MONEY AND BANKING

Money is anything that is **generally acceptable** as a means of exchange for goods and in the settlement of debts in a given period of time.

Before the present form of money there was barter trade system of exchange.

Barter trade system of exchange; this is where goods are exchanged for goods e.g. chicken for salt, beans for sheep etc.

For barter system of exchange to be successful there should be a double coincidence of wants. E.g. for one to exchange with another person he must have what the other person wants and he must want what the other person has.

Advantages of Barter trade system of exchange;

1. It saves the scarce foreign exchange/it minimises the balance of payment problems
2. It facilitates trade among less developed countries
3. It expands the range of markets.
4. Improves international relationship

Disadvantages of barter trade system of exchange

1. Lack of double coincidence of wants.
2. Indivisibility of some items /commodities.
3. Difficulty in transportation of bulky items/commodities.
4. Difficulty in storing value due to perishability
5. Difficult in valuing commodities.
6. It is difficult to arrange credit transactions.
7. Lack of specilisation

Note: Owing to the above challenges, a generally acceptable medium of exchange was developed and this is called **money.**

EVOLUTION OF MONEY

Due to the demerits of barter system of exchange people were forced to use certain commodities of high value as a medium of exchange. These included salt, tobacco, hides, beads cowrie shells etc. However, people could easily acquire these commodities which would reduce their value as a medium of exchange.

Later on they started using precious metals such as gold and silver, however people were inconvenienced with carrying metals and this prompted the emergency of Goldsmith who keep the gold and issue receipts to the owners. The receipts had the same value as the gold kept and people would use them to purchase goods as paper money, this marked the beginning of modern money.

Over time more developments have taken place and these include; use of cheques, credit cards, electronic money e.g. money, mobile banking etc.

Advantages of money

1. It promotes commercialisation of the economy.
2. It promotes specialisation in production
3. It promotes lending
4. It promotes credit transaction
5. It helps in valuing goods
6. It encourages hard work/personal initiative
7. It encourages proper allocation of resources

Disadvantages of money

1. Leads to misallocation of resource.
2. Leads to overexploitation of resources
3. Leads to inflation
4. Promotes income inequality.
5. Encourages corruption

FUNCTIONS OF MONEY:

1. It is a medium of exchange;
2. It is a unit of account
3. It is a store of value/wealth
4. It is a measure of value
5. It is a standard of deferred payment

QUALITIES OF GOOD MONEY:

1. **It should be generally acceptable;** it should be acceptable by all people in the country as legal tender
2. **It should be portable;** it should be easy to carry from one place to another.
3. **It should be divisible**; it should be divisible into small denominations to allow small transactions to take place.
4. **It should be homogeneous**; units of the same denominations in the country should be the same
5. **It should be durable**; it should be able to last for a long time in order to be a good sore of value.
6. **It should be easy to recognise;** it should have features that are easily identified

7. **It should be relatively scarce;** it should not be very easy to obtain in order to give it a stable value.
8. **It should be malleable;** it should be made out of good material that can last long,

CONCEPTS RELATED TO MONEY:

1. **Fiduciary issue;** this is currency issued by central bank at its discretion and it's not backed by gold or foreign reserves**.**
2. **Fiat money;** this refers to money printed and issued by the central bank on government orders irrespective of the level of economic activities, and it is not backed by securities or gold
3. **Near /Quasi money;** this refers to near-liquid assets which can easily be turned into cash for example treasury bills and, Cheques.
4. **Treasury bill;** this refers to a short term financial security issued by the central bank to borrow money from the public not exceeding one year.
5. **Treasury Bond;** this refers to long term financial security issued by businesses or government as a means of borrowing from the public exceeding one year
6. **Intrinsic money;** this refers to coins whose metallic value is equal to the face value
7. **Token money;** refers to coins whose face value is greater than the value of the metal used in making it.
8. **Paper note;** this is money **printed** out of paper materials by the central bank
9. **Coins;** this is money which is **minted** out of metallic materials by the central bank
10. **Legal tender;** this is money which according to law must be accepted in making of transactions in a country at a given time
11. **Currency**; this refers to the paper notes and coins that are used as money in a country. These include local and foreign currency.

THE DEMAND FOR MONEY/LIQUIDITY PREFERENCE; this refers to the desire by individuals to hold wealth in cash form.

Determinants of liquidity preference

1. **Interest rate**; high interest rate reduces liquidity preference because individuals prefer to invest and earn from their money to keeping cash, while low interest rate increases liquidity preference because there are very low earnings from investing money.

