

MONEY AND BANKING

MONEY:

Money refers to anything which is generally acceptable as a medium of exchange by the society in settlement of debts or for making payments for goods and services.

Money includes bank notes and coins (currency), metals, commodities, and other risk free liquid assets such as bill of exchange, Cheque, treasury bills and bonds etc.

Money in a particular country is **legal tender, that is**, by law it has to be accepted as a means of settling debts and for the exchange of goods and service within the country.

Medium Of Exchange:

Medium of exchange refers to a commodity, currency or a financial instrument used in settlement of commercial transactions between buyers and sellers as a measure and standard of value.

The two mediums of exchange include:

- Barter exchange
- Monetary exchange

Barter exchange is a system where goods are exchanged for goods or services.

Whereas monetary exchange is a system where goods and services are exchanged for money in form of bank notes, coins and other instruments of credit.

BARTER TRADE:

This is a type of trade where goods are exchanged for goods or services.

It is the earliest form of exchange which dominated the world over before the inception of paper money and coins/legal tender.

Some elements of barter trade have spilled over to the modern monetary economy of bank notes and coins/legal tenders which is evident and more significant in the rural setting where people exchange agricultural commodities for other commodities.

Barter system can work when there exists 'double coincidence of wants'. Double coincidence of wants refers to the simultaneous fulfillment of mutual wants/needs of buyers and sellers. However, it is difficult to find double coincidence wants in real life.

Advantages / merits of Barter trade:

- It preserves scarce foreign exchange since goods are exchanged for goods or services.
- It reduces imported inflation since currency money is not used.
- It minimizes balance of payment problems.
- It saves time since a lot of paper work and documentation is reduced.
- Effects of price fluctuation are avoided since physical quantities are used as price in exchange.
- It promotes trade among LDC'S that experience shortage of foreign exchange because goods are exchanged for goods.
- It creates more jobs since many people are involved in handling physical commodities inform of exports and imports.
- Promotes good relationship among trading countries.

Disadvantages of Barter trade:

- There is no generally acceptable medium of exchange in effecting payment.
- It requires double coincidence of wants whereby a person has to get one who has what he wants and also wants what he has for exchange to take place which is difficult.
- The system is time consuming and tiresome since it involves physical goods.
- There is no unit of account to carry out business calculations and records.
- Transportation of physical goods from place to place is difficult. (No portability)
- There is a problem of indivisibility i.e. it's difficult to break down some commodities into small units to enable small transactions to take place.
- There is no convenient way of storing wealth/value since most commodities are bulky and perishable.
- There is no standard of deferred payment to facilitate settlement of debts and transactions at a future date.
- Most commodities appear in plenty and therefore lose value easily. i.e. are not scarce.

Evolution of Money (Origin of Money):

Money was not invented overnight but rather is a result of a process of evolution through several hundreds of years. Money has passed through numerous historical stages which include the following;

- **Barter.** This was the earliest form of exchange where goods were exchanged for goods or services and services for goods. The money used

therefore was referred to as commodity money. A variety of commodities such as cattle/livestock, cowry shells, grains, tobacco, spears, hides and skins, precious stones, food stuffs etc as a medium of exchange. It was later discovered by people that they were missing some characteristics of money and there was a challenge of double coincidence of wants which made exchange difficult.

- It was then decided that **commodities of high value** were to be used as a medium of exchange. These included salt, tobacco, grains, hides and skins, livestock, cowry shells etc. These commodities were used to determine the value of other commodities and also served many purposes hence their ability to satisfy human wants/needs. However these commodities could not measure well the value of all commodities because they were bulky and perishable.
- Later **durable commodities** were used and these included; gold, iron, silver, beads, cowry shells. After sometime, it was later discovered that some of these commodities were in plenty and they would not act as a good medium of exchange.
- It was therefore decided that **precious metals i.e. gold and silver** should be the only ones to act as a medium of exchange. However as time went on people were inconvenienced with carrying metals, this prompted the emergency of goldsmith who would keep the gold in warehouse and issue receipts to the owners. The receipts had the same value as the gold kept in the warehouses. These receipts would be accepted as a medium of exchange since sellers would claim and obtain the amount of gold against the receipts from goldsmith. This marked the beginning of paper money.

In this case the receipts were used as money and this kind of money was known as gold standard money.

- **Gold standard money.** This was in form of currency notes/ paper money issued by the central bank and were backed by gold reserves. It is freely convertible into gold at a fixed price and a country settles all its international trade transactions using gold. Because of gold being too scarce in some countries, it made it difficult for some countries with limited gold to import required goods. This was one of the causes of world Great economic depression in 1929. This made countries to rethink the gold standard money and adopted legal tender; money not backed by gold thus the present day banknotes and coins.
- **Legal tender.** This refers to bank notes and coins which are issued by the central bank and must be acceptable by law as a medium of exchange by people in a given country. Legal tenders are not backed by gold.
- Over time more developments have taken place and these include use cheques, credit cards and most recently financial systems have evolved electronic money (E-currency) e.g. mobile money, E-accounts e.tc.

Qualities of Good Money:

For anything to be used and acceptable as money it should have the following features/ attributes/ qualities:-

- **Acceptability**, good money must generally be acceptable by people in the settlement of transactions.
- **Divisibility**, good money should be capable of being divided into suitable units/denominations to enable purchase of goods in small and in large quantities without problem of change.
- **Portability**, good money should be convenient to carry from one place to another.
- **Durability**, good money should be able to last for a fairly long time to reduce the cost of frequent printing and minting.
- **Homogeneity/Uniformity**, same units of money/currency must be identical to be accepted. e.g all notes of 10,000/ shillings in circulation in the country must be uniform and have same value.
- **Scarcity**, good money should be relatively limited in supply so that it maintains its value.
- **Stability of value**, good money should have stable value for a long period of time. i.e. it should not lose its exchange value easily.
- **Recognisability**, good money should be easy to be recognized/ identified as money by everyone in the country whether it is real or counterfeit money (fake money).
- **Malleability**, good money should be cheap and convenient to print.
- Good money should be difficult to forge otherwise if forged people would not accept it as a medium of exchange.

Characteristics of good money;

- Should be acceptable.
- Should be stable in value.
- Should be durable.
- Should be divisible.
- Should be relatively scarce.
- Should be portable.
- Should be homogeneous.
- Should be easily recognizable.
- Should be malleable.

Functions of money:

Money serves the following static functions:-

- It is a medium of exchange, it makes it possible for exchange of goods and services to take place.
- It is a measure of value, money is used to determine the relative value of goods and services and makes it possible for goods and services to be sold and bought.

- It is a store of value/wealth, money is the most convenient way of storing value since it is relatively durable than other goods and can be used later to buy goods when required.
- Unit of account, money is used as a unit to carry out business calculations and accounting procedures.
- It is a means of deferred payment, money makes it possible for credit transactions to take place and payment is made at a later date.
- It is a means of non-commercial payments such as taxes, fine, and gifts.

Role of money in a modern economy:

Money plays the following dynamic role in an economy;

Advantages of money as a medium of exchange;

- Leads to division of labour and specialization. Individuals specialize in the production of goods and services in order to obtain money which they use in getting other commodities.
- Avails payments for goods and services. It facilitates exchange of goods and services which helps in carrying on trade smoothly.
- Enhances commercial production. The use of money enables an economy to transform from a subsistence sector to a commercial sector since individuals produce for sale/exchange which increases their incomes.
- Used as a valuable social economic instrument for promoting economic welfare. E.g. use of the monetary policy.
- Money allows deferred/ future payments to be made. These are payments to be effected in future and they can be easily estimated before hand by use of money.
- Money facilitates international trade. Countries can participate in international trade in order to earn foreign exchange which helps them to purchase the goods that they do not produce.
- Money act as an incentive/attraction for the factors of production .Many individuals offer their factors of production in order to earn money e.g. labour is offered to earn wages and salaries, land is offered to earn rent.
- Money is also used to demand for factors of production. This enables the production of goods and services to take place which increase economic growth.

- It measures the value of goods. Money helps in valuing goods and services i.e. it determines the quality and quantity of goods to be produced.
- Money can be used as a substitute/ a solution to problems encountered in barter trade. It is a way in which societies try to overcome the problems encountered in barter trade by using money as a medium of exchange.
- It encourages hard work and effort i.e. money encourages people to work harder to accumulate more of it.
- It encourages proper allocation of resources i.e. this is where people produce those commodities that are highly demanded.

Disadvantages of money as a medium of exchange;

- Leads to misallocation of resource. Usually the rich individual dictates the goods to be produced in their favour which leaves out those goods demanded by the poor who are always the majority.
- Money leads to overexploitation of resources in order to accumulate more of it thus leading to their quick depletion.
- Money can lead to inflation. This is mainly experienced when there is too much money in circulation.
- It leads to income inequality .This is because people earn differently such that some individuals are earning more while others are earning less or nothing at all hence creating a gap between the rich and the poor.
- Money encourages rural urban migration and its associated problems/evils. This is mainly experienced when the labour force leaves rural areas to urban centers in search of high incomes. However some individuals are mainly unemployed which results into problems like congestion, creation of slums, robbery, prostitution etc.
- Money encourages corruption and embezzlement of funds. This comes about as individuals ask for bribes and other steal funds to accumulate more money.
- Money can lead to pride and hatred among the people. This kills social cohesion/unity in an economy
- Lack of money leads to poor standards of living, i.e. those who fail to earn enough money live under poor conditions.

