yet a greater role to play in the promotion and channelling of investment into productive activities, with greater growth effect on the economy, and in the growth of indigenous enterprises in the country.

6.0 TUTOR-MARKED ASSIGNMENT

In the Nigerian capital market, the major participant is the Nigerian Stock Exchange (NSE). Discuss the role of NSE in the economic development of Nigeria.

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Unit3: COMMERCIAL BANKING IN NIGERIA

CONTENT

INTRODUTION

The word bank is derived from the Italian word bank-meaning bench. This word has carefully been elected because; the Jews in Bombay who were the early bankers conducted their business at benchers in the market place. However, as a form of financial institution, the commercial banks otherwise known as joint stock banks act as an intermediary body between those who are in need of fund and those who have surpluses. But its function does not end at only accepting deposit from the public and giving out advances to the public.

More so, they provide other functions which include, discounting bills of exchange, act as customer's agents in buying or selling of stocks and securities. Also, they obtain foreign currency for customers and they issue bank drafts, traveller's cheque, etc. You should be informed that the relevance of these services provided by the commercial bank should be emphasized because the development of the economy of a country depends strongly on the efficient performance of its commercial banks as one of the financial institution.

Objectives

- *Describe* the development of Commercial Banks in Nigeria
- *Explain* what are Liquid assets and Cash assets.
- *Discuss* how commercial Banks utilize the deposits from the public
- *Explain* the changing structure of ownership of Banks
- *Highlights* the features and problems of Commercial Banks in Nigeria.

1.0 MAIN CONTENT

1.1 Development of Commercial Banking In Nigeria

The historical evolution of the commercial banking in the country has passed through different major era.

The first era could be regarded as the free banking era. It was the era of monopoly of foreign banks. The first characteristic was the absence of any banking legislation. Before 1952, anybody could set up a banking company, provided he registered under the companies' ordinance. The second feature was that it was this period the three biggest foreign banks and the two largest indigenous banks were established. Commercial banking activities began in 1894 when the Bank of British West Africa, now First Bank of Nigerian Plc. began operations. For the next two and a half decades, this bank pioneered the development of banking in Nigeria until it was joined in 1917 by Barclays Bank, now Union Bank of Nigeria PLC. The third feature of commercial banks during the period was that of an indigenous banking boom.

However, beginning in 1929, indigenous entrepreneurs began to make forays into the banking sector by incorporating and establishing formal banking institutions. In the thirty year 1929 to 1959,25 of these banks were established. A number of factors contributed to this development. The initial impetus could have derived from the attempt to redress the discrimination suffered by indigenous entrepreneurs from the foreign banks. By 1954, of the 23 banks established only 3 were still operational. The remaining 20 had failed with an average life span of less than 3 years.

Of the three established between 1958 and independence in 1960, only one survived to give a total of four survivals out of the 26 banks chartered during this period. The four surviving banks are:

- National Bank of Nigeria Limited
- Agbonmagbe Bank (Now Wema Bank PLC)
- Africa Continental Bank PLC
- Bank of the North Limited

There is one common feature among all the four survivors, namely ownership by Regional/State Governments. In fact, it was the lifeline of support from the three Regional governments that guaranteed the survival of these banks.

In this regard, the Central Bank Act of 1958 has been enacted to control the activities of banks and to specify entry conditions. The 1972 Nigerian Enterprises promotion Decree amended the 1977 Decree. Here, banking was classified under schedule 2 of the Decree, under which at least 60% of the equity of such enterprises must be Nigeria-owned. At the same time Government decided to take control of certain critical sectors of the economy including banking, insurance and oil sectors.

Until 1991, the guidelines for establishing a bank required that within the minimum 60% equity for Nigerians, no single individual could own more than 5%.

That, in effect means that for joint partnership between Nigerian and foreigners at least a minimum of 12 Nigerians were needed to form a bank. For a fully owned Nigerian bank the minimum numbers of individuals is 20.

More so, the guidelines required a wide geographical spread of Nigerian shareholders to reflect the country's diverse ethnicity. The ownership structure recently has been subject to changes.

Assessment Question 1:*Can you say that the ownership structure change had effect on the banking industry?*

1.2 Implications of the Changing Structure of Ownership

1. Response of Foreign Shareholder

The immediate result of indigenization Decree of 1977 was transfer of 60% ownership of the foreign banks to Nigerians. The transfer of management was more gradual but one could safely say that today. Nigerians have full control of the management of most of the banks operating in the country.

However, there was backlash effect, with the loss of control, there emerged a withdrawal attitude among the foreign banks that still persist today. A gradual flight of good experienced personal followed and the Nigerian banks no longer enjoyed the favoured treatment of being full subsidiaries of these foreign banks. This must certainly have had some effect on efficiency and optimum growth.

2. Attitude of Government

The Nigerian experience in indigenization of the banking sector has some element of uniqueness. In most cases, indigenization and nationalization lead to the use of the banking system as a means of implementing monetary policies or Government objectives that does not seem to be the experience in Nigeria. In fairness, the Government has shown the least conflict of interest in its position as both the regulator and major shareholder in many of the banks. Its monetary policies and regulations on the banking industry have regarded the banks as private sector operators in a commercial setting. Government control of the banking industry could be more optimal and effective if it relinquishes the role of shareholder, especially in non-development banks.

3. Quality of Assets

Before indigenization, banks took any short-term positions in their lending portfolio to reflect a similar tenure in their deposits. The effects of indigenization seem to have changed that focus. The banks were sort of transformed to developmental roles and they started taking long-term lending positions. This orientation was subsequently backed-up by CBN guidelines stipulating certain minimum maturity for certain proportion of a bank's risk assets. While it was easier for the commercial banks to sustain this position, it was more difficult for the merchant banks.

4. Quality of State-Owned Banks

The poor position of some state owned banks derived partly from the structure of ownership. By and large, privately owned banks seem to have lesser problems of management. In the past some state governments have, for instance, used their banks as extension of their treasuries. This ownership structure has also imposed constraints on the part of the CBN to deal promptly and decisively with erring state banks until a crisis situation of possible insolvency is reached.

5. Instability in Management

One effect of Government ownership of banks both at the federal and state levels is the instability in the management of these banks. Since the Nigerian Directors include those with Executive responsibilities of these banks are appointed by the Government, they have become politicized and the influence of lobbying and pressure groups on such appointments is becoming increasingly manifest. The attendant insecurity in job tenure arising from this situation no doubt has negative impact on the management of these banks.

1.3 Role of Commercial Banks In Nigeria

You can divide the functions of the commercial banks into two broad groups.

- The money creation function and
- The service rendering function.

The money creation function is undertaken not only to satisfy the customers but also because it enable the banks to get some returns on the money deposited with them by their customers. A number of factors affect the extent to which an individual bank can create credit.

These are:

- The amount of deposit that is made with the bank (the greater this, the more the credit creation capacity of the bank):
- The limitation imposed by legal reserve requirements.
- The volume of demand for currency of cash by the public (an increase in currency requirement of the community would mean a reduction in cash of the banking system and therefore in its ability to create credit) and
- The extent of credit created by other banks in the banking system.

The service functions of commercial banks include the following:

- The collection of cheques, drafts, notes and other obligations for their customers;
- The provision of facilities for domestic and foreign remittances;
- The provision of savings services, and the provision of facilities for the safekeeping of valuables.

Besides these functions, the commercial banks have performed useful functions in the country which include the following:

- They have extended credit to the group of people that the expatriate or mixed banks would not have been able to cater for.
- They have contributed to the development of potential depositors and banking habit by extending banking facilities to urban and rural districts.
- The indigenous banks have large portfolios of local securities and, therefore, have reduced the colonial practice of repatriation of all in vestibule funds to the money and capital markets in London.
- The aggressive mobilization of domestic savings through direct contact with the people has contributed significantly to the pool of funds available to national development.
- They have developed local entrepreneurship.
- They have provided employment opportunities for many Nigerians.

Assessment Question 2: *How do commercial banks utilize the funds generated from the public?*

1.4 Utilization of Funds By The Commercial Banks

The commercial banks try to reconcile their liquidity with their profitability drive. In doing this, they collect funds from the public. There are two major sources of funds. Capital and Reserves, and deposits. The capital and reserves of commercial banks in Nigeria rose considerably since late 50's, from a little over 1 million in 1958 to over N200 million by 1977. There are quiet a good number of factors that were responsible for this shut-up. These include: The fact that the capital and reserves requirement were applicable to only the indigenous banks initially, changes and/or increase in the capital and reserve requirements over time, the increase in the number of banking institutions, the increased in economic activities in the country.

Capital and reserves of commercial banks provide funds for fixed assets and the performance of such functions as meeting the statutory requirements; acting as a confidence booster to the public and providing cushion against risk. Deposit on the other hand provides the working capital. The two types of deposits with commercial banks are demand and time deposits. Thereafter, 1970 the increase has been due to a number of factors among which are:

- Increase in money supply
- Increasing oil revenue to finance development plans,
- Wages and salaries payment under the Udogi awards.

- The deregulation of the economy under the Structural Adjustment Programme (SAP).

The funds derived by the banks are used to acquire assets. These assets could be classified into two broad categories:

1. Liquid Assets

Liquid assets are made up of cash, money at call, and bills discounted. Cash includes cash in hand (i.e. at the coffers of the banks) and balances at the central banks. The cash asset serves two functions. Firstly, it is used to meet depositors and lenders' cash requirements. The need for the latter is great in Nigerian because most of the transactions in the economy are done in cash and money borrowers prefer to get cash.

2. Cash Asset

The importance of cash asset is that it enables banks to affect their clearings at the central bank. The cash asset does not earn any income.

Self Assessment Question 3: *Explain the difference between Cash assets and Liquid assets.*

Money at call serves as a first line of defence against cash shortages. Therefore, if banks are hard pressed for cash, their next line of action invaluably is to draw on money at call. This is money lent to the borrowing institution from overnight to about seven days and that is repayable on call. Thus, it is almost as liquid as cash. However, unlike cash, it earns some interest. Call monies used to be invested in Treasury Bills. However, the scarcity of bills made the central Bank abolish the call money scheme in 1974.

