STANDARD HIGH SCHOOL ZZANA

ECONOMICS NOTES

Instructions.

- Read and write these notes please

MONEY AND BANKING

Money is anything that is generally accepted as a medium of exchange in settlement of financial obligations.

Legal tender

This refers to money which by law must be accepted as a medium of exchange in settlement of financial obligations.

A country's currency is its legal tender. So in Uganda, legal tender denominations include;

- 50,000 shillings note
- 20,000 shillings note
- 10,000 shillings note
- 5,000 shillings note
- 2,000 shillings note
- 1,000 shillings note and coin
- 500 shillings coin
- 200 shillings coin
- 100 shillings coin
- 50 shillings coin

FUNCTIONS OF MONEY

1. **It is a medium of exchange.** Money is used to pay for goods and services
2. **It is a unit of account.** Money is used as a unit of account to carry out book keeping in form of calculations and accounting.
3. **It is a store of value (wealth).** When properties like land or buildings are converted into monetary terms, the money can be stored. This is because it is not bulky and it is not perishable.

4. **Standard of deferred payment.** Modern economics set up is based on credit and credit is paid in terms of money only. Only money is such a commodity in whose form accounts of deferred payments can be maintained that both the creditors and debtors do not stand to lose.
5. **Money is a standard measure of value.** Through money, the relative values or prices of commodities can be determined. Money therefore reflects the quantity and quality of goods sold and bought in the market.

CHARACTERISTICS OF GOOD MONEY

- Should be generally accepted
- Should be divisible
- Should be portable
- Should be durable/ long lasting
- Should be homogeneous/ similar
- Should remain stable in value for long
- Should not easily be forged
- Should be relatively scarce
- Should be malleable (easy to design and print by the monetary authority)
- Should be easily recognized.

BARTER TRADE

Barter trade is a system of exchange where there is direct exchange of goods for goods, goods for services or services for services.

ADVANTAGES OF BARTER TRADE

1. **Barter trade system saves foreign exchange that is scarce especially in LDCs** hence devoted to other uses.
2. **It reduces balance of payments problems in LDCs** by reducing their foreign exchange expenditure abroad.
3. **It promotes specialization** because countries are assured of exchanging with others.
4. **It widens the market for commodities.** This is because one does not need money in order to have a commodity.
5. **It expands friendly relationships between countries and their citizens.**
6. **It shortens the trade process** because it is more direct.
7. **It is not inflationary** because there is no use of money.
8. **It facilitates trade among small countries** and increases their share in international trade.
9. Etc.

DISADVANTAGES

1. **The problem of double coincidence of wants.** It was very difficult to get one who has got what you want and at the same time willing to exchange it for what you have.
2. **Indivisibility of some commodities.** Some commodities could not be divided up into small units to effect small transactions e.g. if one had a cow for exchange but another one had a tin of beans and needed 2kg of beef, then it became difficult to get them from a cow.
3. **Difficulty in determining the exchange rates** for example how many cocks for a cow.
4. **Some commodities were perishable** which made future trade impossible.
5. **Limited storage facilities** since some goods are bulky and others are perishable.
6. **Difficulty in transportation** given the bulkiness of some products and existence of poor roads.
7. **Barter trade system encourages dependence of one economy on another** and in case of conflicts, a country may suffer.
8. **The barter system restricted the number of transactions that could take place.**

ASSIGNMENT

Read and make notes about evolution of money.

CONCEPTS USED IN RELATION TO MONEY

1. **Currency**

   This is money in form of paper notes and coins commissioned by a particular country to facilitate the exchange of goods and services and settlement of debts within the country. For example Uganda's currency is a shilling, Japan – Yen, British – Pound, South Africa – Rand.
2. **Legal tender**

   This refers to money which by law must be accepted as a medium of exchange in settlement of financial obligations
3. **Token money**

   This is money whose intrinsic value is less than the face value. NOTE

   1. **Intrinsic value is one which when the same coin is melted and that metal is sold the cost of that.**
   2. **Face value is the value written on the coin/ currency.**
   3. **If face value = intrinsic value → intrinsic money.**

4. **Commodity money**

   This is money in terms of the value of commodities. For example salt, corn, tobacco, etc.

5. Fiat money

This is money issued on the directive of the government irrespective of the level of economic activity (money printed by the central bank on government orders).

6. Fiduciary issue

This is money issued by the central bank at its discretion and is not backed by gold or foreign reserves.

7. Quasi (near) money

These are financial assets which can easily be turned into money e.g. cheques, treasury bills, postal orders, etc.

8. Narrow money

This is currency in the hands of the public plus demand deposits in commercial bank.

NOTE

Demand deposits is money deposited on current accounts.

9. Broad money

This is the sum of currency in circulation, demand deposits, savings and time deposits.

10. Nominal value of money

This refers to the monetary (face) value of money for example 1000/=.

11. Real money value (value of money)

Value of money refers to the amount of goods and services a unit of money can purchase.

OR

It is the purchasing power of a unit of money.

$$Real\ money\ value = \frac{Nominal\ money\ value}{Price\ index}$$

The value of money depends on the following;

- General Price level/ rate of inflation.
- The velocity of circulation of money
- The quantity of goods and services available.
- Amount of money in circulation
- Government policy e.g. devaluation.

12. Convertible (hard) currency

This is currency which can be exchanged for other currencies and it is internationally accepted in carrying out transactions e.g. pound, dollar, etc.

13. Soft (managed) currency

This is currency which is used only within the country and cannot be accepted in carrying out international transactions e.g. Uganda shillings.

14. Foreign reserves

Foreign reserves refer to the total of foreign currencies, gold and special drawing rights kept/ held by a country (in its central bank) that can be used to make international payments.

INTEREST

Interest refers to the monetary reward/ payment to capital as a factor of production for its contribution in the production process.

INTEREST RATE

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

FACTORS THAT INFLUENCE INTEREST RATES IN MY COUNTRY

1. **The supply of loanable funds.** Loanable funds refer to the amount of money available in financial institutions for lending purposes. The higher the supply of loanable fund, the lower the interest rate and the lower the supply of loanable funds, the higher the interest rate.
2. **The demand for loans.** The higher the demand, the higher the interest rate and the lower the demand, the lower the interest rate.
3. **Government policy towards lending (Bank rate).** The government reduces the rate so as to stimulate economic growth. By reducing the rate, consumers borrow and spend more and the growth rate increases. To avoid over heating of the economy, the government increases the rate again.
4. **Objective of the lender.** Various lending institutions charge different interest rates. Greed for profits by the institutions leads to high interest rate and where institutions are not greedy for profits, the interest rate is low.
5. **Size of the loan.** The smaller the size of the loan, the higher the interest rate and vice versa.
6. **Period of loan repayment.** The longer the period, the higher the interest rate and the shorter the period, the lower the interest rate.
7. **The rate of inflation.** The higher the rate of inflation, the higher the interest rate and the lower the inflation rate, the lower the interest rate.
8. **Number of financial institutions.** The greater the number of financial institution, the lower the interest rate and the smaller the number of financial institutions, the higher the interest rate.

ASSIGNMENT

Mention the factors that have led to high interest rates in your country.

