



*Dr. Bhasa Science*

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## SENIOR SIX TERM 2

### TOPIC 1/2: Money, Banking and Inflation

**Competency:** The learner demonstrates ethical financial management prowess by generating income through legitimate means, utilizing financial institutions to optimize resource allocation, and developing strategies to mitigate the effects of inflation, ultimately contributing to sustainable national development.

#### Money

Money is anything which is legally acceptable for carrying out transactions and discharge of debts. To settle legal payments, money must be legal tender meaning that it must be acceptable by everyone in the country in the settlement and discharge of debts.

#### Functions of money

- (i) **Medium of exchange:** Money eliminates the inefficiencies of barter by allowing goods and services to be traded easily. Example: Paying for groceries with cash instead of exchanging goods.
- (ii) **Unit of account:** Provides a common measure to value goods and services. Example: Prices expressed in Ugandan shillings make comparisons straightforward.
- (iii) **Store of value:** Money preserves purchasing power over time, allowing savings and future spending. Example: Depositing wages in a bank account to use later.
- (iv) **Standard of deferred payment:** Enables contracts, loans, and debts to be settled in the future using money. Example: Repaying a loan in monthly installments.
- (v) **Money helps in the planning process and budgeting.** This is because the estimation of costs and benefits of projects is done in monetary terms.
- (vi) **Money serves as a tool which the government uses in monetary policy.** This is because monetary policy involves the adjustment of volume and value of money in circulation in order to bring about general economic stability.
- (vii) **Money facilitates one way payments.** This helps to simplify the misunderstandings between the parties concerned e.g. taxes are paid in monetary terms.
- (viii) Money makes it possible for price mechanism to operate since prices are determined in monetary terms.

## Qualities (characteristics/features) of money

- (i) **Acceptability:** People must trust and be willing to use it in exchange for goods and services.
- (ii) **Portability:** Money should be easy to carry and transfer from one person to another.
- (iii) **Durability:** It must withstand wear and tear, lasting over time without losing value.
- (iv) **Divisibility:** Money should be capable of being divided into smaller units to facilitate transactions of different sizes.
- (v) **Uniformity:** Each unit of money must be identical in value and appearance to avoid confusion.
- (vi) **Stability of value:** Money should maintain relatively stable purchasing power over time.
- (vii) **Recognizability:** It must be easy to identify and difficult to counterfeit.
- (viii) **Relative scarcity:** Money must be relatively scarce. This is because, if it is in plenty it loses value and fails to perform the useful role of exchange.
- (ix) **Hard to forge.** Money should be difficult to forge or copy by other individuals. This reduces its supply and the loss of value.
- (x) **Identifiable.** Money should be easy to recognize and distinguish from fake or forged money.
- (xi) **Economy.** Money should be convenient and cheap for the government to print. The printing costs should not exceed the value of money printed.

## Barter trade

This is the exchange of commodities for commodities between individuals or countries. For barter trade to take place, it is necessary to have double coincidence of wants, that is, seeking for one who has the commodity you want and who wants the commodity you have.

## Limitations (Problems/Defects) of Barter trade

- (i) **Double coincidence of wants:** Trade only occurs if both parties want exactly what the other offers, which is rare.
- (ii) **Lack of a common measure of value:** No standard unit to compare the worth of different goods (e.g., how many goats equal a sack of maize).
- (iii) **Indivisibility of goods:** Some items (like livestock or tools) cannot be divided into smaller units to match the value of other goods.
- (iv) **Difficulty in storing wealth:** Goods may perish, spoil, or lose value over time, unlike money which can be saved.
- (v) **Limited scope of trade:** Barter is practical only in small communities; it cannot support large, complex economies.
- (vi) **Problems of deferred payments:** Future payments are hard to agree upon since goods may change in value or perish.
- (vii) **Transportation and exchange difficulties:** Moving bulky goods for trade is inconvenient compared to carrying money.

- (viii) It is difficult to measure the relative value of one commodity in terms of another commodity under barter trade.
- (ix) It is difficult to store commodities for future exchange especially when the commodities are highly perishable for example tomatoes.
- (x) Most of the commodities appear in plenty and therefore, they can easily lose value.
- (xi) It does not promote specialization and efficient allocation of resources. This is because there is no common medium of exchange acceptable to both consumers and producers.

## Definitions of concepts

### (a) Token money

**Token money** refers to money whose **face value** (the value written on it) is **greater than its intrinsic value** (the actual value of the material it is made from). In other words, the paper or metal used to make the money is worth much less than the value it represents in transactions.

#### Characteristics of Token Money

- (i) **Face value exceeds intrinsic value:** A 1,000 shilling note costs only a few shillings to print, but it represents 1,000 shillings in trade.
- (ii) **Legal tender by government decree:** Its acceptance is guaranteed by law, not by the material it is made of.
- (iii) **Convenient and portable:** Lightweight and easy to carry compared to commodity money like gold or livestock.
- (iv) **Uniformity:** All notes or coins of the same denomination are identical in value.
- (v) **Durability:** Designed to last through circulation, though less durable than precious metals.

### (b) Intrinsic money

This is money whose metal value is equal to its face value. That is, it is money in terms of metal value. For example gold money

#### Characteristics of Intrinsic Money

- (i) **Has inherent value:** The substance used (gold, silver, copper) is valuable on its own.
- (ii) **Face value  $\approx$  material value:** A gold coin worth 100 shillings contains gold of nearly the same market value.
- (iii) **Durability:** Precious metals last long without losing quality.
- (iv) **Universal acceptability:** Valued across countries and cultures, not just by government decree.
- (v) **Difficult to counterfeit:** Since the value lies in the material, fake versions are harder to produce convincingly.

### (c) Commodity money

**Commodity money** is money that has **intrinsic value** because it is made from materials that are

valuable in themselves. Unlike token or fiat money, commodity money's worth comes directly from the commodity it is made of, not just government decree.

### Characteristics of Commodity Money

- (i) **Intrinsic value:** The commodity itself (gold, silver, salt, cattle) is valuable even without being used as money.
- (ii) **Universally acceptable:** Valued across communities and cultures, making it widely trusted.
- (iii) **Durability:** Commodities like metals last long without losing quality.
- (iv) **Portability:** Precious metals and small items are easier to carry than bulky goods.
- (v) **Divisibility:** Metals can be divided into smaller units to match transaction values.
- (vi) **Stability of value:** Scarce commodities maintain value over time.

### Examples

- (i) Gold coins
- (ii) Silver coins
- (iii) Copper coins
- (iv) Salt, cattle, or cowrie shells (historically used in Africa and Asia)

### (d) Fiat money

**Fiat money** is currency that has **no intrinsic value** and is not backed by a physical commodity like gold or silver. Its value comes entirely from **government decree** and the **trust of the people** who use it

### Characteristics of Fiat Money

- (i) **No intrinsic value:** The paper or metal used is worth far less than its face value.
- (ii) **Legal tender by government decree:** Its acceptance is enforced by law.
- (iii) **Portability:** Lightweight and easy to carry compared to barter or commodity money.
- (iv) **Divisibility and uniformity:** Notes and coins can be issued in standard denominations.
- (v) **Unlimited supply potential:** Governments can print more, unlike commodity money limited by scarcity.
- (vi) **Dependent on trust:** Its value relies on confidence in the issuing authority and economic stability.

### (e) Fiduciary issue

A **fiduciary issue** in monetary terms refers to the **issuance of currency that is not backed by a physical commodity** (like gold or silver), but instead relies on the **trust and confidence of the public** in the government or central bank that issues it

### Points about Fiduciary Issue

- (i) **Based on trust:** The value of the money depends on confidence in the issuing authority, not the material itself.
- (ii) **Not commodity-backed:** Unlike gold or silver coins, fiduciary money has no intrinsic value.

- (iii) **Fiat currency** as example Modern paper notes and coins (e.g., Ugandan shilling, US dollar) are fiduciary issues.
- (iv) **Flexibility in monetary policy:** Governments can adjust supply more easily than with commodity money.
- (v) **Risk of inflation:** Mismanagement (printing too much money) can reduce trust and cause inflation or hyperinflation.

### Examples

- (i) **Ugandan Shilling (UGX):** Issued by the Bank of Uganda without gold backing.
- (ii) **US Dollar (USD):** Since 1971, no longer backed by gold, purely fiduciary.
- (iii) **Euro (EUR):** Backed by the European Central Bank's authority, not commodities.

### Comparison Table of fiduciary issue and fiat money

Aspect	Fiduciary Issue	Fiat Money
<b>Definition</b>	Currency issued without commodity backing, based on trust	Currency with no intrinsic value, accepted by law
<b>Value source</b>	Public confidence in issuer	Government decree + public trust
<b>Focus</b>	Trust-based nature of issuance	Legal authority declaring it money
<b>Examples</b>	Banknotes, paper currency	Ugandan Shilling, US Dollar, Euro
<b>Overlap</b>	Fiduciary issue is a type of fiat money	Fiat money often arises from fiduciary issue

### Summary

- (i) **Fiduciary issue** highlights that money is issued based on **trust** rather than commodity backing.
- (ii) **Fiat money** highlights that money is accepted because of **government decree**.
- (iii) In practice, they overlap: most modern currencies (like the Ugandan Shilling, US Dollar, Euro) are **both fiduciary issues and fiat money**.

### (f) Hot money

**Definition:** It is a short-term capital that moves quickly across borders or markets to chase the highest returns.

**Key feature:** Highly mobile and speculative, often flowing in and out of countries depending on interest rates or currency expectations.

**Impact:** Can cause volatility in exchange rates and financial instability if large amounts leave suddenly.

**Example:** Investors moving funds into Uganda when interest rates rise, then pulling out when rates fall.

### (g) Quasi (Near) money

**Quasi money** (also called **near money**) refers to financial assets that are **not actual legal tender** but can be **quickly converted into cash** or used for transactions. They are highly liquid and function almost like money, though they are not themselves currency.

#### Characteristics of Quasi (Near) Money

- (i) **Not legal tender:** Cannot be directly used to pay for goods and services.
- (ii) **Highly liquid:** Can be easily converted into cash or used in payments.
- (iii) **Interest-bearing:** Many forms of near money earn interest, unlike cash.
- (iv) **Supports transactions indirectly:** Facilitates trade and savings by being close substitutes for money.

#### Examples of quasi money

- (i) **Bank deposits** (savings accounts, fixed deposits)
- (ii) **Treasury bills**
- (iii) **Government bonds**
- (iv) **Certificates of deposit**
- (v) **Traveler's cheques**
- (vi) **Money market instruments**

### (h) Dear money

It is money borrowed at very high interest rates.

### (i) Narrow money

**Narrow money** refers to the most liquid forms of money in an economy—those that can be used immediately for transactions. It is often represented as **M1** in monetary aggregates.

#### Components of Narrow Money

- (i) **Currency in circulation:** Notes and coins held by the public (not by banks).
- (ii) **Demand deposits:** Checking/current accounts in banks that can be withdrawn at any time.
- (iii) **Other highly liquid deposits:** Mobile money balances or electronic wallets that can be spent instantly.

### Example In Uganda, narrow money (M1) includes:

- (i) Ugandan shilling notes and coins in circulation.
- (ii) Demand deposits in commercial banks.
- (iii) Mobile money balances (MTN Mobile Money, Airtel Money), which function as instantly spendable funds.

### (j) Broad money

This is the sum of currency in circulation, demand deposits, savings and time deposits.

### (k) Nominal value of money

This refers to the monetary (face) value of money. For example 2,000/=.

### (l) Real money value (Value of money).

This refers to the amount of commodities a unit of money can purchase. This depends on the general price level. The higher the price level, the lower the value of money.

$$\text{Real money value} = \frac{\text{Nominal money value}}{\text{price index}}$$

### (m) Foreign exchange reserves

This is foreign currency held by the country's central bank.

