KABARAK UNIVERSITY

DEPARTMENT OF COMMERCE

COURSE TITLE : MONEY AND BANKING

COURSE CODE :FNCE 313/ECON 313

INSTRUCTOR : Dr KIBATI .P

CONTACT :0722 577 701

K A B A R A K U N I V E R S I T Y

DEPARTMENT OF COMMERCE

C O U R S E O U T L I N E

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COURSE DESCRIPTION

This course is meant to enlighten the students on the monetary theory issues as well as the role of financial intermediation in contemporary market conditions with special emphasis on the Kenyan monetary policy issues

COURSE OUTCOMES

The learner should be able to:

- Explain the relationship between money and economic activity in a country
- Describe the financial system and institutions in a country
- Explain the determinants of money supply
- Explain the causes and solutions of inflation

LESSON ONE: EVOLUTION OF MONEY

- The barter trade system
- History of Barter System
  Difficulties of barter
- Definitions Of Money:
- Motives Of Holding Money /Keynes Liquidity Preference Theory
- The Evolution Of Money.
- Classification Of Money
- Money and near Money
- History of The Kenyan Currency

LESSON TWO: CHARACTERISTICS, FUNCTIONS, ROLE AND DEFECTS OF MONEY

- Characteristics Of Money
- Functions of Money
- Role Of Money
- Static Role of Money

- Dynamic Role of Money
- Defects Of Money
- Economic Defects
- Non-economic Defects
- Legal Aspects Relating To The Kenyan Currency
- Current Issues On Currency Issuance In Kenya

LESSON THREE: INSTITUTIONS THAT DEAL WITH BANKING

The Central Bank

- Naming of central banks
- Independence of The Central Bank
- Differences Between Central Bank And Commercial Banks.
- Functions Of Central Bank-
- Role Of Central Bank In A Developing Economy
- Role of Central Bank in the Economic Development

Commercial Banks

- Evolution, Origin And Growth Of Banking
- Types Of Banks
- Functions Of Commercial Banks
- Role Of Commercial Banks In A Developing Country

Non-Bank Financial Institutions (NBFIS)

- The Growth Of NBFIS
- The Role of Non-Bank Financial Intermediaries
- Differences between Commercial Banks and Non-Bank Financial Institutions

LESSON FOUR: THE SUPPLY OF MONEY

- Definitions Of Money Supply
- Determinants of Money Supply
- The Process Of Credit Creation
- Limitations On The Power Of Banks To Create Credit

LESSON FIVE: RELATIONSHIP BETWEEN MONEY SUPPLY AND PRICES

- Meaning Of Value Of Money
- Fisher's Quantity Theory Of Money
- The Quantity Theory of Money and Its Variants
- Keynes's Reformulated Quantity Theory Of Money
- The Keynesian Theory Of Money And Prices

LESSON SIX: MONETARY POLICY

- Meaning of Monetary Policy
- Objectives or Goals Of Monetary Policy
- Instruments Of Monetary Policy
- Expansionary (or easy) monetary policy
- Restrictive monetary policy
- Limitations of monetary policy in controlling inflation
- Role Of Monetary Policy In A Developing Economy
- Limitation Of Monetary Policy In LDCs

LESSON SEVEN: INFLATION

- Meaning Of Inflation
- Terms used to describe inflation

Types Of Inflation

- Demand-Pull Inflation
- Cost-Push Inflation

Causes Of Inflation

- Factors Affecting Demand
- Factors Affecting Supply

Effects of Inflation

- The effects of inflation on distribution of income and wealth,
- The effects of inflation on production
- The effects of inflation on the functions of money
- The effects of inflation on the society as a whole.

Measures To Control Inflation

- Monetary Measures
- Fiscal Measures
- Other Measures

LESSON EIGHT: INTERNATIONAL FINANCIAL SYSTEMS

- The International Monetary Fund
- International Bank Of Reconstruction And Development
- Structural Adjustment Programmes (SAPS)
- Characteristics And Effects Of Saps
- Concerns and Criticism About The World Bank And IMF?

Teaching/ learning methodology:

Lectures and Tutorials; Group Discussion; Demonstration; Individual Assignments; Case Studies.

Course Assessment Strategy

Assignment	10%
Two C.A.T'S	20%
Final Exams	70%
TOTAL	100%

Instructional Materials And Equipment

Projector, text books, design catalogues, computer laboratory, design software, simulators

References

Freeric S Mishkin,(2004)The Economic Of Money,Banking And Financial Markets, Seventh Edition, Addison Wesley,Boston.MA.ISBN:0-321-20048-9

Glyn,Boston(2002),A History Of Money From Ancient Time To The Present Day, Third Edition,Cardiff, University Of Wales Press

Jhingan.M.L(2011)Money Banking, International Trade And Public Finance, ISBN 978-81-8281-384-7,Vrinda Publications(P) Ltd,New Delhi India

Central bank of Kenya publications

LESSON ONE: EVOLUTION OF MONEY

The Barter Trade System

Before the evolution of money, exchange was done on the basis of direct exchange of goods and services. This is known as barter. Barter involves the *direct exchange of one good for some quantity of another*. For example, a horse may be exchanged for a cow, or 3 sheep or four goats. In other cases, goods are exchanged for services. A doctor may be paid in kind as payment for his services. For example, he may be paid a cock, or some wheat or rice or fruit. Thus barter economy is a *moneyless economy*. It is also a *simple economy* where people produce goods either for self consumption or for exchange with other goods which they want. Bartering was found in *early societies*. But it is still practiced at places where the use of money has not spread much. Such non-monetised areas are to be found in many rural areas of underdeveloped countries.

History of Barter System

The barter system was one of the earliest forms of trading. It facilitated exchange of goods and services, as money was not invented in those times. The history of bartering can be traced back to 6000 BC. It is believed that barter system was introduced by the tribes of Mesopotamia. This system was then adopted by the Phoenicians, who bartered their goods to people in other cities located across the oceans.

An improved system of bartering was developed in Babylonia too. People used to exchange their goods for weapons, tea, spices, and food items. Sometimes, even human skulls were used for barter. Another popular item used for exchange was salt. Salt was so valuable at that time, that the salary of Roman soldiers was paid in salt. The main drawback of this system was that there was no standard criterion to determine the value of goods and services, and this resulted in disputes and clashes. These problems were sorted out with the invention of money, but the barter system continued to exist in some form or another.

The Europeans started traveling across the globe during the Middle Ages and used barter services to trade their goods like furs and crafts to the East, in exchange of perfumes and silks. People of colonial America did not have enough money for business, which was mainly based on barter services. Most of their business consisted of wheat, skins of male deer (bucks), musketzz balls, etc. They were also experts in exchanging services. If members of one family agreed to help their neighbors in harvesting their crops, the latter would help the former in their task, like roofing their building. The history of barter system can also be linked to the initial years of Oxford and Harvard Universities, where students used to pay their fees as food items, firewood or livestock.

Barter services became popular during the Great Depression in the 1930s', which witnessed a scarcity of money. The barter system was used as a way of obtaining things like food and other services. The trading was done between people or through groups, who acted as agents and facilitated third party bartering. These groups were like banks, where people maintained their accounts. In case of sale of any of the items, the account of the owner would be credited and the account of the buyer would be debited. It is worth mentioning that Adolf Hitler also used barter system to collect money for funding the war. He was engaged in barter trading with Greece, Sweden and Russia. Post World War II, the people of Germany too resorted to bartering, as the German currency had lost its value.

Barter system has been in use throughout the world for centuries. The invention of money did not result in the end of bartering services. Sometimes, monetary crises fueled the revival of the barter system. Even though money is there for trading and for business, barter system still exists and has become more strong and organized.

Difficulties of Barter

But the barter system is the most inconvenient method of exchange. It involves loss of much time and effort on the part of people in trying to exchange goods and services. As a method, the barter system has the following difficulties and disadvantages:

i.Lack of double coincidence of wants. The functioning of barter system requires a double coincidence of wants on the part of those who want to exchange goods or services. It is necessary for a person who wishes to trade his goods or service to find some other person who is not only willing to buy his goods or service, but also possesses that good which the former wants. For example, suppose a person possesses a horse and wants to exchange it for a cow. In the barter system he has to find out a person who not only possess a cow but also wants a horse. The existence of such a double coincidence of wants is a remote probability. For, it is a very laborious and time-consuming process to find out person who want each other's goods. Often the horse-owner would have to carry through a number of intermediary transactions. He might have to trade his horse for some sheep, sheep for some goat and goat for the cows he want. To be successful, the barter system involves multilateral transactions which are not possible practically. Consequently, if the double coincidence of wants is not matched exactly, no trade is possible under barter. Thus, a barter system is time consuming and is a great hindrance to the development and expansion of trade.

ii.Lack of a common measure of value: Another difficulty under the barter system relates to the lack of a common unit in which the value of goods and services should be measured. Even if the two persons who want each other's goods meet by coincidence, the problem arises as to the proportion in which the two goods should be exchanged. There being no common measure of value, the rate of exchange will be arbitrarily fixed according to the intensity of demand for each other's goods. Consequently, one party is at a disadvantage in terms of the trade between the two goods.Moreover, under a barter system the value of each good is required to be stated in as many quantities as there are types and qualities of other goods and services.

iii.Indivisibility of certain goods. The barter system is based on the exchange of goods with other goods. It is difficult to fix exchange rates for certain goods which are indivisible. Such indivisible goods pose a real problem under barter. A person may desire a horse and the other a sheep and both may be willing to trade. The former may demand more than four sheep for a horse but the other is not prepared to give five sheep and thus there is no exchange. If a sheep had been divisible, a payment of four and a half sheep for a horse might have been mutually satisfactory. Similarly, if the man with the horse wants only two sheep, then how will he exchange his horse with only two sheep? As it is not possible to divide his horse, no trade will be possible between the two persons. Thus indivisibility of certain goods makes the barter system inoperative.

iv.Difficulty in storing value. Under the barter system it is difficult to store value. Anyone wanting to save real capital over a long period would be faced with the difficulty that during the intervening period the stored commodity may become obsolete or deteriorate in value. As people trade in cattle, grains and other such

perishable commodities, it is very expensive and often difficult to store and prevent their deterioration and loss over the long period

vi.Difficulty in making deferred payment. In a barter economy, it is difficult to make payments in the future. As payments are made in goods and services, debt contracts are not possible due to disagreements on part of the two parties on the following grounds:

(a) It would often invite controversy as to the quality of the goods or services to be repaid
(b) The two parties will often be unable to agree on the specific commodity to be used for repayment
(c) Both parties would run the risk that the commodity to be repaid would increase or decrease seriously in value over the duration of the contract. For example, wheat might rise markedly in value in terms of other commodities, to the debtors regret; or decrease in markedly in value to the creditors regret. Thus it is not possible to make just payments involving future contracts under the barter system.

vii.Lack of specialization. Another difficulty of the barter system is that it is associated with *a* production system where each person is jack of all trades. In other words, a high degree of specialization is difficult to achieve under the barter system. Specialization and interdependence in production is only possible in an expanded market system based on the money economy. Thus no economic progress is possible in a barter economy due to lack of specialization.

The above mentioned difficulties of barter led to the evolution of money.

Definitions of Money

Money has been defined differently by different economists, as there is no unanimity over its definition. Some definitions are too extensive while others are too narrow. For example, Walker's definition is too wide. In Walker's words" Money is what money does". According to this definition, we can include all those things in money, which perform the functions of money. Thus money does not comprise metallic coins and currency notes only. It also includes cheques, hundies, bills of exchange, etc., because they also perform the functions of money. On the other hand, Robertson's definition of money is rather narrow**.**

According to him, Money is a "commodity, which is used to denote anything which is widely accepted in a payment for goods or in discharge of other business obligations". According to this definition, metallic money alone deserves to be called money in the strict sense of the term because it alone is generally acceptable by the people, left to them. This definition unnecessarily narrows down the field of money.

Some economists define money in legal terms saying that 'anything which the state declares as money is money". Thus, money possesses legal sanction to discharge debts and perform other functions of money. But legal sanction alone is not a significant factor in making money generally acceptable. The bank deposits or credit money are not legal tender money but these are generally acceptable in payment and actually constitute a major part of the circulating medium.

NB ; None of above definitions is satisfactory since they are either two wide or too narrow. A suitable definition of money should emphasize not only the important functions of money, but also its basic characteristic, namely, general acceptability.

From this point of view, Crowther's definition appears to be ideal definition. He defines money as 'anything that is generally acceptable as a means of exchange and that at the same time acts as a measure and as a store of value". This definition points out that money should perform all the three important functions of being a medium of exchange, a standard of value, and a store of value. Besides, money should be a commodity, which is generally acceptable by the community in payment for anything. In other words, the commodity chosen as money must be universally acceptable within community in exchange for goods and services or in payment of debts.

On the basis of the **constituents of money**, the following four approaches to the definitions of money may be mentioned :

(1) Traditional Approach : According to this approach, money (M) includes currency (C) and demand deposits (DD).

M = C + DD

(2) Monetarist Approach : According to this approach, money (M) includes currency (C), demand deposits (DD) and time deposits (TD).

M = C + DD + TD

(3) Liquidity Approach : According to this approach, money (M) includes currency (C), demand deposits (DD), time deposits (TD), savings bank deposits (SB), shares (S), bonds (B), etc.

M = C + DD + TD + SB + S + B, etc.

(4) The Central Bank Approach : According to this approach, money (M) includes currency (C), demand deposits (DD), time deposits (TD), credit from non-bank financial institutions (CNBFI) and credit from unorganised agencies (CUA).

M = C + DD + TD + CNBFI + CUA

Motives of Holding Money /Keynes Liquidity Preference Theory

In 1936, economist John M. Keynes wrote a very famous and influential book, The General Theory of Employment, Interest Rates, and Money. In this book he developed his theory of money demand, known as the **liquidity preference theory**

Keynes believed there were 3 motives of holding money:

- **Transactions motive.** Money is a medium of exchange, and people hold money to buy stuff. So as income rises, people have more transactions and people will hold more money

- **Precautionary motive.** People hold money for emergencies (cash for a tow truck, savings for unexpected job loss). Since this also depends on the amount of transactions people expect to make, money demand is again expected to rise with income.
- **Speculative motive.** Money is also a way for people to store wealth. Keynes assumed that people stored wealth with either money or bonds. When interest rates are high, rate would then be expected to fall and bond prices would be expected to rise. So bonds are more attractive than money when interest rates are high. When interest rates are low, they then would be expected to rise in the future and thus bond prices would be expected to fall. So money is more attractive than bonds when interest rates are low. **So under the speculative motive, money demand is negatively related to the interest rate.**

What Gives Money Value?

Money is a good with a limited supply and there is a demand for it because people want it. The reason one wants money is because they know other people want money, so they can use their money to get goods and services from them in return. They can then use that money to purchase goods and services they want.

Goods and services are what ultimately matter in the economy, and money is a way that allows people to give up goods and services which are less desirable to them, and get ones that are more so. People sell their labour (work) to acquire money in the present to purchase goods and services in the future. If one believes that money will have a value in the future, they will work towards acquiring some.

Our system of money operates on a mutual set of beliefs; so long as enough of us believe in the future value of money the system will work. What could cause us to lose that belief? It is unlikely that money will be replaced in the near future, because the inefficiencies of a dual coincidence of wants system are well known. If one currency is to be replaced by another, there will be a period in which you can switch your old currency for new currency. This is what happened in Europe when countries switched over to the Euro. So our currencies are not going to disappear entirely, although at some future time you may be trading in the money you have now for some form of money that supercedes it.

The Evolution of Money

The word "money" is believed to have originated from a temple of Hera, located on Capitoline, one of Rome's seven hills. In the ancient world Hera was often associated with money. The temple of Juno Moneta at Rome was the place where the mint of Ancient Rome was located. It is derived from the Latin word ‘moneta’ which was the surname of the Roman Goddess of Juno in whose temple at Rome, money was coined.

Even the early man had some sort of money. The type of money in every age depends on the nature of its livelihood. In a hunting society, the skin of wild animals was used as money. The pastoral society used livestock, whereas the agricultural society used grains and foodstuffs as money. The Greek used coins as money.

Stages in the Evolution of Money

The evolution of money has passed through the following seven stages depending upon the progress of human civilization at different times and places.

i.Commodity Money. Various types of commodities have been used as money from the beginning of human civilization. Stone, spears, skins, bows and arrows and axes were used as money in the hunting society. The pastoral society used cattle as money. The agricultural society used grains as money. The Romans used cattle and salt as money at different times. The Mongolians used squirrel skin as money. Precious stone, tobacco, tea, shells, fishhooks and many other commodities served as money depending upon time, place and economic standards of the society. The use of commodities as money had the following defects:

a. All commodities were not uniform in quality such as cattle, grain etc thus lack of standardization made pricing difficult
b. Difficult to store and prevent loss of value in the case of perishable commodities
c. Supplies of such commodities were uncertain
d. They lacked in portability and hence were difficult to transfer from one place to another
e. There was the problem of indivisibility in the cases of commodities such as cattle

ii. Metallic Money. With the spread of civilization and trade relations by land and sea, metallic money, took the place of commodity money. Many nations started using silver, gold, copper, tin etc as money. But metal was an inconvenient thing to accept, weigh divide and assess quality.
Accordingly, metal was made into coins of predetermined weight. This led to the hoarding of full-bodied coins with the result that debased coins were found in circulation. This led to the minting of coins with a rough edge. As the price of gold began to rise, gold coins were melted in order to earn more by selling them as metal. This led governments to mix copper alloy or some other metals.But metallic money had several defects:

a. It was not possible to change its supply according to the requirements of the nations of the nation both for internal and external use
b. Being heavy, it was not possible to carry large sums of money in the form of coins from one place to another by merchants
c. It was unsafe and inconvenient to carry precious metals for trade purposes over a long distance
d. Metallic money was very expensive because the use of coins led to their debasement and their minting and exchange at the mint cost a lot to the government

iii. Paper Money. The development of paper money was started by goldsmiths who kept strong safes to store their gold. As goldsmiths were thought to be honest merchants, people started keeping their gold with them for safe custody. In return the goldsmiths gave the depositors a receipt promising to return the gold on demand. These receipts of the goldsmith were given to the sellers of commodities by the

buyers. Thus receipts of the goldsmith were a substitute for money. Such paper money was backed by gold and was convertible on demand into gold. This ultimately led to the development of bank notes. The bank notes are issued by the central bank of the country. As the demand for gold and silver increased with the rise in their prices, the convertibility of bank notes into gold and silver was gradually given up during the beginning and after the First World War in all the countries of the world. Since then the bank money has ceased to be representative of money and is simply fiat money which is inconvertible and is accepted as money because it is backed by law.

iv. Credit Money. Another stage in the evolution of money in the modern world is the use of the cheque as money. Emergence of credit money took place almost side by side with that of paper money. People keep a part of their cash as deposits with banks, which they can withdraw at their convenience through cheques. The cheque (known as credit money or bank money), itself, is not money, but it performs the same functions as money . It is a means of transferring money or obligation from one person to another. But a cheque is different from a bank note. A cheque is made for a specific sum, and it expires with a single transaction. But a cheque is not money. It is simply a written order to transfer money. However, large transaction is made through cheques these days and bank notes are used only for small transaction.

v. Near Money. This is the use of bills of exchange, treasury bills, bonds, debentures, saving certificates etc. they are known as near money. They are close substitutes for money and are liquid assets.

vi. Plastic Money (Credit Cards): Increasing affluence combined with increasing complexity of life in the modern society has led to the use of credit cards. Credit cards provide convenience and safety in the purchasing process. It is generally known as 'Plastic Money'. The credit cards are made of plastic. Credit card enables the cardholders to purchase products or services without making immediate payments. It is a document which can be used for purchase of goods and services all around the globe. (But in real sense credit card is not money). They aim at removing the need for carrying cash to make transactions.

vii. Digital Currency -Digital currency (**digital money** or **electronic money** or **electronic currency**) is a type of currency available only in digital form, not in physical (such as banknotes and coins). It exhibits properties similar to physical currencies, but allows for instantaneous transactions and borderless transfer-of-ownership. Examples include virtual currencies and cryptocurrencies or even central bank issued "digital base money". Like traditional money, these currencies may be used to buy physical goods and services, but may also be restricted to certain communities such as for use inside an on-line game or social network.
Digital currency is a money balance recorded electronically on a stored-value card or other device. Another form of electronic money is network money, allowing the transfer of value on computer networks, particularly the Internet. Electronic money is also a claim on a private bank or other financial institution such as bank deposits.
Digital money can either be centralized, where there is a central point of control over the money supply, or decentralized, where the control over the money supply can come from various sources.

Virtual Currency

Virtual currency, also known as **virtual money**, is a type of unregulated, digital money, which is issued and usually controlled by its developers, and used and accepted among the members of a specific virtual community. It is "a digital representation of value that is neither issued by a central bank or a public authority, nor necessarily attached to a fiat currency, but is accepted by natural or legal persons as a means of payment and can be transferred, stored or traded electronically". By contrast, a digital currency that is issued by a central bank is defined as "central bank digital currency".

Cryptocurrency

A **cryptocurrency** (or **crypto currency**) is a digital asset designed to work as a medium of exchange that uses cryptography ("hidden, secret"); to secure its transactions, to control the creation of additional units, and to verify the transfer of assets. Cryptocurrencies are classified as a subset of digital currencies and are also classified as a subset of alternative currencies and virtual currencies. Cryptocurrencies use decentralized control as opposed to centralized electronic money and central banking systems. The decentralized control of each cryptocurrency works through a blockchain, which is a public transaction database, functioning as a distributed ledger.

Bitcoin, created in 2009, was the first decentralized cryptocurrency. Since then, numerous other cryptocurrencies have been created. These are frequently called *altcoins*, as a blend of *alternative coin*.

Examples of Cryptocurrency

1. Bitcoin
2. Litecoin (LTC) Litecoin, launched in the year 2011, was among the initial cryptocurrencies following bitcoin and was often referred to as 'silver to Bitcoin's gold.' ...
3. Ethereum (ETH)
4. BitcoinCash
5. Bitcoin Gold
6. Zcash (ZEC)
7. Dash
8. Ripple (XRP)
9. Monero (XMR)
10. The Bottom Line.
11. Tether

Classification of Money

Money can be classified on the following different bases:

1. The physical characteristic of the material of which money are made; or the monetary system criterion and
2. The nature of the issuer such as government, central bank, commercial bank, or other, or the acceptance criterion and

They are explained below.

1. **Money system criterion**

The money system criterion classifies money into:

a. Metallic money
b. Paper money and
c. Credit money

a) Metallic money

Money made of any metal such as gold, silver, nickel, copper etc is called metallic money. Metallic money is further classified into **standard money, token money** and **subsidiary money.**

i) Standard Money:

This is also referred to as the principle money or full-bodied money. Standard coins are made of gold or silver. These coins are made of a well-defined weight and fineness. Standard money has the following characteristics:

1) Standard coin is the principal coin of the country. As such, it is the medium of exchange and also the money of account.

2) The Face value of standard money is equal to its intrinsic value. The face value of standard money is always equal to its metallic or intrinsic value. In other words, the standard coin comprises metal whose value is equal to its face value. If someone melts down a standard coin and sells the gold in the market, he suffers no loss because the coin contains metal equivalent to its face value. That is why the standard money is known as full-bodied money. For example, the Indian rupee before 1893 was a standard coin. It had in it silver whose metallic value was equal to its face value.

3) There is free coinage of standard money. A special characteristic of standard money is that it is minted under free coinage. Under free coinage, the mint is open to the public. Under the system, the people have the right to take their gold or silver to the mint for getting it converted into coins. For this service rendered to the citizens, the mint sometimes charges fee, but sometimes it does not. The main advantage of this system is that there is no shortage of coins in the country. Whenever the people experience shortage of coins they can take their gold or silver to the mint and get it converted into coins.

4) Standard money is unlimited legal tender money. An important characteristic of standard money is that its unlimited legal tender, because it's the principal monetary unit of the country. All big payments can be made in terms of standard money to an unlimited extent.

Merits of Standard Coins:

a) Inspire greater confidence

b) Means of storing purchasing power

c) Easy acceptability in foreign countries)No fear of inflation

Demerits of Standard Coins:

a) Not economical

b) Standard money is not elastic

ii) Token Money:

The token money is used for making smaller payments. It serves as a subsidiary for standard money. It is generally made of inferior and light metals, such as, copper, nickel etc, Token money is different from standard money in several respects,

1) There is no free coinage of token money. The government only mints this, the public enjoys no right to take the metals to the mint and get them converted into token coins.

