S5 ECONOMICS MONEY AND BANKING CONTINUED…..

THE BANK

A bank is a business institution which **accepts deposits from surplus spending units** in form of savings especially from the public and then **lends the same to deficit spending units (investors) to earn a profit**.

TYPES OF BANKS;

DEVELPOPMENT BANKS

This is a bank mainly created by a state or governments of neighboring countries to promote the development of infrastructure in the country or region.

They also promote industrial growth within the country or within the region e.g. the East African development, Uganda development bank, African Development Bank, Arab Bank for Economic Development in Africa.

Their sources of funding is mainly Africa Development Bank, OPEC fund, United States Agency for Development, and the World Bank.

Development banks are **development oriented non-bank financial institutions** offering long-term loans for investment at low interest rate, especially in agriculture, industry and infrastructural development (roads, ports, power dam projects, irrigation schemes)

Development banks perform the following functions:

- They give out loans for investment purposes especially where commercial banks cannot manage.
- They encourage growth of risky but developmental ventures like mining, agriculture.
- They attract foreign technical assistance required in the development of vital areas
- They initiate long term lending to individuals, institutions whose projects are deemed necessary for development of the country.

THE CENTRAL BANK

A central bank refers to a central monetary institution which is responsible for financial management, and controlling other financial institutions in a country operating on non-profit motive. In Uganda the central Bank is **Bank of Uganda.**

SPECIALISED BANKS

These are commercial banks which are set up to serve a special type of customers with specific services. E.g. Housing Finance Bank, Development Finance Company of Uganda (DFCU)

SAVINGS BANKS

These are banks which are set up to promote the culture of savings among people in the country. They attract deposits of any size but limit the withdraw facilities.

COMMERCIAL BANKS

Commercial banks are financial institutions which carry out financial businesses by accepting deposits from the public and lending out money on profit motive. Examples in Uganda include; Standard Chartered Bank, Stanbic Bank, Centenary Bank, Diamond Trust Bank etc.

FUNCTIONS OF COMMERCIAL BANKS/BANKING FINANCIAL INSTITUTIONS

NB: (**These are mandatory duties of any commercial bank)**

- Accepting deposits. This is done by allowing customers to open different types of accounts like, savings account, current account, fixed deposit, by doing so they safeguard customers' money.
- Advancing loans to trustworthy customers. This is done through offering different loan products on short term and long-term basis. Such loans help the customers with financial difficulties e.g. a bank over draft is an example of a short-term loan.
- Act as custodians of their customers valuables/clients. Commercial banks provide strong rooms to keep customers valuable items like academic documents, land titles, important business agreements/contracts etc.
- Issuing of various forms of instruments credit/provide easy means of payment such as cheques, drafts, credit and debit cards. They provide excellent means of enabling payments. These facilitate the transfer of money from debtors to creditors
- Issuing letters of credit to and act as referees to their clients. Commercial banks act as referees or guarantors on behalf of their clients who are buying goods on credit.
- Providing advice to the investors on possible investment choices. This is advice is mainly financial or business related. E.g. they assist customers to make realistic business proposal and business plans.
- Underwrite shares and debentures of companies as wells as discount bills of exchange/ financial securities. Commercial banks trade in the issued securities as primary dealers who sell them to other interested clients.

- They act as trustees and executors of property and will of their deceased clients/ customers. Here they accept to manage the property or estates of their deceased clients to benefit the deceased's family.
- They help in the exchange of currencies of different countries. They buy and sell local and foreign currencies; here they act as foreign exchange bureaus.

THE ROLE OF COMMERCIAL BANKS IN DEVELOPMENT

- They facilitate the process of investment by moblising savings from the public as well as extending loans to people/public.
- They provide employment opportunities because commercial banks employ people to perform different tasks in their different branches and departments e.g. accounts, managers, cleaners, security guards etc
- Commercial banks facilitate/assist the government in implementation of the tools of the monetary policy .i.e. they help the central bank in circulating the newly issued currency.
- They encourage monetisation of the economy by promoting exchange using money they also lend money to people to carry out production for the market.
- Commercial banks promote skills development by providing on job training to their employees.
- They facilitate and stimulate the development of infrastructures in the economy i.e. they participate in the construction of buildings, roads, communication networks in order to improve their services. e.g Mapeera house for centenary bank.
- They increase government revenue. This is because they pay different taxes to the government.
- They facilitate and promote trade both internal and external by enabling traders to transfer their money safely.
- They are instrumental in promoting capital accumulation process. This is because of their capacity to mobilize savings from the public.
- They contribute investment capital in the country through buying shares from various public limited companies.
- They assist potential investors by giving them advice on investment opportunities.
- They give recommendations and covering letters to potential investors which facilitate internal and foreign trade.