### (n) Convertible (Hard) currency

This is currency which can be exchanged for other currencies and it is internationally accepted in carrying out transactions. For example pounds, US dollars, etc.

### Soft (Managed) currency

This is currency which is used only within the country and cannot be accepted in carrying out international transactions. For example Ugandan shilling

## Money supply

The **money supply** is the total amount of money available in an economy at a given time, including cash, deposits, and other liquid assets.

### Importance of Money Supply

- (i) **Influences inflation:** Too much money in circulation can cause prices to rise.
- (ii) **Affects interest rates:** Central banks adjust supply to control borrowing costs.
- (iii) **Guides monetary policy:** Helps governments manage growth and stability.
- (iv) **Reflects liquidity in the economy:** Shows how much money is available for spending and investment.

## Types of Money supply

- (i) **Endogenous (Automatic) Money Supply.** This is money supply which is determined by the level of economic activity. For example level of output, interest rates, etc.
- (ii) • **Exogenous (Discretionary) Money Supply.** This is Money supply which is determined by the monetary authority (Central Bank or Ministry of finance) and it does not depend on the level of economic activity.

## Determinants of money supply

- (i) **Central bank policy:** The central bank (e.g., Bank of Uganda) controls money supply through tools like open market operations, interest rates, and reserve requirements.
- (ii) **Currency held by the public:** The amount of notes and coins people keep outside banks directly affects money supply.
- (iii) **Demand deposits with banks:** Checking/current accounts form part of money supply since they can be used for transactions.
- (iv) **Credit creation by commercial banks:** Banks expand money supply when they issue loans, creating new deposits automatically.
- (v) **Government fiscal policy:** Deficit financing (borrowing or printing money to cover budget gaps) increases money supply.
- (vi) **Foreign capital flows:** Inflows of foreign investment or aid increase domestic money supply, while outflows reduce it.
- (vii) **Money multiplier effect:** The ratio of deposits created by banks relative to reserves determines how much money supply expands.
- (viii) **Level of economic activity.** An increase in the level of economic activity increases money supply and a decrease in the level of economic activity reduce money supply.
- (ix) **The level of monetization of the economy.** The greater the subsistence sector, the lower the money supply. As the economy becomes highly monetized, the need for money increases hence increased money supply.
- (x) **The amount of gold reserves held by the central bank.** The higher the gold reserves, the higher the money supply and the lower the gold reserves, the lower the money supply.

## Demand for money (liquidity preference)

Money demand (liquidity preference) refers to the desire by individuals to hold wealth in cash or near cash form.

## Factors that influence the level of liquidity preference

- (i) **Income level**
  - Higher income → more transactions → greater demand for money.
  - Lower income → fewer transactions → reduced liquidity preference.

(ii) **Interest rates**

- At high interest rates, people prefer bonds or investments (lower liquidity preference).
- At low interest rates, people prefer to hold cash (higher liquidity preference).

(iii) **Price level (inflation)**

- Rising prices increase the need for cash to carry out transactions.
- Stable or falling prices reduce transaction demand for money.

(iv) **Precautionary needs**

- Greater uncertainty (e.g., economic instability, emergencies) increases liquidity preference.
- Stable environments reduce precautionary demand.

(v) **Speculative expectations**

- If people expect interest rates to rise (bond prices to fall), they hold more cash.
- If they expect rates to fall (bond prices to rise), they invest more and hold less cash.

(vi) **Availability of credit**

- Easy access to loans reduces the need to hold large cash balances.
- Limited credit availability increases liquidity preference.

(vii) **Financial innovations**

- Mobile money, ATMs, and digital payments reduce the need to hold physical cash.
- In economies with less financial infrastructure, liquidity preference is higher.

(viii) **Political stability**

**Theories of money demand**

- (a) Keynesian theory of money demand
- (b) The Classical quantity theory of money demand

**(a) The Keynesian theory of Money Demand**

According to Lord John Maynard Keynes (1936), individuals demand for money for three major reasons

(motives). These include;

- (i) **Transactions motive:** People hold money to carry out daily purchases and payments. Directly linked to income levels—higher income means more transactions, hence more demand for money.
- (ii) **Precautionary motive:** Money is held as a safeguard against unexpected expenses (emergencies, sudden opportunities). Increases with uncertainty in the economy.
- (iii) **Speculative motive:** People hold money to take advantage of future investment opportunities. If interest rates are low, individuals may prefer to hold cash rather than bonds (expecting rates to rise and bond prices to fall).

### Relationship between Money Demand and Interest Rates

- (i) Demand for money is **inversely related to interest rates**.
- (ii) At **high interest rates**, people prefer to invest in bonds or assets rather than hold cash.
- (iii) At **low interest rates**, people prefer liquidity (cash) because the opportunity cost of holding money is low.
- (iv) The **equilibrium interest rate** is determined where money demand equals money supply.

### Importance of Keynesian Theory

- (i) Shifted focus from the classical view (interest determined by savings and investment) to a **monetary theory of interest**.
- (ii) Helps central banks understand how changes in **money supply and interest rates** affect liquidity preference.
- (iii) Forms the basis of modern monetary policy, especially in managing inflation and stabilizing economies.

### Liquidity trap

This refers to the point below which the interest rate is too low to encourage speculators to invest in bonds and as a result, they only hold money. OR. It is the point below which the interest rate is too low to break the liquidity preference.

### (b) The Classical Quantity theory of Money Demand

The classical quantity theory of money demand states that, keeping the level of transactions and velocity of money constant, the general price level of goods and services is determined by the stock of money circulating in the economy.

### Core Ideas of the Classical Theory

- (i) **Money is only a medium of exchange:** Classical economists believed money's primary role was to facilitate transactions, not to store value or act as an investment.
- (ii) **Demand for money is proportional to income:** People hold money only to carry out transactions. The amount of money demanded depends on the level of national income and price level.

(iii) **Quantity Equation (Fisher's Equation of Exchange)**

$$MV=PT$$

where

M = Money supply

V = Velocity of circulation (how fast money changes hands)

P = Price level

T = Volume of transactions

This equation shows that the total money spent (MV) equals the total value of goods and services (PTT).

**Example**

Given that in the economy, M = shs.300,000, V = 50, T = 300. Calculate the general price level.

Solution

$$MV=PT$$

$$P = \frac{MV}{T} = \frac{300,000 \times 50}{300} = 50,000$$

(iv) **Cambridge Cash-Balance Approach**

$$\text{Reformulated as: } M^d = k \cdot P \cdot Y$$

where

$M^d$  = Demand for money

k = Fraction of income people want to hold as cash

P·Y = Nominal income

Here, money demand is a fixed proportion of nominal income.

**Assumptions**

- (i) Price is only affected by changes in money supply
- (ii) There is full employment of resources in the economy
- (iii) All money earned is spent on the consumption of goods and services
- (iv) Money is only demanded for transaction motive.
- (v) Absence of barter trade
- (vi) The volume of transactions is constant
- (vii) The velocity of money in circulation is constant

## Importance

- (i) Forms the foundation of **monetarist economics** (Milton Friedman later built on this).
- (ii) Highlights the link between **money supply and inflation**.
- (iii) Provides a simple framework for understanding how excess money supply causes rising prices.

## Summary

The **Classical Quantity Theory of Money Demand** argues that people demand money only for transactions, and that demand is proportional to income and price levels. It assumes stable velocity and output, meaning that changes in money supply directly affect prices.

## Criticisms (Limitations) of the classical Quantity theory of money demand

The quantity theory of money is criticized on the following grounds;

- (i) **Assumption of constant velocity of money:** The theory assumes that the velocity of circulation ( $V$ ) is stable. In reality,  $V$  changes with innovations in banking, mobile money, credit cards, and shifts in saving/spending behavior.
- (ii) **Neglect of interest rates:** It ignores the role of interest rates in influencing money demand. Keynes showed that speculative motives make money demand sensitive to interest rates.
- (iii) **Focus only on transactions motive:** The theory assumes people hold money only for transactions. Keynes argued that precautionary and speculative motives are equally important.
- (iv) **Assumption of full employment:** Classical economists assumed output ( $T$  or  $Y$ ) is constant at full employment. In reality, economies often operate below full employment, so changes in money supply can affect output, not just prices.
- (v) **Direct proportionality between money supply and prices:** The theory claims that increasing money supply leads to a proportional rise in prices. Keynes and modern economists argue that the relationship is not always proportional—other factors like demand, production, and expectations matter.
- (vi) **Neglect of financial markets and institutions:** The theory overlooks the role of banks, credit creation, and financial innovations in shaping money demand and supply.
- (vii) **Static framework:** It treats the economy as static, ignoring dynamic factors like growth, technological change, and globalization.
- (viii) The theory ignores commodities that are transacted through barter trade as a system of exchange.
- (ix) The theory ignores government control of prices in the market as a way of ensuring price stability.
- (x) The theory ignores haggling as a method of price discrimination in the market. That is haggling between buyers and a seller to reach an agreeable price is not taken into account.

- (xi) An increase in money supply may result into higher savings if the marginal propensity to save is high. This reduces the velocity of circulation and prices may fall.

## Interest rate

**Interest** is the reward for use of capital in the production process.

**Interest rate** refers to the price at which money is lent out or borrowed.

## Why interest is paid or charged

- (i) **Time value of money:** People prefer money now rather than later because it can be spent or invested immediately. Interest compensates lenders for waiting.
- (ii) **Risk of default:** Borrowers may fail to repay. Interest is charged to cover this risk.
- (iii) **Opportunity cost:** Lenders could have used the money elsewhere. Interest compensates them for giving up other opportunities.
- (iv) **Inflation:** Over time, money loses purchasing power. Interest ensures lenders are compensated for this loss.
- (v) **Reward for savings:** Savers earn interest as an incentive to deposit money in banks instead of spending it.
- (vi) **Cost of borrowing:** Borrowers pay interest because they gain immediate access to funds they don't currently have.

## Example

If you borrow **1,000,000 Ugandan Shillings** from a bank, you might repay **1,100,000 UGX** after a year.

The extra **100,000 UGX** is interest, covering the bank's cost, inflation, and risk.

## Importance of interest rate

- (i) Encourages savings and investment.
- (ii) Helps allocate resources efficiently.
- (iii) Provides income for lenders and cost discipline for borrowers.
- (iv) Central banks (like the **Bank of Uganda**) adjust interest rates to control inflation and stabilize the economy.

## Determinants of interest rate

- (i) **Inflation expectations**
  - Higher expected inflation → lenders demand higher interest to preserve purchasing power.
  - Lower inflation → interest rates tend to fall.
- (ii) **Supply and demand for money/credit**

- Strong demand for loans (business expansion, consumer borrowing) pushes rates up.
- Weak demand or excess liquidity lowers rates.
- (iii) Central bank policy**
  - Central banks (e.g., Bank of Uganda, Federal Reserve) adjust policy rates to control inflation and stabilize the economy.
  - Tight monetary policy → higher interest rates; loose policy → lower rates.
- (iv) Government fiscal policy**
  - Heavy government borrowing (deficit financing) raises interest rates by competing with private borrowers.
  - Balanced budgets reduce upward pressure.
- (v) Risk and default probability**
  - Riskier borrowers pay higher interest to compensate lenders.
  - Safer borrowers (e.g., governments) enjoy lower rates.
- (vi) Liquidity preference**
  - If people prefer holding cash, banks must raise rates to attract deposits.
  - When liquidity preference is low, rates fall.
- (vii) Foreign capital flows**
  - Inflows of foreign investment can lower rates by increasing available funds.
  - Outflows reduce liquidity, raising rates.
- (viii) Economic growth**
  - Strong growth increases demand for credit, pushing rates up.
  - Weak growth reduces borrowing, lowering rates.
- (ix) The period taken to repay the loan.**
  - longer the period, the higher the interest rate
  - shorter the period, the lower the interest rate.
- (x) Amount of money borrowed.**
  - higher the amount, the higher the interest rate
  - lower the amount, the lower the interest rate.