Solution

Low supply of loanable funds.

- High demand for loanable funds
- Unfavourable government policy
- The greed for profits by financial institutions.
- Small amount of the loan required.
- Long term loan required.
- High rate of inflation.
- Few financial institutions in the country.

WHY INTEREST IS PAID OR CHARGED

- Reward for savings. That is interest is paid to reward those who postpone their consumption to the future.
- To encourage individuals to save.
- It is charged for management. That is it is paid to meet the expenses of the lending institution e.g. files, stationery, man-power, etc.
- It is paid for use of loanable funds.
- It is charged for inconvenience to cover the opportunity cost of lending.
- It is a charge for risk taking e.g. parting with cash involves the risk of losing it.

LIQUIDITY

Liquidity as used in economics means the ease with which an asset can be changed into cash.

Liquidity in my country is desired for the following reasons;

- To carry out day-to-day transactions (Transactions motive)
- To meet unforeseen circumstances (Precautionary motive)
- For speculative motive

DEMAND FOR MONEY (LIQUIDITY PREFERENCE)

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

The demand for money has been variously explained by different economists hence the theories of money demand.

THEORIES OF MONEY DEMAND

There are three theories of money demand namely;

1. Classical quantity theory of money demand
2. Keynes' liquidity preference theory (Keynesian theory of money demand) 3. Friedman's modern quantity theory.

THE CLASSICAL QUANTITY THEORY OF MONEY DEMAND

The theory was advanced by Irving Fisher and other classical economists such as Adam Smith and Ricardo.

The quantity theory of money states that the general price level in an economy is determined by the quantity of money assuming that the velocity of circulation of money (V) and the level of transactions (T) are constant.

OR

The quantity theory of money states that the general price level in an economy tends to vary directly with the quantity of money and velocity of circulation of money and inversely with the volume of transactions.

OR

The quantity theory of money states that an increase in money supply leads to a proportionate increase in the general price level provided the velocity of circulation of money and the level of transactions remain constant. The theory is represented by the equation

$$MV = PT \text{ or } P = \frac{MV}{T}$$

Where M = Quantity of money

V = Velocity of circulation of money

P = General Price level

T = Level of transactions

A change in any of the variables will influence the price. According to the theory, M and V vary directly while T varies inversely with P.

Example

Given that the quantity of money in an economy is shs 1,000,000, its velocity of circulation is 20 and the number of transactions made are 250. Calculate the general price level in an economy.

Solution

Given that M = shs 1,000,000

V = 20

T = 250

P =?

From $P = \frac{MV}{T}$

$$= shs\left(\frac{1,000,000 \times 20}{250}\right)$$

$$P = shs\ 80,000$$

ASSIGNMENT

1. Given that the volume of money in an economy is £ 20 billion; total level of transactions is £ 250 and the transactions velocity of money is 20; calculate the general price level in the economy. (04 marks)
2. a) State Irving Fisher's equation of exchange. (02 marks) b) How is the value of money determined in Fisher's equation of exchange? (02 marks)

ASSUMPTIONS OF THE QUANTITY THEORY OF MONEY

- Velocity of circulation of money is constant.
- The level of transactions is constant.
- All transactions take place using money as a medium of exchange.
- Assumes the general price level which is directly proportional to the amount of money in circulation.
- Assumes that money is only demanded for transactions motive.
- Assumes that the four variables M, V, P and T are independent of each other.
- Assumes that excessive money supply is the only cause of inflation.

RELEVANCY OF THE THEORY

The theory is relevant to a small extent.

1. Price directly depends on the amount of money in circulation i.e. an increase in the amount of money in circulation leads to an increase in price and vice versa.
2. Price directly depends on the velocity of circulation of money i.e. an increase in velocity of circulation of money leads to an increase in price and vice versa.

3. Price level is inversely related to the level of transactions i.e. an increase in the level of transactions leads to a decrease in the price level and vice versa.

LIMITATIONS OF THE QUANTITY THEORY OF MONEY

The theory is irrelevant to a larger extent because of the following reasons.

1. There is no general price level but rather a series of price levels.
2. It ignores the influence of the rate of interest yet it is vital in relation to money and its demand.
3. The theory does not take into account the demand for money (it only looks at money supply).
4. The theory only attempts to explain changes in the value of money but does not show how the value of money is determined.
5. Sometimes an excessive money supply does not lead to inflation when marginal propensity to save (MPS) is high as this reduces the velocity of circulation of money making prices to fall.
6. Where a country has many unemployed resources, an increase in money supply to exploit them increases domestic output hence reducing scarcity making prices to fall or not change at all.
7. The theory ignores haggling/ bargaining between buyers and sellers to reach an agreeable price.
8. The theory does not consider government intervention in the determination of price through setting up minimum or maximum price.
9. The theory does not take into account other causes of price increment like rising cost of production, natural calamities, excessive issuance of currency, etc.
10. It is not a theory but just a truism. It only merely shows that M, V, P and T are related but it does not show how each variable relates or impacts on the other.
11. It ignores barter trade. It only considers exchange through use of money.
12. It only considers the transactions motive of holding money and ignores the speculative and precautionary motives of money demand.
13. The four variables M, V, P and T are not independent of one another as the theory assumes because a change in one induces change in others.
14. The theory assumes that the velocity of circulation of money (V) and the level of transactions (T) are constant but this is not true in real life situation.

KEYNESIAN THEORY OF MONEY DEMAND

Keynes abandoned the classical view that velocity of circulation of money was constant and emphasized the importance of interest rates.

He postulated that there are three motives behind the demand for money namely;

1. **Transactions demand for money**

   Money is a medium of exchange and thus people hold money for use in transactions

2. **Precautionary motive**

   This refers to keeping some money balances at hand to meet unforeseen circumstances such as car breakdown, illness and property damage.

3. **Speculative motive**

   This exists because people desire to hold part of their wealth in form of cash so as to take advantage of any opportunity that may arise from the financial market.

   According to Keynes, as interest rates fall, people wish to hold greater and greater amounts of money in place of any other financial asset. On the other hand, as interest rates rise, people will receive the best return by investing their money in bonds.

LIQUIDITY TRAP

Liquidity trap is where the interest rates are very low forcing people to hold substantially high amounts of money

OR

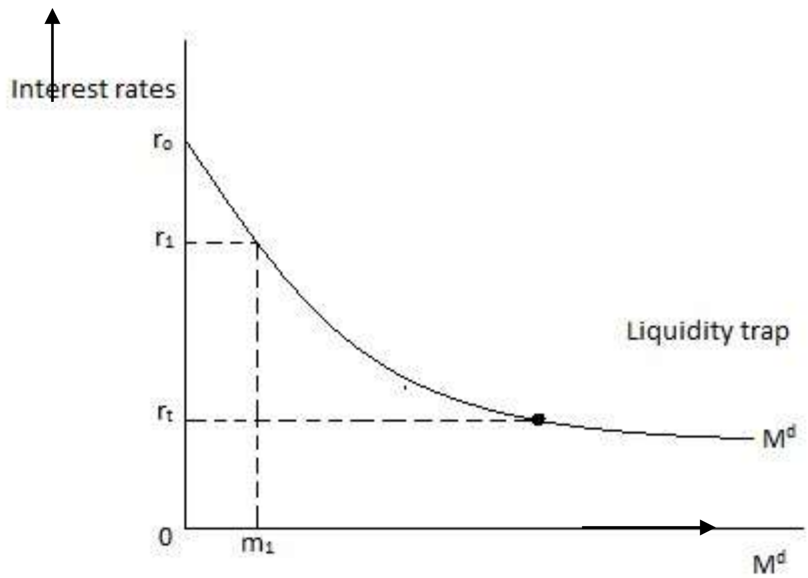
Is a situation in which prevailing interest rates are low forcing people (consumers) to avoid bonds and keep their funds in savings.

