ECONOMICS SS2

National Income

This is the estimated monetary value of all goods and services produced in a country during a specified period of time usually one year.

It is the sum total of all profits, interest, wages and rent recovered within a year or the sum total of all personal income

Importance of Measuring National Income

1. **Economic Planning and Development:** Through National Income statistic relevant information are provided in which future planning may be based. This is because successful planning requires fairly accurate figures upon which good decisions can be based. Thus this enables assessment to be made of development plans and progress in the country.

2. **Determine Growth of Nations Income:** National Income statistics are used to calculate the rate at which a nation's income is growing through this, we are able to know whether the nation's income is growing at a required level or that there is sufficient investment to maintain reasonable living standards in the future. Also we are able to know how better a nation's income level is, when compared with others.

3. **Comparison of Living Standard:** The comparison of living standards could be achieved on the basis of average income per head, that is to say per capital income

4. **Determine Nation's Living Standard:** Through National Income we are able to know the overall standard of living of the people, because National Income is the flow of wealth and wealth is the ideal indication of well – being. Thus the higher the size of National Income, the higher the living standard of people and vice – versa. Provided that the income is equitably distributed.

5. **Revenue Allocation:** National Income figures provide basis through which revenue resources could be allocated to various sectors or tiers of government for nation building.

6. **Attraction and Granting of Aids:** National Income enable us to determine the amount of aid which rich countries can give to the poorer countries and also the amount of contribution a nation can make to an international body like the limited nations.

7. Calculation of Per Capital Income:
8. To know the contribution of various sectors

FACTORS THAT DETERMINE NATIONAL INCOME

1. **Working Population:** The higher the working population of a country, the higher the county's productivity which will likely increase its national income and vice versa.

2. **Availability of National Resources:** A country with abundance of natural resources will experience increase in national income than a country with little or no natural resources.

3. **Industrial Development:** Industrialization influence national income. The presence of industries or increased industrial activities contribute positively to national income.

4. **Economic Stability:** Economic stability plays crucial role in increasing a country's national income and guarantees meaningful productivity as such economic instability decreases

5. **The Level of Technology:** The higher a country's level of technology, the higher its National Income and verse versa.

6. **Nature of Factors of Production:** The amount of capital available the quantity of the labour force the fertility of the land and entrepreneurship will positively or negatively affects a country's national income.

7. **Political Situation:** Political stability in any country can contribute positively to national income while political instability reduces it.

8. Availability of Economic Infrastructures
9. Level of corruption

LIMITATION

Although National income estimates are very useful, a number of problems arise in using them to measure the standard of living a country or for the purposes of comparison between countries and between different periods in the same country.

1. **They do not reveal the income distribution in a country:** National Income do not disclose whether income is widely spread or concentrated in a few hands. Even if a country has a high national income or income per capital while a large percentage of output is controlled by an insignificant percentage of the population, the masses are not well off and income per capital estimates becomes almost useless as measure of the general standard of living

2. **There are differences in the internal value of money:** The standard of living to a large extent depends on the value of money (ie the purchasing power of money). Some countries may be having a high rate of inflation while others may be having deflation. The per capital income may therefore not give a true picture.

3. **There challenges in the value of money:** The value of money changes over time. If the level of prices in the country has increased, an increase in national income or per capital income may not mean that the standard of living has increased. This is because a given quantity of money can now purchase fewer goods and services. Charges in the price level limit the comparison of national income between years.

4. **There are differences in tastes and values between countries and times:** People tastes and preference differ from one country to another. Again in the same country, tastes and prefences changes over time. Although.

5. **There are differences in working conditions and opportunity cost of output:** National income figures do not take into considering the differences in working conditions and the real cost of increasing national output. Although a country may have a high level of national income. This may have been achieved by increased working hours and poor social relations.

6. **Their may be different approaches to measurement of national income:** Different counties may have arrived at their national income figures by using different approaches and systems of valuation. In these circumstances, it is possible that one country may include what another included in the measurement of output. What constitutes income may be different. One country may include self – services and services not paid for while another may not. In addition a country may have worked out GDP and Factor Price while another has done so at market price.

7. **There are differences in the structure of production:** In some countries there is a large subsistence sector. In such countries the level of output is more likely to be grossly underestimated than in a country with a market economy

ELEMENTS OF NATIONAL INCOME

1. **PERSONAL INCOME:** It is the earnings of an individual (in monetary terms) for taking part in the production of goods and services either by him or his property.

2. **DISPOSABLE INCOME:** This is part of income which is left after personal income tax is deducted: That is personal income less taxation. It is the amount left for spending and saving.

3. **GROSS DOMESTIC PRODUCT (GDP):** This is the total value (in monetary terms) of all goods and services produced in a country within a period of one year by all the residents of the country regardless of whether they are citizens or foreigners.

   It excludes the earnings of citizens or their investments abroad but includes the earnings of foreigners or earnings from foreign investment in the country.

   In calculating GDP no allowances is made for depreciation. G.D.P is the same as Gross Domestic Income

   GDP = NDP + Depreciation

   GDP = C + I + G + (X – M)

4. **GROSS NATIONAL PRODUCT:** This is the total monetary value of goods and services produced by the citizens of a country

(including income from their investments) both at home and abroad.