2. **Rate of inflation;** high rate of inflation leads to high liquidity preference because people keep a lot of cash to make transactions, while low rate of inflation leads to low liquidity preference because people need little cash for transactions since the goods are cheap .

3. **Knowledge of services provided by commercial banks**; high level of awareness of services provided by commercial banks leads to low liquidity preference because many people keep money banks, while limited knowledge of services provided by commercial banks leads to high liquidity preference because they unable to open bank accounts and therefore keep the cash.

5. **Level of cash transaction;** high level of cash transactions leads to high liquidity preference because people need a lot of cash to make their daily transactions, while low level of cash transactions leads to low liquidity preference because people keep very cash for the few transactions and bank the rest

5. **Level of income;** high level of income leads to low liquidity preference because high income earners keep very little cash and invest much of the money, while low incomes lead to high liquidity preference because low income much of their money for transactions and do very little investment

6. **Level of speculation**; high level of speculation leads to high liquidity preference because people keep a lot of cash in anticipation of a lucrative investment opportunity, while low level of speculation leads to low liquidity preference because people keep very little cash because of limited investment opportunities.

7. **Nature of distribution of commercial banks;** even distribution of commercial banks leads to low liquidity preference because many people keep their money in banks, while poor distribution of commercial banks leads to high liquidity preference because it is hard for people to open bank accounts, so they keep the cash.

8. **Degree of uncertainty;** high degree of uncertainty leads to high liquidity preference because people keep a lot of cash to cater for eventualities and therefore reluctant to invest, while low degree of uncertainty leads to low liquidity preference because people invest much of the money since they assured of the safety of their lives and property.

9. **Requirements for opening and maintaining bank account**; relax procedures for opening bank accounts leads to low liquidity preference because many people open bank accounts and save, while stringent procedures for opening bank accounts leads to high liquidity preference because many people are discouraged from opening bank accounts and therefore they keep cash.

10. **Level of literacy;** high level of literacy leads to low liquidity preference because such easily open bank accounts and save, while low level of literacy leads to high level of liquidity preference because people find it hard to open bank accounts and therefore keep the cash.

MOTIVES OF DEMAND FOR MONEY

- **The Transaction motive;** This is the desire to hold money in cash form for carrying out day-to-day transactions e.g. buying food, fuel. It is influenced by level of income and the rate of inflation.
- **The precautionary motive;** this is the desire to hold money so as to cater for unforeseen circumstances e.g. falling sick. It is influenced by the level of income and the rate of inflation.

- **The speculative motive;** this is the desire to hold money in cash by people to cater for any lucrative investment opportunity e.g. an increase in treasury bills or treasury bonds. This motive is influenced by the level of income and interest rate on bonds.

  Note; the public will invest in bonds at a higher rate of interest and when the interest rate falls so low they lose interest in investing in bonds, this is called a liquidity trap.

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

MONEY SUPPLY; this refers to the total amount of money in circulation and on demand deposits in an economy at a particular time

Factors that influence the money supply in an economy:

1. **Level of investment**; high level of investment leads to high money supply because of the high rate of borrowing for investment, while low level of investment leads to low money supply because of the low rate of borrowing.
2. **Level of capital inflow;** high level of capital inflow leads to high money supply because a lot of foreign currency is injected into the economy, while less capital inflow leads to low money supply because less foreign currency is injected in the economy.
3. **Monetary policy through the central bank**; an expansionary monetary policy leads to high money supply because borrowing is encouraged, while a restrictive monetary policy leads to low money supply because borrowing is discouraged.
4. **The Interest rate**; high interest rate leads to low money supply because it discourages borrowing, while low interest rate leads to high money supply because it encourages borrowing.
5. **Level of government expenditure;** high level of government expenditure leads to high money supply because the government injects more money in circulation, while low level of government expenditure leads to low money supply because the government injects less money in circulation.
6. **Level of government borrowing**; high level of internal borrowing by the government limits money supply because the public surrenders money to the government; while low level of internal borrowing by the government leads to high money supply because the public retains the money.
7. **The level issuance of currency**; excessive issuance of currency by the central bank leads to high money supply because more money is injected in circulation, while low level of issuance

of currency by the central bank leads to low money because less money is injected in circulation.

8. **The amount of export earning;** high level of export earnings leads to high money supply because more foreign is injected in the economy, while low level of export earnings leads to low money supply because less foreign exchange is injected in the economy.

