MONEY & BANKING

THE THEORY OF MONEY

Money is any anything valuable which can be accepted as medium of exchange for goods and services.

Or; it is any anything which is generally acceptable for the discharge of a debt or financial obligations.

Or; any asset capable of serving as a temporary a bode of purchasing power in an economy.

The word money is derived from a Latin word 'Moneta' which was the surname of the Roman goddess of June in whose temple money was coined.

Question

What is meant by the term Money?

EVOLUTION OF MONEY

Before the evolution of money exchange was done through barter. Barter trade is the direct exchange of goods and services for goods and services.

In a barter economy a cow may be exchanged for with goats, sheep, or grains. For a transaction to take place there must be double coincidence of wants. For instance, if a cow owner wants goats, he must not only find a person who has goats but also wants a cow. Barter exchange existed mainly in primitive society although it still exists in some societies today.

MERITS OF BARTER

1. Preserves scarce foreign exchange. This is because importation of goods and services is done in exchange for other goods and services not money.

2. No paper work & documentation. This is because there is no need for paper work and other unnecessary delays.

3. Protects the economy from inflation. This is because transactions are carried out in

terms of goods or services not money.

4. Provides employment to the people. This is because there are many jobs in production and distribution like splitting wood, burning charcoal and cutting wood.

Or; it is due to many jobs in the import-export sector like loading and offloading cargo.

5. Promotes unity. This is because transactions involve close discussions and compromises between the buyer and seller which create unity.

6. Minimizes defects of currency conversion. This is because transactions are done in exchange for goods and services not money.

DIFFICULTIES OF BARTER TRADE

1. Lack of common measure of value. This is because it is not easy to agree on a standard measure for goods during exchange of goods and services.

2. Lack of double coincidence of wants. This is because barter makes it is difficult for two parties to meet when each of them is in need of what the other wants.

3. Indivisibility of items. This is because it is difficult to divide goods into small units so as to carry out small transactions.

4. Transport problems. This is due to certain goods which are too bulky to transfer from one place to another.

Or; it is due to certain goods which are dangerous to transfer from one place to another like hungry dogs or crocodiles for tourist purposes.

5. Difficulty in storing value. This is because some goods are perishable and therefore cannot be stored for future use like tomatoes.

Or; it is because people cannot save capital for future use in form of commodities.

6. Difficult to make deferred payment. This is because barter makes it difficult to agree on the quality of goods or services to be repaid in future.

Or; it is due to disagreement of the specific commodities to be used for repayment of goods and services in future.

Question

a) What is Barter trade?

b) Mention any three merits of barter in an economy.

c) Outline any three demerits of barter trade in Uganda.

STAGES IN EVOLUTION OF MONEY

1. Commodity money or Specific goods. These included commodities or ornaments like cattle, grains, fur, leather, tea, salt, shells, precious stones and fish hooks.

Question

State the defects of commodity money

1. Not all commodities were uniform in value.
2. It was difficult to store and prevent loss of value for perishable commodities.
3. They were bulky hence difficult to transfer from one place to another.
4. There was a problem of indivisibility in case of commodities like cattle.

2. Metallic money. This involved use of silver, gold, copper and tin as money.

Question

Mention any three defects of Metallic money.

1. Difficult to influence supply according to demand.
2. Tedious to transfer metallic money from one place to another.
3. Unsafe to carry precious metals for trade purposes over long distances.

3. Paper money. This involved keeping money in form of gold and other valuables with goldsmiths for safe custody. In turn receipts were issued to the savers for carrying out transaction which resulted into paper money.

4. Credit money. This involves use of cheques as well as credit and debit cards as money.

5. Near money. This involves use of close substitutes to money like treasury bills, bonds bills of lading for exchange.

TYPES OF MONEY

Convertible money: This is one easily converted into currencies of other countries like pounds and dollars.

Inconvertible currency: This is one legally accepted as a medium of exchange it its country of origin. It is also known as soft currency like Uganda shillings.

Fiat money: This is the money printed by the central bank on the orders of government.

Fiduciary issue: This is the money issued by the central bank but not backed by gold or foreign exchange reserves. They are backed by government securities like treasury bills.

Deposit money: This is one created by commercial banks through credit creation.

Token money: This is one whose metal value is less than its face value.

Or; it is one where the financial value of the metal is less than what is written on the face of the coin.

Liquid money: This is one which consists of coins and notes in circulation.

Intrinsic money: This is one whose inner value is more than the face value.

Or; is one where the value of the raw material used to make money is less than the value indicated on the face.

Ring money: This consists of rings, bracelets, armlets, gold and silver.

Question

Mention any four qualities of good money.

1. Good money should be acceptable.
2. Good money should be portable in an economy.

3. Good money should be divisible.
4. Good money should be durable in an economy.
5. Good money should be homogenous in an economy.
6. Good money should be scarce in an economy.

FUNCTIONS OF MONEY

1. A medium of exchange. This is because money makes it easy for business transactions for goods and services to take place.

2. A measure of value. This is because money enables producers and suppliers to express the values of commodities in standard units.

Or; it is because money reduces the expression of goods in terms of weights or volume.

3. Money is a standard for deferred payments. This is because money enables payments for goods and services to be postponed.

Or; it is because monetary values tend to be stable for some time.

4. Money acts as a store of value or wealth. This is because it can be saved in banks for future investment.

5. It acts as a unit of account. This is because money makes it easy to express values of goods and services in form of prices.

Or; it is because money enables producers to express incomes and expenditures in form of prices.

6. Promotes the operation of price mechanism. This is because money enables producers to determine what, when, how and for whom to produce.

7. It is a government tool for monetary policy. This is because money helps government through the central bank to control the amount money in circulation so as to regulate economic activities.

8. Money facilitates transfer of value. This is because money enables in transfer of ownership from one person to another.

Question

a) Mention any four functions of money in an economy.

b) State any four functions of money in Uganda.

ROLE OF MONEY IN ECONOMIC DEVELOPMENT

1. Promotes hard work. This is because money forces people to work very hard so as to get more of it for buying goods and services which improves on their living conditions hence development.

Or; it is because money forces people to sacrifice their little incomes saved for investment which generates economic growth.

2. It promotes division of labour and specialization. This is because money forces people to take up particular skills and professions highly paid so as to get more of it which make them more productive in the country hence fostering development.

3. Encourages saving and investment. This is because it is money which is saved and invested in productive activities which increases on the output produced leading to economic growth.

4. Money facilitates exchange. This is because money simplifies exchange of goods and services which increases output hence economic growth.

5. Money allows the efficient operation of the monetary policy. This is because money enables the central bank to restrict the amount f money in circulation so as to control prices.

6. Money facilitates borrowing and lending. This is because money enables traders to acquire goods and services on credit to expand their businesses hence development.

Or; it is because money enables producers' to get raw materials on credit and pay later which increases production of goods and services leading to development.

7. Helps in the operation of price mechanism. This is because money directs producers on what, how, when and for whom to produce which leads to increased output hence development.

Or; it is because money attracts people to engage in production so as to get more of it which increases trade and production of goods and services hence development.

Question

a) Explain the role of money in economic development.

b) Explain the role of money in the development of your country.

DEMERITS OF MONEY

1. Instability in the value of money. This is because money loses value at times which increases prices of goods and services leading to inflation.

Or; it is because money leads to inflation which limits consumption and production of goods and services leading to poor living conditions.

2. Leads to income inequality. This is because money makes producers to earn more incomes and live a better life compared to workers which results into social unrests.

3. Growth of monopolies. This is because money makes financially stable firms to outcompete weak ones which kill production of goods and services which limit development.

4. Wastage of resources. This is because money can be used to produce goods and services not necessary for consumption hence wastage.

Or; it is because money can be used in wasteful competition which destroys resources and this retards development.

5. Leads to economic malpractice. This is because money forces people to use illicit means in trade so as to get more money which cripples development.

Or; it is because money forces people to evade and avoid taxes to as to get more of it which make it difficult for government to execute development programmes.

Or; it because money forces people to hoard commodities so as to sell them at high prices and gets more money which leads to inflation hence retarding development.

6. Moral decay. This is because money forces people to engage in immoral acts like prostitution so as to get money which destroys the moral fabrics of the society.

7. Promotes crime. This is because money forces people to take up criminal activities like robbery and murder so as to get money which results into loss of lives.

Question

a) What are the disadvantages of money in an economy?

b) Explain the demerits of using money in development of Uganda.

MONEY SUPPLY

This is the total quantity of money in circulation in a specified time period in the country.