OR

Is a situation where bank cash holdings are rising and banks cannot find sufficient number of qualified borrowers even at extra ordinary low interest rates.

Keynes believed that such a circumstance is likely to exist during a serious depression.

Illustration



From the diagram, when the interest rate is high, i.e. at r_1; the demand for money is low because investors are investing in securities to obtain higher profits. However as the interest rate reduces, investors are not willing to invest in securities hence increasing the demand for money.

FACTORS THAT INFLUENCE LIQUIDITY PREFERENCE IN AN ECONOMY

1. **Level of (cash) transactions.** The higher the level of transactions, the more money is needed to meet day-to-day expenditures hence high level of liquidity preference and the lower the level of transactions, the less the desire for money hence low level of liquidity preference.
2. **General Price level/ rate of inflation.** A high price level leads to high liquidity preference because a lot of cash is needed to purchase goods and services at a high price while a low price level necessitates less cash at hand hence liquidity preference being low.
3. **Level of income.** High income levels result into high levels of liquidity preference because funds are readily available for saving, spending and for investing while low income levels result into low levels of liquidity preference because there are less funds for spending.
4. **Degree of uncertainty.** The higher the degree of uncertainty, the higher the level of liquidity preference because people are not sure of what will happen in the future while a low degree of uncertainty in the future enables people to save and invest hence leading to low levels of liquidity preference.
5. **Interest rates on financial assets.**

6. **Knowledge of banking facilities or services provided by commercial banks.** Knowledge of banking facilities by the public enables them to deposit their money in those banks other than risking walking with money hence liquidity preference is low while ignorance about banking facilities by the public leads to high liquidity preference.
7. **Distribution of commercial banks or level of development of commercial banks and other financial institutions.** Well developed financial institutions especially banks attract people to save in those institutions hence liquidity preference is low while underdeveloped financial institutions discourage people to save their money with them hence high liquidity preference.
8. **Level of literacy**
9. **Level of speculation.**
10. **Requirements for opening and operating bank accounts 11. Level of infrastructural development.**

MONEY SUPPLY

Money supply refers to the total amount of money in circulation in an economy at any given time.

TYPES OF MONEY SUPPLY

1. **Exogenous money supply.** It refers to money supply by the central bank irrespective of the level of economic activity. It is also called autonomous money supply.
2. **Endogenous money supply.** This is money supply that depends on the level of economic activity influenced by the forces existing within the economy.

FACTORS THAT AFFECT MONEY SUPPLY IN AN ECONOMY

1. **Level of economic activity.** The higher the level of economic activity, the higher the money supply because people get loans from banks to finance these activities and the lower the level of economic activity, the lower the need for loans hence low money supply.
2. **The nature of monetary policy.** A tight/ restrictive/ contractionary monetary policy leads to low money supply in an economy while an expansionary monetary policy leads to high money supply in an economy.
3. **The level of monetization of the economy.** An economy with a large monetary sector has got high money supply. However, an economy with a large subsistence sector where money is not used as a medium of exchange has got low money supply.
4. **The rate of government borrowing (financial accommodation).** A high rate of government borrowing from the central bank implies printing more money which leads to high money supply. On the other hand, a low rate of government borrowing leads to low money supply as less money needs to be printed.

5. **Balance of payments position.** A balance of payments surplus leads to high money supply because foreign exchange earnings are converted into low currency. On the other hand, a balance of payments deficit leads to low money supply because local currency is used to close the deficit.
6. **The level of capital inflow and outflow.** Capital inflows say in form of foreign investments by foreigners lead to high money supply while capital outflows like profit repatriation lead to low money supply.
7. **The level of credit creation by commercial banks.** The higher the level of credit creation by commercial banks, the higher the money supply and the lower the level of credit creation by commercial banks, the lower the money supply. Credit creation leads to high money supply through the multiplier process.
8. **Method of deficit financing.** Printing of more money by the government through the central bank to meet budgetary deficits leads to high money supply and government borrowing from the public to finance budgetary deficits leads to low money supply.

BANKING

FINANCIAL INTERMEDIARIES

Financial intermediaries are institutions which operate in the financial market by channeling savings from lenders to borrowers who wish to invest.

OR

These are institutions that help to connect surplus spending units (lenders) to deficit spending units (borrowers).

Financial intermediaries trade in money as their commodity and charge a price called interest. They accept deposits from customers and extend loans to investors.

TYPES OF FINANCIAL INTERMEDIARIES

There are two types financial intermediaries namely;

1. Banking financial intermediaries.
2. Non-banking financial intermediaries.

BANKING FINANCIAL INTERMEDIARIES

Banking financial intermediaries are financial institutions that accept or receive deposits from the public, give out loans and create credit or new deposits.

Commercial banks are the main examples of banking financial intermediaries.

A commercial bank is a financial institution that receives deposits from the public (customers), gives out short term loans at high interest rates and creates credit.

Examples of commercial banks in Uganda include;

- ABC capital bank
- Bank of Africa
- Bank of Baroda
- Bank of India
- Barclays bank
- Cairo international bank
- Centenary bank
- Citibank Uganda limited
- Commercial bank of Africa
- Crane bank
- DFCU
- Diamond trust bank
- Ecobank Uganda
- Equity bank

- Finance trust bank
- Global trust bank
- Guaranty trust bank
- Housing finance bank
- Kenya commercial bank (KCB)
- Stanbic bank
- Standard chartered bank

FUNCTIONS OF COMMERCIAL BANKS

A) **PRIMARY FUNCTIONS**

1. They accept and safeguard deposits from the public by permitting people to open up various types of accounts such as savings account, current account and the fixed deposit account.
2. They extent credit facilities to the public in form of bank loans and bank overdrafts.

B) **SECONDARY FUNCTIONS**

Besides the primary functions of accepting deposits and lending money, banks perform a number of other functions which are called secondary functions. These include;

1. They provide excellent means of payment by use of facilities such as cheques, credit transfers and standing orders.
2. They act as trustees to the execution of wills of the deceased persons.
3. They act as custodians of valuable documents such as land titles, wills, academic certificates, etc.
4. They advise their customers on investment decisions.
5. They act as agents of the stock exchange by buying and selling shares and securities on behalf of their customers.
6. They facilitate international trade by opening up letters of credit to intending importers and granting payment in international transactions as well as issuing traveler's cheques.
7. They assist the central bank in implementing the tools of monetary policy.
8. They provide foreign exchange to their customers i.e. commercial banks deal in buying and selling of foreign .exchange.
9. The create credit through the process of credit creation whereby customers' deposits are lent out several times to other customers.