THE QUANTITY THEORY OF MONEY (IRVING FISHER 1911)

This theory of money states that the general price level is determined by the quantity of money in circulation assuming that the velocity of circulation of money (V) and the level of transactions (T) are constant. The theory is expressed by the Fisher Equation;

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

Where;

M= Quantity of money in circulation

V= Velocity of circulation of money (average number of times each unit of a currency changes hands in financing a transaction)

P= General Price level

T= Level of transactions (total amount of goods and services supplied.

Examples:

Assumptions of the quantity theory of money

1. Assumes constant velocity of circulation of money and the level of transactions
2. Assumes only a transitionary motive
3. Money supply is the only determinant of the general price level
4. Assumes no hoarding or saving of money
5. Assumes no barter trade.

Limitations of the quantity theory of money

1. The theory only attempts to explain changes in the value of money, but does not show how the value of money is determined.
2. The theory assumes that the demand for money is only for transitionary motive, ignoring other motives like precautionary and speculative motives.
3. The theory does not take into account other factors that bring about a change in the general price level other than money supply e.g. costs of production (cost push inflation)
4. The theory assumes that velocity of circulation and the level of transactions are constant but this is not the case in real life as the two variables can change according to changes in economic conditions.

5. There is no general price level as assumed by the theory but rather a series of price levels given the fact that price is responsive to forces of demand and supply.
6. The theory ignores the influence of interest rate on the general price level and money supply and yet the high interest rate discourages borrowing which leads to low money supply.
7. It ignores the high marginal propensity to save because as money supply increases people may save money which may the general prices at the same level.
8. It ignores existence of idle resources, because money supply may increase and instead they use it to produce more goods which may keep the prices at the same level or may fall
9. It ignores bargaining between sellers and buyers because may bargain and lower the price.
10. Ignores maximum price legislation because money supply may increase but the general prices fail to increase because they are controlled by the state.
11. It is just an expression or a truism which merely shows the relationship between four variables M, V, P, T but not a true theory.
12. It only considers the monetary transactions and yet some are made using the barter trade.
13. It ignores the demand for money and only looks at money supply in an economy and yet money supply may increase and yet demand for it may be low.

Example;

Given that the volume of money in an economy is £ 40 billion, total level of transaction is £ 500million and the velocity of circulation is 25 Calculate the general price level in the economy

VALUE OF MONEY; this refers to the amount of goods and services a unit of money can buy.

Factors that influence the value of money

1. The rate of inflation.
2. The quantity of money in circulation.
3. Availability of goods and services
4. Level of transactions
5. The velocity of circulation of money

BANKING; this refers to 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 intermediaries.

FINANCIAL INTERMEDIARIES/ INSTITUTIONS; these are financial institutions that bring together savers(depositors) and borrowers(investors)

CATEGORIES OF FINANCIAL INTERMEDIARIES

(i)Banking Financial Intermediaries/Institution; these are financial institutions that **receive deposits**, **give out loans** and **create credit**.e.g. commercial banks

(ii)Non-Banking financial intermediaries/institution; these are financial institutions that **receive deposit**, **give out loans** but **do not create credit** e.g. Development, banks, insurance companies, post savings banks.

THE ROLE OF NON- BANKING FINANCIAL INTERMEDIARIES

1. **They mobilise savings**; this because they allow the public to deposit their money with them.
2. **They facilitate investment**; this is because they extend loans to the people.
3. **They promote infrastructural development;** this is because they participate in construction of infrastructure such as roads, buildings
4. **They create employment opportunities;** a number of institutions are set up and they hire labour to work
5. **They provide revenue to the government;** this is through taxes that are imposed on these institutions.
6. **They promote the development of entrepreneurial skills;** this is by lending money to people to start businesses.
7. **They provide for the social welfare of the people;** this is done by through pension schemes by the social security institutions and life assurance by insurance companies.

   Note: Non-banking financial intermediaries operate in capital markets.

   Capital markets; this is market where long term financials securities are traded e.g. long term loans, treasury bonds etc.

BANKING FINANCIAL INTERMEDIARIES;

These are majorly commercial banks.

COMMERCIAL BANKS; these are financial institutions which carry out financial businesses by accepting deposits from the public and lending out money on profit motive.e.g. in Uganda include; Standard Chartered Bank, Stanbic Bank, Centenary Bank

Note; most of the commercial banks in Uganda are foreign owned.