## Summary

Interest rates are shaped by **inflation, monetary policy, fiscal policy, credit demand, risk levels, and global capital flows**. In Uganda, for example, the **Bank of Uganda** adjusts policy rates to fight inflation, while government borrowing and mobile money liquidity also influence lending rates.

## Revision exercise 1

### Section A questions

- 1 (a) What is meant by liquidity preference  
(b) Mention three factors which determine liquidity preference in an economy
- 2 (a) Define the term Barter trade.  
(b) Give four limitations of Barter system of exchange.

- 3 (a) What is meant by the term "Legal tender"  
(b) Mention three circumstances under which an increase in money supply may not necessarily lead to inflation in an economy?
- 4 (a) Define the term interest rate  
(b) Mention three determinants of interest rate in your country
- 5 (a) What is meant by the Liquidity trap  
(b) Explain the relationship between interest rate and money demand
- 6 (a) what is meant by instruments of credit?  
(b) Mention three instruments of credit in an economy
- 7 (a) What is meant by the term "money supply"?  
(b) Give three factors that influence money supply in your country.
- 8 Distinguish between the following terms  
(a) Nominal money value and real money value  
(b) Fiat money and fiduciary issue
- 9 (a) State the quantity theory of money exchange  
(b) Given an economy where the quantity of money in circulation is \$300 million, volume of production is \$100 million and the velocity of money in circulation is 50 times. Determine the general price level.
- 10 The total money supply in an economy is Ushs150 billion. 40% of this is held for transaction purpose, while the balance is held equally for the other Keynesian purposes for holding money. How much is held for precautionary motive?

### Section B questions

1. (a) Explain the qualities of good money  
(b) Explain the functions of money in an economy  
(c) What factors limit the quantity of money supplied in the economy?
- 2 (a) Explain the quantity theory of money according to Fisher.  
(b) Explain the limitations of the Fisher's quantity theory of money exchange.

### Financial intermediaries

**Financial intermediaries** are institutions that act as the **middlemen between savers and borrowers**, helping channel funds from those who have surplus money to those who need it.

**Banking financial intermediaries.** These are financial institutions which create secondary deposits (create credit) and advance short term loans mainly to less risky investments. Examples are commercial banks.

**Non-bank financial intermediaries.** These are financial institutions which do not create credit but they assist in channeling long term loans from surplus spending units to deficit spending units. Examples include building societies, Insurance companies, Post office, saving banks, development banks etc.

### Differences between Banking and Non-banking financial intermediaries

Banking Financial Intermediaries	Non-Bank financial Intermediaries
They create credit which is considered as money (deposit money)	They do not create credit. They just lend funds got from surplus spending units.
They lend on short term basis	They usually lend on long term basis.
They pay lower interest rates on deposits	They pay higher interest rates on deposits.
They maintain short term deposits	They maintain long term deposits.
They undertake less investment risks	They undertake greater investment risks.
They charge high interest rates on borrowers.	They charge low interest rates on borrowers

### Functions of Financial Intermediaries

- (i) **Mobilizing savings:** Collect funds from individuals and businesses (e.g., deposits).
- (ii) **Providing credit:** Lend money to households, firms, and governments.
- (iii) **Risk management:** Spread and manage risks through diversification, insurance, and guarantees.
- (iv) **Liquidity provision:** Allow savers to access their money easily while borrowers get long-term funds.
- (v) **Payment facilitation:** Enable transactions through checks, mobile money, and electronic transfers.
- (vi) **Information role:** Assess creditworthiness and reduce information asymmetry between lenders and borrowers.

### Examples of Financial Intermediaries

- (i) **Commercial banks** – accept deposits and provide loans.
- (ii) **Savings and credit cooperatives (SACCOs)** – mobilize community savings and lend to members.
- (iii) **Microfinance institutions** – provide small loans to low-income households.
- (iv) **Insurance companies** – pool risks and provide coverage.
- (v) **Pension funds** – collect retirement savings and invest them.
- (vi) **Investment funds** – channel savings into stocks, bonds, and other assets.
- (vii) **Mobile money operators** (e.g., MTN Mobile Money, Airtel Money in Uganda) – facilitate payments and savings electronically.

## Importance of Financial Intermediaries

- (i) Promote **economic growth** by financing investment.
- (ii) Encourage **financial inclusion** by providing services to underserved populations.
- (iii) Stabilize the economy by managing risks and providing liquidity.
- (iv) Support government financing through bond purchases.

## Summary

Financial intermediaries are the **bridge between savers and borrowers**, ensuring that money flows efficiently through the economy. In Uganda, institutions like **commercial banks, SACCOs, microfinance institutions, and mobile money platforms** are vital in promoting financial inclusion and supporting development.

## Central banking

Central banking refers to the role of a nation's **central bank** as the supreme monetary authority responsible for managing currency, controlling money supply, regulating interest rates, and ensuring financial stability

A **central bank** is the highest monetary authority in a country, responsible for managing the nation's currency, money supply, and interest rates. It ensures financial stability and acts as the **lender of last resort** to commercial banks.

## Functions of the Central bank

- (i) **Issuing currency:** Sole authority to print and regulate the nation's money (e.g., Bank of Uganda issues the Ugandan shilling).
- (ii) **Formulating and implementing monetary policy:** Controls inflation and stabilizes the economy by adjusting interest rates, reserve requirements, and money supply.
- (iii) **Regulating and supervising banks:** Ensures commercial banks operate safely, protects depositors, and maintains trust in the financial system.
- (iv) **Lender of last resort:** Provides emergency loans to banks during financial crises to prevent collapse.
- (v) **Managing foreign exchange and reserves:** Stabilizes the national currency by holding foreign reserves and intervening in exchange markets.
- (vi) **Controlling inflation and stabilizing prices:** Uses monetary tools to keep inflation within target levels.
- (vii) **Debt management:** Helps the government finance deficits by issuing bonds and managing public debt.
- (viii) **Promoting financial stability:** Prevents systemic risks and ensures smooth functioning of payment systems.

- (ix) **Banker to commercial banks.** The central bank accepts deposits from commercial banks and it acts as a clearing house for commercial banks, that is, they settle their debts through the central banks.
- (x) **Manager and custodian of foreign currencies.** It is the task of the central bank to maintain a stable foreign exchange rate so as to maintain the value of the domestic currency.

### Example (Uganda Context)

The **Bank of Uganda (BoU)**:

- (i) Issues the Ugandan shilling.
- (ii) Sets the Central Bank Rate (CBR) to control inflation.
- (iii) Regulates commercial banks and microfinance institutions.
- (iv) Manages foreign reserves to stabilize the shilling against global currencies.

### Summary

The central bank is the **backbone of the financial system**, ensuring stability by **issuing currency, controlling inflation, regulating banks, managing reserves, and acting as lender of last resort.**

### The monetary policy

**Monetary policy** refers to the actions taken by a country's **central bank** to regulate the supply of money and credit in the economy, with the aim of achieving stability, controlling inflation, encouraging growth, and maintaining employment.

### Aims (Objectives) of the monetary policy

- (i) **Price stability:** Control inflation and prevent deflation to maintain the purchasing power of money.
- (ii) **Economic growth:** Ensure adequate money supply to support investment, production, and overall development.
- (iii) **Employment generation:** Encourage borrowing and investment to create jobs and reduce unemployment.
- (iv) **Stability of currency:** Maintain confidence in the national currency by preventing excessive fluctuations in value.
- (v) **Balance of payments stability:** Manage foreign reserves and exchange rates to support international trade and avoid deficits.
- (vi) **Financial stability:** Prevent banking crises, ensure smooth functioning of payment systems, and protect depositors.
- (vii) **Control of credit:** Direct credit to productive sectors and discourage speculative or harmful lending.
- (viii) Ensure equitable income distribution
- (ix) Maintain a stable foreign exchange rate

## Example (Uganda Context)

The **Bank of Uganda (BoU)** pursues monetary policy objectives such as:

- (i) Keeping inflation around its target level (5%).

**Note:** An inflation level of 5% means that, on average, the **general price level of goods and services in the economy has increased by 5% over a year** compared to the previous year.

- (ii) Using the **Central Bank Rate (CBR)** to influence lending rates.
- (iii) Managing liquidity through open market operations.
- (iv) Stabilizing the Ugandan shilling against foreign currencies.

## Instruments (Tools) of the monetary policy

The **central bank** uses various instruments to regulate the supply of money and credit in the economy. These tools are broadly divided into **quantitative (general)** and **qualitative (selective)** instruments.

### Quantitative (General) Instruments

These affect the overall money supply in the economy.

- (i) **Open Market Operations (OMO)**

Buying and selling government securities to control liquidity.

- Buying securities → increases money supply.
- Selling securities → reduces money supply.

- (ii) **Bank Rate Policy**

The interest rate at which the central bank lends to commercial banks.

- Lower bank rate → cheaper loans → expansionary policy.
- Higher bank rate → costlier loans → contractionary policy.

- (iii) **Cash Reserve Ratio (CRR)**

Percentage of deposits commercial banks must keep with the central bank.

- Higher CRR → less money for lending → contractionary.
- Lower CRR → more money for lending → expansionary.

- (iv) **Statutory Liquidity Ratio (SLR)**

Minimum percentage of deposits banks must hold in liquid assets (cash, gold, approved securities). Used to regulate credit flow and ensure stability.

## Qualitative (Selective) Instruments

These target specific sectors or uses of credit.

- (i) **Credit rationing:** Restricting or prioritizing loans to certain industries (e.g., agriculture, manufacturing).
- (ii) **Margin requirements:** Setting rules on how much can be borrowed against securities.
- (iii) **Directives to banks:** Central bank issues guidelines on lending practices (e.g., discouraging speculative loans).
- (iv) **Moral suasion:** Persuading banks to align lending with national economic goals.
- (v) **Currency reforms.** This refers to the act of changing money by the government from one form to another. It is aimed at reducing money supply and knowing the amount of money in the economy. It is normally done when the currency has totally lost value due to high levels of inflation.

## Example (Uganda Context)

The **Bank of Uganda (BoU)** uses:

- (i) **Central Bank Rate (CBR)** to influence lending rates.
- (ii) **Open Market Operations** to manage liquidity.
- (iii) **Reserve requirements** to control credit creation.
- (iv) **Selective credit controls** to support priority sectors like agriculture.

## Limitations of the application of the monetary policy in developing countries

- (i) **Underdeveloped financial markets:** Weak banking systems and limited capital markets reduce the transmission of monetary policy. Many people rely on informal financial systems (e.g., cash savings, SACCOs, mobile money), making central bank tools less effective.
- (ii) **Large informal sector:** A significant portion of economic activity occurs outside the formal banking system, limiting the reach of monetary policy.
- (iii) **Low financial literacy and inclusion:** Many citizens lack access to banking services, so changes in interest rates or reserve requirements have little direct impact.
- (iv) **Dependence on agriculture:** Economies heavily reliant on agriculture face supply shocks (like droughts) that monetary policy cannot control.
- (v) **Weak institutional capacity:** Central banks may lack independence or face political interference, reducing credibility and effectiveness.
- (vi) **Inflationary pressures from structural issues:** Inflation often arises from supply-side problems (poor infrastructure, food shortages), which monetary policy cannot easily fix.
- (vii) **External dependence:** Developing countries rely heavily on imports and foreign capital. Exchange rate fluctuations and global shocks weaken domestic monetary control.
- (viii) **Limited data and forecasting capacity:** Poor statistical systems make it difficult to design and implement precise monetary policies.
- (ix) **Fiscal dominance:** Governments often run large deficits and borrow heavily, forcing central banks to accommodate fiscal needs rather than focus on inflation control.