TYPES/FORMS OF MONEY:

- **Fiduciary issue/money.** This refers to currency notes and coins issued by the central bank and are not backed by gold or foreign exchange reserves.
- **Full bodied money/ gold standard money.** This refers to currency notes and coins issued by the central bank and are backed by gold reserves. It is freely convertible into gold at a fixed price and a country settles all its international trade transactions using gold.
- **Legal tender.** This refers to bank notes and coins which are issued by the central bank and must be acceptable by law as a medium of exchange by people in a given country. Legal tenders are not backed by gold.
- **Fiat money/order money.** This is money issued on government orders or directive not backed by gold or foreign exchange reserves. It is not convertible into other forms of money. I.e it is an inconvertible paper money.
- **Hard currency/Convertible money.** This is money/currency that can be exchanged into other currencies without restrictions. For example, euro, British pound sterling, US dollar, Japanese yen e.t.c. Legal tender is convertible money.
- **Managed currency.** This refers to money which is used within one country only and is not fully convertible into other currencies.
- **Token money.** This refers to coins whose metallic value is less than face value. This is done to discourage people from melting the coins to sell metals.
- **Intrinsic money.** Is one whose metal value is equal to its face value.
- **Commodity money.** This refers to money in form of physical goods which are exchanged for other goods and services.
- **Deposit money.** This refers to money held in the bank by people as deposits on various accounts and made available on demand. This includes sight/ demand deposits held by people in banks.
- **E-money.** This refers to all types of money which people deal with electronically, far from the traditional ways of payment like banks, cheques, paper money and coins. E-money allows users through internet or wireless devices to pay the charges of their purchases directly from their bank accounts by electronic ways such as smart cards, digital wallets and mobile money payments e.t.c.
- **Quasi/ near money.** This refers to risk free liquid assets. i.e assets which can easily be converted into cash.

Quasi money includes:

- ✓ **A bill of exchange**, this is an unconditional order in writing by a creditor to a debtor instructing him to pay a specified amount of money to a named person and in a specified time period.
- ✓ **Treasury bill**, this is a financial security issued by government through the central bank when borrowing short term loans. It matures within a period less than one year.
- ✓ **Treasury bond**, this is a financial security issued by government through the central bank when borrowing long term loans.
- ✓ **Cheque**, this is a written order by a bank customer instructing his bank to pay a specified amount of money to a named person.

NB: Quasi money is also called credit money/ instruments of credit.

Instruments of credit refers to documents that enable the bearer to obtain cash or goods.

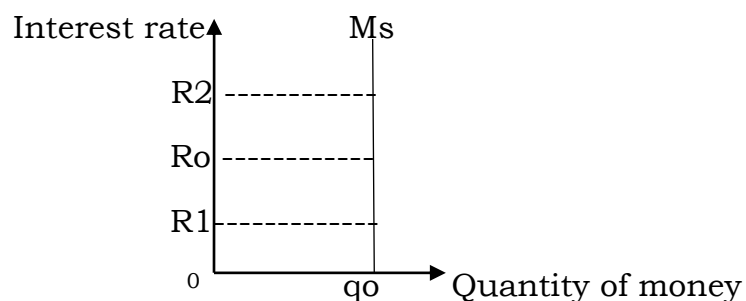
MONEY SUPPLY:

Money supply refers to the total quantity/ volume of money both in circulation in a particular country and the demand deposits held in banks at a given time.

Types of money supply:-

- a) **Exogenous / Discretionary money supply.** This is one where the quantity of money in circulation in an economy is determined by the central authority/ central bank and usually the supply is fixed.

Illustration of exogenous money supply;



Ms= money supply.

From the above graph, money supply remains fixed at q_0 despite changes in the interest rate.

- b) **Endogenous / automatic money supply.** This is the supply of money which depends on the level of economic activities in an economy. Factors such as interest rate, price level, level of national output, capital inflow etc. determine the volume of money in circulation.

Composition of money supply:

- **M1**, this is narrow money supply which consists of currency in circulation i.e. bank notes and coins and demand/sight deposits.
- **M2**, this is broad money supply which consists of currency in circulation, demand deposits, savings and time/fixed deposits.
- **M3**, this consists of the sum of M1 and M2 and quasi money. i.e. assets that can easily be converted into cash.

Determinants of money supply in an economy:

- **The level of monetization of the economy/Size of the subsistence sector.** Money supply is high when the economy is highly monetized because production is for sale and thus high use of money as a medium of exchange while money supply is low when there is a large subsistence sector because production is for home consumption and there is less use of money as a medium of exchange.
- **Monetary policy.** A restrictive/ tight monetary policy reduces money supply because its intention is to increase amount of money in circulation while an expansionary monetary policy increases money supply in an economy its intention is to reduce the amount of money in circulation.
- **The level of economic activities/investment.** High level of economic activities/ investment leads to high volume of money in circulation because there is high use of money in financing different production activities by firms. Whereas low level of economic activities /investment leads to low money supply since there is limited expansion of economic activities which requires little money.
- **Financial accommodation.** Government borrowing from the central bank by printing of more money to finance its budgetary deficits increase money supply whereas when there is no borrowing from the central bank by government i.e. borrowing from the public leads to low money supply.
- **The level of liquidity preference.** High liquidity preference increases money supply because people prefer holding their wealth in cash form rather than having assets while low liquidity preference reduces money supply because people prefer hold their wealth in asset form rather than money itself.
- **Interest rates.** Interest rates affect the rate of borrowing. A low interest rate on loans reduces the cost of borrowing which leads to high rate of borrowing and thus high money supply while high interest rate increases the cost of borrowing which leads to low rate of borrowing and low money supply.
- **Level of government expenditure.** High level of government expenditure especially on productive projects leads to high money

supply. On the other hand low government expenditure leads to low money supply.

- **Level of Inflow and outflow of funds.** High level of inflow of funds by foreign investors, remittances by nationals living abroad, by tourists from abroad leads to high the level of money supply. On the other hand, high level of outflow of funds in form of profit and income repatriation, expenditure on imports, investing in the outside economy leads to low level of money supply.
- **The balance of payment position of a country.** Balance of payment surplus in an economy leads to increase in money in circulation leading to high levels of money supply, this due to the increased foreign exchange inflow. While a balance of payment deficit leads to low amount of money in circulation leading to low levels of money supply in the economy, this is due to low foreign exchange inflow in the country.
- **Rate of credit creation by commercial banks.** High level of credit creation by commercial banks through lending process increase money supply while low level of credit creation lowers money supply in an economy because it limits the amount of money/credit created.
- **The level of printing and issuance of currency.** Excessive printing and issuance of currency by the central bank increases the amount of money in circulation hence increasing money supply. On the other hand limited printing and issuance of currency by the central bank reduces the amount of money in circulation hence low levels of money supply.

Monetary measures that can be used to reduce money supply developing countries;

- Sale of government securities, for example, sale of treasury bills.
- Increase bank rate.
- Increase variable reserve requirements / increase cash and liquidity ratio.
- Increase or set high legal reserve requirements.
- Call for (enforcement) supplementary legal reserve requirements / special deposits.
- Selective credit control.
- Currency conversion.
- Increase the margin requirement.
- Direct action.
- Moral suasion.
- Increase in legal reserve requirement.
- Ration credit.

Measures being used to reduce money supply in Uganda;

- Selling of government securities for example treasury bills and bonds.
- Increasing the bank rate.
- Increasing the minimum legal reserve requirement.
- Increasing the variable reserve requirement / increasing the cash ratio and liquidity ratio.
- Calling for special deposits.
- Increasing the margin requirement.
- Implementing a selective credit control policy (system).
- Embarking on moral suasion / persuading commercial banks to restrict lending
- Rationing of credit.

DEMAND FOR MONEY (LIQUIDITY PREFERENCE)

Demand for money/Liquidity preference refers to the desire by individuals to hold wealth/assets in cash or near cash form.

Determinants of liquidity preference/ demand for money:

- **The level of transactions.** High level of cash transactions raises the liquidity preference because more money is required to effect the transactions. While low level of cash transactions lead to low demand for money since there is less need to hold money in cash form for purposes of carrying out transactions.
- **The general price level.** High general price level leads to high liquidity preference since people tend to hold money in cash form to enable them meet their needs whereas low level of general prices leads to low liquidity preference because less cash money is required to meet needs to earn more money.
- **Level of interest rate.** Low interest rate on financial assets increases demand for money because people do not see much reward in investing their money whereas high interest on financial assets leads to low liquidity preference as people prefer investing their money in financial asset.
- **Income levels.** People with low incomes tend to hold most of their wealth in cash form since they are likely to need it any time. While those with high income have low liquidity preference since they can invest their money elsewhere to earn interest in both short term and long term investments.
- **Degree of uncertainty.** High degree of uncertainty leads to high demand for money since people tend to hold more cash as precaution against unforeseen requirements and less money is held in cash or near cash form when people are certain about the future.