Bills discounted serves as the second line yield income but usually at a rate lower than that earned by money at call.

The other categories of assets (less liquid or hard) are investments, which banks make mainly to meet profit expectations of the shareholders. They are usually made in investments and loans and advances. The latter constitutes the biggest component of the hard assets. They are the most profitable in the most liquid of bank's assets. It is important to add that, in spite of their high profitability their relative obliquity coupled with bank's concern for their depositors and lenders makes banks reluctant to invest all their funds in loans and advances.

2.0 CONCLUSION

As at the end of 1990, the federal government's equity participation in the 58 commercial banks was 12.6% state governments, 24.5%. Private shareholders, 47.5% and foreigners,! 5.4%.

The banking sector shows a mix of government, private sector as well as foreign participation, in terms of ownership. Although foreign participation remains significant it is however, no longer dominant.

However, there is cause for concern in view of the increasing rancour and discord that have characterized the indigenous new banks. There is also the issue of who owns which shares.

It is therefore on this note that the well-meaning Nigerian looks up to the regulatory activities to instil discipline and ensure a sound and virile banking industry in Nigeria.

It is widely held that the soundness of any institutions is a reflective of the effectiveness of its management. Thus, effective Boards and managements are indispensable in ensuring safe, sound and efficient banking practices that will foster the expected role of the banking industry in our economic development.

3.0 SUMMARY

Commercial Banks refer to the joint stock banks which are financial institutions that enhance the economic development of Nigeria. The numbers of commercial banks have grown phenomenally over the last two decades. Several factors account for the rapid expansion of commercial banks over this period. Amongst these factors are:

- Indigenization policy and The oil boom
- Perceived increased awareness of the need for banking by the populace
- Higher profits declared by existing banks etc

However, the commercial banks act as vital catalyst of Nigeria's economic development by:

- encouraging saving
- providing capital needed for development
- encouraging trading activities through making the use of cheque possible
- encouraging investment by providing direct loan to government and individuals for investment purpose

4.0 TUTOR-MARKED ASSIGNMENT

The commercial banks in Nigeria act as a vital catalyst for economic development. Discuss.

5.0 REFERENCES/FURTHER READING

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Unit 4: CENTRAL BANKING AND THE NIGERIAN ECONOMY

CONTENT

1.0 INTRODUCTION

In discussing the various financial institutions in a country, it should be noted that the apex bank in the financial system is called the Central Bank. The name differs from one country to another. In India it is called the Reserve Bank of India, the Bank of England in England, the Federal Reserve System in America, the Bank of France in France, the Risk bank in Sweden etc, while in Nigeria it's known as the Central Bank of Nigeria. A Central Bank is basically different from a commercial bank. The central bank does not engage itself in ordinary banking activities like accepting deposits and advancing loans to the public. It does not aim at making profits like the commercial banks. The issue here is what the central bank rather does is aimed at controlling the commercial banks and implementing the economic policies of the government. The central bank is generally owned by government and is managed by government officials or those who are connected with the government. But the commercial bank is owned by shareholders like any other joint stock company. It is worthy to note that every country has only one central bank with only few offices.

2.0 OBJECTIVES

After going through this unit, you should be able to:

Explain the reasons for establishing the Central Bank of Nigeria?

Identify the functions of the Central Bank of Nigeria, and examine its

role in the economic development of the nation.

2.0 MAIN CONTENT

2.1 Evolution of the Central Bank of Nigeria

The establishment of a workable monetary system including the basic fundamentals of credit system and central bank is an essential condition for economic growth in any country. In Nigeria, just like other countries that were formerly under colonial masters, the establishment of the central Bank was regarded as the outward

symbol of attaining monetary independence. With the establishment of the Central Bank of Nigeria on July L 1959, the stage was set for a new era. The Act establishing the Central Bank of Nigeria endowed it with a number of functions among which are: **the right to issue legal tender in Nigeria; the maintenance of *external reserves* in order to safeguard the *international value of currency* and the maintenance of the commercial banks *minimum liquidity ratio.*** Like the old Currency Board, the Central Bank of Nigeria is the mains issuer of currency for the whole economy. The bank can, for example, expand or decrease the currency in circulations without any corresponding increase or decrease in the external backing of the currency. The Bank can also, through a number of policy measures, change their lending policies by controlling deposits which, together with the currency in the hands of the public make up the money supply. The central bank influences the activities of the commercial banks. **Self Assessment Question 1**: *Do you think the CBN plays any fundamental role in the economic development of the country?* **The Role of The Central Bank of Nigeria (CBN)**. Since its establishment in 1958, the objectives of the CBN have remained broadly the same, but the strategies for achieving these objectives have changed in consonance with the varying legal, institutional and macro-economic environment. The various amendments of the CBN Act of 1958 and the Banking Decree of 1969 tended to erode the authority of the CBN with regard to the execution of its primary mandate. However, the CBN Decree No 24 of 1991 and Banks and other financial institutions Decree (BOFID) No. 25 of 1991 which replaced the previous attempt to strengthen the bank's supervisory role in response to the widened scope of its activities and financial sector forms initiated since 1986. It is noteworthy that the CBN Decree of 1991 gave presidency in contrast to the practice, through the minister of finance. However, these practices have been reversed.

a) Owing to the rapid structural growth of the financial sector in the last three decades, the bank has modified the nature and style of its surveillance. It has systematically developed policy instruments more relevant for a market-based financial sector. The Bank's size and structure have also witnessed a corresponding growth; and

b) The Nigerian economy has recorded vast structural changes; economic management moved from reliance on control mechanisms in the late 1960s and up to 1985 to a system of deregulation between 1986 and 1993 and back to control in 1994. Presently, it had to revert to the system of deregulation. The banks response has influenced its operations appropriately through the establishment of the relevant bureaucratic structure and technologies.

3.2 Functions of The Central Bank

The functions of the Central Bank of Nigeria can be broadly classified into two categories, namely, service and issuing of legal tender currency, and being both banker and adviser to the government. By status, the central of Nigeria is the sole bank of issue in Nigeria. The Bank issued the first national currency in 1959, hence, replacing those earlier issued by the West African currency Board that was in existence before the establishment of the central Bank. The civil war led to the change of the 1959 notes in 1968. Finally, in order to conform with most monetary standards the world over, the decimal currency was introduced in 1972.

To this end, the central bank has taken over the banking business of the federal government and has been providing banking to state governments and state owned agencies. The central bank can make ways and means advances to the Federal Government up to 25% of its estimated current revenue. It can hold Treasury bills and Treasury certificates up to 15% of estimated revenue of all government (Federal and State) and it can provide long-term loans, by way of long term securities, to the governments.

In its role as adviser to the governments on financial matters, the central bank tries to advice on coordination between the government's financial policy and the main economic objectives within the context of monetary stability. One of the policy functions of the central bank is, thus, that which relates to monetary policy. In this regard, the Bank has responsibility for formulating and executing monetary policy. Its tools are open market operations, the discount rate, the liquidity ratio or reserve requirements, moral suasion and selective credit control.

A second aspect of the policy making function is the bank's exchange rate policy. The central Bank has responsibility for maintaining external reserves in order to safe guard the international value of the country's currency. In order to achieve this, the central Bank keeps custody and manages the country's gold and foreign exchange reserves. The government and others surrender their foreign exchange earning to the bank, which then meets foreign exchange requirements of the governments and the commercial banks.

Self Assessment Question 2: *How does the central bank regulate the activities of the commercial banks?*

3.3 Regulatory Role of The Central Bank In The Nigerian Economy

1. Open Market Operation

These involve the discretionary sale or purchase of government debt instruments in the money market by the central bank. The bank engages in open market operations with a view of regulating the cost (interest rates) and availability of credit and, by so doing, influences commercial banking system credit operations. The sales of government debt instruments or securities are carried out to reduce the liquidity; on the other hand, securities are bought. In an inflationary situation, the central bank can decide to curtail expansion by selling securities in the money market. The impact of this is to reface the cash reserve position on the commercial banking system and thus limit the funds available to the system in carrying out its credit expansion. This cause interest rates to rise, which will discourage investment, lower aggregate spending and result in ameliorating inflationary pressures.

Open market operations have not been effectively used by the central Bank of Nigeria because of the underdeveloped nature of the financial markets. Other reasons include insufficient supply of the necessary securities in the economy and the fact that the interest rates on government securities (forming 90% of money markets) are not variable.

For this instrument to be effective there should be existence of a well-developed financial system, an integrated and interest sensitive financial markets in which the amount of government securities held by banks, private corporation and individuals is large.

2. Rediscount Rate

The Central Bank, as a lender of last resort, stands ready to honour demand for financial accommodation from the commercial banks. In performing this role the Bank takes into account the financial environment and the economic situation in general. Such temporary financial accommodation is generally extended to the banks at the "discount window" of the central Bank. In operating the "discount window", penalties are involved since commercial banks are not expected to resort to it until it becomes absolutely necessary.

Rediscount rate, the cost of this last resort borrowing is very important because changes in all interest rates charged by the commercial banks follow those of the rediscount rate. If the rediscount rate is high, the interest rate charged by commercial banks will also be high, and vice versa. In the advanced and more sophisticated financial markets, changes in the rediscount rate produce important announcement effects in the credits markets. An increase in rediscount rate is an indication to the credit institutions that they should raise cost, hence, restrains credit availability to potential borrowers.

The rediscount rate policy has not played a significant role in influencing the cost and availability of credit in Nigeria. A major limitation to the effectiveness of interest rate charges, as a technique of resource management in Nigeria, arises from the fact that investment decisions are more dependent on the expected rate of returns on investment than on the cost of borrowing. The returns on investment are so high in Nigeria that the restraining rates of interest might be too high for the monetary authorities to contemplate. Although an amendment to the central bank of Nigeria in 1962 required bank lending rates to have a specified and defined relationship with the rediscount rate, the rigidity inherent in the administered structure of the Nigeria interest rates makes rediscount rate an ineffective tool of control.