### Example (Uganda Context)

- (i) The **Bank of Uganda** sets the Central Bank Rate (CBR) to manage inflation.
- (ii) However, widespread use of **mobile money and informal savings groups** means many Ugandans are outside the formal banking system.
- (iii) Inflation driven by **food prices and fuel imports** often lies beyond the reach of monetary policy tools.

### Commercial banking

A **commercial bank** is a financial institution that accepts deposits from the public and provides loans and other financial services to individuals, businesses, and governments. It operates with the primary goal of earning profit while supporting economic activity.

### Functions of commercial banks

- (i) **Accepting deposits:** Provide safe custody for money through savings accounts, current accounts, and fixed deposits. They encourage savings by offering interest on deposits.
- (ii) **Providing loans and advances:** Offer personal loans, business loans, mortgages, and overdrafts. They support investment, consumption, and economic growth.
- (iii) **Facilitating payments and settlements:** Enable transactions through cheques, debit/credit cards, mobile banking, and electronic transfers. Hence, act as a bridge for smooth trade and commerce.
- (iv) **Credit creation:** By lending more than the deposits they hold, banks expand the money supply in the economy.
- (v) **Foreign exchange services:** Provide currency exchange and international remittance services to support trade.
- (vi) **Agency functions:** Act as agents for customers by collecting bills, paying insurance premiums, and managing investments.
- (vii) **Safe custody and advisory services:** Offer lockers for valuables and financial advice to clients.
- (viii) They give financial advice and offer technical services to customers on business and money.

### Example (Uganda Context)

- (i) **Stanbic Bank Uganda** – offers loans, deposits, and digital banking.
- (ii) **Centenary Bank** – focuses on financial inclusion, serving rural communities.
- (iii) **DFCU Bank** – provides corporate and SME financing.
- (iv) **Equity Bank Uganda** – strong in mobile and agency banking.

### Types of deposits (Accounts)

- (i) **Demand Deposits (Current Accounts)**
  - Money can be withdrawn at any time without notice.
  - Usually no interest is paid.
  - Commonly used by businesses for frequent transactions.

(ii) **Savings Deposits (Savings Accounts)**

- Encourage individuals to save regularly.
- Limited withdrawals allowed.
- Earn interest at a modest rate.

(iii) **Fixed Deposits (Time Deposits)**

- Money is deposited for a fixed period (e.g., 6 months, 1 year).
- Higher interest rates compared to savings accounts.
- Cannot be withdrawn before maturity without penalty.

(iv) **Recurring Deposits**

- Depositors pay a fixed amount regularly (monthly).
- Useful for salaried individuals to build savings over time.
- Earn interest similar to fixed deposits.

(v) **Call Deposits**

- Short-term deposits that can be withdrawn on demand with prior notice.
- Often used by businesses and institutions for temporary surplus funds.

(vi) **Certificates of Deposit (CDs)**

- Issued by banks for a fixed term at a fixed interest rate.
- Tradable in some markets.
- Suitable for investors seeking safe, short-term returns.

## **Assets and Liabilities of Commercial banks**

### **Assets of commercial banks**

Assets are items from which the bank receives income and profits and claims against other institutions. They include;

- (i) Reserves with the central bank.
- (ii) Deposits with other banks and non-banks.
- (iii) Fixed assets e.g. buildings, furniture, vehicles etc.
- (iv) Loans, advances and overdrafts to customers
- (v) Acceptances and guarantees made by other parties.
- (vi) Investments in securities and shares in other companies.
- (vii) Retained profits
- (viii) Bills discounted for customers (that is, the bank pays less money than that stated on bill before the maturity period.)

### **Liabilities of Commercial banks**

Liabilities are claims against the commercial bank, that is, what the bank owes to other banks and non-bank institutions. They include;

1. Deposits of customers

2. Deposits in the bank by other banks
3. Money borrowed from the Central banks
4. Capital contributed by shareholders (Paid up capital)
5. Acceptances, receivables and guarantees on behalf of the customers
6. Dividends payable to shareholders
7. Reserve funds.

## Credit

**Credit** refers to the trust or agreement that allows one party (the borrower) to receive money, goods, or services now and pay for them later, usually with interest.

**Credit instruments** are the documents or tools used to provide, record, and regulate credit transactions between lenders and borrowers. They serve as evidence of debt and outline the terms of repayment.

Credit instruments include the following:

- (i) **Promissory note:** A written promise by a borrower to repay a specific sum to the lender at a future date. **Legally binding and often used in personal or business loans.**
- (ii) **Bill of exchange:** A written order directing one party to pay a fixed amount to another at a specified date. Common in international trade and commercial transactions.
- (iii) **Cheque:** A written order by an account holder instructing the bank to pay a certain amount to a person or organization. Used for everyday payments and settlements.
- (iv) **Bank Draft:** A payment instrument issued by a bank guaranteeing payment to the recipient. Safer than cheques since it is backed by the bank.
- (v) **Letter of Credit:** Issued by a bank to guarantee payment to a seller once conditions of a trade contract are met. Widely used in international trade.
- (vi) **Credit Card:** Allows holders to borrow funds up to a limit for purchases, repayable later with interest. Convenient for consumer credit.
- (vii) **Debit Card (with overdraft facility):** Though primarily linked to deposits, some debit cards allow overdraft, functioning as a credit instrument.
- (viii) **Trade Credit:** An informal arrangement where suppliers allow buyers to pay later for goods/services. Common in business-to-business transactions.

## Example (Uganda Context)

- (i) **Commercial banks** like Stanbic and Centenary issue **cheques, drafts, and credit cards.**
- (ii) **Microfinance institutions** often rely on **promissory notes** for loan agreements.
- (iii) **International trade in Uganda** frequently uses **letters of credit** to guarantee payments for imports and exports.

## Credit creation

**Credit creation** is the process by which **commercial banks expand the money supply** in an economy by lending more than the actual cash deposits they receive.

## How Credit Creation Works

- (i) **Deposits received:** Customers deposit money in banks (e.g., 1,000,000 UGX).
- (ii) **Reserve requirement:** Banks are required to keep a fraction of deposits as reserves with the central bank (say 10%). In this case, 100,000 UGX is kept aside.
- (iii) **Loans issued:** The remaining 900,000 UGX is lent out to borrowers.
- (iv) **Re-deposit of loans:** Borrowers spend the loan, and the money eventually gets redeposited into the banking system.
- (v) **Cycle continues:** Each time, banks keep a fraction as reserves and lend out the rest. This process multiplies the initial deposit many times over.

### Credit (Bank deposit/ Money) multiplier

Credit multiplier (M) is the number of times the initial bank deposits multiply to give the final bank deposits

$$\text{Credit multiplier (M)} = \frac{\text{Total final deposits}}{\text{Total initial deposits}} = \frac{1}{\text{Cash ratio}}$$

#### Example 1

Calculate the total credit created when the initial deposits are 5,000/= and the cash ratio is 5%

Solution

$$\text{Credit multiplier} = \frac{1}{\text{CR}} = \frac{1}{5\%} = \frac{1}{0.05} = 20$$

$$\text{Credit multiplier} = \frac{\text{Total final deposits}}{\text{Total initial deposit}}$$

$$\text{Total final deposit} = 20 \times 5000 = 100,000/=$$

Note. From  $M = \frac{1}{\text{Cash ratio}}$ ; when the cash ratio is increased the credit multiplier reduces and a reduction in the cash ratio leads to an increase in the multiplier.

#### Example to illustrate the process of credit creation by the commercial bank

- Assume one commercial bank which lends to several individuals  $A_1, A_2, A_3, \dots, A_n$ .
- Assume the cash ratio be fixed at 20%
- Let the initial deposits ( $D_0$ ) be 1000/=
- Assume that the several individuals  $A_1, A_2, A_3, \dots, A_n$  are able and willing to borrow money from the bank and the bank is willing to lend.

This process of credit creation is illustrated as below;

Person	New deposit	Cash reserve (Cr=20%)	New loan (80%)
A <sub>1</sub>	1000	200	800
A <sub>2</sub>	800	160	640
A <sub>3</sub>	640	128	512
A <sub>4</sub>	512	102.4	409.6
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A <sub>n</sub>	5000/=	1000/=	4000/=

- From the above table, person A, deposited 1000/= in the bank, The bank kept 20% as cash reserve and lent out 80% in form of a cheque to person A<sub>2</sub>.
- Person A<sub>2</sub> deposited the cheque to the same bank which gave him a loan. Then out of 800/=, the bank kept 20% as cash reserve and lent out 640/= to person A<sub>3</sub> and the process continues.

Total deposits = 1000 + 800 + 640 + 512 + ..... .

Total deposits created are given by the formula; Total deposits =  $Do \cdot \frac{1}{CR}$

Where Do = Initial deposits

Total deposit created =  $1000 \cdot \frac{1}{20\%} = 1000 \times 5 = 5000/=$

### Limitations of credit creation by Commercial banks in developing countries

- (i) **Large informal sector:** A significant portion of economic activity occurs outside the formal banking system, limiting deposits and loans.
- (ii) **Low financial inclusion:** Many people lack access to banking services, so fewer deposits are mobilized for credit creation.
- (iii) **Weak banking infrastructure:** Limited branch networks, poor technology, and inadequate capital reduce banks' ability to expand credit.
- (iv) **High default risks:** Weak enforcement of loan repayment and poor credit information systems discourage banks from lending widely.
- (v) **Dependence on agriculture:** Seasonal incomes and vulnerability to droughts or floods make deposits unstable and loan recovery difficult.
- (vi) **Inflationary pressures:** Credit expansion often fuels inflation instead of productive investment, especially when supply-side constraints exist.
- (vii) **Political interference:** Governments may pressure banks to lend to unproductive sectors, undermining efficiency.
- (viii) **Limited reserves and capital:** Small deposit bases and low savings rates restrict the multiplier effect of credit creation.

- (ix) **External shocks:** Heavy reliance on imports and foreign capital makes domestic credit creation vulnerable to global price changes and currency fluctuations.
- (x) **Use of restrictive monetary policies by the central bank.** The central bank limits the powers of commercial banks to create credit by using the restrictive tools of the monetary policy for example increasing bank rate, selling government securities to the public, increasing minimum legal reserve requirement etc.
- (xi) **Presence of inadequate credit worthy borrowers.** In developing countries, there is lack of enough credit worthy borrowers due to lack collateral securities. This leads to excess liquidity in commercial banks due to limited borrowing hence limiting the process.
- (xii) **The theory assumes that borrowers deposit cheques they get in the same bank.** This is not always true. Therefore one bank keeps on losing deposits to other banks hence limiting the process of credit creation by a single bank.

### Example (Uganda Context)

- (i) Many Ugandans rely on **mobile money and SACCOs** rather than formal banks, limiting deposit mobilization.
- (ii) Agricultural dependence means credit creation is unstable during poor harvests.
- (iii) Inflationary pressures from fuel and food imports reduce the effectiveness of bank lending.

### Dilemma facing the Commercial banks in their Lending policy

The commercial bank is usually faced with the problem of achieving the objectives of profitability, liquidity and security simultaneously. If it increases lending so as to earn profits, it will not meet the customers' demands (liquidity). On the other hand, if it maintains liquidity for its customers, it will not get profits as there will be no loanable funds. In order to minimize these conflicts, the commercial bank has to do the following;

### Measures of commercial bank for profit maximization

- (i) Giving low interest rates to the depositors and charging high interest rates on the borrowers.
- (ii) under taking short term and medium term commercial investments.
- (iii) **Charging** commission for the services rendered to their customers.
- (iv) **Investment** in government securities as a way of earning interest.
- (v) **Discounting** bills of exchange i.e. the bank can pay less money to the holder of the bill as compared to that stated on it before it's maturity.