It is the total value of goods and services plus net income from abroad. That is it includes the earnings of the citizens or their investments in other countries but excludes the earnings of foreigners or their investments in the country. In this case no allowance is made for depreciation

NDP = GDP - Depreciation

5. **NET NATIONAL PRODUCT (NNP):** This is the gross National Product less Depreciation. It is the total monetary value of all final goods and services produced by all the citizens of a country and income from their investments (whether at home or aboard) after allowance has been made for depreciation

NNP = GNP - Depreciation

6. **NATIONAL INCOME:** It is the estimated monetary value of all goods and services produced in a country during a specified period of time usually a year. It is also the record of all economic activities in the course of the year.

This is equal to the total income accruing to all the four factors of production in a country. It is the sum total of all profits interest, wages and rents recurred within a year or the sum total of all personal income.

7. **INCOME PER CAPITAL:** This is the income per lead of the population. It is the national income divided the total population of a country.

$$\text{Per capital income} = \frac{\text{N I}}{\text{Population}}$$

METHODS OF MEASURMENT

1. **INCOME APPROACH (INCOME METHOD):** This is obtained by adding recurred from the production of goods and services (factors of production). The income to be added include workers earning (wages and salary) profit entrepreneurs, rent on land, interest from capital etc but excludes transfer payment ie gifts

given to old people, students and beggars, pension paid to old people etc. because they are part of people's income which are already counted.

(Business expenses are excluded) by using this approach, we arrive at either GNP or GDP at factor cost. This is because the total figure is found by adding up the costs (ie income) of the various factors of production.

To get the GNP or GDP at market prices, add taxes and subtract subsidies

2. **OUTPUT METHOD:** This method measures the total money value of all goods and services produced in the country in a year.

   This is also known as value added method. It involves sector by sector addition of money values of goods and services produced within a year.

   The net value of the output of the various sectors of the economy are summed u to get the total output

PROBLEMS ASSOCIATED WITH OUTPUT METHOD OF MEASURING NATIONAL INCOME INCLUDE

1. **Double Counting:** This is the problems of calculating intermediate and finished products
2. **Problem of Self Employed Person:** No adequate record are kept in terms of money value for personal service rendered in the economy.
3. **Inflation:** This is calculating National Income without due consideration to the value of money as at the time of calculation
4. **Insufficient Statistical Data/Information:** Due to poor data system in the country some items are left out during calculation
5. **Ignorance and Illiteracy:** This constitute a problem because necessary items and information withdrawn during calculation because of ignorance and illiteracy

EXPENDITURE METHOD

The expenditure approach calculate eth total amount spent on consumption and investment purposes during the year.

It measures the total expenditure on currently produced final goods and services by the individuals or households, firms and government plus net export.

Transfer payment such as pension are excluded as they are not paid in exchange for currently produced goods and services

REASONS FOR MEASURING NATIONAL INCOME

Countries measure their national income for various reasons which includes.

1. National Income figures are used for economic planning. Data from national incomes estimates guide policy – makers and economic planners on the right line of action to follow

2. **It is used to measure economic progress:** National Income figures provide information about the performance and growth rate of the economy by comparing the figures for different years. It will be possible to know what is happening to the economy as a whole. It can show whether the rate of economic growth is low or high.

3. National Income estimates are used to measure the level of the general standard of living of the people. Income per capital is an indicator of the general well being of the people in the country. If the pr capital income is high other things remaining equal the standard of living will be high.

4. National Income estimates are used for purposes of international comparison between different periods in a particular country. The per capital income of countries is used for this purpose

5. **It provides basis for aid and technical assistance:** By looking at national income and per capital incomes of different countries a rough idea will be obtained of those countries which are poor and those which are well off. In giving and technical assistance, world organisations sometimes give priority to the poorer countries.

6. **It influences Foreign Investments:** National income estimates gives rough idea of the potential demand to a foreign investor.

Foreign investors will usually seek countries with rich or fast growing markets.

7. **For Future Forecast:** The national income data is used to forecast future rate of economic growth and development

FACTORS THAT DETERMINE NATIONAL INCOME

1. **Working Population:** The higher the working population of a country's productivity which will likely increase its national income and vice versa

2. **Availability of Natural Resource:** A country with abundance of natural resources will experience increase in national income than a country with little or no natural resources

3. **The Level of Industrial Development:** Industrialization influence national income. The presence of industries or increased industrial activities contribute positively to national income

4. **Economic Stability:** Economic stability plays crucial role in increasing a country's national income and guarantees meaningful productivity as such economic instability decreases.

5. **Nature of Factor of Production:** The amount of capital available the quantity of the labour force the fertility of the land and entrepreneurship will positively or negatively affect a country's national income

6. **Political Situation:** Political stability in any country can contribute positively to national income while political instability reduces it.

7. Availability of Economic Infrastructures:

ix Level o corruption
x General working conditions
xi Incidence of national disasters.