Or; it is the total cash in circulation outside banks and bank deposits in the country.

TYPES OF MONEY SUPPLY

1. Exogenous money supply. This is one determined by the government through the central bank. The state determines how much money is needed and for what purpose at any time. It can instruct the central bank to print more money in case of need.

2. Endogenous money supply. This is one determined by the level of economic activity in the country.

In a boom, money supply increases due to economic activities yet; economic hardships results to a fall in money supply.

FACTORS INFLUENCING MONEY SUPPLY IN AN ECONOMY

1. Level of government borrowing. High levels of government borrowing, increases money supply especially with extensive use of the borrowed funds within the country compared to limited borrowing.

2. Level of government expenditure. High government expenditure increases money

supply due to increased amount of money in circulation compared to limited government expenditure.

3. Level of capital inflows and outflows. High capital inflows in form of donations, transfers and remittances from abroad increases money supply because people spend the money in large quantities compared to high levels of capital outflow.

4. Level of liquidity preference. High levels of liquidity preference increases money supply because people hold cash in large quantities for transaction purposes compared to high levels of saving.

5. Government monetary policy. Money supply increases with expansionary monetary policies of the central bank because it encourages extensive lending to the public compared to restrictive money supply which reduces the amount of money in circulation.

6. Level of economic activity. During the boom period, money supply increases as many people use large volumes of money for business transaction compared to a period of economic depression where less money is in circulation.

7. Level of monetization of the economy. High levels of monetization increases money supply because people use a lot of money during that period compared to high levels of subsistence where little money is used.

8. Level of financial accommodation. Money supply increases with increased financial accommodation because the central bank prints large volumes of money and injects it into circulation compared to a period of limited printing of money.

9. Rate of interest. Money supply increases with low interest rate because many people keep money at home due to limited incentive to save compared to high interest.

10. Level of government securities. Selling of more government bonds and treasury bills to the public reduces the level of money supply as government drains money from circulation compared to high purchase of securities from the public.

Question

a) Explain the factors which influence money supply in the economy.

b) Explain the factors influencing the level of money supply in your country.

MERITS OF INCREASE IN MONEY SUPPLY

1. Increases the aggregate demand. This is due to the fact that the increase in money supply enables people to get more money for buying goods and services in large quantities which improve on their living conditions.

2. Increases the level of economic growth. This is due to the fact that the increase in money supply reduces the rate of interest which encourages borrowing and investment in production of goods and services hence economic growth.

Or; it is due to the fact that the increase in money supply increases demand for goods and services which attracts more production of goods and service hence economic growth.

3. Promotes employment. This is due to the fact that the increase in money supply increases funding to certain sectors for job creation like the case with selective credit control.

4. Reduces BOP problems. This is due to the fact that the increase in money supply increases production of goods and services formerly imported if selective credit control is used which reduces foreign exchange expenditure abroad.

Or; it is due to the fact that the increase in money supply increases production of more goods and services for export if selective credit control is used which increases foreign exchange earnings.

Question

a) Explain the merits of increased money supply in an economy.

b) Explain the advantages of increased money supply in the development of your country.

DEMERITS OF INCREASED MONEY SUPPLY

1. Increased money supply may be inflationary. This is because it increases demand for goods and services which leads to high prices hence inflation.

2. Purchasing power falls. This is due to high prices which arise from the fall in the value of money.

3. Promotes trade malpractices. This is due to the fall in the value of money where people engage in hoarding of goods, smuggling and corruption.

4. **Money may lose the quality of acceptability**. This is arises from the fact that it is longer reliable as a medium of exchange for goods and services.

Question

a) Assess the merits and demerits of increase money supply in an economy.

b) Examine the merits and demerits of increased money supply in your country.

CONDITIONS UNDER WHICH INCREASE IN MONEY SUPPLY MAY NOT LEAD TO INFLATION

1. When there is increase in purchase of capital goods. This is because of fact that the increase in money supply increases production of more goods and services which keeps prices stable and low hence controlling inflation.

2. When there is high marginal propensity to save. This is because increase in incomes due to increased money supply increases saving which keeps prices unchanged which averts inflation.

3. When there is a strict price control system used. This is because prices are controlled by government despite increases in money supply which guards against inflation.

4. When the supply of consumer goods is high. This is because prices remain low so long as there is variety more goods and services produced in the country.

5. When increase in money supply is followed by high tax policy. This is due to increases in taxes imposed on additional incomes earned in the country.

6. When increase in money supply is followed by increase in capital outflows. This is because more incomes earned are taken out of the country which keeps prices unchanged which limits inflation.

Or; it is because increases in money supply may result into increased incomes and profit repatriations by foreign expatriates in the country.

7. When there is also reduction in government expenditure. This is because it will lead to reduced amount of money in circulation which keeps prices at low levels.

8. When there is an economic depression. This is because it increases demand for goods and services which increases production.

Or; it is because it stimulates economic growth and increases output.

9. When it is followed by increased imports. This is because increased money supply is checked by increased availability of goods and services which keeps prices unchanged.

10. When increase in money supply is followed by decrease in exports. This is because a decrease in exports makes scarce goods and services more available on the domestic market.

Question

a) Under what circumstances may increase in money supply not lead to inflation?

b) Explain the circumstances under which increase in money supply may not lead to inflation in your country.

DEMAND FOR MONEY

This is the amount of wealth the public wishes to hold in cash form.

Or; it is the quantity of money needed by households, firms & government for transactions.

Question

What is meant by demand for money?

TYPES OF DEMAND FOR MONEY

Aggregate demand for money in a closed economy: This is the total amount of money required for consumption and investment expenditures only.

Aggregate money demand in an open economy: This is the total amount of money required for consumption, investment, and government expenditure and net foreign expenditures on imports and exports.

MOTIVES OF DEMAND FOR MONEY

Transaction motive: This suggests that people or firms require money to carry out transactions like buying food or clothes.

Question

a) What is meant by transaction motive?

b) State two determinants of Transaction motive

1. Level of income.
2. Expenditure pattern of the people.
3. Level of prices.
4. Rate of interest.
5. Level of monetization of the economy.

Precautionary motive: This suggests that people require money to finance events of uncertain nature like sickness and accidents.

Question

a) What is the Precautionary motive?

b) Mention two determinants of precautionary motives.

1. Prevalence of risks.
2. Level of development of social security services.
3. Level of incomes.
4. Possibility of borrowing from others.

Speculative motive: This suggests that people or firms to finance investments which yield financial returns in future like bonds and treasury bills.

Question

a) What is the Speculative motive?

b) Outline two determinants of speculative motive.

1. Level of interest rate.
2. Market level of securities.
3. Accessibility to vital funds.

Financial motive: This suggest that individuals and firms demand for money to fiancé already ongoing investments like buying raw materials and paying salaries.

Question

a) What is the financial motive?

b) Mention two determinants of financial motive.

1. Rate of interest.
2. Level of income.
3. The political climate.
4. Expected returns on investment.
5. Government policy on investment.

LIQUIDITY PREFERENCE

This is the desire by an individual to hold money in cash form other than in form of other wealth.

Question

Define the term liquidity preference.

DETERMINANTS OF LIQUIDITY PREFERENCE

1. Level of prices in the country. High prices lead to increase in liquidity preference because people keep money in big amounts to finance transactions compared to low prices.

2. Level of interest rate. Low interest results into high liquidity preference as many people keep more money in cash than saving compared to high interest which increases saving.

3. Level of transaction. High levels of transaction increase liquidity preference because people make purchase in large quantities compared to limited use of money which lowers liquidity preference.

4. Degree of uncertainty. Anticipation of risks and uncertainties like loss, accidents and holidays force people to keep money in big amounts compare to a period of limited risks and losses.

5. The investment climate. High levels of investment increase liquidity preference because firms and individuals use money in big amounts compared to a period of limited investments in the country.

6. Level of incomes. People who earn incomes in big amounts also hold large sums of money in cash compared to those with little incomes.

7. Level of infrastructural development. Highly developed infrastructures like roads, school and hotels force people to use money in big amounts for expenditures compared to poor infrastructures with limited economic activities.

8. Level of monetization. In a boom period people hold money in large amounts to finance economic activities compared to high level of subsistence which is associated with limited use of money.

9. The political climate. Peace and security, attracts trade and investment which force people to hold money in large amounts compared to political instability which discourages production.

10. Level of education. Educated people with banking knowledge keeps little money in cash hence low liquidity preference compared to limited education where people keep large cash.