THE ROLE OF COMMERCIAL BANKS IN THE DEVELOPMENT OF AN ECONOMY

1. **Provision of employment opportunities.** They create employment opportunities for the people in the country hence improving the standards of living.

2. **Contribute to government revenue through paying taxes.** The revenue obtained can be invested in the public sector.
3. **Development of peoples' skills.** They provide training facilities to their employees in order to produce efficient managers and bankers and this improves on the stability and efficiency of the banking system and contributes to human capital development.
4. **Development of entrepreneurship skills.**
5. **Mobilize savings.** They mobilize savings by providing facilities which enable investment in future (fixed deposit accounts) leading to development.
6. **Promote price stability.** They promote price stability by helping the central bank to implement the tools of monetary policy. Price stability encourages investments leading to development.
7. **Invest in directly productive activities** hence increased output and economic growth.
8. **Lend money for investment.** Commercial banks promote investment by providing credit facilities to potential investors in form of bank loans and bank overdrafts.
9. **Provide advice to potential investors.** They assist potential investors for example traders by giving them advice on trade.
10. **Monetize the economy.** They help to reduce the subsistence sector by encouraging many people to borrow and invest for commercial purposes.

CREDIT

This is defined as money facilities borrowed to be paid at a later date.

INSTRUMENTS OF CREDIT

Instruments of credit are written or printed financial documents that serve either as promises to pay or orders to pay an entity named on the document. Examples of instruments of credit in an economy;

- **Promising note.** This is a written promise by the buyer to the seller to make a specific payment at a future date.
- **Bill of exchange.**
- **Credit card.** This is used by the holder to buy goods and services from organizations that accept payment by this method.

- **Bank notes.**
- **Cheque.** Is a written order by the account holder to the bank to pay a specified amount of money to the person named on the cheque or his order.
- **Letter of credit.**
- **Treasury bills and bonds.**
- **Bank draft.** This is the cheque drawn on the bank itself and the bank issues it only if the person requesting it has paid an equivalent amount of money to the bank.
- **Credit transfer system.** This is a service offered by a commercial bank for settling many debts using one cheque.
- **Standing order.** This is an instruction to the bank by the account holder to pay a specified sum of money to a named person at a regular or specified interval for a specified period of time.
- **Direct debit scheme.** This is similar to a standing order but instead of asking the bank to make payment on one's behalf, the account holder gives an organization or an individual permission to withdraw money directly from the lender.
- **Travelers' cheque.**

CREDIT CREATION

Is the process by which commercial banks create several (new) deposits/ loans out of initial deposits made by customers.

COMMON TERMS

1. **Liquidity ratio.**

   Is the proportion of commercial bank (total) deposits that is/ must be kept in cash or/ and near cash form.
2. **Cash ratio.**

   Is the percentage of commercial bank deposit that must be kept in cash form to meet the cash demands of the depositors.
3. **Legal reserve requirement**

   This is the proportion of customers' deposits that by law commercial banks are supposed to deposit with the central bank.

4. **Excess reserves**

   In banking, excess reserves are bank reserves in excess of the reserve requirement set by the central bank.

5. **reserve ratio**

   This refers to the fraction of the total reserves by commercial banks to their total deposits. Total reserves are the sum of the excess reserves and the legal reserve requirement

   OR

   Reserve ratio is the fraction of commercial bank's total deposits which by law must be either kept with the commercial bank or with the central bank.

ASSUMPTIONS OF THE PROCESS OF CREDIT CREATION

- It assumes that there is a fixed cash ratio and this can be 10%, 20%, etc.
- It assumes that a bank has several branches in which people deposit the money lent to them.
- It assumes that transactions are carried out using a cheque facility.
- It assumes that several people get loans and deposit them in the same bank or in branches of the same bank.
- It assumes that people are willing to borrow.
- It assumes that commercial banks are willing to lend with less conditionality.
- It assumes credit worthiness among the public.
- It assumes that there is an initial positive deposit against which credit is created.

CREDIT CREATION PROCESS

Question

How does a commercial bank create credit using an initial deposit of shs 1,000,000 and a uniform cash ratio of 20%? (Illustrate your answer).

Solution

1. A commercial bank creates credit by receiving deposits and lending part of it.
2. Receiving of deposits by a commercial bank that is shs 1,000,000.
3. Keeping of a percentage of the deposit as cash ratio that 20%.
4. Lending out the balance after removing the cash ratio to credit worthy borrowers that is 80%.

5. The process of receipt and lending is shown in the table below.

Banks/ Branches	New deposit (shs)	Cash ratio 20% (shs)	New loans (shs)
A	1,000,000	200,000	800,000
B	800,000	160,000	640,000
C	640,000	128,000	512,000
:	:	:	:
:	:	:	:
Etc	:	:	:
Total	5,000,000	1,000,000	4,000,000

6. The process continues till the initial deposit defuses in the system. 7. At the end of the process,

$$Total\ credit\ created = Initial\ deposit\ \times Credit\ multiplier\ or\ \frac{1}{CR}$$

$$Total\ deposit\ created = shs\ 1{,}000{,}000\ \times\ \frac{1}{20\%}$$ 8.

$$= shs\ 1{,}000{,}000\ \times\ \frac{100}{20}$$

$$= shs\ 5{,}000{,}000$$

CREDIT MULTIPLIER/ BANK DEPOSIT MULTIPLIER

Is the number of times initial deposit in a bank multiplies itself to give total credit created.

$$Bank\ deposit\ multiplier = \frac{1}{cash\ ratio}$$

Using the example above in which the cash ratio is 20%, the bank deposit multiplier is given as;

$$Bank\ deposit\ mulplier = \frac{1}{20\%} = \frac{100}{20} = 5\ times$$.

This means that the initial deposit (shs 1,000,000) multiplies itself 5 times to give total credit created (shs 5,000,000).

EXAMPLES

1. Given that a microfinance bank has initial deposits of shs 1,000,000 and the required cash ratio of 25%. Calculate the; a) Credit multiplier.

   b) Total deposits that will be created in a multi-bank system.
2. Given that in a multi-bank system an initial deposit of shillings 10,000,000 generates a total amount of credit of shillings 50,000,000. Determine the cash ratio.
3. Given cash ratio of 0.2 and the final deposit created is Ug.shs 200m, calculate the initial deposit that was available to the commercial bank.
4. Given a cash ratio of 10% and initial deposit of shs 200,000, determine;

   (i) Bank deposit multiplier

   (ii) Total credit created assuming there are three banks in the system.

TRIAL QUESTION

Given a cash ratio of 0.1% and initial deposits of shs 250,000, determine;

a) Credit multiplier (02 marks)

b) Total credit created. (02 marks)

FACTORS THAT INFLUNECE THE PROCESS OF CREDIT CREATION IN MY COUNTRY

1. **Availability of creditworthy borrowers/ customers.** A large number of people with the ability to borrow and pay back the loans leads to high credit creation while a small number of credit worthy customers as a result of majority being poor results into low levels of credit creation.
2. **Size of the cash ratio.** A high cash ratio leads to low credit creation as more money is reserved by the bank while a low cash ratio leads to high levels of credit creation because more funds are made available for lending.
3. **Availability of collateral security.** A small number of people with collateral security to present for loans limit borrowing and lending hence low credit creation while a large number

of borrowers with collateral security leads to high level of credit creation since banks are sure of receiving back their money through the security offered by the borrowers.

