Central Bank of Nigeria, Monetary Policy Department

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HOW DOES THE MONETARY POLICY DECISIONS OF THE CENTRAL BANK OF NIGERIA AFFECT YOU? PART ONE

THE MONEY SUPPLY EFFECT

The Central Bank of Nigeria (CBN) takes a number of monetary policy decisions, including a change in the level of money supply (M_2), the Minimum Rediscount Rate (MRR), or a change in the exchange rate. The central bank defines money supply in two ways: narrow and broad money. Narrow money (M1) is defined to include currency in circulation plus current account deposits with commercial banks. Broad money measures the total volume of money supply in the economy and is defined as narrow money plus savings and time deposits with banks including foreign denominated deposits. There is excess money supply when the amount of money in circulation is higher than the level of total output of the economy. When money supply exceeds the level the economy can efficiently absorb, it dislodges the stability of the price system, leading to inflation or higher prices of goods. In this brief, we shall examine how a change in money supply by the CBN affects people and the economy. In subsequent series, we shall look at the effects of an increase/decrease in interest rate and the effects of depreciating/appreciating the exchange rate on the people and the economy.

When the CBN changes the level of money supply, it does so through the control of the base money. Base money is made up of currency and coins outside the banking system plus the deposits of banks with the central bank. If the central bank perceives that there is too much money in circulation and prices are rising (or there is potential pressure for prices to rise), it may reduce money supply by reducing the base money. To reduce the base money, the central bank sells financial securities to banks and the no-bank public so as to reduce the ability of deposit money banks to create new money. The central bank can reduce the money supply by also raising the cash reserve deposits that banks are required to hold with the central bank. The larger the deposit balances on bank balance sheets, the higher their ability to create more money. Central bank monetary policy, therefore, targets the growth in those deposit balances so as to control the expansion in money supply which could precipitate price distortions.

A reduction in money supply affects the ability of banks to create new money through giving loans to their customers. In this way, the central bank could be said to be pursuing a contractionary monetary policy. When investors cannot get new loans to expand their investments, it reduces the level of total output in the economy. A reduction in output affects the level of employment and prices as less money is available for purchasing goods. In this way, prices remain stable or fall. The central bank can also pursue an expansionary monetary policy when it reduces the cash reserve ratio and buy securities from the open market. In this case, the reverse of our analysis above, holds.