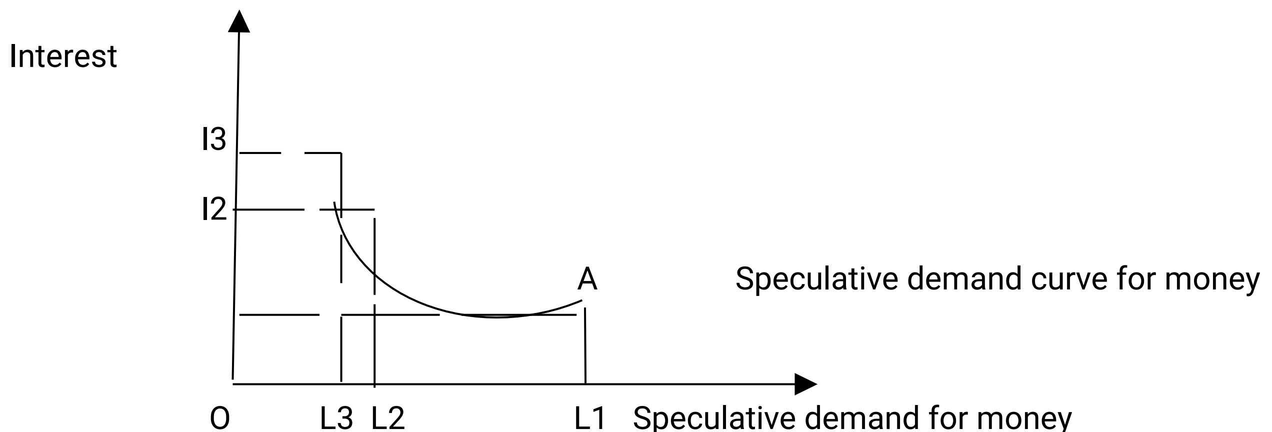
Question

a) Explain the factors which influence liquidity preference in an economy.

b) Explain the factors influencing liquidity preference in your country.

CONCEPT OF LIQUIDITY TRAP

This is the point at which the interest rate is too low to attract speculation. At low interest speculators are not willing to trade in government securities like bonds and treasury bills.



The speculative demand curve becomes perfectly elastic after point A and at such a low rate of interest people prefer to hold their wealth in cash form rather than investing it in bonds because it would imply a definite loss.

Question

What is meant by the term Liquidity preference?

INTEREST RATE

This is the payment for the use of borrowed funds.

Or; it is the cost of borrowing money in an economy.

Or it refers to the reward to saving and those who buy securities in an economy.

Question

What is meant by the term interest?

TYPES OF INTEREST

Market rate o interest: This is the interest at which the supply of loanable funds is equal to demand for loanable funds.

Or; it is where the actual rate of saving is equal to the actual investment in an economy.

Real interest rate: The percentage rate point on borrowed funds after making adjustments or changes in the price level.

Money rate of interest: This the percentage rate point on borrowed funds and it is equal to the interest plus the rat of change in the price level.

Gross interest: This is the payment the borrower makes to the lender excluding the principle. It includes the reward for the use of capital, risk taking and other expenses incurred in lending.

Question

a) State two reasons for paying interest.

1. Reward for saving.

2. Payment for accepting to part away with capital.
3. Reward for risk bearing since the venture may fail.
4. Acts as a reward for inconveniences incurred by the lender.
5. Reward for management of credit in the economy.

b) Mention two sources of interest.

1. Ways and means paid when government borrows from the central bank.
2. Bank rates.
3. Treasury bills.
4. Deposit rates charged by lenders when processing loans.
5. Bonds.

DETERMINANTS OF INTEREST RATES IN AN ECONOMY

1. Availability of collateral security. Interest increases limited collateral security because of the high risks involved in lending compared to availability of collateral security.

2. Period of loan repayment. Interest increases with long period of repayment because it takes a lot of time to pay back compared to short repayment periods.

3. Level of supply of loanable funds. Interest increases with limited supply of loans because many people compete for few loans compared to high supply of loans.

4. Demand for loanable funds. Interest increases with high demand for loans because many people go for it compared to limited demand for loans.

5. The government's monetary policy. Interest increases with restrictive monetary policy because government wishes to reduce the amount of money in circulation compared to expansionary monetary policy.

6. The economic situation. Interest increases during an economic boom because people demand for money for trade compared to a period of economic hardships.

7. Level of development of the banking sector. Interest increases with high development of banking because most people demand for loans compared to poorly developed banking system.

8. Policy of individual lenders. Interest increases with lenders who prefer to charge high interest earn more profits compared to other lenders.

9. The credit worthiness of borrowers. Interest increases with customers who lack trust in paying back the loans due to high risks involved in it compared to credit worthy customers.

10. The amount of the loan. Interest increases with borrowers of small loans because they yield little profit to the lender compared to big loan goers.

Question

a) Explain the factors which influence interest in an economy.

b) Explain the factors influencing the rate of interest in your country.

c) Given the principle sum of UGX. 100.000, lent for a period of 3 years at an interest of 10 % p.a.

Calculate;

i) The simple interest

$$SI = \frac{P \times T \times R}{100}$$

$$= \frac{100.000 \times 3 \times 10}{100}$$

$$= \frac{100.000 \times 30}{100}$$

$$= 30.000$$

ii) The compound interest earned

CI = Amount – Principle

But A = $P(1 + r)^n$

$= P(1 + r)^n - P$

$= 100.000(1 + 0.1)^3 - 100.000$

$= 100.000(1.1)^3 - 100.000$

= 100.000(1.331) – 100.000

= 133100 – 100.000

= UGX. 33100.

Method-11

Year	**Principle**	**Interest**
1	100.000	$\frac{10}{100} \times 100.000$ = 10.000
2	100.000 + 10.000 = 110.000	$\frac{10}{100} \times 110.000$ = 11.000
3	110.000 + 11.000 = 121.000	$\frac{10}{100} \times 121.000$ = 12.100

VALUE OF MONEY

This is the quantity of goods and services which a unit of money can buy in a given period of time.

Or; it is the purchasing power of a given unit of money.

If the quantity of goods is big then the value of money is said to be high but when the quantities of goods is small the value of money is said to be low.

Question

What is meant by the term value of money?

TYPES OF VALUE OF MONEY

Nominal value of money: This is the value of money which is either in form of coins or bank notes.

Real value of money: This is the purchasing power of nominal value of money expressed in terms of goods and services

Relative value of money: This is the average quantity of goods in relation to a given quantity of money.

DETERMINANTS OF THE VALUE FOR MONEY

1. The general price level. Money value increases with low prices because people use little of it to buy more goods and services compared to high prices.

2. Quantity of goods available. Money value increases with availability of goods and services because people get more of them using little money compared to shortage of goods.

3. Amount of money in circulation. Money value increases with limited amount of money in circulation because it maintains prices at low levels compared to increased amount of money in circulation.

4. The government monetary policy. Money value increases with restrictive money supply because it keeps prices at low levels compared to expansionary monetary policy.

5. Velocity of circulation. Money value increases with low velocity of circulation

compared to high velocity of circulation.

6. Government policy on devaluation or revaluation. Money value increases with revaluation because this makes it competitive in the economy compared to devaluation which reduces its value.

7. Level of speculation. Money value increases with limited speculation because prices remain stable and low compared to high speculation increases demand and prices in the current period.

8. Level of aggregate demand. Money value increases with low demand because prices are low compared to high levels of demand for goods and services.

Question

a) Explain the factors influencing the rate of interest in an economy.

b) Explain the determinants of interest rate in your country.

QUANTITY THEORY OF MONEY (Cash transaction approach)

This states that the general price level varies directly with the amount of money in circulation assuming the rate of transaction and velocity of circulation are held constant.

This is illustrated by the Irving Fischer's equation of exchange as shown below;

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

Where;

P **-** General Price level of money in the economy

M **-** Quantity of money in circulation

V **-** Velocity of money

T **-** Level of transaction

Any change in the three variables, leads to change in prices for example, when the

quantity of money in circulation doubles, prices also double.

Assumptions

1. Assumes the level of transaction is held constant.

2. Assumes the level of velocity of money is kept constant.

3. Assumes the quantity of money in circulation is fixed.

4. The economy is at full employment.

5. The economy is highly monetized.

Question

Given that the amount of money in circulation is 200 million shillings, velocity is 10 while the level of transaction is 40.000; calculate the general price level in the economy.

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

$$= \frac{200.000.000}{40.000} \times 10$$

$$= 50.000$$

LIMITATIONS OF THE THEORY

1. Increase in money supply may not increase prices if the MPS is high. This is because increase in money increases saving which keeps prices for goods and services unchanged.