2) The face value of token money is higher than its intrinsic value.

3) Token money is limited legal tender money: Token coins can be used for making payments only to a limited extent. No one can be forced to accept then coins beyond a certain limit.

4) Token money is a subsidiary of standard money: Token coins are generally used for making payments in smaller transactions. As such, they act as subsidiaries of standard coins.

Merits of Token Coins:

a) Economical use of metals

b) Token currency is much more elastic

Demerits of Token Coins:

a) Inspire less confidence

b) Consistability

c) Fear of it being over-issued)

d) Acceptability within the country only

e) Limited legal tender

Eg The Kenyan sh 40 coin in circulation in Kenya is a token coin. If it is melted, its metal will not be worth sh 40 but less.

iii) Subsidiary Money:

Subsidiary coins are issued to facilitate smaller payments. The main characteristics of subsidiary coins are:

a) The subsidiary coins are low-value coins and are made of lighter metals.

b) They facilitate the exchange of low-priced goods and services

c) These coins are not subject to free coinage, they are issued by the government itself

d) All subsidiary coins are token coins

e) The relationship of subsidiary coins with the standard coins is defined and determined under statute.

All coins of the denomination from 5 ct,10 cts,50 ct, sh 1 are subsidiary money. Such coins are limited legal tender in which payments can only up to specified amounts.

b) Paper money

Paper money refers to notes different denominations made of paper and issued by the central bank and/or the government of the country. Paper money can be classified into **representative paper money, convertible money, inconvertible paper money and fiat money.**

i) Representative Paper Money.

This type of paper money is fully backed up by gold and silver reserves. In the beginning ,to avoid wastage of metals the paper currency was issued. Hence, the monetary authority maintained metallic reserves equivalent to the value of paper notes issued. The demand for converting paper notes into cash was met by making use of gold and silver kept in reserves. Thus, under the system of representative paper money, gold and silver equivalent to the value of paper notes issued were kept in reserves by the monetary authority.

Advantages of Representative money:

a) No fear of inflation

b) Economy in use of valuable metals

c) Public confidence

Disadvantages of Representative money:

a)No saving in gold and silver

b) Lack of elasticity

c) Unsuitable for poorer countries

eg The gold certificates which circulated in the united states prior to 1933 were representative money

ii) Convertible Paper Money

It refers to that type of paper money, which is convertible into standard coins/gold at the option of the holder. The characteristics of convertible paper money ;

a) The basic principle underlying this system is that the public for encashment does not simultaneously present all the notes. Therefore, the value of gold, silver kept in reserves is less than the value of notes issued by monetary authority.

b) The monetary authority assures the public that they can get their paper notes converted into gold at their option.

c) The approved securities such as gold, and silver can be encashed at anytime.

d) Thus, gold and silver in the reserves are not kept equivalent to the value of the paper currency issued, but they are somewhat less than that of currency.

e) Under this system, the people are given gold and silver in exchange for paper currency for making payments abroad.

f) The government is ever ready to buy gold and silver at predetermined rates.

Merits of Convertible Paper Money:

a) Economy in use of valuable metals

b) Flexibility

c) Inspire greater public confidence

d) Facilitates foreign trade

Demerits of Convertible Paper Money:

a)Fear of over –issue of paper currency

b)It does not inspire as much confidence as representative money Though this system spread to many countries and is widely adopted, it's the system of inconvertible money, which is in force.

iii) Inconvertible Paper Money;

This system prevails in a country when the monetary authority gives no guarantee to convert the paper notes into coin or other valuable metals. Such a type of paper currency circulates on account of the high credit enjoyed by the monetary authority. The following are its characteristics.

a) Under this system, the issuing authority keeps no metallic reserves behind paper currency nor does it guarantee the convertibility of paper note into coins and metals. It's possible that the issuing authority backs up the note-issue with government securities, treasury bills and even bonds.

b) The issuing authority is able issue more paper notes without metallic cover.

iv) Fiat Money:

Money which circulates on the authority (i.e fiat) of the government. Fiat money is created and issued by the state. But it is not convertible and by law it is legal tender. Fiat money is not representative or token money. The notes and coins issued by the Central Bank is Fiat money. In a **fiat money system**, the main thing that gives the money value is its relative scarcity and the faith placed in it by the people that use it. The value of fiat money also depends on the strength of the issuing country's economy. Inflation results when a government issues too much fiat money.

In a fiat monetary system, there is no restrain on the amount of money that can be created. This allows unlimited credit creation. Initially, a rapid growth in the availability of credit is often mistaken for economic growth, as spending and business profits grow and frequently there is a rapid growth in equity prices. In the long run, however, the economy tends to suffer much more by the following contraction than it gained from the expansion in credit. This expansion in credit can be seen in the Debt/GDP ratio.

In most cases, a fiat monetary system comes into existence as a result of excessive public debt. When the government is unable to repay all its debt in gold or silver, the temptation to remove physical backing rather than to default becomes irresistible. This was the case in 18th century France during the Law scheme, as well as in the 70s in the US, when Nixon removed the last link between the dollar and gold which is still in effect today.

The main characteristics of fiat money may be summed up as follows:

a) Fiat money is issued in limited quantities

b) There is no-cover (metallic or fiduciary) behind it .The fact of the matter is that fiat money is an extra-ordinary type of money and is issued under special circumstances.

c) Fiat money however, is an unlimited legal tender.

d) No reserves of any type are kept behind and are neither backed up by the metallic and fiduciary cover. The monetary authority gives no guarantee to convert fiat money into metallic coins.

Hyper-inflation is the terminal stage of any fiat currency. In hyper-inflation, money looses most of its value practically overnight. Hyper-inflation is often the result of increasing regular inflation to the point where all confidence in money is lost. In a fiat monetary system, the value of money is based on confidence, and once that confidence is gone, money irreversibly becomes worthless, regardless of its scarcity. Gold has replaced every fiat currency for the past 3000 years.

c) Credit money

Credit money or bank money is the use of a cheque or draft. A demand deposit or current account deposit in a bank is money which is withdrawable by a holder of the deposit through a cheque or draft. Thus it is demand deposit which is credit or bank money that is transferable from one person to another through a cheque or draft. But a cheque or draft is not legal tender and may not be accepted as a means of payment or medium of exchange. However, in advanced countries bank money is as important as the paper notes issued by the government or the central bank of the country.

2) Acceptance criterion

On the basis of acceptability criterion, money is classified into **legal tender money** and **non-legal tender money**

1. **Legal tender money.** Legal tender money is that which the state and people accept as the means of payment and in discharge of debts. Since it has the authority of the government, such money is accepted compulsorily by the people. All notes and coins issued by the government and the central bank of a country are compulsory legal tender in that country. Legal tender money is further divided into limited and unlimited legal tender money

a) **Limited legal tender money.** Limited legal tender money is that in which payments can be made legally upto a certain limit. All coins are limited legal tender in Kenya. Payments in them can be made up to a specific limit. Coins of a denomination of fifty cents shall be legal tender only for payments up to twenty shillings, and coins of a denomination of less than fifty cents shall be legal tender only for payments up to five shillings in kenya.
b) **Unlimited legal tender**. Money is unlimited legal tender when payments can be made in it legally in unlimited quantities. All paper notes are unlimited legal tenders in Kenya. People have to accept payments in unlimited quantities in notes.

2. **Non-legal tender or optional money**. Money which does not possess a legal tender authority of the state or the central bank is non-legal tender money. It is also called 'optional money'. It is that money, which ordinarily accepted by the people, but has no legal sanction behind it. No one can be forced to accept this type of money against his wishes. It is optional money. If the persons paying this money enjoy high credit in the market, everyone will readily accept it. However, no one can be forced to accept it. Different types of credit instruments like cheques, bankers cheques, time deposits, bonds, securities, debentures, bills of exchange, treasury bills, postal certificates, insurance policies etc. they are known as 'near money' of value. They possess moneyness or liquidity. They also yield income. But they do not have any legal status.

The above mentioned are the different types of money which have been and are being used in the countries to carry on their daily transactions

Money and near Money

Near money (or quasi-money) is a term used to describe highly liquid assets that can easily be converted into cash .Money consists of currency and bank deposits. Coins and currencies notes issued by the central bank of a country and cheques of commercial banks of a country are liquid assets. This is not the case with time deposits(fixed deposits) which can be withdrawn either at the end of the fixed period or by giving prior notice to the bank and incurring a penalty. Thus time deposits are not real money and for them to become money they must be converted into cash or demand deposits. However they are near money for they can be converted into real money in a short period without any loss. Thus near money assets serve the store of value function of money temporarily and are convertible into a medium of exchange in a short time without loss in their face value.

Besides demand deposits(**current account** deposits)**, other near money assets are bonds, debentures, bill of exchange, treasury bills, insurance policy** etc. all these type of assets have a market and are negotiable so that they can be converted into real money within a short time.

How these negotiable instruments are near moneys.

- Bonds, securities and debentures fall in the same category. Bonds and securities are issued by the government, while debentures are issued by companies. They are the means to borrow funds for

short, medium or long periods and carry a fixed interest. They are near money assets because they are convertible into cash at a short notice in the money market.

- A bill of exchange is another form of money. It is an IOU (I owe you). It is drawn by individual or firm to pay a stated sum of money on a specified date which is never more that 90 days. A bill of exchange is not money by itself but is certainly money on the date due. It is, however near money if its owner wishes to turn it into cash. It can be easily converted into money at a discount or by receiving less money than its face value

- Treasury bills issued by the government also falls in the category of near money. A treasury bill is a promise by the government to pay a stated sum in the near future usually 91,182 and 364 days. A treasury bill is also like a bill of exchange which is convertible into money at a discount within a short period.

- Life insurance policy is another example of near money. Some intermediaries have come into existence to provide market for certain assets. Such intermediaries are financial companies which provide funds on the security of some assets and brokers who buy and sell property, bonds, debentures, shares etc. They help in increasing the liquidity of such assets thereby converting them into near money.

History of the Kenyan Currency

Entry of what is commonly considered as real currency in Kenya can be traced back to between 1800 - 1850 when the Maria Theresa Thalers were introduced in the Kenyan coast. The Thalers were 18th and 19th Century silver coins used by Indian, Greek and European merchants at the Eritrean and Kenyan coasts. Despite the Thaler's popularity in the East African Coast, it was not able to penetrate upcountry. The Indian Rupee which was used for payment of Indian workers during the building of the Kenya – Uganda railway in 1896 managed to move inwards becoming acceptable by the African population who in various mother tongues called it different names such as "Rupia" or "Pesa".

In 1897 Harry Jackson the leader of the British East African Protectorate (B.E.A.P.) introduced a new currency called "Specie" and "Pice" but it was not successful and hence in 1905 the Indian Rupee was made the official currency of the B.E.A.P. (Kenya- Uganda). They were in the following denominations.

COINS	**NOTES**
1/2 Cent	1 Rupee
1 Cent	`
5 Cent	10 Rupees

10 Cent	20 Rupees
20 Cent	50 Rupees
50 Cent	100 Rupees
	500 Rupees

Establishment of the East African Currency Board (EACB)

The Indian Rupee was abolished after Kenya became a crown colony in 1920 when the Imperial British East Africa's (IBEA) mandate was terminated. A central body known as the East African Currency Board was then established to oversee the issuance of currency in the region. The Board comprised of four commissioners who reported to the secretary of state for colonies under the advisory of the Bank of England. Replacement of the Indian Rupee was to be done using the East African Protectorate Rupees. This was however short-lived as the East African Florins were instead introduced.

The East African Shilling

On January 1, 1922 the shilling equivalent was introduced in all the three East African countries and by June 1923, the E.A. shilling was firmly established as official currency in Kenya, Uganda and Tanganyika.

Currency after Independence

In 1964 after the independence of Kenya, Uganda and Tanganyika, there was a desire to establish a common East African Central Bank. Interim currencies were therefore introduced by the EACB to circulate within the region. For banknotes, the interim currency was commonly known as the Lake Victoria Money because of the background of Lake Victoria on the notes. The Lake Victoria designed notes were in the denominations of 5, 10, 20 and 100 shillings. There were also a number of coins minted and referred to as the "Uhuru" coins since they too had no head or monarch on them.

Advent of the Kenyan Shilling

Kenya began printing and minting its own currency in 1966 under the mandate given to the Central Bank of Kenya in the Central Bank of Kenya Act cap 491. The initial issue of Kenya shilling notes were in the denominations of 5, 10, 20, 50 and 100 shillings, all bearing the portrait of the First President of Kenya, H.E. Mzee Jomo Kenyatta in the front, and diverse scenes of economic activities in Kenya at the back. Denominations have progressively changed since then. Current denominations of banknotes and coins in circulation are as follows:- Coins – 5cent, 10 cent, 50 cent, 1 shilling, 5 shilling, 10 shilling, 20 shilling and 40 shilling Notes – 50 shilling, 100 shilling, 200 shilling, 500 shilling and 1,000 shilling.

New Generation Currency

Kenya voted in the 2010 constitutional referendum to get rid of individual portraits on the money. In December 2018, President Uhuru Kenyatta and CBK Governor Patrick Njoroge unveiled new generation coins. On Madaraka Day 2019, the new-look notes are fashioned to enable the visually-impaired to use them, were unveiled.

They are in notes of Sh50, Sh100, Sh200, Sh500 and Sh1,000.
The Sh1 coin will now bears the image of a giraffe, the Sh5 coin a rhino, the Sh10 a lion and the Sh20 coin will spot an elephant.The coins have also been minted with embossed features that will make them easy to identify.

NOTE:
Sh 5 notes were replaced by coins in 1985, with the same happening to Sh 10 and Sh 20 in 1994 and 1998.
In 1986, Sh 200 notes were introduced, followed by sh 500 in 1988 and Sh 1000 in 1994.
The banknotes are printed in Nairobi by British security printer De La Rue.

LESSON TWO: CHARACTERISTICS, FUNCTIONS, ROLE AND DEFECTS OF MONEY

Characteristics of Money

Economists have pointed towards the following characteristics or qualities for a thing to be money:

1. **General acceptability**. For anything to be money, it should be acceptable by everybody. People accept a thing as money which is used by everybody as a medium of exchange. Gold and silver are considered good money materials because they have alternative uses and are generally accepted. Paper notes are accepted as money when they are issued by the central bank and/or the government and are legal tender. Cheques and bills of exchange are not acceptable generally. Hence they are not money.
2. **Durability.** For a thing to be money, it must possess durability. It should be storable and last long without losing value over a period of time. Animals and perishable commodities are not good money materials because they do not possess durability. In this sense, gold, silver, alloy, brass etc are best materials which are used as money. Paper notes are less durable than these metals. But they are money because they are legal tenders.

3. **Portability.** The materials used as money should be easily carried and transferred from one place to another. It should contain large values in small bulk. Gold and silver possess this quality hence they are good money materials. But they involve risk in carrying or transferring them from one place to another. Therefore, paper is considered as a better material and is used in the form of notes.
4. **Cognisability.** The materials with which money is made should be easily recognized by sight or touch. Coins and currency notes of different denominations in different designs and sizes meet this quality of good money.
5. **Homogeneity.** The material with which money is made should be of the same quality. All coins of one denomination must be of same metal, weight, shape and size. Similarly paper notes of one denomination must have the same quality of paper, design and size.
6. **Divisibility.** The money material should be capable of being divided into smaller parts without losing value. Gold, silver and other such materials possess this quality. Gold has the same value in whatever number of parts it may be divided. The same is the case with paper when notes of small and large denominations are issued which facilitate the operation of small and large transactions.
7. **Stability.** Money should be stable in value because it has to serve as a measure of value. Gold and silver possess this quality because they are not available in abundance. They are neither very scarce because being durable they can be easily stocked. Their supplies can be thus increased or decreased when required. So they can act as a store of value because their value is stable. But governments prefer paper money to gold and silver because it is cheap and easily available. Its value is kept stable by keeping control over its issue.

Functions of Money

Medium of exchange

When money is used to intermediate the exchange of goods and services, it is performing a function as a medium of exchange. It thereby avoids the inefficiencies of a barter system, such as the 'double coincidence of wants' problem.

Unit of account

A unit of account is a standard numerical unit of measurement of the market value of goods, services, and other transactions. Also known as a "measure" or "standard" of relative worth and deferred payment, a unit of account is a necessary prerequisite for the formulation of commercial agreements that involve debt. To function as a 'unit of account', whatever is being used as money must be:

- Divisible into smaller units without loss of value; precious metals can be coined from bars, or melted down into bars again.
- Fungible: that is, one unit or piece must be perceived as equivalent to any other, which is why diamonds, works of art or real estate are not suitable as money.

- A specific weight, or measure, or size to be verifiably countable. For instance, coins are often milled with a reeded edge, so that any removal of material from the coin (lowering its commodity value) will be easy to detect.

Store of value

If money becomes a unit of value and a means of payment then it may also perform the function of serving as a store of value. The holders of money are holders of generalised purchasing power that can be spent through time. They know that it will be accepted at any time for any good or service and is thus a store of value. This function will be performed well as long as money retains a constant purchasing power.

It may be noted that any asset other than money may also perform the function of store of value, for example, bonds, land, houses, etc. These assets have the advantage that, unlike money, they yield income and may appreciate in value over time. However, they are subject to the following:

(1) They may involve storage costs,

(2) They may not be liquid in the sense that they could not be quickly converted into money without loss of value, and

(3) They may depreciate in value. A person may choose to store value in any form depending on considerations of income, safety and liquidity.

Standard of Deferred Payment

In the absence of money, borrowing and lending were difficult or borrowed and lending amount could be returned only in terms of goods and services, but the modern money economy has greatly facilitated the borrowing and lending process in terms of money. In other words, money now acts as the standard of deferred payments for the following reasons:

- the value of money is stable compared to the values of other commodities,
- Money is more durable compared to other commodities:
- Money has the quality of general acceptability. Hence it continues to be always desirable.

But in its role as a standard of deferred payments, money also suffers from certain drawbacks. They are; its own value is not wholly stable. On the contrary, its value keeps on fluctuating from time to time. As a consequence, debtors and creditors are differently affected at different times. For instance, if the value of money depreciates on account of a price rise, the creditors lose while debtors gain.

Role of Money

Money is of vital importance to the operation of the national and international economy. Money plays an important role in the daily life of a person whether he is a consumer, a producer, a businessman, an academician, a politician or an administrator

Significance or Role of Money

Money is of vital importance to an economy due to its static or its dynamics role .Its static role emerges from its static or tradition functions. In its dynamic role, money plays an important role in life of every citizen and in the economy system as a whole.

Static Role of Money

In its static role, the importance of the money lies in removing the difficulties of barter in the following ways:

i) **By serving as a medium of exchange,** money removes the need for double coincidence of wants and the inconveniences and difficulties associated with barter trade. The introduction of money as a medium of exchange breaks up the single transactions of barter into separate transactions of sales and purchases, thereby eliminating the double coincidence of wants

ii) **By acting as a unit of account,** money becomes a common measure value`. The use of money as a standard of value eliminates the necessity of quoting the price of apples in terms of oranges, the price of oranges in terms of nuts and so on. Money is the standard of measuring value and value expressed in money is price. The prices of different commodities are expressed in terms of so many units of shillings, dollars, rupees, pounds etc depending on the nature of monetary unit in a country. The measurement of the values of goods and services in the monetary unit facilitates the problem of measuring the exchange value of goods in the market

iii) **Money acts as a standard of deferred payments.** Under barter, it was easy to take loans in goats or grains but difficult to make payments in such perishable articles in future. Money has simplified both taking and repayment of loans because the unit of account is durable. It also overcomes the difficulty of indivisibility of commodities.

iv) **By acting as a store of value**, money removes the problem of storing of commodities under barter. Money being the most liquid asset can be kept for long periods without deterioration or wastage.

v) Under barter, it was difficult **to transfer value** in the form of animals, grains, etc from one place to another. Money removes the difficulty of barter by facilitating the transfer of value from one place to another. A person can transfer his money through draft, bill of exchange, etc. and his assets by selling them for cash at one place and buying them at another place.

Dynamic Role of Money

In its dynamic role, money plays an important part in the daily life of a person whether he is a consumer, producer, a businessman, an academician, a politician or an administrator. Besides, it influences the economy in a number of ways.

1. **To the consumer-**Money possesses much significance for the consumer. The consumer receives his income in the form of money rather than in goods and services. With money in hands, he can get any commodity and service he likes, in whatever quantities he needs, and at any time he requires. Not only this, money acts as an equalizer of marginal utilities for the consumer. The main aim of a

consumer is to maximize his satisfaction by spending his limited income on different goods which he wants to purchase. Since prices of goods indicate their marginal utilities and are expressed in money, money helps in equalizing the marginal utilities of goods. This is done by substituting goods with higher utilities for others having lower utilities. Thus money enables a consumer to make a rational distribution of his income on various commodities of his choice.

2. **To the producer**. Money is also important to the producer. He keeps his account of the values of inputs and outputs in money. The raw materials purchased, the wages paid to workers, the capital borrowed, the rent paid, the expenses on advertisements, etc. are all expenses of production which are entered in his account books. The sale of products in money terms are his sale proceeds. The difference between the two gives him profit. Thus a producer easily calculates not only his costs of production and receipts but also profit with the help of money. Further, money helps in general flow of goods and services from agriculture, industrial and tertiary sectors of the economy because all the activities are performed in terms of money.
3. **In Specialization and Division of Labour**. Money plays an important role in large scale specialization and divisions of labour in modern production. Money helps the capitalist to pay wages to a large number of workers engaged in specialized jobs on the basis of division of labour. Each worker is paid money wages in accordance with the nature of work done by him. Thus money facilitates specialization and division of labour in modern production. These, in turn, help the growth of industries. It is, in fact, through money that production in large scale is possible. All inputs like raw materials, labour, machinery, etc are purchased with money and all output sold in exchange for money. As right pointed out by Prof. Pigou, "In the modern world industry is closely enfolded in a garment of money.
4. **As the basis of credit** .The entire modern business is based on credit and credit is based on money. All monetary transactions consist of cheques, draft, bills of exchange etc. These are credit instruments which are not money. It is the bank deposits that are money. Banks issue such credit instruments and create credit. Credit creation, in turn, plays a major role in transferring funds from depositors to investors Thus credit expands investment on the basis of public saving lying in the bank deposits and helps in maintaining a circular flow of income within the economy.
5. **As a means of capital formation** By transforming savings into investment, money acts as a means of capital formation. Money is a liquid asset which can be stored and storing of money implies savings, and savings are kept in banks deposits to earn interest on them. Banks, in turn, lend these savings to businessmen for investment in capital equipment, buying of raw materials, labour etc from different sources and places. This makes capital mobile and leads to capital formation and economic growth.
6. **As an Index of economic growth** Money is also an index of economic growth. The various indicators of growth are national income, per capita income and economic welfare. These are calculated and measured in money terms. Changes in the value of money or prices also reflect the growth of an economy. Fall in the value of money (or rise in prices) means that the economy is not progressing in real terms. On the other hand, a continuous rise in the value of money (or fall in prices) reflects retardation of the economy. Somewhat stable prices imply a growing economy. Thus money is an index of economic growth.

7. **In the distribution and calculation of Income.** The rewards to the various factors of production in a modern economy are paid in money. A worker gets his wages, capitalist his interests, a landlord his rent, and an entrepreneur his profits. But all are paid their rewards in money. An organizer is able to calculate the marginal productivity of each factor in terms of money and pay it accordingly. For this, he equalizes the marginal productivity of each factor with its price. Its price is, in fact, its marginal productivity expressed in terms of money. As payments are made to various factors of production in money, the calculation of national income becomes easy.
8. **In National and international trade** Money facilitates both national and international trade. The use of money as a medium of exchange, as a store of value and as a transfer of value has made it possible to sell commodities not only within a country but also internationally. To facilitate trade, money has helped in establishing money and capital markets. There are banks, financial institutions, stock exchanges, produce exchanges, international financial institutions, etc which operate on the basis of the money economy and they help both in national and international trade. Further, trade relations among different countries have led to international co-operation. As a result, the developed countries have been helping growth of underdeveloped countries by giving them loans and technical assistance. This has been made possible because the value of foreign aid received and its repayment by developing countries is measured in money.
9. **In solving the central problems of an economy** Money helps in solving the central problems of an economy: what to produce, for whom to produce, how to produce and in what quantities. This is because on the basis of its functions money facilitates the flow of goods and services among consumers, producers and the government.
10. **To the government.** Money is of immense importance to the government. Money facilitates the buying and collection of taxes, fines, fees and prices of services rendered by government to the people. It simplifies the floating and management of public debt and government expenditure on development and non- developmental activities. It would be impossible for modern governments to carry on their functions without the use of money. Not only this, modern governments are welfare states which aim at improving the standards of living of the people by removing poverty, inequalities and unemployment, and achieving growth with stability. Money helps in achieving these goals of economic policy through its various instruments.
11. **To the society.** Money confers many social advantages. It is on the basis of money that the superstructure of credit is built in the society which simplifies consumption, production, exchange and distribution. It promotes national unity when people use same currency in every corner of the country. It acts a lubricant for the social life of the people, and oils the wheels of material progress. Money is at the back of social prestige and political power. Thus money is the pivot round which the whole science of economics clusters.