- They offer specialized and diversified services which are necessary for people's welfare and development e.g. issuing travellers' cheques.

FOREIGN COMMERCIAL BANKS

These are banks established in the country i.e. Uganda by foreigners and they have their headquarters in their mother countries. e.g. Barclays bank, Standard Chartered bank, Cairo international bank etc.

Role of foreign commercial banks

Positive roles:

- They provide employment opportunities because commercial banks employ people to perform different tasks in their different branches and departments e.g. accounts, managers, cleaners, security guards etc
- They promote good international relationships among countries i.e. between their mother country and their host country and this promotes international peace.
- They facilitate investment in the private sector through the provision of loans to the potential investors.
- They promote efficiency in the banking sector through creating stiff competition with the local banks.
- They facilitate the process of international trade by exchanging the foreign currencies for importers and exporters.
- They offer international banking services.
- They promote development of local managerial skills through demonstration effect since the people employed learn a lot of from expatriates and in addition the banks provide training banking skills.
- They increase the rate of monetisation of the economy because the loans they give out help people to produce for commercial purposes.
- They contribute to the development of infrastructure in attempt to improve on their services. They participate in construction of roads, buildings, extension of power supply in rural areas etc.

- They facilitate technological development in the economy because transfer modern methods of banking into the country. E.g. computerised banking services including the use of Automated Teller Machines (ATM).
- They increase the rate of capital inflow into the country by facilitating the transfer of money by citizens of the host countries.

Negative role of foreign commercial banks

- They worsen the balance of payment deficit because of the increased profit repatriation.
- There is limited creation of employment opportunities in the country because the banks mainly use capital intensive technology which is labour saving and also they have discriminating employment policies in that they prefer employing foreign manpower especially at ranks jobs.
- They outcompete local banks because they have more finances and better technology than the local banks.
- They encourage rural urban migration and its related evils since the banks are concentrated in urban areas which attract people from rural areas to urban areas.
- They make the implementation of the monetary policy difficult because they do not co-operate with the central bank since they have a lot of cash to inject in the economy from their mother banks abroad. i.e they rarely borrow from the central bank.
- They discourage mobiliastion of savings because they require high initial deposit which many people cannot afford.

PROBLEMS FACING COMMERCIAL BANKS IN DEVELOPING COUNTRIES (UGANDA)

- The limited/small size of bank deposits because of the high level of poverty among the people which limits the number of clients to the bank.
- The limited number of credit worthy customers/There are a few credit worthy borrowers who can pay back the loans advanced to them hence limiting expansion of the banking sector

- Political interference in the management of commercial banks and this makes it difficult for banks to make decisions on their own, i.e. they are forced to function according to the desires of the government.
- Political instability/ High levels of insecurity where people fear to borrow for investment therefore funds remain underutilized in commercial banks. Banks can't easily extend to rural areas for fear of losing property and depositors money.
- Limited skills among banking officials which makes them incompetent to run the commercial banks, the inadequate supply of skilled manpower to manage the bank forces the banks to hire foreign managers who are highly paid leading to a high cost of production.
- Low levels of accountability or high level of corruption among banking officials which makes commercial banks to incur huge losses leading to closure of many of them. e.g managers and other workers steal funds from banks
- Stiff competition with other financial institutions such as microfinance institutions, post office savings banks, mobile money services and credit cooperatives all of which make commercial banks earn little profit.
- High liquidity preference by the people which reduces savings with commercial banks.
- Uneven distribution of commercial banks where the majority are urban based hence neglecting the potential borrowers and savers in rural areas.
- Ignorance of the public/People about banking facilities, this limits the use of commercial banks by the population resulting into low deposits.