STANDARD OF LIVING AND COST LIVING STANDARD OF LIVING

This refers to the level of welfare attained by individuals in a country at a particular time. This level of welfare is measured in terms of the quantity and quality of goods and services consumed within a period of time. E.g

1. The quantity and quality of good eaten
2. The type of house one lives in
3. The availability of medical facilities

Standard of living of a country is determined by

i. Income per head
ii. Distribution of income

Cost of Living

An individual's cost of living refers to the total amount of money spent to obtain the goods and services which will enable him exist at a particular time.

It refers to the money cost of such things or food, shelter, clothing medical facilities, education, recreation etc which he consumes.

Cost of living largely depends on the prices of goods and services which an individual consumes. If prices of goods and services are high, the cost of living will be high because he has to spend much money to obtain goods and service. But if prices are low, less money will be spend and so the cost of living is low.

RELATIONSHIP BETWEEN STANDARD OF LIVING AND COST OF LIVING

A rise in the cost of living reduces the standard of living while a reduction in the cost of living increase the standard of living it is the cost of living that determines the standard of living.

MEASUREMENT OF NATIONAL INCOME

1. **INCOME APPROACH (INCOME METHOD):** In using this method, account is taken of all the income received by individuals, firms and the government within a year for their participation in production.

The income received by factors of production in the form of

a. Wages or Salaries
b. Rent
c. Interest
d. Profit are added together.

To avoid double counting, transfer incomes or payments are not included. Examples of transfer incomes are gift given to old people, students and beggars, pension paid to old people etc.

The income which must be included must be that which arises from the production of goods and services. Business expenses are not included while gods and services consumed by the producers are included.

Using this approach GNP or GDP at factor cost is arrived at.
To get GNP or GDP at market price we add taxes and subtract subsidies

GNP = W + I + R + P + D + I D

W	=	Wages or Salaries
I	=	Interest
R	=	Rent
P	=	Profit
D	=	Depreciation
Tb	=	Indirect business taxes

LIMITATIONS / PROBLEMS

1. **Double Counting due to Transfer Payment:** Gifts to beggars, value of scholarship, pension to retried workers, unemployment benefit may be included leading to overestimation

2. **Inadequate Data:** Due to the presence of large informal and self employment sectors. Records of income are most often either poorly kept or not kept at all

3. **Services not paid for e.g:** Services of housewives and voluntary organisations. Their values are difficult to ascertain because they are not paid for.

4. **Retained Earnings by forms (ploughed back profits):** Part of the income of firms which are not paid as dividends but retained for re-investment may not be included.

5. **Problem of measuring the value of depreciation:** Value of depreciation is difficult to ascertain or estimate.

6. **Problem of owner – occupied houses:** The value of rent which owners of houses would have paid if they do not live in their own houses is most often under estimated.

7. **Problem of assessing net income from abroad:** Many payments made to other countries do not pass through official channels, making national income estimation difficult.

8. A large proportion of the people of West Africa are either self employed or employed in the informal sector. It is usually difficult to estimate the income of such people.

9. **Frequent Price Changes:** Rapid changes in prices may lead to overestimation

10. **Income from Capital Gain:** This is most often mistaken to be transfer payments, leading to underestimation of National Income.

2. **OUTPUT OR NET PRODUCT APPROACH**
This method sees national income in terms of the monetary value of all goods and services produced by the various economic units (individuals, firms and the government) in a year.

In this method, national income is measured by adding together the value of the net contributions of the various sectors or enterprises (both private and public) in the country. To avoid double counting, income is measured on value added basis (value added basis is the value of output less cost of inputs).

The value of exports are included while the value of imports are subtracted.

The following are also added.

1. Value of goods and services produced and consumed by the producers themselves
2. The value of owner occupied houses
3. The value of services rendered by voluntary organisations, house helps and house wives.
4. The value of public services such as defence and justice

PROBLEMS / LIMITATIONS

1. **Large Subsistence Production:** It is difficult to measure the value of self consumed goods and services in the subsistence sector eg in subsistence farming

2. **Double Counting:** It is difficult to estimate the value of input and business expenses especially in the informal sector, thereby leading to double counting

3. **Frequent Price Changes in the value of money:** It makes it difficult to estimate accurately the value of output