### Measures of commercial bank for liquidity

**Liquidity** refers to a commercial bank's ability to **meet its short-term obligations**—mainly the withdrawal demands of depositors and payment commitments—without facing financial distress. To ensure liquidity, banks adopt several measures.

- (i) **Maintaining Cash Reserves:** Holding adequate cash in hand and balances with the central bank to meet daily withdrawal needs.
- (ii) **Statutory Reserve Requirements:** Complying with central bank rules like the **Cash Reserve Ratio (CRR)** and **Statutory Liquidity Ratio (SLR)**. Ensures banks always keep a minimum portion of deposits as liquid reserves.

- (iii) **Investment in Short-term Securities:** Placing funds in highly liquid assets such as treasury bills and government bonds that can be quickly converted to cash.
- (iv) **Interbank Lending and Borrowing:** Using the interbank market to borrow funds from other banks when liquidity is tight.
- (v) **Maintaining Liquidity Ratios:** Monitoring ratios like the **Liquidity Coverage Ratio (LCR)** and **Quick Ratio** to ensure sufficient liquid assets relative to liabilities.
- (vi) **Diversification of Assets:** Avoiding excessive lending in illiquid sectors (like long-term real estate projects) and balancing with short-term loans.
- (vii) **Access to Central Bank Facilities:** Using the central bank's **lender of last resort** function to borrow emergency funds when needed.
- (viii) **Prudent Credit Policy:** Ensuring loans are given responsibly to minimize defaults and maintain liquidity.

### Measures of commercial bank for security,

- (i) The bank has to secure a collateral security from the borrower.
- (ii) It should have aimed personnel to safe guard the bank.
- (iii) The bank should be made up of strong buildings for security purposes,

### Problems facing Commercial banks in Developing countries

- (i) **Low financial inclusion:** A large portion of the population remains unbanked, relying on informal savings groups or mobile money. This reduces deposit mobilization and limits credit creation.
- (ii) **Weak financial infrastructure:** Limited branch networks, outdated technology, and poor connectivity hinder banking services. Rural areas often lack access to formal banking.
- (iii) **High default risks:** Weak credit information systems and poor enforcement of loan repayment increase non-performing loans. Banks become cautious, restricting lending to SMEs and farmers.
- (iv) **Dependence on agriculture:** Seasonal incomes and vulnerability to droughts or floods make deposits unstable and loan recovery difficult.
- (v) **Inflation and currency instability:** Frequent inflationary pressures erode savings and complicate lending. Exchange rate volatility affects foreign trade financing.
- (vi) **Political interference:** Governments may pressure banks to lend to unproductive sectors or bail out state-owned enterprises. This undermines efficiency and independence.
- (vii) **Limited capital and reserves:** Low savings rates restrict the deposit base, limiting the multiplier effect of credit creation.
- (viii) **External shocks:** Heavy reliance on imports and foreign capital makes banks vulnerable to global price changes and currency fluctuations.
- (ix) **Unfavorable government policies in form of fixing high interest rates.** This discourages individuals from borrowing money from commercial banks.
- (x) **Limited skilled manpower in developing countries.** Labour in developing countries lacks the necessary skills required to operate and manage banking activities. This leads to mismanagement of funds. Some banks are forced to import skilled manpower from abroad which is expensive.
- (xi) **High levels of political instability in developing countries.** This makes it difficult to open up more branches especially in rural areas due to fear of losing life and making losses.
- (xii) **High levels of corruption and embezzlement of funds.** There is a high degree of corruption and embezzlement of bank funds by bank officials. This limits the expansion of the banking sector.

## Example (Uganda Context)

- (i) Many Ugandans rely on **mobile money and SACCOs** rather than formal banks, limiting deposit growth.
- (ii) Agricultural dependence means credit creation is unstable during poor harvests.
- (iii) Inflationary pressures from fuel and food imports reduce the effectiveness of bank lending.
- (iv) Political influence sometimes affects lending priorities, especially in state-linked projects.

## The role of foreign commercial banks in developing countries

### Positive Role (Implications) of foreign commercial banks in developing countries

- (i) **Employment creation:** Foreign banks employ local staff such as accountants, credit officers, managers, and support workers. This raises household incomes and improves living standards.
- (ii) **Improved efficiency and competition:** They introduce advanced banking technologies and service delivery methods. Local banks are forced to innovate, improving overall efficiency in the sector.
- (iii) **Government revenue:** Foreign banks pay taxes, contributing to national revenue. This supports public services and infrastructure development.
- (iv) **Capital inflows:** They bring foreign capital into the country, strengthening the financial system. This increases funds available for lending to businesses and individuals.
- (v) **Financial inclusion:** By offering modern services like ATMs, mobile banking, and credit cards, foreign banks expand access to financial services. This helps integrate more people into the formal economy.
- (vi) **Support for international trade:** Foreign banks facilitate trade by offering letters of credit, foreign exchange services, and international payment systems. This reduces barriers for exporters and importers.
- (vii) **Skill transfer:** Local employees gain exposure to international banking practices and standards. This builds human capital and strengthens the domestic financial sector.
- (viii) **They promote the exploitation and utilization of the idle local resources.** This is because they help to attract foreign investors to invest their capital in the country. This improves on the productive capacities in the economy hence economic growth and development.
- (ix) **They promote entrepreneurial skills in the economy.** The foreign commercial banks help to train the local individuals with the necessary managerial skills required to operate modern banking enterprises. This helps to close the manpower gap in developing countries. In addition, they help to local individuals to get loans and set up business activities.
- (x) They promote good international relationships between their countries of origin and other countries where their business activities are extended. This enhances mutual understandings among countries.
- (xi) They help to facilitate and promote international trade. This is because they finance export and import trade by providing foreign exchange and money transfer services to the traders.

### Negative role (Implications) of foreign commercial banks in developing countries

1. **They accelerate regional income inequalities in economy.** This is because most of their banking activities are mainly concentrated in urban areas neglecting the rural areas. This creates regional

imbalance.

2. **They lead to profit repatriation.** Foreign commercial banks tend to plough back the profits made to their home countries instead of re-investing them in the countries where they operate. This leads to low capital accumulation in the economy.
3. **They undermine the provision of banking services to the small scale local investors.** This discourages the production of cheap goods and services for the local people.
4. **They lead to unemployment in the economy.** This is because they tend to employ mainly foreigners especially at the level of management and they use capital intensive techniques of service delivery hence technological unemployment.
5. **They encourage rural -urban migration.** This is because most of their business activities are concentrated in urban centers due to poor infrastructure in rural areas. This leads to congestion in urban areas and minimal contact with the local population,
6. **They lead to divergence between private and society interests.** This is because foreign commercial banks aim at maximizing profits at the expense of the society. Some of their policies are not in line with the national development goals of the country like poverty eradication, rural development etc.
7. **They discourage the development of local financial institutions.** This is because foreign commercial banks have huge capital and they have the capacity to operate on a large scale and provide better quality services to their customers at competitive rates. This undermines the growth of the local banking sector.
8. **They interfere in the politics of developing countries.** Foreign commercial banks use their economic power to influence national policies and politics of the countries in which they operate in their favor. This results into loss of independence in local decision making.
9. **They limit the successful implementation of the monetary policies.** This is because the central bank has little control over their activities.

## Non-Bank financial Intermediaries

**Non-Bank Financial Intermediaries (NBFIs)** are financial institutions that provide services similar to banks but **do not have a full banking license** and cannot accept traditional demand deposits. They play a crucial role in mobilizing savings, providing credit, and supporting financial inclusion, especially in developing countries.

### Key Types of NBFIs

- (i) **Insurance Companies**
  - Provide risk coverage (life, health, property insurance).
  - Mobilize long-term savings through premiums.
- (ii) **Pension Funds**
  - Collect retirement savings and invest them in securities.
  - Provide long-term capital for development projects.
- (iii) **Microfinance Institutions (MFIs)**
  - Offer small loans to low-income households and small businesses.
  - Promote financial inclusion in rural and underserved areas.
- (iv) **Savings and Credit Cooperative Organizations (SACCOs)**
  - Member-owned cooperatives that mobilize savings and provide loans.

- Strong presence in rural communities.
- (v) **Development Finance Institutions (DFIs)**
  - Provide long-term financing for infrastructure, agriculture, and industrial projects.
  - Often supported by governments or international organizations.
- (vi) **Leasing and Finance Companies**
  - Offer leasing services for equipment, vehicles, and machinery.
  - Help businesses access assets without large upfront payments.
- (vii) **Investment Funds / Mutual Funds**
  - Pool money from investors and invest in diversified portfolios.
  - Provide opportunities for small investors to access capital markets.

### Example (Uganda Context)

- (i) **Uganda Microfinance Support Centre (MSC)** – provides affordable credit to SACCOs and MFIs.
- (ii) **Insurance companies** like Jubilee Insurance and UAP Old Mutual – mobilize savings and provide risk coverage.
- (iii) **NSSF (National Social Security Fund)** – acts as a pension fund, investing workers’ savings in long-term projects.
- (iv) **SACCOs** – widespread in rural Uganda, supporting farmers and small traders.

### Importance of NBFIs

- (i) Promote **financial inclusion** by reaching populations underserved by banks.
- (ii) Mobilize **long-term savings** for investment.
- (iii) Provide **specialized financial services** (insurance, pensions, leasing).
- (iv) Support **economic development** by financing SMEs, agriculture, and infrastructure.

### Challenges of Non-Bank financial Intermediaries

- (i) **Limited capital base:** Many NBFIs operate with small funds, restricting their ability to provide large-scale loans or investments.
- (ii) **High default risks:** Weak credit assessment systems and poor enforcement of loan repayment lead to high non-performing loans.
- (iii) **Low financial literacy:** Many clients lack knowledge of financial products, leading to misuse of services or reluctance to participate.
- (iv) **Weak regulatory framework:** Inadequate supervision and regulation expose NBFIs to fraud, mismanagement, and instability.
- (v) **Competition from commercial banks:** Larger banks with stronger capital and technology often overshadow NBFIs, limiting their market share.
- (vi) **Limited outreach:** Many NBFIs struggle to expand beyond urban centers, leaving rural populations underserved.
- (vii) **Dependence on donor funding:** Some microfinance institutions and cooperatives rely heavily on external support, making them vulnerable when funding declines.
- (viii) **Technological challenges:** Lack of modern systems for digital banking, record-keeping, and mobile services reduces efficiency.
- (ix) **Economic instability:** Inflation, currency fluctuations, and external shocks reduce savings mobilization and increase loan defaults.

- (x) **Governance and corruption issues:** Poor management practices and political interference weaken trust and sustainability.

### Solution to the Challenges of Non-Bank financial Intermediaries

- (i) **Strengthening regulation and supervision:** Governments should establish clear legal frameworks and strong regulatory bodies to monitor NBFIs. Regular audits and compliance checks reduce fraud and mismanagement.
- (ii) **Capacity building and training:** Provide training for NBFI staff in risk management, governance, and modern financial practices. Build managerial skills to improve efficiency and accountability.
- (iii) **Enhancing financial literacy:** Educate communities about savings, insurance, pensions, and credit management. Awareness campaigns increase trust and participation in NBFIs.
- (iv) **Improving access to technology:** Adopt digital platforms for mobile banking, record-keeping, and loan tracking. Technology reduces costs and expands outreach, especially in rural areas.
- (v) **Expanding capital base:** Encourage partnerships with commercial banks, DFIs, and international donors to increase funding. Promote savings mobilization through attractive products.
- (vi) **Risk management systems:** Establish credit information bureaus to track borrowers' repayment history. Use insurance schemes to protect against loan defaults and agricultural risks.
- (vii) **Promoting rural outreach:** Support SACCOs and MFIs to expand services in rural areas. Provide incentives for NBFIs to serve farmers and small traders.
- (viii) **Reducing dependence on donor funding:** Encourage self-sustainability through income-generating activities and diversified investments.
- (ix) **Strengthening governance:** Enforce transparency, accountability, and democratic management in cooperatives and MFIs. Limit political interference in NBFI operations.