FUNCTIONS OF BANKING FINANCIAL INTERMEDIARIES

1. **Accepting deposits**; This is done by allowing customers to open bank accounts and save.
2. **Advancing loans to trustworthy customers**; This is done by offering different loan products on short term and long term basis.

3. **Keeping valuables items for the clients e**.g. land titles, wills and academic documents; Commercial banks provide strong rooms where to keep such valuable items.
4. **Providing means of payment;** they facilitate transfer of money from debtors to creditors by suing cheques, credit cards etc.
5. **Issuing letters of credit to and acting as referees to their clients**; Commercial banks guarantee their clients who wish to buy goods on credit.
6. **Providing advice to the investors**; they advise their customers on possible viable investment opportunities.
7. **Underwriting shares and debentures of companies;** commercial banks trade in the issued securities as primary dealers who sell them to other interested clients.
8. **Acting as trustees and executors of property and wills of their deceased clients;** commercial banks to manage distributes the benefits to the deceased's family
9. **Exchanging currencies of different countries;** commercial buy and sell local and foreign currencies

THE ROLE OF COMMERCIAL BANKS

1. **They promote investment;** this is done by extending loans to the public.
2. **They provide employment opportunities**; they have a number of branches countrywide where people are hired to work as managers, accountants etc.
3. **They promote monetisation of the economy;** they lend money out money to the people to carry out production for the market.
4. **They promote skills development**; they provide specialised training to their employees so that they become more efficient at work
5. **They facilitate infrastructural development**; they participate in the construction of buildings, roads, communication network in order to improve their services e.g. Mapeera House for centenary bank.
6. **They generate government revenue;** government imposes taxes on their activities and profits.
7. **They facilitate trade**; they enable the traders to transfer their money safely
8. **They promote capital accumulation**; this is done by moblising savings to the public.
9. **They facilitate technological development**; they transfer modern methods of banking into the country e.g. computerized banking services like Automated Teller Machines(ATM), mobile banking etc.
10. **They increase capital inflow**; this because they transfer foreign exchange into the country.

11. **They improve international relations especially foreign owned commercial banks**; this is because the host country creates a cordial relationship with the mother country of the foreign commercial banks.

FOREIGN COMMERCIAL BANKS; these are banks established in the country by foreigners and they have their headquarters in their mother countries.e.g. Standard Chartered bank, Equity, Stanbic Bank, Bank of Baroda, Bank of India

Note; For the role of foreign commercial banks refer to the roles of commercial banks.

Demerits of foreign commercial banks

1. **They worsen the balance of payment deficit;** this because of the increased profit repatriation.
2. **They create few employment opportunities;** this is because they mostly use capital intensive technology which is labour saving.
3. **They outcompete local banks;** this is because they have more finances and better technology.
4. **They worsen rural urban migration and its related evils;** this is because they are mostly urban based which attracts people from rural areas with hope of securing jobs in such banks.
5. **They make the implementation of the restrictive monetary policy difficult;** this is because they rarely borrow from the central bank because they have alternative sources of cash from their mother banks.
6. **They discourage mobilisation of savings;** they require high minimum balance which discourage people from opening bank accounts to save.

PROBLEMS BY COMMERCIAL BANKS IN DEVELOPING COUNTRIES

1. **High level of poverty;** this discourages people from opening bank accounts which limits bank deposits.
2. **Limited number of credit worthy customers;** this limits the loans given and therefore limits the profits of the banks.
3. **Political interference in the management of commercial banks;** this scares people from opening bank accounts since they fear government monitoring their accounts.
4. **Political instability;** this limits the extension of banks to rural areas for fear of losing their property and depositors money

5. **Limited labour skills;** this forces the banks to hire foreign managers who are highly paid leading to high cost of operation
6. **Low levels of accountability;** this leads huge losses by commercial banks as some managers and other workers still funds from the banks.
7. **Stiff completion from other financial institutions such as micro finance, mobile money etc.**; this limits the number of savers leading to low bank deposits.
8. **High liquidity preference;** this limits the number of savers leading to low bank deposits.
9. **Under developed infrastructure;** this increases the cost of operation which limits the profits
10. **High level of taxation;** this increases the cost of operation which limits the profits.

MEASURES THAT MAY BE TAKEN TO IMPROVE THE PERFOMANCE OF THE BANKING INDUSTRY

1. Improve infrastructure
2. Strengthen the supervision of commercial banks by the central bank
3. Sensitise the public on the importance of the public.
4. Encourage training of more bankers.
5. Promote commercialisation of the economy
6. Reduce interference by politicians in the running of commercial banks
7. Ensure political stability
8. Improve accountability in commercial banks.