2. Existence of unexploited resources. This is because increase in money supply results into increased production of goods and services which keeps prices at low levels.

3. The theory does not take into account haggling between buyers and sellers. This is

because prices of goods and services are influenced by haggling not relationships like M, V, or T.

4. Government control of prices is not taken into account by the theory. This is because the theory does not explain price levels set by government either through maximum or minimum price legislations.

5. The theory does not take into account the rate of interest. This is because it does not explain price changes caused by changes in the rate of interest which is common today.

6. Quantity theory of money is a mathematical truism that shows how M, V, T & P are related. This is because it suggests that money supply MV PT which is not applicable.

7. The theory assumes that the level of velocity is constant which is unrealistic. This is because the velocity of money in circulation is ever changing basing on the economic conditions in the country.

8. The theory does not take into account the demand for money for other than transactions. This is because money is demanded for many things like precautionary or financial motives.

9. There is no general price level but rather a series of price levels. This is because capital and consumer goods exist which are bought at different prices.

11. The theory ignores barter trade and only considers the use of money. This is because certain goods and services are exchange for other goods or services which is common in trade.

12. It does not account for other causes of price increases (inflation) other than the increase in money supply. This is because causes of high prices like high taxes, shortage of goods and services are not seen in the theory yet they lead to inflation.

Question

a) Explain the quantity theory of money.

b) Explain the limitation of quantity theory of money.

BANKING

This is the facilitating for receiving, lending, exchanging and safe guarding money and other variables such as gold, titles, jewelry, certificates, etc.

BANK

This is a financial institution which deals in credit or borrowed funds.

Or; it is an institution which stands between surplus spending units (lenders) & deficit spending units (borrowers). The word bank originates from a French word ‘Banqui’ and the Italian word ‘Bauca’ which refers to a bench for keeping, lending and exchanging of money and coins in the market place by money lenders and changers in the 17th & 18th century.

Question

a) Outline any four features of the banking sector in an economy.

b) Mention two features of the banking sector in your country

1. Mainly located in urban centers.
2. Mainly foreign owned.
3. Generally weak and under developed.
4. Mainly privately owned.
5. Many are undercapitalized.
6. They have limited liquidity especially the locally owned firms.

TYPES OF BANKS

Commercial bank: This is one which under take activities including accepting deposits, safeguarding the deposits received from the public, lending out funds in return for interest on loans and security, transfer of funds from one person to another by means of credit transfer and cheque system and the agency function.

Exchange or Merchant bank. This is one which deal in foreign exchange and specialize in foreign trade like accepting bills of exchange, giving loans and securities to foreign traders.

Industrial bank: This is one concerned with providing medium term and long term finance to industrialists to purchase land, machinery, raw material.

They under write the debentures and shares of industries and also subscribe to them.

Agricultural bank: This is a specialized public and private financial institution which provides medium term and long term loans for the creation and expansion of the agricultural enterprises only.

In developing countries however, this is done by development banks that serve both the industries and the agricultural sector

Cooperative bank: This is a financial institution founded and owned by cooperative societies. It provides short term and long term loans to cooperative societies.

Savings bank: This is a financial institution set up to provide a safe place for keeping of money and to promote the habit of saving among people.

Development bank: This is a specialized public and private financial institution which provides medium term and long term loans for creation and expansion of industrial and agricultural enterprises in developing countries.

Central bank: This is the supreme bank in the country established and owned by government to control, guide and assist other banks in the county and to provide banking services and financial advice to government.

COMMERCIAL BANK

This is the profit making financial institution which deals in credit or borrowed funds with a motive of making profits.

Commercial banks can be established as sole proprietorship, or joint venture that is, between government and the private individuals or foreign banks. Examples include;

Stanbic, Bank of Baroda, Standard chartered, crane bank, etc.

FUNCTIONS OF COMMERCIAL BANKS

1. Accepting deposits. This is by accepting all forms of deposits from their clients like savings account, current account and fixed deposit account.

2. Advancing loans. This is by lending a percentage of the cash lying in deposits at high interest than it pays on those deposits.

3. Agency services. This is by acting as agents of its customers in collecting and paying cheques, bills of exchange, drafts and dividends.

Or; it is by trading in shares, securities, debentures, on behalf of its customers.

Or; it is by paying subscription, insurance premia, rent, electric and water bills and other similar charges on behalf of its clients.

Or; it is by acting as trustees and executors of wills and property of their customers and charge fees on each of the services rendered.

4. Finances foreign trade. This is by assisting in import and export trade by accepting foreign bills of exchange and collecting them from foreign banks.

Or; it is by making foreign payments through means such as telegraphic money on behalf of their customers.

5. They act as custodians of their customer's variables. This is by providing strong rooms where documents like jewellery, certificates and titles for customers.

6. They advise investors on possible investment choices. This is by helping to promote productive investment in the country.

7. Helps government in implementing the monetary policy. This is by undertaking measures like selective credit control, open market operation and special deposits.

8. Helps government to collect tax revenues. This is by collecting revenues in form of PAYE, NSSF, and corporate taxes.

Question

a) Explain the functions of commercial bank in an economy.

b) Explain the functions of commercial bank in the development of your country.

ROLE OF COMMERCIAL BANKS IN DEVELOPMENT

1. Mobilizes savings for development. This is because they have a variety of deposit schemes which induce people to save and invest in future for development.

2. Helps to implement the monetary policy. This is because they reduce or increase the amount of money in circulation basing on the guidelines of the central bank.

3. Invests in productive activities. This is because they invest in economic activities like agriculture and industry which increases output.

4. Provides employment opportunities to people. This is because they invest in industries and other sectors which generate jobs to people.

Or; it is because they advance loans to people to investors which increase economic activities and employment.

5. Provide revenue to government by paying taxes. This is because they pay taxes to government like any other profit making institution in the country.

6. Contributes to infrastructural development. This is because they participate in construction of roads, schools and health facilities.

7. Development of skills. This is because they provide scholarship to people interested in banking.

Or; it is because they provide consultancy skills to businessmen and investors.

8. Promotes diversification of the economy. This is because they provide loans to people to carry out different economic activities in the country.

9. Monetizes the economy. This is because they inject money into circulation to stimulate production and investment.

10. Give advice to potential investors. This is because they guide investors on what, when and where to invest resources.

Question

a) Explain the role of commercial banks in an economy.

b) Explain the role of commercial banks in the development of your country.

FOREIGN COMMERCIAL BANK

This is a bank multilateral corporation with headquarters on one country but with branch offices in a wide range of both developed and developing countries.

Examples include; Barclays bank (United Kingdom), Stanbic bank (South Africa), Standard chartered (United kingdom) and Bank of Baroda.

Question

What is meant by foreign commercial banks?

CONTRIBUTIONS OF FOREIGN COMMERCIAL BANKS TO DEVELOPMET

Positive

1. Facilitates international trade. This is because they have branches worldwide which helps in money transfers from one country to another.

2. Provides employment to the local people. This is because they give jobs to local people as bank officers and guards.

3. Mobilizes foreign exchange. This is because they increase on the local foreign exchange by transferring foreign exchange from their branches abroad.

4. Promotes international relations. This is because they create friendship between the host governments and their home countries.

5. Development of infrastructures. This is because they participate in the establishment

of roads, schools and health facilities in the country.

6. Leads to development of the private sector. This is because they give loans to private individuals to expend their businesses.

7. Monetizes the economy. This is because they inject money into circulation to increase economic activities.

8. Encourages efficiency of labour. This is because they provide consultancy skills to businessmen and investors to improve production.

Question

a) Explain the role of foreign commercial banks in developing countries.

b) Explain the contributions of foreign commercial banks in the development of your country.

Negative

1. Encourages capital outflow. This is due to foreign investors who take part of the profits to their home countries.

2. Discriminative lending policies. This is because they prefer lending to investors especially from their home countries.

3. Promotes income inequality. This is due to high salaries given to expatriates who take up senior positions in these banks compared to the local people.

Or; it is due to employment of local people in low ranked jobs with low incomes compared to imported experts.

4. Outcompetes the local commercial banks. This is because they advance loans to customers at low interest compared to local commercial banks.

Or; it is because they provide a variety of attractive services which induce customers compared to local banks.

5. Interferes with government monetary policy. This is because they are reluctant in implementing government set monetary policies so as to maximize profits.

6. Encourages economic dependence. This is due to continued reliance on foreign resources like capital and technology in the development of the country.