### Example (Uganda Context)

- (i) The **Bank of Uganda** has strengthened regulation of microfinance institutions and SACCOs to reduce fraud.
- (ii) The **National Social Security Fund (NSSF)** invests workers' savings in infrastructure and government securities to ensure sustainability.
- (iii) **Mobile money integration** has helped SACCOs and MFIs expand outreach to rural communities.
- (iv) Financial literacy programs by NGOs and government agencies are improving awareness of savings and insurance.

### Revision exercise 2

#### Section A questions

1. (a) Distinguish with the help of examples between Banking and Non-Banking financial intermediaries  
(b) Outline two features of banking financial intermediaries in your country
2. (a) Differentiate between cash ratio and liquidity ratio  
(b) Give two reasons as to why liquidity is desired in the economy
3. Given that a bank has an initial deposit of shs. 1 million and the required cash ratio of 25%.

Calculate the;

- (i) Credit multiplier      (ii) Total deposits created.
- 4 (a) what is meant Bank deposit (credit) multiplier?  
(b) State three determinants of bank deposits multiplier in your country
  - 5 (a) What is a Central bank?  
(b) Mention three functions of the Central bank.
  - 6 (a) Define the term "credit creation"  
(b) Given that the initial deposit amounts to 10,000/= and final deposit amounts to 200,000/=.  
Calculate the cash ratio of the commercial bank
  - 7 Given cash ratio of 0.2 and initial deposit of USD. 1000. Calculate the total credit in Uganda shillings that is created on the basis of this deposit. (USD 1. = Ug. Shs. 1,500/=).
  8. Distinguish between the following terms
    - (i) Cash ratio and liquidity ratio.
    - (ii) Treasury bills and bonds
    - (iii) Bank rate and re-discount rate
    - (iv) Reserve ratio and legal reserve requirement
    - (v) Credit squeeze and cash reserve
    - (vi) Nominal money value and real money value

### Section B questions

- 1 (a) Explain the objectives of the monetary policy.  
(b) What factors limit the effective implementation of the monetary policy in your country?
- 2 (a) What is meant by the monetary policy?  
(b) Explain the various monetary policy instruments used by the central bank of your country.  
(c) Explain the factors that influence the application of the monetary policy in an economy?
- 5 (a) Given the initial deposit of 250,000/= and cash ratio of 20%, show how a commercial bank would create credit.  
(b) What are the limitations of credit creation in your country?
- 6 (a) Illustrate how commercial banks create credit in an economy  
(b) Explain the factors that influence the process of credit creation in your country?
- 7 (a) What is the role of foreign commercial banks in the development process of your country?  
(b) What problems do commercial banks face in developing countries?
- 8 (a) What are the assets and liabilities of a commercial bank?  
(b) How are commercial banks able to achieve both liquidity and profitability?

## Economic inflation

**Inflation** refers to the continuous (persistent) rise in the general price level of goods and services in the economy in a given time. It is measured using price indices by the following formula:

$$\text{Inflation} = \frac{P_t - P_{t-1}}{P_{t-1}}$$

Where  $P_t$  = present year price index,  $P_{t-1}$  = previous year prices

## State of inflation

**State of inflation** refers to the **current condition or situation of inflation in an economy** at a given time. It describes whether prices of goods and services are rising, stable, or falling, and at what rate.

### Key Aspects of the State of Inflation

- (i) **Level of inflation:** Whether inflation is **high, moderate, or low**. Example: 2–3% is considered stable, while 20%+ is high inflation.
- (ii) **Trend of inflation:** Whether inflation is **increasing, decreasing, or stable** over time. Example: Inflation falling from 10% to 5% shows a declining trend.
- (iii) **Type of inflation:** Can be **demand-pull inflation** (caused by high demand), **cost-push inflation** (caused by rising production costs), or **structural inflation** (due to inefficiencies in the economy).
- (iv) **Impact on the economy:** The state of inflation affects **purchasing power, savings, investment, and economic growth**. High inflation reduces the value of money, while moderate inflation can encourage spending and investment.

### Example

- (i) If Uganda's inflation rate is **3% and declining**, the **state of inflation** is *low and stable*.
- (ii) If Zimbabwe's inflation rate is **200% and rising**, the **state of inflation** is *hyperinflation*.

## Classification of inflation

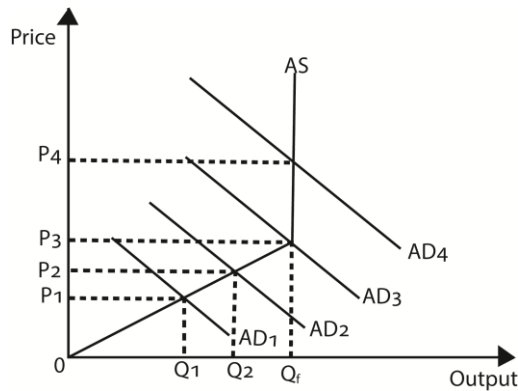
### 1) According to the state of inflation

- **Mild (creeping / gradual/moderate) inflation.** This is where the persistent increase in the general price level proceeds at a slow rate usually not exceeding 10%. This state of inflation is good since it acts as an incentive to the producers. It increases savings, investments, and output and employment opportunities.
- **Hyper (Run away / Galloping) Inflation.** This is where the general price level increases at a very high rate, the increase taking place within hours, days or weeks and the percentage point increase per annum exceeds 20%. In this case, money loses total value and people prefer to hold real goods than money. This state of inflation is bad because it discourages production as consumers are reluctant to buy commodities at very high prices.

### 2) According to causes

#### (a) Demand pull inflation

Demand pull inflation is where the persistent increase in the general price level arises out of excess aggregate demand for goods and services over aggregate supply at conditions of full employment. It is described as a situation where there is too much money chasing too few goods.



The figure above shows that increase in aggregate demand from AD1 to AD3 is accompanied by higher output as well as higher prices. Increase in aggregate demand beyond AD<sub>3</sub> does not increase output but only prices. At AD<sub>3</sub>, the economy attains full employment level OQ<sub>f</sub>.

### Causes of demand pull inflation

- (i) **Excess consumer spending:** When households increase consumption due to higher incomes, easy credit, or optimism, demand rises faster than supply.
- (ii) **Government expenditure:** Large public spending on infrastructure, subsidies, or social programs increases overall demand for goods and services.
- (iii) **Expansionary monetary policy:** Central banks lowering interest rates or increasing money supply makes borrowing cheaper, boosting investment and consumption.
- (iv) **Rapid economic growth:** Strong growth raises employment and wages, which fuels demand for goods and services.
- (v) **Foreign demand (exports):** A surge in exports increases demand for domestic goods, reducing availability for local consumers and pushing prices up.
- (vi) **Speculative demand:** When investors or consumers expect prices to rise, they buy more now, creating excess demand relative to supply.
- (vii) **Increase in population growth.** This increases the consumption of commodities in the economy hence demand pull inflation.
- (viii) Increase in exportation of scarce commodities and a decrease in importation of scarce commodities

### Example

If Uganda experiences **higher government spending on infrastructure** and **increased household borrowing due to lower interest rates**, demand for cement, fuel, and consumer goods may exceed supply. This leads to **higher prices**, a classic case of demand-pull inflation.

### Policies (solutions) for demand - pull Inflation

#### Monetary Policies

- (i) **Increase interest rates:** Makes borrowing more expensive, reducing consumer spending and business investment.

- (ii) **Reduce money supply:** Central banks can sell government securities or raise reserve requirements to limit liquidity.
- (iii) **Tight credit controls:** Restricting excessive lending prevents overheating of demand.

### Fiscal Policies

- (iv) **Reduce government spending: Cutting public expenditure lowers aggregate demand.**
- (v) **Increase taxes: Higher taxes reduce disposable income, curbing consumption.**
- (vi) **Balanced budgets:** Avoiding deficit financing prevents excess demand pressures.

### Supply-Side Policies

- (vii) **Boost production capacity: Encourage investment in industries to increase supply and meet demand.**
- (viii) **Support agriculture and SMEs: Expanding output in key sectors reduces shortages.**
- (ix) **Improve infrastructure: Better transport, energy, and technology lower production costs and expand supply.**

### Trade Policies

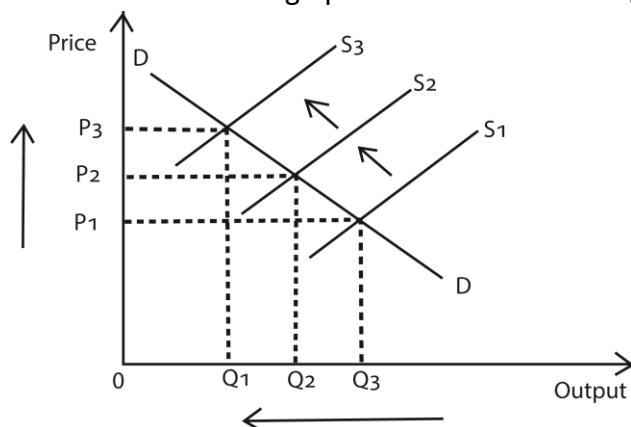
- (x) **Encourage imports of essential goods: Helps meet excess demand and stabilize prices.**
- (xi) **Reduce trade barriers:** Ensures smoother flow of goods to balance demand and supply.

### Example (Uganda Context)

- (i) The **Bank of Uganda** often raises the **Central Bank Rate (CBR)** to control inflation when demand surges.
- (ii) Government adjusts **tax policies** and reduces subsidies to manage excess demand.
- (iii) Programs to support **agriculture and manufacturing** aim to expand supply and reduce inflationary pressures.

### (b) Cost push inflation

**Cost push inflation** is where the persistent increase in the general price level arises out of increase in the costs of production which increases the prices of commodities for example increase in wages, interest, rent and prices for raw materials. The costs are shifted to consumers in form of high prices of the consumer goods.



From the graph, there is a continuous shift in the supply curve to the left (decrease in supply) due to increase in the costs of production at constant demand. This increases the prices of commodities in the economy.

### Forms (Causes) of cost push inflation

- (i) **Increase in wages:** Higher labor costs due to wage hikes, union demands, or minimum wage laws. Because firms pass these costs on to consumers through higher prices.
- (ii) **Rising raw material costs:** Increases in the price of inputs like oil, metals, or agricultural products. Example: A global oil price surge raises transport and production costs.
- (iii) **Imported inflation:** When the cost of imported goods rises due to currency depreciation or global price increases. Developing countries reliant on imports are especially vulnerable.
- (iv) **Supply chain disruptions:** Natural disasters, pandemics, or geopolitical conflicts reduce supply and raise costs. Example: COVID-19 disrupted global supply chains, increasing costs worldwide.
- (v) **Government regulations and taxes:** New environmental rules, higher corporate taxes, or tariffs increase production costs. Firms respond by raising prices.
- (vi) **Monopoly or market power:** When dominant firms raise prices to maintain profit margins despite higher costs.
- (vii) **Decline in productivity:** Inefficiencies, outdated technology, or poor infrastructure reduce output per worker, raising unit costs.

### Example (Uganda Context)

- (i) **Rising fuel prices** increase transport and production costs, leading to higher food and commodity prices.
- (ii) **Currency depreciation** makes imports like machinery and medicine more expensive, fueling inflation.
- (iii) **Tax increases** on goods such as alcohol or fuel push up consumer prices.

### Policies (solutions) to cost push inflation

#### Monetary Policies

- (i) **Cautious interest rate adjustments:** Raising rates can reduce inflationary pressures, but too much tightening may worsen supply constraints.
- (ii) **Stabilizing currency:** Central banks can intervene to prevent depreciation, reducing imported inflation.