3. Reserve Requirement

All commercial banks are legally expected to have a certain percentage of their deposit liabilities with the central bank. The bank has the right to raise or lower the ratio depending on its credit policy at a particular point in time. The cash and liquidity ratios are expressed as the ratios between their deposit liabilities and their cash holding and selected liquid assets respectively. The cash ratio was not emphasized in Nigeria until recently. Rather, emphasis was placed, on the liquidity ratio which has, nevertheless, oscillated between 25% and 40% since it was stipulated, although the composition of qualified liquid assets has been veined over time.

The cash ratio is designed to raise or reduce the liquidity of the banking system by determining the level of cash reserve balances (the credit base of the system) which commercial banks should maintain with the central bank.

4. Special Deposit

These are supplementary reserves used to reduce the volume of commercial banks' liquidity when it is fevered that excessive bank cash balances may induce credit expansion. They are made by commercial banks in the central banks and not allowed to be used as base for credit expansion in that they are not allowed to be used as base for credit expansion, in that they are not counted as liquid assets. Generally these deposits earn no interest.

Stabilization Securities, which also belong to the same class of instrument as special deposits, are issued by the central bank to commercial banks at given interest rates, and they serve the same purpose as special deposits, in terms of instruments like special deposits are issued by the central bank to commercial banks at given interest rate, as well as serve the same purpose as special deposits, in terms of squeezing the commercial banks' excess cash holding and restricting their credit expansion. The securities are issued at the discretion of the central bank based on the level of excess cash holdings of the commercial banks as judged by the central bank.

5. Direct Credit Control

By far the most effective technique of control of commercial banks relative to other techniques available has been through credit guidelines. Starting from 1969/70 fiscal year, the central bank has consistently issued guidelines to commercial banks particular in the area of loans and advances to the various sectors of the economy.

Direct credit control involves the imposition of quantitative ceilings by the Central Bank on the overall and/or sectoral distribution of commercial banks' credit. The Central Bank of Nigeria is empowered to fix ceilings on the volume as well as the rate of increase in bank credit, which the commercial bank should maintain from time to time.

It can also prescribe a sectorial distribution of credit with or without a specified rate of credit expansion. An important feature of this instrument is the power to prescribe minimum ratios of loan and advances, which the commercial bank must allocate to the preferred sectors of the economy as opposed to the less preferred ones. This instrument is of great relevance to the economic conditions of Nigeria in which the central bank in co-operation with fiscal and planning authorities is called upon to promote accelerated economic development. The sectorial allocation of credit suffers from the basic defect that funds may be borrowed for one purpose and diverted to other purposes.

6. Moral Suasion

This has been a traditional tool used by the Central Bank of Nigeria inits dealings with its commercial banks. It involves the use of the power of persuasion to influence the lending operations of the commercial banks in the direction desired by the central Bank. No official directive is involved. However, some punishment of measures are observed with this instrument, the governor of the central bank merely uses his position to persuade and appeal to the commercial banks to exercise restraints in credit expansion, under an inflationary situation. The banks normally comply for fear that the central bank may use its statutory powers to force them to behave accordingly. In addition all commercial banks normally want to maintain cordial relationship with the Central Bank of Nigeria.

6.0 CONCLUSION

6.1 Although the challenges ahead are enormous if not daunting, the central bank will respond adequately ifgiven the support to carry out its functions. Its contributions to the economy will be enhanced and its role in creating a robust financial sector will increase. The bank should shed off some of its developmental activities which can effectively be taken over by other agencies. It should focus on its stabilization functions, which can sustain price stability and restore full confidence to the finan3cial sector. If given the autonomy, it should become more effective, efficient and responsive institution, gaining greater confidence of the general public.

5.0 SUMMARY

The Central Bank of Nigerian (CBN) is an institution owned by the government of a nation, run by Board of Directors chaired by a governor appointed by the government (prior to 1997) and charged with the responsibility of managing the expansion and contraction of the volume, cost and availability of money in the interest of the public welfare. In doing this, it is the banker to the government. It controls, supervises, and assists the activities of the commercial banks. Also, it carries out the monetary policy of the country and acts as a lender of last resort to the commercial Banks.

6.0 TUTOR-MARKED ASSIGNMENT

Discuss the policy-making functions of the Central Bank of Nigeria and state how effective it has been carrying out these policy functions.

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MODULE 5

1. **Unemployment in the Nigerian Economy**
2. **Balance of Payment Disequilibrium in Nigeria**
3. **Introduction to Information Technology in Nigeria.**

Unit 1: UNEMPLOYMENT IN THE NIGERIAN ECONOMY

CONTENTS

1.0 INTRODUCTION

Unemployment as a phenomenon, is a situation whereby people who are professionally qualified, able and willing to work are unable to find employment.

This situation presents itself in different ways.

- **Seasonal Unemployment**

A situation whereby people are laid off seasonally due to the nature ofjob they do e.g. agricultural jobs.

- **Technological Unemployment**

- Unemployment caused by technological changes or new methods of production in an industry or business e.g. a non-computer literate accountant may not be able to get a desired job in a bank.

- **Disguised unemployment**

- A situation whereby people take up jobs unrelated to their area of specialization when the job they are qualified for is not forthcoming.

- **Under employment**

- A condition where people are employed in less-skilled jobs than they are qualified to do.

Sectoral Unemployment

- A situation that affects certain professions because of over production of graduates in such areas. This can also happen as a consequence of rural-urban migration.

Up to the early eighties, university graduates had jobs waiting for them on graduation, at times more than one offer. What obtains now is a situation whereby graduates of ten years or more are still seeking for employment. What then went wrong and where?

2.0 OBJECTIVES

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

- *Define* the meaning of the unemployment
- *Identify* the courses of the urban unemployment
- *Discuss* at the government policies towards solving unemployment in the country.

Self Assessment Question 1: *What is unemployment? How does it present itself?*

3.0 MAIN CONTENT

3.1 Causes of Urban Unemployment in Nigeria

The general cause of urban unemployment in Nigeria is the fact that supply of labour is greater than the demand and, therefore, they're in disequilibrium in the urban labour market. The imbalance between supply of labour and demand for labour can be said to be the result of several factors, which

affect both the supply of and demand for labour. Some of these factors are now discussed.

Self Assessment 2: *What factors are responsible for urban unemployment in Nigeria?*

3.1.1 Wage Rate

The classical or the Keynesian analysis of wage rate and unemployment would be sufficient if the rate of unemployment was relatively uniform as between urban and rural centres. But the unemployment problem in Nigeria is mainly urban in nature. In discussing the relationship between wage rate and unemployment, the critical explanatory variable is the wage rate differential between urban and rural workers. Since public expenditures can be regarded in some cases as wage payment in kind, the effective differential between urban and rural workers should take into account the wage effect of public expenditures.

Now, if the rural-urban migration will increase and unless employment Opportunities are created in the urban areas equal to the increased migration, unemployment in urban areas will increase. The Todaro labour migration and employment model seems to explain the Nigerian situation, to some extent. The rural-urban income differential has been in favour of urban workers.

From the above, we may rightly conclude that the increase in the rural-urban wage differential during the 1960s must have contributed to increase in urban and total unemployment during the 1960s, to buttress this, for example, the Adebo Commission found that the average income of fanners ranged from N68 to N144 per annum in contrast to the minimum pay of the urban worker which ranged from between N168 and N216 per annum. Thus the minimum wage for urban workers was found by this Commission to be from 1.5 to 2.5 times the average income of the farmers.

Self Assessment 3*: Does education affect the supply of labour in Nigeria?*

3.1.2 Expansion in Education and the Supply of Labour

The very rapid upsurge in unemployment can be traced, to a very large extent, to the rapid development of primary education which does not give the recipients any skill that could enable them get good jobs. The supply of primary school graduates far outstrips the demand for this category of workers. Unfortunately, only a small proportion of the primary school leavers were absorbed by the secondary schools. For example, according to the Second Plan document, out of an estimated out-run of 240,000 primary school leavers in 1966, only 70,00 could be offered places in secondary schools. A further dropout rate of 400,000 students contributed to the pool of youths who had no skill to offer employers and yet they were in search of wage employment. The supply of secondary school graduates has also been out of proportion with the demand for their labour.

The problem of unemployment among university graduates and high level manpower has begun in the southern part of Nigeria and this is attributable to the fact that university and technical college education has little or no practical work content. The private sector, for instance, has tended in recent years, to recruit 1 out of 8 university graduates.

The problem of youth unemployment is much greater in the south than in the north where primary school education was generally not taken much advantage of. With the countrywide Universal Primary Education (UPE) scheme becoming compulsory in 1979, it has been projected in the Third National Development Plan that primary school enrolment will be 11.5 million by 1980. It is even estimated that during this period (1975-80) about 849,000 young persons would be turned out yearly from primary schools. And on the basis of 70 percent primary to secondary school transition rate expected towards the late 1970s, it has been estimated that about 255,900 primary school leavers in addition to thousands of primary and secondary school drop-outs would join the labour force annually. The situation might be worse than what the 'Third Plan' would lead one to believe. This is because some states in the country have embarked on free education at all levels. We may not see the uncontrollable effect of this until these new sets of students graduate from secondary schools.

Self Assessment 4: *A part from wage differentials and education, what other factors affect the supply of labour?*

3.1.3 Population Growth and Labour Supply

Population growth as a factor that influences the supply of labour. The size of labour force is a function of total population. Labour force in Nigeria is comprised of people in the 15-55 year age bracket. However, an increasing number of organizations are increasing their retirement age to 65 years so that in the near future, the potential labour force will increase further because of a change in definition of labour force. In the face of limited labour demand, the acceleration in the growth of the labour force has led to increased urban and total unemployment problem in Nigeria and this will continue to be so unless corrective measures are evolved to halt it.

3.1.4 Institutional Factors Contributing to Urban Unemployment

There are institutional factors that contribute to the problem of urban unemployment. Geographical immobility of labour causes unemployment. In the Nigerian setting, the unemployment problem, especially among high-level manpower, is due, in large measure, to institutional factors which lead to a restriction of human resource flow among various parts of the country. While it is now apparent that the southern states are over-producing some categories of high-level manpower with consequent urban unemployment (since most of them remain in the cities), it is also clear that most of the northern states suffer from acute shortage in almost all categories of high-level manpower. Some northern states, after two years of independence still prefer expatriate labour to local labour even when expatriate labour is not as good as local. If a free flow of high-level manpower were permitted between the states, the problem of unemployment among high-level

manpower would be reduced. The major institutional factor restricting the free flow is the policy of state governments that stipulate that civil servants must be state indigenes. This policy is now being extended to the private sector as some of the state government pressurize private companies to ensure that no non-state indigenes are employed in companies operating in the state.