7. Leads to high government expenditure in form of incentives. This is because government gives them a lot of money and other incentives like free taxes so as to stay in business.

Question

a) Assess the role of foreign commercial banks in developing countries.

b) Examine the merits and demerits of foreign commercial banks in the development of your country.

ASSETS OF A COMMERCIAL BANK

Bank assets: These are possessions of a commercial bank including claims on other financial institutions and people.

These include;

i. Loans and bank overdrafts.
ii. Deposits with other banks eg. Central bank, other commercial banks and non-bank financial institutions.
iii. Cash in liquid form consisting of coins and currency notes in reserves with it and in its branches.
iv. Investments in government securities such as state bonds, treasury bills and shares.
v. Value of its permanent assets such as buildings, furniture, cars, etc.

LIABILITES OF COMMERCIAL BANKS

Bank liabilities: These are claims by the customers, other financial institutions and

government on the bank. These include;

i. Share capital of the bank contributed by the shareholders.
ii. Reserves accumulated to meet contingencies such as losses at any time during the year.
iii. Deposits by customers, other banks and any other financial intermediaries.
iv. Deposits by government.
v. Loans borrowed from the central bank.
vi. Cheques drawn by the bank from other banks.

Question

a) Describe the assets of a commercial bank.

b) Explain the assets of a commercial bank in your country.

CREDIT

This is a facility which enables an individual or firm to get goods and services without immediate payment.

Or; it means the business transactions for which payment is to be made in future

Or; it is a promise by one party to pay another party for money borrowed or goods or services received.

Or; it is a medium of exchange to receive money or goods on demand at some future date.

The word credit s derived from the Latin word creditum which means to believe or trust.

Question

What is meant by the term credit?

FEATURES OF CREDIT

1. Trust & confidence. This suggests that the lender is willing to give money to a borrower who will pay back.

2. Time element. This suggests that lending is done on condition that the borrower will pay at a future time.

3. Transfer of goods and services. This suggests that credit involves transfer of goods or services from seller to buyer with hope of paying back.

4. Willingness & ability. This suggests that lenders are willing to give credit to a person who is honest in character, capacity and capital.

5. Purpose of credit. This suggests that lenders give more loans or credit to investors compared to other activities like parties.

6. Security. This suggests that credit is given in exchange for a collateral security like a title, property or gold.

Question

a) Mention any four features of credit in an economy.

b) Outline any four features of credit in your country.

INSTRUMENTS OF CREDIT

These are written, typed or printed financial documents that serve either as promises to pay or as orders to pay. They provide the means by which funds are transferred from one party to another.

Question

What is meant by the term instruments of credit?

They include;

1. Promisionary notes: This is a written promise by a debtor to pay another person a specific sum of money by an agreed date, usually within a year with three years of grace.

2. Bill of exchange or commercial bill: This is an order drawn by the creditor to the debtor instructing the latter to pay a specified sum of money to the former, or to the bearer, or to his nominee.

3. Use of credit cards: This is a card enabling the holder to obtain goods and services from specific suppliers including travel, meals and hotel accommodation, up to a specified maximum amount, payment being made monthly to the issuer of the card.

4. Use of cheques: This is an order on the bank written by the drawer who has his deposit with the bank to pay on demand the stated amount of money to the person named on the cheque.

Drafts: This is an order of a bank to its branch in some other city or town for making payments for the mount specified in it to the person or organization.

Question

a) Mention any four instruments of credit.

b) State any four instruments of credit in your country.

c) Mention two merits of credit in an economy.

i) Increases aggregate demand.

ii) Influence employment and output maximization.

iii) Facilitates optimal utilization of resources.

iv) Facilitates production and exchange of goods and services.

v) Improves on the living of conditions of people.

d) Give two factors considered by commercial banks before giving out loans.

i) The integrity and credit worthiness of the customer.

ii) The purpose for which the loan is advanced whether it is given for investment or consumption.

iii) The collateral security of the loan borrower.

iv) The general profitability of the business for which the loan is to be acquired.

v) The economic conditions of the country at the time.

vi) The government's policy on advancing loans at the time.

HOW COMMERCIAL BANKS ACHIEVE THE OBJECTIVES OF LIQUIDITY, SECURITY, & PROFITABILITY

LIQUIDITY

This is the ease with which an asset can be converted into cash. A commercial bank needs cash all the time for its customers but it must invest part of this money to make profits. However, if it keeps a lot of money in cash without investing it the profits reduces yet, if it invests all the money customers will be disappointed. Therefore, a bank must strike a balance between cash and profits.

Commercial banks achieve the objective of liquidity or cash at the bank in the following ways;

1. By maintaining a cash ratio. This is by keeping a proportion of the deposits in cash form to meet day to day demands of customers.

2. Maintaining near to cash assets. This is by keeping liquid assets which can easily be changed into money like bills and money at short notice.

3. Pursue short term lending policies. This is by giving loans to borrowers for short periods.

4. Regulating the volume and frequency of withdrawals. This is by maintaining minimum balances of customers on their accounts.

Or; it is by regulating the number of times a customer withdraws money from the account.

5. Maintaining accounts with other banks. This helps to draw cash from other banks in case of need.

6. Commercial bank can borrow from the central bank as the lender of last resort. This helps to get money for use by the customers.

7. Commercial banks borrow from other financial institutions. This also helps the commercial bank to get cash for customer's use in case of need.

SECURITY

Commercial bank operates under conditions of uncertainty and risk. They cannot be sure of how much to earn and spend in the future. This is due to changes in the interest and borrowers who fail to pay back.

Therefore due to such risks commercial banks ensure security by;

1. Establishing the credit worthiness of borrowers. This is by finding out if a person can pay back the loan before it is released to him.

2. Obtaining the collateral security. This is by getting a collateral security from the borrower such that failure to pay back it is sold to recover the money.

3. Use of armed personnel. This is by using armed police to protect money in the bank an on transit from being stolen.

4. Use of strong building and hard coffers. This is by establishing strong walls, doors and coffers to protect people's money.

5. Maintaining credit departments. This is by maintaining loans department that must follow up on people who took loans so as to make them pay back.

6. Insuring with many insurance companies. This helps in getting compensation in case of any occurrences insured against.

PROFITABILITY

A commercial bank aims at making profits. This is in form of paying interest to

depositors, wages to staff, dividends to shareholders and meeting other expenses. It cannot afford to hold a large amount of funds in cash for that will mean foregoing incomes.

Therefore, Commercial banks ensure profitability by;

1. Investing in profitable projects. This is by investing in profit making businesses like industry or agriculture.

2. By advancing loans and overdrafts at fixed rates of interest. This helps the commercial bank to get interest in form of profits.

3. By discounting and underwriting shares of public limited liability companies for commissions. This is by paying the holders of bills of exchange on behalf of their customers at a fee hence making profits.

4. Charging fees for services rendered. This is by charging fees on all services provided by the commercial bank.

5. Buying government securities. This is by trading in bonds and bills which have interest.

6. Buying shares from prominent companies on which dividends are paid to the shareholding commercial banks hence making profits.

7. Keeping time or fixed deposits with other banks where money is to yield high interest to the lending bank.

Question

Explain how commercial banks reconcile the objectives of liquidity, security and profitability.

PRINCIPLES OF BANK LENDING

1. Principle of liquidity. This suggests that banks should ensure that there is cash for customers all the time not to disappoint them.

2. Principle of safety. This suggests that banks should lend only to customers who are able to pay back.

3. Principle of diversity. This suggests that banks should invest its surplus money a variety of projects that bring in returns.

4. Principle of stability. This suggests that banks should lend but ensure that prices of goods and services are stable and lo.

5. Principle of profitability. This suggests that banks should invest in securities and other ventures that bring in profits.

Question

a) Explain the principles of a good banking system in an economy.

b) Explain the principles of a good banking system in your country.

CREDIT CREATION

This is the process by which commercial banks create several deposits out of initial deposits made by customers. Commercial banks use this system of extending secondary deposits to its borrowers in form of loans t create more money through charging interest o borrowers.

ASSUMPTIONS OF CREDIT CREATION

i) Assumes existence of many banks such as Bank A, B, C, D, etc.

ii) Assumes existence of an initial deposit in the bank.

iii) Assumes that people are willing to borrow and banks ready to lend.

iv) Assumes that the loan lent out is either deposited in the same bank or in other banks.

v) Assumes that people hold money on deposit accounts and pay bills by use of cheques.

vi) Assumes that the bank keeps a cash ratio out of the deposit of each customer.

Question

What is meant by the term credit creation?