MEASURES THAT MAY BE TAKEN TO IMPROVE THE PERFOMANCE OF THE BANKING INDUSTRY IN DEVELOPING COUNTRIES LIKE UGANDA.

- Encourage extension of banking services to rural areas.
- Close the banks that do not meet the minimum requirements.
- The central bank should Undertake close supervision of the commercial banks
- Sensitize the public on the importance of banking
- Encourage training of more bankers
- Increase people's incomes so as to increase their deposits with banks
- Government should reduce her interference in the activities of commercial banks

- Ensure political stability so as to promote economic activities which will motivate people to borrow for investment purposes.

FEATURES OF COMMERCIAL BANKS IN UGANDA

- They are mainly urban based
- They are generally weak and underdeveloped
- Most are foreign owned
- Many have a weak capital base
- They mainly charge high interest and service fees
- They mainly offer few products(services)
- They have few branches.
- Many are privately owned

ASSETS AND LIABILITIES OF COMMERCIAL BANKS:

ASSETS OF COMMERCIAL BANKS

Assets are possessions of a bank and all other claims on other financial institutions and customers. Assets include the following:

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

LIABILITIES OF COMMERCIAL BANKS

Liabilities are claims against the assets of the bank by its creditors, depositors or what the bank owes.

Liabilities include the following;

- Share capital.
- Customer deposits.

- Deposits by other banks.
- Government funds deposited in the bank.
- Dividends payable to shareholders.
- Reserve funds payable to the central bank.
- Bills discounted with the central bank.

CONFLICTING OBJECTIVES OF COMMERCIAL BANKS

Commercial banks are always faced with the dilemma of achieving various objectives of liquidity, profitability and security. eg. if the banks increase lending so as to earn more profits, it won't meet the customers money demand which will make them lose confidence in the bank and thereby depositing less of their money in the bank.

In the same way, when they maintain liquidity to attract confidence in the customer the banks will not get profits and therefore there will be no funds for lending. Commercial banks therefore have to find a way of reconciling the conflicting objectives.

How commercial banks ensure liquidity

Commercial banks undertake the following to ensure that they always have cash to give their clients.

- By purchasing of short-term securities that can be turned into cash easily e.g. buying treasury bills.
- They lend out money in phases such that at all times there is some money to meet the daily cash requirements.
- By maintaining the cash ratio. This is intended to have sufficient cash to meet the daily demands of the customers.
- Maintaining a minimum balance on the different accounts of their customers.
- Commercial banks lend on short term basis such that the cash is easily restored
- They ensure that the borrowers deposit a marketable security with the bank which can be liquidated in case of failure to pay the loan.

How Commercial banks ensure profitability/Maintain profitability

The commercial banks undertake the following to ensure that they make profits;

- Advancing loans and overdrafts at a given interest. Here commercial banks charge interest depending on the amount of money borrowed and the time taken. The interest earned improves profitability.
- Undertaking investment in profitable projects. The commercial banks invest their money in businesses/project that are highly profitable e.g. investing in real estates and securities.
- They charge fees for their different services e.g. they have bank charges, ledger management fees, charges on money withdrawals etc, such money is accumulated to create profits for the banks.
- Charging a commission for services rendered to customers e.g. where they act as custodians of estates of the deceased. The commission they earn improves their revenue and profitability.
- By discounting bills of exchange and promissory notes at a fee.
- They buy shares in other companies like other members of the public. Commercial banks buy shares floated by companies. From these they earn dividends annually to improve their revenue and profits.

How commercial banks ensure security:

Commercial banks ensure security in the following ways;

- They demand for marketable collateral security to extend loan to their customers.
- They spread their assets in different categories of liquid assets e.g. cash deposits with other banks, fixed assets etc.
- They extend short term loans and avoid long term loans
- They put up strong buildings where they carry out their activities
- They employ security guards
- They take up insurance covers against various risks.

CREDIT CREATION:

Credit creation is the process by which commercial banks create excess deposits/ new deposits out of the initial deposits made by customers. This is through lending out excess funds to credit worthy borrowers who deposit the borrowed funds at different branches of the same bank.