Note: Commercial banks operate in money markets.

Money market; this is a market where short term financial securities are traded e.g. short term loans and treasury bills.

ASSETS OF COMMERCIAL BANKS; these are possessions of a bank. These include;

1. Cash at hand in local and hard currencies.
2. Reserves with central bank.
3. Investment in securities including; treasury bills, bonds.
4. Fixed assets in form of land, buildings etc.
5. Loan advances and overdrafts to customers.
6. Long-term investments.
7. Deposits with other banks and non-bank financial intermediaries.
8. Interest on loans advanced to customers.

LIABILITIES OF COMMERCIAL BANKS; th**ese** are claims against the assets of the bank by its creditors. These include;

1. Share capital.
2. Customer deposits.
3. Deposits by other banks.
4. Government funds deposited in the bank.
5. Dividends payable to shareholders.
6. Reserve funds payable to the central bank.
7. Bills discounted with the central bank.

OBJECTIVES OF COMMERCIAL BANKS

Commercial banks have three main objectives which they have to full fill at all times and these;

To ensure profitability, liquidity and security.

LIQUIDITY; this requires the commercial bank to have sufficient cash at all times to meet the demands of the clients**.**

Liquidity can be achieved in the following ways**;**

1. Purchasing short term securities.
2. Lending money in phases
3. Maintaining a cash ratio
4. Maintaining a minimum balance on people's accounts
5. Extending short term loans

PROFITABILITY; this requires commercial banks to use the customers' deposits to make profits.

Profitability is achieved in the following ways;

1. Advancing loans to customers at a given interest
2. Undertaking investments in profitable projects e.g. buying shares in other companies, investing in real estates
3. Charging fees on services provided to customers.
4. Charging commission on services rendered to customers e.g. credit transfer
5. Discounting bills of exchange and promissory notes.

SECOURITY; this requires the commercial banks to safe guard the deposits of the customers.

Security is achieved in the following ways;

1. Demanding for marketable collateral security from the borrower

2. Putting up strong buildings where they carry out their activities.
3. Employing security guards
4. Taking up insurance covers against various risks e.g. cash in transit policy

CREDIT CREATION; this refers to the process by which commercial banks create new deposits out of the initial deposit through lending.

Assumptions of credit creation

1. Assumes a fixed cash ratio
2. Assumes a fixed initial deposit
3. Assumes a multi-bank system
4. Assumes use of a cheques system
5. Assumes that the public that the public is willing to borrow from commercial bank
6. Assumes a credit worthy public
7. Assumes many depositors.
8. Assumes commercial banks are willing to lend money

Concepts related to credit creation

1. **Banks deposits;** this refers to money deposited with financial institutions by the public
2. **Bank deposit/ Credit Multiplier;** this refer to the number of times by which an initial bank deposit multiplies itself to generate a final change in total credit created

Credit multiplier = 1/(cash ratio)

3. **Cash ratio;** this refers the proportion of the bank deposit that must be kept in the bank in in cash form to meet the demands of the depositors.
4. **Reserve ratio**; this refers to the proportion of the commercial bank's total deposit which by law must be kept with the central bank.
5. **Liquidity ratio**; this refers to the proportion of total deposits of a commercial bank in form assets that can easily be turned into cash e.g. bank drafts, cheques
6. **Liquidity**; this refers to the extent to which an asset can easily be turned into cash.
7. **Interest rate**; this refers to the rate at which the interest on borrowed money accumulates and it is expressed in percentage form.

Determinants of interest rate

i. Supply of loanable funds
ii. Level of demand for loanable funds
iii. Period of loan repayment
iv. The rate of inflation
v. Level of development of the banking sector
vi. The monetary policy
vii. Level of money supply

8. **Credit;** this is an agreement whereby a financial institution agrees to lend a borrower a given amount of money over a period of time.

Credit is made using instruments of credit.

Note; instruments of credit; this refers to written documents which guarantee payment in future and they give the holder the right to receive money. These include; cheques, promissory notes, bills of exchange, backdrafts, credit cards, travelers cheques.