4. **Interest rate on loans.** High interest rates discourage people from borrowing because they make borrowing expensive. This leads to low credit creation. However, low interest rates encourage borrowing hence high credit creation.
5. **Level of accountability.** Rampant corruption and embezzlement of funds by bank officials weakens their ability to extend loans hence low levels of credit creation. On the other hand, proper accountability of funds leads to growth and development of commercial banks putting them in a better position to create more credit.
6. **Level of liquidity preference.** A high level of liquidity preference limits deposits in commercial banks since people prefer to keep money themselves without making deposits hence limiting the level of credit creation while a low level of liquidity preference avails adequate funds in banks for lending leading to high level of credit creation.
7. **Knowledge about services offered by commercial banks.**
   Awareness of the public about services offered by commercial banks leads to high savings and popularity of loans leading to high level of credit creation. However, high degree of ignorance by the public about services offered by commercial banks limits saving in banks and results into unpopularity of loans hence limiting the credit creation process.
8. **The popularity of loans among the people.**
9. **Level of investment.** A high level of investment increases effective use of commercial banks and demand for loans to run the investments hence high level of credit creation while a low level of investment reduces the use of commercial banks and lowers demand for loans leading to low level of credit creation.
10. **Degree of economic certainty/ rate of inflation/ economic climate.** Economic instabilities such as inflation discourage investment thus reducing the demand for loanable funds hence low levels of credit creation. On the other hand, economic stability in form of stable prices of goods and services encourages people to borrow and invest leading to high credit creation.
11. **Political atmosphere.**
    Political stability creates a conducive investment climate thus encouraging investment making commercial banks to give out loans hence leading to high credit creation. However, political

instability creates a poor investment climate thus discouraging investment making commercial banks reluctant to give out loans hence limiting the credit creation process.

12. **Monetary policy by the central bank.** A restrictive monetary policy leads to low credit creation because it reduces the commercial banks' ability to extend loans while an expansionary monetary policy leads to high credit creation as more money is available for lending.
13. **Size of bank deposits/ level of savings.** A big size of bank deposits avails large sums of money for commercial banks to lend hence resulting into high level of credit creation while a small size of the bank deposits results into small funds for lending limiting the level of credit creation.
14. **Distribution of commercial banks.** The concentration of commercial banks in urban centres makes them to compete for the deposits within the area and fail to capture savings from rural areas leading to low level of credit creation. On the other hand, distribution of commercial banks in all parts of the country reduces competition among commercial banks for customers resulting into high level of credit creation.
15. **Level of income of the population.**

    High income level of the population encourages savings leading to high credit creation while low income level of the population limits savings thus leading to low level of credit creation.
16. **Size of the subsistence sector/ level of monetization of the economy.**

    A highly monetized economy leads to increased demand for loanable funds as people use money as a medium of exchange hence leading to high level of credit creation. However, a large sub subsistence sector discourages borrowing, saving and investment. Such a combination reduces the process of credit creation since the sector is not money oriented.

FACTORS WHICH LIMIT CREDIT CREATION BY COMMERCIAL BANKS IN MY COUNTRY

1. **Few creditworthy customers.** Very few people in LDCs are in position to borrow and pay back. This is due to low income levels of the population. This limits the credit creation process.
2. **High cash ratio.** This makes the amount of money available for lending and borrowing very limited thereby limiting credit creation.

3. **Inadequate collateral security.** Most people in LDCs do not have assets to present as collateral security to banks in order to get loans. Therefore very few loans are advanced to the public and this limits the process of credit creation.
4. **High interest rate on loans.** High interest rates charged by commercial banks discourage borrowing thereby limiting the process of credit creation.
5. **Corruption tendencies by bank officials.** Most bank officials extend loans only to those who bribe them whereas others swindle the customers' deposits. This weakens the performance of commercial banks and reduces their ability to extend loans.
6. **High level of liquidity preference by the public.** This limits the amount of deposits received by commercial banks and thus limits their ability to extend loans.
7. **High degree of ignorance by the public about banking services.**
   This limits saving in banks and leads to unpopularity of loans hence leading to low level of credit creation.
8. **Unpopularity of loans among the people.**
9. **Low level of investment.** Limited investment opportunities lowers demand for loanable funds thereby limiting the process of credit creation.
10. **Economic uncertainty.** Economic instabilities such as inflation discourage investment and the demand for loanable funds.
11. **Political instability that creates a poor investment climate.** This makes commercial banks reluctant to give out loans and also discourages investment thus limiting the credit creation process.
12. **Restrictive/ contractionary monetary policy of the central bank/ government.** The restrictive monetary policy reduces the capability of commercial banks to extend loans hence limiting the process of credit creation.
13. **Small size of initial deposit/ low savings.**
14. **Poor distribution of commercial banks.** The concentration of commercial banks in urban centres makes them to compete for the deposits within the area and fail to capture savings from areas leading to low level of credit creation.
15. **Low income level of the population.**
    This limits saving in banks thus limiting the credit creation process.

16. **Large subsistence sector.** A large subsistence sector discourages borrowing, saving and investment. Such a combination reduces the process of credit creation since the sector is not money – oriented.

OR

Low level of monetization of the economy. This leads to limited demand for loanable funds as people use barter system of exchange other than money hence limiting the process of credit creation.

ASSETS AND LIABILITIES OF A COMMERCIAL BANK

Assets are possessions of a commercial bank plus its claims against other institutions and customers. They include;

1. Cash in form of notes and coins.
2. Deposits with other banks.
3. Loans and advances/ overdrafts to customers.
4. Securities (bonds, treasury bills, etc) bought by the bank from the central bank.
5. Special deposits with the central bank.
6. Reserves with the central bank.
7. Long term investment in other institutions.
8. Fixed assets owned by the bank e.g. land, buildings, vehicles, etc.

Liabilities are claims against the commercial bank by its creditors i.e. what the bank owes to other banks and non-bank institutions. They include;

1. Capital contributed by shareholders (share capital/ paid up capital)
2. Reserves payable to the central bank.
3. Customers' deposits.
4. Dividends payable to shareholders.
5. Deposits in the bank by other banks.
6. Money borrowed from the central bank.
7. Government funds deposited in commercial banks

DILEMMA FACING COMMERCIAL BANKS IN THEIR LENDING POLICY

Commercial banks are usually faced with the problem of achieving the objectives of profitability, liquidity and security simultaneously. For instance if the bank increases lending so as to earn profits, it will not meet the customers' demand (liquidity), if it maintains liquidity for its customers, it will not get profits as there will be no loanable funds and so on.