Assumptions of credit creation

- It assumes that there is a fixed cash ratio e.g. 10%
- It assumes a fixed initial deposit e.g. Shs. 100,000
- It assumes that there are several banks in the system (multi-bank credit creation process) or there is only one bank with very many branches (Uni-bank credit creation process).
- It assumes that when people get loans in form of cheques, such cheques are deposited in other banks or in other branches of the same bank.
- It assumes that the public/ are willing to borrow money from commercial banks.
- It assumes that the public should be credit worthy.
- It assumes the use of cheques i.e. there must be a large number of current account holders so that commercial banks use the deposits to create credit.
- It assumes that there are many people willing to deposit money in the bank therefore have confidence in the bank.
- It assumes that commercial banks are willing to give/lend money to the public.

The basic terms used in credit creation

Bank deposit/ Credit Multiplier.

Credit multiplier is the number of times by which an initial bank deposit multiplies itself to generate a final change in total credit created/total bank deposits

Credit multiplier $= \frac{\text{Total deposit}}{\text{Initial deposit}}$ or $\frac{1}{\text{r}}\left(\frac{1}{\text{cash ratio}}\right)$

The size of the bank deposit depends on the following;

1. Level of liquidity preference
2. Interest rate on deposits
3. The willingness by the masses/public to borrow

4. The size of the cash ratio
5. Number of banks in the system
6. Size of initial deposit

- **Cash ratio.** This is the proportion/ fraction/percentage of commercial banks deposits that must be kept/remain in the bank in cash form to meet the cash demands of depositors.
- **Reserve ratio.** This refers to percentage/fraction of the commercial bank's total deposits which by law must either be kept with the commercial bank or with the central bank.

Factors that influence the reserve ratio

1. The rate of inflation/The amount of money in circulation
2. The level of credit creation
3. Level of liquidity of the commercial bank
4. The level of uncertainty in the financial sector

Reasons for adoption of reserve ratio in an economy

1. To control inflation/reduce the amount of money in circulation.
2. To restrict credit creation by commercial banks.
3. To protect interests of depositors in times of crisis and financial instability.
4. To safe guard commercial banks against uncertainties i.e. during periods of economic recession

- **Liquidity ratio.** This is the proportion of total deposits of a commercial bank in form of assets that can easily be turned into cash such as bank drafts, cheques etc.

THE PROCESS OF CREDIT CREATION

1. Receiving an initial deposit of the first bank **(Bank A)** from customers/ depositors.e.g Shs. 100000
2. Keeping a certain percentage of the initial deposit as cash ratio e.g. 30% or shs.30, 000 as cash reserves.
3. Lending out the remaining percentage of the initial deposit as a loan to a trusted borrower, for example shs.70, 000.

4. Receiving the money lent out as new deposit by another/the second bank **(Bank B)** i.e. 70,000=
5. Keeping a percentage of the new deposit by the second bank as cash ratio, for example 30% of shs.70, 000= or shs.21, 000=.
6. Lending out part of the new deposit to a trusted borrower by the second bank for example, shs.49, 000=.
7. The process continues until the initial deposit defuses into the banking system.
8. At the end of the process, the total credit created is equal to initial deposit x Bank multiplier.

Total credit created = Initial deposit x bank multiplier but bank multiplier is equal to 1/r $\left(\frac{1}{cash\ ratio}\right)$ = 100, 000 × 5

= shs.500, 000

ILLUSTRATION OF CREDIT CREATION

Given that Bank **A** has initial deposit of UgShs.100, 000, and the required cash ratio is 30%, credit is created as shown in the table below.

Banks/Branches	Initial Deposit/ New deposits.	Cash Ratio (30%)	Loanable funds
	100,000=	$\frac{30}{100}$x100,000= 30,000	100,000-30,000 = 70,000
B	70,000=	$\frac{30}{100}$x70,000= 21,000	70,000-21,000 = 49,000
C	49,000=	$\frac{30}{100}$x49,000= 14,700	49,000-14,700 = 34,300
D	34,300=	$\frac{30}{100}$x34,300= 10,290	34,300-10,290 = 24,010
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NB. Total credit created for four banks = 100,000+70,000+49,000+34,300 = 253,300/=

FACTORS INFLUENCING THE PROCESS OF CREDIT CREATION

- Level of liquidity preference by individuals. High demand for cash implies that people deposit less in commercial banks and this reduces the ability of commercial banks to lend hence low credit creation, on the other hand low liquidity preference implies that individuals make large deposits into commercial banks. This increases the funds available for lending thus promoting the process of credit creation.