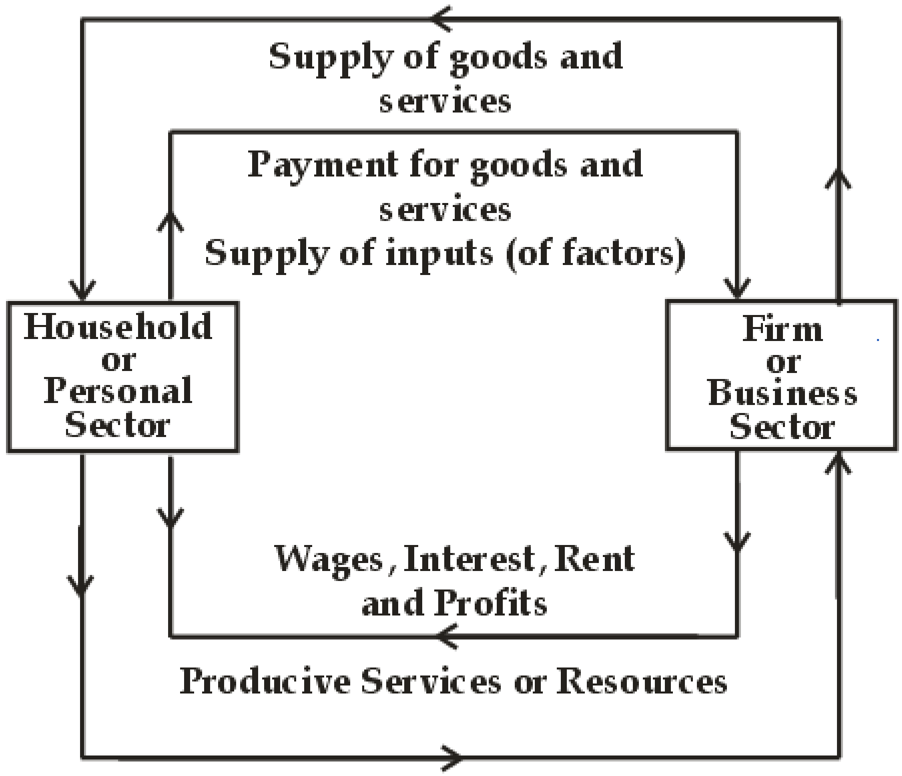
4. **Welfare Services Provided by the Government:** Values of welfare services are most often underestimated

5. **Value of Services not paid for:** It is difficult to measure the value of services not paid for

ELEMENTARY THEORY OF MONEY

CIRCULAR FLOW OF INCOME

The circular flow of income refers to the flow of payments and receipts for factor services and for currently produced outputs passing between domestic firm and household



Individuals earn income by taking part in the production of goods and services. On the other hand, income is earned by firms selling their outputs (goods and services).

The circular flow of income describes the flow of payments from businesses to households in exchange for labour and other productive services and in return the flow of payments from households to businesses in exchange for goods and services.

CONCEPTS OF SAVINGS, INVESTMENT AND CONSUMPTION

SAVINGS

This is the part of income which are not spent. In other words savings refers to all or part of income which are not spent immediately but reserved for future purposes.

INVESTMENT

This is the expenditure on physical assets which are not for immediate consumption but for the production of consumer and capital goods and services

CONSUMPTION

Consumption is the total quantity of goods and services purchased and used by consumers during a specified period of time.

ELEMENTARY THEORY OF THE MULTIPLIER

1. Income, consumption and savings are related. This is represented by

$$Y = C + S$$

Where

Y = Income

C = Consumption Expenditure

S = Savings

The amount of income earned determines to a large extent the level of consumption of an individual as well as the amount which can be saved. Ie the higher the income, the higher the level of consumption and savings and vice versa other things remaining equal

2. Income, consumption and investment are related thus

$$Y = C + I$$

Where

Y = Income

C = Consumption

I = Investment

This relationship is based on the fact that all expenditure in the economy can be regarded as either consumption expenditure or investment expenditure.

AVERAGE PROPENSITIES TO CONSUME AND SAVE

This is a measure of the proportion of income spent on consumption of goods and services ie the ratio of consumption expenditure to total income

$$APC = \frac{C}{Y} = \text{ie } \frac{\text{Total Expenditure on consumption}}{\text{Total Income}}$$

The average propensity to consume decreases with increasing income level. In this case APC is 1. But as income increases the proportion to income consumed will be less.

The level of income at which APC is equal to 1 is known as BREAK EVEN level of income

AVERAGE PROPENSITY TO SAVE

This is a measure of the proportion of income which is saved (not spent on consumption) ie ratio of savings to total income. It tells the expected amount of savings at different level of income.

$$APS = \frac{S}{Y}$$

Where: S = Total Savings

Y = Total Income

The average propensity to save increases with increases in income. As the level of income increases one is able to save more money.

$$APC + APS = 1$$

Examples
If an individual earns an annual income of ₦6000 and spends ₦4000 on the consumption of goods and services. Calculate his average propensities to save and consume.

Solution
Total income = ₦6,000
Consumption Expenditure = ₦4,000

$$\text{APC} = \frac{\text{C}}{\text{Y}} = \frac{4000}{6000} = \frac{2}{3}$$

= 0.67 or 67%

Since APC is = 1 – APC
= 1 – 0.67
= 0.33 or 33%

Alternatively
Expected savings = N6000 – N4,000
= N2000

$$\text{APS} = \frac{\text{N } 2{,}000}{\text{N}6000} = 0.33$$

MARGINAL PROPENSITIES TO CONSUME AND SAVE
It measures the relationship between change sin come and changes in consumption. It is the ratio of changes in consumption to changes in income. It shows the extent to which the level of consumption changes as a result of changes in income

$$\text{MPC} = \frac{\Delta \text{C}}{\Delta \text{Y}}$$

Where
ΔC = Change in consumption
ΔY = Change in income

MARGINAL PROPENSITY TO SAVE (MPS)
This measures the relationship between changes in the level of savings and changes in income

It is the radio of change in savings to change in income. It shows the change in savings brought about by a change in income level.

$$\text{MPS} = \frac{\Delta \text{S}}{\Delta \text{Y}}$$

MPC and MPS are connected with finding out what happens to additions to income with respect to how much of the addition is devoted to consumption or savings