Other institutional factors such as the ineffective operation of Labour Exchange (Labour Offices) and the "influence system" (or long leg system) of recruiting and the operation of the expatriate quota system tend to compound unemployment problem. Labour exchanges are few. The "influence system" of employment operates in such a manner that unless the potential employee knows somebody of importance he or she may not be able to secure a job compatible with his skill even when a vacancy exists.

The expatriate quota, which makes influx of foreigners into Nigeria possible, clearly contributes to urban and total unemployment of high-level manpower. Many university graduates, even those in some scientific fields and engineering, have been known to remain unemployed in Nigerian cities while expatriates who are not better qualified perform such jobs.

3.1.5 Factor Proportion and Demand for Labour

It is sometimes suggested that the production functions in modern sector of developing countries reflect fixed factor proportions. There is need for a careful application of this theory in Nigeria. It is true that in Nigeria, the expatriate firms generally use a production function that reflects high capital intensity and fixed factor proportions. Accordingly, a

reduction in wage, it is thought, may not increase the amount of labour demand. However, there is a large intermediate sector where the production function shows more variable factor proportions-this refers to the small scale industries, repair shops where more labour-intensive technology is used and the same applies to the government sector which is even the greatest labour employer.

Because of this, the factor proportion in these sectors will be more sensitive to wage rate changes. The possibility is high that the Udoji awards, which led to higher wages, has helped to press down the employment rate and, therefore, increased urban unemployment.

The Nigerian situation, to an extent, therefore, seems to corroborate a hypothesis that 'in the last two and half decades, there had been a high degree of negative correlation between rises in real wages and growth of employment in several African countries'.

3.1.6 Government Expenditure Policy

The government expenditure policy whereby most of government projects (industries and public utilities) are concentrated in urban areas at the utter neglect of the rural encourages mass exodus of rural unskilled labour from villages into the urban towns and, therefore, causes urban unemployment.

Various government policies (e.g. the numerous and sometimes over-generous industrial incentives) tend to encourage capital intensive and labour saving techniques of production in most of the urban industrial establishments. This aggravates the urban unemployment problem,

3.1.7 Attractiveness of the Urban Centres

Apart from the marked differences between urban and rural earnings, many potential migrants usually have little or no valid information about urban unemployment conditions.

There is the deceptive display of 'prosperity' by many city dwellers (even when unemployed) whenever they visit their homes in the rural areas. This gives a wrong impression and encourages some youths to migrate to the cities.

The Nigerian 'Social Security System' emanating from the extended family system whereby a relative may cater for a new migrant who may be unemployed for some time normally lessens the fear of joining the unemployed people in the urban areas.

3.2 Effects of Urban Unemployment In Nigeria

For you to understand the effects of urban and total unemployment you could roughly separate it on the basis of the individual and the nation. For the individual, the young and active Nigerian, hoping to place himself in the modern world-a long period of unemployment in the city may undermine his self-confidence and turn his optimism to disillusionment. For him, unemployment means lower standard of living resulting from no income and it carries a suggestion of failure which is often accompanied by loss of prestige and status. In a competitive economy such as ours, the psychology of failure can lead to complete loss of self-respect and indulgence of otherwise unacceptable behaviour and attitude.

Urban unemployment has high social and economic costs. Those unemployed reduce the disposable income of those who are working and

they distort the expenditure and savings patterns of their immediate families with whom they are staying and in this way they help to retard the rate of capital formation and development of the economy.

Another consequence of urban unemployment is its effect on the industrial sector. A high level of urban unemployment does not constitute a factor conductive to the instruction of innovations designed to bring about a rapid increase in labour productivity in industry.

As indicated earlier, most of the urban unemployed are young persons with levels of education ranging from a few years of primary schooling to full secondary school training. Their state of unemployment, therefore, constitutes a double loss to the society, in view of the tremendous amount of resources that had been invested in their formal education and the consumption demands they themselves make on the economy. They consume but do not produce.

Unity may be elusive because of the existence of urban unemployment of high-level manpower. You could now say that, the slogan of 'one Nigeria' means nothing to an unemployed and hungry man who knows that he could obtain employment and satisfy his hunger in a part of the country, but cannot do so because of the accident of his birthplace, very often, not even of himself, but of his parents and great grandparents.

4.0 CONCLUSION

There is strong need for institutional collaboration and improved coordination of policy measures for dealing with unemployment. While there are some discernable lapses, the overall policy direction for employment promotion appears to be adequate. What is required is the

political will to pursue the policies that work, as well as transparency in programme implementation.

5.0 SUMMARY

Unemployment is when a person who is able and willing to work, and is available for work, does not have work. Therefore, unemployment causes misery, social unrest and hopelessness for the unemployed. However, unemployment could be frictional unemployment, structural unemployment, etc. In event time you will witness urban unemployment. This could have been caused by, high-wage rate, educational facilities, and social attractiveness in the urban centers. But the government has put in place summary facto to resolve this problem.

6.0 TUTOR-MARKED ASSIGNMENT

What are the causes of urban unemployment in Nigeria?

7.0 REFERENCES/FURTHER READING

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Unit 2: BALANCE OF PAYMENT DISEQUILIBRIUM IN NIGERIA

CONTENTS

1.0 INTRODUCTION

When a country interacts with another country there is bound to be some economic transaction between them. Therefore, balance of payments of a country is a systematic record of all economic transactions between the residents of the foreign countries during a given period of time. The major reason for keeping such an account is to inform governmental authorities of the international position of the country so that appropriate decision on monetary and fiscal policy can be taken. In theory, the balance of payments is kept in standard double entry format. There are two entries for each transaction. The first indicates the goods, services, and securities that are imported or exported while the second entry shows how this transaction is financed. As a result of the underlying double entry structure, the payments to foreigners, by Nigerian residents must be equal to the value of domestically produced goods, services and securities sold to foreigners, fit is this fact that accounts for die well known holism that the balance of payment always balances.

2.0 OBJECTIVES

The balance of payment in a country could be in equilibrium or disequilibrium. What should be very interesting to you to know is that our country has always been suffering from balance of payment disequilibrium.

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

- *Explain* possible causes of balance of payments
- *Carry out* the measurement of balance of payments Adjustment mechanisms
- *Explain* the use of policy measures in Nigeria.

3.0 MAIN CONTENT

3.1 Meaning and Possible Causes of Balance of Payments Disequilibrium

You should be told that balance concept of the balance of payments, equilibrium exists when a country's receipts and payments are equalized during the period under review. When receipt is greater or smaller than payments, then disequilibrium exists.

Self Assessment 1: *What are possible causes of balance of payment disequilibrium?*

Having defined the terms equilibrium and disequilibrium in the balance of payments, it will be pertinent to consider the traditional causes of disequilibrium situations in the balance of payments. These causes are discussed in turn.

1. **Changes in Demand Conditions**: When there is a change in demand conditions, there is going to be disequilibrium in the balance of payments. When the change is favourable in terms of export commodities, then a surplus arises; whereas a deficit results if the change is in favour of imports.

2. **International Competition**: Here it is assumed that the domestic economy is either sold out of the market or outsells competitors out of international market because its cost of production is higher or lower than that of its rivals. When either of these situations arises, there will be disequilibrium in the balance of payments situation of the domestic country.

3. **Exchange Rate Valuation**: This affects the equilibrium situation of the balance of payments to the extent that the, exchange rate is over-valued or under-valued. An over-valuation of the exchange rate will lead to a deficit while an under-valuation of exchange rate may lead to a surplus in the balance of payments. Since either a deficit or surplus is a deviation from equilibrium, therefore, disequilibrium exists in the balance of payments.

4. **Tax Regulations**: an unfavourable export tax regulation leads to a deficit in the balance of payments while an unfavourable import tax regulation could lead to a surplus in the balance of payments and hence to a disequilibrium situation.

5. **Inflation**: Inflation in the domestic economy causes exports to be relatively more costly in the world market and this leads to a loss of exports and its attendant deficit in the balance of payments. Conversely, inflation in rival countries" domestic economies causes more to be bought from the domestic country since her exports will be relatively cheaper. When this happens, a surplus exists in the country's balance of payments and hence it could cause disequilibrium.

6. **Transfer**: When out-transfer payment exceed transfer receipts from other countries or when in-transfer are greater than out- transfer payments, there will be disequilibrium in the balance of payments.

7. Heavy reliance on services performed by firms owned by other countries: This leads to excess of invisible imports over exports and, hence a disequilibrium in the balance of payments. Conversely when services performed by firms owned by the domestic country are relied

upon by foreign countries, there will result a surplus in the balance-of-payments situation of the domestic economy.

8. **International Commitments**: When a country has more international commitments (e.g. United States of America) than it receives in the form of foreign aid, scholarships, payment to troops stationed abroad etc., there might be excess of invisible imports over exports and this could throw the balance of payments out of equilibrium if there are no favourable balance in other accounts of the balance of payments.

9. **Development Programmes**: The incidence of development programmes and the wish to finance it through importation of goods and services and capital provided by foreign countries could throw the balance of payments into disequilibrium

10. **National Income:** A country's export will depend on the national incomes of its trading partners. An increase in income abroad will have a favourable effect on the country's exports. Similarly, if income increase in the domestic economy, imports would likely increase. All these cause disequilibrium in the balance of payments.

11. **Tastes**: A change in tastes in *favour* of imports from abroad would have unfavourable effects on balance of payments while an unfavourable change in tastes in connection with imports from abroad could lead to a favourable effect on balance of payments. Once any of these happens, there is going to be disequilibrium in the balance of payments of the domestic economy.