Defects of Money

There are a number of economic and non economic defects of money which includes;

Economic Defects

The economic defects are under:

1. **Instability in the value of money.** The first drawback about money is that its value does not remain stable over time. When the value of money falls, means rise in the price level or inflation. On the contrary, rise in the value of money means fall in the price level or deflation. These changes are brought about by increase or decrease in the supply of money. Large changes in the value of money are disastrous and even moderate changes have certain disadvantages. Inflation or fall in the value of money causes direct and immediate damage creditors and consumers. On the contrary, deflation or rise in the value of money brings down the level of output, unemployment and income. Thus instability in the value of money of money adversely affects consumers, producers and other sections of the society.
2. **Unequal Distribution of wealth and income**. The second defect of money is that changes in the value of money lead to unequal distribution of wealth and income. Inflation or deflation which brings benefits to some damages others leads to redistribution of wealth and income not only between social and industrial classes, but between different persons in the same class. Such changes in the structure of society widen the differences between the rich and the poor and lead to class conflict.
3. **Growth of Monopolies**. Too much of money leads to the concentration capital in the hands of a few capitalists. This leads to growth of monopolies which exploit both consumers and workers.
4. **Wastage of resource.** Money is the basis of credit. When banks create too much of credit, it may be used for productive purposes. If much credit is used in production, it leads to over capitalization and over production and consequently to wastage of resources. Similarly, if liberal credit facilities are given for unproductive uses, they also lead to wastage of resources.
5. **Black money**. Money being the store of value lures people to hoard it. The tendency to hoard money and become rich is the root cause of the evil of black money .When people evade taxes and conceal their income and hoard it, it is black money. This leads to a "parallel" economy within the country which encourages conspicuous consumption, black marketing, speculation, etc.
6. **Cyclical Fluctuations**; another defect of the institution of money is that it leads to a boom and when it contracts there is a slump. In a boom, contrary, they decline during a depression, thereby leading to under consumption. Such cyclical fluctuations bring untold miseries to the people.

Non-economic Defects

Money has the following non-economic defects:

1. Besides the above noted economic drawbacks of money, the Institution of money has brought down the moral, social and political fiber of the society. It leads to corruption, turpitude etc . In fact, money is "the cause of theft and murder, of deception and betrayal
2. Political Instability: Over issue of money leads to inflation and to political instability and downfall of governments. This has happened in many Latin American countries, Arab countries.
3. Tendency to exploit. People, who want to amass money and wealth, adopt underhand methods and have tendency to exploit others. Even nations are not far behind in this. As pointed out by Davenport, "Money has enabled strong nations to destroy backward communities to win them on their side with the help of financial aid"

Note

All these defects are not due to money but are the result of the attitude of man towards the use of money. It is impossible to imagine this world without money. Money is an indispensable lubricant, a tool of convenience, for a continuous and smooth functioning of the economic machine.

Legal Aspects Relating To the Kenyan Currency

The Central Bank of Kenya is the only body in Kenya with the specific mandate of issuing currency notes and coins. This mandate is prescribed under the Central Bank of Kenya Act Cap 491 Section 4 A (1) f. The Act also sets out other provisions in relation to Kenyan currency. The Penal Code Cap 63 has specific provisions in reference to offenses relating to coin and banknote currency.

Summary on Actions That Constitute Violating the Good Use of the Kenyan Currency.

- Making any counterfeit coin
- Beginning to make any counterfeit coin
- willfully and without authority or excuse defaces any currency
- willfully and without authority or excuse tears any currency
- willfully and without authority cuts any currency
- willfully and without authority mutilates any currency
- Dealing with any coin in such a manner as to diminish its weight with intent that when so dealt with it may pass as coin of higher denomination
- Melting down, breaking up, defacing by stamping thereon any name, word or mark, or uses otherwise than as currency any coin current for the time being in Kenya
- Sells or offers or exposes for sale any article which bears a design in imitation of any currency or bank note or coin in current use in Kenya or elsewhere
- Exports or puts on board of a vessel or vehicle of any kind for the purpose of being exported any counterfeit coin whatever, knowing it to be counterfeit

LESSON THREE: INSTITUTIONS THAT DEAL WITH BANKING

The major institutions that deal with money issues are three;

a) The Central Bank,

b) Commercial Banks and

c) Non Bank Financial Institutions

a) The Central Bank

Introduction

A **central bank**, **reserve bank**, or **monetary authority** is a public institution that manages a nation's currency, money supply, and interest rates. Central banks also usually oversee the commercial banking system of their respective countries. Examples include the European Central Bank (ECB), the Federal Reserve of the United States, and the People's Bank of China.

History on the Formation of Central Banks

The Bank of Amsterdam established in 1609 is considered to be the precursor to modern central banks. The central bank of Sweden ("Sveriges Riksbank" or simply "Riksbanken") was founded in Stockholm in 1664 thus making it the oldest central bank still operating today. The Bank of England, created in 1694. The War of the Second Coalition led to the creation of the Banque de France in 1800.

The US Federal Reserve was created by the U.S. Congress through the passing of The Federal Reserve Act in the Senate and its signing by President Woodrow Wilson on the same day, December 23, 1913. Australia established its first central bank in 1920, Colombia in 1923, Mexico and Chile in 1925 and Canada and New Zealand in the aftermath of the Great Depression in 1934. By 1935, the only significant independent nation that did not possess a central bank was Brazil, which subsequently developed a precursor thereto in 1945 and the present central bank twenty years later. Having gained independence, African and Asian countries also established central banks or monetary unions.

The People's Bank of China evolved its role as a central bank starting in about 1979 with the introduction of market reforms, which accelerated in 1989 when the country adopted a generally capitalist approach to its export economy. Evolving further partly in response to the European Central

Bank, the People's Bank of China has by 2000 become a modern central bank. The most recent bank model, was introduced together with the euro, involves coordination of the European national banks, which continue to manage their respective economies separately in all respects other than currency exchange and base interest rates.

Naming of Central Banks

There is no standard terminology for the name of a central bank, but many countries use the "Bank of Country" form (for example: Bank of England, Bank of Canada, Bank of Mexico). Some are called "national" banks, such as the National Bank of Ukraine; but the term "national bank" is more often used by privately owned commercial banks, especially in the United States. In other cases, central banks may incorporate the word "Central" (for example, European Central Bank, Central Bank of Ireland, Central Bank of Kenya); but the Central Bank of India is a (government-owned) commercial bank and not a central bank. The word "Reserve" is also often included, such as the Reserve Bank of India, Reserve Bank of Australia, Reserve Bank of New Zealand, the South African Reserve Bank, and U.S. Federal Reserve System.

Independence of the Central Bank

Governments generally have some degree of influence over even "independent" central banks; the aim of independence is primarily to prevent short-term interference. For example, the chairman of the U.S. Federal Reserve Bank is appointed by the President of the U.S.

International organizations such as the World Bank, the Bank for International Settlements (BIS) and the International Monetary Fund (IMF) are strong supporters of central bank independence. This results, in part, from a belief in the intrinsic merits of increased independence. The support for independence from the international organizations also derives partly from the connection between increased independence for the central bank and increased transparency in the policy-making process. The IMF's Financial Services Action Plan (FSAP) review self-assessment, for example, includes a number of questions about central bank independence in the transparency section. An independent central bank will score higher in the review than one that is not independent.

Over the past decade, there has been a trend towards increasing the independence of central banks as a way of improving long-term economic performance. Advocates of central bank independence argue that a central bank which is too susceptible to political direction or pressure may encourage economic cycles ("boom and bust"), as politicians may be tempted to boost economic activity in advance of an election, to the detriment of the long-term health of the economy and the country. In this context, independence is usually defined as the central bank's operational and management independence from the government.

The literature on central bank independence has defined a number of types of independence.

Legal independence

The independence of the central bank is enshrined in law. This type of independence is limited in a democratic state; in almost all cases the central bank is accountable at some level to government officials, either through a government minister or directly to a legislature. Even defining degrees of legal independence has proven to be a challenge since legislation typically provides only a framework within which the government and the central bank work out their relationship. The Central Bank of Kenya is a public institution established under Article 231 of the Constitution of Kenya, 2010.

Goal independence

The central bank has the right to set its own policy goals, whether inflation targeting, control of the money supply, or maintaining a fixed exchange rate. While this type of independence is more common, many central banks prefer to announce their policy goals in partnership with the appropriate government departments. This increases the transparency of the policy setting process and thereby increases the credibility of the goals chosen by providing assurance that they will not be changed without notice. In addition, the setting of common goals by the central bank and the government helps to avoid situations where monetary and fiscal policy are in conflict; a policy combination that is clearly sub-optimal.

Operational independence

The central bank has the independence to determine the best way of achieving its policy goals, including the types of instruments used and the timing of their use. This is the most common form of central bank independence. The granting of independence to the Bank of England in 1997 was, in fact, the granting of operational independence; the inflation target continued to be announced in the Chancellor's annual budget speech to Parliament.

Management independence

The central bank has the authority to run its own operations (appointing staff, setting budgets, and so on.) without excessive involvement of the government. The other forms of independence are not possible unless the central bank has a significant degree of management independence. One of the most common statistical indicators used in the literature as a proxy for central bank independence is the "turn-over-rate" of central bank governors. If a government is in the habit of appointing and replacing the governor frequently, it clearly has the capacity to micro-manage the central bank through its choice of governors.

It is argued that an independent central bank can run a more credible monetary policy, making market expectations more responsive to signals from the central bank.

Differences between Central Bank and Commercial Banks.

A central bank is basically different from a commercial bank in the following ways:

1. The central bank is the apex institution of the monetary and banking structure of the country. The commercial bank is one of the organs of the money market.

2. The central bank is a non-profit institution which implements the economic policies of the government. But the commercial bank is a profit making institution.
3. The central bank is owned by the government, whereas the commercial bank is owned by shareholders.
4. The central bank is a banker to the government and does not engage itself in ordinary banking activities. The commercial bank is a bank to the general public.
5. The central bank has the monopoly of note issue, while the commercial bank can issue only cheques. The notes are legal tender. But the cheques are in the nature of near-money.
6. The central bank is the banker's bank. As such, it grants accommodations in commercial banks in form of rediscounts facilities, keeps their cash reserve and clear their balances. On the other hand, the commercial bank advances loan and accepts deposits from the public.
7. The central bank controls credits in accordance with the needs of business and economy. The commercial bank creates credit to meet the requirements of business.
8. Every country has only one central bank with its offices at important centers of the country. On the other hand, there are many commercial banks with hundreds branches within and outside country.
9. The central bank is the custodian of the foreign currency reserves of the country while the commercial bank is the dealer of foreign currencies.
10. The chief executive of the central bank is designated as "Governor" whereas the chief executive of a commercial is called 'managing director or CEO'.

Functions of Central Bank-

A central bank performs the following functions:

1. Regulation of currency

The Central Bank of Kenya is the only institution in Kenya with full discretion and sole rights to issue currency notes and coins. The mandate is derived from the Laws of Kenya in the Central Bank of Kenya Act, Section 4 A (1) f. This mandate involves the following responsibilities:

- Planning, forecasting, procuring and distributing currency notes and coins.
- Setting up suitable currency distribution mechanisms.
- Safeguarding the integrity of Kenyan currency as a medium of exchange.
- Developing policies for proper handling.

In its role of issuing currency, the Central Bank must also ensure that currency is distributed throughout the country. To accomplish this, the Central Bank has Branches in Mombasa, Kisumu and Eldoret and

Currency Centres in Nyeri, Nakuru and Meru. These Branches and Currency Centres form a key focal point for currency distribution to the local financial institutions.

The monopoly issuing note vested in the central bank ensures uniformity in the notes issued which helps in facilitating exchange and trade within the country. It brings stability in the monetary system and creates confidence among the public. The central bank can restrict or expand the supply of cash according to the requirements of the economy. Thus it provides elasticity to the monetary system. By having a monopoly of notes issue to the central bank, the government is able to earn profit from printing notes whose cost is very low as compared with their face value.

Removal of Damaged Currency

Currency is considered damaged or unfit when it is mutilated, torn or marked with ink. It is typically removed from circulation when it is brought into the Central Bank, through deposits from commercial banks, and sorted out from fit currency. However, members of the general public who find damaged currency can also bring it to commercial banks or to the Central Bank offices and have it replaced, on condition that the following requirements are met:

1. They have not been deliberately mutilated
2. The currency must be genuine
3. The currency must be more than half and continuous
4. The banknote should bear at least one complete serial number

2. Banker, Fiscal Agent and Adviser to the Government.

Central banks everywhere act as bankers, fiscal agents and adviser to their respective governments. As bankers to the government, the central bank;

- keeps the deposits of the national government
- Makes payments on behalf of governments.
- It buys and sells foreign currencies on behalf of the government.
- It keeps the stock of gold of the government. Thus it is the custodian of government money and wealth.
- As fiscal agent, the central bank makes short-term loans to the government for period not exceeding 90 days.
- It floats loans, pays interest to them, and finally repays them on behalf of the government.Thus it manages the entire public debts.
- The central bank also advices the government on such economic and money matters as controlling inflation, deflation or revaluation of the currency, deficit financing, balance of payments, etc.

3. Custodian of Cash Reserve of Commercials banks

Commercials banks are required by law to keep reserves equal to a certain percentage both of time and demand deposits liabilities with the central banks. It is on the basis of these reserves that the central bank transfers funds from one bank to another to facilitate the clearing of cheques. Thus the central bank acts as the custodian of the cash reserves of commercial banks and helps in facilitating their transactions. There are many advantages of keeping the cash reserves of the commercial banks with the central bank. They include;

i. The centralization of cash reserves in the central bank is a source of great strength to the banking system of a country.

ii. Centralized cash reserves can serve as the basis of a large and more elastic credit structure than if the same amount were scattered among the individual bank.

iii. Centralized cash reserves can be utilized fully and most effectively during periods of seasonal strains and in financial crises or emergencies.

iv. By varying these cash reserve the central bank can control the credit creation by commercial banks.

v. The central bank can provide additional funds on a temporary and short term basis to commercial banks to overcome their financial difficulties.

4. Custody and Management of Foreign Exchange Reserves

As the custodian and manager of foreign exchange reserves the central bank does the following;

- The central bank keeps and manages the foreign exchange reserves of the country.
- It is an official reservoir of gold and foreign currencies.
- It sells gold at fixed prices to the monetary authorities of other countries.
- It also buys and sells foreign currencies at international prices.
- It fixes the exchange rates of narrow limits in keeping with its obligation as a member of the international Monetary Fund
- It tries to bring stability in foreign exchange rate.
- It manages exchange control operations by supplying foreign currencies to importers and person visiting foreign countries on business, studies, etc. in keeping with the rule laid down by the government.

5. Lender of the Last Resort

By granting accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers, or other financial institutions, the central bank acts as the lender resort. The central bank lends to such institution in order to help them in time of financial stress. This is done through the discount window

Discount Window; The discount window refers to a mechanism whereby eligible institutions (financial institutions, commercial banks) borrow money from the central bank, typically on a short term basis (and typically via repurchase and reverse repurchase agreements); and usually as a means of meeting temporary shortages of liquidity. The interest rate charged on such loans is called the discount rate (also referred to as the base rate or repo rate). The discount window is a key tool in promoting financial market and banking system stability, particularly when money markets tighten, as in times of crisis

5. Clearing House for Transfer and Settlement

As bankers' bank, the central bank acts as a clearing house for transfer and settlement of mutual claims of commercial banks. Since the central bank holds reserves of commercial banks, it transfers funds from one bank to other banks to facilitate clearing of cheques. This is done by making transfer entries in their accounts on the principal of book-keeping. To transfer and settle claims of one bank upon others, the central bank operates a separate department in big cities and trade centre. This department is known as the "clearing house" and renders the service free to commercial banks.

When the central bank acts as a clearing agency, it is time-saving and converting for the commercial banks to settle their claims at one place. It also economizes the use of money. "It is not only a means of economizing cash and capital but it's also a means of testing at any time the degree of liquidity which the community is maintaining."

7. Controller of credit

The most important function of the central bank is to control the credit creation power of commercial banks in order to control inflationary and deflationary pressures within this economy. For this purpose, it adopts quantitative method and qualitative method. Quantitative methods aim at controlling the cost and quantity of credit by adopting bank rate policy, open market operations and by variations in reserve ratios of commercial banks. Qualitative methods control the use direction of credit. These involve selective credit control and directed action. By adopting such methods, the central bank tries to influence and control credit by commercial banks in order to stabilize economic activity in the country.

Besides the above noted functions, the central banks in a number of developing countries have been entrusted with the responsibility of developing a strong banking system to meet the expanding requirements of agriculture, industry, traders and commerce. Accordingly, the central banks posses some additional powers of supervision and control over the commercial banks.

They are the issuing of licences; the regulation of branch expansion ;to see that every bank maintains the minimum paid up capital up capital and reserves as provided by law; inspecting or auditing such merger banks in accordance with the rules and qualifications; to control and recommend merger of weak bank in order to avoid their failures and protect the mend merger of weak banks in order to avoid their failures and to protect the interests of depositors; to recommend nationalism of certain banks to the

government in public interest; publish periodical reports relating to different aspects of monetary and economic policies for the benefit of banks and the public; and to engage in research and train banking personnel etc.

Role of Central Bank in a Developing Economy

The central bank in a developing economy performs both traditional and non-traditional functions. The principal traditional functions performed by it are the monopoly of note issue, banker to the government, bankers' bank, lender of the last resort, controller of credit and maintaining stable exchange rate. But all these functions are related to the foremost function of helping in the economic development of the country.

Role of Central Bank in the Economic Development

The central bank in a developing country aims at the promotion and maintenance of a rising level of production, employment and real income in the country. The central banks in the majority of underdeveloped countries have been given wide power to promote the growth of such economies. They therefore, perform the following functions towards this end.

a) **Creation and expansion of Financial Institutions.** One of the aims of a central bank in an underdeveloped country is to improve its currency and credit system. More banks and financial institutions are required to be set up to provide larger credit facilities and to divert voluntary savings into productive channels. Financial institutions are localized in big cities in underdeveloped countries and provide credit facilities to estates, plantations, big industrial and commercial houses. In order to remedy this, the central bank should extend branch banking to rural areas to make credit available to peasants, small businessmen and traders. In underdeveloped countries, the commercial banks provide only short-term loans. Credit facilities in rural areas are mostly non-existent. The only source is the village moneylender in rural areas can be slackened if new institutional arrangements are made by the central bank in providing short-term, medium term and long-term credit at lower interest rates to the cultivators. A network of co-operative credit societies with apex banks financed by the central bank can help solve the problem. Similarly it can help in the establishment of lead banks and through them regional rural banks for providing credit facilities to marginal farmers, landless agricultural works and other weaker sections. With the vast resources at its command, the central bank can also help in establishing industrial banks and financial corporations in order to finance large and small industries.

b) Proper Adjustment between Demand for and Supply of money

The central banks play an important role in bringing about a proper adjustment between demand and supply of money. An imbalance between the two is reflected in the price level. A shortage of money supply will inhibit growth while an excess of it will lead to inflation. As the economy develops the demand for money is likely to go up due to gradual monetization of the non-monetized sector and the increase in agriculture and industrial production and prices. The demand for money for transaction and speculative motives will also rise. So the increase in money supply will have to

be more than proportionate to the increase in money supply being used for speculative purposes, thereby inhibiting growth. The central bank controls the uses of money and credit by an appropriate monetary policy. Thus in an undeveloped economy, the central bank should control the supply of money in such a way that the price level is prevented from rising without affecting investment and production adversely.

c) **A Suitable Interest Rate Policy**. In an underdeveloped country the interest rate structure stands at a very high level. There are also vast disparities between long-term and short-term interest rates in different sectors of the economy. The existence of high interests rates acts as an obstacle to the growth of both private and public investment, in an underdeveloped economy. A low interest rate is therefore, essential for encouraging private investment in agriculture and industry. Since in underdeveloped countries businessmen have little savings out of undistributed profits, they have to borrow from the banks or from the capital market for purposes of investment and they would borrow only if the interest rate is low. A low interest rate policy is a cheap money policy. It makes public borrowing cheap, keeps the cost of servicing public debt low and thus helps in financing economic development.

   In order to discourage the flow of resource into speculative borrowing and investment, the central bank should follow a policy of discriminatory interest rates, charging high rates of non-essential and unproductive loans and low rates in productive loans. But this does not imply that savings are interest-elastic in an underdeveloped economy. Since the level of income is low in such economies, a high rate of interest is not likely to raise the propensity to save.

   In the context of economic growth as the economy develops, a progressive rise in the price level is inevitable. The value of money falls and the propensity to save declines further. Money conditions become tight and there is a tendency for the rate of interest to rise automatically. This could result in inflation. In such a situation any effort to control inflation by raising the rate of interest would be disastrous. A stable price level is, therefore, essential for the success of a low interest rate policy which can be maintained by the following a judicious monetary policy by the central which can be maintained by the following a judicious monetary policy by the central bank.

d) **Debt Management**. Debt Management is one of the important functions of the central bank in an underdeveloped country. It should aim at proper timing and issuing of government bonds and making timely changes in the structure and composition of public debt. It is the central bank which undertakes the selling and buying of government bonds and making timely changes in the structure and composition of public debt. In order to strengthen and stabilize the market for government bonds, the policy of low interest rates is essential. For a low rate of interest raises the price of government bonds, thereby making them more attractive to the public and giving an impetus to the public borrowing programmes of the government. The maintenance of structure of low interest rates is also called for in the minimizing of the cost of servicing the national debt. Further, it discourages funding of debt by private firms. However, the success of debt management in which would depend upon the existence of well-developed money and capital markets in which wide range of securities exist both for short and long-term periods. It is central banks which can help in the development of these markets.

e) **Credit Control**. Central bank should aim at controlling credit in order to influence the pattern of investments and production in a developing economy. Its main objective is to control inflationary pressures arising in the process of development. This requires the use of both quantitative and qualitative methods of credit control.

f) **Solving the balance of Payment Problem.** The central bank should also aim at preventing and solving the balance of payments problems in a developing economy. Such economies face serious balance of payment difficulties to fulfill the targets of development. An imbalance is created between imports and exports which continue to widen with development. The central bank manages and controls the foreign exchange of the country and also acts as the technical adviser to the government on foreign exchange policy. It is the function of the stability. It does so through exchange controls and variations in the bank rate. For instance, if the value of the national currency continues to fall, it may raise the bank rate and thus encourage the inflow of foreign currencies.

Conclusion. Thus the central bank plays an important role in achieving economic growth of a developing country through the various measures discussed above. It should promote economic growth with stability, help in attaining full employment of resources, in overcoming balance of payments disequilibrium, and in stabilizing rates.

b) Commercial Banks

Evolution, Origin and Growth of Banking

The word 'bank' is used in the sense of a commercial bank. It is of Germanic origin though some persons trace its origin to the French word 'Banqui' and the Italian word 'Banca'. It referred to a bench for keeping, lending, and exchanging of money or coins in the market place by money lenders and money changers.

There was no such word as 'banking' before 1640, although the practice of safe-keeping and savings flourished in the temple of Babylon as early as 2000 B.C. Chanakya in his Arthashastra written in about 300 B.C. mentioned about the existence of powerful guilds of merchant bankers who received deposits, advanced loans and issued hundis (letter of transfer). The Janin scriptures mention the names of two bankers who built the famous Dilwara Temples of Mount Abu during 1197 and 1247 A.D.

The first bank called the 'Bank of Venice' was established in Venice, Italy in 1157 to finance the monarch in his wars. The bankers of Lombardy were famous in England.