HOW COMMERCIAL BANKS RECONCILE THE CONFLICTING OBJECTIVES OF LIQUIDITY, PROFITABILITY AND SECURITY.

a) Liquidity objective

This objective demands that commercial banks must have money in cash form at all the time to meet the demands of the customers or liabilities on it. Commercial banks reconcile and achieve this objective through the following ways;

1. By maintaining a cash ratio. Keeping a percentage of the bank deposits in cash form to meet the cash demands of the depositors hence being able to achieve liquidity.
2. By undertaking credit squeeze. This is the policy of lending out money in phases such that all the time there is some money to meet the needs of the customers.
3. Pursuing short term lending policies. Commercial banks avoid investing customer's money in long term projects which may not bring in returns immediately but instead they pursue short term lending which may bring in returns immediately.
4. Purchasing short term assets that can easily be turned into cash e.g. treasury bills.
5. Maintaining a high minimum balance. A minimum balance is the amount of money an account holder is not supposed to withdraw. Such a high minimum balance helps the commercial bank to maintain liquidity.
6. Receiving more deposits from the customers.
7. Borrowing from the central bank.
8. Keeping some of the deposits with the central bank.
9. Regulating withdraws especially with the savings account holders e.g. one cannot withdraw more than once a week and withdraws are limited to a given amount.

10. Demanding collateral security from prospective borrowers which may be liquidated in case of financial problems.

b) Profitability objective

This objective demands that commercial banks use the funds available to them to make some profits. Commercial banks reconcile and achieve this objective through the following ways;

1. Through advancing loans and overdrafts at relatively higher interest rates and giving low interest rates to depositors.
2. By investing in profitable projects such as housing estates, buying land thus earning profits out of such projects.
3. By discounting bills of exchange i.e. the bank can pay less money to the holder of the bill as compared to that stated on it before its maturity and the difference becomes a profit to the commercial bank.
4. By charging fees for the services offered to customers e.g. charging holders of cheques, people who make payments through the banks (payment of school fees, utilities), charges on withdraw (whether ATM or counter), loan application fees and such fees are profits to the bank.
5. Buying government securities like bonds that bear high interest rate. On selling them, they earn high interest hence making profits.

c) Security objective

This objective demands that commercial banks should keep customers' money secure and have liquid cash or assets to meet the financial objectives.

1. By employing armed personnel to safeguard the bank against robbers and this ensures that customers' money is safe.
2. By operating in strong buildings with burglar proof to ensure that customers' money and commercial bank assets within the bank are secure.
3. By obtaining collateral security from the intending borrower such as land titles, insurance policies, etc such that in the event of the borrower failing to pay, property is sold to recover the funds.

4. By establishing the credit worthiness of the borrower i.e. investigating the borrowers' business, assets, financial history and financial discipline before advancing the loans.
5. By lending to more reliable institutions like government through purchase of government securities where payment is more certain
6. By monitoring the progress of the project funded by the loan to ensure that the project is properly managed and is able to realize funds to pay back the loan.
7. By regulating the amount and frequency of the loan such that if turns out to be risky, the remaining part of the loan is terminated.

FOREIGN COMMERCIAL BANKS

Foreign commercial banks are part of trans-national/ multi-national/ international co-operations that have headquarters in one country but with a variety of branches and offices of operation in other countries both developed and developing countries. Such banks include;

- Bank of Baroda
- Barclays bank
- Standard chartered bank.
- Etc.

THE ROLE OF FOREIGN COMMERCIAL BANKS IN DEVELOPING COUNTRIES

POSITIVE

1. **They help to increase efficiency in the banking sector.** Foreign commercial banks create a competitive atmosphere in the local banking sector by employing efficient techniques of service delivery. This helps to improve on the quality of services of the local banks.
2. **They create employment opportunities.** Foreign commercial banks provide employment to the local people in form of bank accountants, credit officers, marketing managers, cleaners, etc. This increases the incomes of the people hence better standards of living.

3. **They are a source of government revenue through taxation.** Foreign commercial banks help to widen the tax base in form of taxes imposed on their profits, employment incomes and other business activities created hence generating more tax revenue to the government. The revenue realized is used to construct social and economic infrastructure like roads, hospitals, schools, etc.
4. **They help to close the foreign exchange gap.** Foreign commercial banks facilitate foreign exchange inflow in developing countries. This increases the country's foreign exchange reserves and its monetary base. Such foreign exchange is used to import capital and consumer goods which cannot be produced locally.
5. **They facilitate the development of social and economic infrastructure.** foreign commercial banks promote the development of social and economic infrastructure in form of roads, schools, hospitals etc and this leads to economic development.
6. **They increase capital inflow in the country.** Foreign commercial banks help to fill the savings – investment gap in developing countries by extending credit in form of loans to the local people. This increases investments in the country hence economic growth and development.
7. **They promote technological development in the banking sector.** Foreign commercial banks facilitate technological progress through technology transfer from developed to developing countries. Local banks learn and adopt the modern techniques hence improving on their efficiency in service delivery.
8. **They promote the exploitation and utilization of idle resources.** This is because they help to attract foreign investors to invest their capital in the country. This improves on the productive capacities in the economy hence economic growth and development.
9. **They promote industrial development.** Foreign commercial banks help to mobilize financial resources which are used for development of heavy industries like iron and steel industries, electrical engineering, etc. Such industries require a lot of capital which is only accessed through borrowing from commercial banks.
10. **They promote entrepreneurial skills in the economy.** Foreign commercial banks help to train the local individuals with the necessary managerial skills required to operate modern banking enterprises. This helps to close the man-power gap in developing countries.

11. **They promote good international relationships between their countries of origin and other countries where their business activities are extended.** This enhances mutual understanding among countries.
12. **They help to promote and facilitate international trade.** This is because they finance export and import trade by providing foreign exchange and money transfer services to traders.

NEGATIVE

1. **They lead to profit repatriation.** Foreign commercial banks tend to plough back profits made to their home countries instead of re-investing them where they operate. This leads to low capital accumulation in the economy.
2. **They worsen the problem of unemployment in the economy.** This is because they mainly employ foreigners especially the top officials and they use capita intensive techniques of service delivery hence technological unemployment.
3. **They accelerate regional income inequalities in the economy.** This is because most of their banking activities are mainly concentrated in urban areas neglecting the rural areas. This creates regional imbalance.
4. **They discourage the development of local financial institutions.** This is because foreign commercial banks have huge capital and have the capacity to operate on a large scale and provide better quality services to their customers at competitive rates. This undermines the growth of the local banking sector.
5. **They limit the successful implementation of the monetary policies.** This is because the central bank has little control over their activities.
6. **They interfere in the politics of developing countries.** Foreign commercial banks use their economic power to influence national policies and politics of the countries in which they operate in their favour. This results into loss of independence in local decision making.
7. **They lead to divergence between private and society interests.** This is because foreign commercial banks aim at maximizing profits at the expense of the society. Some of their policies are not in line with the national development goals like poverty eradication, rural development.