- Size of the cash ratio. The higher the cash ratio, the lower the level of credit creation since banks retains much of the deposits which limit lending, however the lower the cash ratio, the higher the level of credit creation since banks are able to retain less of the customer's deposits which limits the amount of money for lending.

- Interest rates on loans. High interest rate on loans lead to low demand for loans as borrowing becomes expensive hence limiting credit creation, on the other hand low interest rate on loans lead to high demand for loans as borrowing becomes cheap, thus promoting the process of credit creation.

- Availability of collateral security. Presence of collateral security encourages commercial banks to lend out money to the public hence high level of credit creation. On the other hand, absence of collateral security discourages commercial banks from lending out money to the public thus low level of credit creation.
- Level central bank interference through the monetary policy. Restrictive monetary policy by the central bank reduces the amount of money to be held by commercial banks for lending hence limiting the process of credit creation, on the other hand, an expansionary monetary by the central bank increases the amount of money held by the commercial banks for lending thus promoting the process of credit creation.
- Level of monetisation of the economy/Size of the subsistence sector. High level of monetization of the economy leads to high level of credit creation because most economic activities require use of money hence increased borrowing from commercial banks. On the other hand, a large subsistence sector reduces the amount of credit created as most of

activities done do not require a lot of funds hence reduced borrowing from commercial banks.

- Nature of distribution of commercial banks/Level of development of the banking sector. Even distribution of commercial banks in a country promotes credit creation as lending services are within the reach of the customers, alternatively even distribution of commercial banks encourages saving thus increasing the size of bank deposits. On the other hand, poor distribution of commercial banks limits the credit creation as lending services are not wholly accessed by the public and at the same time it limits the size of bank deposits.
- Level of awareness of people about the banking services. High level awareness about banking services promotes the process of credit creation, this is so because many people are knowledgeable about the existence of bank loans and therefore go for loans. On the other hand limited knowledge about bank loans limit the process of credit creation because few people go for bank loans.

- Availability of funds for lending/Size of bank deposit. A large amount of bank deposits increases the loanable funds and there promotes the process of credit creation On the other hand, a small amount of bank deposits reduces the loanable funds which limits the process of credit creation
- Degree of accountability in the commercial banks. Transparency in commercial banks promote the process of credit creation because bank officials do not ask for bribes before advancing loans, thus encouraging the public to borrow, on the other hand low level of accountability in commercial banks limits the process of credit creation because bank officials make it hard for customers to access loans since they ask them for loans.
- Availability of investment opportunities. Existence of man investment promotes borrowing since different people need money to take on such opportunities and this leads to high level of credit creation, on other hand existence of few investment opportunities in the country results into low demand for loans hence limiting the process of credit creation.
- Availability of credit worthy borrowers/ customers. Existence of many creditworthy customers promotes the process of credit creation because there are many people qualify

for bank loans, on other hand a small number of credit worthy customers limits the process of credit creation because few people qualify for bank loans.

- Political climate/Atmosphere, political instability discourages borrowing and lending and this limits the process of credit creation because people fear to lose their lives and property, on the other hand political stability encourage borrowing and lending which encourages investment because people are not scared of losing their lives and property.

LIMITATIONS OF CREDIT CREATION

- High liquidity preference.
- High cash ratio
- Lack of collateral security (houses, gold, machinery, land titles, vehicles Limited number of commercial banks.
- Limited number of commercial/poor distribution of commercial banks.
- Limited investment opportunities.
- Ignorance of the public about banking service
- High interest rates on loans.
- Restrictive monetary policy.
- Large subsistence sector/low levels of commercialization.
- Political instability/Political turmoil
- Low levels of accountability
- Limited number of credit worthy borrowers.
- Low level of bank deposits/Low level of savings

FACTORS THAT PROMOTE CREDIT CREATION

- Low level of liquidity preference.
- Low cash ratio
- Presence of collateral security (houses, gold, machinery, land titles, vehicles Limited n
- High number of commercial banks/ Even distribution of commercial banks.
- Large number of investment opportunities.
- High level awareness of the public about banking services
- Low interest rates on loans.