THE PROCESS OF CREDIT CREATION

1. Receiving an initial deposit of the first bank **(Bank A)** from customers e.g. Shs. 100000
2. Keeping a certain percentage of the initial deposit as cash ratio e.g. 30% of Shs. 100,000
3. Lending out the remaining percentage of the initial deposit as a loan to a trusted borrower, e.g. shs.70, 000.
4. Receiving the money lent out as new deposit by the second bank e.g. Bank B Shs. 70,000
5. Keeping a percentage of the new deposit by the second bank as cash ratio, for example 30% of shs.70, 000
6. Lending out part of the new deposit to a trusted borrower by the second bank for example, shs.49, 000=.
7. The process continues until the initial deposit defuses into the banking system.
8. At the end of process the total credit created is equal to initial deposit x Bank credit multiplier.

Total credit created = Initial deposit x bank multiplier but bank multiplier = to 1/r $\left(\frac{1}{cash\ ratio}\right)$

100,000X100/30

Shs.333333.33

ILLUSTRATION OF CREDIT CREATION

Given that Bank **A** has initial deposit of UgShs.100, 000, and the required cash ratio is 30%, illustrate the process of credit creation in a 4 bank model.

Banks/Branches	Initial Deposit/ New deposits.	Cash Ratio (30%)	Loanable funds
	100,000=	$\frac{30}{100}$ x100,000= 30,000	100,000-30,000 = 70,000
B	70,000=	$\frac{30}{100}$x70,000= 21,000	70,000-21,000 = 49,000

C	49,000=	$\frac{30}{100}$x49,000= 14,700	49,000-14,700 = 34,300
D	34,300=	$\frac{30}{100}$x34,300= 10,290	34,300-10,290 = 24,010
E Up to n	-	-	-

FACTORS INFLUENCE/AFFECT/DETERMINE CREDIT CREATION

1. **Level of liquidity preference**; high liquidity preference limits credit creation because very few take their money to the banks which limits the bank's deposits and hence limited lending, while low liquidity promotes credit creation because many people deposit their money with the banks which increases their deposits hence promoting lending.
2. **Size of the cash ratio**; high cash ratio limits credit creation because much of the deposits is retained in the bank as cash which limits lending, while low cash ration promotes credit creation because less cash is retained by the bank which promotes lending.
3. **Interest rates on loans**; high interest rate on loans credit creation because it reduces the number of borrowers, while low interest rate on loans promotes credit creation because it attracts many borrowers.
4. **Availability of collateral security**; Presence of collateral security encourages promotes credit creation because there are many people who qualify to take loans from the banks, while absence of collateral security limits credit creation because there are very few people who qualify to take loans from the banks.
5. **Monetary policy by the central bank;** restrictive monetary policy limits credit creation because it makes borrowing expensive while, an expansionary monetary policy promotes credit creation because it makes borrowing cheap.
6. **Level of monetisation of the economy;** high level of monetisation of the economy promotes credit creation because there are many economic activities which require borrowing, while low level of monetisation of the economy limits credit creation because there are few economic activities which limits the level of borrowing.
7. **Nature of distribution of commercial banks;** even distribution of commercial banks promotes credit creation because people easily open bank accounts and deposit money which promotes lending, while poor distribution of commercial banks limits credit creation because many people cannot access banks which limits borrowing.

8. **Level of awareness of people about the banking services**; high level of awareness about banking services promotes credit creation because many people go for loans while, limited knowledge about services offered by banks limits credit creation because few people go for bank loans.
9. **Degree of accountability in the commercial banks;** high degree of accountability promotes credit creation because customer easily obtain loans without giving bribes, while poor accountability limits credit creation because customers find it hard to access loans since bank officers ask for bribes
10. **Level of investment;** high level of investment promotes credit creation because it leads to high demand for loans to buy capital goods, while low level of investment limits credit creation because there is low demand for loans
11. **Availability of credit worthy borrowers**; a big number of credit worthy customers promotes credit creation because there are many people who qualify for loans, while small number of credit worthy customers because there are few people who qualify for loans.
12. **Political atmosphere**, political stability promotes credit creation because people are encouraged to borrow and invest since there is no fear for loss of lives and property, while political instability limits credit creation because people are discouraged from borrowing for investment for fear of losing lives and property.

LIMITATIONS TO CREDIT CREATION

1. High liquidity preference.
2. High cash ratio
3. Lack of collateral security
4. poor distribution of commercial banks.
5. Low level of investment.
6. Ignorance of the public about banking services
7. High interest rates on loans.
8. Restrictive monetary policy.
9. Low levels of commercialisation of the economy
10. Political instability
11. Low levels of accountability in commercial banks
12. Limited number of credit worthy borrowers.