- **Knowledge of banking services.** Adequate knowledge about banking services leads to low liquidity preference since people invest in facilities such as fixed deposits to earn interest and where people have limited knowledge about banking services liquidity preference is high since people find it convenient to hold their money in cash form rather than in asset form.
- **Availability of investment incentives.** Provision of investment incentives such as subsidies in a country leads to low liquidity preference as people invest their money in different economic activities for a profit. On the other hand, limited provision of investment incentives leads to high liquidity preference as people are reluctant to invest in different economic activities due to low profit levels resulting from high cost of production.
- **Level of speculation.** High level of speculation leads to high liquidity preference as people hold cash to take advantage of future positive trends in both money and capital markets. Where the level of speculation is low, liquidity preference is low.
- **Level of development of financial institutions/Nature of distribution of commercial banks.** High level of development of financial institutions leads to low liquidity preference as people make use of banks by keeping their money in them and by buying financial assets offered by commercial banks. On the other hand, low level of development of financial institutions leads to high liquidity preference because banking becomes an inconvenience.

Question:

- i) **Distinguish between liquidity ratio and liquidity preference.**
- ii) **Give 2 reasons for high liquidity preference in developing countries.**

Solution;

Liquidity ratio is the proportion of commercial bank total deposits that is kept in cash or near cash form.

While,

Liquidity preference is the desire by individuals to hold wealth/assets in cash or near cash form rather than investing it.

Reasons for high liquidity preference in LDC'S;

- Low level of income
- High level of speculation
- High level of cash transactions
- High degree of uncertainty
- High general price level

- Low interest rates on financial assets
- Limited knowledge of services provided by commercial banks.
- Poor distribution of banks
- Stringent requirements for opening and running bank accounts.

Reasons for low liquidity preference in developing countries;

- High level of income.
- Low level of speculation.
- Low rates of inflation or high price level.
- Low degree of uncertainty.
- High level of development of commercial banks and other financial institutions
- High interest rates on financial assets.
- Increased awareness or knowledge of services provided by commercial banks.

THE VALUE OF MONEY

Value of money refers to the quantity of goods and services that a unit of money can buy. (**Real value of money**)

It is the purchasing power of a unit of money.

Value of money can be categorized as:

- **Nominal value.** This refers to the face value of notes and coins irrespective of what value it can command in terms of goods and services.
- **Real value.** This refers to the amount of goods and services that can be bought using a given amount of money.
- **Intrinsic value.** This refers to value of paper or metal from which money is made.

Determinants of value of money;

- **Quantity of money in circulation.** High quantity of money in circulation leads to low value of money because it increases demand for goods and services which increases the price level thus reducing the purchasing power whereas low quantity of money in circulation leads to high value of money because it reduces the price level thus increasing purchasing power of money.
- **Velocity of circulation of money.** High velocity of circulation of money leads to low value of money because it leads to high prices while low velocity of circulation of money leads to a fall in price level and a high value of money.

- **The rate of inflation/general price level.** High rate of inflation leads to a decrease in purchasing power of money and a fall in value of money while low rate of inflation lead to increase in purchasing power and increase in value of money.
- **Government policy of devaluation and revaluation.** Government can deliberately reduce the value of money through devaluation or it can increase the value of its money through revaluation.
- **Level of output.** High level of output in an economy leads to low prices and thus high value of money whereas low level of output in an economy leads to high prices thus low value of money.
- **The level of transactions.** High level of transactions increases the price for goods which leads to a fall in value of money while low level of transactions leads to low prices and rise in the value of money.

THEORIES OF DEMAND FOR MONEY:

a) The Keynesian theory of demand for money:

According to John Maynard Keynes, people do not demand for money for its own sake but due to influence of some motives which include the following;

- **Transaction motive.** People hold money in cash form to meet the day today cash transactions such as buying food, water, transport and other daily personal requirements which require cash.

The transaction motive is influenced by the following factors:

- ✓ The level of income
 - ✓ The general price levels
 - ✓ Level of monetization of the economy
 - ✓ Level of economic activities
 - ✓ The time it takes for one to receive money/income.
- **Precautionary motive.** People demand for money to meet some contingencies/ unforeseen circumstances that require sudden expenditure and to provide for unforeseen business opportunities of advantageous nature e.g. sickness, loss of a relative, loss of job etc.

The precautionary motive is influenced by the following factors:

- ✓ The level of income of people.
- ✓ The cost of insurance and health facilities.
- ✓ The level of inflation in an economy.
- ✓ Business opportunities for unexpected profitable deals.
- ✓ The time it takes for one to receive income.

- **Investment/ finance motive.** People demand for money to finance the ongoing investment projects in which has been sunk. . The finance motive is influenced by the following factors:
 - ✓ Marginal efficiency of capital.
 - ✓ Availability of investment incentives/Government policies towards investment
 - ✓ The political climate.
- **Speculative motive.** People demand for money in order to earn more money or income in future through speculation i.e. Investing in bonds and other financial assets when interest rate in high or buying shares or stock when prices are low and change them into cash at a profit when prices rise. The amount demanded for this purpose depends on interest payable on **treasury bills and bonds** i.e. at a high rate of interest speculators prefer to hold securities instead of money whereas at low rate of interest speculators prefer to hold money instead of securities.

The least (minimum) rate of interest below which people would rather hold their money in cash form instead of investing it in bonds or stocks is known as Liquidity trap.

Liquidity trap is a situation where the interest rate is too low to induce people to invest in securities.

Or

Liquidity trap is a situation where the interest rate is too low to break the liquidity preference.

Or a situation where interest rate is too low to encourage speculators to invest in bonds or stock and as a result hold their money in cash form.

The speculative motive is influenced by the following factors:

- ✓ The interest rate in financial institutions in relation to returns.
- ✓ The level of people's income to buy securities.
- ✓ The business trends in the country whether favourable or unfavorable.
- ✓ The willingness of the public to buy securities.

b) **The quantity theory of money:**

It states that the general price level is determined by the quantity of money in circulation provided that the velocity of circulation of money and level of transactions are held constant.

The theory is illustrated by Professor Irving Fisher's equation of exchange; $MV=PT$

Where;

M= quantity of money

V= velocity of circulation of money i.e. the average number of times a unit of money changes hands.

P= general price level

T= level of transactions.

An increase in M leads to a proportionate increase P leading to a fall in value of money and a decrease in M leads to a proportionate decrease in P leading to a rise in value of money.

Examples:

1. Given that the volume of money in an economy is £ 20 billion, total level of transaction is £ 250million and the velocity of circulation is 20. Calculate the general price level in the economy.

2. Given that the quantity of money is Shs. 1million, Velocity of circulation is 20 and the price level is Shs. 80000, calculate the volume of transaction.

3. Assuming Velocity of circulation and transactions made are held constant i.e. 10 and 50 respectively but money supply is doubled from Shs. 100 to Shs. 200, calculate the new price level.

Assumptions underlying the quantity theory of money;

- Supply of money is exogenous/ determined by the central authority.
- It assumes full employment in an economy
- It assumes demand and supply of money to be equal and proportional.
- Money is only demanded for transaction motive.
- It assumes all business transactions are settled by use of money.
- It is operational in the long run.
- It assumes that velocity of circulation of money and level of transaction are constant.
- Price is only affected by changes in money supply.
- Assumes that the interest rate has no role to play.

Limitations of the quantity theory of money:

- The theory assumes Velocity of circulation of money and level of transactions to be constant which is unrealistic because a change in money supply leads to changes in velocity of circulation of money and level of transactions since the variables are not independent of one another.
- The theory only recognizes the transaction motive of demand for money and ignores other motives such as finance, precautionary and speculative motives.

- It does not consider barter system of exchange as it assumes that all transactions are settled by use of money.
- The quantity theory does not consider rate of interest as a determinant of money supply.
- The theory does not put into account of demand for money as it only looks at supply of money.
- It considers only changes in value of money without showing how the value of money is determined.
- It does not explain price increase due to other causes like increase in production costs and rise in demand.
- It ignores government intervention in form of price control and taxation in influencing the price level.
- Where a country has many unemployed resources, an increase in money supply leads to an increase in output which makes prices to fall or not to change at all.
- Where the marginal propensity to save is high, the theory may not apply because high savings reduce velocity of circulation of money leading to a fall in price level.
- There is nothing like general price level as the theory assumes. It should have talked about series of price levels like those used to calculate consumer price indices.
- The theory talks of a proportionate change in the general price level yet prices of different commodities do not change at same proportion.
- It does not consider haggling between buyers and sellers to reach an agreed price in the market.
- This theory is simply a hypothesis that shows the four variables are related ($MV=PT$) without explaining how these variables change.
- The four variables M, V, P and T are not independent of one another because a change in one induces change in others.