CREDIT CREATION PROCESS

i) Receiving of deposits from the customers.

ii) Lending out to borrowers.

iii) Keeping a percentage of the deposits.

iv) Accepting money lent out as new deposit.

v) Retaining a percentage as cash ratio.

vi) The process continues until the initial deposit diffuses in the system.

vii) The value of the total deposit = initial deposit x $\frac{1}{\text{Cash ratio}}$

Question

a) Explain the process of credit creation by commercial banks in an economy.

b) Outline the process of credit creation in your country.

AN ILLUSTRATED DESCRIPTION OF CREDIT CREATION BY COMMERCIAL BANKS

1. By receiving deposits and lending part of it to its customers. For example, bank A receives 600.000= as deposit

2. By keeping percentage of the deposit as cash ratio. For example, bank A keeps 20% of the deposit above or 120.000= as reserves.

3. Lending out part of the deposit to bank B. For example, 600.000-120.000 = 480.000=

4. Receiving of new deposit by bank B for example, 480.000=

5. Keeping a percentage of the deposit as cash ratio. For example, 20% of 480.000= or 96.000= as cash ratio

6. The process continues until the initial deposit diffuses itself into the system

7. The final deposit = initial deposit x $\frac{1}{\text{Cash ratio}}$

$= 600.000\text{x}\frac{1}{20\%}$

= 3.000.000=

Calculate the credit created where the initial deposit =10.000=, cash ratio = 5% and four banks are involved.

Method-1

Bank	Initial deposit	Cash ratio/Reserves (5%)	Loan advance
A	10,000	$\frac{5}{100}$X10,000 =500	9,500=
B	9,500	$\frac{5}{100}$ ×9,500 =475	9,025=
C	9,025	$\frac{5}{100}$ ×9,025 =451.25	8,537.5=
D	8,573.75	$\frac{5}{100}$ ×8,537.5 =428.69	8145.06=
Total	37,098.75		

Method-11

Credit Created =

Calculate the amount of credit created if the initial deposit is 100,000=, cash ratio is 20% and four banks are involved.

Question

Explain an illustrated process of credit creation by commercial banks.

BANK DEPOSIT MULTIPLIER

This is the number of times an initial change in bank deposit multiplies itself to give a final change in the total deposit.

Question

a) What is bank deposit multiplier?

b) Mention any two determinants of bank deposit multiplier.

i) Size of the cash ratio.

ii) Number of banks in the country.

iii) Policy of the central bank.

iv) Rate of borrowing.

v) Level f liquidity preference.

vi) Size of initial deposit.

DETERMINANTS OF CREDIT CREATION

1. Availability of collateral security. Credit creation increases with clients who have collateral securities because banks lend more to them hence making profits compared to those with limited collateral security.

2. Credit worthiness of customers. Credit creation increases with credit worth customers because banks lend a lot of money to them which increases credit compared to customers who are not able to pay.

3. Level of conservatism. Credit creation increases with highly motivated and knowledgeable with banking knowledge because they go for more loans which enable the bank to create credit compared to high levels of conservatism.

4. Level of accountability. Credit creation increases with high levels of transparency because money is lent to people who are able to pay back compared to high levels of corruption where some people bribe bank officers to get loans they cannot pay back.

5. Level of liquidity preference. Credit creation increases with low liquidity preference because many people get loans from banks for trade compared to high levels of liquidity prefenrce.

6. Degree of popularity of loans. Credit creation increases when most people are aware of the importance of loans because many of them get loans compared to when loans are not popular to people.

7. Rate of interest. Credit creation increases with low interest because many people go for cheap loans which increases credit compared to high interest which limits borrowing.

8. Level of distribution of commercial banks. Credit creation increases when banks are distributed in most parts of the country because many people go for loans compared to few banks in the country.

9. Political climate. Credit creation increases with peace and security because many people get loans to do business compared to a period of political unrest.

10. The central bank's monetary policy. Credit creation increases with expansionary monetary policy because loans are given out in big amounts compared to restrictive monetary policy.

11. Level of monetization. Credit creation increases when most people use money because they go for loans compared to when little money is used in the country.

Question

a) Explain the factors influencing credit creation in an economy.

b) Explain the factors that influence creation by commercial banks in your country.

FACTORS THAT HAVE INFLUENCED THE LEVEL OF CREDIT CREATION IN UGANDA

1. Availability of collateral security. Credit creation has increased with clients who have collateral securities because it has increased lending to customers hence making profits compared to those with limited collateral security.

2. Credit worthiness of customers. Credit creation has increased with credit worth

customers because it has encouraged banks to lend a lot of money which has increased credit compared to customers not able to pay.

3. Level of conservatism. Credit creation has increased with highly motivated and knowledgeable with banking knowledge because it has motivated banks to give more loans which has enabled banks to create credit compared to high levels of conservatism.

4. Level of accountability. Credit creation has increased with high levels of transparency because money has been lent to people who are able to pay back compared to high levels of corruption where some people have bribed bank officers and got loans they cannot pay back.

5. Level of liquidity preference. Credit creation has increased with low liquidity preference because many people have got loans from banks for trade compared to high levels of liquidity preference.

6. Degree of popularity of loans. Credit creation has increased when most people have been aware of the importance of loans because many of them have got loans compared to when loans are not popular to people.

7. Rate of interest. Credit creation has increased with low interest because many people have gone for cheap loans which have increased credit compared to high interest which has limited borrowing.

8. Level of distribution of commercial banks. Credit creation has increased when banks are distributed in most parts of the country because many people have gone for loans compared to few banks in the country.

9. Political climate. Credit creation has increased with peace and security because many people have got loans to do business compared to a period of political unrest.

10. The central bank's monetary policy. Credit creation has increased with expansionary monetary policy because loans have been given out in big amounts compared to restrictive monetary policy.

11. Level of monetization. Credit creation has increased when most people use money because they have gone for more loans compared to when little money is used in the country.

Question

Explain the factors which have influenced the level of credit creation in your country.

FACTORS THAT LIMIT CREDIT CREATION

1. Limited collateral security. This is due to most people do not have collateral securities hence they can't qualify to get loans from banks which limit credit creation.

2. Limited credit worthy customers. This is because many people do not pay back the money borrowed from banks.

Or; banks do not lend to people who are not credit worthy which limit credit creation.

3. Conservatism. This is due to some people who keep money at home and refuse to save with banks.

Or; it is due to people who hoard incomes under pillows and see no need of getting loans from banks.

6. Corruption by bank officials. This is due to bank officials who steal funds meant for lending hence limiting credit creation.

7. High levels of liquidity preference. This is due to people who keep money in cash form with themselves and see no need of getting loans from banks.

8. Unpopularity of loans. This is due to the fact that many people do not know the importance of getting loans.

Or; it is because many people fear to get loans for fear of losing their assets when they fail to pay back.

9**. High liquidity with commercial banks**. This is due to banks which prefer keeping more

of liquid assets then cash for lending out.

10. High rate of interest which discourage borrowing. This is due to banks which make loans very expensive for borrowers hence limiting borrowing.

11. Low levels of development of commercial banks. This is due to banks which are mainly urban based hence serving few people in the country.

Or; it is due to the difficulties faced by the rural people in accessing loans in urban banks which limit credit creation.

12. Low levels of incomes. This is due to the fact that people are just poor and cannot save which limit the lending power.

13. Political unrests. This makes lending and borrowing too risky in the country.

Or; it I because people fear to get loans yet, banks also fear to lend in such a period.

Question

a) Explain the factors which limit credit creation in an economy.

b) Explain the factors which limit credit creation in your country.

c) Distinguish between cash ratio and liquidity ratio.

Cash ratio is the proportion of the total deposit kept in cash form to meet day today requirements of the customers where as liquidity ratio is the proportion of bank deposit kept in cash and near to cash form.

d) Give two reasons why reserve ratio may be increased.

i) To save guard the bank against uncertainties especially during the period of economic depression.

ii) To control inflation or reduce the amount of money in circulation.

iii) To reduce the liquidity level of banks.

iv) To restrict credit creation by banks.

v) To protect the interest of depositors in times of crisis.

e) Define the following;

i) Reserve ratio is the percentage or fraction of the total bank deposit which by law must be kept with the central bank.

ii) Soft loan is the loan with very low interest and long period of repayment.

iii) Hard loan is the loan with high rate of interest and short period of repayment.

f) Give two reasons why your country continues to rely on loans.

i) To finance long term projects.

ii) To fill the persistent budgetary deficits of government.

iii) To supplement the export earnings.

