

20. Aids to Commerce – Banking

Objectives

At the end of this chapter the students should be able to define a bank, state the functions of a Central Bank, and assess the effectiveness of the control of the economy by the Central Bank.

20.1 Definition of Bank

A bank is a firm or business organisation which performs services connected with money, i.e. where money is kept and paid out, and where money may be borrowed.

20.2 Types of Banks

In the rest of this chapter and [chapters 21](#) and [22](#), we would concern ourselves with the following types of banks: the Central Bank, the commercial banks, the merchant banks, the savings banks, and the specialized banks. The development banks are distinguishable from the other types of banks mentioned above by their peculiar functions of financing industrial development projects, rather than acting as agencies for savings. The specialized banks will be discussed under “Other Financial Institutions” in the next chapter.

20.3 The Central Bank

20.3.1 Origin

A country usually has one Central Bank. This follows from the nature of its functions which are more or less monopolistic in dimension and operation as an effective agency of the central government. Economics and politics have become so mixed up that any central political authority must control the central monetary authority, if it would be in charge and in control of the national economy. This explains the rush for the establishment of Central Banks in West Africa in the 1950s and early 1960s as more and more countries achieved political independence. Before then, currencies used in British West African countries were issued by the West African Currency Board (WACB) with the British Bank of West Africa as its sole agent. The failure of WACB to meet the economic and political aspirations of the emerging British West African Countries led to the establishment of their own central banks, e.g. the Central Bank of Ghana in 1957 which started operation in 1959; the Central Bank of Nigeria in 1959 which started operation in 1960; others were the Central Bank of Sierra Leone in 1964 and that of Gambia in 1971.

20.3.2 Functions of the Central Bank (Financial)

- (i) *Issue and control of currency notes:* The Central Bank is the sole agent for the issue and control of the national currency. The premier position of the Central Bank as a close associate of the central government enables it to perform this function very well, and gives

credibility to currency issued. This function also tallies with other functions of the Central Bank as a regulator of the national economy.

- (ii) *The bank of the government:* It is a repository for the cash deposits of the government. All proceeds from taxes, court fines, customs and excise duties, etc. are deposited with the Central Bank; and these in its weekly return under the heading *Public Deposits*.
- (iii) *The manager of national debts:* The government does its borrowings, loan interest payments, and the loan repayment itself through the Central Bank.
- (iv) *Holder of foreign reserves:* The Central Bank keeps records of the country's stock of foreign reserve. This is in conformity with its function of superintending over the national economy by assessing, among other functions, the country's external trade position from time to time and advising government accordingly.
- (v) *Agency for ministry of finance:* It is an agent through which government monetary policies are carried out in active co-operation with the Ministry of Finance.
- (vi) *Government representative:* As an agent of government on monetary policies, the Central Bank is the obvious representative of the same government in any meeting of international monetary organizations like the World Bank, the International Monetary Fund, African Central Banks and the like.
- (vii) *Control of other financial institutions:* In accordance with the main function of assisting the government in promoting economic development, the Central Bank is further charged with controlling and regulating the lending activities of other financial institutions like the commercial banks, merchant banks, etc.
- (viii) *The bankers' bank:* The Central Bank requires the commercial banks legally to keep part of their cash as deposits with it (the Central Bank). By this, the Central Bank can exert its control over the lending activities of the commercial banks as a means of controlling the national economy as mentioned in (vii) above.

20.3.3 Other functions (non-financial)

For reasons of the unique status and powers of the Central Bank, it performs other subsidiary (non-financial) functions:

- (i) *A valuable source of statistics:* Consequent upon the Central bank's premier position on monetary and financial matters, it is capable of amassing a colossal amount of statistics – financial, monetary, economic, etc – which it makes available to the world at large.
- (ii) *A formidable centre for research:* The Central Bank's peculiar position in the national economy marks it out for a special ability to conduct various researches for the management of the economy.
- (iii) *An Author of periodical reports:* The Central Bank often produces comprehensive periodical reports and makes authoritative pronouncements on economic and financial issues.