Circumstances under which an increase in money supply may not necessarily lead to an increase in the general price level;

- ✓ When there is a corresponding increase in the level of output of goods and services in a country.
- ✓ If the increased money supply is used to purchase capital goods for investment, prices will remain constant.
- ✓ When there is a high marginal propensity to save, the increased money supply will not lead to inflation/ increase in price the money will be saved.
- ✓ Where there is government control over prices i.e. if the government fixes the maximum prices.
- ✓ Where the interest rate on capital is high.

BANKING:

Banking is a business activity of **accepting and safeguarding money** owned by individuals and business entities, and then **lending it out in order to earn a profit**. Banking is done by financial institutions which direct the flow of money to productive use and investments.

A bank is an institution which carries out certain types of financial businesses. The basic functions of a bank include the following:

- The collection and safeguarding of the surplus funds or money from the general public.
- The lending of such funds in return for interest and security in form of overdrafts and loans.
- The transfer of the funds from one person to another by means of credit transfer and cheque systems.

Features of the Banking sector in Uganda;

- It is mainly urban based.
- Basically operates on a small scale.
- Dominated by commercial banks.
- Dominated by foreign owned commercial banks.
- Mainly privately owned.
- Mainly comprised of joint stock companies.
- Mainly charges high interest rates.
- Mostly uses capital intensive techniques of production.

FINANCIAL INSTITUTIONS/INTERMEDIARIES:

Financial intermediaries are institutions that bring together surplus spending units (lenders) and deficit spending units (borrowers).

Financial institutions are specialized business units which are developed to provide finance required in the modern sector.

These institutions deal in money as their commodity and they usually serve as channels through which savings flow into productive investments, and they charge a price known as interest.

Surplus spending units are economic units or entities whose assets are greater than the liabilities hence willing to extend credit.

Deficit spending units are economic units or entities who can not meet their liabilities/expenses hence they depend on borrowed funds/ credit.

Financial intermediaries are categorized into two;

- a) Banking financial intermediaries
- b) Non-banking financial intermediaries.

Banking financial intermediaries are financial institutions that receive deposits from the public, give loans on short term, create credit and undertake less risky investment ventures. e.g. commercial banks.

Non-banking financial intermediaries are financial institutions that accept deposits from the public give medium term and long term loans but do not create credit.

Examples of Non-banking financial intermediaries in Uganda include;

- Development banks such as East African development bank (EADB), Uganda dev't bank (UDB)
- Saving banks such as Post bank Uganda
- Insurance companies
- Savings and credit cooperative societies
- Social security fund e.g. NSSF etc.
- Housing finance bank

COMMERCIAL BANKING:

Draw the difference between the following:

- a) Commercial bank and a development bank.
- b) Money markets and capital markets

Commercial bank is a financial institution which carries out financial business by accepting deposits from the public and lending out money on profit motive. Examples of commercial banks in Uganda include; Stanbic Bank, Centenary Bank, Kenya commercial Bank, DFCU bank, Equity bank, ABSA Bank etc.

Whereas,

A development bank is a non-banking financial institution that accepts long term deposits, gives long term loans and aims at promoting economic development in the country or region.

Development banks are mainly created by a state or governments of neighboring countries to promote the development of infrastructure in the country or region.

They also promote industrial growth within the country or within the region the country or within the region. Examples of development banks include; The East African development bank, Uganda development bank,

African Development Bank, Arab Bank for Economic Development in Africa e.t.c

More differences between:

Commercial banks (Banking financial intermediaries)	Development banks (Non-banking financial intermediaries)
• Aim at making profits	• Aim at enhancing national economic development
• Give short term loans	• Give long term loans
• Create credit	• Do not create credit
• Undertake lower investment risks	• Undertake greater investment risks
• Charge high interest rate	• Charge low interest rate
• May be owned privately or by government	• Mainly owned by government
• Generally maintain current or short-term deposits	• Maintain time or fixed deposit account

Money markets are credit markets mainly owned by banking financial intermediaries which give short term loans and deal in highly liquid financial instruments with maturity period of less than one year such as treasury bills.

Or one in which short-term financial assets (securities) are exchanged.

While,

Capital markets are credit markets mainly owned by non-banking financial intermediaries and they give long term loans. Stock exchange market is a good example of capital market.

Or. This is a market where long-term financial assets (securities) are traded. It is a market for long-term company loan capital, share capital and government bonds. Players in this market are the Central bank, commercial Banks, and saving-Investment institutions etc.

Money markets have the following feature;

- They are mainly urban based.
- They charge mainly high interest rates.
- They mainly operate on small scale basis.
- There are few participants in the market.
- They deal in a limited variety of financial assets.

The functions of a capital market;

- Mobilizing of savings.
- Encouraging investment.
- Regulating the prices of financial assets.
- Promoting easy convertibility of assets (from near cash to cash form).

Stock exchange markets. These are financial institutions where already issued shares are sold and bought.

Treasury bill. This is a financial security issued by a country's central bank as a means for government to borrow money for short periods of time, for example treasury bills of 90 days.

A bond. This is a financial security issued by businesses and government as a means of borrowing long term funds, for example bonds for 1 year and above.

Functions of Commercial Banks:

- They accept and safe guard money of the public in form of deposits on various accounts such as savings, current account and fixed deposit account.
- They give credit facilities to creditworthy customers through advancing them loans and overdraft facilities.
- They act as forex bureaux i.e. they buy and sell different currencies.
- They provide excellent means of payment by use of cheques, bank drafts, credit transfer, standing orders etc.
- They act as custodians or safe places for keeping valuable items such as land titles, academic certificates, wills etc of their customers.
- They give financial advice to their customers on investment matters.
- They act as agents of stock exchange market by buying and selling shares on behalf of their customers.
- They act as referees for their customers who are applying for credit facilities.
- They manage property of the deceased customers and do distribution according to the will and legal proceedings.
- They help the central bank in implementing the monetary policy.
- They help government to receive money from tax payers.
- They facilitate international trade by enabling transfer of money using traveler's cheques and issuing letters of credit to importers.

Role of commercial banks in development of Uganda:

- They create employment opportunities to people in form of managers and accountants, which reduces on the unemployment problem.
- They are a source of revenue to government in form of corporate taxes.
- They contribute to investment capital in the country by purchasing shares from various companies.

- They promote investment and production through provision of credit to their customers thus increasing national output.
- They mobilize savings through offering savings accounts and fixed deposit accounts which facilitates investment in future.
- They give covering letters to potential investor which promotes investment.
- They assist government in ensuring economic stability by implementing the monetary policy thus creating a favorable investment climate.
- Commercial banks invest in other fields such as transport, building etc. thus contributing to economic growth and development.
- They encourage monetization of the economy by promoting exchange using money they also lend money to people to carry out production for the market.
- They promote skills development by providing on job training to their employees.
- They facilitate and stimulate the development of infrastructures in the economy i.e. they participate in the construction of buildings, roads, communication networks in order to improve their services e.g Mapeera house for centenary bank.
- They facilitate and promote trade both internal and external trade by enabling traders to transfer their money safely.

In addition to the above, foreign owned commercial banks have following positive role in economic development:

- They promote efficiency in the banking sector through promoting competition with the local banks thus improving banking services in the country.
- They bring foreign exchange into the country which helps in filling the foreign exchange gap.
- They promote good international relationship between Uganda and their mother countries which provides the basis for further business activities such as trade.
- They encourage foreign investments in the country since foreign investors have more confidence in foreign owned commercial banks.
- They facilitate transfer of modern banking technology through direct transfer of modern machinery such as automatic teller machines that allow 24hour banking thus bridging the technological gap in the banking sector.
- They train local man power in modern banking skills thus filling the man power gap in the banking sector.

Negative role/ contributions of foreign owned commercial banks:

- They repatriate most of their profits to their home countries thus limiting expansion of banking sector in Uganda and worsening the balance of payments deficit.
- They prefer employing their own personnel especially in top positions which leaves the local labour force unemployed.
- They are mainly urban based which leads to imbalance in development.
- Central bank has limited control over foreign owned commercial banks since they are financed by their mother countries which limits success of the monetary policy.
- They use modern capital intensive technology which leads to technological unemployment.
- Most of foreign owned commercial bank operate with large capital base and create stiff competition in the banking sector thus out competing some local banks.

Role of non-bank financial intermediaries in my country include;

- Promoting savings e.g. savings banks
- Encouraging investment through provision of long term loans.
- Providing employment opportunities.
- Developing/ improving labour skills through training of manpower.
- Contributing revenue to government through taxation.
- Promoting entrepreneurship.
- Encouraging production hence economic growth.
- Monetizing the economy.
- Facilitating industrial development in the economy.
- Facilitating rural transformation and development through provision of agricultural loans.
- Ensuring social security of the public e.g. National Social Security Fund (NSSF), life assurance.
- Indemnifying/ providing compensation to businesses in case of insurance companies. This guarantees continuity of business.
- Financing infrastructure development e.g. development banks, housing finance bank etc.

Types of Bank Accounts;

Banks provide different types of account for different needs. Customers can open.

- 1. A current account.** This provides a cheque book but usually earns no interest to the holder. Current accounts are mainly used to pay bills and are mainly operated by firms/companies/ business men.