PROBLEMS FACED BY COMMERCIAL BANKS

1. Ignorance about the importance of commercial banks. This is due to many people in the country who do not know the services offered by commercial banks.

2. General poverty. This is due to many people who are poor and therefore do not have collateral securities to get loans.

3. Many customers are not credit worthy. This is due to many people who get loans and refuse to pay back what they borrowed.

4. Poorly developed infrastructure. This is due to poor roads that make it difficult for banks to tap the rural saving.

5. Limited public confidence in commercial banks. This is due to lack of trust for local banks as some of them have closed and disappeared with people’s money.

6. Rampant robbery. This is due to large sums of money which has been robbed making hard to lend to people.

7. Influence of foreign owned banks. These outcompetes local banks because of their efficient services to customers.

8. Government influence. This is due to strict instructions from the central bank which limits lending in the country.

9. Corruption by bank officials. This is due to some bank officials who steal funds meant for lending by commercial banks which limit their activities.

10. Political unrests. This hinders lending due to limited economic activities.

Question

a) Explain the problems faced by commercial banks in an economy.

b) Explain the problems faced by commercial banks in your country.

NATIONALISATION OF COMMRCIAL BANKS

This is the taking over of ownership by government of formerly privately owned commercial banks in the country.

Question

What is meant by nationalization of commercial banks?

MERITS OF NATIONALISATION OF COMMERCIAL BANKS

1. It increases distribution of commercial banks. This is because government locates banks in most parts of the country which increases on saving.

2. It reduces discrimination in the lending system. This is because government lends to all categories of people in the country.

3. It reduces capital outflow. This is because the profits and incomes earned by banks are used locally.

4. It reduces wasteful competition. This is because resources in the banking sector are

allocated well.

5. It maintains efficiency. This is because it reduces all inefficiencies associated with private banking.

6. It controls money and credit. This is because it makes it easy to control the amount of money in circulation.

7. It offers soft loans. This is because it enables government to extend loans to many people in the country.

Question

a) Explain the merits of nationalization of commercial banks in an economy.

b) Explain the advantages of commercial banks in the development of your country.

DEMERITS OF NATIONALISATION OF COMMERCIAL BANKS

1. Promotes monopolies in the banking sector. This is due to nationalized banks that dominate the banking sector which leads to poor services.

2. Encourages bureaucracy and delays. This increases the cost of production a lot of time is taken to handle issues of investors.

3. Limits choice of customers for the best banking services. This is due to a single baking system in the country.

4. High restrictions on banks. This scares investors in the banking sector as it is difficult to open up a private bank.

5. Sometimes leads to loss of confidence in government. This is due to the poor services provided by government owned banks.

Question

a) Assess the merits and demerits of nationalization of commercial banks in an economy.

b) Examine the role of nationalization of commercial banks in your country.

NON-BANKING FINANCIAL INTERMEDARIES

This refers to financial institutions which accept deposits from the public lend out loans but do not create credit.

Question

What is meant by the term non-banking financial intermediaries?

TYPES OF NON-BANK FINANCIAL INSTITUTIONS

Insurance companies: These insures against business risks like arson, robbery, and accidents.

Cooperative savings and credit societies: These provide funds to members of the cooperative.

Building societies: These provide funds to members who construct residences or business houses.

Post saving banks: These do not create credit but encourage low income savers and students and extend simple loans to members.

DIFFERENCES BETWEEN COMMERCIAL BANKS AND NBFI's

i. Commercial banks create credit which is not the case with NBFIs.

ii. Commercial banks are profit motivated unlike NBFIs.

iii. Commercial banks deal in short term loans while NBFIs in long term loans.

iv. Commercial banks charge mainly high interest while NBFIs low interest.

v. Commercial banks operate in money markets while NBFIs in capital markets.

ROLE OF NBFIs

1. Helps to mobilize saving both internally and externally so as to avail enough funds for the borrowers.

2. Helps to create employment opportunities for many people who work in those institutions.

3. Provides government with revenue by paying taxes on the profits made by them.

4. Training of local manpower to acquire skills in banking.

4. Helps to improve technology by use of improved banking facilities such as ATM, Computer system.

5. Helps to monetize the economy by extending credit to its customers with increased use of money in business.

6. Facilitates by financing commercial bank activities, giving to traders and safe guarding against risks in trade.

7. Helps in development of infrastructure such as communication system, property development, real estates, power supply as they provide long term loans.

Question

a) Mention any four advantages of non-bank financial intermediaries in an economy.

b) Outline any four merits of non-bank financial institutions in your country.

c) Mention two international non-bank financial institutions.

i) World Bank which helps governments on industry, agriculture, transport, power, health and education.

ii) International Finance Corporation which helps governments to46-46 invest in both private sector and government sector industries.

iii) International development agency which finances social infrastructure development in education, roads, and health.

iv) International monetary fund which lends huge sums of money to member states.

d) What is IMF?

This is a world body which deals in lending huge sums of money to member states.

e) State two functions of IMF.

i) To maintain the stability of foreign exchange.

ii) To recommend policies for improving BOP positions.

iii) Recommend member states to get loans from international finance institutions.

f) Mention two international monetary fund conditionalities.

i) Carrying out periodic devaluation.

ii) Export diversification.

iii) Economic liberalization.

iv) Privatization.

v) Improve tax policy.

vi) Ensure strict monetary and credit policy.

vii) Ensure hospitality to foreign investments.

Assess the role of IMF in the development of your country.

Positive

i) Encourages price stability.

ii) Reduces government expenditure.

iii) Encourages trade liberalization.

iv) Leads to privatization.

v) Increases government revenue.

vi) Promotes international relations.

vii) Corrects BOP positions.

Negative

i) Worsens income and wealth inequalities.

ii) Leads to poor living conditions.

iii) Leads to economic dependence.

iv) Promotes devaluation and its effects.

v) Worsens the debt burden of the country.

STOCK EXCHANGE MARKETS

This is the market where already issued government securities are traded. These include treasury bills, bonds, shares and stocks.

Stock exchange markets operate in speculation where securities are traded with the hope that prices of securities will increase to make profits. In Uganda it is under the capital markets authority. Companies listed under the Uganda securities exchange markets include;

i) The new vision printing & publishing company.

ii) Nation media group.

iii) Uganda clays limited.

iv) Stanbic bank.

Question

What is meant by stock exchange market?

MEMBERS OF STOCK EXCHANGE

Brokers: These are people who trade in securities on behalf of the owners. They are paid a commission called brokerage.

Jobbers: These are people who trade in securities on their own. They earn a commission called Jobber turn.

Bulls: These are jobbers who buy securities when prices are low and sell when prices rise.

Bears: Theses are jobbers who sell securities at a high price hoping to buy when their prices are low again.

FUNCTIONS OF STOCK EXCHANGE

1. To secure markets for government securities and encourage buyers to engage in risk taking.

2. To monitor financial performance of quoted companies.

3. To publish useful information on listed companies

4. To encourage saving for long term investments.

5. To regulate prices of traded securities by ensuring that they are stable to encourage trade.

Question

a) Mention any four functions of stock exchange in an economy.

b) State any four functions of stock exchange in your country.

TREASURY BILLS

These are short term financial documents. They are traded by government through the central bank at a discounted rate and an individual or firm buys at face value at maturity hence earning more profit.

Specimen

Name	Nekesa Edina Samantha
Amount paid	UGX. 2.000.000
Date of issue	1/1/2015
Time period	5Years

Expiry	1/1/2020
Interest rate	8% p.a
Amount due	UGX. 2.960.000

Question

a) What is a treasury bill?

b) Give two reasons why government by securities or treasury bills.

i) To earn interest at maturity.

ii) To store wealth in securities for future use.

iii) To pay debts incurred by government.

iv) No risks or losses are involved with securities.

c) Mention two reasons why companies or individuals sell securities.

i) To raise enough capital for investment.

ii) To boost the financial position of the company.

iii) To mobilize savings.

iv) For image improvement of the company and prestige.

v) To diversify ownership and responsibility of the company.

BONDS

These are long term financial documents. They are traded by the government through the central bank at a discounted rate but bought at a face value at maturity. They are bought for similar reasons for similar reasons like treasury bills.

Specimen

Name	Tangwa Lolo
Amount	UGX. 800.000.000
Date of issue	31/12/2006
Rate of interest	4% p.a
Time period	25 Years
Expiry period	31/12/2031
Amount due	870.000.000

Question

a) Distinguish between corporate and government bonds.

b) State to functions of capital markets in your country.

i) To mobilize savings.

ii) To encourage investment.

iii) To regulate the prices of financial assets.

iv) To promote ease of convertibility of assets like changing assets from near cash to cash.

c) Mention two features of money markets in an economy.

i) Few participants in the market.

ii) Mainly urban based.

iii) Charge mainly high interest rates.

iv) Mainly small scale.

v) Deal in limited variety of financial assets.