8. **They encourage rural – urban migration.** This is because most of their business activities are concentrated in urban centres due to poor infrastructure in rural areas. This leads to congestion in urban areas and other negative effects.
9. **They undermine the provision of banking services to small scale local investors.** This discourages the production of cheap goods and services for the local people.
10. **Etc.**

PROBLEMS FACED BY COMMERCIAL BANKS IN LDCS/ UGANDA

1. Limited credit worthy customers. Many borrowers fail to pay back the loans and this affects the activities of commercial banks.
2. Ignorance of the public on the importance and the functions of the commercial banks.
3. The poor infrastructure such as bad roads, unreliable power supply especially in rural areas hinders the activities of commercial banks and makes coordination with different branches difficult.
4. The concentration of commercial banks in urban areas limits the ability of these banks to mobilize savings. Most commercial banks are situated in urban centres neglecting rural areas.
5. The rampant corruption and embezzlement of funds by bank officials weakens their performance.
6. High level of competition among these commercial banks increases their costs of operation as a lot of money is spent on advertising and promotion activities. This limits their fast expansion.
7. The large subsistence sector in the economy. The proportion of the subsistence sector in Uganda is still big whereby people do not use money in their economic activities. So they neither borrow nor deposit in banks.
8. The low levels of incomes of most people in the country limits the level of savings as well as deposits in commercial banks since people use the little income to survive.
9. Economic conditions such as inflation, high interest rates on loans discourage people from depositing and borrowing.
10. Inadequate capital to stock modern equipments. Most banks have limited funds to equip all their branches with modern sophisticated machines necessary for their activities.

11. Conditionarities from the central bank. The activities of commercial banks are highly influenced by the central bank depending on the development objectives of the country. This interferes with the objectives of the individual commercial banks. This is common with a restrictive monetary policy.

NON-BANKING FINANCIAL INTERMEDIARIES

These are financial institutions that receive deposits from the public, give out medium and long term loans at low interest rates but do not create credit.

Examples of non-banking financial intermediaries in Uganda include;

- Development banks (A development bank is a non – banking financial institution set up to finance long term development projects in a country).
- Post bank Uganda
- Insurance companies
- Building societies
- Housing finance institutions e.g. housing finance company of Uganda.
- Savings and credit schemes.
- Social security fund e.g. NSSF (National Social Security Fund)
- Etc.

FUNCTIONS OF NON – BANKING FINANCIAL INTERMEDIARIES

- They give loans to the public (mainly medium and long term loans)
- They accept peoples' deposits and safeguard them.
- They ensure social security for the public e.g. NSSF.
- They encourage trade.
- They indemnify those who incur losses in case of insurance companies.
- They finance long term projects.
- They supplement the activities of commercial banks.

THE ROLE OF NON – BANKING FINANCIAL INTERMEDIARIES IN LDCS/ DEVELOPMENT OF AN ECONOMY

1. **Promote savings.** They supplement the efforts of commercial banks in mobilizing savings through their expert financial services.
2. **They finance long term projects which have long gestation period and high risks but with a big potential for growth and development of the economy** e.g. construction of dams, roads, airports, etc.
3. **Encourage investment.** They undertake investments using the savings mobilized e.g. they invest in securities which facilitate the process of capital formation and economic growth.
4. **They create job opportunities for the nationals.** This enables people to earn income and improve their standard of living,
5. **They help in the development of the agricultural and industrial sectors** by advancing loans to them as well as giving technical advice.
6. **They facilitate rural development** since they are spread through the country e.g. cooperative societies mobilize rural savings under savings and credit schemes.
7. **Promote entrepreneurship.** They advance credit to the indigenous entrepreneurs e.g. women groups, rural peasant farmers and small scale industrialists. They do so on soft terms.
8. **They provide competition for the banking financial intermediaries** which improves the quality of services offered.
9. **Contribute revenue to the government** by paying taxes and the revenue collected is used to construct social economic infrastructure.
10. **Develop labour skills.** They provide training facilities to their employees in order to produce efficient workers and this contributes to human capital development.

IMPORTANT TERMS

1. **Term deposits**

   These refer to customers' deposits on both savings and fixed deposit accounts so it is in two forms;

   a) **Time deposits**

These are customers' deposits on fixed deposit accounts. Such deposits earn higher interests because withdrawals are made only at the expiry of the agreed time.

b) **Savings deposits**

These are customers' deposits on savings accounts. They earn relatively low interest rates because customers can withdraw their money at particular times.

2. **Demand deposits**

These are customers' deposits that are on checkable accounts for example deposits on current accounts. Such deposits normally do not attract interest because withdrawals are made at any time and it is difficult for commercial banks to invest this money elsewhere.

CENTRAL BANKING

A central bank is a government owned financial institution established to control other financial institutions and ensure economic stability in the country.

The central bank in Uganda is the **"Bank of Uganda."**

FUNCTIONS OF THE CENTRAL BANK

1. **Issuing of currency.** The central bank has the sole authority to issue the country's currency that circulates within the country i.e. it is the one responsible to order for minting of coins and printing of bank notes that act as legal tender within the country.
2. **It acts as a banker to the government and government institutions i.**e. it accepts the deposits from the government and safeguards such deposits as well as providing other banking services.
3. **It is a banker to commercial banks and other financial institutions i.e.** it accepts and safeguards deposits from commercial banks and acts as a clearing house to settle inter-bank indebtedness.
4. **It acts as a banker to international agencies operating within the country e.g.** IMF, Red Cross, F.A.O, UN agencies.
5. **It controls the amount of money in circulation.** The central bank uses the tools of monetary policy to regulate the amount of money in circulation and ensure economic stability.

6. **It manages the country's debt (public debt).** The central bank is responsible for keeping an up-to-date profile/ record on the country's total indebtedness.
7. **It advises the government on monetary and economic issues e.**g. formulating budgets, taxation, devaluation and other economic policies.
8. **It is responsible for the control and supervision of all commercial banks and other financial institutions i.**e. it ensures that peoples' money is not at risk through close monitoring and supervision of these institutions.
9. **It acts a custodian of foreign reserves.** The central bank acts as the manager of foreign reserves in the country.
10. **It regulates foreign exchange rates.** The central bank is responsible for the day-to-day management of foreign exchange operations carried out by forex bureau.

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, full employment and balance of payments equilibrium.

OR

Monetary policy refers to the guidelines taken by the government through the central bank to regulate and control the amount of money supply in an economy in order to influence the level of economic activities.

OBJECTIVES OF MONETARY POLICY

1. **To attain and maintain full employment level in the economy.** This is achieved through expansionary monetary policy through encouraging lending to productive sectors like the agricultural sector thereby increasing employment opportunities.
2. **To maintain stable balance of payments position.** This is achieved through use of selective credit control that promotes domestic manufacturing sectors with a view of increasing exports which helps in increasing the country's foreign exchange earnings while discouraging importation hence improving the country's B.O.P position.

3. **To ensure stability in exchange rates** by regulating inflow and outflow of foreign exchange currencies.
4. **To maintain domestic price stability.** This is achieved through use of restrictive monetary policy that helps in controlling aggregate demand eventually stabilizing prices.
5. **To attain balanced growth and development of the economy.**
6. **To attain equitable distribution of income.**
7. **To stimulate economic growth and development.**
8. **To create a broad and continuous market for government securities (bonds and treasury bills).**
9. **To encourage growth of the financial sector.** This is mainly through promotion of expansionary monetary policies e.g. reduction in cash ratio, bank rate, reserve ratio in order to encourage commercial banks to lend to willing borrowers hence being able to grow through realizing higher profits from credit creation.
10. **To foster savings of the community** through the manipulation of interest rates.