Self Assessment 2: *How do you measure balance of payment?*

3.2 Measurement of Balance of Payments

The balance of payment situation of Nigeria could be viewed in one of three possible ways. These are discussed, in turn.

i. **Basic Balance Approach**: This approach tries to consider as autonomous the current account and long-term capital account while regarding the other items of the balance of payments as accommodating transactions for financing the balance in the autonomous accounts. This approach is of relevance when determining the role of the foreign trade sector on the economy and the long-run movements of resources. Similarly this approach is justified on the ground that short-term capital may be accommodated. Also some items are prone to volatile and possible erratic shifts. To the extent that above the line, transaction is fairly stable in the short ran but changes only gradually in response to the broad forces at work in the domestic and international economy in the long ran, ibis definition is appropriate. However, the approach has been seriously criticized on the ground that the concept is defective for the dichotomy underlying the distinction is quite artificial. Similarly, not all short-term capital flows are responsive to monetary policy. Many are not accommodating at all. far like manner, some basic items (e.g. merchandise trade account) appear to be responsive to monetary policy.

ii. **Net Liquidity Balance Approach**: This approach considers as autonomous the current account and long-term capital account transactions, short-term capital assets, errors and omissions as well

as Allocation of Special Drawing Rights (SDRs) while regarding all other items as accommodating.

This approach is of particular appropriateness when we want to determine the net liquidity position of a country. However, the approach has been criticized on the ground that liquidity of any country does not need to correspond with the concept of net money flows. Also the approach draws too sharp an artificial distinction between private foreigners and private domestic residents, while not distinguishing between private foreigners and foreign financial authorities. Apart from these, the approach implies that domestic reserve assets are needed to protect the domestic currency only against withdrawals of foreign holding, whereas historical experience demonstrates that outflows of domestic capital typically play a leading role in payments deficits and speculative runs on a currency. Finally, the approach is criticized on the ground that it implies that all foreign holdings represent an equal change in the domestic currency.

iii. **Official Settlement Balance**: The official settlement balance approach distinguishes between types of transactions. Therefore, it regards as autonomous the current account, longterm capital account, while regarding as accommodating items such as the net change in official monetary reserves and the net change in liabilities to foreign official institutions. It is the International Monetary Fund definition of balance of payments equilibrium It is recommended for use of member countries of the IMF. This approach is defended on the ground that only official reserve transactions represent official intervention in the foreign exchange market It truly represents

accommodating flows under the present international monetary system Only financial authorities have the responsibility for maintaining stable exchange rates. Their gains and losses of reserve assets and liabilities to foreign official authorities provide the best index of the financing required by surpluses and deficits and hence constitutes the most accurate measure of balance.

The fact that certain official transactions have nothing at all to do with financing gaps in the balance of payments in the current period stands as the strongest criticism against this approach. Similarly, Central Bank Occasionally decides to borrow in foreign capital market to augment their reserves or to sell reserves to domestic commercial banks when they want to drain internal liquidity

Self Assessment 3: *What do you mean by traditional balance of payments adjustment mechanism?*

3.3 Traditional Balance of Payments Adjustment Mechanisms (Measures)

You will then find out that a Balance of Payments adjustment mechanism should be defined as any balance of payments disturbance which can be deliberately initiated in order to correct some other disturbances. The traditional mechanisms, based on changes in exchange rates, prices and income, can no longer be applied effectively because they ate domestically unpalatable.

Some traditional measures are temporary and do not seek to remove the underlying causes of the disequilibrium but rather to arrest a

deteriorating situation. They are called stop-gap measures which enable policy makers to "buy time" and design mote permanent solution to the problem

However, it will be appreciable if we can ignore a balance of payments surplus situation since it calls for no problem and concentrates on balance of payments deficit with its attendant unpalatable consequences for policy makers. Thus all measures to be discussed in this section are those relevant to correcting balance of payments deficit situations. Deficits make a country to lose foreign reserves and perhaps gold.

A country laced with a balance of payments deficit will normally employ the tight monetary policy under the gold standard and, in modern times. Policy, instruments open to such a country include exchange restriction, licensing, quotas, rationing, selective granting of foreign exchange, raising of bank rate, decrease in money supply, changes in custom duties and total ban. However, these policy instruments will be considered under two major headings: namely, expenditure reducing and expenditure switching policies.

3.3.1 Expenditure-Reducing Policies

In light with our discussion on Traditional Balance of Payment Adjustment, the expenditure-reducing policies can be divided into two broad categories. These are monetary and fiscal policies.

a. **Monetary Policy**: Here the major approach to curing a balance of payments deficit is the raising of interest rate. This affect investment since the cost of money (borrowing) increases and as the availability of credit becomesmore scarce, producers borrow

and invest less. Similarly, a conscious effort of the monetary authority to reduce expenditure is by going to participate in the bond or securities market. Here the government sells bond to the commercial banks, households and other financial institutions. As a result of this transaction, the liquidity of the banking system falls and the availability of credit decreases. The sale of bonds will also lead to a fall in their prices and to an upward pressure on interest rates. The decrease in availability of credit, coupled with an increase in interest rate, can have a negative influence on investment. Thus producers may now find it impossible to borrow money. With this condition, investment will definitely be curtailed. However, the efficiency of the open market operation depends on the fact that commercial banks keep a given stated ratio between their liquid and their loanable funds. In the final analysis, a fall in investment will affect income and once this happens, there will be less disposable income for people to spend on imports. The deficit in the balance of payment will be reduced if not cured. It is also believed that NEUTRAL monetary policy will automatically work to curb a deficit.A deficit implies that payments by residents of the country are larger than receipts by residents. This means that residents are depleting their cash balance. The neutral monetary policy assumes that the deficits should be left to continue. In this case cash balances will eventually become depleted, and payments will be brought in line with receipts. This means that the deficit will be self-correcting. Neutrality in this sense means

that the Central Bank does not increase the money supply despite the depletion of cash balances.

In real life. Central Banks will not adopt this method of neutrality because they will not wait until reserves totally are exhausted for the policy to be implemented. However, as cash holdings become scarcer, the interests rate increase, which will also work toward curing balance of payments deficits. For a central bank that does not want to tolerate an increase in interest rates, it has to increase the money supply, and the deficit is no longer self-correcting

b. **Fiscal Policy**: Fiscal policy measures can be divided into two broad categories. These are the instruments of taxation and of government budget fat the case of taxation, an increase in direct taxes will reduce household incomes. A decrease in decrease in disposable income may lead in part to a reduction in savings and certainly lead to a reduction of consumption and consequently a decrease in imports. An increase in indirect taxes, especially sales taxes, will produce identical effect Here the effect on savings may be relatively smaller since indirect taxes, as opposed to direct ones, are sparingly progressive. Fiscal measures curtail investment A decreased investment will, through the multiplier effect, lead to a decrease in the national income and to a fall in imports. A fall in imports will have a favourable effect on the balance ofpayments.

Government expenditures include public consumption, investment and transfer payments. A cut in government

expenditure especially with respect to transfer payments will reduce income of the beneficiaries of such transfer payments. This will in the final analysis lead to a fall in imports and a favourable situation in the balance of payments. A decrease in public investment produces the same effect on national income as a Ml in private investment, and leads to a Ml in national income and imports.

However, of the two policies, monetary and fiscal policies, the latter is more efficient and effective than the former. A country with a deficit in the balance of payments can pursue a tighter monetary policy or a more restrictive fiscal policy. This will have a deflationary effect on the national income and lead to a Ml in imports, or at least act as a brake on the increase in imports. It will also have a positive effect on exports and on import-competing industries. A fall in activity level will lead to a downward pressure on factor prices, wages may fall or, at least, be stable. The result is that export and import competing industries will be in a more competitive position. Thus an expenditure reducing policy will have a positive effect on the balance of payments both by reducing imports and by promoting export expansion.

c. **Expenditure-Switching Policies:**

Expenditure-Switching policies can take one of two forms. These are exchange rate changes and direct control.

An exchange rate change takes the form of devaluation or a revaluation of the domestic currency. Devaluation means a

lowering in value of a currency with respect to gold while revaluation is a rise in the value of currency with respect to gold. Depreciation and appreciation mean a fall and a rise in the price of domestic currency in terms of foreign currency respectively.

Devaluation causes a change in relative prices. It leads to an increase in import prices and thus a fall in the demand for imports. Similarly, import-competing industries will be in better competitive situation. There will be increased earnings for exporters who can now lower their prices. This places them in a more competitive situation. However, their sales expansion abroad will depend on the foreign demand elasticity for their goods. For a devaluation to have a positive effect on a country's trade balance, Marshal-Lerner condition, which states that the sum of the elasticity's of demand for a country's exports and of her demand for imports has to be greater than unity must be satisfied.

If it is less that unity, an appreciation should be used to cure a deficit in the trade balance instead of devaluation. However, the magnitude of the elasticity depends on whether the goods are primary goods or manufactured goods and the conditions of the market One unpleasant effect of devaluation is Inflation which can of course be limited by joint pursuance of devaluation with tight monetary and fiscal policies. We must not, however, lose sight of the income redistributing effect of devaluation. The use of monetary or fiscal policy or of payments presupposes that income is sensitive to policy measures or that price changes will lead to changes in consumption and production. This may not be

so because adjustment through these channels may take too long if ever it would be possible. A way to get out of this ugly situation is to use direct controls.

These operate through quantitative and exchange restrictions. The essence of direct trade controls is usually a wish to restrict imports since factors affecting exports are purely exogenous to the domestic economy. Direct controls can equally he considered in terms of commercial and financial controls. However, policy measures under direct controls include the following:

Impart Restriction: Here the government can decide that only a given percentage of the previous volume of imports can be imported in the current year. Such a restriction of imports will make their internal value higher than their external valise.

Import Licensing: Here the government puts the importation of certain commodities under license. This will reduce imports if managed effectively and hence have a positive impact on the balance of payments.

Quotas: This is when the government puts a limit to the amount of imports from each of its trading partners.

Foreign Exchange Regulation: A government trying to hold complete control over all dealings in foreign exchange may state that exporters should sell their foreign earnings to a central board e.g. the Central Bank, and that importers have to buy their foreign currency from the same board. If this arrangement is successful, die government would hold complete control over

foreign trade. It would then be able to cure any deficit in the balance of payment by equating sales of foreign exchange with export earnings.