Features of a current account

- ✓ It requires minimum deposit.
- ✓ Customers can withdraw or deposit money in any amount and at any time whenever they like.
- ✓ The account holders are required to pay monthly service fee to the bank for the services rendered by the bank.
- ✓ The banks issue cheque books to the current account holders.
- ✓ Current account holders can get the facility of overdraft if arranged with the bank in advance.
- ✓ The bank sends statements of account to the current account holders at regular intervals e.g. on monthly basis.

2. A fixed deposit accounts. These accounts are normally opened by those individuals who have surplus money and they do not want to use it in the present but in the near future.

Features of fixed deposit accounts;

- ✓ Fixed deposit accounts are opened for a specific period e.g. six months, one year, two years e.t.c.
- ✓ When a fixed deposit account is opened, no further deposits or withdrawal is allowed before the expiry of that period.
- ✓ A high interest is paid on deposits as the bank can safely lend the money on a fixed deposit account.
- ✓ The deposits in fixed accounts can be used as security to apply for an overdraft against the current account of the same person.
- ✓ The account holders are issued with a receipt book which they must present to withdraw their money at the expiry of the deposit period

3. An investment or savings account. This is operated by people who would want to save and create /expand capital for future investment.

Features of savings account;

- ✓ The account holders are required to deposit a specific amount initially and they must keep a specific minimum balance in the account all the time.
- ✓ It is operated by means of a pass book which must be presented when depositing or withdrawing money.
- ✓ In these accounts, money can be deposited any time but there are some restrictions on withdrawals. The account holders can withdraw money once or twice a week only.
- ✓ The banks pay interest on the deposits in the savings accounts. The rate varies from bank to bank but interest paid is lower than that on a fixed deposit account.

- ✓ Overdraft facilities are not provided on savings account.
- ✓ The account holder has to go to the bank personally in case of withdrawals.

Collateral security. This refers to an asset of value that is mortgaged /pledged against a loan given.

Loan is a specified amount of money advanced to an individual or a firm by a financial institution at a specified rate of interest upon presenting collateral security. **Types of loans include;**

Soft loan. Is a loan having either no interest rate or a very low interest rate and it has a long repayment period

Hard loan; is a loan with a very high interest rate and a very short repayment period.

Short term loan; is a loan payable within a period of less than one year.

Medium term loan; is a loan payable within a period of one year to five year.

Long term loan; is a loan payable within a period of five years and above.

Ways how commercial banks advance loans:

Commercial banks advance loans to their customers in the following ways;

- **By direct bank loans,** this is money advanced by commercial banks to their customers after presenting collateral security and the bank charges interest on this money.
- **Through overdraft,** this is money advanced to a bank customer with a current account when bank allows customer to withdraw money in excess of the amount on his account. Interest is charged on the amount overdrawn.
- **By discounting bills of exchange,** this involves commercial banks buying off bills of exchange at a discounted rate before maturity.

Determinants of the demand for loans;

- The interest rates charged on loans.
- Investment opportunities.
- Political climate.
- Size of subsistence sector / monetary sector.
- Availability of collateral security.
- The returns on the capital borrowed.
- Availability of entrepreneurs.

Determinants of the supply of loanable funds in the bank;

- Income level.
- Level of savings by the general public.
- Liquidity preference.
- Rate of inflation in the economy.
- Size of subsistence sector / monetary sector
- The reserve ratio.
- The interest given on deposits.
- The confidence the general public has in the banking sector.

INTEREST RATE:

Interest rate refers to the proportion of capital borrowed that must be paid to the lender in addition to the principle, as reward to capital as a factor of production.

Interest is the monetary payment/reward for use of capital as a factor of production.

Why is interest paid?

The following are reasons why interest is paid;

- It is paid as a reward for use of credit.
- It is a reward for risk taking by lenders.
- It is paid as reward for savings i.e. those who save forego present consumption and so must be rewarded.
- It is paid as a reward to those who manage credit institutions.
- It is paid as a reward for the inconvenience to cover the opportunity cost of lending.
- It is paid to reverse the positive rate of time preference.

NB: Time preference is the rate at which people prefer consumption in the present than in the future.

Questions:

- Distinguish between deposit rate and lending rate.**
- Explain the determinants of interest rate in your country.**

Soln:

Deposit rate is the interest paid by commercial banks on customers' deposits on fixed deposit and savings accounts.

While.

Lending rate is the interest charged on loans advanced to customers by commercial banks.

Determinants of interest rate include the following;

- **Period of loan payment.** Long term loans are charged high interest rate than short term loans. This is because high administrative costs are involved in long term loans and the opportunity cost involved in long term loans is higher than on short term loans.
- **The demand for loanable funds.** High demand for loanable funds leads to high interest rate whereas low demand for loanable funds leads low interest rate.
- **Supply of loanable funds.** High supply of loanable funds relative to demand leads to a low interest rate and low supply of loanable funds leads to high interest rate.
- **The prevailing economic conditions.** During inflation, interest rates are increased due to rise in cost of operation and reduction in value of money while during deflation interest rates are lowered due to low cost of operation and need to stimulate aggregate demand.
- **Size of the loan.** Bigger loans are charged a low interest rate than small loans because of the administrative economies of big loans .i.e. the cost of supervising a loan per shilling is higher on small loans than on large loans.
- **Time preference.** High rate of time preference leads to high interest rate charged on loans due to high demand for loans and low savings as people prefer consumption in the present whereas low rate of time preference leads to low interest rate as many people prefer consumption in the in the future resulting into high savings and low demand for loans for consumptive purposes.
- **The level of liquidity preference.** A high liquidity preference implies low savings in commercial banks leading to charging of high interest rates while low liquidity preference implies that there are more savings in the banking system leading to charging of low interest rates.
- **The level of development of the banking sector.** High level of development of commercial banks leads to low interest rates due to competition among commercial banks for customers while low level of development of the banking sector leads to high interest rates due to limited competition.
- **Risks involved in lending.** Where lending is more risky, a high interest rate is charged and low interest rate is charged on less risky loans depending on the creditworthiness of the borrowers.
- **Government policy on lending/monetary poicy.** Government may charge high bank rate and hence high interest rate in pursuant of a contractionary monetary policy to reduce money supply and may charge a low bank rate and hence a low interest rate in pursuant of an expansionary monetary policy through the central bank.

- **The policy of individual lenders.** Liberal lenders may offer low interest rate loans while hard lenders may offer high interest rate loans.

The causes of high interest rates in Uganda;

- Low level of savings / low supply of loanable funds.
- High demand for loanable funds.
- The greed for profits by financial institutions.
- High risks of investment.
- High bank rate.
- High rate of inflation.
- Few financial institutions in the country.

The measures that should be taken to stabilize interest rates in Uganda;

- Fight against inflation.
- Promote the growth of financial institutions or banks.
- Stabilize the bank rate.
- Encourage savings.

Assets and Liabilities of Commercial Banks:

Assets of a commercial bank are possessions of the bank and its claims on its customers and other financial institutions.

Assets of commercial banks include the following:

- Fixed assets such as buildings, land, vehicles etc.
- Loans advanced to customers
- Overdraft to customers
- Shares held in other companies
- Cash at bank
- Reserves with the central bank
- Deposits with other commercial banks
- Securities held such as Treasury bills and bonds.
- Special deposits with the central bank.

Liabilities of a commercial bank are the claims against assets of the commercial bank by its creditors or depositors.

Liabilities of a commercial bank include;

- Customers deposits on various accounts and deposits of government and other banks
- Loans from other banks
- Dividends payable
- Salaries due

- Share capital
- Reserves payable to the central bank

Conflicting objectives of commercial banks:

- Liquidity
- Profitability
- Security

Commercial banks have to maintain funds to meet the day today cash demands of customers at the same time have to make profits by advancing loans to customers and investing in other securities.

As a result, commercial banks are faced with a dilemma/ conflicting objectives of liquidity, profitability and security. This is so because making more profits would mean advancing more loans and investing in securities such as bonds yet they reduce liquidity and lending is at times risky.

Therefore commercial banks have to reconcile liquidity and profitability as well as security.

Bank liquidity refers to the bank's ability to pay cash on demand to its customers. This calls for banks to maintain customers' deposits in cash form or near cash form.

Commercial banks ensure liquidity in the following ways;

- By maintaining cash ratio i.e. they do not lend out all the money to customers but retain a certain percentage with them in cash.
- By maintaining more liquid assets such as treasury bills, bank drafts, cheques, credit cards.
- By giving short term loans such that cash can easily be restored.
- By maintaining minimum balance on different accounts of their customers such that customer needs are always met
- By carrying out phased lending i.e. giving loans to different types of customers at different time periods.
- They ensure that the borrower deposit a marketable security with the bank which can be liquidated in case of failure to pay the loan.

Commercial banks ensure profitability through the following;

- Advancing loans and overdrafts to customers which are paid back with interest.
- Investing in other profitable projects which generate money e.g real estate, buying shares.
- Investing in government securities such as treasury bills and bonds which are risk free.
- Discounting bills of exchange and cheques at a fee.