#### Fiscal Policies

- (iii) **Subsidies for producers:** Governments can subsidize fuel, electricity, or raw materials to lower production costs.
- (iv) **Tax relief:** Reducing corporate or indirect taxes (like VAT) lowers costs for firms, easing price pressures.
- (v) **Targeted government spending:** Invest in productivity-enhancing infrastructure (roads, energy, technology) to reduce long-term costs.

## Supply-Side Policies

- (vi) **Boost productivity:** Encourage adoption of modern technology, training, and innovation to lower unit costs.
- (vii) **Diversify energy sources:** Reduce dependence on volatile imports like oil by investing in renewable energy.
- (viii) **Improve logistics:** Better transport and storage systems reduce wastage and costs, especially in agriculture.

## Trade Policies

- (ix) **Encourage imports of cheaper inputs:** Lower tariffs on essential raw materials to reduce production costs.
- (x) **Promote export diversification:** Avoid over-reliance on a few commodities that are vulnerable to global price shocks.

## Wage and Labor Policies

- (xi) **Moderate wage agreements:** Encourage collective bargaining that balances fair wages with productivity growth.
- (xii) **Invest in skills development:** Skilled labor increases efficiency, reducing cost pressures.

## Example (Uganda Context)

- (i) Rising **fuel prices** have been a major driver of cost-push inflation. The government sometimes responds with **temporary subsidies** or tax reductions on fuel.
- (ii) The **Bank of Uganda** stabilizes the shilling to reduce imported inflation.
- (iii) Investments in **hydropower and renewable energy** aim to lower long-term production costs.
- (iv) Agricultural reforms (better storage, irrigation, and transport) help reduce food price volatility

## (c) Structural (Bottleneck) Inflation

Structural inflation is where the persistent increase in the general price level arises out of supply rigidities in the economy which keep down the level of production.

### Causes of structural inflation

- (i) **Agricultural bottlenecks:** Low productivity due to poor land ownership systems, outdated farming methods, and inadequate infrastructure. Food supply grows slowly compared to demand, pushing prices upward.
- (ii) **Deficit financing by government:** Governments often rely on printing money to fund development projects. This increases demand without a matching rise in supply, fueling inflation.
- (iii) **Foreign exchange constraints:** Developing countries often have low exports but high import needs. Currency shortages and devaluations make imports expensive, raising domestic prices.
- (iv) **Structural rigidities in production:** Industries face inefficiencies due to poor technology, lack of skilled labor, and weak infrastructure. Supply cannot expand quickly to meet demand.

- (v) **Inefficient resource allocation:** Capital is often directed to non-productive sectors due to political interference or weak planning. This reduces output growth and creates inflationary pressures.
- (vi) **Low voluntary savings:** Weak savings culture forces governments to rely on deficit financing, increasing money supply and inflation.
- (vii) Existence of political instabilities which discourage both domestic and foreign investors. This reduces output and hence high prices.
- (viii) Infrastructural break down in form of poor roads.
- (ix) Scarcity of raw materials due to limited foreign exchange. Producers fail to import scarce raw materials hence low levels of production.

### Example (Uganda Context)

- (i) **Agriculture:** Despite being the backbone of Uganda's economy, productivity remains low due to reliance on subsistence farming and poor storage facilities.
- (ii) **Imports:** Heavy dependence on imported fuel and machinery exposes Uganda to foreign exchange shortages and price hikes.
- (iii) **Infrastructure gaps:** Limited transport and energy infrastructure increase production costs, contributing to inflation.

### Solutions to structural Inflation

#### (i) Agricultural reforms

- Invest in modern farming techniques, irrigation, and storage facilities.
- Improve land tenure systems to encourage productivity.
- Expand rural infrastructure (roads, electricity) to reduce post-harvest losses.

#### (ii) Industrial and productivity improvements

- Promote industrialization and diversification beyond agriculture.
- Encourage adoption of modern technology and training to boost efficiency.
- Support SMEs with credit and technical assistance.

#### (iii) Fiscal discipline

- Reduce reliance on deficit financing (printing money).
- Mobilize domestic savings through pension funds, insurance, and capital markets.
- Ensure government spending is directed toward productive sectors.

#### (iv) Foreign exchange management

- Diversify exports to reduce dependence on a few commodities.
- Encourage import substitution where feasible to reduce foreign exchange shortages.
- Stabilize currency through prudent monetary and trade policies.

#### (v) Infrastructure development

- Invest in transport, energy, and communication systems to lower production costs.
- Public-private partnerships can accelerate infrastructure growth.

(vi) **Strengthening institutions and governance**

- Improve transparency and accountability in resource allocation.
- Reduce political interference in economic planning.
- Strengthen regulatory frameworks for financial and non-bank institutions.

(vii) **Promoting savings and investment culture**

- Encourage voluntary savings through attractive financial products.
- Expand access to financial services in rural areas via SACCOs and microfinance.

**(d) Imported inflation**

**Imported inflation** occurs when the general price level in a country rises due to increases in the cost of imported goods and services. It is especially common in developing countries that rely heavily on imports for fuel, machinery, food, and raw materials.

**Causes of Imported Inflation**

- Currency depreciation:** When the local currency loses value against foreign currencies, imports become more expensive. Example: If the Ugandan shilling weakens against the US dollar, fuel and machinery prices rise.
- Global commodity price increases:** Rising international prices of oil, food, or metals directly raise domestic costs. Example: A surge in global oil prices increases transport and production costs locally.
- Dependence on imports:** Countries that rely heavily on imported goods (fuel, medicine, technology) are more vulnerable to external price shocks.
- Trade restrictions or tariffs:** Higher import duties or global supply chain disruptions increase the cost of imported goods.

**Example (Uganda Context)**

- Uganda imports most of its **fuel and machinery**, so global oil price hikes directly raise domestic inflation.
- Currency depreciation** of the Ugandan shilling against the US dollar makes imports more expensive.
- Rising costs of imported **fertilizers and food products** contribute to higher local food prices.

**Policies (Solutions) to imported inflation**

- Currency Stabilization: through**
  - Maintain stable exchange rates through prudent monetary policy.
  - Build strong foreign reserves to cushion against currency depreciation.
  - Encourage foreign investment to strengthen the balance of payments.
- Import Substitution**

- Promote local industries to produce goods domestically instead of relying on imports.
- Support agriculture and manufacturing with subsidies, credit, and infrastructure.
- (iii) **Diversification of Exports**
  - Expand export base beyond a few commodities to earn more foreign exchange.
  - Reduce vulnerability to global price shocks.
- (iv) **Trade Policy Adjustments**
  - Lower tariffs on essential imports to reduce costs.
  - Strengthen regional trade agreements to source cheaper goods from neighboring countries.
- (v) **Energy and Commodity Reserves**
  - Establish strategic reserves of fuel, food, and other essentials to cushion against global price hikes.
- (vi) **Fiscal Discipline**
  - Avoid excessive deficit financing that weakens the currency.
  - Direct government spending toward productive sectors that reduce import dependence.
- (vii) **Encouraging Savings and Investment**
  - Mobilize domestic savings to reduce reliance on external borrowing.
    - Invest in infrastructure that lowers production costs and supports local industries.

### Example (Uganda Context)

- (i) Uganda faces imported inflation mainly from **fuel and machinery costs**.
- (ii) The **Bank of Uganda** stabilizes the shilling through prudent monetary policy and foreign reserves.
- (iii) Government programs encourage **local production of goods** like cement, textiles, and processed foods to reduce import dependence.
- (iv) Regional trade under the **East African Community (EAC)** helps Uganda source cheaper goods from neighboring countries.

### (e) Suppressed Inflation.

This is where the excessive persistent increase in the general price level of commodities is controlled by the government through the use of price controls.

### (f) Open Inflation.

This is where inflation is not controlled by the government through price controls, rationing and other means.

## Stagflation, deflation and reflation

**Stagflation** is an unusual and harmful economic condition where an economy experiences **three problems at the same time**:

- **Stagnation** → slow or no economic growth.
- **High unemployment** → many people out of work.
- **Inflation** → rising prices of goods and services.

This combination is dangerous because normally, inflation occurs when the economy is growing fast, but stagflation means prices rise **even when growth is weak and jobs are scarce**.

## Causes of Stagflation

- (i) **Supply shocks:** Sudden increases in the price of essential goods (e.g., oil crises in the 1970s).
- (ii) **Cost-push inflation:** Rising wages or raw material costs reduce supply, while demand remains weak.
- (iii) **Poor economic policies:** Excessive money printing or deficit financing combined with restrictions on production.
- (iv) **Structural rigidities:** Inefficient industries, weak infrastructure, and low productivity trap economies in stagnation while prices rise.

## Example

- (i) The **1970s oil crisis** is the classic case: oil prices quadrupled, leading to higher production costs, inflation, and economic slowdown in many countries.
- (ii) In developing countries like Uganda, stagflation could occur if **fuel prices rise sharply** while agricultural output stagnates and unemployment increases.

## Costs of stagflation

- (i) **Reduced purchasing power:** Rising prices erode the value of money, making basic goods and services unaffordable.
- (ii) **High unemployment:** Job losses increase poverty and reduce household incomes, worsening living standards.
- (iii) **Slow or negative economic growth:** Businesses cut investment due to uncertainty, leading to stagnation or recession.
- (iv) **Increased cost of borrowing:** Central banks often raise interest rates to fight inflation, making loans more expensive for households and firms.
- (v) **Decline in savings and investment:** Inflation discourages savings, while stagnation reduces profitable investment opportunities.
- (vi) **Social and political instability:** Rising unemployment and falling living standards can trigger unrest, strikes, and political pressure.
- (vii) **Fiscal strain on government:** Lower tax revenues (due to weak growth) combined with higher spending needs (subsidies, welfare) worsen budget deficits.
- (viii) **Erosion of confidence:** Both consumers and investors lose trust in the economy, leading to capital flight and reduced foreign investment.

## Example (Uganda Context)

- (i) If Uganda faced stagflation due to **global fuel price hikes** and **low agricultural output**, households would struggle with high food and transport costs while unemployment rises.
- (ii) Government would face pressure to subsidize fuel and food, straining public finances.
- (iii) Businesses would cut back on expansion, worsening stagnation.

## Policies (Solutions) to Stagflation

- (i) **Supply-side reforms:** Improve productivity, infrastructure, and technology to expand output.
- (ii) **Monetary discipline:** Control money supply to reduce inflationary pressures.
- (iii) **Targeted fiscal policy:** Invest in productive sectors (agriculture, manufacturing) rather than excessive subsidies.
- (iv) **Diversify energy sources:** Reduce dependence on imported oil and fuel.
- (v) **Encourage employment programs:** Support SMEs and rural enterprises to reduce unemployment.

## Deflation

**Deflation** refers to a **sustained decrease in the general price level of goods and services in an economy**. In simple terms, money gains value over time because prices are falling.

### Causes of Deflation

- (i) **Reduced aggregate demand:** Consumers and businesses cut spending, leading to lower demand and falling prices.
- (ii) **Excess supply:** Overproduction or surplus goods push prices down.
- (iii) **Tight monetary policy:** High interest rates or reduced money supply limit borrowing and spending.
- (iv) **Falling wages or incomes:** Lower purchasing power reduces demand, forcing firms to cut prices.
- (v) **Technological progress:** Innovations reduce production costs, making goods cheaper.
- (vi) **Debt deflation:** When households and firms focus on repaying debt instead of spending, demand falls.

### Costs of Deflation

- (i) **Reduced consumer spending:** People delay purchases expecting prices to fall further.
- (ii) **Business losses:** Firms earn less revenue, leading to layoffs and closures.
- (iii) **Higher unemployment:** Reduced demand for labor worsens joblessness.
- (iv) **Debt burden increases:** The real value of debt rises, making repayment harder.
- (v) **Economic stagnation:** Investment slows down due to low profitability.