Selective Granting of Foreign Exchange: This happens when the government permits only those imports, which, are deemed desirable such as necessities, capital goods, military equipment, but does not permit luxury goods.

Bilateral Trade Agreements: Under this arrangement the government enters into terms under which it will trade with its trade partners.

3.4 The Use of Policy Measures In Nigeria

Nigerian authorities, both civilian and military, have adopted various measures to arrest deterioration in her balance of payment situations.

a. Fiscal Measures

i. **Government Budget**: The various governments of the Federation, having realized the impact of excessive government spending, had on many occasions cut down on die size of government budgets overtime. This was particularly true of the civil war years and the low profile budget of 1978//79-budget year.

ii. **Tariffs**: The government introduced various tariff policies over the years with a view to arresting the adverse balance of payments situations. Thus in 1964, the Federal Government increased indirect taxes on a wide range of imports and domestic manufactures to protect the balance of payments position. Also,

additional indirect taxes have been imposed on luxury commodities in high demand. Super tax was introduced during the war. All these were intended to improve the adverse balance of payment situations.

b. Monetary Measures

In 1964, the Central Bank of Nigeria adopted a measure of selective control and moral suasion and certain general regulatory measures to restrain private spending without discouraging capital formation. This has also been done in some recent years. Other measures include the use of guidelines. The Central Bank in 1964 limited the rate of increase of aggregate advances by commercial banks. In 1965 and 1966 and also in other years, the Central Bank of Nigeria placed a ceiling on the rate of expansion of commercial bank advances over a given period to aid balance of payments and to create relative credit scarcity and to lead, therefore, to credit rationing.

c. Foreign Exchange Regulation

In 1962, the Federal Government felt the need to regulate her foreign exchange policy. To this effect, the Nigerian Foreign Exchange Control Act was passed in 1962. This Act had provision covering a wide range of activities such as foreign exchange permission on selected items. However, this Act has been abrogated in 1968; the Exchange Control regulations and procedures were further tightened. Thus transfers in respect of dividends, profits and other capital transfers were suspended. Payment for certain invisible items including management

agency fees, royalties, technical charges and commissions, and expenses due from Nigerian firms to their agents and representatives in countries outside Nigeria were suspended. Reduction of cash gifts to charitable organizations abroad were reduced from 500 to 100 percent year. All shipping companies were requited to give at least one month's notice of their foreign exchange requirement for charter-fees to the Federal Ministry of Finance, giving all relevant information in respect of vessels and the terms of charter.

In 1970, it was required that payments for current transactions be met only out of current receipts as foreign exchange became available and it was an offence to export; Nigeria currency. Personal remittance by foreign nationals residing in Nigeria was limited to 50 percent of their gross taxable income in Nigeria and was subject to prior approval by the central bank. Basic travel allowance of N500 per annum per person was reduced to N200 a year (N100 a year for children) in 1970. All these were further reduced in 1971. Following a strong wave of foreign exchange scandals, the Federal Government promulgated the foreign Exchange Anti-Sabotage Decree under which some highly placed Nigerians were persecuted and convicted.

d. Export Promotion

The government felt the need to improve her balance of payments situation through export expansion. To this effect, the government embarked on massive export drive. To do this she adopted the following

i. **Protection for Domestic Industries**: In doing this, the government restricted the importation of goods whose local supplies were

found adequate both in terms of price and quality in 1972. This policy was equally introduced in 1978 when total ban was placed cm certain category of consumer commodities e.g frozen meat.

ii. **Granting of Incentives**: Right from time, the Government embarked on the giving of incentive to domestic businessmen and industrialist. In 1965 the government introduced the granting of incentives to attract further investment in the private sector. In 1970, industrial concessions were granted industrialist in Nigeria in respect of certain capital and initial allowances. Similarly, special assistance has been rendered to Nigerian businessmen to enable them to expand their activities. The super tax introduced during the civil war was abolished in 1972. In the same year, 1972, import duties on raw materials for industrial production were reduced by between 10%. The two-tier tax on marketing board produce was abolished and replaced by a single tax of 10% (an valorem). The Federal government in 1971 started to buy "made in Nigeria" goods. In the same manner, the government in 1972 exempted companies earning a profit of less than N6,000 from company tax. Similarly, the 25% import duty on paper used for manufacturing exercise books was abolished.

e. **Trade Agreement and Economic Cooperation:**

The need to protect her balance of payment led Nigeria into entering various trade agreements and economic cooperation's right from 1961. In 1962, Nigeria entered into International Tin Agreement to arrest the declining commodity's prices. En 1972, the Nigerian National Oil

Corporation signed an agreement with SAFRAP, through which the government acquired 35% of the company's operations. Also an agreement was signed with a Soviet technical firm whereby the Soviet firm will undertake to establish an oil production-training centre at Warn. Nigeria also joined the Organization of Petroleum Exporting Countries with a view to earn more on her petroleum export and to improve her balance of payments. The motive behind the formation of the Niger Basin Authority, the Chad Basin Authority and the Economic Community of West African States has balance of payments undertones.

f. Exchange Rate Policy (Devaluation)

For a developing country like Nigeria, exchange rate is not a powerful instrument for influencing the outlook of our balance of payments, particularly in the short run. The main reasons are obvious. First, our trade position may not be improved. Indeed, currency depreciation worsens the terms of trade and adjustments to the altered international trade could take a long time to materialize. Secondly, in the short run, the prices of our export of primary export commodities, including petroleum, might have been determined in the world markets. In this case, exchange rate depreciation is not likely to confer any important benefits in terms of increased export receipts. Thirdly, owing to our growing need for imports, exchange depreciation would have caused inevitably, higher import prices, including the import of raw materials. Also, the fear is always there that devaluation would add to inflationary forces either directly through the effects of higher imports prices on domestic price level or indirectly by encouraging excessive wage claims. It is important to add that the short-run results

of devaluation in a country like Nigeria could be partially offset by increased value of external assets especially in cases where devaluation does not provoke equip proportionate devaluation by the major reserve centres.

4.0 CONCLUSION

Nigeria's balance of payments has been under persistent pressure since 1982 when the second oil shock occurred and the debt burden became pronounced. Attempts at managing the balance of payments, involved restrictive exchange and trade control practice to achieve the policy objectives. The liberalization of exchange controls and the institution of a market-based exchange rate mechanism with the commencement of the Structural Adjustment Programme (SAP) temporarily stabilized international payments. However, slippages in policy-in particular the deflation of the economy in 1988, intensified pressure on the external sector. Non-oil exports that initially rose at the inception of SAP declined in 1989 and have remained depressed ever since.

More so, the disproportionate size of oil exports vis-a-vis non-oil exports, the excruciating debt burden, and the unfavourable domestic and international economic environments have constrained the achievement of a balanced and sustained economic growth that could foster balance of payments viability.

5.0 SUMMARY

Balance of payment equilibrium is a situation whereby a country's receipts and payments are equalized. However, factors such as demand conditions, international competition, exchange rate valuation, tax regulation, etc., are responsible for the balance of payment disequilibrium in the country. In this regard, the government has put in place over the years certain policy measures

such as, fiscal policy, monetary measures, foreign exchange regulation, export promotion to address this problem

6.0 TUTOR-MARKED ASSIGNMENT

What were the policy measures that respective governments in Nigeria have employed to ameliorate the balance of payment position?

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Unit 3: INTRODUCTION TO INFORMATION TECHNOLOGY MANAGEMENT

CONTENTS

1.0 INTRODUCTION

The strategic and operational importance of information technology to business is no longer questioned. As the 21st century unfolds, many companies throughout the world are intent on transforming themselves into global business powerhouse via major investments in global e-commerce, and other IT initiatives. Therefore, there is real need for business managers and professionals to understand how to manage this vital organizational function. In this course, we will explore who the information system and technology can be organized and managed and stress to importance of a customer a business value focus for the management of information technologies. So whether you plan to be an entrepreneur and run your own business, a manager in a corporation, ora business professional, managing information systems and technologies will be one of your major responsibilities.

The case study of Chicago Board of Trade portrays a dramatic failure and rebound to success of the information technology functions. Earlier, the IT group was so ineffective and so poorly managed that it seemed powerless to stop the weekly trading-floor system crashes that were costing the organization millions of dollars in lost income. The IT infrastructure was ancient, unreliable, and undocumented. Project and budget control were lacking, return on investment of IT projects had never been done, and quality control was substandard. Morale was low, and IT lacked credibility with the business units.

Chief Information Officer (CIO) was hired to turn the IT function around, which he began to do quickly through proper management. For example,

new computer systems and databases software were installed, a project management was established, RIO evaluation of IT projects were required, and IT managers were assigned work with business unit managers to assure that IT was supporting their business goals. Now through proper management, information technology is now completing new projects and the trading-floor system are processing a third more than transactions without any system failure.

2.0 OBJECTIVES

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

- explain what is information technology
- identify the basic components of information technology management
- compare conventional method of managing an IT project with recent approaches
- explain how to manage IT functions
- discuss the functions of key IT officials and executives
- define and explain the key issue of information technology management.

3.0 MAIN CONTENT

3.1 Components of Information Technology Management

Information technology is an essential component of business success for companies today, but information technology is also a vital business source that must be properly developed.

How should information technology be managed? Figure 1.1 overleaf illustrates one popular approach to managing information

technology in a large company. This managerial approach has three components:

- Managing the Joint Development and Implementation of Business / IT Strategies: Led by the Chief Executive Officer and Chief Information Officer, proposals are developed by business and IT managers and professionals for using IT to support the strategic business priorities of the company. This business / IT planning process align IT with strategic business goals / the process also includes evaluating the business goals. The process also includes: evaluating the business case for investing in the development and implementation of each proposed business / IT project.