- Charging fees for certain services rendered to customer. e.g. they have bank charges, ledger management fees, charges on money withdrawals etc, such money is accumulated to create profits for the banks.
- Charging a commission for services rendered to customers e.g. where they act as custodians of estates of the deceased. The commission they earn improves their revenue and profitability.

Commercial banks ensure security in the following ways;

- Demanding for marketable collateral security to extend loan to their customers.
- Determining the creditworthiness of borrowers before advancing loans.
- Spreading their assets in different categories such as liquid assets e.g. cash deposits with other banks, fixed assets etc.
- Extending short term loans and avoiding long term loans.
- They put up strong buildings where they carry out their activities.
- They employ security guards.
- They take up insurance covers against various risks.
- Supervising / monitoring projects funded by the bank loans.
- Using margin requirement measures.
- Investing in sound projects especially purchase of government securities such as bonds and treasury bills.

Problems faced by Commercial Banks in Uganda:

- Limited deposits due to low incomes among people this limits deposits and operations of commercial banks.
- There are few creditworthy customers due to lack of collateral security which limits lending.
- Inadequate capital which limits credit creation by commercial banks.
- Stiff competition among commercial banks which limits profits.
- Inadequate skilled labour force in the banking sector which limits operations of commercial banks due to inefficiency.
- Political instability in some parts of the country which limits operations of commercial banks due to increased risks of loss of life and property.
- Rampant corruption and embezzlement of bank funds by bank officials which results into losses leading to collapse of some banks e.g former Green land bank, Co-operative bank, Crane bank etc.
- Poor infrastructure such as roads, electricity especially in rural areas which increase operational costs and limit operations of commercial banks.

- Loss of public confidence in the banking sector as a result of rampant closure of banks reduces deposits in commercial banks.
- High rate of inflation which discourages lending by commercial banks and also makes people to fear to deposit money in banks for fear of loss of value of money.
- Loan defaulting by some customers which results into losses thus limiting operations of commercial banks.
- Central bank interference in operations of commercial banks through the monetary policy sometimes limits their operations. e.g. a high bank rate and legal reserve requirement limits credit creation by commercial banks.
- The limited number of credit worthy customers/There are a few credit worthy borrowers who can pay back the loans advanced to them hence limiting expansion of the banking sector.
- Political interference in the management of commercial banks and this makes it difficult for banks to make decisions on their own, i.e. they are forced to function according to the desires of the government.
- High liquidity preference by the people which reduces savings with commercial banks.
- Uneven distribution of commercial banks where the majority are urban based hence neglecting the potential borrowers and savers in rural areas leading to low deposits.

Steps taken to improve/revamp on performance of the commercial banking sector in Uganda;

- Liberalization of the banking sector has been done to encourage establishment of financial institutions and promote competition so as to improve quality banking services.
- Closure of financially unsound and mismanaged banks such as Crane bank, Green land bank, co-operative bank has been done to improve on services offered by commercial banks.
- Government has strengthened the supervisory role of the central bank to improve performance and soundness of commercial banks.
- Infrastructure such as roads, electricity and telecommunication has been improved to reduce operational costs, increase access which has facilitated operations of commercial banks.
- Political stability has been restored in most parts of the country. This has provided a conducive climate for operation of commercial banks since it has reduced risks of loss of life and property arising from insecurity.
- Privatization of some government banks e.g. Uganda Commercial bank has been done to promote efficiency in the banking sector.
- Government has sensitized the public about the importance of banks through mass media and even required all civil servants to

have bank account through which they can be paid. This has increased on number of people opening and using bank accounts thus increased bank deposits.

- Government has encouraged training of labour force in banking through various institutions of learning for example Makerere University Business School (MUBS), colleges of commerce etc. this has increased supply of skilled labour and increased labour efficiency in the banking sector.
- Government has paid former depositors of defunct banks namely Green Land bank and co-operative bank to regain public confidence in the banking sector and attracted more depositors.
- Government has tried to stabilize the economy by controlling inflation through use of a contractionary monetary policy so as to keep the banking sector robust. This has given the public confidence in the banking sector and thus increased the number of people using banks.
- Improved technology. Commercial banks have introduced modern technology in banking activities, for example, computerization of banking activities to make handling of money easier and faster as well as use of ATMs which has reduced congestion in banking halls.

Credit Creation by Commercial Banks:

Credit creation is the process by which money lent out by commercial banks using Cheque facility expands to result into greater volume of credit than the amount initially lent out.

Or

Credit creation is the process by which part of the deposit received by commercial banks is lent and it expands into greater volumes of credit.

Assumptions underlying credit creation;

- There are many banks in the system or one bank with many with many branches.
- The only way of lending to the public is by means of cheques.
- It assumes that there is a fixed cash ratio.
- It assumes a fixed initial deposit.
- It assumes that when people get loans in form of cheques, such cheques are deposited in other banks or in other branches of the same bank.
- It assumes that the public/ are willing to borrow money from commercial banks.
- It assumes that the public should be credit worthy.

- It assumes the use of cheques i.e. there must be a large number of current account holders so that commercial banks use the deposits to create credit.
- It assumes that there are many people willing to deposit money in the bank therefore have confidence in the bank.
- It assumes that commercial banks are willing to give/lend money to the public.

Commercial banks create credit in the following ways;

A description of the credit creation process by commercial banks

Commercial banks create credit by:

- Receiving deposits from customers. For example an initial deposit of shs100,000
- Keeping percentage of deposits as cash ratio. For example, 20% of shs 100,000 = shs 20,000
- Lending out the remaining part of deposits to creditworthy borrowers. For example, shs 100,000 - 20,000 = shs 80,000
- Accepting money lent out as new deposits. For example, shs80,000
- Retaining percentage of the deposits as cash ratio. For example, 20% of 80,000 = shs: 16,000
- Lending out part of the new deposits again to creditworthy borrowers. For example shs 80,000 -16,000 =shs 64,000
- And the process continues till the initial deposits defuse in the banking system i.e. process continues till amount to be lent is negligible.

Value of total deposit or total amount created = Initial deposit x bank deposit multiplier,

But, Bank deposit/Credit multiplier (CM)= $1/\text{cash ratio} = 1/20/100 = 5$ times

Hence Total deposit/credit created = shs 100,000 *5

= shs 500,000

Given that bank A had an initial deposit of Shs. 100,000 and the required cash ratio of 20%. Illustrate how the bank will create more credit.

Illustration of credit creation by bank A:

Customers	Initial/new deposit	Cash ratio (20%)	Loanable funds
A	100,000	20,000	80,000
B	80,000	16,000	64,000
C	64,000	12,800	51,200
D	51,200	-	-

Total credit created= Initial deposit x multiplier

CM= $1/\text{cash ratio} = 1/20/100 = 5$ times

Therefore; total credit created = 100,000 x 5 = Shs 500,000

Question:

Given an initial deposit of Shs. 10,000 in the bank and cash ratio of 20%.

Calculate: a) Credit multiplier b) Total deposits created

Credit creation process in a multi-bank system:

- Receiving of the initial deposit from bank customer by the first bank A. For example an initial deposit of shs100,000
- Keeping percentage of initial deposit as cash ratio by bank A. For example, 20% of shs 100,000 = shs 20,000
- Lending out the remaining part of deposit to creditworthy borrower by bank A. For example, shs 100,000 - 20,000 = shs 80,000
- Receiving money lent out as new deposit in bank B. For example, shs80,000
- Retaining percentage of the deposit as cash ratio by bank B. For example, 20% of 80,000 = shs: 16,000
- Lending out part of the new deposit again to creditworthy borrower by bank B. For example shs 80,000 -16,000 =shs 64,000
- And the process continues till the initial deposit defuses in the banking system i.e. process continues till amount to be lent is negligible.

NB:

Cash ratio: Is the proportion/percentage of commercial bank total deposits which are kept in cash form to meet cash demands of customers.

Liquidity ratio: Is the proportion of commercial bank's total deposits that is kept is cash or near cash form.

Liquidity: Is the ease with which a certain asset can be converted into cash.

Reserve ratio: Is the percentage of commercial bank's total deposits that is not lent out but kept in cash form with the central bank or at the commercial bank as a requirement by law. It is a combination of cash ratio and liquidity ratio.

The reserve ratio may be increased in order;

- To reduce money supply/control inflation
- To restrict credit creation by commercial banks
- To increase liquidity levels of commercial banks
- To safe guard banks against uncertainty i.e. during periods of economic recession

- To protect interests of depositors in times of crisis and financial instability.