20.4 The Central Bank's Control of the National Economy

20.4.1 We shall next address ourselves to how the Central Bank exercises control over the national economy. Here are some of the measures

of control

- (i) *The commercial banks' conventional cash-to-deposit ratio:* The commercial banks are expected by the Central Bank to arrange their investment portfolios, i.e. the investment uses to which they put their deposits, in such a way that they would also have ready cash or liquid assets (near cash) to meet the daily demands of depositors for cash withdrawals. To this end, by tradition, commercial banks, holding of cash should always be between 8% and 12% of total deposits. The Central Bank monitors and enforces this ratio of cash-to-deposit religiously, through the periodical reports of the commercial banks that are usually furnished the Central Bank.
- (ii) *Cash reserves with the central bank:* The commercial banks are requested by law to keep a ratio of their cash-to-deposits with the Central Bank. A reduction or an increase in the ratio would decide whether the commercial banks have more or less respectively for their lending activities.
- (iii) *Bank rates:* These are the rates at which first class securities are discounted. The Central Bank normally lends money to the commercial banks at these bank rates which are usually higher than the market rates by which the commercial banks themselves lend money to their customers. For the commercial banks to go and borrow from the Central Bank (as a lender of last resort) therefore, is to borrow at a `penal' rate. This is financially imprudent. Consequently, if the commercial banks would escape this penal rate they must avoid as much as possible coming to the Central Bank for borrowing. This would only be possible if the commercial banks would avoid indulging in excessive lending to their customers.
- (iv) *By the use of Open Market Operations (OMO):* This is the selling of government securities in the open market. By selling government securities, the government intends to borrow money from the public (open market). Those who buy the securities call on their deposits with the commercial banks to pay for the securities bought. This causes commercial bank's deposits to fall, and with it the fall in lending activities to their customers. Alternatively, the banks' deposits would rise when the Central Bank buys the securities from the commercial banks which could then increase their lending operation. In effect, the use to which the Central Bank puts OMO would depend on whether the Central Bank hopes to reduce or increase the volume of money in circulation.
- (v) *Persuasion, directives or moral suasion:* This is when the Central Banks gives directives as to which sectors of the economy the lending activities of the commercial banks should be directed, e.g. into the manufacturing industry, rather than the construction or consumption industry.
- (vi) *Use of Form `M' :* This is the form filled by certain categories of importers in order to give the Central Bank of Nigeria an advance notice of an intention to import certain goods into the country. The forms are processed through the importers' commercial banks to the Central Bank which would either approve or disapprove of such goods. On approval, a high percentage of the import bill is demanded as an advance deposit. It is a means of conserving foreign reserves by limiting imports.

20.4.2 Effectiveness of the Measures

There is no doubt that without some of the measures mentioned above, the national economy would be in a state of unmanageable chaos. The mere pronouncements of any of these measures would be regarded by the business world at large, and the financial institutions in particular, as a

government policy on the national economy. Desired results sometimes come out of the enforcement of these measures. In spite of these measures, however, one still observes that the national economy is not moving in the right direction. It tends towards an organized chaos. This means that the measures have not achieved the desired goals. Let us now examine the reasons why.

- (i) *Time lag*: There is sometimes a time lag between when the measures are pronounced and when the financial institutions actually act on the measures. It is not uncommon to find that such measures are already overtaken by economic events.
- (ii) *The state of the economy*: The condition under which a businessman would reduce his borrowings from the financial institutions at the face of high interest rates would depend on his interpretation of the economic situation. If the economy is buoyant, then high interest rates might not sufficiently deter borrowers from borrowing for investment purposes. However, in periods of economic recession, an extremely low interest rate would not necessarily produce enough incentive for borrowing for business purposes.
- (iii) *Economic expectation*: Closely associated with the state of the economy is the businessman's expectation of the economy. If the businessman foresees that interest rate would fall further but that the economy is taking a nosedive, the very substantial current low interest would not attract the businessman's propensity to borrow for the investment and vice versa.
- (iv) *Customers' bonds of relationship*: The banks and their customers have forged some longstanding bonds of goodwill relationship. The former would loathe to disappoint the latter, even when the Central Bank's policy is to make loans unavailable to such customers. The result is that the commercial banks may be more prepared to frustrate the Central Bank's loans measures than to disappoint a long-term trusted and reliable customer.
- (v) *Self-defeat*: Some of the measures could be self-defeating. If a high interest rate policy is designed to mop up a high rate of inflation, this policy itself could further aggravate the inflationary trend, especially if businessmen take an optimistic view of the economy and continue to borrow for investment purposes as mentioned earlier on, even at high interest rates. The policy could, therefore, be self-defeating.