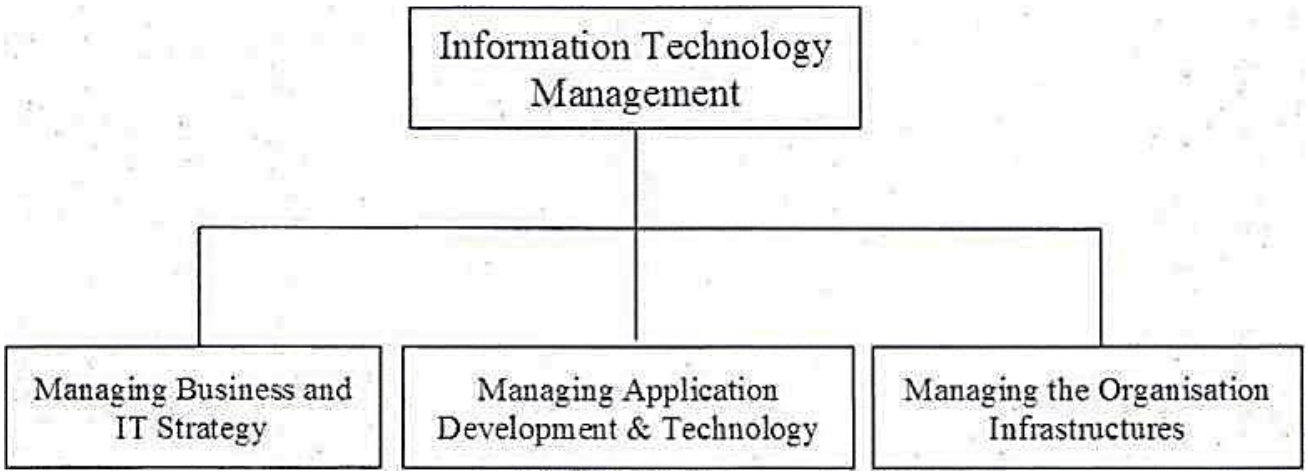


Figure 1.1:The major components of Information Technology Management

Managing the Development and Implementation of new Business / IT application and Technologies: This is the primary responsibility of the Chief Information Officer and Chief Technology Officer. This area of management of IT involves managing the processes for information

systems development and implementation, as well as responsibility for research into the strategic business uses of new information technologies.

- **Managing the IT Application and IT Infrastructures:** The Chief Information Officer and the IT manager share responsibility for managing the work of IT professionals who are typically organized into a variety of project teams and other organizational subunits. In addition, they are responsible for managing the IT infrastructure of hardware,, software, databases, telecommunication networks and other IT resources which must be acquired, operated, monitored and maintained.

3.2 Comparison between Conventional and e-Business- Driven IT

In this section of the unit, we compare and contrast the conventional method of managing business and an e-Business-driven by IT. The figure 1.2 overleaf compares how Avnet Marshall's information technology management differs from conventional IT management. Notice that they use IT management illustrated in figure 1.1. For example, in technology management, Avnet Marshall uses a best-of- breed approach that supports business needs instead of enforcing a standardized and homogenous choice of hardware, software, database and networking technologies. In managing its IT organisation, Avnet Marshall hires information systems (IS) professionals who can integrate IT with business. These IS professionals are organized in workgroups around business / IT initiatives that focus on building IT-enabled business service for customers.

Figure 1.2: Comparing conventional and e-Business-driven IT management approaches

IT Management	Conventional Practices	Avnet Marshall's Business / IT Process
Technology Management	Approaches to IT infrastructures may sacrifice match with business needs for vendor homogeneity and technology platform choices	Best-of-breed approach to IT infrastructures in which effective match with business needs takes precedence over commitment to technology platform choices and vendor homogeneity.
Managing the IT Organisation	• Hire "best-by-position" who can bring specific IT expertise • Department organized around IT expertise with business liaisons and explicit delegation of tasks • IT problems have separable cost / value considerations. Funding typically allocated within constraints of yearly budget for IT function.	Hire "best-of-breed" IS professionals who can flexibility integrate new IT and business competence Evolving workgroups organized around emerging IT-intensive business initiatives with little explicit delegation of tasks IT funding typically based on value proposition around business opportunity related to building services for customers. IT projects as inseparable part of business initiatives.

3.3 Business / IT Planning

Business / IT planning process, which focuses on discovering innovative approaches to satisfying a company's customer value and

business value goals. This planning process leads to development of strategies and business model for new business applications, processes, products and services. Then, the company can develop IT strategies and an IT infrastructure that supports building and implementing their newly planned business applications.

Both the Chief Executive Officer and the Chief Information Officer of the company must manage the development of complementary business and IT strategies to meet its customer's value and business value vision. This *co-adoption* process is necessary because we have seen so often in this unit; information technologies are fast changing vital components in many strategic business initiatives. The business / IT planning process have three major components:

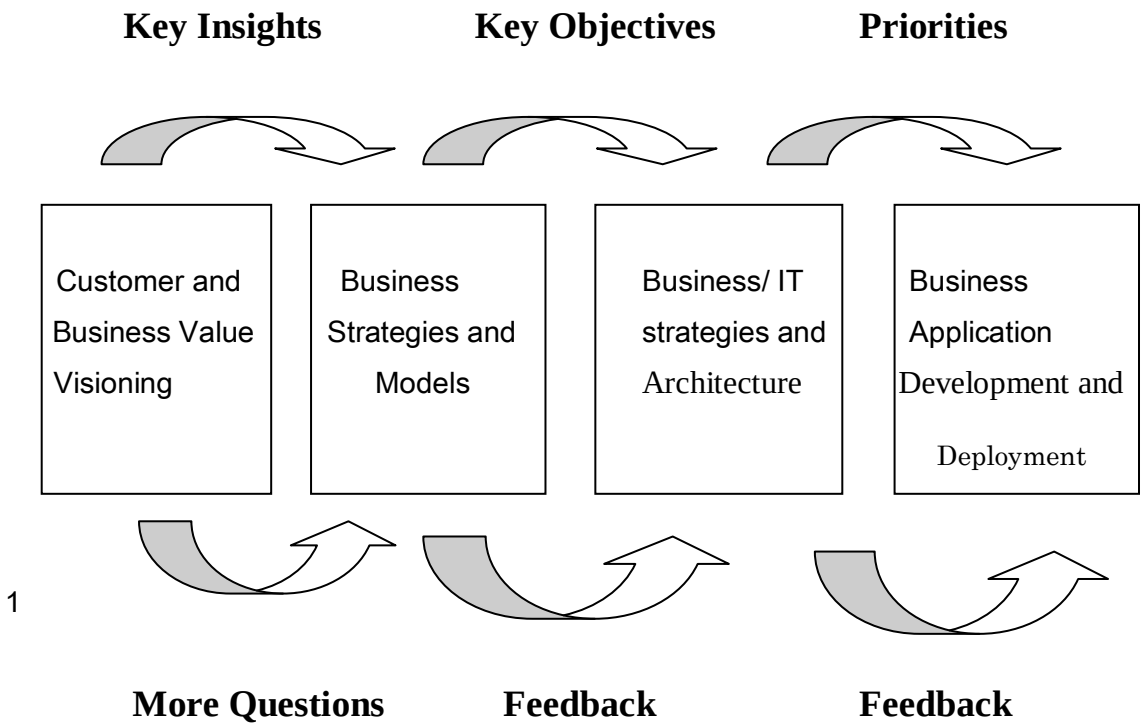
- **Strategy Development:** Developing business strategies that support a company's business vision. For example, use information technology to create innovative e-Business systems that focus On customer and business value.

- **Resource Management:** Developing strategic plans for managing or outsourcing a company's IT resources, including Information System personnel, hardware, software, database and network resources.

- **Technology Architecture:** Making IT choices that reflect information technology architecture designed to support a company's business / IT initiatives.

Figure 1.3 below:

Information Technology Architecture



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The IT infrastructure that is created by the strategic business / IT process is a conceptual design, or blueprint that includes the following major components:

- *Technology Platform:* The Internet, intranets, extranets and other networks, computer systems, systems software and integrated enterprise application software provide a computing and communication infrastructure or platform that supports the strategic use of information technology from e-Business, e-Commerce and other business / IT applications.

- *Data Resources:* Many types of operational and specialised databases, including data warehouses and Internet / Intranet databases store and provide data and information for business process and decision support.

- *Application Architecture:* Business applications of information technology are designed as an integrated architecture or portfolio of enterprise systems that supports strategic business initiatives, as well as cross-functional business processes. For example, application architecture should include support for developing and maintaining the infrastructure supply, chain application and integrated resource planning as well as customer relationship management application.

- *IT Organisation:* The organizational structure of the information system functions within a company and the distribution of Information System specialists are designed to meet the changing strategies of a business. The form of the IT organisation depends on the management philosophy and business / IT strategies formulated during the strategic planning process.

Comparing Conventional and Avnet Marshall Business /IT Planning

In this section, we consider the Avnet Marshall's business / IT planning as compared to conventional business / IT planning. Avnet Marshall waves both business and IT strategic planning together ***co-adaptability*** under the guidance of the Chief Executive Officer and the Chief Information Officer, instead of developing IT strategy by just tracking and supporting business strategies. Avnet Marshall also locates IT application development projects within the business

units that are involved in an e-Business initiative to form centres of business / IT expertise through the company. Finally, Avnet Marshall uses a prototyping application development process with rapid deployment of new business applications, instead of a traditional system development approach. This application development strategy trade the risk of implementing incomplete application with the benefits of gaining competitive advantages from early deployment of new e-Business services to employees, customers and other stakeholders, and of involving them in the Tine-tuning' phase of application development.

Figure 1.4 below: Comparing business / IT strategic and application planning approaches

Conventional IT Planning	Avnet Marshall's Business / IT Planning
• Strategic alignment: IT strategy tracks specialized enterprise strategy • CEO endorses IT vision shaped through CIO * IT application development projects financially organized as technological solutions to business issues. * Phased application development based on learning from pilot project	♦ Strategic Improvisation: IT strategy and enterprise business strategy co-adaptability unfold based on the clear guidance with a focus on customer value ♦ CEO proactively shapes IT vision jointly with CIO as part of e-Business strategy ♦ IT application development projects co- located with e-Business initiatives to form centres of IT-initiative business enterprise ♦ Perpetual application development based on continuous learning from rapid

	deployment and prototyping with end user involvement

3.4 Managing the IT Function

A radical shift is occurring in corporate computing. Think of it as the recentralization of management. It is a step back towards the 1970s, when a data processing manager could sit at a console and track all the technology assets of the corporation. Then come the 1980s and 1990s when departments got their own PCs and software, and client / server network sprang up all across companies.