THE CENTRAL BANK

This is the central monetary institution responsible for the management of the monetary system in the country. It also assists and advises government on matters of financial nature and importance as well as providing government with the main channels through which the monetary policies.

Question

What is meant by a central bank?

FUNCTIONS OF THE CENTRA BANK

1. Issuance of the currency. This is by issuing new notes and coins of all denominations in the country.

2. Banker to government. This is by keeping funds of the central government and government ministries.

Or; it is by receiving all revenues accruing to government accounts.

3. Lender to government. This is by selling government securities so as to raise revenue for the country.

Or; it is by providing government with short term loans through selling securities.

4. Advises government on issues of financial nature. This is guiding government on the cheaper sources of internal and external loans.

Or; it is by guiding government on the best measures to control inflation in the country.

Or; it is by advising government on the best policy measures for regulating the BOP position in the country.

5. Banker for international agencies. This is by keeping money for international agencies like World Bank, IMF, UNDP, etc.

6. Banker to commercial banks. This is by keeping money for commercial banks as a must policy for government.

7. Controller of commercial banks. This is by advising commercial banks on monetary policies and any changes.

Or; it is by guiding commercial banks on monetary policies to take up so as to regulate economic activities in the country.

8. Lender of last resort. This is by lending to commercial banks in case of need at a high interest.

9. Custody and management of foreign exchange reserves. This is by determining the rate at which a local currency is exchanged for currencies of other countries.

Or; it is by managing and keeping foreign exchange reserves for the country.

10. Controller of credit. This is taking the overall control of the amount of money in circulation.

Or; it is by controlling the general level of prices for goods and service in the country.

Or; this is by taking use of the monetary tools to control the amount of money in circulation.

Question

a) Explain the functions of the central bank in an economy.

b) Explain the functions of bank of Uganda.

THE MONETARY POLICY

This is the deliberate government attempt through the central bank to regulate the amount of money in circulation, rate of interest and foreign exchange so as to achieve the objectives of development.

These include; stable prices, stable employment and economic growth.

Or; it is a deliberate policy to regulate the amount of money in circulation so as to influence the level of economic activities in the country.

Question

What is meant by the term monetary policy?

OBJECTIVES OF THE MONETARY POLICY

1. Ensure price stability. This is by using restrictive monetary policy to reduce the amount of money in circulation so as to ensure price stability in case of inflation.

Or; it is by increasing the amount of money in circulation during a deflation so as to stimulate prices, investment and production.

2. To achieve full employment. This is by reducing the rate of interest which attracts borrowing so as to set up industries for employing people.

Or; it is by increasing the amount of money in circulation which increases demand for goods and services which attracts investment.

3. To influence B.O.P position. This is by selling foreign exchange reserves in exchange for the excess local currency in case of a BOP deficit.

Or; it is by buying excess foreign exchange reserves in exchange for the local currency in case of a BOP surplus.

4. To increase the level of investment. This is by reducing interest which attracts borrowing for investment in the country.

5. To stabilize the rate of foreign exchange. This is by using a restrictive monetary policy so as to reduce the amount of local currency used to buy foreign currencies.

Or; it is by buying the local currency using foreign exchange reserves so as to increase the amount of the local currency in the country.

6. To encourage the growth of the financial sector. This is by encouraging investors to set up banks in most parts of the country.

7. To attain economic growth. This is by reducing interest to attract investment in production of more goods and services.

Question

a) Explain the objectives of the monetary policy in an economy.

b) Explain the objectives f the monetary policy in your country.

TERMS UNDER CENTRAL BANK

Contractionary monetary policy: These are measures undertaken by the central bank to reduce the amount of money in circulation so as to control inflation. These include; increasing the bank rates, sale of government securities, and increasing the variable reserve requirements.

Expansionary monetary policy: These are measures undertaken by the central bank to increase the amount of money in circulation so as to attract saving and investment. These include; reducing the bank rate, and buying government securities from the public.

Foreign reserves: This is the total value of all gold, foreign exchange reserves and special drawing rights held by the central bank.

Special drawing rights: These are assets created by IMF which give holders unconditional drawing rights from the fund.

Or; it is the financial assets created by IMF to increase the international liquidity of member states.

TOOLS OF THE MONETARY POLICY

These are instruments, guidelines or weapons used by government through the central bank to regulate the amount of money in circulation, interest rate and foreign exchange so as to achieve the objectives of development such as price stability, full employment.

These include;

1. The Bank rate. To restrict credit, the bank rate is raised to scare commercial banks and limit their lending ability which reduces the amount of money in circulation hence a

fall in demand and prices yet, to expand credit, the interest is reduced which attracts commercial banks to borrow

from it which expands its lending hence increasing the amount of money in circulation, demand and prices.

2. Open market operation. To restrict credit, the central bank sells securities to the public which reduces the amount of money in circulation hence a fall in demand and prices yet, to expand credit, the central bank buys securities from the public which increases the amount of money in circulation hence a rise in demand and prices.

3. Legal reserve requirements. To restrict credit, the legal reserve is raised to reduce the lending power of commercial banks which reduce the amount of money in circulation hence a fall in demand and prices yet, to expand credit, the legal reserve is reduced which empowers to commercial banks to lend more money to the public hence a rise in demand and prices.

4. Variable reserve requirement or cash ratio. To restrict credit, the central bank instructs commercial banks to increase the size of their cash ratio which reduces their lending hence a fall in demand and prices yet, to expand credit, the cash ratio is reduced which enables commercial banks to increase lending which increases the amount of money in circulation, demand and prices.

5. Selective credit control. To restrict credit, commercial banks are forced to lend to selected projects which reduces the amount of money in circulation hence a fall in demand and prices yet, to expand credit, selective credit is relaxed which encourages banks to lend more hence a rise in demand and prices.

6. Margin requirements. To limit credit, margin requirement is raised by commercial banks which reduce the lending hence a fall in demand and prices yet, to expand credit, margin requirement is reduced which increase the amount of money in circulation hence a rise in demand and prices.

7. Special deposits. To expand credit, the central bank freezes all the special deposits by commercial banks which increase the lending hence a rise in demand and prices yet, to

restrict credit, the central bank increases the special deposit which limits the amount of money in circulation, demand and prices.

8. Moral Suasion. To limit credit, the central bank, persuades banks to reduce lending so as to control demand and prices yet, increasing credit involves use of an expansionary monetary policy.

9. Direct action. To restrict credit, tight measures are undertaken on lending so as to reduce the amount of money in circulation, demand and prices compared to a period of expansionary monetary policy.

10. Rationing of credit. To expand or restrict credit, the central bank keep on varying the amount of money lent to the public.

Question

a) Explain the monetary policies used in developing countries.

b) Explain how the central bank controls credit in your country.

FACTORS LIMITING EFFECTIVE IMPLEMENTATION OF THE MONETARY POLICY

1. Ignorance about the open market operation. This is because many people are not aware of the importance and availability of government and corporate securities in the country.

2. Excess liquidity in commercial banks. This is because commercial banks keep a lot of cash hence they do not borrow from the central bank to influence their lending.

3. High liquidity preference among the population. This is due to many people who keep a lot of cash and cannot borrow from commercial banks.

4. Dominance of foreign banks. This is because they inject a lot of money into circulation in the process of creating credit.

Or; it is because they lie outside the control of the central bank since are not affect by monetary policies of the country.

5. Presence of large subsistence sector. This is because the sector does not make use

of money through which the monetary policy works.

6. High rate of corruption among bank officials. This is due to bank officials who lend to many people who bribe them.

7. Political interference. This is due to politicians who interfere with the activities of the monetary authority by ordering banks to lend more money to the public at a time when it is not necessary.

Or; it is due to politicians who influence lending of a lot of money to sectors which are not productive.

8. Under developed money & capital markets. This is due to limited use of securities like bills and bonds.

9. Limited use of commercial banks. This is because commercial banks are used only by those who know its importance.

Or; t is due to the fact that many people are ignorant of the importance of loans.

10. Poor distribution of commercial banks. This is because banks are mainly found in towns which make it difficult to regulate the use of money in rural areas.

Question

a) Explain the factors which limit effective implementation of the monetary policy in an economy.

b) Explain the factors which limit the effective implementation of the monetary policy in your country.