- Expansionary monetary policy.
- Low level of subsistence sector/High levels of commercialization.
- Presence of political stability
- High levels of accountability
- Large number of credit worthy borrowers.
- High level of bank deposits/High level of saving

INTEREST RATE DETERMINATION

Interest is the cost of borrowing money from a lender for a given period of time.

OR; Interest is monetary reward /payment by a borrower to a lender for use of a sum of money for a period of time.

Interest rate refers to the rate at which the interest on borrowed money accumulates. It expressed in percentage form.

Reasons why interest is paid by borrowers to lenders

- Lending involves foregoing present consumption which is painful; therefore the lender should be paid for this in form of interest.
- Capital cannot be accumulated without savings which involves a lot of sacrifices; therefore, interest is paid as a reward for savings.
- Lending involves risks; and the lender should be rewarded for undertaking such risks.
- Different expenditures are incurred during lending for instance keeping proper accounts which requires stationery, manpower, licenses, legal charges, which implies that interest is charged as reward for proper management.
- It is a reward for inconveniencing the lender.

DETERMINANTS OF INTEREST RATE IN A COUNTRY:

- Supply of loanable of loanable funds. High supply of loanable funds leads to low interest rate, this is because lenders to want make borrowing cheap so as to attract borrowers. On other hand low supply of loanable funds leads to high interest rate, this is so because there many bowers competing for the few funds and therefore the lenders take advantage and hike the interest rate.
- Period of loan repayment. Long repayment period attracts high interest rate because of the high risks involved. On the other hand, short repayment period attracts low interest rate because of the low risks involved.

- Level of demand for loanable funds (investment capital). High level of demand for loanable funds attracts high interest rate since customers show a lot of interest in using loanable funds. On the other hand, low level of demand for loanable funds reduces interest rate so as to attract customers to borrow money.
- Level of money supply in an economy. High level of money supply in an economy leads to high interest rate high rate; this is because it is increased to reduce money supply. On the other hand, low level of money supply attracts low interest rate in order to attract borrowers and increase money supply
- The price levels/ rate of inflation. Inflation leads to high interest rate so as to discourage people from borrowing due to maintain the encourage money value. On the other hand, a deflation leads to low interest rate so to attract borrowers to increases to increase the amount of money in circulation.
- Number of banking institutions/level of development of banking sector. High level of development of banking institutions leads to low interest rates because there are many banking institutions which compete for borrowers. On the other hand, low level of development banking institutions leads to high interest rates because there few banks and less competitions for borrowers.
- Government monetary policies. Restrictive monetary policy attracts high interest rate because the central bank wants to reduce amount of money in circulation. On the other hand, expansionary monetary policy attracts low interest rate because the central bank wants to increase amount of money in circulation.

MORE CONCEPTS USED IN BANKING

1. **Credit.** This is a financial facility which enables an individual or firm to borrow money to purchase products, raw materials over an extended period of time.

2. **Instruments of credit.** Instruments of credit are written documents which guarantee payment in near future and they give the holder a right to receive money. Examples of instruments of credit include: Cheques, Promissory notes, Bills of exchange, Bank drafts, Bank overdraft, Travelers cheques, and Credit cards.

ADVANTAGES OF CREDIT

- It helps to develop trade and industry by providing working capital
- Facilitates the process of credit creation leading to increased investment
- It reduces the use of cash which helps to reduce inflation
- It encourages the development of entrepreneurship in the economy.

3. **Liquidity.** Liquidity refers to the extent to which an asset can quickly be converted into currency notes and coins to be used as a medium of exchange. The level of liquidity can be influenced by the following factors:
   - Level of income
   - Level of transaction
   - Price levels
   - Nature and duration of wage payment
   - Monetary policy of the country

4. **Credit crunch (squeeze or crisis)**

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

   Causes of credit crunch in an economy

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

2. THE CENTRAL BANK

- A central bank refers to a central monetary institution which is responsible for financial management, and controlling other financial institutions in a country operating on non-profit motive.