But modern banking began with the English goldsmiths only after 1640. The first bank in India was the 'Bank of Hindustan' started in 1770 by Alexander & Co., an English agency house in Calcutta which failed in 1782 with the closure of the agency house

It was the 'merchant worker' who first evolved the system of banking by trading in commodities than money. Their trading activities required the remittances of money from one place to another. For this, they issued 'hundis' to remit funds. In India, such merchant bankers were known as 'Seths'.

The next stage in the growth of banking was the goldsmith. The business of goldsmith was such that he had to take special precautions against theft of gold and jewellery. If he seemed to be an honest person, merchants in the neighbourhood started leaving their gold, money and ornaments in his care. As this practice spread, the goldsmith started charging something for taking care of the money and gold. As evidence for receiving valuables, he issued a receipt. Since gold and silver coins had no marks of the owner, the goldsmith started lending them. As the goldsmith was prepared to give the holder of the receipt an equal amount of money on demand; the goldsmith receipts became like cheques as a medium of exchange and a means of payment.

The next stage in the growth of banking is the moneylender. The goldsmith found that on an average the withdrawals of coins were much less than the deposits with him. So he started advancing coins on loan by charging interest. As a safeguard, he kept some money in the reserve. Thus the goldsmith-moneylender became a banker who started performing the two functions of modern banking that of accepting deposits and advancing loans.

Characteristics of Banking

i. Banker deals with others' money

ii. Banks repay deposits either on demand or after the expiry of specified period

iii. They utilise deposits for lending/investment

iv. They perform subsidiary services and innovative functions

v. Banking should be dominant part of business of bank

Types of Banks

They include:

1. Commercial banks/Deposit banks

Banks accept deposits from public and lend them mainly for commercial purposes for comparatively shorter periods are called Commercial Banks. They provide services to the general public, organisations and to the corporate community. They are oldest banking institution in the organised sector. Commercial banks make their profits by taking small, short-term, relatively liquid deposits and transforming these into larger, longer maturity loans. This process of asset transformation generates net income for the commercial bank. Many commercial banks do investment banking business although the latter is not considered the main business area.

Features of Commercial banks are;

- They accept deposits on various accounts.
- Lend funds to organisations, trade, commerce, industry, small business, agriculture etc by way of loans, overdrafts and cash credits.
- They are the manufacturers of money.
- They perform many subsidiary services to the customer.
- They perform many innovative services to the customers.

2. Industrial banks/Investment banks

Industrial banks are those banks which provide fixed capital to industries. They are also called investment banks, as they invest their funds in subscribing to the shares and debentures of industrial concerns. They are seen in countries like US, Canada, Japan, Finland, and Germany.

Features of Industrial Banks are:

- Participate in management.
- Advise industries in making right investment
- Advise govt. on matters relating to industries

3. Agricultural banks

Agricultural banks are banks which provide finance to agriculture and allied sectors. It is found in almost all the countries. They are organised generally on co-operative basis. They generally give credit facilities to small farmers, salaried employees, small-scale industries, etc. Co-operative Banks are available in rural as well as in urban areas. Agricultural banks are of two types;

4. Agricultural co-operative banks: They provide short term finance to farmers for purchasing fertilizers, pesticides and seeds and for the payment of wages.

5. Land Development Banks: They provide long term finance for making permanent improvement on land. They assist to purchase machinery, equipments, installation of pump sets, construction of irrigation works etc.

5. Exchange banks

Exchange banks finances foreign exchange business (export, import business) of a country.Special exchange banks are found only in some countries. The main functions of exchange banks are remitting money from one country to another country, discounting of foreign bills, buying and selling gold and silver, helping import and export trade etc.

6. Savings bank

Savings banks are those banks which specialise in the mobilisation of small savings of the middle and low income group. They help promote small savings and mobilize them. They have been very successful in Japan and Germany. In Kenya, saving bank activities are done by commercial banks and the post offices including the postbank.

Features of savings banks are;

- Mobilise small and scattered savings
- Promote habit of thrift and savings
- Keep only small portion in hand and invest major part in govt. securities
- They do not lend to general public.

6. Central / National banks

It is the highest banking and monetary institution in a country. It is the leader of all other banks. Since it is occupying a central position, it's known as Central Bank. It is operating under state's control and is not a profit motive organisation. Central Bank of Kenya, Reserve Bank of India (India), Bank of Canada (Canada), Federal Reserve System(USA) etc are examples of Central Banks. The **main functions** of a Central Bank are;

- Monopoly of currency issue
- Acts as banker to the govt.
- Serves as bankers' bank
- Act as controller of credit
- Custodian of nation's gold and foreign exchange reserve.

Functions of Commercial Banks

Commercial banks perform a variety of functions which can be divided as: (1) accepting deposits; (2) advancing loans; (3) credit creation; (4) financing foreign trade; (5) agency services; (6) miscellaneous services to customers, and (7) innovative functions

These functions are discussed below:

(1) Accepting Deposits

Most important function of a commercial bank is to accept deposit from those who can save but cannot profitably utilise these savings themselves. By making deposits in bank, savers can earn something in the form of interest and avoid the danger of theft. To attract savings from all sorts of customers, banks maintain different types of accounts such as current account, Savings bank account, Fixed Deposit account.

Features of Current Accounts

- It is generally opened by trading and industrial concerns.
- It is opened not for profit or savings but for convenience in payments
- Introduction is necessary to open the account.
- Any number of transactions permitted in the account.
- Withdrawals are generally allowed by cheque
- Deposit is repayable on demand

- No interest is allowed but incidental charges claimed.
- Overdraft facilities are allowed

Features of Saving Bank (SB) accounts

- It is generally opened by middle/low income group who save a part of their income for future needs
- Introduction is necessary to open the account if cheque facility is allowed.
- There are some restrictions on number of withdrawals.
- Fair interest (less than FD) is offered on the deposits of this account.

Features of Fixed Deposit accounts

- It is generally opened by small investors who do not want to invest money in risky industrial securities like shares.
- No introduction is necessary to open the account.
- No maximum limit for investing.
- Minimum period of investment is 15 days
- Withdrawal is allowed only after the expiry of a fixed period.
- Withdrawal is generally allowed by surrendering FD Receipt
- Higher rate of interest is offered on the deposits of this account

(2) Advancing Loans

One of the primary functions of a commercial bank is to advance loans to its customers. A bank lends a certain percentage of the cash in deposits on a higher interest rate than it pays on such deposits. This is how it earns profits and carries on its business. The bank advances loans in the followings ways:

i. **Cash Credit** – The bank advances loans to businessmen against certain specified securities. The amount of the loan is credited to the current account of the borrower. In case of a new customer a loan account for the sum is opened. The borrower can withdraw money through cheques according to his requirements but pays interest on the full amount.

ii. **Call Loans** – These are very short-term loans advanced to the bill brokers for not more than fifteen days. They are advanced against first class bills or securities. Such loans can be recalled at a very short notice. In normal times they can also be renewed.

iii. **Overdraft** – A bank overdraft often permits a businessman to draw cheques for a sum greater than the balance lying in his current account. This is done by providing the overdraft facility up to a specific amount to the businessman. But he is charged interest only on the amount by which his current account is actually overdrawn and not by the full amount of the overdraft sanctioned to him by the bank.

iv. **Discounting Bills of Exchange** – If a creditor holding a bill of exchange wants money immediately, the bank provides him the money by discounting the bill of exchange. It deposits the amount of the bill in the current account of the bill-holder after deducting its rate of interest for the period of the loan which is not more than 90 days. When the bill of exchange matures, the bank gets its payment from the banker of the debtor who accepted the bill.

(3) Credit Creation

Credit creation is one of the most important functions of the commercial banks. Like other financial institutions, they aim at earning profits. For this purpose, they accept deposits and advance loans by keeping small cash in reserve for day to day transactions. When a bank advances a loan, it opens an account in the name of the customer and does not pay him in cash but allows him to draw the money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

(4) Financing Foreign Trade

A commercial bank finances foreign trade of its customers by accepting foreign bill of exchange and collecting them from foreign banks. It also transacts other foreign exchange business and buys and sells foreign currency.

(5) Agency Services

A bank acts as an agent of its customers in ;

- Collecting and paying cheques, bills of exchange, drafts, dividends etc.
- Buying and selling shares, debentures etc for its customers.
- Paying subscriptions, insurance premium, rent, electric and water bills, and other similar charges on behalf of its clients.
- Acting as a trustee of its customers.
- Acting as an income tax consultant to its clients.
- Acting as the executor of the will of its customers.

For these services, the bank charges a nominal fee.

(6) Miscellaneous Services

Besides the above noted services, the commercial bank performs a number of other services which includes;

- It acts as the custodian of the valuables of its customers by providing them lockers where they keep their jewellery and valuable documents
- It issues various forms of credit instruments, such as cheques, drafts, travellers cheques etc which facilitate transactions.
- The bank also issues letters of credit
- The bank also acts as a referee to its clients.
- It underwrites shares and debentures of companies and help in the collection of funds from the public.
- Some commercial banks also publish journals which provide statistical information about the money market and business trends of the economy.

7) Innovative Functions

The adoption of Information and Communication technology enables banks to provide many innovative services to the customers such as;

1. ATM services

Automated Teller Machine (ATM) is an electronic telecommunications device that enables the clients of banks to perform financial transactions by using a plastic card. Automated Teller Machines are established by banks to enable its customers to have anytime money. It is used to withdraw money, check balance, transfer funds, get mini statement, make payments etc. It is available at 24 hours a day and 7 days a week.

2. Debit Card and Credit Card Facility

Debit card is an electronic card issued by a bank which allows bank clients access to their account to withdraw cash or pay for goods and services. It can be used in ATMs, Point of Sale terminals, e-commerce sites etc. Debit card removes the need for cheques as it immediately transfers money from the client's account to the business account. Credit card is a card issued by a financial institution giving the holder an option to borrow funds, usually at point of sale. Credit cards charge interest and are primarily used for short- term financing.

3. Tele-banking :

Telephone banking is a service provided by a bank or other financial institution, that enables customers to perform financial transactions over the telephone, without the need to visit a bank branch or automated teller machine

4. Internet Banking:

Online banking (or Internet banking or E-banking) is a facility that allows customers of a financial institution to conduct financial transactions on a secured website operated by the institution. To access a financial institution's online banking facility, a customer must register with the institution for the service, and set up some password for customer verification. Online banking can be used to check balances, transfer money, shop onlline, pay bills etc.

5. Bancassurance:

It means the delivery of insurance products through banking channels. It can be done by making an arrangement in which a bank and an insurance company form a partnership so that the insurance company can sell its products to the bank's client base. Banks can earn additional revenue by selling the insurance products, while insurance companies are able to expand their customer base without having to expand their sales forces

6. Mobile Banking:

Mobile banking is a system that allows customers of a financial institution to conduct a number of financial transactions through a mobile device such as a mobile phone or personal digital assistant. It allows the customers to bank anytime anywhere through their mobile phone. Customers can access their banking information and make transactions on Savings Accounts, Demat Accounts, Loan Accounts and Credit Cards at absolutely no cost.

7. Electronic Clearing Services :

It is a mode of electronic funds transfer from one bank account to another bank account using the services of a Clearing House. This is normally for bulk transfers from one account to many accounts or vice-versa. This can be used both for making payments like distribution of dividend, interest, salary, pension, etc. by institutions or for collection of amounts for purposes such as payments to utility companies like telephone, electricity, or charges such as house tax, water tax etc

8. Electronic Fund Transfer/National Electronic Fund Transfer(NEFT):

National Electronic Funds Transfer (NEFT) is a nation-wide payment system facilitating one-to-one funds transfer. Under this Scheme, individuals, firms and corporate can electronically transfer funds from any bank branch to any individual, firm or corporate having an account with any other bank branch in the country participating in the Scheme. In NEFT, the funds are transferred based on a deferred net settlement in which there are 11 settlements in week days and 5 settlements in Saturdays.

9. Real Time Gross Settlement System (RTGS):

It can be defined as the continuous (real-time) settlement of funds transfers individually on an order by order basis . 'Real Time' means the processing of instructions at the time they are received rather than at some later time. It is the fastest possible money transfer system in the country.

Role of Commercial Banks in a Developing Country

Besides performing the usual banking functions, banks in developing countries play an effective role in their economic development. The majority of people in such countries are poor, unemployed and engaged in traditional agriculture. There is acute shortage of capital

1.Mobilizing Savings for Capital Formation – The commercial banks help in mobilizing savings through a network of branch banking. People in developing countries have low incomes but the banks induce them to save by introducing variety of deposit schemes to suit the needs of individual depositors. They also mobilize idle savings of the few rich. By mobilizing savings, the banks channelize them into productive investments. Thus they help in the capital formation of a developing country.

2. Encouragement to entrepreneurial innovations

Entrepreneurs in developing economies, generally hesitate to invest & undertake innovations due to lack of fund. Bank loan facilities enable them to introduce innovative ideas and increase productive capacity of the economy.

3. Monetisation of economy

Monetisation means allowing money to play an active role in the economy. Banks, which are creators and distributors of money, help the monetisation in two ways;

- They monetise debt i.e., buy debts (securities) which are not as acceptable as money and convert them to demand deposits which are acceptable as money.
- By spreading branches in rural areas they convert non-monetised sectors of the economy to monetised sectors.

4. Influencing economic activity

They can directly influence the economic activity and pace of economic development through its influence on:

- The rate of interest (reduction in rates make investment more profitable and stimulates economic activity)
- Availability of credit. (Through Credit creation banks helps in increasing supply of purchasing power)

5. Promotion of trade and industry

The commercial banks finance the industrial sector in a number of ways. They provide short-term, medium-term and long term loans to industry. Economic progress of industrialised countries in last 2 centuries is mainly due to expansion in trade and industrialisation which could not have been made possible without development of a good banking system. Use of cheques, drafts and Bill of exchange as a medium of exchange has revolutionalised the internal and international trade which in turn accelerated the pace of industrialisation.

6. Regional development

Banks can play role in achieving balanced development in different regions of the economy. They can transfer surplus funds from developed region to less developed regions, where there is shortage of funds.

7.Financing Agriculture – The commercial banks help the large agricultural sector in developing countries in a number of ways. They provide loans to traders in agricultural commodities. They open a network of branches in rural areas to provide agricultural credit. They provide finance directly to agriculturists for the marketing of their produce, for the modernization and mechanization of their farms, for providing irrigation facilities, for developing land etc. they also provide financial assistance for animal husbandry, dairy farming, sheep breeding, poultry farming and horticulture. The small and marginal farmers and landless agricultural workers, artisans and petty shopkeepers in rural areas are provided financial assistance through the regional rural banks. These regional rural banks operate under a commercial bank. Thus the commercial banks meet the credit requirements of all types of rural people.

8. Financing Consumer Activities – People in underdeveloped countries being poor and having low incomes do not possess sufficient financial resources to buy durable consumer goods. The commercial banks advance loans to consumers for the purchase of such items as houses, scooters, fans, refrigerators, etc. in this way, they also help in raising the standard of living of people in developing countries by providing loans for consumptive activities.

9. Financing Employment Generating Activities – The commercial banks finance employment generating activities in developing countries. They provide loans for the education of young persons studying in engineering, medical and other vocational institutes of higher learning. They advance loans entrepreneurs, medical and engineering graduates, and other technically trained persons in establishing their own business. Such loan facilities are being provided by a number of commercial banks in Kenya. Thus the banks not only help in human capital formation but also in increasing entrepreneurial activities in developing countries.

List of Commercial Banks in Kenya (2015)

1 African Banking Corporation Limited

2 Bank of Africa Kenya Limited

3 Bank of Baroda (K) Limited

4 Bank of India

5 Barclays Bank of Kenya Limited

6 CfC Stanbic Bank Limited

7 Charterhouse Bank Limited

UNDER - STATUTORY MANAGEMENT

8 Chase Bank (K) Limited

9 Citibank N.A Kenya

10 Commercial Bank of Africa Limited

11 Consolidated Bank of Kenya Limited

12 Co-operative Bank of Kenya Limited

13 Credit Bank Limited

14 Development Bank of Kenya Limited

15 Diamond Trust Bank Kenya Limited

16 Ecobank Kenya Limited

17 Equatorial Commercial Bank Limited

18 Equity Bank Limited

19 Family Bank Limited

20 Fidelity Commercial Bank Limited

21 Guaranty Trust Bank (K) Ltd

22 First Community Bank Limited

23 Giro Commercial Bank Limited

24 Guardian Bank Limited

25 Gulf African Bank Limited

26 Habib Bank A.G Zurich

27 Habib Bank Limited

28 Imperial Bank Limited (IN RECEIVERSHIP)

29 I & M Bank Limited

30 Jamii Bora Bank Limited

31 Kenya Commercial Bank Limited

32 Sidian Bank Limited (Formerly K-Rep Bank)

33 Middle East Bank (K) Limited

34 National Bank of Kenya Limited

35 NIC Bank Limited

36 Oriental Commercial Bank Limited

37 Paramount Universal Bank Limited

38 Prime Bank Limited

39 Standard Chartered Bank Kenya Limited

40 Transnational Bank Limited

41 UBA Kenya Bank Limited

42 Victoria Commercial Bank Limited

Mortgage Finance Companies

1. HFC Limited

Authorised Non-Operating Bank Holding Companies

1.Bakki Holdco Limited

Licensed Subsidiary: Sidian Bank Ltd (formerly K-Rep Bank Ltd)

2 **CfC Stanbic Holdings Limited**

Licensed Subsidiary: CfC Stanbic Bank Ltd

3 **Equity Group Holdings Limited**

Licensed Subsidiary: Equity Bank Kenya Ltd

4 **HF Group Limited**

Licensed Subsidiary: HFC Ltd

5 **I & M Holdings Limited**

Licensed Subsidiary: I & M Bank Kenya Ltd

6 **KCB Group Limited**

Licensed Subsidiary: KCB Bank Kenya Ltd

7 **M Holdings Limited**

Licensed Subsidiary: Oriental Commercial Bank Ltd

Authorised Representative Offices

1 Bank of China Limited Kenya Representative Office

2 Bank of Kigali Ltd Kenya Representative Office

3 FirstRand Bank Limited Kenya Representative Office

4 HDFC Bank Limited Kenya Representative Office

5 Mauritius Commercial Bank Limited Kenya Representative Office

6 Nedbank Limited Kenya Representative Office

7 Rabobank Nederland Kenya Representative Office

Microfinance Banks

1 Caritas Microfinance Bank Limited

2 Century Microfinance Bank Limited

3 Choice Microfinance Bank Limited

4 Daraja Microfinance Bank Limited

5 Faulu Microfinance Bank Limited

6 Kenya Women Microfinance Bank Limited

7 Rafiki Microfinance Bank Limited

8 Remu Microfinance Bank Limited

9 SMEP Microfinance Bank Limited

10 Sumac Microfinance Bank Limited

11 U & I Microfinance Bank Limited

12 UWEZO Microfinance Bank

13 Maisha Microfinance Bank Limited

Credit Reference Bureaus

1. Credit Reference Bureau Africa Limited (Trading as TransUnion)

2. Metropol Credit Reference Bureau Limited

3. Creditinfo Credit Reference Bureau Kenya Limited

Other Depository Corporation under Liquidation

1 Trade Bank Ltd.

2 Pan African Bank Ltd.

3 Meridien Biao Bank Ltd.

4 Heritage Bank Ltd.

5 Kenya Finance Bank Ltd.

6 Ari Bank Corporation Ltd

7 Prudential Bank Ltd.

8 Reliance Bank Ltd.

9 Trust Bank Ltd.

10 Euro Bank Ltd.

11 Prudential Building Society

12 Daima Bank Ltd.

Other Financial Corporation under Liquidation

1 Central Finance Ltd.

2 Fortune Finance Ltd.

3 Inter-Africa Credit & Finance Ltd.

4 Middle Africa Finance Ltd.

5 Pan-African Credit & Finance Ltd.

6 Postbank Credit Ltd.

7 Thabiti Finance Ltd.

Mergers And Acquisitions Among The Kenyan Financial Institutions

Due to changes in the operating environment, several licensed institutions, mainly commercial banks, have had to merge (combine their operations in mutually agreed terms) or one institution takes over another's operations (acquisitions). Some of the reasons put forward for mergers and acquisitions are: to meet the increased levels of share capital; expand distribution network and market share; and to benefit from best global practices among others. The schedules below detail the Institutions which have merged or participated in acquisitions as well as the dates when mergers or acquisitions were approved.

No.	Institution	Merged with	Current Name	Date approved
1	9 Financial Institutions	All 9 Financial Institutions Merged together	Consolidated Bank of Kenya Ltd	1989
2	Indosuez Merchant Finance	Banque Indosuez	Credit Agricole Indosuez	10.11.1994
3	Transnational Finance Ltd.	Transnational Bank Ltd.	Transnational Bank Ltd.	28.11.1994
4	Ken Baroda Finance Ltd.	Bank of Baroda (K) Ltd.	Bank of Baroda (K) Ltd.	02.12.1994
5	First American Finance Ltd.	First American Bank Ltd.	First American Bank (K) Ltd.	05.09.1995
6	Bank of India	Bank of India Finance Ltd.	Bank of India (Africa) Ltd.	15.11.1995

7	Stanbic Bank (K) Ltd.	Stanbic Finance (K) Ltd.	Stanbic Bank Kenya Ltd.	05.01.1996
8	Mercantile Finance Ltd.	Ambank Ltd.	Ambank Ltd.	15.01.1996
9	Delphis Finance Ltd.	Delphis Bank Ltd.	Delphis Bank Ltd.	17.01.1996
10	CBA Financial Services	Commercial Bank of Africa ltd	Commercial Bank of Africa ltd	26.01.1996
11	Trust Finance Ltd.	Trust Bank (K) Ltd.	Trust Bank (K) Ltd.	07.01.1997
12	National Industrial Credit Bank Ltd.	African Mercantile Banking Corp.	NIC Bank Ltd.	14.06.1997
13	Giro Bank Ltd.	Commerce Bank Ltd.	Giro Commercial Bank Ltd.	24.11.1998
14	Guardian Bank Ltd.	First National Finance Bank Ltd.	Guardian Bank Ltd.	24.11.1998
15	Diamond Trust Bank (K) Ltd.	Premier Savings & Finance Ltd.	Diamond Trust Bank (K) Ltd.	12.02.1999
16	National Bank of Kenya Ltd.	Kenya National Capital Corp.	National Bank of Kenya Ltd.	24.05.1999
17	Standard Chartered Bank (K) Ltd.	Standard Chartered Financial Services	Standard Chartered Bank (K) Ltd.	17.11.1999
18	Barclays Bank of Kenya Ltd.	Barclays Merchant Finance Ltd.	Barclays Bank of Kenya Ltd.	22.11.1999
19	Habib A.G. Zurich	Habib Africa Bank Ltd.	Habib Bank A.G. Zurich	30.11.1999
20	Guilders Inter. Bank Ltd.	Guardian Bank Ltd.	Guardian Bank Ltd.	03.12.1999
21	Universal Bank Ltd.	Paramount Bank Ltd.	Paramount Universal Bank	11.01.2000
22	Kenya Commercial Bank	Kenya Commercial Finance Co.	Kenya Commercial Bank Ltd.	21.03.2001
23	Citibank NA	ABN Amro Bank Ltd.	Citibank NA	16.10.2001
24	Gold Bank Ltd.	Southern Credit Banking Corp. Ltd.	Southern Credit Banking Corp. Ltd.	07.12.2001
25	Co-operative Merchant Bank ltd	Co-operative Bank ltd	Co-operative Bank of Kenya ltd	28.05.2002

26	Biashara Bank Ltd.	Investment & Mortgage Bank Ltd.	Investment & Mortgage Bank Ltd.	01.12.2002
27	First American Bank ltd	Commercial Bank of Africa ltd	Commercial Bank of Africa ltd	01.07.2005
28	East African Building Society	Akiba Bank ltd	EABS Bank ltd	31.10.2005
29	Prime Capital & Credit Ltd.	Prime Bank Ltd.	Prime Bank Ltd.	01.01.2008
30	CFC Bank Ltd.	Stanbic Bank Ltd.	CFC Stanbic Bank Ltd.	01.06.2008
31	Savings and Loan (K) Limited	Kenya Commercial Bank Limited	Kenya Commercial Bank Limited	01.02.2010
32	City Finance Bank Ltd.	Jamii Bora Kenya Ltd.	Jamii Bora Bank Ltd.	11.02.2010
33	Equatorial Commercial Bank Ltd	Southern Credit Banking Corporation Ltd	Equatorial Commercial Bank Ltd	01.06.2010

Acquisitions

No.	Institution	Acquired by	Current Name	Date approved
1	Mashreq Bank Ltd.	Dubai Kenya Ltd.	Dubai Bank Ltd.	01.04.2000
2	Credit Agricole Indosuez (K) Ltd.	Bank of Africa Kenya Ltd.	Bank of Africa Bank Ltd.	30.04.2004
3	EABS Bank Ltd.	Ecobank Kenya Ltd.	Ecobank Bank Ltd.	16.06.2008

c) Non-Bank Financial Institutions (NBFIs)

Meaning

NBFIs were set up to fill a gap in the financial system and rectify inefficiencies in loan facilities. These specialized financial institutions supplement the availability of finance provided by commercial banks. The NBFIs are both public and private. These institutions mobilize savings, in competition with commercial banks. The savings are then channeled into credit for commerce, agriculture, industry and household sectors. Non-bank financial intermediaries are such institutions as savings and loan associations, life insurance companies, mutual savings banks, pension funds, and government lending agencies such as The Youth Enterprise Development Fund, The Women Enterprise Development Fund and the Uwezo fund. These intermediaries pool funds from net savers and lend them to finance expenditures of business firms and local bodies. Kenya continues to develop a wider range of these financial institutions.