Factors influencing/affecting/determining the process of credit creation;

- Level of liquidity preference by individuals. High demand for cash implies that people deposit less money in commercial banks and this reduces the ability of commercial banks to lend hence low credit creation, on the other hand low liquidity preference implies that individuals make large deposits into commercial banks. This increases the funds available for lending thus promoting the process of credit creation.
- Size of the cash ratio. The higher the cash ratio, the lower the level of credit creation since banks retain much of the deposits which limit lending, however the lower the cash ratio, the higher the level of credit creation since banks are able to retain less of the customer's deposits which leave them with more amount of money for lending.
- Interest rates on loans. High interest rate on loans lead to low demand for loans as borrowing becomes expensive hence limiting credit creation, on the other hand low interest rate on loans lead to high demand for loans as borrowing becomes cheap, thus promoting the process of credit creation.
- Availability of collateral security. Presence of collateral security encourages commercial banks to lend out money to the public hence high level of credit creation. On the other hand, absence of collateral security discourages commercial banks from lending out money to the public thus low level of credit creation.
- Level central bank interference through the monetary policy. Restrictive monetary policy by the central bank reduces the amount of money to be held by commercial banks for lending hence limiting the process of credit creation, on the other hand, an expansionary monetary by the central bank increases the amount of money held by the commercial banks for lending thus promoting the process of credit creation.
- Level of monetization of the economy/Size of the subsistence sector. High level of monetization of the economy leads to high level of credit creation because most economic activities require use of money hence increased borrowing from commercial banks. On the other hand, a large subsistence sector reduces the amount of credit created as most of activities done do not require a lot of funds hence reduced borrowing from commercial banks.
- Nature of distribution of commercial banks/Level of development of the banking sector. Even distribution of commercial banks in a country promotes credit creation as lending services are within the reach of the customers, alternatively even distribution of commercial banks encourages saving thus increasing the size of bank deposits. On the other hand, poor distribution of commercial banks limits the credit creation as lending services are not wholly accessed by the public and at the same time it limits the size of bank deposits.

- Level of awareness of people about the banking services. High level awareness about banking services promotes the process of credit creation, this is so because many people are knowledgeable about the existence of bank loans and therefore go for loans. On other hand limited knowledge about bank loans limit the process of credit creation because few people go for bank loans.
- Availability of funds for lending/Size of bank deposit. A large amount of bank deposits increases the loanable funds and there promotes the process of credit creation On the other hand, a small amount of bank deposits reduces the loanable funds which limits the process of credit creation
- Degree of accountability in the commercial banks. Transparency in commercial banks promote the process of credit creation because bank officials do not ask for bribes before advancing loans, thus encouraging the public to borrow, on the other hand low level of accountability in commercial banks limits the process of credit creation because bank officials make it hard for customers to access loans since they ask them bribes for loans.
- Availability of investment opportunities. Existence of man investment promotes borrowing since different people need money to take on such opportunities and this leads to high level of credit creation, on other hand existence of few investment opportunities in the country results into low demand for loans hence limiting the process of credit creation.
- Availability of credit worthy borrowers/ customers. Existence of many creditworthy customers promotes the process of credit creation because there are many people qualifying for bank loans, on other hand a small number of credit worthy customers limits the process of credit creation because few people qualifying for bank loans.
- Political climate/Atmosphere, political instability discourages borrowing and lending and this limits the process of credit creation because people fear to lose their lives and property, on the other hand political stability encourage borrowing and lending which encourages investment because people are not scared of losing their lives and property.

**Factors that limit credit creation by commercial banks;
(Limitations of credit creation)**

- High liquidity preference.
- High cash ratio.
- Lack of collateral security by some bank customers (houses, gold, machinery, land titles, vehicles).
- Limited number of commercial/poor distribution of commercial banks.
- Limited investment opportunities.
- Ignorance of the public about banking service
- High interest rates on loans.
- Restrictive monetary policy.

- Large subsistence sector/low levels of commercialization.
- Political instability/Political turmoil
- Low levels of accountability in the banking sector
- Limited number of credit worthy borrowers.
- Low level of bank deposits/Low level of savings

Factors that promote credit creation;

- Low level of liquidity preference.
- Low cash ratio.
- Presence of collateral security (houses, gold, machinery, land titles, vehicles)
- High number of commercial banks/ even distribution of commercial banks.
- Large number of investment opportunities.
- High level awareness of the public about banking services
- Low interest rates on loans.
- Expansionary monetary policy.
- Low level of subsistence sector/High levels of commercialization.
- Presence of political stability
- High levels of accountability in the banking sector.
- Large number of credit worthy borrowers.
- High level of bank deposits/High level of saving.

Credit Control:

This is the deliberate government policy through the central bank to regulate lending by commercial banks and other financial institutions in order to achieve desired macro-economic objectives.

The reasons for Credit Control/ control of credit creation;

- To create employment opportunities.
- To stabilize prices / to control inflation.
- To improve the balance of payments position.
- To increase economic growth rate.
- To increase the level of investment.
- To stabilize exchange rates.
- To ensure growth and stability of the banking/financial sector
- To manage the (internal) public debt.
- To ensure safety to customers deposits.

Measures used to control credit creation

- Use of the bank rate
- Special deposits
- Use of variable reserve requirements
- Using the margin requirements
- Moral suasion
- Open market operations

- Selective credit control
- Rationing of credit

Measures being used to reduce credit creation in Uganda;

- Sale of government securities, for example, treasury bills
- Increasing the bank rate
- Increasing the variable reserve requirement / increasing the cash ratio and liquidity ratio.
- Increasing the minimum legal reserve requirement
- Increasing the margin requirement
- Increasing the special deposits
- Implementing a selective credit control policy (system)
- Persuading commercial banks to restrict lending / embarking on moral suasion.
- Rationing of credit.

Credit expansion; Is a deliberate policy by government through the central bank to increase/enhance lending capacity of commercial banks other financial institutions.

Credit squeeze; Is a deliberate policy by government through the central bank to reduce/limit/restrict lending by commercial banks other financial institutions.

Credit crunch/crisis;

A credit crunch is a reduction in the general availability of loans /credit accompanied by an increase in the severity of conditions required to be granted credit.

A credit crunch is usually an extension of an economic recession. It makes it nearly impossible for companies to borrow money because lenders are scared of bankruptcies (defaults) which results into very high interest rates.

Causes of credit crunch in an economy

- Anticipated decline in the value of collateral used by banks to secure loans.
- The central government imposing direct credit controls on the banking system.
- Sudden and unexpected increase in legal reserve requirements by the central bank.
- Sustained period of careless and inappropriate lending which results into losses for lending institutions.
- Reduction in market prices of previously over inflated assets/securities.

CENTRAL BANK:

A central bank is a state owned financial institution established to control all other financial institutions and ensure economic stability in the country e.g. Bank of Uganda, Central bank of Kenya, Bank of England e.t.c

Functions of the Central bank:

- Printing and issuing of the currency. It has the sole authority of issuing national currency i.e. notes and coins which are sufficient to enable the public carry out transactions.
- It is a banker to the government and various government institutions by keeping government funds. This is because the central bank keeps all the government money .i.e. it manages the government treasury.
- It acts as banker to commercial banks and other financial institutions. The central bank accepts deposits from commercial banks and commercial banks are required by law to have an account in the central bank.
- It acts as a banker to International financial institutions such as international Monetary Fund, World Bank. Each of these financial institutions operates an account in the central bank for their operations in the country.
- It is a lender of last resort to the commercial banks, i.e. if commercial banks fail to raise money to settle their customers' demands from other sources; they borrow from the central bank.
- It is the regulator and supervisor of other financial institutions especially the commercial banks to ensure that they operate within the laws established. (To ensure financial soundness)
- It is responsible for management of foreign exchange reserves through enforcing foreign exchange regulations and it acts as the chief custodian of all the currencies in the country both local and foreign.
- It is the advisor to the government on good and sound monetary and economic issues depending on the level of economic activities e.g. formulating the national budget, taxation.
- The Central bank manages a country's public debt it is involved in the acquisition, utilization, servicing and repayment of the public debt.
- It is a clearing house for all commercial banks i.e. they settle their indebtedness through it.
- The central bank is the controller of credit/money supply in the economy i.e. it uses the monetary policy tools to regulate the amount of money in circulation.

THE MONETARY POLICY:

Monetary policy refers to the deliberate attempt by the government through the central bank to regulate the amount of money in circulation so as to attain objectives of development such as price stability, stable economic growth rates, equitable distribution of income etc.

The monetary policy can be categorized into two, namely;

- Expansionary monetary policy
- Contractionary/ Restrictive / tight monetary policy.

An expansionary monetary policy refers to the deliberate effort by the government through the central bank to increase the amount of money in circulation so as to control the level of economic activities.

A Restrictive/contractionary / tight monetary policy refers to the deliberate effort by the government through the central bank to reduce amount of money in circulation so as to control the level of economic activities.

Objectives of the monetary policy in Uganda:

- To attain price stability. During inflation a tight monetary policy is used to reduce money supply to bring down prices and during a deflation an expansionary money policy is adopted to increase the amount of money in circulation so as to raise prices.
- To attain full employment. This is through expanding credit to allow investors to more raise more capital for investment and create more jobs.
- To improve balance of payment position. This is achieved through an expansionary monetary policy which promotes domestic production and minimize importation thus improve the balance of payment position.
- To ensure stability of exchange rates. This is through regulation of both local and foreign currencies to avoid fluctuations in exchange rates.
- To influence the level and nature of investment. This is achieved through encouraging the commercial banks to offer credit facilities to the priority sectors and limiting accessibility to credit by investors in non priority sectors.
- To encourage growth of the financial sector. This achieved through expanding credit to enable investors expand production for the market.
- To influence the rate of economic growth. This is achieved by encouraging the production of goods and services through the expansionary monetary.