Notes

- (i) The Central Bank by tradition does not compete with the other financial institutions for business. Its activities are entirely devoted to Federal Government finance and formulation of monetary policies; although it might serve the interest of a negligible number of commercial customers.
- (ii) The Central Bank of Nigeria has its headquarters at Abuja but maintains branch and cash offices in most of the state capitals, while planning to open more branch offices in the remaining state capitals.

Summary

- â€¢ The birth of modern banking is a mere accident of history as an extension of the function of the old goldsmith as keeper of clients' gold assets.
- â€¢ The West African Currency Board was created as the controller of the volume of currency in the old British West African colonies; and the Board collapsed because of its

failure to meet the needs of the countries.

The Central Bank exercises control on the national economy through the use of stated cash-to-bank-deposit ratio, open market operations, and by persuasion and directives. But the effectiveness of such control measures has been hampered by such factors as time lag, state of economy, borrowers' personal relationship and the self-defeating nature of such measures.

Revision Questions

A. *Essay Questions*

1. (i) What is the West African Currency Board (WACB)?
(ii) Critically assess its functions.
2. Describe FIVE ways in which the Central Bank could keep control over the commercial banks in your country.
3. What is meant by the Central Bank as the "Bankers' Bank"? Explain its operation.

B. *Objective Questions*

1. Which of the following institutions is a lender of last resort?
 - A. Commercial bank
 - B. Central bank
 - C. Merchant bank
 - D. Federal Mortgage bank

(WASSCE 2000)

2. The practice by which the Central Bank controls the money in circulation through the purchase and sale of government bonds is called
 - A. open market operation
 - B. moral suasion
 - C. special directive
 - D. bank rate

(WASSCE 2000)

3. Which of the following functions is performed by the Central Bank?
 - A. Acceptance of personal deposits
 - B. Buying and selling of shares
 - C. Execution of wills
 - D. Issuing bank notes

(WASSCE 2000)

4. The minimum charge by which the Central Bank lends to commercial banks is called
 - A. discount rate
 - B. bank rate
 - C. market rate
 - D. interest rate

(WASSCE 2002)

5. Which function of the Central Bank regulates the volume of money in the economy?
- control of foreign exchange
 - dealing with other central banks on money/financial matters
 - governments' monetary policy
 - serve as government's bank
 - servicing of national debts

(NECO 2001)

6. The Central Bank performs the following functions except
- Banker to the government
 - Banker of the last resort
 - Printer of bank notes
 - Banker to the banks
7. Which of the following is a banker to all commercial banks in Nigeria?
- The Federal Savings Bank
 - The Federal Mortgage Bank
 - The National Bank of Nigeria
 - The Central Bank of Nigeria
 - The National Bank for Commerce and Industry
8. Monetary policy of a country is carried out by the Central Bank through
- Bank rate
 - Granting overdrafts to the commercial banks
 - Discounting bills
 - Acting as banker of last resort
9. The Central Bank can control lending by the commercial banks through the following measures except
- cash-to-deposit ratio
 - cash reserves with the Central Bank
 - bank rate
 - credit guarantee
10. The Open Market Operation (OMO) can be used by the Central Bank to ensure
- reduction in foreign exchange
 - reduction of money in the economy
 - reduction in import bills
 - reduction in foreign debts

Project

- Find out the names of Nigerians who personally or jointly own any commercial banks in this country. What does it take in financial terms to own a bank single-handedly or jointly with others?
- Mention about ten Nigerians whom you think can afford to buy the Central Bank of Nigeria; and what will be the likely economic consequences on the Nigerian economy as a

whole?