The Growth of NBFIS

In 1980s, (NBFIS) grew rapidly in number, assets and liabilities. This growth mainly reflected some defects in the banking act such as:

• The minimum capital required to establish NBFIS was lower than needed by Commercial banks.

• Unlike banks, NBFIS were not required to maintain cash reserve ratio.

• NBFIs were permitted to impose higher lending rates on their facilities.

• Banks were restricted from undertaking mortgage lending.

• Banks would only lend the equivalent of 25% or less of their capital to any one single borrower.

The growth of non-banking institutions was a development that was so positive. Initially, they provided financial services that were specialized. This included hire purchase, leasing and merchant banking. The regulatory differences encouraged commercial banks to set up non-banking financial institutions to avoid the restrictions enforced on them and benefit from the higher interest rates. As a result, the restrictions between banks and NBFIs started to lessen with time, causing the competition between them to increase.

The increasing competition forced many of the NBFIs to become unusually aggressive. Some undertook risky lending and mismatched maturities whereby they accepted lower matches. The operation of non-banking financial institutions became unsustainable and contributed to the collapse of several institutions in mid 1980s and early 1990s. As a result, there was a flight of quality depository institutions as most depositors shifted funds from small NBFIs to larger and more established banks.

The Central Bank, on realizing that NBFIs were no longer complimenting activities of commercial banks, took the following measures:

1. It broadened the definition of money supply so as to include the deposits held at NBFIs.

2. With effect from 1995 NBFIS were required to observe cash ratio requirements at stipulated levels. They were to do this by involving reserves at the Central Bank.

3. It adopted the policy of universal banking in 1995. Since then, the central bank has encouraged NBFIS to convert into Commercial banks and merge where possible

Cases Where NBFIS are Affiliated to Commercial Banks

By August 2000, 25 conversions and 12 mergers had occurred, leaving only 11 institutions still operating as NBFIs.

Examples of Non Banking Financial Institutions In Kenya

The following institutions are categorized as specified financial institutions because they fall under the regulatory provision of the Central Bank of Kenya Act. They include:

a)Housing Finance of Kenya.

b)Savings and Loan Kenya Ltd.

c)Akiba Loans and Finance Ltd.

d)Kenya National Capital Cooperation Ltd

e)Commercial Bank of Africa Finance Company.

f)The Kenya Commercial Finance Company.

g) Mombasa Savings and Finance Ltd.

h)Industrial Development Bank. (IDB)

i)Kenya industrial estates

The Role of Non-Bank Financial Intermediaries

Non-bank financial intermediaries operate in both money and capital markets depending upon the type of financial institution. The rationale for their participation in money markets is similar to that of commercial banks. However, these institutions tend to concentrate their borrowing and investment in instruments different from those used by commercial banks. For example, mutual savings banks, life insurance companies and building societies are suppliers of long term funds in the capital markets. Investment companies are also involved in capital markets when they purchase and sell stocks and bonds. Finance companies, especially the deposit taking types, are short-term demanders and suppliers of funds, often borrowing on short-term basis from banks to make short-term consumer loans. They act as intermediaries between deficit and surplus units of the economy in the financial intermediation process which is the essence of the role of financial institutions within the markets and the general economy at large.

The role of non-bank financial intermediaries in the Kenyan economy is as follows:

a) They stimulate competition with commercial banks over deposits and over the credit market, which stimulates efficiency in terms of improved services for savers and borrowers in the financial market.

b) They have enhanced the development of the financial market through the introduction of a great variety of financial instruments. Thus, for example, deposits such as investment deposits accounts, mortgage deposit accounts, savings and credit union members' contribution accounts, building societies members' accounts feature in the financial market. A greater variety of financial instruments is desirable for the development of financial markets in order to cater for differences in

savers' and borrowers' interests.

c) Commercial banks traditionally lend out funds on a short-term basis to safe borrowers and thus do not effectively cater for long term, risky borrower market whereas non-bank financial intermediaries often lend out on longer-term basis and to risky areas, which explains why, they often charge high rates of interest than commercial banks.

d) Non-bank financial intermediaries often provide financial services, which are beyond the scope of commercial banks such as chattel mortgage loans and purchase finance.

e) The development of non-bank financial intermediaries through expansion of the financial markets has created an additional vehicle for the more effective execution of the government's monetary policy.

Differences between Commercial Banks and Non-Bank Financial Institutions

The major differences between commercial banks and non-bank financial institutions are as follows:

a) Commercial banks operate cheque accounts, which make them members of the central bank clearing houses whereas non-bank financial institutions are not members of the central bank clearing houses since they do not operate cheque accounts.

b) Commercial banks can create credit by allowing cheques to be drawn on them in excess of the amounts deposited with them whereas non-bank financial institutions merely transmit funds that have been deposited with them.

c) Commercial banks usually accept short term deposits and lend on short term to relatively secure borrowers, whereas non-bank financial intermediaries may accept long term deposits and lend on relatively long term and more risky ventures which enables them to charge higher interest rates.

d) Commercial banks operate bank accounts with the central bank, which is the banker's bank whereas non-bank intermediaries do not have this facility.

e) Some deposits placed with commercial banks, notably current account deposits, are non-interest bearing whereas all deposits placed with non-bank financial intermediaries are interest bearing.

LESSON FOUR: THE SUPPLY OF MONEY

Definitions of Money Supply

The supply of money is a stock at a particular point of time, though it conveys the idea of a flow over time. The term ‘the supply of money’ is synonymous with such terms as ‘money stock’, stock of money’ ‘money supply’ and quality of money’. The supply of money at any moment is the total amount of money in the economy. It is the currency in the form of notes and coins with the public, plus all the

deposits the public hold with deposit taking institutions. There are four alternative views regarding the definition or measures of money supply.

The **most common** view is associated with the traditional and Keynesian thinking which stresses the **medium of exchange function of money**. According to this view, money supply is defined as **currency with the public** and demand deposits (current account deposits) with commercial banks. These are liquid form of money because depositors can draw cheques for any amount lying in their accounts and the bank has to make immediate payment on demand. Demand deposits with commercial banks plus currency with the public are together denoted as M_1, the money supply. This is referred to as the Traditional Approach. This is regarded as a narrower definition of the money supply.

The **second definition** is broader and is associated with the modern quality theorists headed by Friedman. Professor Friedman defines the money supply at any moment of time as '**literally the number of dollars people are carrying around in their pockets, the number of dollars they have to their credit at banks** in the form of **demand deposits**, and also commercial banks time deposits." Time deposits are fixed deposits of customers in a commercial bank. Such deposits earn a fixed rate of interest varying with the time period for which the amount is deposited. Money can be withdrawn before the expiry of that period by paying a penal rate of interest to the bank. So time deposits possess liquidity and are included in the money supply by Friedman. Thus this definition includes M_1 plus time deposits of commercial banks in the supply of money. This wider definition is known as M_2 in America and M_3 in Britain and India. It stresses the store of value function of money or what Friedman says, 'a temporary abode of purchasing power'. This is referred to as the Monetarist Approach

The **third definition** is the broader. According to this approach, money includes currency, demand deposits, time deposits , savings bank deposits ,shares (S), bonds (B), etc. This is referred to as the Liquidity Approach

The fourth **definition** is the broadest. According to this approach, money includes currency, demand deposits, time deposits, credit from non-bank financial institutions (CNBFI) and credit from unorganised agencies (CUA). This is referred to as the Central Bank Approach

BANK CAPITAL DEPOSITS, LOANS, NPLS AND PROFITABILITY (2018)

	BANK NAME	Category	CAPITAL SHAREHOLDERS FUNDS (Millions)	DEPOSITS (millions)	LOANS (millions)	BALANCE millions)	NPLS (millions)	PROFITS (millions)
1	KCB Bank Kenya Ltd	Large	97.7	475,396	434,361	41,035	30,012	31,384.94
2	Co-operative Bank of Kenya Ltd	Large	68.3	303,450	257,566	45884	28,953	17,586.76

3	Equity Bank Kenya Ltd	Large	60.5	340,941	231,026	109,915	17,064	24,382.34
4	Barclays Bank of Kenya Ltd	Large	43.3	207,105	186,984	20111	13,910	10,250.07
5	Standard Chartered Bank Kenya Ltd	Large	47.7	223,391	133,166	90225	21,661	11,433.57
6	Commercial Bank of Africa Limited	Large	33.7	182,261	118,271	63990	9,271	7,952.41
7	Diamond Trust Bank Kenya Limited	Large	45.3	204,831	152,287	52544	11,036	9,264.77
8	Stanbic Bank Kenya Ltd	Large	34.5	196,539	155,498	41041	16,644	8,797.96
9	I & M Bank Ltd	Large	38.3	175,177	144,434	30743	21,115	8,725.33
10	NIC Bank PLC	Medium	31.1	134,992	117,786	17286	15,830	5,982.05
TOTAL FOR THE BANKING INDUSTRY			**678.3 Billion**	**3.3 TRILLION**	**2.4 TRILLION**	**0.9 TRILLION**	**316 BILLION**	**152 BILLION**

Determinants of Money Supply

There are two theories of the determination of the money supply. According to the first view, the money supply is determined **exogenously** by the central bank. The second view holds that the money supply is determined **endogenously** by changes in the economic activity which affects people's desire to hold currency relative to deposits, the rate of interest, etc.

Main determinants of the supply of money are (a) monetary base and (b) the money multiplier. These two broad determinants of money supply are, in turn, influenced by a number of other factors. They are discussed below:

a. Monetary Base:

Monetary base refers to the supply of funds available for use either as cash or reserves of the central bank. Monetary base changes due to the policy of the government and is also influenced by the value of money.Magnitude of the monetary base is the significant determinant of the size of money supply. Money supply varies directly in relation to the changes in the monetary base.

b. Money Multiplier:

Money multiplier has positive influence upon the money supply. An increase in the size of money multiplier will increase the money supply and vice versa.

Money multiplier (also known as monetary multiplier) represents the maximum extent to which the money supply is affected by any change in the amount of deposits. It equals ratio of increase or decrease in money supply to the corresponding increase and decrease in deposits.

Money Multiplier Effect

The money multiplier effect arises due to the phenomenon of credit creation. When a commercial bank receives an amount A, its total reserves are increased. The bank is required by the central bank to hold only an amount equal to $r \times A$ in hand to meet the demand for withdrawals, where r is the required reserve ratio. The bank is allowed to extend the excess reserves i.e. $(A - r \times A)$ as loans. When the borrower keeps the whole amount of loan in bank (it is assumed), it increases its total reserves by an amount equal to $(A - r \times A)$. Again, the bank is required to hold only a fraction of this second round of deposits and it can lend out the rest. This cycle continues such the ultimate increase in money supply due to an initial increase in checking deposits of amount A is equal to $m \times A$, where m is the money multiplier. The opposite happens in case of a decrease in deposits through the same mechanism.

Formula

$$\text{Money Multiplier} = \frac{1}{\text{Required Reserve Ratio}}$$

Required reserve ratio is the fraction of deposits which a bank is required to hold in hand. It can lend out an amount equals to excess reserves which equals (1 − required reserves).

Higher the required reserve ratio, lesser the excess reserves, lesser the banks can lend as loans, and lower the money multiplier, Lower the required reserve ratio, higher the excess reserves, more the banks can lend, and higher is the money multiplier.

In the above relationship it is assumed that there is no currency drainage, i.e. the borrowers keep 100% of the amount received in banks.

Currency drainage

In reality, borrowers do keep a fraction of loans received in cash. This reduces the money multiplier. When there is some currency drainage, money multiplier is calculated as per following formula:

$$\text{Money multiplier when there is currency drainage} = \frac{1 + \text{drainage ratio}}{\text{required reserve ratio} + \text{drainage ratio}}$$

Examples

Example 1

Ishkebar is an alien country that has seen little financial innovation. Its central bank requires commercial banks to keep 100% of their deposits as reserves. Calculate money multiplier for the economy.

Money multiplier = 1/required reserve ratio = 1/100% = 1

The country has a money multiplier of 1. No money creation is possible because in response to an increase in bank deposits of say 100 million Ishkebar dollars (I$), the money supply will increase by 1 × 100 $million = 100 million.

Example 2

North Sarrawak is run by a dictator who knows no economics and is not willing to listen to any advice. He thinks he can always print money whenever a depositor wants to withdraw so he does not think having any required reserve ratio for the sole bank of the country is necessary. What could be the consequences?

Zero required reserve ratio means infinite money multiplier and infinite money creation. Infinite money creation means no scarcity of money which means money would no longer be money since it would no longer be a store of value.

Example 3

Palmolive has required reserve ratio of 30% and a currency drainage of 15%. Calculate the money multiplier and compare it with Parazuela, a country where drainage is zero and required reserve ratio is 30%.

Money multiplier in Palmolive = (1 + 15%) ÷ (30% + 15%) = 2.56

Money multiplier in Parazuela = 1/30% = 3.33

Parazuel has higher money multiplier which makes sense because it has zero drainage. Zero drainage means all of the excess reserves loaned out in round 1 form part of total reserves in round 2.

The **other sources of changes in money** supply which are therefore the determinants of money supply are as follows:

1. **Open market operations:** Open market operations refer to the selling and buying of government securities on the open market by the central bank. A reduction in money supply will occur if the government sells securities through its broker since buyers will pay for these securities with cheques drawn on their accounts with the commercial banks. Conversely, there is an expansion of money supply if securities are bought on the open market by central bank and paid for by cheques drawn upon the central bank. In this case, money supply will further be increased if commercial banks undertake a multiple expansion of bank deposits.
2. **Interest rate policy:** Since liberalisation of interest rates in 1991, central bank influences the general level of interest rates by means other than the direct prescription of deposits and lending rates. The most important way is through changes in the 91-day Treasury bill interest rate, which significantly affects the other rates of interest in the economy since commercial banks constitute important buyers of this financial asset. An increase in this rate of interest tends to reduce money supply and credit creation.
3. **Changing the cash reserves ratio:** An increase in the cash reserve ratio reduces the credit multiplier and hence reduces the money supply. A reduction in the cash reserves ratio is likely to `increase the credit multiplier and hence increase money supply
4. **Special deposits:** The central bank of Kenya has the power to require commercial banks to lodge special deposits with it. Since special deposits are compulsory, they ensure a reduction in commercial banks' liquid assets and reduce the banks' ability to increase credit and hence the money supply.
5. **Government expenditure financed by borrowing from the central bank:** If currency is issued to the government to finance its expenditure, money supply will increase and conversely a reduction in government borrowing from central bank will reduce the rate of growth of money supply.
6. **Government borrowing from the banking system:** If the public sector is running a deficit, it may want to borrow some funds from the banking system which may lead to a further reduction of money supply.
7. **A change in the public's desired cash holdings:** A decision by the public to hold more cash and small bank deposits will reduce money supply through its effect on credit creation. If the public decides to hold less cash and bigger bank deposits, money supply would be increased through a higher degree of credit creation.
8. **A change in banks' demand for excess reserves:** Most models in the determination of money supply assume that banks will adhere to a constant ratio of cash reserves to deposits, on the assumption that banks will wish to expand deposits to the maximum. In practice, however, banks could decide or be forced to hold cash reserves in excess of the legal requirement as happens in many developing countries. This could happen if there is an insufficient number of credit worthy

borrowers. In this case, the bank cannot be sure of success if it uses open market operations to increase money supply.

9. **Balance of payments disequilibrium:** A balance of payments deficit involves a net outflow of foreign currency and the central bank has to finance the deficit by providing foreign currencies in exchange for domestic currency. Unless offset by an expansionary open market operation, this will result in an increase in the money supply. Conversely, a balance of payments surplus involves a net inflow of currency and unless offset by a contractionary open market operation which will result in an expansion of the money supply.

10. **Other factors**
    The money supply is determined not only by the central bank but also by interest rates, income and other factors. The latter factors change the proportion of money balances that the public holds cash. Changes in business activity can change the behaviour of banks and the public and thus affect the money supply. Hence the money supply is not an exogenous controllable item but also an endogenously determined item.

Conclusion

Examined above the factors which determine money supply through the creation of bank credit. But **money supply** and **bank credit** are indirectly related each other. When the money supply increases, a part of it is saved in banks depending upon the depositors' propensity to save. These savings become deposits of commercial banks who in turn,, lend after meeting the statutory reserve requirements. Thus with every **increase** in the **money supply**, **the bank credit goes up**. But it may not happen in exactly the same proportion due to the following factors.

(a) The marginal propensity to save does not remain constant. It varies from time to time depending on changes in income levels, prices, and subjective factors.

(b) Banks may also create more or less credit due to the operation of leakage in the credit creation process.

(c) The velocity of circulation of money also affects the money supply. If velocity of money circulation increases, the bank credit may not fall even after decrease in the money supply. The central bank has little control over the velocity of money which may adversely affect bank credit.

Importance of Money Supply

The money supply matters because it affects three very important things:

- Economic recessions,
- The price level, and
- Inflation

i. **Recessions may be caused by steep declines in the Money supply growth rate**-- In the past 50 years, there have been eight recessions, and every single one of them was preceded by a notable decline in the money (M2) growth rate. Then again, not every decline in the M2 growth rate was followed by a recession

ii. **Price level:** higher levels of the money supply are a direct cause of higher price levels. Likewise, increases in the money supply tend to cause the general price level to increase. Inflation (an increase in supply increases faster than the productive capacity of the economy) is the usual result.

iii **Inflation:** faster money supply growth rates tend to cause higher rates of inflation-- From international comparisons we see a close relationship between money (M2) growth rates and inflation rates. A hyperinflation (explosive growth of prices, inflation rates of over 50% per month, or well over 1000% per year) is impossible without extremely rapid money-supply growth.

Question : Since money supply growth is inflationary, and perfect price stability (0% inflation) seems like an ideal, wouldn't we be better off keeping the money supply perfectly stable, and not increasing it at all?

No. Money demand (people's demand for money for their transactions and savings) increases virtually every year as the volume of transactions (real GDP) increases, and if the money supply did not keep pace with money demand, then the economy would run into serious problems -- cash shortages, sky-high interest rates, and probably recession.

The Process of Credit Creation

Multiple expansion of deposits is called credit creation. When a bank extends loans it is not directly paid to the borrower, but is only credited to his account and a cheque book is given. Thus every bank loan creates an equivalent amount of derivative deposit.

By using this deposit, banker can again extend loan to some other parties after keeping a specified amount as reserve. Thus with a little cash in hand the banks can create additional purchasing power to a considerable degree.Credit can be created by a single bank or by more than one banker. When it is created by more than one banker, it is called multiple credit creation.

Let us explain the actual process of credit creation. We have seen above that the ability of banks to create credit depends on the fact that banks need only a small percentage of cash to deposits. If banks kept 100 percent cash against deposits, there would be no credit creation. Modern banks do not keep 100 percent cash reserves. They are legally required to keep a fixed percentage of their deposits in cash, say 10, 15 or 20 percent. They lend/or invest the remaining amount which is called *excess reserves.* A bank can lend equal to its excess reserves. But the entire system can lend and create credit (or deposits) upon a multiple of its original excess reserves. The deposit multiplier depends upon the required reserve ratio which is the basis of credit creation. Symbolically, the required reserve ratio

$$RRr = \frac{RR}{D}$$

Or RR= RRr x D`

Where RR are the required cash reserves with banks, RRr is the required reserve ratio and D is the demand deposits of banks.

The extent to which the entire banking system can create credit can be expressed by the following equation.

$$\Delta D = \Delta RR\ [1+(1-RRr)+(1-RRs)^2 \ldots\ldots + (1-RRr)^n]$$

The deposit expansion multiplier rests on the assumptions that banks lend out all their excess reserves and RRr remains constant.

To explain the process of credit creation , we make the following assumptions:

1. There are many banks, say A, B, C, etc in the banking system.

2. Each bank has to keep 10 per cent of its deposits in reserves. In other words, 10 per cent is the required reserve ratio fixed by law.

3. The first bank has ksh 1000 as deposits.

4. The loan amount drawn by the customer of one bank is deposited in full in the second bank and that of the second bank into the third bank, and so on.

5. Each bank starts with the initial deposit which is deposited by the debtor of the other bank.

Given these assumptions suppose that Bank A receives a cash deposit of sh 1000 to begin with. This is the cash in hand with the bank which is its asset and this amount is also the liability of the bank. The bank keeps sh 100 in reserves and lends sh 900 to one of its customers who in turn, gives a cheque to some person from whom he borrows or buys something. The net changes in Bank A's balance sheet are + sh 100 in reserves and + sh 900 in loans on the assets side and sh 1000 in demand deposits on the liabilities side as shown in Table 1. Before these changes Bank A had zero excess reserves

Table i: Balance Sheet of Bank A

Assets		*Liabilities*	
Reserves	sh1000	Deposits	sh 1000
	net changes		*Net changes*
Reserves	sh 100	Deposits	sh 1000
Loans	Sh 900		

This loan of sh 900 is deposited by the customer in Bank B whose balance sheet is shown in Table II. Bank B starts with a deposit of sh 900, keeps 10 per cent of it or sh 90 as cash in reserve. Bank B has sh 810 as excess reserves which it lends thereby creating new deposits

Table ii: Balance Sheet Of Bank B

Assets		*Liabilities*	
Reserves	sh 900	Deposits	Sh 900
	net changes		*Net changes*
Reserves	Sh 90	Deposits	Sh 900
Loans	sh 810		

This loan of sh 810 is deposited by the customer of Bank B into Bank C. The balance sheet of Bank C is shown in Table III. Bank C keeps sh 81 or 10 per cent of sh 810 in cash reserves and lends sh. 729.

Table iii: Balance Sheet Of Bank C

Assets		*Liabilities*	
Reserves	sh 810	Deposits	sh 810
	net changes		*Net changes*
Reserves	sh 81	Deposits	sh 810
Loans	sh 729		

This process goes on to other banks. Each Bank in the sequence gets excess reserves, lends and creates new demand deposits equal to 90% of the preceding banks. In this way, new deposits are created to the tune of sh 10000 in the banking system, as shown in Table IV

Table iv: Multiple Credit Creation

Bank	*Required Reserves*	*New Loans*	*New Deposits*
A	sh 100	sh 900	sh 1000
B	sh 90	sh 810	sh 900
C	sh 81	sh 729	sh 810
All other Banks	sh 729	sh 6561	sh 7290
Total for the Banking System	sh 1000	sh 9000	sh 10000

The multiple credit creation shown in the last column of the above Table can also be worked out algebraically as:

sh 1000 $[1 + (9/10) + (9/10)^2 + (9/10)^3 \ \ldots\ldots + (9/10)^n]$

= sh 1000 (1/1-9/10) = sh 1000 (1/1/10) = sh 1000 x 10 = sh 10000.

Limitations on the Power of Banks to Create Credit

We have seen above how the banking system as a whole can create credit. But it does not mean that banks have unlimited powers to create credit. In fact, they have to function under certain restrictions. The following are the limitations on the power of commercial banks to create credit.