## Policies (Solutions) to Deflation

- (i) **Expansionary monetary policy:** Lower interest rates, increase money supply to encourage borrowing and spending.
- (ii) **Fiscal stimulus:** Government increases spending or cuts taxes to boost demand.
- (iii) **Support for industries:** Subsidies and incentives to stimulate production and employment.
- (iv) **Encourage consumption:** Programs to raise wages, reduce unemployment, and restore consumer confidence.

### Example (Global Context)

- (i) The **Great Depression (1930s)** is the most famous case of deflation, where falling prices, collapsing demand, and mass unemployment devastated economies.
- (ii) In modern times, **Japan** has struggled with deflation due to weak demand and aging demographics.

### Reflation

**Reflation** refers to the deliberate use of economic policies to **revive an economy that is experiencing slowdown, stagnation, or deflation**. It is essentially the process of stimulating demand and restoring growth, often after a recession.

#### Key Features of Reflation

- (i) **Policy-driven:** Governments and central banks intentionally adopt measures to boost demand.
- (ii) **Temporary rise in prices:** Prices increase moderately as demand recovers, but not excessively like in inflation.
- (iii) **Focus on growth:** The main goal is to restore employment, production, and investment.
- (iv) **Controlled inflation:** Unlike runaway inflation, reflation aims for a healthy level of price rise to encourage spending and investment.

#### Causes / Triggers of Reflation

- (i) Economic slowdown or recession.
- (ii) Deflationary pressures (falling prices, weak demand).
- (iii) High unemployment and underutilized resources.
- (iv) Weak consumer and business confidence.

#### Policies (Solutions) Used for Reflation

- (i) **Expansionary monetary policy:** Lowering interest rates to encourage borrowing and investment. Increasing money supply to stimulate demand.
- (ii) **Expansionary fiscal policy:** Government spending on infrastructure, health, and education to create jobs. Tax cuts to increase disposable income and boost consumption.
- (iii) **Supply-side measures:** Supporting industries and SMEs to expand production. Investing in technology and infrastructure to reduce costs and increase output.

### Example

- (i) After the **2008 Global Financial Crisis**, many countries adopted **reflationary policies** such as stimulus packages, tax cuts, and low interest rates to revive growth.

- (ii) In Uganda, reflation could involve **government investment in agriculture and infrastructure**, combined with **lower interest rates by the Bank of Uganda** to stimulate borrowing and production.

### General cause of inflation in developing countries (Uganda)

- (i) **Food and transport costs:** Uganda's economy is heavily dependent on agriculture, with over 80% of the population in rural areas. Poor infrastructure and reliance on subsistence farming make food supply unstable, while rising fuel prices increase transport costs.
- (ii) **Fiscal and monetary factors:** Government deficit financing (borrowing or printing money) increases money supply. Loose monetary policy can fuel excess demand, pushing prices upward.
- (iii) **Demand-pull pressures:** Rising household incomes, government spending, or credit expansion increase aggregate demand beyond supply capacity.
- (iv) **Cost-push factors:** Rising wages, fuel prices, and imported raw materials raise production costs, which businesses pass on to consumers.
- (v) **Imported inflation:** Uganda relies on imports of fuel, machinery, and manufactured goods. Currency depreciation against the US dollar makes imports more expensive, raising domestic prices.
- (vi) **Structural bottlenecks:** Low productivity in agriculture and industry, poor infrastructure, and inefficient resource allocation limit supply growth. This mismatch between demand and supply creates persistent inflationary pressures.

### Example

- (i) A rise in **global oil prices** increases transport costs, which directly raises food prices in Uganda.
- (ii) **Currency depreciation** makes imported goods like fuel and machinery more expensive, contributing to inflation.
- (iii) **Government deficit financing** during budget shortfalls increases money supply, fueling demand-pull inflation.

### Policies (measures) to control inflation in developing countries

#### Monetary policies

- (i) Tighten money supply by raising interest rates to reduce borrowing and demand.
- (ii) Strengthen central bank independence to ensure credible anti-inflation measures.
- (iii) Stabilize exchange rates to prevent imported inflation.

#### Fiscal policies

- (iv) Reduce government deficit financing (avoid excessive money printing).

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- (v) Rationalize subsidies and redirect spending to productive sectors like agriculture and infrastructure.
- (vi) Improve tax collection efficiency to reduce reliance on inflationary borrowing.

### Trade and external policies

- (vii) Diversify exports to earn more foreign exchange and reduce vulnerability to global shocks.
- (viii) Lower tariffs on essential imports to reduce costs for consumers and producers.
- (ix) Build foreign reserves to cushion against currency depreciation.

### Supply-side measures

- (x) Invest in agriculture (modern farming, irrigation, storage) to stabilize food supply.
- (xi) Support SMEs and industries to expand production capacity.
- (xii) Improve infrastructure (roads, energy, transport) to reduce production and distribution costs.

### Structural reforms

- (xiii) Strengthen institutions to reduce corruption and inefficiency in resource allocation.
- (xiv) Encourage savings and financial inclusion to mobilize domestic capital.
- (xv) Promote education and skills development to boost productivity.

### Example (Uganda Context)

- (i) The **Bank of Uganda** raises the Central Bank Rate (CBR) when inflation rises, curbing excess demand.
- (ii) Government invests in **hydropower dams and road networks** to reduce production bottlenecks.
- (iii) Programs like **Operation Wealth Creation** aim to modernize agriculture and stabilize food prices.
- (iv) Regional trade under the **East African Community (EAC)** helps Uganda access cheaper imports and diversify exports.

### Positive effects (Implications) of inflation

- (i) **Encourages spending and investment:** When people expect prices to rise moderately, they are more likely to spend or invest rather than hoard cash. This stimulates economic activity and growth.
- (ii) **Reduces real burden of debt:** Inflation lowers the real value of outstanding loans and government debt. Borrowers benefit because they repay with money that is worth less than when they borrowed.
- (iii) **Promotes wage growth:** Moderate inflation often leads to higher wages, improving living standards if productivity also rises.

- (iv) **Facilitates relative price adjustments:** Inflation allows prices of different goods and services to adjust more flexibly. This helps resources shift to more productive sectors.
- (v) **Boosts production and employment:** Rising demand (linked to moderate inflation) encourages firms to expand output and hire more workers.
- (vi) **Supports monetary policy flexibility:** A small positive inflation rate gives central banks room to cut interest rates during recessions. Zero or negative inflation (deflation) limits this flexibility.
- (vii) **Encourages investment in assets:** Inflation makes holding cash less attractive, pushing investors toward productive assets like real estate, stocks, or business ventures.

### Example (Uganda Context)

- (i) Moderate inflation around **3–5%** helps encourage **consumer spending** and **business investment**.
- (ii) It reduces the **real burden of government debt**, making it easier to finance infrastructure projects.
- (iii) Farmers benefit when agricultural prices rise moderately, encouraging them to produce more

### Negative effects (implications) of inflation

- (i) **Reduced purchasing power:** Prices rise faster than wages, making basic goods and services less affordable.
- (ii) **Uncertainty and instability:** Businesses struggle to plan for the future due to unpredictable costs, discouraging investment.
- (iii) **Erosion of savings:** Inflation reduces the real value of money saved, discouraging long-term savings.
- (iv) **Income inequality:** Fixed-income earners (like pensioners) suffer more, while those with assets (like property) may benefit.
- (v) **Higher cost of borrowing:** Central banks often raise interest rates to fight inflation, making loans more expensive.
- (vi) **Balance of payments problems:** Domestic goods become less competitive abroad if inflation is higher than in trading partners.
- (vii) **Social and political unrest:** Rising living costs can trigger strikes, protests, and political instability.
- (viii) **Fiscal strain on government:** Higher spending on subsidies and welfare, combined with reduced real tax revenue, worsens deficits.

### Example (Uganda Context)

- (i) Rising **fuel and food prices** reduce household purchasing power, especially for low-income families.
- (ii) Inflation erodes the value of **savings in mobile money and banks**, discouraging financial inclusion.

- (iii) Businesses face **higher borrowing costs** when the Bank of Uganda raises interest rates to control inflation.
- (iv) Political pressure mounts when **living costs rise sharply**, forcing government to intervene with subsidies.

### Why is it difficult to control inflation in developing countries?

- (i) **Dependence on agriculture and food prices:** A large share of household spending goes to food. Poor infrastructure, climate shocks, and low productivity make food supply unstable, causing frequent price spikes.
- (ii) **Imported inflation:** Heavy reliance on imports (fuel, machinery, medicine) means global price increases or currency depreciation quickly raise domestic prices.
- (iii) **Weak monetary transmission:** Central banks may raise interest rates, but many people and businesses operate outside formal banking systems. This limits the effectiveness of monetary policy.
- (iv) **Fiscal pressures:** Governments often rely on deficit financing (borrowing or printing money) to fund development projects. This increases money supply and fuels inflation.
- (v) **Structural bottlenecks:** Poor infrastructure, low industrial capacity, and inefficient resource allocation restrict supply growth. Even small increases in demand can trigger inflation.
- (vi) **High informality:** Large informal sectors make it difficult to monitor and regulate prices, wages, and credit.
- (vii) **External shocks:** Developing countries are vulnerable to global oil price hikes, supply chain disruptions, and currency fluctuations. These shocks quickly spill over into domestic inflation.
- (viii) **Political and institutional constraints:** Inflation control measures (like subsidy cuts or tax increases) are often unpopular. Weak institutions may struggle to enforce disciplined fiscal and monetary policies.

### Example (Uganda Context)

- (i) Rising **fuel prices** immediately raise transport and food costs, affecting most households.
- (ii) **Currency depreciation** against the US dollar makes imports more expensive.
- (iii) The **Bank of Uganda** may raise interest rates, but many rural households are outside the formal credit system, limiting impact.
- (iv) Structural issues like **low agricultural productivity** and poor storage facilities keep food inflation persistent.

### Revision exercise 3

#### Section A questions

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- 1 (a) Distinguish between creeping inflation and galloping inflation  
(b) Mention any two merits of creeping (mild) inflation.
- 2 (a) Define the term "Reflation"  
(b) State three causes of structural inflation in an economy
- 3 (a) Distinguish between structural inflation and imported inflation  
(b) Outline two solutions to imported inflation in your country
- 4 (a) Distinguish between state of inflation and reflation  
(b) Mention two solutions to structural inflation in Uganda
- 5 (a) Distinguish between state of inflation and type of inflation.  
(b) Mention two possible remedies to cost push inflation in an economy
6. (a) With the help of diagrams, distinguish between Cost push and demand pull inflation.
7. State four reasons why an increase in money supply may not necessarily lead to inflation
8. State any four policy measures that should be taken to control cost push inflation in an economy.
9. Distinguish between the following types of inflation.  
(a) Suppressed Inflation and Open Inflation  
(b) Speculative inflation and monetary inflation  
(c) Underlying inflation and headline inflation
- 10 (a) Distinguish between demand pull inflation and bottleneck inflation.  
(b) Give two causes of demand pull inflation in your country.
- 11 (a) Define the term disinflation.  
(b) State three instruments of a disinflation policy.
- 12 Explain the relationship between the following  
(a) Unemployment and inflation in your country  
(b) Inflation and the real value of money.

### *Section B questions*

- 1 (a) Why may creeping inflation be desirable in your country  
(b) Suggest the measures that should be taken to tackle inflation in your country
- 2 (a) What are the causes of inflation in Uganda?  
(b) Explain the measures being taken to control inflation in your country.
- 3 (a) Distinguish between deflation and inflation  
(b) Assess the impacts (implications) of inflation in an economy
4. (a) Explain why the government may induce inflation in an economy?  
(b) Account for the persistent increase in the general price level of goods and services in your country.

**Thank you**  
**Dr. Bbosa Science**