MPC + MPS = 1

Example

If the daily income of an individual increase from ₦300 to ₦450 and he increases his level of consumption ₦50. Calculate the MPC and MPS

Solution

Initial income per day = ₦300

New income per day = ₦450 - ₦300

Change in income ΔY = ₦150

Change in consumption ΔC = ₦50

$$MPC = \frac{50}{150} = 0.33$$

MPC + MPS = 1

MPS = 1 - MPC

MPS = 1 - 0.33 = 0.67

Alternatively

Change in level of consumption ₦150

Change in level of savings ₦150 – ₦50 = ₦100

$$MPS = \frac{\Delta S}{\Delta Y} = \frac{₦100}{₦150} = \frac{2}{3} = \underline{\underline{\mathbf{0.67}}}$$

THE CONCEPT OF THE MULTIPLIER (K)

The multiplier measures the effect of a change in any of the components of aggregate demand such as private consumption, private investment, government expenditure and exports and imports on national income.

The multiplier is the ratio of change in income to a change in any of the components of total spending.

For example if total investments change by a stated amount, the extent to which income will change can be determined by using the multiplier.

CONSUMPTION EXPENDITURE AND THE MULTIPLIER

An increase in consumption expenditure leads to a higher increase in national income. On the other hand, if consumption expenditure is reduced, the fall in income will be greater than the rate at which consumption expenditure has been reduced.
The multiplier can therefore be defined as the ratio of increase or decrease in consumption spending

$$\text{The multiplier K} = \frac{1}{1-\text{MPC}} = \frac{1}{\text{MPS}} = \frac{\Delta Y}{\Delta C}$$

A knowledge of the national propensity to save helps to know the multiplier. And a knowledge of the multiplier helps us to know the extent to which consumption expenditure should be increased or decreased to achieve a desired level of income or output.

A higher MPC increases national income while a higher MPS will reduce it.

Examples

a. If the marginal propensity to consume is 0.75. Calculate the multiplier

b. By how much must consumption expenditure be increased to increase income by ₦2000

Solution

$$K = \frac{1}{1-\text{MPC}} = \frac{1}{1-0.25} = \frac{1}{0.25} = 4$$

b. $$K = \frac{\Delta Y}{\Delta C}$$

$$4 = \frac{₦2000}{C}$$

$$4C = ₦2000$$

$$C = \frac{₦2000}{4} = ₦500$$

INVESTMENT EXPENDITURE AND THE MULTIPLE

Expenditure on investment goods constitutes part of aggregate expenditure. If investment expenditure is increased, there will be an increase in National Income which is greater than the increases in expenditure.

On the other hand a reduction in the level of investment will reduce income by a higher proportion compared with the proportion by which investment is reduced.

The multiplier K $= \frac{1}{1-MPC} = \frac{1}{MPS} = \frac{\Delta Y}{\Delta I}$

By knowing the multiplier, it becomes possible to alter the level of investment as desired to achieve given level of national income.

Example

If the Marginal propensity to save is 0.5 Calculate

a. The multiplier

b. The level of investment which is required to raise income by ₦3000

Solution

$$K = \frac{1}{MPC} = \frac{1}{0.5} = 2$$

b. $$K = \frac{\Delta Y}{\Delta I}$$

$$2 = \frac{₦3000}{I}$$

$$2I = ₦3000$$

$$1 = \frac{₦3000}{2} = ₦1500$$

GOVERNMENT EXPENDITURE AND THE MULTIPLIER

As with private consumption and investment, expenditure by government has multiplier effects on the national income. Increased government spending, increase the National income at an increasing rate, while reduction in government spending will have a reverse effect.

The multiplier K $= \frac{1}{1-MPC} = \frac{1}{MPS} = \frac{\Delta Y}{\Delta G}$

Example

If the marginal propensity to consume is 0.6 by how much will national income increase if government expenditure is increases by ₦4000

Solution

$$K = \frac{1}{1 - MPC} = \frac{1}{1 - 0.6} = 2.5$$

b. $$K = \frac{\Delta Y}{\Delta I}$$

$$2.5 = \frac{\Delta Y}{₦4000}$$

$$\Delta Y = ₦4000 \times 2.5 = ₦10000$$

FINANCIAL INSTITUTION

Financial institutions refers to all organisation which hold money for individuals and institutions and may borrow from them in order to give loans or make other investment.

Banking Financial Institutions are

a. Commercial Bank
b. Central Bank
c. Development Bank
d. Merchant Bank
e. Savings Bank

Non Financial Institutions are

i. Insurance Companies
ii. Hire Purchase Companies
iii. Building Societies.

TRADITIONAL INSTITUTIONS

These include the traditional sources of fund that are available on different societies. In most cases their existence are not known to the government.

THRIFT CO – OPERATIVE

Under this, the members contribute money on regular basis and later each is paid plus accruing interest

COMMERCIAL BANK

A commercial bank may be defined a s financial institution which deals in money and credit and which receives deposits from the public and organisations for safe keeping, some of which are repayable on demand by cheque.

Commercial banks are public limited companies owned by shareholders.