THE CENTRAL BANK; this is a central monetary institution which is responsible for implementation the monetary policy, issuing currency and regulating other financial institutions in the country. **e.g. Bank of Uganda**

Functions of the central bank

1. **Printing and issuance of currency**; it has the sole authority of printing and issuing national currency.
2. **It is a banker to the government**; it keeps all government money in the national treasury.
3. **It is a banker to commercial banks**; commercial banks are required by law to open and keep deposits with the central bank.
4. **It is a banker to International financial institutions e.g. international Monetary Fund, World Bank**; all international financial institutions operate accounts in the central bank for their operations in the country.
5. **It is a lender of last resort;** commercial banks borrow from the central bank when they fail to get cash from other sources.
6. **It is a supervisor of other financial institutions;** the central bank's supervision department monitors the performance of commercial banks.
7. **It is a manager of foreign exchange reserves;** it is in charge of accumulation and utilisation of the foreign reserves.
8. **It is an advisor to the government on monetary issues**; it advises on what to include in the national budget as well as taxation policies to be adopted.
9. **It manages the public debt;** this is because it is involved in the acquisition, utilisation, serving and repayment of the debt.
10. **It is a clearing house for all commercial banks;** this is because they meet in the central bank and settle their indebtedness.
11. **It is the controller of credit/money supply;** it uses the monetary policy tools to regulate the amount of money in circulation.

MONETARY POLICY; this refers to the deliberate attempt by the government through the central bank to regulate the amount of money in circulation so as to attain the desired development objectives.

Categories of monetary policy

i. **Restrictive/contractionary monetary policy**; this is a deliberate government effort through the central bank to reduce money in circulation.

ii. **Expansionary monetary policy**; this is a deliberate government effort through the central bank to increase money in circulation.

Objectives of monetary policy:

1. **To ensure price stability in the economy**; during inflation a tight monetary policy is used to reduce money supply to bring down prices
2. **To ensure full employment of resources;** credit is expanded to allow investors get more capital for investment
3. **To improve balance of payments position**; this can be achieved by through an expansionary monetary policy which promotes domestic production and reduce importation.
4. **To ensure stability of exchange rate**; this is through regulating supply of foreign exchange on the market.
5. **To increase the rate of economic growth**; this can be achieved through encouraging production of goods by using the expansionary monetary policy.
6. **To encourage growth of the financial sector**; this achieved by enabling commercial banks to extend credit facilities through the expansionary monetary policy
7. **To promote investment**; this can be achieved by allowing the public to borrow using the expansionary monetary policy.
8. **To influence the interest rate;** this can be achieved by manipulating the bank rate.

TOOLS /INSTRUMENTS OF MONETARY POLICY; these are guidelines employed by the government through the central bank to regulate the amount of money in circulation so as to achieve development objectives. These include;

1. **Open market operation;** this refers to the central bank's action of selling and buying of government securities such as treasury bills and treasury bond. To reduce the amount of money in circulation the central bank sells securities to the public in order to withdraw excess money from the public and to increase money in circulation it buys back the securities from the public.
2. **Bank rate;** This is the rate at which commercial banks borrow money from the central bank. An increase in the bank rate makes borrowing expensive for commercial to borrow from the central bank which prompt them to increase interest rate to customers and reduce borrowing by the public while a decrease in the bank rate males borrowing cheaper for commercial banks from the central bank which prompts them to lower the interest rate which encourages the public to borrow.
3. **Legal reserve requirement**; this is the minimum amount of money that commercial banks are legally required to deposit/keep with the central bank. To increase the amount of money in circulation, the central bank lowers the legal reserve requirement so that

commercial banks are left with enough money for lending, while to reduce the amount of money in circulation the central bank increases the legal reserve requirement so that commercial banks have limited amount of money to lend to the general public.