Functions of the central bank

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

MONETARY POLICY

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

Categories of monetary policy

- Restrictive/contractionary monetary policy. This is a deliberate government effort through the central bank to control the level of economic activities by reducing the amount of money in circulation.
- Expansionary monetary policy. This is a deliberate government effort through the central bank to control the level of economic activities by increasing the amount of money in circulation.

Objectives of monetary policy:

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

- To help create a broad and continuous market for government securities such as. treasury bills and bonds. The example sells securities to the public using the open market operation.

TOOLS /INSTRUMENTS OF MONETARY POLICY

These are guidelines employed by the government through the central bank to regulate the amount of money in circulation so as to achieve development objectives.

The tools of monetary policy include:

1. **Open market operation.** This refers to the central bank action of selling and buying back of government securities such as treasury bills and bonds to or from the public with an aim of reducing or increasing the amount of money in circulation. To increase the amount of money in circulation, the central bank buys back securities from the general public and to reduce the amount of money in circulation, the central bank sells securities to the general public with an intention of withdrawing money from people.

2. **Bank rate/Discount rate.** This is the rate at which commercial banks borrow money from the central bank. An increase in bank rate by the central bank discourages commercial banks from borrowing money. Commercial banks therefore increase interest rate on loans given to customers thereby discouraging the public from borrowing money from commercial banks. However, to increase the amount of money in circulation, the central bank lowers its bank rate so that commercial banks can be able to lower the interest rate hence encouraging borrowing money by the public from commercial banks.

3. **Legal reserve requirement.** This is the minimum amount of money that commercial banks are legally required to deposit/keep with the central bank. To increase the amount of money in circulation, the central bank lowers the legal reserve requirement so that commercial banks are left with enough money for lending. However, to reduce the amount of money in circulation the central bank increases the legal reserve requirement so that commercial banks have limited amount of money to lend to the general public.

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4. **Variable reserve requirement /Cash Ratio.** This is the proportion of commercial bank's total deposits/assets which it keeps in cash form to meet day-to-day requirements of customers and other financial commitments. To increase the amount of money in circulation, the central bank instructs commercial banks to lower the cash ratio so as to increase the loanable funds, and to reduce the amount of money in circulation, the central bank instructs commercial banks to increase cash ratio so as to reduce the amount of money for lending.

5. **Margin requirement.** This is the difference between the value of collateral security and the value of a loan to be advanced. The value of collateral security must exceed the value of a loan to be advanced with the interest to be paid. Margin requirement is increased to discourage people from borrowing money from commercial banks thereby reducing on the amount of money in circulation. On the other hand, margin requirement is reduced to encourage people to borrow money hence increasing the amount of money in circulation.

   Example: If a building worth 200, 000,000/= is presented as collateral security against a loan of 150,000,000/=; margin requirement will be 50,000,000/=.

6. **Rationing of credit.** This is where the central bank allocates credit/loans to avoid over borrowing from commercial banks by some sectors. In case of reducing the amount of money in circulation, commercial banks are given little money by the central bank in form loans hence reducing their lending capacity. On the other hand, in case there is need to increase money in circulation, the central bank suspends the rationing of credit such that the commercial banks have sufficient funds to lend to the customers.

7. **Selective credit control.** This refers to situation where the central bank encourages commercial banks to give loans to specific sectors of importance or priority like agriculture, industry and denying other sectors from acquiring loans so as to reduce the amount of money in circulation during inflation. On the other hand, in case the central bank wants to increase lending, it suspends the policy of selective credit control hence encouraging borrowing by all sectors of the economy.

8. **Special deposits (supplementary reserve requirement).** Special deposits are those deposits that the central bank demands from commercial banks on top of legal reserve requirement. During inflation the central bank calls for special deposits which reduces the loanable funds, thus reducing the commercial banks capacity to lend. On the other hand, special deposits are given back to the commercial banks when prices stabilise to increase their capacity to lend.

9. **Moral suasion.** This is a way of persuading or advising commercial banks about dangers of too much money or too little money in circulation. During inflation the central bank appeals to the commercial banks to reduce lending in order to reduce money supply in the economy. On the other hand, during low price levels, the central banks appeal to the commercial to lend as much as they can an increase money supply.