They operate on Commercial basis ie they are out to maximise profit by trading with money. They are Limited Liability Companies. Examples of Commercial Banks are

a. First Bank PLC
b. Diamond Bank PLC
c. Access Bank PLC
d. Zenith Bank PLC

FUNCTIONS OF COMMERCIAL BANK

1. **Mobilisation of Savings or Acceptance of deposits:** They accept money deposits from people and organisations for safe keeping. The amount deposited is credited to the customer's account

   Three types of Account can be kept with commercial banks.

   i. **CURRENT ACCOUNT:** Money deposited into this account is called DEMAND DEPOSIT. Money is withdrawn from this account on demand by cheque.

   ii. **SAVINGS ACCOUNT:** This is the account which is operated with a pass book. The withdrawals and deposits of the customer are recorded in this book by the bank

   iii. **TIME OR FIXED ACCOUNT:** Money deposited in this account cannot be withdrawn on demand. There is usually a fixed period which sometimes may be up to six months or one year before money can be withdrawn from the account and when money is withdrawn after the agreed time, notice (usually about seven days) must be given to the bank.

2. **Commercial banks act as agents of payment on behalf of their customers:** If a customer has regular payments to be made such as rent, insurance, premiums or school fees, a standing order can be left with the bank which will a regular payment on his behalf

3. **Commercial banks acts as agent of payment:** They can give direct loans to borrowers who have the necessary collateral security such as stock and share, certificate, landed property etc.
   They could give loan facilities to current account customers in the form of overdrafts.

   They also lend money to the government by purchasing government treasury bills.

   By acting as intermediary between large numbers of depositors of money and borrowers, commercial banks help to mobilise capital and give it to those who can make effective use of it in productive ventures thereby helping to speed up economic development.

4. **Commercial banks helps in the safe keeping of their customer's valuables:** Such valuables include costly jewellery and important documents such as will, share certificate etc.

5. **They act as referees as to the integrity of their customers:** They could recommend their customers to foreign firms who require indigenous business partners for carrying out their businesses

6. **They give financial and technical advise to their customers in matters relating to investment:** They could advise their business customers on how best to carry out their business operations, how to raise capital for business or to expand an existing one

7. **Commercial bank helps in the foreign exchange transactions thereby facilitating foreign trade and travel:** They facilitate foreign trade by selling foreign currencies to importers. One who wishes to travel abroad could purchase traveller's cheques from commercial banks.

8. **Commercial banks help directly in economic development by investing directly in the productive sectors of the economy:** They could own shares in commercial, agricultural and industrial ventures or they could set up businesses on their own, by participating in business concern, enough capital is provided for raising the level of production in the economy.

9. **A commercial bank can assume the responsibility of carrying out the duties of an attorney, executor and trustee:** It could look after a deed man's assets and distribute them among his heirs according to his will.
10. **They act as agents that purchases stocks and shares for their customers:** They also sell stocks and shares to their customers on behalf of issuing houses.

11. **Commercial banks are important agent for carrying out government monetary policy:** By adopting certain measures as directed by the central bank, they help in contracting or expanding the money supply or in carrying out other government monetary policies

12. **Commercial bank facilitates business transactions by making possible the use of cheque:** This helps to solve the problem of having to carry about large amounts of money. It is safer to carry cheques than cash.

THE CREATION OF MONEY
Bank lending increases the quantity of money in circulation in other words it increases the total purchasing power. The total purchasing power increases by the amount of loaned out.

This is why it is said that bank lending creates money.

i. By giving direct loans to people and organisations and charging interest on loans

ii. By granting overdrafts to customers with current accounts, that is allowing them to draw above the amount in their current accounts (p to a certain limit and interest is charged on the overdraft).

Overdraft is the excess amount which a current account customer is allowed to draw over/above the amount he has in his current account.

iii. By purchasing treasury bills from the government and by discounting bills of exchange.

CHALLENGES FACING THE BANKING INDUSTRIES IN NIGERIA

1. **Corruption and high incidence of bank fraud:** They are may reported cases of bank frauds by customers and corrupt bank officials who steal customers money and siphon funds from the banks.
2. **High incidence of bad debts (ie non repayments of loans):** Many times loans are given without collateral security due to social pressures from friends, relatives and influential persons. Recently many banks in Nigeria have become insolvent because the management gave out huge loans which cannot be recovered.

3. **Excessive control by the central bank or by the government:** Excessive liquidity squeeze through the use of monetary policy makes it difficult for banks to meet the demand of their customers for loans and advances.

4. **Inadequate collateral security:** Many borrowers do not have the collateral security required by banks for lending money to them. This limits lending by commercial banks to many prospective customers.

5. **Inadequate deposits and capital shortage that limits expansions:** The level of income in West Africa is generally low. This makes it difficult for banks to attract adequate deposits.

6. **Concentration of banks in urban centres to the neglect of many rural areas:** It is therefore not easy to mobilise savings from the rural population. Banking operations are not often close to the needs for the ordinary man.

7. **Inadequate skilled personnel:** Highly qualified management and other staff are often inadequate in indigenous banks due to shortage of funds to pay for their services.

