COMMERCE – S4

THE CENTRAL BANK

A central bank is a national bank of any country, managed by the government to control and guide other financial institutions in the country. It is responsible for issuing new currency.

It is an important bank in the country which also assists and advises government on financial matters. The central bank in Uganda is called **Bank of Uganda (BOU).**

FUNCTIONS OF THE CENTRAL BANK (BANK OF UGANDA)

- **Issuing of currency**

The central bank is responsible for issuing currency i.e. it controls the process of printing bank notes and minting coins. Therefore, it takes the responsibility of issuing new currency and replacing the worn our paper notes.

- **Banker to the government**
  The central bank provides banking services to government by receiving deposits on behalf of the government from various sources e.g. income tax, customs duty, etc.
- **Lender to the government**

The central bank is one of the sources of short-term income to the government i.e. the government borrows money in various forms from the central bank. This money can be in form of a public debt.

(A public debt is money borrowed by government from the public through commercial banks on behalf of its people or it is any money due by the government to its people.)

The central bank is also responsible for controlling government borrowing and to pay back government debts. So, it manages the public debt.

- **Adviser to the government**

The central bank through the Ministry of Finance and Economic Planning advises the government on financial matters e.g. on how to control inflation in the country, how to raise short term finance for government projects, the best projects to invest in.

- **Exchange control**

It controls foreign exchange or currency in the country by restricting the outflow of foreign currency to other countries. This foreign currency can be used to pay for imported goods and services.

- **It acts as a banker to international agencies**

The central bank provides banking services to international agencies working within the country like the International Monetary Fund (IMF), World Vision, Red Cross, etc.

- **It acts as a banker to commercial banks**
  It provides banking facilities to commercial banks in the country i.e. all commercial banks and other savings banks keep their money (deposits) with the central bank.
- **It keeps the country's gold reserves**
  It keeps the country's gold and foreign exchange reserves which are used for settling the country's debts.
- **Lender of last resort**
  The central bank is not basically a money lending institution but it does sometimes lend money to the government, commercial banks and other financial institutions when there is no other source available for borrowing. Hence acts as a lender of last resort.
- **It supervises and controls commercial banks**
  The central bank directs and controls commercial banks on all financial matters of importance e.g. lending money to the public.

CREDIT CONTROL

This is an act taken by the central bank to control the lending capacity of commercial banks in order to ensure that there is just the right amount of money in the economy. (Usually *a loan granted by a commercial bank increases money in circulation, hence need for credit control.)*

There are two policies employed by the central bank to control credit i.e. monetary policy and fiscal policy.

MONETARY POLICY

This refers to deliberate attempts and measures taken by the government to control and regulate the amount of money in circulation.

TOOLS OF MONETARY POLICY (CREDIT CONTROL)

These are tools used by the government through the central bank to ensure that there is a reasonable amount of money in circulation so as to maintain the value of its currency.

The tools include;

Bank rate

This is the rate of interest charged by the central bank on any short-term loan it may advance to commercial banks.

When there is a lot of money in circulation, the central bank will restrict borrowing by raising the bank rate at which commercial banks borrow from the central bank. This process forces the interest rate up and hence discourages borrowers thus reducing the amount of money in circulation.

On the other hand, if there is little money in circulation, the central bank will encourage borrowing by lowering the bank rate. This means that the commercial bank will also reduce the interest rate charged to the public thus encouraging borrowing which will lead to increased amount of money in circulation.

Open market operation (OMO)

This involves the sale and purchase of government securities i.e. treasury bills, bonds and stock to and from the public respectively.

When there is too much money in circulation (inflation), the government through the central bank will sell securities to the public which will result into withdrawing of money from the public hence reducing it in circulation.

N.B: *Any money received through the sale of these securities is frozen i.e. withdrawn from circulation.*

On other hand, if there is little money in circulation (deflation), government through the central bank will buy securities from the public hence putting more money in circulation.

Compulsory or special deposits

This is an additional amount of money which commercial banks are required to deposit in the central bank on their accounts.

If there is too much money in circulation, the central bank may instruct commercial banks to deposit more money on their central bank accounts. This reduces the amount of money available for commercial banks to lend. While during deflationary periods they are requested to withdraw from their accounts. This increases the amount of money for commercial banks to effect their lending hence controlling the amount of money in circulation.

Selective control

This is when the central bank directs or requests all commercial banks and other financial institutions to approve or give loans to certain sectors of the economy and leave out others.

For example the agricultural sector will be given loans first and those who wish to buy expensive luxury items like expensive vehicles are given last or not given at all, hence regulating money in circulation.

Raising the cash ratio

Cash ratio refers to the percentage of deposits that is not lent out by commercial banks but kept in cash form.

The central bank may instruct commercial banks to keep a higher percentage of the deposits received by them in cash form if there is too much money in circulation. This results in less cash being available with commercial banks for lending and vice versa.

Moral suasion / instruction to commercial banks

The central bank may persuade commercial banks to exercise a general restraint (control / limit) in granting loans to businessmen if there is too much money in circulation.

It involves persuasion, request, appeal and advice by the central bank to commercial banks to control and regulate the lending policies.

Currency reform.

This refers to the withdrawal of a given currency from circulation and replacing it with a new currency of higher value.

When there is too much money in circulation and losing value at a high speed, the central bank may be forced to undertake a currency reform and replace the old currency with a new one if other measures have failed.

Legal reserve requirement.

This is the percentage of commercial banks total deposits that are required by law to be kept with the central bank before operation.

During inflation the commercial banks are required to keep a high legal reserve requirement with the central bank so as to reduce the amount available to commercial banks for lending. And as such is lowered (reduced) to increase the amount of money in circulation during a deflation.

Margin Requirement.

This is the difference between the value of the collateral security offered by the borrower to the bank and the amount of money advanced by the bank in form of a loan.

When there is too much money in circulation, commercial banks are required to maintain a high margin requirement to scare away the borrowers hence reducing money in circulation.

Rationing of credit.

This is where the central bank limits the amount of loans lent out to commercial banks.

If the central bank wants to reduce the amount of money in circulation, it fixes a maximum amount a given commercial bank can borrow from the central bank. This reduces / limits the amount of money the commercial banks would give out to the public as loans.

REVIEW QUESTIONS

1. Define the following terms;

    i. Inflation
    ii. Reflation
    iii. Deflation
    iv. Devaluation
    v. Depreciation
    vi. Variable resource requirement.
    vii. Standing orders
    viii. Credit transfer

2. Describe the functions of the Bank of Uganda.

3. (a)Distinguish between monetary policy and fiscal policy.

    (b) Explain the methods or tools used by the Central Bank to control credit.

4. Define the following terms;

    i) Legal tender

    ii) Public debt

    iii) Fiduciary issue

    iv) Bank rate.

5. Outline any five differences between a commercial bank and a central bank.