1. *Amount of Cash.* The credit creation power of banks depends upon the amount of cash they posses. The larger the cash, the larger the amount of credit that can be created by banks. The amount of cash that a bank has in its vaults cannot be determined by it. It depends upon the primary deposits with the bank. The banks power of creating credit thus limited by the cash it posses.
2. *Power securities.* An important factor that limits the power of a bank to create credit is the availability of adequate securities. A bank advances loans to its customers on the basis of a security, or a bill or a share, or stock or a building or some other type of asset. It turns ill-liquid form of wealth into liquid wealth and thus creates credit. If proper securities are not available with the public, a bank cannot create credit. As pointed out by Crowther, "thus the bank does not create money out of thin air, it transmutes other forms of wealth into money"
3. *Banking habits of the people.* The banking habits of the people also govern the power of credit creation on the part of banks. If people are not in the habit of using cheques, the grant loans will lead to the withdrawal of cash from the credit creation stream of the banking system. This reduces the power of banks to create credit to the desired level.
4. *Minimum legal reserve ratio.* The minimum legal reserve ratio of cash to deposits fixed by the central bank is an important factor which determines the power of banks to create credit. The higher this ratio (RRr), the lower the power of banks to create credit; and the lower the ratio, the higher the power of banks to create credit.
5. *Excess reserves.* The process of credit creation is based on the assumption that banks stick to the required reserve ratio fixed by the central bank. If banks keep more cash in reserves than the legal reserve requirements, their power to create credit is limited to that extent. If Bank A of our example keeps 25 per cent of sh 1,000 instead of 10 percent, it will lend sh 750 instead of sh 900. Consequently, the amount of credit creation will be reduced even if the other banks in the system stick to the legal reserve ratio of 10 per cent.
6. *Leakages.* If there are leakages in the credit creation stream of the banking system, credit expansion will not reach the required level, given the legal reserve ratio. It is possible that some persons who receive cheques do not deposit them in their bank accounts but withdraw the money in cash for

spending or for hoarding at home. The extent to which the amount of cash is withdrawn from the chain of credit expansion, the power of the banking system to create credit is limited.

7. *Cheque Clearances.* The process of credit expansion is based on the assumption that cheques drawn by commercial banks are cleared immediately and reserves of commercial banks expand and contract uniformly by cheque transactions. But its not possible for banks to receive and draw cheques of exactly equal amount. But it is possible for banks to receive their reserves increased and others reduced through cheque clearances. This expands and contracts credit creation on the part of banks. Accordingly, the credit creation stream is disturbed.
8. *Behaviour of other banks.* The power of credit creation is further limited by the behaviour of other banks. If some of the banks do not advance loans to the extent required of the banking system, the chain of credit expansion will be broken. Consequently, the banking system will not be "loaned up"
9. *Economic Climate.* Banks cannot continue to create credit limitlessly. Their power to create credit depends upon the economic climate in the country. If there are boom times there is optimism. Investment opportunities increase and businessmen take more loans from banks. So credit expands. But in depressed times when the business activity is at low level, banks cannot force business community to take loans from them. Thus the economic climate in a country determines the power of banks to create credit.
10. *Credit Control policy of the Central Bank.* The power of commercial banks to create credit is also limited by the credit control policy of the central bank. The central bank influences the amount of cash reserves with banks by open market operations, discount rate policy and varying margin requirements. Accordingly, it affects the credit expansion or contraction by commercial banks.
11. *Contagion Effect.* If a bank fails to remain solvent due to huge loan losses, a credit panic is created among banks. The fear of failure of a particular bank may spread to other banks. This is called the "Contagion effect" whereby credit creation stops altogether.

We may conclude that commercial banks do not posses unlimited powers to create credit.

LESSON FIVE: RELATIONSHIP BETWEEN MONEY SUPPLY AND PRICES

Meaning of Value of Money

The value of money is the quantity of goods in general that will be exchanged for one unit of money. The value of money is its purchasing power, i.e., the quantity of goods and services it can purchase. What money can buy depends on the level of prices. When the price level rises, a unit of money can purchase less goods than before. Money is then said to have depreciated. Conversely, a fall in prices signifies that a unit of money can buy more than before.

Money is then said to appreciate. The "general level of prices" and the value of money are thus the same thing from two opposite angles. When the prices rise the value of money falls and vice versa. In other words, the value of money and the general price level are inversely proportional to each other. A violent change in the value of money (or the price level) disturb economic life and does great harm. We must, therefore, carefully study the factors which' determine the value of money.

Suppose we have found by measurement that a room is four metres long. Measuring it again next day we are surprised to see that the same room is five metres in length. How could the room stretch itself by a metre overnight? Was some partition knocked out or an extension added during the night? Or is it that our metre measure has grown shorter by 1 meter? Which out of these is the correct answer? In the same way, if a shilling can buy one kg of wheat today but purchases only half a kg tomorrow, we are greatly perplexed.

We feel disgusted with our food-measure, the shilling, which has shrunk to half its length. We want to know what has happened. We are told "the value of money has changed." Exactly this is what has happened in Kenya. Over time, there are many times more shilling notes circulating in the country now than previously, while the value of goods has not increased to that extent. Hence a shilling buys less. Two theories that explain the relationship between money and prices are discussed below.

Quantity Theory Of Money

In monetary economics, the **quantity theory of money** (**QTM**) states that the general price level of goods and services is directly proportional to the amount of money in circulation, or money supply. The theory was originally formulated by Polish mathematician Nicolaus Copernicus in 1517, and was

influentially restated by philosophers John Locke, David Hume, Jean Bodin, and by economists Milton Friedman and Anna Schwartz in A Monetary History of the United States published in 1963.

The theory was challenged by Keynesian economics, but updated and reinvigorated by the monetarist school of economics. Critics of the theory argue that money velocity is not stable and, in the short-run, prices are sticky, so the direct relationship between money supply and price level does not hold.

The quantity theory descends from Nicolaus Copernicus, followers of the School of Salamanca like Martín de Azpilicueta, Jean Bodin, Henry Thornton, and various others who noted the increase in prices following the import of gold and silver, used in the coinage of money, from the New World. The "equation of exchange" relating the supply of money to the value of money transactions was stated by John Stuart Mill who expanded on the ideas of David Hume. The quantity theory was developed by Simon Newcomb, Alfred de Foville**, Irving Fisher,** and Ludwig von Mises in the late 19th and early 20th century.

Fisher's Quantity Theory of Money

The quantity theory of money states that the quantity of money is the main determinant of the price or the value of money. Any change in the quantity of money produces an exactly proportionate change in the price level.

In the words of Fisher, "Other things remaining unchanged, as the quantity of money in circulation increases, the price level also increases in direct proportion and the value of money decreases and vice versa. If the quantity of money is doubled, the price level will also double and the value of money will be one half. On the other hand, if the quantity of money is reduced by one half, the price level will also be reduced by one half and the value of money will be twice.

The Quantity Theory of Money and Its Variants

Fisher has explained his theory in terms of his equation of exchange:

$$\mathbf{PT=MV+M^1V^1}$$

Where P = Price level, or I/P = the value of money;
T = the total amount of goods and services exchanged for money or transactions performed by money.

M = the total quantity of legal tender money;
V = the velocity of circulation of M;
M^1 = the total quantity of credit money;
V^1 = the velocity of circulation of M^1

This equation equates the demand for money (PT) to supply of money ($MV+M^1V^1$). The total volume of transactions (T) multiplied by the price level (P) represent the demand for money.

According to Fisher, PT is $\sum PQ$. In other words, price level (P) multiplied by quantity bought (Q) by the community ($\sum PQ$) gives the total demand for money. This equals the total supply of money in the community consisting of the quantity of actual money M and its velocity of circulation V plus the total quantity of credit money M^1 and its velocity of circulation V^1. Thus the total value of purchases (PT) in a year is measured by $MV + M^1V^{1.}$ Thus the equation of exchange is $PT=MV + M^1V^1$. In order to find out the effect of the quantity of money on the price level or the value of money, we make p the subject of the formulae

$$P = \frac{MV + M^1V^1}{T}$$

What would happen to the price level if the money supply (numerator) increased holding transactions constant?

Assumption of the Theory

Fisher's theory is based on the following assumptions:

1. P is a passive factor in the equation of exchange which is affected by other factors.
2. The proportion of M' to M remains constant.
3. V and V' are assumed to be constant and are independent of changes in M and M'
4. T also remains constant and is independent of other factors such as M, M' and V'.
5. It is assumed that the demand for money is proportional to the value of transactions.
6. The supply of money is assumed as an exogenously determined constant.
7. The theory is applicable in the long run.
8. It is based on the assumption of the existence of full employment in the economy.

The Keynesian Theory of Money and Prices

Introduction

Keynes **does not agree** with the **older quantity theorists** that there is a **direct** and **proportional relationship** between **quantity of money** and **prices.**

According to him, the effect of a change in the quantity of money on prices is indirect and non-proportional.

Keynes's Reformulated Quantity Theory of Money

The Keynesian reformulated quantity theory of money is based on the following assumptions:

(a) All factors of production are in perfectly elastic supply so long as there is any unemployment.
(b) All unemployed factors are homogenous, perfectly divisible and interchangeable.
(c) There are constant returns to scale so that prices do not rise or fall as output increases.
(d) Effective demand and quantity of money change in the same proportion so long as there are any unemployed resources.

Given these assumptions, if the quantity of money is increased, its first impact is on the rate of interest which tends to fall. Given the marginal efficiency of capital, a fall in the rate of interest will increase the volume of investment. The increased investment will raise effective demand through the multiplier effect thereby increasing income, output and employment. Since the supply of factors of production is perfectly elastic in a situation of unemployment, wage and non-wage factors are available at constant rate of remuneration.

There being constant returns to scale, prices do not rise with the increase in output so long as there is any unemployment. Under the circumstances output and employment will increase in the same proportion as the quantity of money. But "once full employment is reached, output ceases to respond at all to changes in the supply of money and so is effective demand.

The elasticity of supply of output in response to changes in the demand, which was infinite as long as there was unemployment falls to zero. The entire effect of changes in the supply of money is exerted on prices, which rise in exact proportion with the increase in effective demand.

Thus so long as there is unemployment, output will change in the same proportion as the quantity of money, and there will be no change in prices; and when there is full employment, prices will change in the same proportion as the quantity of money. Therefore, the reformulated quantity theory of money stresses the point that with increase in the quantity of money prices rise only when the level of full employment is reached, and not before this.

Keynes himself pointed out that the real world is so complicated that the simplifying assumptions upon which the reformulated quantity theory of money is based, will not hold. According to him, the following possible complications would qualify the statement that so long as there is unemployment, output will change in the same proportion as the quantity of money, and when there is full employment, prices will change in the same proportion as the quantity of money.

(1) “Effective demand will not change in exact proportion to the quantity of money.
(2) Since resources are homogenous, there will be diminishing, and not constant returns as employment gradually increases.
(3) Since resources are not interchangeable, some commodities will reach a condition of inelastic supply while there are still unemployed resources available for the production of other commodities.
(4) The wage-unit will tend to rise, before full employment has been reached.
(5) The remunerations of factors entering into marginal cost will not all change in the same proportion.

According to Keynes, **an increase in the quantity of money** increases **aggregate money demand on investment** as a result of the **fall in the rate of interest**. This increases **output** and **employment** in the beginning but **not** the **price level**

Real Bills Doctrine/ Commercial Loan Theory of Banking

The real bills doctrine, argues that the issue of money does not raise prices, as long as the new money is issued in exchange for assets of sufficient value. The **real bills doctrine** (a term coined by Lloyd Mints in his 1945 *History of Banking Theory*) is perhaps better understood by its old, pre-1945, name "the commercial loan theory of banking". The doctrine seeks to have real output determine its own means of purchase without affecting prices. There is but one policy role for the central bank under the real bills doctrine, namely lending commercial banks the necessary reserves against customer real bills offered by the banks as collateral.

The doctrine says that as long as bankers lend to businessmen only against the security (collateral) of short-term 30-,60-,90-day commercial paper representing claims to real goods in the process of production, the loans will be just sufficient to finance the production of goods. Moreover, as bank-loans are granted to businessmen in the form either of new bank notes or of additions to their current account deposits, which deposits constitute the main component of the money stock, the doctrine assures that the volume of money created will be just enough to allow purchasers to buy the finished goods off the market as final product without affecting prices. From their sales receipts, businessmen then pay off their real bills bank loans. Banks retire the returned money from circulation until the next batch of goods need financing.

The doctrine has roots in some statements of Adam Smith. John Law (1671-1729 in his *Money and Trade Considered: With a Proposal for Supplying a Nation with Money* (1705) originated the basic idea of the real bills doctrine, the concept of an "output-governed currency secured to real property and responding to the needs of trade". Law sought to limit monetary expansion and maintain price stability, by using land as a measure of, and collateral for, real activity. Smith then substituted short-term self-liquidating commercial paper for Law's production proxy, land, and so the Real Bills Doctrine was born.

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LESSON SIX: MONETARY POLICY

Meaning of Monetary Policy

Monetary policy refers to the credit control measures adopted by the central bank of a country. It can also be defined as "any conscious action undertaken by the monetary authorities to change the quantity, availability or cost of money"

Objectives or Goals of Monetary Policy

The following are the principal objectives of monetary policy.

1. Full Employment

Full employment has been ranked amongst the foremost objectives of monetary policy. It is an important goal not only because unemployment leads to wastage of potential output, but also because of the loss of social standing and self-respect. It also breeds poverty.

According to Keynes, full employment means the absence of involuntary unemployment. In other words, full employment is a situation in which everybody who wants to work gets work.

Lord Beveridge in his book Full Employment in a Free Society defined it as a situation where there were more vacant jobs than unemployment so that the normal lag between losing one job and finding another will be very short. By full employment he does not mean zero unemployment which means that full employment is not always full. There is always a certain amount of fractional unemployment in the economy even when there is full employment

Full employment can be achieved in an economy by following an expansionary monetary policy.

2. Price Stability

One of the policy objectives of monetary policy is to stabilize the price level. Economists favour this policy because fluctuations in prices bring uncertainty and instability to the economy. Rising and falling prices are both bad because they bring unnecessary loss to some and undue advantage to others. Again, they are associated with business cycles. So a policy of price stability keeps the value of money stable, eliminates cyclical fluctuations, brings economic stability, helps in reducing inequalities of income and wealth, secures social justice and promotes economic welfare.

3.Economic Growth

One of the most important objectives of monetary policy in recent years has been the rapid economic growth of an economy. Economic growth is defined as "the process whereby the real per capita income of a country increases over a long period of time." Economic growth is measured by the increase in the amount of goods and services produced in a country. A growing economy produces more goods and services in each successive time period. Thus, growth occurs when an economy's productive capacity increases which, in turn, is used to produce more goods and services. In its wider aspect, economic growth implies raising the standard of living of the people, and reducing inequalities of income distribution.

Generally economies believe in the possibility of continual growth. This belief is based on the presumption that innovations tend to increase productive technologies of both capital and labour over time. But there is very likelihood that an economy might not grow despite technological innovations. Production might not increase further due to the lack of demand which may retard the growth of the productive capacity of the economy. The economy may not grow further if there is no improvement in the quality of labour in keeping with the new technologies.

4.Balance of Payments

Many developing countries like Kenya suffer from the Disequilibrium in the BOP. The Central Bank of Kenya through its monetary policy tries to maintain equilibrium in the balance of payments. It is also recognized in that deficit in the balance of payments will retard the attainment of other objectives.

5.Exchange Rate Stability :

Exchange rate is the price of a home currency expressed in terms of any foreign currency. If this exchange rate is very volatile leading to frequent ups and downs in the exchange rate, the international community might lose confidence in our economy. The monetary policy aims at maintaining the relative stability in the exchange rate. The Central Bank of Kenya by altering the foreign exchange reserves tries to influence the demand for foreign exchange and tries to maintain the exchange rate stability

6. Equal Income Distribution :

Many economists used to justify the role of the fiscal policy in maintaining economic equality. However in recent years economists have given the opinion that the monetary policy can help and play a supplementary role in attaining an economic equality. Monetary policy can make special provisions for the neglect areas such as agriculture, small-scale industries, village industries, etc. and provide them with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Thus in recent period, monetary policy can help in reducing economic inequalities among different sections of society.

7. Promotion of Fixed Investment:

The aim here is to increase the productivity of investment by restraining non essential fixed investment.

8. Promotion of Exports and Food Procurement Operations

Monetary policy pays special attention in order to boost exports and facilitate the trade. It is an independent objective of monetary policy.

Monetary authority has control over the decisions regarding the allocation of credit to priority sector and small borrowers. This policy decides over the specified percentage of credit that is to be allocated to priority sector and small borrowers.

10. To Promote Efficiency

It is another essential aspect where the central banks pay a lot of attention. It tries to increase the efficiency in the financial system and tries to incorporate structural changes such as deregulating interest

rates, ease operational constraints in the credit delivery system, to introduce new money market instruments etc

Instruments of Monetary Policy

The instruments of monetary policy include the following;

1.Bank rate policy

The bank rate is the minimum lending rate of the central bank at which it rediscounts first class bills of exchange and government securities held by the commercial banks. When the central bank finds that inflationary pressures have started emerging within the economy, it raises the bank rate. Borrowing from the central bank becomes costly and commercial banks, in turn, raise their lending rates to the business community and borrowers borrow less from the commercial banks. There is contraction of credit and prices are checked from rising further. On the contrary, when prices are depressed, the central bank lowers the bank rate. It is cheap to borrow from the central bank on the part of commercial banks. The latter also lower their lending rates. Businessmen are encouraged to borrow more. Investment is encouraged. Output, employment, income and demand start rising and the downward movement of prices is checked.

2.Open Market Operations

Open market operations refer to sale and purchase of securities in the money market by the central bank. When the prices are rising and there is need to control them, the central bank sells securities. The reserves of commercial banks are reduced and they are not in a position to lend more to the business community. Further investment is discouraged and the rise in prices is checked. Alternatively, when recessionary forces start in the economy, the central bank buys securities. The reserves of commercial banks are raised. They lend more. Investment, output, employment, income and demand rise, and fall in price is checked.

3.Changes in reserve Ratios

This weapon was suggested by Keynes in his Treatise on Money and the USA was the first to adopt it as a monetary device. Every bank is required by law to keep a certain percentage of its total deposits in the form of a reserve fund in its vaults and also a certain percentage with the central bank. When prices are rising, the central bank raises the reserve ratio. Banks are required to keep more with the central bank. Their reserves are reduced and they lend less. The volume of investment, output and investment are adversely affected. In the opposite case, when the reserve ratio is lowered, the reserves of commercial banks are raised. They lend more and the economic activity if favourably affected.

4.Selective Credit Controls

Selective credit controls is used to influence specific types of credit for particular purposes. They usually take the form of changing margin requirements to control speculative activities within the economy. When there is brisk speculative activity in the economy or in particular sectors in certain commodities and prices start rising, the central bank raises the margin requirement on them. The result

is that the borrowers are given less money in loans against specified securities. For instance, raising the margin requirement to 60% means that the pledge of securities of the value of sh10,000 will be given 40% of their value, i.e sh 4,000 as loan. In case of recession in a particular sector, the central bank encourages borrowing by lowering margin requirements.

5) A Regulation of Margin Requirements

This method is employed to prevent use of credit to purchase of carry securities by speculators. The central bank fixes minimum margin requirements on loans for purchasing or carrying securities. They are, in fact, the percentage of the value of the security that cannot be borrowed or lent. In other words, it is the minimum value of loan which a borrower can have from the banks on the basis of the security (or collateral). For example, if the central bank fixes a 10 per cent margin on the value of a security worth ksh. 1,000, then the commercial bank can lend only ksh, 900 to the holder of the security and keep ksh 100 with it. If the central bank raises the margin to 25 percent the bank can lend only ksh. 750 against a security of ksh. 1,000. If the central bank wants to curtail speculative activities, it will raise the margin requirements. On the other hand, if it wants to expand credit, it reduces the margin requirements.

6) Direct Action

Central bank in all countries frequently resorts to direct action against commercial banks. Direct action is in form of "directives" issued from time to time to the commercial banks to follow a particular policy which the central bank wants to enforce immediately. This policy may be used against erring banks. For example, the central bank refuses rediscounting facilities to certain banks which may be granting too much credit for speculative purposes, or in excess of their capital and reserves, or restrains them for granting advances against the collateral of certain commodities,etc. It may also charge a penal rate of interest from those banks which want to borrow from it beyond the prescribed limit. The central bank may even threaten a commercial bank to be taken over by it in case it fails to follow its policies and instructions.

7) Moral persuasion

Moral persuasion may take the form of request or of informal suggestion and of advice to the commercial bank.The executive head of the central bank calls a meeting of the heads of the commercial banks wherein he explains to them the need for the adoption of a particular monetary policy in the context of the current economic situation , and then appeals to the to follow it. This "jawbone control" or "slaps on the wrist" method has been found to be highly effective as a selective method of credit in control in India, New Zealand, Canada and Austraria, though it failed in the U.S.A.

8) Publicity

The central bank also uses publicity as an instrument of credit control. It publishes weekly or monthly statements of the assets and liabilities of the commercial bank for the information of the public. It also publishes statistical data relating to money supply, prices, production and employment, and of capital and money market, etc. This is another way of exerting moral pressure on the commercial bank. The aim is to make the public aware of the policies being adopted by the commercial bank vis-à-vis the central bank in the light of the prevailing economic conditions in the country.

It cannot be said with defiteness about the success of this method. It pre-supposes the existence of an educated and knowledgeable public about the monetary phenomena. But even in advanced countries the percentage of such persons is negligible. It is therefore highly doubtful if they can exert any moral pressure on the banks to strictly follow the policies of the central bank. Hence, publicity as an instrument of selective credit control is only of academic interest.

Conclusion

It has been accepted by all monetary theorists that, the success of monetary policy is nil in a depression when business confidence is at its lowest ebb and that expansionary (or easy) monetary policy is used to overcome a recession or a depression or a deflationary gap.

Expansionary (or easy) monetary policy

When there is a fall in consumer demand for goods and services and in business demand for investment goods, a deflationary gap emerges. The central bank starts an expansionary monetary policy that eases the credit market conditions and leads to an upward shift in aggregate demand. For this purpose, the central bank purchases government securities in the open market, lowers the reserve requirements of member banks, lowers the discount rate and encourages consumer and business credit through selective credit measures. By such measures, it decreases the cost and availability of credit in the money market, and improves the economy.

Restrictive monetary policy

A monetary policy designed to curtail aggregate demand is called restrictive (or dear) monetary policy. It is used to overcome an inflationary gap. The economy experiences inflationary pressures due to rising consumers' demand for goods and services and there is also boom in business investment. The central bank starts restrictive monetary policy in order to lower aggregate consumption and investment by increasing the cost and availability of bank credit. It might do so by selling government securities in the open market, by raising reserve requirements of member banks, by raising the discount rate, and controlling consumer and business credit through selective measures. By such measures, the central bank increases the cost and availability of credit in the money market and thereby controls inflationary pressures.