FACTORS INFLUENCING THE OPERATION OF MONETARY POLICY

1. Level of liquidity preference among the general public. High level of liquidity preference among the public limits effective use of commercial banks and other financial institutions as a lot money is in hands of the people thereby limiting operation of monetary policy. On the other hand, low level of liquidity preference means that a lot of money is deposited with commercial banks and other financial institutions thereby making the monetary policy effective.
2. Level of development of the money markets and capital markets i.e. stock exchange markets to do with securities through which the central bank can operate. High level of development of money and capital markets leads to effective operation of monetary policy because of the many people who trade in securities. On the other hand, underdeveloped money and capital markets limit effective operation of monetary policy as there are a few people who are aware and trade in securities such as treasury bills and bonds.

3. Level of liquidity in commercial banks which influences their frequency of going to the central bank. Excessive liquidity in commercial banks reduces the rate at which they go to central bank to borrow. This makes them remain with a lot of money for lending thereby limiting effective operation of monetary policy, in particular the bank rate tool.

On the other hand, low level of liquidity in commercial banks increases the rate at which they go to the central bank to borrow thereby making the monetary policy effective through implementation of the bank rate policy.

4. The size of monetary sector/subsistence sector. Large commercial sector makes it effective to implement the monetary policy, this is because when the central bank wants to increase money supply many people to borrow to expand production. On the other a large subsistence sector limits the operation of the monetary policy because very few people to borrow even if the central bank wants to increase money supply through lowering the bank rate.
5. Nature of distribution of commercial banks. Even distribution of commercial banks promotes the effective operation of the monetary policy, because many people deposit their money in those several banks hence enabling the central bank to control the many in those banks, yet uneven distribution of commercial banks limits the effective operation of the monetary policy since few people deposit their money in commercial banks, thereby making it hard for the central bank to control such money.

6. Degree of political interference in central bank activities. High level of political interference in central bank activities in terms of influencing lending policies leads to excessive amount of money in circulation thereby failing the monetary policy. On the other hand, low level of political interference in central bank activities, allows the central bank to implement its policies according to its plans.

7. Level of accountability by the central bank officials especially in the implementation of some tools like selective credit control. High level of accountability by central bank officials ensures that central bank officials are not bribed by commercial banks to issue loans to non priority sectors. On the other hand, low level of accountability by central bank officials means that central bank official is bribed by commercial banks and extends loans to non priority sectors, thereby rendering implementation of monetary policy tools ineffective.
8. Level of coordination of government objectives. In a situation where government has clearly stated objectives such as reducing the amount of money in circulation without

favouring certain sectors, the monetary policy becomes effective. On the other hand, conflicting government objective limits the operation of the monetary policy, because at the time when central bank wants to reduce money the government comes up with other projects which increase money supply.

9. Level/ Degree of effective in the use of commercial banks. High use of commercial banks by the public in terms promotes the effectiveness of monetary policy, this is because many people do deposit their money in commercial banks which is easily controlled by the central bank. On the other hand, limited use of commercial banks limits the operation of the monetary policy, because most people do not deposit their money in commercial banks, therefore cannot be accessed by the central bank.

10. Degree of ignorance/awareness of the public about facilities offered by commercial banks. High degree of awareness of the public about the facilities offered by the commercial banks promotes the implementation of the monetary policy; this is because many people go for loans which make it easy for the central banks to increase money supply when the need arises. On the other hand, high level of ignorance of the public about the facilities offered by the commercial banks limits the operation of the monetary policy because very few people go for loans which makes it hard for the central bank to increase money supply even when the need arises.

FACTORS LIMITING THE EFFECTIVE OPERATION OF MONETARY POLICY;

- High level of liquidity preference among the general public
- Low level of development of money market and capital markets.
- High level of liquidity in commercial banks
- Large subsistence sector
- Uneven distribution of commercial banks
- High degree of political interference in central bank activities
- Low level of accountability by central bank officials
- Conflicting government objectives
- Limited use of commercial banks

- High level of ignorance of the public about the facilities offered by commercial banks

FACTORS PROMOTING THE EFFECTIVE OPERATION OF THE MONETARY POLICY:

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