8. **Interference of politics with business decision:** There have been occasions when the government in power has influenced appointment to the Board of Directors. Government interest may therefore be projected in business decision

9. **Limited use of cheques and other instruments of money transfer:** Many people still prefer to carry cash instead of cheques and other monetary instruments thereby limiting the importance of banks in commerce and industry

ROLE OF COMMERCIAL BANKS IN ECONOMIC DEVELOPMENT

1. They give out loans and advance thereby providing short term and medium term capital for investors with amount borrowed investors could finance various projects
   in the area of industry, agriculture and commerce.

2. **Commercial banks contribute directly to economic development by investing in the productive sectors of the economy:** They could own shares in commercial, industrial and agricultural ventures. On the other hand, they could establish their own business concerns. By participating in business ventures, they help to provide much of the required capital for investment and help raise the level of productivity in the economy.

3. **They give financial technical and management advice to their customers in matters relating to investment:** They advise their business customers on how best they can carry out their business

operations. They advise investors on the various ways of raising finance for investment purposes.

The managers of various business enterprises, who are customers of a bank could get management advise.

4. **Commercial banks facilitate business transactions by making the of cheques and bank drafts possible:** Traders and industrialists who handle plenty of money find it easier and safer to carry large amount of money in the form of cheques and bank drafts from one place to another. The incidence of money lost by trader and investors is therefore reduced. This contributes to the growth of their business.

   They also facilitate business transactions by making payment on behalf of their customers. They could help in transferring money from one place to another thereby facilitating trader.

5. **Commercial banks encourage investment by making it possible for private individuals and business men to purchase government treasury bills and government stocks:** They enable individuals, businessmen and the government to purchase the stocks and shares of companies. The capital raised is used to finance business enterprises. They also act as agents who help their customers to sell their stocks and shares. This promotes the stability of business

6. **They facilitate International Trade and Travel by making foreign exchange transactions easier:** They help in making overseas payments for their customers. They also assist in international trade by issuing letters of credit to importers and providing travellers cheques to overseas travellers. By performing this role, people and businessmen are able to settle their international indebtedness

7. **They act as referees as to the integrity and financial standing of their customers:** Indigenous investors who want to go into partnership with foreign investors could obtain references from their bankers. Investment opportunities can therefore be created within the country. This speeds up economic development

8. **The operation of commercial banks encourages savings:** They provide facilities for saving. By performing this role they help to mobilise capital which can then be lent to investors. They therefore encourage capital accumulation which helps to speed up economic development.

CENTRAL BANK OF NIGERIA

This is a financial institution owned by the government of a nation, run by board of directors, chaired by a governor appointed by the government and charged with the responsibility of managing the expansion and contraction of the volume, cost and availability of money in the interest of public welfare. It is an exclusively federal government owned bank which helps to control and supervise the entire monetary and financial system of the country.

It regulates, directs, assists and coordinates the operations of other financial institutions so as to make them comply with the monetary and economic policies of the government.

FUNCTIONS OF CENTRAL BANK OF NIGERIA

1. It acts as a banker and financial adviser to the government.

   The central bank receives the proceeds from taxation and some other sources of government revenue and makes payments on behalf of the government.

   It helps the government to raise loans for economic development by arranging the sale of government treasury bills and development stock.

They advise the government on financial matters.
It services or manages the national debt paying interest on loan taken by the government

2. **It acts as the bankers' bank**
The central bank acts as a banker to the commercial banks. Commercial bank use the central bank as their own bank just as individuals use commercial bank. They keep a percentage of their deposits with the central bank. It provides facilities for making interbank payments and for the clearing of cheques.

3. **It acts as a lender of last resort**
This function stems from its function as a banker's bank. At time when a commercial bank may run short of funds to meet the withdrawals and demand for loans by its customers the commercial bank will approach the central bank and obtain loans or have its bills rediscounted in order to be able to meet its financial commitments. This function helps to prevent any monetary crises in the economy.

4. **Issuing of Currency**
The Central Bank is the sole authority empowered by law to issue bank notes and coins within the economy. It controls the circulation of currency, arranges the withdrawals of old currency and replaces with new currency whenever the need arises.

5. **Maintenance of Monetary Stability**
The Central Bank controls, supervises, assists and coordinates the activities of commercial banks and other financial institutions so that they fulfil the requirement of government monetary policy. They do this by using different monetary policy thereby maintaining monetary stability within the economy.

6. **Central Bank promotes economic growth**
It achieves this in many ways. These include the development of the money and capital markets to finance various development

projects. It helps in promoting price stability and also makes money available to entrepreneurs for production purposes. They sometimes promote economic growth by direct financing of development projects.

7. **It acts as banker to discount houses and other financial institutions which operates in the money and capital markets**
   Apart from keeping account with the central bank, they approach the central bank for loans when they require money.

8. **The Central Bank carries out external business for a country**
   It deals with the central banks of other countries and with world financial institutions such as

   loans are raise from these financial institutions by central bank and used in development projects.

CONTROL OF COMMERCIAL BANKS BY THE CENTRAL BANK
The Central Bank controls the credit policy of Commercial Banks by using various instruments of monetary policy.

1. **Open Market Operation**
   Open market operation refers to the buying and selling of government securities. Such as treasury bills and bonds from and to the public and business organisation. This policy will either expand or restrict the volume of money in circulation.