- To ensure equitable distribution of income. This through use of selective credit control where commercial banks are directed by the central bank to be discriminative in their lending policies by favoring sectors, firms and individuals that face capital challenges so as to enable them raise more funds for investment and raise their income.

Tools of the monetary policy and how they are used;

- **The bank rate.** This is the rate charged by central bank on loans advanced to commercial banks.

During inflation when there is much money in circulation, the central bank raises the bank rate to reduce lending. This makes borrowing by commercial banks difficult and costly and in turn commercial banks raise the interest rate on loans to customers. This makes borrowing from commercial banks costly and discourages borrowing, and reduces amount of money in circulation.

On the other hand, during deflation the bank rate is lowered making borrowing easier and cheaper. More people borrow loans which increase amount of money in circulation and aggregate demand for goods and services.

- **Open market operation.** This is the selling or buying of government securities such as treasury bills and bonds.

When there is inflation, central bank sells government securities to the public which makes the public to withdraw money from commercial banks to buy securities thus reducing cash reserves, credit creation by commercial banks and the amount of money in circulation.

During a period of deflation, the central bank buys securities from the public and deposits of public with commercial banks increase, cash reserves too increase hence increasing money supply and aggregate demand.

- **Selective credit control.**

This is where commercial banks are directed by the central bank to be discriminative in their lending policies by favoring specified sectors and disfavoring others. This reduces the number of sectors getting loans hence reducing money supply and controlling inflation.

On the other hand when government wants to increase money in circulation through the central bank it directs commercial banks to give loans to all sectors of the economy.

- **Legal reserve requirement.** This is the minimum amount of total bank deposits that commercial banks must keep with the central bank as required by law.

During inflation, the central raises the legal reserve requirement which reduces funds available for lending with commercial banks thus reducing money supply and inflation.

During deflation the legal reserve requirement is lowered which leaves commercial banks with a lot of money for lending thus increasing money supply and aggregate demand.

- **Variable reserve requirement.** This includes cash ratio and liquidity ratio. It is the proportion of commercial bank's total deposits which must be kept in cash form or near cash form to meet the daily cash demands of customers.

To increase money supply, the central bank reduces the reserve ratio thereby increasing money supply and credit creation ability by commercial banks.

On the other hand to reduce money supply, the central bank increases the variable reserve requirements which reduces credit creation ability of commercial banks and inflation is reduced.

- **Special deposits (supplementary reserve requirement).** Central bank may call upon commercial banks to make special deposits over and above the legal reserve requirement which reduces credit creation ability by commercial banks thereby reducing money supply. When central bank wants to increase money supply it does not call for special deposits.
- **Margin requirement.** This is the difference between the value of collateral security and the value of loan to be advanced.

To reduce inflation and money supply, the central bank directs commercial banks to raise the margin requirement which makes borrowing risky and difficult thus limiting borrowing. During deflation, central bank directs commercial banks to lower the margin requirement which encourages borrowing, increase money supply and aggregate demand.

- **Moral suasion.** This involves central bank issuing directives, instructions, appeals and persuasion of commercial banks to reduce lending during inflation and increase lending during deflation.

- **Rationing of credit.** This involves central bank advancing loans to commercial banks up to a specific amount.

During inflation, central bank reduces loan advances to commercial banks which limits their lending capacity thus reducing money supply and inflation. During deflation, central bank increases loan advances to commercial banks which increases their ability to give out loans and money supply increases.

- **Currency reform.** When there is too much money in circulation especially the cash component with a very high rate of inflation, government through the central bank may change the currency and introduce a new currency with an exchange value. This was the case in Uganda in 1987.

Factors limiting the effective operation of monetary policy;

(Reasons why the monetary policy has not been successful as an instrument of economic management in Uganda)

- ✓ Commercial banks in developing countries usually have excess liquidity and therefore rarely borrow from the central bank which limits effectiveness of the bank rate as a monetary tool.
- ✓ High liquidity preference among the public, most people in Uganda prefer keeping their assets in cash form and so they do not keep money in banks which makes it difficult for the central bank to control money outside the banking system.
- ✓ Ignorance of the public about facilities offered by commercial banks. E.g. majority do not buy treasury bills and bonds limiting effectiveness of open market operation as a monetary policy tool.
- ✓ Dominance of private foreign owned commercial banks in Uganda which are not under direct control by the central bank. These banks sometimes defy the monetary policy tools like bank rate, variable reserve requirements because they have access to finance from abroad making it difficult to control their activities.
- ✓ Rampant corruption and bribery in the banking sector where some people who do not deserve loans are given by some commercial bank officials which limits the implementation of selective credit as a monetary policy tool.
Low level of accountability by central bank officials means that central bank official is bribed by commercial banks and extends loans to non priority sectors, thereby rendering implementation of monetary policy tools ineffective.
- ✓ There is a lot of government interference in activities of the central bank e.g. government may order printing of more money to finance budgetary deficits even when conditions do not warrant so which

leads to inflation and monetary policy failure to achieve its objectives.

- ✓ Presence of a large subsistence sector leads to low incomes among people limiting deposits in banks and operation of monetary policy tools like OMO, variable reserve requirements and bank rate as few people borrow money from banks.
- ✓ Underdeveloped money and capital markets in LDC's limits effectiveness of open market operations as a monetary policy tool.
- ✓ Unfavorable external influence such as World Bank and International Monetary Fund (IMF) conditionalities which may not be in line with the monetary policy objectives of the central also leads to failure.
- ✓ Limited effective use of commercial banks due to lack of collateral security, low incomes limits lending by commercial banks and success of monetary policy tools such as bank rate, selective credit control etc.
- ✓ Poor/uneven distribution of commercial banks e.g in Uganda commercial banks are mainly found in urban areas and the rural people have limited access to banking services which limits the effective use of bank rate and open market operation as monetary policy tools.
- ✓ High level of political interference in central bank activities in terms of influencing lending policies leads to excessive amount of money in circulation thereby failing the monetary policy.
- ✓ Conflicting government objectives e.g. during an inflation period coupled with high rate of unemployment, government may fail to effectively use monetary policy since solutions to unemployment are sometimes inflationary.

Factors promoting the effective operation of the monetary policy;

- ✓ Low level of liquidity preference among the general public
- ✓ High level of development of money market and capital markets.
- ✓ Low level of liquidity in commercial banks
- ✓ Large commercial sector
- ✓ Even distribution of commercial banks
- ✓ Low degree of political interference in central bank activities
- ✓ High level of accountability by central bank officials
- ✓ High level of coordination of government objectives
- ✓ High level of use of commercial banks
- ✓ High level of awareness of the public about the facilities offered by commercial banks

Factors which influence/affect/determine the effectiveness of monetary policy;

- ✓ Level of liquidity preference among the general public
- ✓ Level of development of the money markets and capital markets i.e. stock exchange markets to do with securities through which the central bank can operate.
- ✓ Level of liquidity in commercial banks which influences their frequency of going to the central bank.
- ✓ The size of monetary sector/subsistence sector.
- ✓ The distribution of commercial banks/ Level of development of commercial banks.
- ✓ Degree of political interference in central bank activities.
- ✓ Level of accountability by the central bank officials especially in the implementation of some tools like selective credit control.
- ✓ Level of coordination of government objectives.
- ✓ Level/Degree of effective in the use of commercial banks.
- ✓ Degree of awareness of the public about facilities offered by commercial banks.

REVISION QUESTIONS:

- 1 a) Explain the credit creation process by commercial banks. 06mks
b) What factors limit credit creation by commercial banks in LDC's? 14mks
- 2 a) Explain the objectives of the monetary policy in Uganda. 06mks
b) Explain the monetary policy tools used in Uganda . 14mks
c) What factors limit the effectiveness of the monetary policy as an instrument of economic management? 14mks
- 3 a) Explain the quantity theory of money. 6mks
b) What are the limitations of the quantity theory of money? 14mks
- 4 a) Explain functions of the central bank in Uganda. 6mks
b) How does the central bank control credit in Uganda? 14mks
- 5 a) Distinguish between Banking and Non-banking financial intermediaries. 04mks
b) What are the functions of banking financial intermediaries in Uganda? 16mks
- 6 (a) what is the role of commercial banks in development of your country. 10mks
(b) Explain the challenges /problems faced by commercial banks in Uganda. 10mks
- 7 (a) Distinguish between lending rate and deposit rate. 4mks
(b) Explain the determinants of interest rate in Uganda. 16mks
- 8 a) Outline assets and liabilities of commercial banks. 8mks
b) Explain how commercial banks reconcile the conflicting objectives of liquidity, profitability and security. 12mks
- 9 a) Differentiate between a commercial bank and a development bank. 04mks
b) Discuss the contribution of foreign owned commercial banks to the development of developing countries. 16mks

END