Three things have happened in the past few years. The Internet boom inspired business to connect all those networks; companies put on their intranet essential application without which their business could not function; and it becomes apparent that maintaining PCs on a network is very, very expensive. Such change creates an urgent need for centralization.

Organizing Information Technology

In the early years of computing, the development of large mainframe computers and telecommunications networks and terminals cause a **centralization** of computer hardware and software, databases and information specialists at the corporate level of organisations. Next, the development of minicomputers and microcomputers accelerated a **downsizing** trend, which prompted a move back to **decentralization** by many business firms. Distributed client / server networks at the corporate, department, workgroup

and team levels came into being. This promoted a shift of database and information specialists to some departments, and the creation of information centres to support end-user and workgroup computing.

Later the trend is to establish more centralized control over the management of the IT resources of a company, while still serving the strategic needs of its business units, especially their e-Business and e- Commerce initiatives. This has resulted in the development of hybrid structure with both centralized and decentralized components. For example, the information technology functions at Avnet Marshall are organized into several business-focused development groups as well as operations management and planning groups.

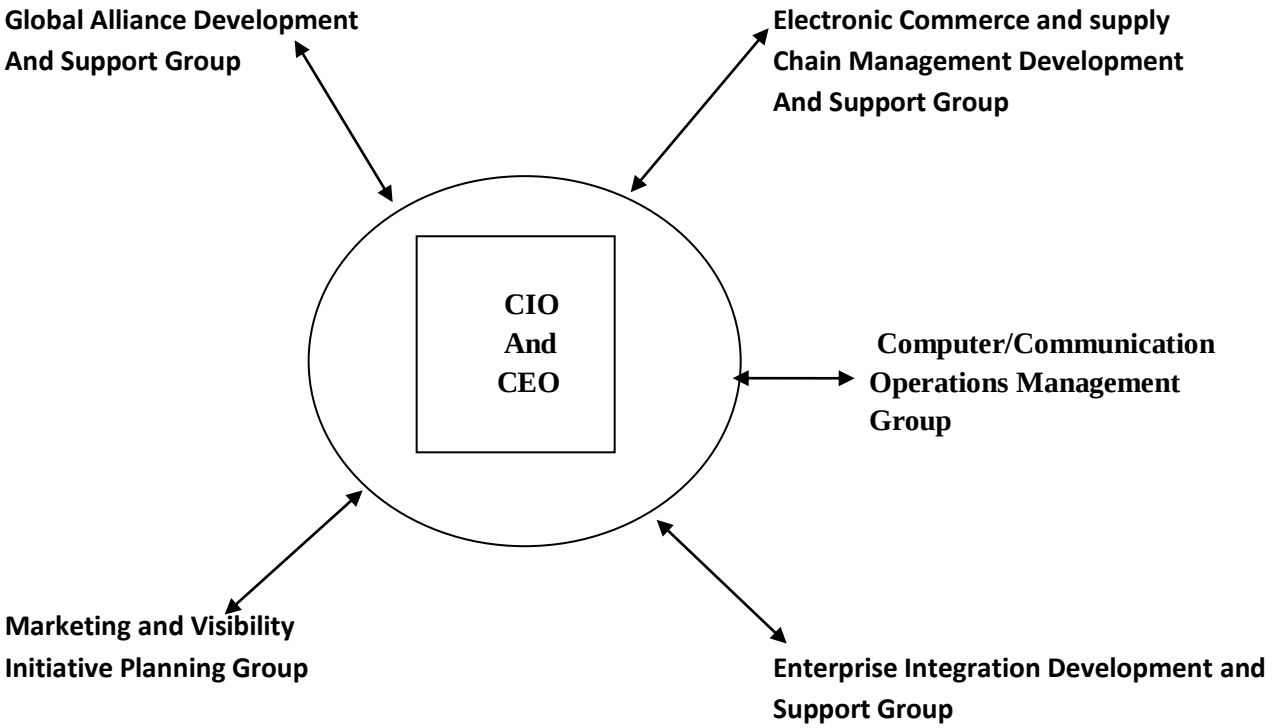

Figure 1.5 above: The Organisational Components of the IT Functions as Avnet Marshall

Some organisations spin-off their information systems function into information systems (IS) **subsidiaries** that offer IS services to external organisations as well as to their parent company. Other companies create or spin-off their e-Commerce and Internet-related business units or IT groups into separate companies or business units. Other corporations **outsource,** that is, turn over all or some parts of their operations to outside contractors known as ***system integrators.*** In addition, some companies are outsourcing software procurement and support to ***application service providers*** (ASPs), who provide and support business application and other software via the Internet and intranets to all of a company's employee workstations.

Application Development Management

Application development management involves managing activities such as systems analysis and design, prototyping, applications programming, project management, quality assurance and system maintenance for all major business / IT development projects. Managing application development requires managing the activities of teams of system analysts, software developers and other information system and technology professionals working on a variety of information systems development projects. Thus, project management is a key management IT responsibility if business / IT projects are to be completed on time, within their budgets, as well as meeting their design objectives. In addition, some systems development groups have established ***development centres*** staffed with information technology professionals.

Their role is to evaluate new application development tools and to help information systems specialists use them to improve their application development efforts.

3.5 Information Technology Operations Management

This concerned the user of hardware, software, network and personnel resources in the corporate or business unit ***data centres*** (computer centres) of an organisation. Operational activities that must be managed include computer systems operations, network management, production control and production support.

Most operations management activities are being automated by the use of software packages for computer system performance management. This ***system performance*** monitors the processing of computer jobs, help develop a planned schedule of computer operations that can optimize computer system performances and produce detailed statistics that are invaluable for effective planning and control of computing capacity. Such information evaluates computer system utilization, costs and performance. This evaluation provides information for capacity planning, production planning and control, and hardware / software acquisition planning. It is also used in quality assurance programmes, which stress quality of service to business end-users.

System performance monitors also supply information needed by ***check back systems*** that allocate cost to users based on the information services rendered. All costs incurred are recorded, reported, allocated and charged back to specific end-user business units, rather than being lumped with other administrative service costs and treated as an overhead cost.

Many performance monitors also feature ***process control*** capabilities. Such packages not only monitor but automatically control computer operations at large data centres. Some use built-in expert systems modules based on knowledge gleaned from experts in the operation of specific computer systems and operating systems. These performance monitors provide more efficient computer operations than human- operated systems. They also enable 'light out" data centres at some companies, where computer systems are operated unattended, especially after normal business hours.

3.6 Human Resource Management for Information Technology

The success or failure of any information service organisation rests primarily on the quality of its people. Many computer using firms consider recruiting, training and retraining quality information technology personnel as one of the greatest challenges. Managing information services functions involves the management of managerial, technical and clerical personnel. One of the most important jobs of information services managers is to recruit qualified personnel and to develop, organize and direct the capabilities of existing personnel. Employees must be continually trained to keep up with the latest developments in a fast-moving and highly technical field. Employees' job performance must be continually evaluated and outstanding performance rewarded with salary increases or promotions. Salary and wage levels must be set, and career path must be designed so individuals can move to new jobs through promotion and transfer as they progress in seniority and expertise.

The CIO and Other IT Executives

The Chief Information Officer oversees all use of information technology in many companies and brings them into alignment with strategic business goals. Thus, all traditional computer services, internet technology, telecommunication network services and other information system technology support services are the responsibility of IT chief executive. Also, the CIO does not direct the day-to-day information services activities. Instead CIOs concentrate on business / IT strategy, they also work with the CEO and other top executives to develop strategic uses of information technology in electronic, business and commerce that help make the firm more competitive in the marketplace. Many companies have also filled the CIO position with executives from the business functions or units outside the IT field. Such CIOs emphasise that the chief role of information technology is to help the company meet its strategic business objectives.

3.7 Technology Management

The management of rapidly changing technology is important to an organisation. Changes in information technology like the rise of the PC, client / server networks and internet and intranets, have come swiftly and dramatically and are expected to continue into the future. Developments in information systems technology have had, and will continue to have, a major impact on the operations, costs, management work environment and competitive position of many organisations.

Thus, all information technologies must be managed as technology platform for integrating internally focused or externally facing-business applications. Such technologies include the internet, intranets and variety of electronic commerce and collaboration technologies as well as integrated software for customer relationship management, enterprise resource planning and supply chain management. In many companies, technology management is the primary responsibility of *Chief Technology Officer* (CTO) who is in charge of all information technology planning and deployment.

4.0 CONCLUSION

Information technology has come to stay as major driving force behind business successes in the world today. This trend has come with its attending challenges, which businesses will continue to contend with. The various components that need to make this a success, though sometimes complex, are being improved upon to enhance the relevance of information technology in business.

5.0 SUMMARY

The strategic and operational importance of information technology to business is no longer questioned. As the 21st Century unfolds, many companies through the world are intent on transforming themselves into global business powerhouse via major investments in global e-Commerce and other IT initiatives.

Information technology is an essential component of business success for companies today, but information technology is also a vital business source that must be properly developed.

Both the CEO and the CIO of a company must manage the development of complementary business and IT strategies to meet its customer's value and business value vision.

Avnet Marshall also locates IT application development projects within the business units that are involved in an e-Business initiative to form centres of business / IT expertise through the company.

A radical shift is occurring in corporate computing. In the early years of computing, the development of large mainframe computers and telecommunications networks and terminals cause a **centralization** of computer hardware and software, databases and information specialists at the corporate level of organisations.

Application development management involves managing activities such as systems analysis and design, prototyping, applications programming, project management, quality assurance and system maintenance for all major business / IT development projects. Most operations management activities are being automated by the use of software packages for computer system performance management.

6.0 TUTOR-MARKED ASSIGNMENT

1. Compare the conventional and AVnet Marshall's e-Business-driven IT management approaches.

2. Discuss the major components of IT planning as outlined in this unit.

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