2. **Use of Bank Rate:** The bank rate is the rate at which the central bank discount or re-discount bills for commercial banks and other financial institution or the rate at which it lends money to them.

   During inflation the Central Bank will increase the bank rate forcing the commercial bank to increase their own interest rate, the lending ability of people and organisations are reduced, lending to a reduction in the amount of money in circulation and a consequent control of inflation vice versa.

3. **Cash Deposit Rate or Liquidity Radio:** This refers to the minimum legal cash reserve requirements of the commercial banks. If the amount of money in circulation is too large and has to be reduced, the central bank will increase the cash deposit ratio. If the commercial banks keep a high percentage of their total deposits as reserve, their lending ability will be reduced. The amount of money in circulation will therefore be reduced and vice versa.

4. **Use of Special Directives and Moral Suasion:** A directive is an instruction or guideline from the central bank to commercial bank regarding the size of loans to give and the areas which to direct bank lending.

   If it is the policy of the government to encourage the growth of a particular sector of the economy (such as agriculture), the central bank will instruct the commercial bank to increase their lending to such a priority area of the government. On the contrary the central bank could give instructions to commercial bank to reduce or stop lending to certain types of business if the government does not want to encourage such sectors or business ventures.

   Moral Suasion

   This is an aspect or suggestion by the central bank from the commercial bank to pursue certain lending policies.

   The central bank could appeal to the commercial banks to restrict their lending habits or to adopt a more liberal loan policy.

5. **Use of Special Deposit:** They are additional deposit (other than the one required by law) which the central bank may require commercial banks to keep with it. This is used when the use of the cash deposit ratio is not adequate to keep down the rate of inflation. If inflation persists the central bank may ask the commercial bank to keep special deposit with it.

6. **Funding:** This refers to the conversion of short term government securities to long term securities. For example, treasury bills (short term securities) could be converted to long term securities (such as bond) if the central bank feels that the condition of the economy has not yet improved for short term loans to be repaid.

MONEY MARKET

The money market is a financial market made up of institutions which provide short – term finance for investment.

They bring short term borrowers and lenders together. They provide loans to borrowers for periods from a few months to two years.

Financial institutions that operate in the money market are

1. Commercial Banks or Joint Stock Banks
2. Merchant Banks or Acceptance Houses
3. Discount Houses
4. Hire Purchase Companies
5. Finance Companies
6. The Central Bank.

The money market uses certain financial instruments to transfer money from lenders to borrowers they are

1. **Treasury Bills:** This are short term government securities. The maturity is usually about ninety – one days

2. **Treasury Certificate:** These are securities of large maturity. The maturity ranges from 12 to 24 months

3. **Bill of Exchange:** This is a bill which is used mostly in making payments abroad.
4. **Money at Call**

USES / FUNCTIONS OF THE MONEY MARKET

1. Provision of short term capital for investors in both the private and public sector

2. Provision of short term investment opportunities from which income may be earned
3. Mobilisation of savings for investment
4. Provision of investment, technical and managerial advice
5. Provision of opportunity for the public to participate in the management of the economy.

MORTGAGE BANK

Mortgage Banks helps in providing housing loans to individuals and organisations wishing to buy or own houses. It is called a building society.

During the period of repayment of the loan, the bank usually keeps the certificate of ownership or title deed to the house to serve as a security.

Building societies accept deposits on which interest are paid. They are also funded by the government.

FUNCTIONS OF MORTGAGE BANK

1. **Development of Mortgage Institution:** They supervise and encourage the development of mortgage institutions
2. Provision of houses and offer them for sale to the people
3. **Equipment Leasing:** They assist companies wishing to lease their equipment
4. **Acceptance of Deposit:** They accept deposits from customers in order to encourage savings towards owning a house
5. **Provision of long term loans:** They provide long term loans to people or to estate developer to build houses.
6. **Give advice on housing matters:** They advise and assist the government on housing matters

MERCHANT BANK (ACCEPTANCE HOUSES)

Merchant bank perform functions which promote the growth of commerce and industry and enhance business stability.

They are banks that accept large deposits often fixed for particular period and give large loans on long term basis. Examples First City Monument Bank, Merchant Bank for Africa etc

FUNCTIONS

1. **Arranging the issue of shares:** Merchant banks in Nigeria undertake the specialised task of arranging the issue of new shares by public companies. This enables public companies to obtain the required capital for business operations.

2. **Underwriting and issue of shares:** They guarantee an issue of shares by undertaking to take up any unsubscribed shares. It buys shares which are left unsubscribed by the public and sell them later when there is a high demand for the shares of the company.

3. **Accepting bills of exchange:** A merchant bank accepts bill by signing across its face. By doing so it guarantee the bills and undertakes to pay the discount house. If the debtor defaults on the maturity of the bills. For taking this risk the acceptance house charges a commission.

4. **Acting as investment advisers:** They offer technical and management advice to investors. They advise them on how best to carry out successful businesses.

THE CAPITAL MARKET

The capital market is made up of the financial institution which deal in long term financing they provides medium and long term loans for investment. They bring long term lenders and borrowers together.

Institutions that operates in the capital market are

1. Insurance Companies
2. Development Banks
3. Building Society or Mortgage Bank