TOOLS (INSTRUMENTS) OF MONETARY POLICY

These are the various methods adopted by the central bank to control credit (money supply).

Credit control is the government policy/ measures through the central bank to regulate lending by commercial banks in order to influence the level of economic activities/ in order to achieve desired macro-economic activities such as price stability, full employment and B.O.P equilibrium.

During inflation, the central bank adopts measures to reduce money in circulation. Such measures constitute what we call **restrictive/ contractionary/ tight monetary policy.**

During a deflation; the central bank adopts measures that increase money in circulation. Such measures constitute what we call **expansionary monetary policy.**

These tools include:

1. **The Bank rate**

   This is the rate at which the central bank advances loans to commercial banks. During inflation, the central bank raises the bank rate which forces commercial banks to increase the interest rate as well on loans to their customers. This discourages borrowing hence the supply of money falls. In case of a deflation, the central bank lowers the bank rate which influences commercial banks to reduce interest rates to their customers thereby encouraging borrowing and hence increase in money supply.

2. **Open market operation (O.M.O)**

   This is the sale or purchase of government securities by the central bank to and from the public through an open market. During inflation, the central bank sells securities to the public and individuals who buy the securities write out cheques through their commercial banks paying the central bank. This reduces the money available to commercial banks and finally their lending capacity is reduced. In case of a deflation, the central bank buys the securities from the public hence injecting more money in circulation.

3. **Legal reserve requirement.**

   This is the proportion of customers' deposits that by law commercial banks are supposed to deposit with the central bank. During inflation, the legal reserve requirement is increased which reduces loanable funds available with commercial banks as well as money supply. In times of a deflation, the legal reserve requirement is reduced enabling commercial banks to give more loans to the public hence increasing money supply.

4. **Special deposits (supplementary reserve deposits)**

   This is the additional deposit which commercial banks are required to keep with the central bank over and above the legal reserve requirement. Special deposits are increased during high inflation rates to discourage borrowing and reduced during times of a deflation/ recession to encourage lending by commercial banks.

5. **Selective credit control**

   This tool is commonly used during times of high inflationary rates. The tool involves the central bank directing commercial banks to advance loans to a few priority sectors of the economy like agriculture and industry and deny the other sectors. This reduces the number of sectors getting loans hence reducing money supply. During a deflation, the selective credit control tool is abolished.

6. **Margin requirement**

This is the difference between the value of the collateral security required to acquire a loan and the actual amount of the loan advanced. During inflation, the central bank raises the margin requirement which makes borrowing expensive hence a decrease in money supply.

During a deflation, the central bank lowers the margin requirement and borrowing becomes cheap hence increasing money supply in the economy.

7. **Moral suasion**

This involves the central bank appealing to/ requesting/ persuading commercial banks to behave in a specific way when extending credit for purposes of regulating money supply. The central bank does this by writing letters or circulars to commercial banks. The commercial banks do what they are told because they depend on the good will of the central bank for their operations.

8. **Direct action (direct government intervention)**

The central bank at times issues orders to commercial banks to advance more or less loans as may be required to control money supply. The central bank does not give any financial accommodation to all banks that may fail to comply. Actions taken may include;

- Refusal to grant loans
- Monetary penalties.
- Changing the terms and conditions of rediscounting.
- Refusal to grant rediscount facilities among others.

9. **Cash ratio**

This is the percentage of commercial bank deposit that must be kept in cash form to meet the cash demands of the depositors. The percentage is increased during periods of high inflation rates to reduce the money available for lending and reduce money supply and reduced when the central bank wants to increase the amount of loanable funds and money supply.

10. **Rationing of credit**

This involves the central bank prescribing the maximum amount in terms of loans that commercial banks should give in a period of time or how much commercial banks can get from the central bank in terms of advances. During inflation, the central bank limits the amount of loans advanced to commercial banks i.e. they can only borrow up to a certain limit hence reducing money supply. During a deflation, the maximum is raised or waived off altogether.

11. **Currency reforms**

The central bank through the banking institutions and other financial intermediaries withdraws the existing legal tender from circulation and issues new currency after reducing the value of the one in circulation by a given proportion.

For example the government of Uganda made a currency reform and introduced new currency in 1987.

FACTORS THAT INFLUENCE THE SUCCESSFUL IMPLEMENTATION OF MONETARY POLICY

1. The degree of awareness of the public of the open market operations.
2. The level of liquidity in commercial banks.
3. The degree of liquidity preference of the population/ people.
4. The size of the subsistence sector/ the degree of commercialization of the economy.
5. The level of control of the economy by foreign owned commercial banks.
6. The level of development/ availability of money markets.
7. The degree of conflict in government objectives
8. The level of use of commercial banks due to degree of ignorance of the use of commercial banks; degree of illiteracy; the credit worthiness of customers; availability of collateral security.
9. The distribution of commercial banks/ the level of development of commercial banks.
10. The degree of political interference.

FACTORS THAT LIMIT THE SUCCESSFUL IMPLEMENTATION OF MONETARY POLICY IN LDCS/ UGANDA

1. **Excessive liquidity among the commercial banks.** Many commercial banks enjoy a lot of liquidity and rarely borrow from the central bank hence making the use of the bank rate as a tool of monetary policy ineffective.
2. **Domination of foreign commercial banks which are not under direct control of the central bank.** Many of these banks receive money from their parent organizations overseas. This makes it hard for the central bank to regulate their activities.
3. **High liquidity preference among the public.** This leads to limited use of commercial banks. The central bank cannot have effective control over money that is outside the banking system.

4. **Ignorance of the public about the facilities offered by commercial banks.** For example many people are ignorant about open market operations hence do not buy government securities whenever they are declared. This limits the effectiveness of open market operation as a tool of monetary policy.
5. **Unfavourable external influence** such as IMF conditionarities that are at times not in line with the monetary policy objectives.
6. **Underdeveloped money and capital markets.** In Uganda and other LDCs, money and capital markets are underdeveloped. This limits the effectiveness of open market operations as the buying and selling of government securities is made difficult.
7. **Rampant corruption and bribery by commercial banks in the implementation of some tools (**such as selective credit control) limits the effectiveness of monetary policy.
8. **Government interference in the activities of the central bank** for example ordering it to print more money to finance budgeted deficits. This affects the effectiveness of monetary policy.
9. **Poor distribution of commercial banks/ urban concentration of commercial banks.** Most of the commercial banks are concentrated in towns limiting the effectiveness of the monetary policy in rural areas.
10. **Persistent inflation in the country.** Persistent inflation leads to continuous loss of value in the country's currency hence people fear to deposit their money in banks because after a long time, it would have lost value. They prefer to invest it in physical assets and this limits deposits which makes monetary tools inefficient.
11. **Limited effective use of commercial banks** due to low incomes, limited collateral security, high level of illiteracy, few creditworthy borrowers among others.
12. **Conflicting government objectives.** The government and the central bank at times have conflicting objectives. This is because if the government wants to achieve its objectives, it increases its expenditure yet the central bank pursues a restrictive monetary policy so as to achieve objectives like price stability making the implementation of monetary policy difficult.

FINANCIAL MARKETS