Role of Monetary Policy In A Developing Economy

Monetary policy in an underdeveloped country plays an important role in increasing the growth rate of the economy by influencing the cost and availability of credit, by controlling inflation ad maintaining equilibrium in the balance of payments. So the principal objectives of monetary policy in such a country are to control credit for controlling inflation and to stabilize the price level, to stabilize the exchange rate achieve equilibrium in the balance of payments and to promote economic development.

a) **To Control Inflationary Pressures;**To control inflationary pressures arising in the process of development. Of the instruments of monetary policy, the open market operations are not successful in controlling inflation in underdeveloped countries because the bill market is small and

undeveloped. Commercial banks keep an elastic cash-deposit ratio because the central bank's control over them is not complete. They are also reluctant to invest in government securities due to their relatively low interest rates. Moreover, instead of investing in government securities, they prefer to keep their reserves in liquid form such as gold, foreign exchange and cash. Commercial banks are also not in the habit of rediscounting or borrowing from the central bank

b) **To Achieve Price Stability;** Monetary policy is an important instrument for achieving price stability. It brings a proper adjustment between the demand for and supply of money. An imbalance between the two will be reflected in the price level. A shortage of money supply will retard growth while an excess of it will lead to inflation. As the economy develops, the demand for money increases due to the gradual monetization of the non-monetized sector, and the increase in agricultural and industrial production. These will lead to increase in the demand for transactions and speculative motives. So the monetary authority will have to raise the money supply more than proportionate to the demand for money in order to avoid inflation.

c) **To Bridge BOP Deficit;** Monetary policy in the form of interest rate policy plays an important role in bridging the balance of payments deficit. Underdeveloped countries develop serious balance of payment difficulties to fulfill the planned targets of development. To establish infrastructure like power, irrigation, transport, etc and directly productive activities like iron and steel, chemicals, electricals, fertilizers etc., underdeveloped countries have to import capital equipment, machinery, raw materials, spares and components thereby raising their imports. But exports are almost stagnant. They are high-priced due to inflation. As a result, an imbalance is created between imports and exports which leads to disequilibrium in the balance of payments. Monetary policy can help in narrowing the balance of payments deficit through high rate of interest. A high interest rate attracts the inflow of foreign investments and helps in bridging the balance of payments gap.

d) **Interest Rate Policy;** A policy of high interest rate in an underdeveloped country also acts as an incentive to higher savings, develops banking habits and speeds up the monetization of the economy which are essential for capital formation and economic growth. A high interest rate policy is also anti-inflationary in nature, for it discourages borrowing and investment for speculative purposes, and in foreign currencies. Further, it promotes the allocation of scarce capital resources to more productive channels. Certain economists favour a low interest rate policy in such countries because high interest rates discourage investment. But empirical evidence suggests that investment in business and industry is interest-inelastic in underdeveloped countries because interest forms a very low proportion of total cost of investment. Despite these opposite views, it is advisable for the monetary authority to follow a policy of discriminatory interest rate-charging high interest rates for non-essential and unproductive uses and low interest rates for productive uses.

e) **To Create Banking and Financial Institutions;**One of the objectives of monetary policy in underdeveloped country is to create and develop banking and financial institutions in order to encourage, mobilize and channelise savings for capital formation. The monetary authority should encourage the establishment of branch banking in rural and urban areas. Such a policy will help in monetizing the non-monetized sector and encourage saving and investment for capital formation. It

should also organize and develop money and capital market. These are essential for the success of a development-oriented monetary policy which also includes debt management.

f) **Debt Management;**Debt management is one of the important functions of monetary policy in an underdeveloped country. It aims at proper timing and issuing of government bonds, stabilizing their prices and minimizing the cost of servicing the public debt. The primary aim of debt management is to create conditions in which public borrowing can increase from year to year. Public borrowing is essential in such countries in order to finance development programmes and to control the money supply. But public borrowing must be at cheap rates. Low interest rates raise the price of government bonds and make them more attractive to the public. They also keep the burden of the debt low.

Thus an appropriate monetary policy, as outlined above, helps in controlling inflation, bridging balance of payments gap, encouraging capital formation and promoting economic growth.

Limitation Of Monetary Policy In Ldcs

The experience of underdeveloped countries reveals that monetary policy plays a limited role in such countries. The following arguments are given in support of this view.

a. **Large Non-monetized Sector.** There is a large non-monetized sector which hinders the success of monetary policy in such countries. People mostly live in rural areas where barter is practiced. Consequently, monetary policy fails to influence this large segment of the economy.

b. **Undeveloped Money and Capital Markets**. The money and capital markets are undeveloped. These markets lack bills, stocks and shares which limit the success of monetary policy.

c. **Large Number of NBFIs.** Non-bank financial intermediaries like the indigenous bankers operate on a large scale in such countries but they are not under the control of the monetary authority. This factor limits the effectiveness of monetary policy in such countries.

d. **High Liquidity**. The majority of commercial banks posses high liquidity so that they are not influenced by the credit policy of the central bank. This also makes monetary policy less effective.

e. **Foreign Banks**. In almost every underdeveloped country foreign owners of commercial banks exist. They also render monetary policy less effective by selling foreign assets and drawing money from their head offices when the central bank of the country is following a tight monetary policy.

f. **Small Bank Money**. Monetary policy is also not successful in such countries because bank money comprises a small portion of the total money supply on the country. As a result, the central bank is not in a position to control credit effectively.

g. Money not deposited with Banks. The well-to-do people do not deposit money with banks but use it in buying jewellery, gold, real estate, in speculation in conspicuous consumption, etc. Such activities encourage inflationary pressures because they lie outside the control of the monetary authority.

On the account of these limitations of monetary policy in an under-developed country, economists advocate the use of fiscal policy along with it.

LESSON SEVEN: INFLATION

Meaning of Inflation

Inflation is a highly controversial term which has undergone modifications since it was first defined by the neo-classical economists. They meant by it a galloping rise in prices as a result of the excessive increase in the quantity of money.

To the neo-classical, inflation is fundamentally a monetary phenomenon. In the words of Friedman, "Inflation is always and everywhere a monetary phenomenon and can be produced only by a more rapid increase in the quantity of money than output. Economists, therefore, define inflation in terms of a continuous rise in prices. Johnson defines **"inflation as a sustained rise in prices**, Brooman defines it as "**a continuing increase in the general price level.**" Shapiro also defines inflation in a similar way, "**as a persistent and appreciable rise in the general level of prices**. Dernberg and Mcgougall are more explicit when they say that "**the term usually refers to a continuing rise in prices as measured by an index such as the consumer price index (CPI) or by the implicit price deflator for gross national product**.

Types of Inflation

Inflation is of various types. We discuss below some of its important types,

- **Creeping Inflation.** When the rise in prices is very slow like that of a snail or creeper, it is called creeping inflation. In terms of speed, a sustained rise in prices of annual increase of less than 3 per cent per annum is characterized as creeping inflation. Such an increase in prices is regarded safe and essential for economic growth.
- **Walking or Trotting Inflation.** When prices rise moderately and the annual inflation rate is a single digit. In other words, the rate of rise in prices is in the intermediate range of 3 to 6 per cent per annum or less than 10 per cent. Inflation at this rate is a warning signal for the government to control it before it turns into running inflation.
- **Running Inflation**. When prices rise rapidly like the running of a horse at a rate or speed of 10 to 20 per cent per annum, it is called running inflation. Such inflation affects the poor and middle classes adversely. Its control requires strong monetary and fiscal measures, otherwise it leads to hyperinflation.
- **Hyper Inflation.** When prices rise very fast at double or triple digit rates from more than 20 to 100 per cent per annum or more, it is usually called runaway or galloping inflation. It is also characterized as hyperinflation by certain economists. In reality, hyperinflation is a situation when the rate of inflation becomes immeasurable and absolutely uncontrollable. Prices rise many times every day. Such a situation brings a total collapse of the monetary system because of the continuous fall in the purchasing power of money.

- The speed with which prices tend to rise is illustrated in Figure below. The curve C shows creeping inflation when within a period of ten years the price level has been shown to have risen by about 30 per cent.

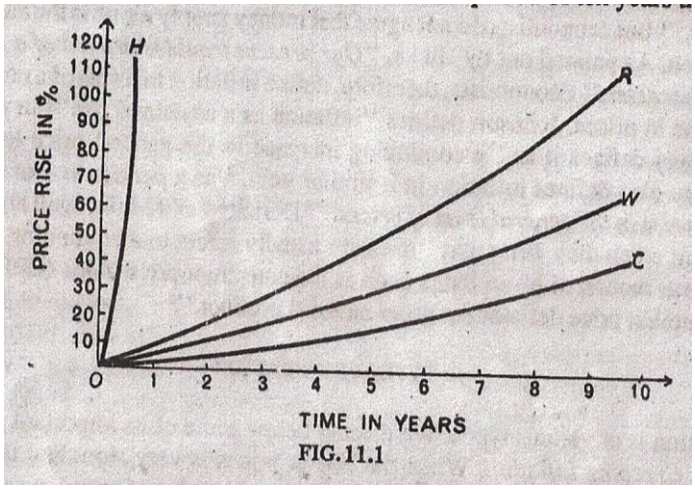

FIG.11.1

- The curve W depicts walking inflation when the prices rose by more than 50 per cent during ten years. The curve R illustrates running inflation showing a rise of about 100 per cent in tern years. The steep curve H shows the path of hyperinflation when prices rose by more than 120 ;per cent in less than one year.

Terms used to describe inflation

- **Semi-Inflation**. According to Keynes, so long as there are unemployed resources, the general price level will not rise as output increases. But a large increase in aggregate expenditure will face shortages of supplies of some factors which may not be sustainable. This may lead to increase in costs and prices start rising. This is known as semi-inflation or bottleneck inflation because of the bottlenecks in supplies of some factors.
- **True Inflation.** According to Keynes, when the economy reaches the level of full employment, any increase in aggregate expenditure will raise the price level in the same proportion. This is because it is not possible to increase the supply of factors of production and hence of output after the level of full employment. This is called true inflation.
- **Open Inflation**. Inflation is open when "markets for goods or factors of production are allowed to function freely, setting prices of goods and factors without normal interference by the authorities." Thus Open inflation is the result of the uninterrupted operation of the market mechanism. There are no checks or controls on the distribution of commodities by the government. Increase in demand and shortage of supplies persist which tend to lead to open inflation. Unchecked open inflation ultimately leads to hyperinflation.
- **Suppressed Inflation.** When the government imposes physical and monetary controls to check open inflation, it is known are repressed or suppressed inflation. The market mechanism is not allowed to function normally by the use of licensing , price controls and rationing in order to suppress extensive rise in prices. So long as such controls exist, the present demand is postponed and there is diversion of demand from controlled to uncontrolled commodities. But as soon as these controls are removed, there is open inflation. Moreover, suppressed inflation adversely affects the economy. When the distribution of commodities is controlled, the prices of uncontrolled commodities rise very high.

Suppressed inflation reduces the incentive to work because people do not get the commodities which they want to have. Controlled distribution of goods also leads to mal-allocation of resources. This results I the diversion of productive resources from essential to non-essential industries. Lastly, suppressed inflation leads to black marketing, corruption and profiteering.

- **Stagflation.** Stagflation is a new term which has been added to economic literature in the 1970s. It is a paradoxical phenomenon where the economy experiences stagnation as well as inflation. The word stagflation is the combination of stag plus 'flation' taking 'stag' from stagnation and 'flation' from inflation. Stagflation is a situation when recession is accompanied by high rate of inflation. It is, therefore also called inflationary recession. The principal cause of this phenomenon has been excessive demand in commodity markets thereby causing prices to rise, and at the same time the demand for labour is deficient thereby creating unemployment in the economy. Three factors have been responsible for the existence of stagflation in the advanced countries since 1972. First, rise in oil prices and other commodity prices along with adverse changes in the terms of trade; second, the steady and substantial growth of the labour force; and third, rigidities in the wage structure due to strong trade unions.
- **Mark-up Inflation.** The concept of mark-up inflation is closely related to the price push problem. Modern labour organizations possess substantial monopoly power. They, therefore, set prices and wages on the basis of mark-up over costs and relative incomes. Firms possessing monopoly power have control over the prices charged by them. So they have administered prices which increase their profit margin. This sets off an inflationary rise in prices. Similarly, when strong trade unions are successful in raising the wages of workers, this contributes to inflation.
- **Sectoral Inflation**. Sectoral inflation arises initially out of excess demand in particular industries. But it leads to a general price rise because prices do not fall in the deficient demand sectors.
- **Reflation,** is a situation when prices are raised deliberately in order to encourage economic activity. When there is depression and prices fall abnormally low, the monetary authority adopts measures to put more money in circulation so that prices rise. This is called reflation.

Demand-Pull Inflation

Demand-Pull or excess demand inflation is a situation often described as "too much money chasing very few goods" According to this theory, an excess of aggregate demand over aggregate supply of goods and services will generate inflationary rise in prices. Its earliest explanation is to be found in the simple quantity theory of money. The theory states that prices rise in proportion to the increase in the money supply. Given the full employment level of output, doubling the money supply will double the price level. So inflation proceeds at the same rate at which the money supply expands. In this analysis the aggregate supply is assumed to be fixed and there is always full employment in the economy. Naturally, when the money supply increases it creates more demand for goods but the supply of goods cannot be increased due to the full employment of resources. This leads to rise in prices.

Modern quantity theorists led by Friedman hold that "inflation is always and everywhere a monetary phenomenon." The higher the growth rate of the nominal money supply, the higher the rate of inflation. When the money supply increases, people spend more in relation to the available supply of goods and services. This bids prices up. Modern quantity theorists neither assume full employment as a normal situation nor a stable velocity of money. Still they regard inflation as the result of excessive increase in the money supply.

The Keynesian theory on demand-pull inflation is based on the argument that so long as there are unemployed resources in the economy, an increase in investment expenditure will lead to an increase in employment, income and output. Once full employment is reached and bottlenecks appear, further increase in expenditure will lead to excess demand because output ceases to rise, thereby leading to inflation.

Cost-Push Inflation

Cost push inflation is caused by wage increases enforced by unions and profit increases by employers. This type of inflation has not been a new phenomenon and was found even during the medieval period. But it was revived in the 1950s and 1970s as the principal cause of inflation. It also came to be known as the "New Inflation" Cost-push inflation is caused by wage-push and profit-push to prices for the following reasons:

Rise in Wages. The basic cause of cost-push inflation is the rise in money wages more rapidly than the productivity of labour. In advanced countries trade unions are very powerful. They press employers to grant wage increases considerably in excess of increases in the productivity of labour, thereby raising the cost of production of commodities. Employers, in turn, raise prices of their products. Higher wages enable workers to buy as much as before, in spite of higher prices. On the other hand, the increase in prices spiral continues, thereby leading to cost-push or wage-push inflation. Cost-push inflation may be further aggravated by upward adjustment of wages to compensate for rise in the cost of living index.

Sectoral Rise in Prices. Again a few sectors of the economy may be affected by money wage increases and prices of their products may be rising. In many cases, there are products such as steel, raw materials etc.which are used as inputs for the production of commodities in other sectors. As a result, production cost of other sectors will rise and thereby push up the prices of their products. Thus wage-push inflation in a few sectors of the economy may soon lead to inflationary rise in prices of the entire economy.

Rise in prices of Imported Raw materials. An increase in the prices of imported raw materials may lead to cost-push inflation. Since raw materials are used as inputs by the manufacturers of the finished goods, they enter into the cost of production of the latter. Thus a continuous rise in the prices of raw materials tends to set off a cost-price-wage spiral.

Profit-Push Inflation. Oligopolist and monopolist firms raise the prices of their products to offset the rise in labour and production costs so as to earn higher profits. There being imperfect competition in the case of such firms, they are able to "administer prices" of their products. "In an economy in which so called administered prices abound there is at least the possibility that these prices may be administered upward faster than cost in an attempt to earn greater profits. To the extent such a process is widespread

profit-push inflation will result. Profit-push inflation is, therefore, also called administered-price theory of inflation or price-push inflation or sellers inflation or market-power inflation.

Causes of Inflation

Inflation is caused when the aggregate demand exceeds the aggregate supply of goods and services. We analyses the factors which lead to increase in demand and the shortage of supply.

Factors Affecting Demand

Both Keynesians and monetarists believe that inflation is caused by increase in the aggregate demand. They point towards the following factors which raise it:

- **Increase in Money Supply**. Inflation is caused by an increase in the supply of money which leads to increase in aggregate demand. The higher the growth rate of the nominal money supply, the higher is the rate of inflation. Modern quantity theorists do not believe that true inflation starts after the full employment level. This view is realistic because all advanced countries are faced with high levels of unemployment and high rates of inflation.
- **Increase in Disposable Income**. When the disposable income of the people increases, it raises their demand for goods and services. Disposable income may increase with the rise in national income or reduction in taxes or reduction in the saving of the people.
- **Increase in Public Expenditure**. Government activities have been expanding much with the result that government expenditure has also been increasing at a phenomenal rate, thereby raising aggregate demand for goods and services. Governments of both developed and developing countries are providing more facilities and starting public enterprises with the result that they help in increasing aggregate demand.
- **Increase in Consumer Spending.** The demand for goods and services increases when consumer expenditure increases. Consumers may spend more due to conspicuous consumption or demonstration effect. They may also spend more when they are given credit facilities to buy goods on hire purchase and installment basis.
- **Cheap Monetary Policy**. Cheap monetary policy or the policy of credit expansion also leads to increase in the money supply which raises the demand for goods and services in the economy. When credit expands, it raises the money income of the borrowers which, in turn, raises aggregate demand relative to supply, thereby leading to inflation. This is also known as credit-induced inflation.
- **Deficit Financing.** In order to meet its mounting expenses, the government may resort to deficit financing by printing more notes. This raises aggregate demand in relation to aggregate supply, thereby leading to inflationary rise in prices. This is also known as deficit-induced inflation.

- **Expansion of the Private Sector**. The expansion of the private sector also tends to raise the aggregate demand. For huge investments increase employment and income, thereby creating more demand for goods and services. But it takes time for the output to enter the market.
- **Black Money.** The existence of black money in all countries due to corruption, tax evasion, etc. increases the aggregate demand. People spend such unearned money extravagantly, thereby creating unnecessary demand for commodities. This tends to raise the price level further.
- **Repayment of Public Debt.** Whenever the government repays its past internal debt to the public, it leads to increase in the money supply with the public. This tends to raise the aggregate demand for goods and services.
- **Increase in Exports**. When the demand for domestically produced goods increases in foreign countries, this raises the earnings of industries producing export commodities. This, in turn, create more demand for goods and services with the economy.

Factors Affecting Supply

There are also certain factors which operate on the opposite side and tend to reduce the aggregate supply. Some of the factors are as follows:

- **Shortage of Factors of Production**. One of the important causes affecting the supplies of goods is the shortage of such factors as labour, raw materials, power supply, capital etc. They lead to excess capacity and reduction in industrial production.
- **Industrial Disputes.** In countries where trade unions are powerful, they also help in curtailing production. Trade unions resort to strikes and if they happen to be unreasonable from the employers' view point and are prolonged, they force the employers to declare lock-outs. In both cases, industrial production falls, thereby reducing supplies of goods. If the unions succeed in raising money wages of their members to a very high level then the productivity of labour, this also tends to reduce production and supplies of goods.
- **Natural Calamities.** Drought or floods is a factor which adversely affects the supplies of agricultural products. The latter, in turn, create shortages of food products and raw materials, thereby helping inflationary pressures.
- **Artificial Scarcities.** Artificial scarcities are created by hoarders and speculators who indulge in black-marketing. Thus they are instrumental in reducing supplies of goods and raising their prices.
- **Increase in Exports**. When the country produces more goods for export than for domestic consumption, this creates shortages of goods in the domestic market. This leads to inflation in the economy.
- **Lop-sided Production.** If the stress is on the production comforts, luxuries, or basic products to the neglect of essential consumer goods in the country, this creates shortages of consumer goods. This again causes inflation.

- **Law of Diminishing Returns**. If industries in the country are using old machines and outdated methods of production, the law of diminishing returns operates. This raises cost per unit of production, thereby raising the prices of products.
- **International Factors.** In modern times, inflation is a world wide phenomenon. When prices rise in major industrial countries with which a country has trade relations, this may lead to an increase in the prices of the goods in the country .Often the rise of basic raw materials like petrol in the international market leads to rise in the prices of all related commodities in a country.

Effects of Inflation

Inflation affects different people differently. This is because of the fall in the value of money. When price rise or the value of money falls, some groups of society gain, some lose and some stand in-between. Broadly speaking, there are two economic groups in every society, the fixed income group and the flexible income group. People belonging to the first group lose and those belonging to the second group gain. The reason is that the price movements in the case of different goods, services, assets etc are not uniform. When there is inflation, most prices are rising, but the rates of increase of individual prices differ much. Prices of some goods and services rise fast, of others slowly and of others still remain unchanged. We discuss below;

a) The effects of inflation on distribution of income and wealth,
b) The effects of inflation on production
c) The effects of inflation on the functions of money
d) The effects of inflation on the society as a whole.

a) The Effects of Inflation on Distribution of Income and Wealth

Inflation tends to increase inequalities in the distribution of income and wealth. The poor and middle class suffer because their wages and salaries are more or less fixed but the prices of commodities continue to rise. They become more impoverished. On the other hand, businessmen, industrialists, traders, real estate holders, speculators, and others with variable incomes gain during rising prices. The latter category of persons becomes rich at the cost of the former group. There is an unjustified transfer of income and wealth from the poor to the rich. As a result, the rich roll in wealth and indulge in conspicuous consumption, while the poor and middle classes live in abject misery and poverty. The effects of inflation on different groups of society are discussed below.

Debtors and Creditors. During periods of rising prices, debtors gain creditors lose. When prices rise, the value of money falls. Though debtors return the same amount of the money but they pay less in terms of goods and services. This is because the value of money is less than when they borrowed the money. Thus the burden of the debt is reduced and debtors gain. On the other hand, creditors lose. Although they get back the same amount of money which the lent, they receive less in real terms, because the

value of money falls. Thus there is transfer of wealth from creditors to debtors.

Salaried Persons. Salaried workers such as clerks, teachers and other white collar persons lose when there inflation. The reason is that their salaries are slow to adjust when prices are rising.

Wage Earners. Wage earners may gain or lose depending upon the speed with which their wages adjust to rising prices. If their unions are strong, they may get their wages linked to the cost of living index. In this way, they may be able to protect themselves from the bad effects of inflation. But the problem is that there is often a time lag between the raising of wages by employers and the rise in prices. So workers lose because by the time wages are raised, the cost of living index may have increased further. But where the unions have entered into contractual wages for a fixed period, the workers lose when prices continue to rise during the period of contract. On the whole, the wage earners are in the same position as the white collar persons.

Fixed Income Group. Pensioners, recipients of interest and rent belong to the fixed income group. Pensioners get fixed pensions. Similarly the rentier class consisting of interest and rent receivers get fixed payments. The same is the case with the holders of fixed interest bearing securities, debentures and deposits. All such persons lose because they receive fixed payments, while the value of money continues to fall with rising prices.

Equity Holders or Investors. Persons who hold shares or stocks of companies gain during inflation. For when prices are rising, business activities expand which increases profits of companies. As profits increase, dividends on equities also increase at a faster rate than prices. But those who invest in debentures securities, bonds etc. which carry fixed interest rate lose during inflation because they receive a fixed sum while the purchasing power is falling.

Businessmen. Businesses of all types such as producers, traders and real estate holders gain during periods of rising prices. Take producers first, when prices are rising, the value of their inventories (goods in stock) rise in the same proportion. So they profit more when they sell their stocked commodities. The same is the case with traders in the short run. But producers profit more in another way. Their costs do not rise to the extent of the rise in the prices of their goods. This is because prices of raw materials and other inputs and wages do not rise immediately to the level of the price rise. The holders of real estates also profit during inflation because the prices of landed property increase much faster than the general price level.

Agriculturists. Agriculturists are of three types, landlords, peasant proprietors, and landless agricultural workers. Landlords lose during rising prices because they get fixed rents. But peasant proprietors who own and cultivate their farms gain. Prices of farm products increase more than the cost of production. For prices of inputs and land revenue do not rise to the same extent as the rise in the prices of farm products. On the other hand, the landless agricultural workers are hit hard by rising prices. Their wages are not raised by the farm owners, because trade unionism is absent among them. But the prices of

consumer goods rise rapidly. So landless agricultural workers are losers.

Conclusion

Thus inflation redistributes income from wage earners and fixed income groups to profit recipients and from creditors to debtors. In so far as wealth redistributions are concerned, the very poor and the very rich are more likely to lose than middle income groups. This is because the poor hold what little wealth they have in monetary forms and have few debts, whereas the very rich hold a substantial part of their wealth in bonds and have relatively few debts. On the other hands, the middle income groups are likely to be heavily in debt and hold some wealth in common stocks as well as in real assets.

b) The Effects of Inflation on production

When prices start rising production is encouraged. Producers earn high profits in the future. They invest more in anticipation of higher profits in the future. This tends to increase employment, production and income. But this is only possible upto the full employment level. Further increase in investment beyond this level will lead to severe inflationary pressures within the economy because prices rise more than production as the resources are fully employed. So inflation adversely affects production after the level of full employment. The adverse effects of inflation on production are discussed below.

Misallocation of Resources. Inflation causes misallocation of resources when producers divert resources from the production of essential to non-essential goods from which they expect higher profits.

Changes in the System of Transaction. Inflation leads to change in the transaction pattern of producers. They hold a smaller stock or real money holdings against unexpected contingencies than before. They devote more time and attention to converting money into inventories or other financial or real assets. It means that time and energy are diverted from the production of goods and services and some resources are used wastefully.

Reduction in production. Inflation adversely affects the volume of production because the expectation of rising prices along with rising costs of inputs bring uncertainty. This reduces produc6tion.