4. **Cash Ratio;** this refers the proportion of the bank deposit that must be kept in the bank in in cash form to meet the demands of the depositors. To increase the amount of money in circulation the central banks instructs the commercial to lower the cash ratio so as to increase the loanable funds and to reduce the amount of money in circulation the central bank instructs the commercial bank to increase the cash ratio so as to reduce the loanable funds.
5. **Margin requirement;** this is the difference between the value of collateral security and the value of a loan to be advanced; Margin requirement is increased to discourage people from borrowing from commercial banks thereby reducing on the amount of money in circulation and margin requirement is reduced to encourage people to borrow hence increasing the amount of money in circulation.
6. **Rationing of credit;** this is where the central bank allocates credit to commercial banks discourage lending and to encourage lending the policy is suspended such that commercial banks have sufficient funds to lend to customers.
7. **Selective credit control;** this is where the central bank instructs commercial banks to lend money to only priority sectors during inflation while when the inflation rate reduces it suspends the policy of selective credit control to allow commercial banks to lend to all sectors.
8. **Special deposits/supplementary reserve requirement**; special deposits are those deposits that the central bank demands from commercial banks on top of legal reserve requirement during inflation which reduces the loanable funds, and when the inflation rate reduces the central bank gives back the special deposits to commercial banks which increases the loanable funds.
9. **Moral suasion;** this is where the central bank persuades commercial banks to follow the monetary policy desired by government. During inflation the central bank appeals to the commercial banks to reduce lending in order to reduce money supply, while during low rate of inflation the central banks appeals to the commercial banks to lend as much as they can to increase money supply.

FACTORS INFLUENCE THE OPERATION OF MONETARY POLICY

1. **Level of liquidity preference**; high level of liquidity preference limits the monetary policy because many people do not take their money to banks and therefore the central cannot access it when it wants to limit money in circulation, while low liquidity preference improves the operation of the monetary policy because many people take their money to banks which is easily accessed by the central when it wants to reduce money in circulation
2. **Level of development of the money markets**; high level of development of money improves the operation of the monetary policy because there are many people who buy treasury bills while underdeveloped money markets limits the operation of the monetary policy because there are very few people who buy treasury bills.
3. **Level of liquidity in commercial banks;** excessive liquidity in commercial banks limits the operation of the monetary policy because commercial banks do not go to borrow from the central banks which limits the effectiveness of the bank rate tool while low level of liquidity in commercial banks improves the operation of the monetary policy because commercial banks go to borrow from the central bank which makes the bank rate policy effective.
4. **The size of monetary sector**; a large monetary sector improves the operation of the monetary policy because when the central bank wants to increase money supply money people borrow to expand production, while a small monetary sector limits the operation of the monetary sector because very few people borrow even if the central banks wants to increase money supply.
5. **Nature of distribution of commercial banks**; even distribution of commercial banks improves the operation of the monetary policy because many people deposit their money in the banks which enable the central bank to control the money the need arises, while poor distribution of commercial banks limits the operation of the monetary policy because very people deposit their money in commercial banks which makes it for the central bank to control such money when the need arises.
6. **Degree of political interference in central bank activities**; high level of political interference limits the effectiveness of the monetary policy because politicians compel the central bank to go against the restrictive monetary policy which results into too much money in circulation, while limited interference by politicians improves the operation of the monetary policy because the central bank implements the monetary policy as designed.
7. **Level of accountability in the banking sector**; proper accountability in the banking sector improves the operation of the monetary policy because commercial bank officials are honest and only lend money to priority sectors as instructed by the central bank while poor

accountability limits the operation of the monetary policy because commercial banks officials are dishonest and give out loans to non-priority sectors against the instruction of the central bank

8. **Level of coordination of government objectives**; proper coordination of government objectives improves the operation of the monetary policy because the central bank is able to implement the set objectives without any conflicts, while conflicting government objectives limits the operation of the monetary policy because at the time when the central bank wants to reduce money in circulation the government comes up with other projects which increase money supply
9. **Level of effective in the use of commercial banks;** high level of effectiveness in the use of commercial banks improves the operation of the monetary policy because many people deposit their money in banks which is easily controlled by the central bank when the need arises, while limited use of commercial banks limits the operation of the monetary policy because most people do not deposit their money in commercial banks and therefore cannot be accessed by the central bank when the need arises.
10. **Degree of awareness of the public about facilities offered by commercial banks;** high degree of awareness of the public about the facilities offered by commercial banks improves the operation of the monetary policy because many people go for loans which makes it easy for the central bank to increase money supply when the need arises, while high level of ignorance of the public about the facilities offered by the commercial banks limits the operation of the monetary policy because very few people go for loans which make it hard for the central bank to increase money supply even when need arises.

FACTORS THAT LIMIT THE EFFECTIVE OPERATION OF MONETARY POLICY;

- High level of liquidity preference
- Underdeveloped money markets.
- High level of liquidity in commercial banks
- Small monetary sector
- Poor distribution of commercial banks
- High degree of political interference in central bank activities
- Low level of accountability in the banking sector
- Conflicting government objectives
- Limited use of commercial banks by the public
- High level of ignorance of the public about the facilities offered by commercial bank