Fall in Quality. Continuous rise in prices creates a seller's market. In such a situation, producers produce and sell sub-standard commodities in order to earn higher profits. They also indulge in adulteration of commodities.

Hoarding and Black-marketing. To profit more from rising prices, producers hoard stocks of their commodities. Consequently, an artificial scarcity of commodities is created in the market. Then the producers sell their products in the black market which increase inflationary pressures.

Reduction in Saving. When prices rise rapidly, the propensity to save declines because more money is needed to buy goods and services than before. Reduced saving adversely affects investment and capital formation. As a result, production is hindered.

Hinders Foreign Capital. Inflation hinders the inflow of foreign capital because the rising costs of materials and other inputs make foreign investments less profitable.

Encourage Speculation. Rapidly rising prices create uncertainty among producers who indulge in speculative activities in order to make quick profits. Instead of engaging themselves in productive

activities, they speculate in very types of raw materials required in production.

c) The Effects of Inflation on the Functions of Money

Inflation refers to the persistent increase in the general price level. Inflation inhibits the ability of money to perform its functions effectively in the following ways:

- **As a means of exchange.** When inflation is extremely high people may prefer not to use money at all. They may instead revert back to the barter economy or use money alternatives such as gold or a foreign currency whose value will increase against the currency of hyperinflation economy.
- **As a unit of account.** Inflation will contribute to the variations of the relative values of different commodities over time since individual goods or services do not rise in price by the same proportion. This reduces the stability of money as a unit of account.
- **As a standard of deferred payment.** In periods of inflation, lenders lose while borrowers gain because the real value of the debt declines. Lenders may, therefore, only accept to lend money at very high rates of interest in order to compensate for the fall in the real value of the loan.
- **As a store of value.** During the periods of inflation, although money retains its normal value, it loses some of its purchasing power. This implies that the real value of money declines. The loss of this value may cause people to store their wealth in a variety of assets such as property or paintings which they do not expect to lose value

d) **Other Effects of Inflation**

Inflation leads to a number of other effects which are discussed as under.

- **Government.** Inflation affects the government in various ways. It helps the government in financing its activities through inflationary finance. As the money income of the people increases, government collects that in the form of taxes on incomes and commodities. So the revenues of the government increase during rising prices. Moreover, the real burden of the public debt decreases when prices are rising. But the government expenses also increase with rising production costs of public projects and enterprises and increase in administrative expenses as prices and wages rise. On the whole, the government gains under inflation for rising wages and profits spread an illusion of prosperity within the country.
- **Balance of Payments.** Inflation affects adversely the balance of payments of a country. When prices rise more rapidly in the home country than in foreign countries, domestic products become costly compared to foreign products. This tends to increase imports and reduce exports, thereby making the balance of payments unfavourable for the country.
- **Exchange Rate.** When prices rise more rapidly in the home country than in foreign countries, it lowers the exchange rate in relation to foreign currencies

- **Collapse of the Monetary System.** If hyper-inflation persists and the value of money continues to fall many times in a day, it ultimately leads to the collapse of the monetary system, as happened in Germany after World War I and as has happened in Zimbabwe.
- **Social.** Inflation is socially harmful. By widening the gap between the rich and poor, rising prices create discontentment among the masses. Pressed by the rising cost of living, workers resort to strikes which lead to loss in production. Lured by profit, people resort to hoarding, black-marketing, adulteration, manufacture of substandard commodities, speculation etc. Corruption spreads in every walk of life. All this reduces the efficiency of the economy.
- **Political.** Rising prices also encourage agitations and protests by political parties opposed to the government. And if they gather momentum and become unhappy they may bring down the government. Many governments have been sacrificed on the alter of inflation.

Measures To Control Inflation

We have studied above that inflation is caused by the failure of aggregate supply to equal the increase in aggregate demand. Inflation can, therefore, be controlled by increasing the supplies and reducing money incomes in order to control aggregate demand. The various methods are usually grouped under three heads: monetary measures, fiscal measures and other measures.

Monetary Measures

Monetary measures aim at reducing money incomes.

a) **Credit Control.** One of the important monetary measures is monetary policy. The central bank of the country adopts a number of methods to control the quantity and quality of credit. For this purpose, it raises the bank rates, sells securities in the open market, raises the reserve ratio, and adopts a number of selective credit control measures, such as margin requirements and regulating consumer credit. Monetary policy may not be effective in controlling inflation, if inflation is due to cost-push factors. Monetary policy can only be helpful in controlling inflation due to demand-pull factors.

b) **Demonetisation of Currency**. However, one of the monetary measures is to demonetize currency of higher denominations. Such a measure is usually adopted when there is abundance of black money in the country.

c) Issue of New Currency. The most extreme monetary measure is the issue of new currency in place of the old currency. Under this system, one new note is exchanged for a number of notes of the old currency. The value of bank deposits is also fixed accordingly. Such a measure is adopted when there is an excessive issue of notes and there is hyperinflation in the country. It is very effective measure. But is inequitable for it hurts the small depositors the most.

Limitations of Credit Control in Controlling Inflation

But the scope of monetary policy is severely limited in controlling inflation. The following are its limitations.

a. **Increase in the Velocity of Money;** One of the important limitations on the effectiveness of monetary policy in controlling inflation is the increase in the velocity of money held by the public. The Central Bank can control the money supply and the cost of money by a tight monetary policy but it does not posses any power to control the velocity of money. The public can make an effective use of the money supply held by them thus making a restrictive monetary policy ineffective. This can be done in a number of ways.

b. **Commercial Bank Portfolio Adjustments;** In the face of a restrictive monetary policy, commercial banks meet the borrowers demand for loans by selling government securities to the central bank. Such a policy simply converts idle deposits held by the banks in the form of securities into active deposits. Government securities lying in the bank's portfolios are substituted for loans. But there is no change in either the total deposits or the money supply with the banks. However, this leads to increase in total spending when the banks lend money to borrowers. Thus the restrictive monetary policy of the central bank becomes ineffective.

c. **Methods to Make Better Use of Available Money Supply;**The private sector has evolved many ways to make better use of available supply of money which make a restrictive monetary policy ineffective. Some of the methods are the evolvement of improved methods of collecting funds by borrowing funds by companies from the public at higher rates than offered by commercial banks etc. By getting funds from sources other than the commercial banks, such institutions are able to increase the velocity of the available supply of money even under restrictive monetary policy.

d. **Discriminatory;**A restrictive monetary policy is discriminatory in its effects on particular sectors of the economy. It is argued that firms that depend upon internal sources of financing are not affected by a restrictive monetary policy. On the other hand, only those firms are affected that depend for funds on the banking system. In particular, a tight monetary policy "is though to work against small businessmen, because they are poorer credit risks, and against residential construction and some types of state and local government spending, because they are most sensitive to changes in credit cost." It may slow down or even halt spending by them.

e. **Threat to Credit Market;** If the central bank rigorously tightens the credit market and investors expect continued increases in interest rates, this may lead to the drying up of loanable funds to the credit market. As a result, securities may not be sold and the credit market may cease to function.

f. **Threatens Solvency of NBFIs;** A rigorous restrictive monetary policy by swiftly raising interest rates may threaten the solvency of such NBFIs as savings banks, and savings and loan associations. This is because unlike the commercial banks, they are not in a position to adjust themselves to rapidly increasing interest rates.

g. **Alter Expectations of Borrowers and Lender;** A very tight monetary policy may alter the expectations of borrowers and lender. So they bring irreversible changes in credit market conditions. A rapid rise in interest rates may so change expectations that even when this policy is abandoned

and an expansionary policy is started, lenders may be reluctant to make long-term loans in anticipation of rise in interest rates again. On the other hand, borrowers may borrow long-term funds even if they do not need them immediately in anticipation of rise in interest rates in the future.

h. Time Lags. Another important limitation of a tight monetary policy is the existence of time lags which are related to the need of action, its recognition and the decision and operation of actions in time. As the monetary authority is not able to adopt restrictive monetary measures in time due to these time lags, monetary policy works very slowly and hence it is not very effective in controlling inflation.

Fiscal Measures

Monetary policy alone is incapable of controlling inflation. It should therefore be supplemented by fiscal measures. Fiscal measures are highly effective for controlling government expenditure, personal consumption expenditure and private and public investment. The principal fiscal measures are the following:

a) Reduction in Unnecessary Expenditure. The government should reduce unnecessary expenditure on non-development activities in order to curb inflation. This will also put a check on private expenditure which is dependent upon government demand for goods and services. But is not easy to cut government expenditure. Though economy measures are always welcome, but it becomes difficult to distinguish between essential and non-essential expenditure. Therefore, this measure should be supplemented by taxation.

b) Increase in Taxes. To cut personal consumption expenditure, the rates of personal, corporate and commodity taxes should be raised and even new taxes should be levied. But the rates of taxes should not be so high as to discourage saving , investment and production. Rather, the tax system should provide larger incentives to those who save, invest and produce more. Further, to bring more revenue into the tax-net, the government should penalize the tax evaders by imposing heavy fines. Such measures are bound to be effective in controlling inflation. To increase the supply of goods within the country, the government should reduce import duties and increase export duties.

c) Increase in Savings. Another measure is to increase savings on the part of the people. This will tend to reduce disposable income with the people, and hence personal consumption expenditure. But due to the rising cost of living, people are not in a position to save much voluntarily. Keynes, therefore, advocated compulsory savings or what he called ‘deferred payment’ where the saver gets his money back after some years. For this purpose, the government should float public loans carrying high rates of interest, start saving schemes with prize money, or lottery for long periods etc. it should also introduce compulsory provident fund, provident fund cum-pension schemes etc compulsorily. All such measures which tend to increase savings are likely to be effective in controlling inflation.

d) Surplus Budgets. An important measure is to adopt anti-inflationary budgetary policy. For this purpose, the government should give up deficit financing and instead have surplus budgets. It means collecting more in revenues and spending less.

e) **Public Debt**. At the same time, it should stop repayment of public debt and postpone it to some future date till inflationary pressures are controlled within the economy. Instead, the government should borrow more to reduce money supply with the public.
Like the monetary measures fiscal measures alone cannot help in controlling inflation. They should be supplemented by monetary, non-monetary and non-fiscal measures.

Other Measures

The other types of measures are those which aim at increasing aggregate supply and reducing aggregate demand directly.

- **To Increase Production**. The following measures should be adopted to increase production: (i) One of the foremost measures to control inflation is to increase the production of essential consumer goods like food, clothing, kerosene oil, sugar, vegetable oils etc. (ii) If there is need, raw materials for such products may be imported on preferential basis to increase the production of essential commodities. (iii) Efforts should also be made to increase productivity. For this purpose, industrial peace should be maintained through agreements with trade unions, binding them not to resort to strikes for some time. (iv) The policy of rationalization of industries should be adopted as a long term measure. Rationalization increases productivity and production of industries though the use of brain, brawn and gold. (v) All possible help in the form of latest technology, raw materials, financial help, subsidize. , etc. should be provided to different consumer goods sectors to increase production.
- **Rational Wage Policy**. Another important measure is to adopt a rational wage and income policy. Under hyperinflation, there is a wage-price spiral. To control this, the government should freeze wages, incomes, profit, dividends, bonus, etc. But such a drastic measure can only be adopted for a short period and by antagonizing both workers and industrialists. Therefore, the best course is to link increase in wages to increase in productivity. This will have a dual effect. It will control wages and the same time increase productivity, and hence production of goods in the economy.
- **Price Control**. Price control and rationing is another measure of direct control to check inflation. Price control means fixing an upper limit for the prices of essential consumer goods. They are the maximum prices fixed by law and anybody charging more than these prices is punished by law. But it is difficult to administer price control.
- **Rationing.** Rationing aims at distributing consumption of scarce goods so as to make them available to a large number of consumers. It is applied to essential consumer goods such as wheat, rice, sugar, kerosene oil, etc. it is meant to stabilize the prices of necessaries and assure distributive justice. But it is very inconvenient for consumers because it leads to queues, artificial shortages, corruption and black marketing. Keynes did not favour rationing for it "involves a great deal of waste, both of resource and of employment.

Conclusion

From the various monetary, fiscal and other measures discussed above, it becomes clear that to control inflation, the government should adopt all measures simultaneous. Inflation is like a hydra-headed

monster which should be fought by using all the weapons at the command of the government.

LESSON EIGHT: INTERNATIONAL FINANCIAL SYSTEMS

Introduction

After the first World War there was complete lack of monetary co-operation among the countries of the world. The gold coin standard used before World War I, was abandoned during the war. As a result of the breakdown in gold standard, the World lost the most efficient automatic standard upon which nations had for a long time used as a vehicle for restoring equilibrium in their balance of payments whenever it was disturbed.

It was therefore necessary that a concerted effort be made on international level to create some effective international arrangement whereby exchange stability could be guaranteed. A common plan evolved at United Nations Monetary and Fiscal Conference of 44 world nations held at Bretton Woods, New Hampshire in July 1944. Out of the deliberation of this conference sprang up the Brettonwoods twins - the International Monetary Funds (IMF) and the International Bank for Reconstruction and Development (IBRD).

International Financial Institutions

There are several international organizations, funding and assisting the development of nations. These include International Monetary Fund, World Bank, Regional Development Bank e.t.c. the influence of some of them is, indeed, very profound. The economic policies and programmes of member countries which take financial assistance from these organizations may be influenced by policies and conditions of assistance of these organizations.The IMF has several schemes of financial assistance for countries with balance of payment problems. It also provides different types of technical assistance.

Assistance from the World Bank and Regional Development Banks are substantial sources of public investments in a number of countries and such investments may help improve the general business conditions in those countries. Many of these public projects are implemented by private parties and it is mandatory that contracts in respect of large projects funded by these institutions shall be award by global tendering.

Further some of the organizations also provide direct financial assistance to the private sector.

International Monetary Fund (IMF)

The International Monetary Fund (IMF), which was established on December 27, 1945 with 29 countries and which began financial operation on March 1, 1947, is the result of the Bretton Woods Conference of nations held in 1944 to discuss the major international economic problems, including reconstruction of the economies ravaged by World War II, and to evolve practical solutions for them.

The IMF is the central institution of the international monetary system. It aims to prevent crises in the system by encouraging countries to adopt sound economic policies. Also, as it name suggests, a fund can be tapped by members needing temporary financing to address balance of payment problems.

Membership in the IMF is open to every country that controls its foreign relations and is able and prepared to fulfill the obligation of membership.

(a) Purpose of IMF

The IMF's statutory purposes include promoting the balance expansion of world trade, the stability of exchange rates, the avoidance of competitive currency devaluations, and the orderly correction of a county's balance of payments problems.

According to Article one of Agreement of the International Monetary Fund, ***the purposes of the IMF are:***

- To promote international monetary cooperation through a permanent institutions which provide the machinery for consultation and collaboration on international monetary problems.
- To facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- To promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
- To assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- To give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international **prosperity.**

In accordance with the above, to shorten the duration and lessen the degree of disequilibria in the international balances of payments of members.

(b) Technical Assistance

The IMF provides technical assistance in areas within its core mandate; these areas are macroeconomic policy, monetary and foreign exchange policy and systems, fiscal policy and management, external debt, and macroeconomic statistics.

The objective of IMF technical assistance is to contribute to the development of the productive resources of member countries by enhancing the effectiveness of economic policy and financial policy.

In practice, the IMF fulfills this objective by providing support to capacity building and policy design. It helps countries strengthen their human and institutional capacity, as a means to improve the quality of policy-making, and gives advice on how to design and implement effective macroeconomic and structural policies.

The IMF provides technical assistance in three broad areas:-

- Designing and implementing fiscal and monetary policies.
- Drafting and receiving economic and financial legislation, regulations, and procedures, thereby helping to resolve difficulties that often lie at the heart of macroeconomic imbalances
- Institution and capacity building, such as in central banks, treasuries, tax and customs departments, and statistical services.

World Bank

The World Bank Group, originated as a result of the Bretton Woods Conference of 1944, is one of the World's largest sources of development assistance and it has extended assistance to more than 100 developing economies bringing a mix of finance and ideas to improve living standards and eliminate the worst forms of poverty. For each of its clients, the bank works with government agencies, non-governmental organizations, and the private sector to formulate assistance strategies.

The World Bank Group consists of five closely associated institutions playing a distinct role in the mission to fight poverty and improve living standards for people in the developing world. The term ***World Bank*** refers specifically to two of the five, that is, The International Bank for Reconstruction and Development (IBRD) and The International Development Association (IDA).

The other 3 institutions are:-

- The International Finance Corporation IFC)
- The multilateral investment guarantee agency
- The International Centre for Settlement of Investment Disputes (ICSID)

While all five specialize in different aspects of development, they use their comparative advantages to

work collaboratively towards the goal of poverty reduction.

(a) The purposes of the World Bank, as laid down in its Articles of agreement, are:-

(a) To assist in the reconstruction and development of the territories of its members governments, by facilitating investments of capital for productive purposes, including the restoration of economies destroyed or disrupted by war and the encouragement of the development of productive facilities and resources in less developed countries.

(b) To promote foreign private investment by guarantees of or through participation in loans and other investments made by private investors.

(c) Where private capital is not available on reasonable terms, to make loans for productive purposes out of its own resources or out of the funds borrowed by it.

(d) To promote the long term growth of international trade and the maintenance of equilibrium in balance of payments by encouraging international investment for the resources of members.

The bank advances loans to member countries in the following three ways:

i) By making or participating in direct loans out of its own funds.

ii) Out of funds raised in the markets of a member or otherwise borrowed by the bank.

iii) By guaranteeing in whole or part loans made by private investors through the investments channels.

The bank has made loans for specific development projects in the field of Agriculture, Power, Transport, Industry and Education, Railway Rehabilitation, Highway Constructions etc.

Structural Adjustment Programmes (SAPs)

Structural adjustment programmes is the name given to a set of 'free market' economic policy conditions imposed on developing countries by the World Bank and international monetary fund [IMF] as a condition for receipt of loans. Thus structural adjustment programmers are the policies implemented by the international monetary fund (IMF) and the World Bank in developing countries.

These policy changes are conditions for getting new loans from international monetary fund or World Bank, or for obtaining lower interest rates on existing loans. The conditions are implemented to ensure that the money lent will be spent in accordance with the overall goods of the loan.

What were the structural adjustment programmes (SAPs) designed to do?

SAPs are designed to:-

i. Improve a country's foreign investment climate by eliminating trade and investment regulations.

ii. To boost foreign exchange earnings by promoting exports.

iii. To reduce government deficits through cuts in spend.

SAPs were developed in the early 1980s as a means of gaining stronger influence over the economies of debt-strapped governments in the south. To ensure the continued inflow of funds, countries already devastated by debt obligations have little choose but to adhere to conditions mandated by the IMF and World Bank. The structured adjustment programmers (SAPs) are created with the goal of reducing the borrowing country's fiscal imbalances. The SAPS are supposed to allow the economies of the developing countries to become were market oriented. This then forces them to concentrate more on trade and production so it can boost their economy.

Through conditionalities, structural adjustment programmes and policy these programs include;

1) Internal changes (privatization and deregulation)
2) External changes, especially the reduction of trade barriers.

Countries which fail to enact these programs may be subject to severe fiscal discipline.

Conditions For Structural Adjustment Programmes (what measures are imposed under SAPs?)

1. Cutting expenditures (austerity) – that is, deep cuts to social programs usually in the areas of health, education and housing and massive layoffs in the civil service.
2. Shift from growing diverse food crops for domestic consumption to specializing in the production of cash crops or other commodities like rubber, cotton, coffee, copper, tin for export.
3. Abolishing food and agricultural subsidies to reduce government expenditures
4. Devaluation of currencies –currency devaluation measures increase import costs while reducing the value of domestically produced goods.
5. Trade liberalization, i.e. lifting import and export restrictions and high interest rates to attract foreign investment.
6. Balancing budgets and not overspending.
7. -Removing price controls and state subsidies.

8. Privatization of government held enterprises.
9. Enhancing the rights of foreign investors vis- vis national laws.
10. Improving governance and fighting corruption.
11. Increasing the stability of investments by supplemental foreign direct investment with the opening of domestic stock markets.
12. Focusing economic output on direct export and resource extraction.

These conditions have also been sometimes labeled as the ***Washington consensus***.

Why the need for SAPs?

The World Bank and the IMF argue that SAPs are necessary to bring a developing country from crisis to economic recovery and growth. Economic growth driven by private sector foreign investment is seen as the key to development. These agencies argue that the resulting national wealth will eventually 'trickle down' or spread throughout the economy and eventually to the poor.

Criticisms on SAPs

Multiple criticisms that focus on different elements of SAPs

1. **National sovereignty**- critics claim that SAPs threaten the sovereignty of national economies because an outside organization is dictating a nation's economic policy. Critics argue that the creation of good policy is in a sovereign nation's own best interest. Thus, SAPs are unnecessary given the state is acting in its best interest. However, supporters consider that in many developing countries the government will favor political gain over national economic interests; that is, it will engage in rent-seeking practices to consolidate political power rather than address crucial practices to consolidate political power rather than address crucial economic issues.

   Also some critic argue that the democratic policy process of countless countries has been undermined by decisions formulated miles away by western economic bureaucrats and that the implementation of such policy has solely benefited the largest donor countries like US, UK, Canada & Japan.

2. **Privatization**: - A common policy in structural adjustment is the privatization of state-owned industries and resources. This policy aims to increase efficiency and investments, and decrease state spending. State-owned resources are to be sold whether they generate a fiscals profit or not.

   Critics argue that when resources are transferred to foreign corporation and/or national elites, the goal of public prosperity is replaced with the goal of private accumulation.Privatization makes essential needs such as water and health cure a commodity, and these who are poor are unable to access such basic necessities. Therefore, many scholars have argued that SAPs are not in the interest of the borrowing country, but rather caters to the elites of the eliminating and undeveloped worlds.

The privatization of a previously social service such as health care is actually counter-intuitive to the alleged purpose of structural adjustment.

3. **Agriculture**:-The agricultural, anti-land reform and food trade policies associated with SAPs have been pointed to as a major engine in the urbanization of the developing. In the irrigation sub-sector the trend has been towards disengagement of governments from irrigation development and management.

   There are also sources of contention for environmental activities. If large portion of SAPs policy in agriculture focuses on the increased use of fertilizers and pesticides which harm the health of local bodies of water and therefore fish populations

   Impact- the privatization of the agricultural sector increased the inequality of good distribution and inequality wealth in general as some farmers adapted to privatization and flourished and others fell behind.

   Farmers were introduced to fertilizers that left the hand nutrient barren and unusable. In theory, devolution, by lowering the relative price of farm commodities on the international market, should make a country's agriculture exports more competitive. However, it is by no means certain that increased exports compensate for the loss of purchasing power of a cheaper currency.

4. **Environment**

   Local environments can easily become casualties of pro-trade policies. Pro-trade policy promotes an increase of industry geared toward western needs. As a result of the policy, local industries begin the focus on producing in expensive goods to sell on the international market.

   Impact**:** - the focus on creating the least expensive product often leads to environment exploitative industry. As these industries are often unregulated there are no laws prohibiting this exploitation. For example, emission from factories is much less regulated in developing nations.

   SAPs call for increased exports to generate foreign exchange to service debt. The acceleration of resource extraction and commodity production that results as countries increase exports is not ecologically sustainable.

   Deforestation, land degradation, soil erosion and sanitization, biodiversity loss, increased production of green house gases, and air and water pollution are but a many the long-term environmental impacts that can be traced to the imposition of SAPs.

5. **Austerity**

   SAPS emphasized maintain a balanced budget which forces austerity programs. The casualties of

balancing a budget are often social programs.

The programs most often cut are education, public health, and other miscellaneous social safety nets. Commonly, those are programs that are already underfunded and desperately need monetary investment for improvement.

Impact: - if government cuts education funding, universally is impaired, and therefore long-term economic growth.

6. Gendered effects

Poverty is a gendered issue, that is, various differences in circumstances between males and females cause variances in the way poverty affects each. With this structural adjustment programs fail to address poverty as a gendered issue. Thus implementation of

SAPs caused many problems which include:-

- Local health, welfare and infrastructures (especially water and sanitation) are usually considered "women's work" and fall directly to them. Withdrawing government support directly affects the amount of work women are required to do, resulting in lessened health and well-being for women and indeed the entire family.
- In addition, opening markets causes an upsurge of jobs in cities. As rural man leave to go to those jobs, women and children are left behind, with increased responsibility for wives and mothers to single handedly run the household.