TOPIC TWO: MONEY SUPPLY & MONEY DEMAND

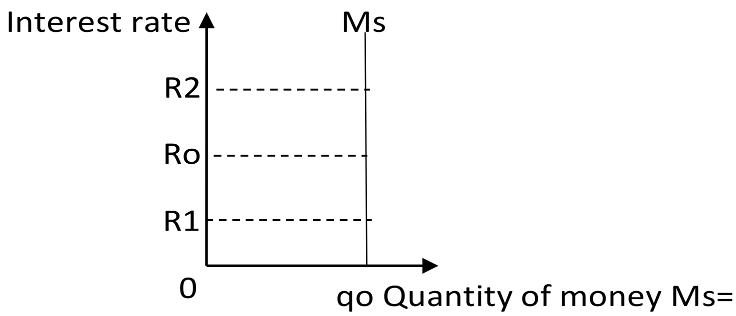
MONEY SUPPLY

Money supply refers to the total quantity/ volume of money both incirculation in a particular country and the demand deposits held in banks at a given time.

Types of money supply:-

a) **Exogenous / Discretionary money supply.** This is one where the quantity of money in circulation in an economy is determined by the central authority/ central bank and usually the supply is fixed.

Illustration of exogenous money supply;



money supply.

From the above graph, money supply remains fixed at oqo despitechanges in the interest rate.

b) **Endogenous / automatic money supply.** This is the supply of money which depends on the level of economic activities in an economy. Factors such as interest rate, price level, level of national output, capital inflow etc. determine the volume of money in circulation.

Composition of money supply:

- **M1,**this is narrow money supply which consists of currency incirculation i.e. bank notes and coins and demand/sight deposits.
- **M2,** this is broad money supply which consists of currency incirculation, demand deposits, savings and time/fixed deposits.
- **M3,** this consists of the sum of M1 and M2 and quasi money. i.e.assets that can easily be converted into cash.

Determinants of money supply in an economy:

- **The level of monetization of the economy/Size of the subsistence sector**. Money supply is high when the economy is highly monetized because production is for sale and thus high use of money as a medium of exchange while money supply is low when there is a large subsistence sector because production is for home consumption and there is less use of money as a medium of exchange.
- **Monetary policy**. A restrictive/ tight monetary policy reduces money supply because its intention is to increase amount of money in circulation while an expansionary monetary policy increases money supply in an economy its intention is to reduce the amount of money in circulation.
- **The level of economic activities/investment**. High level of economic activities/ investment leads to high volume of money incirculation because there is high use of money in financing different production activities by firms. Whereas low level of economic activities /investment leads to low money supply since there is limited expansion of economic activities which requires little money.
- **Financial accommodation**. Government borrowing from the central bank by printing of more money to finance its budgetary deficits increase money supply whereas when there is no borrowing from the central bank by government i.e. borrowing from the public leads to low money supply.
- **The level of liquidity preference**. High liquidity preference increasesmoney supply because people prefer holding their wealth in cash formrather than having assets while low liquidity preference reduces money supply because people prefer hold their wealth in asset form rather than money itself.
- **Interest rates**. Interest rates affect the rate of borrowing. A low interest rate on loans reduces the cost of borrowing which leads to high rate of borrowing and thus high money supply while high interest rate increases the cost of borrowing which leads to low rate of borrowing and low money supply.
- **Level of government expenditure**. High level of government expenditure especially on productive projects leads to high money supply. On the other hand low government expenditure leads to lowmoney supply

- **Level of Inflow and outflow of funds.** High level of inflow of funds by foreign investors, remittances by nationals living abroad, by tourists from abroad leads to high the level of money supply. On the other hand, high level of outflow of funds in form of profit and income repatriation, expenditure on imports, investing in the outside economy leads to low level of money supply.

- **The balance of payment position of a country**. Balance of payment surplus in an economy leads to increase in money in circulation leading to high levels of money supply, this due to the increased foreign exchange inflow. While a balance of payment deficit leads to low amount of money in circulation leading to low levels of money supply in the economy, this is due to low foreign exchange inflow in the country.

- **Rate of credit creation by commercial banks**. High level of credit creation by commercial banks through lending process increase money supply while low level of credit creation lowers money supplyin an economy because it limits the amount of money/credit created.

- **The level of printing and issuance of currency**. Excessive printing and issuance of currency by the central bank increases the amount of money in circulation hence increasing money supply. On the other hand limited printing and issuance of currency by the central bank reduces the amount of money in circulation hence low levels of money supply.

Monetary measures that can be used to reduce money supplydeveloping countries;

- Sale of government securities, for example, sale of treasury bills.
- Increase bank rate.
- Increase variable reserve requirements / increase cash and liquidity ratio.
- Increase or set high legal reserve requirements.
- Call for (enforcement) supplementary legal reserve requirements / special deposits.
- Selective credit control.
- Currency conversion.
- Increase the margin requirement.
- Direct action.
- Moral suasion.
- Increase in legal reserve requirement.
- Ration credit.

Measures being used to reduce money supply in Uganda;

- Selling of government securities for example treasury bills and bonds.
- Increasing the bank rate.
- Increasing the minimum legal reserve requirement.
- Increasing the variable reserve requirement / increasing the cash ratio and liquidity ratio.
- Calling for special deposits.
- Increasing the margin requirement.
- Implementing a selective credit control policy (system).
- Embarking on moral suasion / persuading commercial banks to restrict lending
- Rationing of credit.

DEMAND FOR MONEY (LIQUIDITY PREFERENCE)

Demand for money/Liquidity preference refers to the desire by individuals to hold wealth/assets in cash or near cash form.

Determinants of liquidity preference/ demand for money

1. **The level of transactions.** High level of cash transactions raises the liquidity preference because more money is required to effect thetransactions. While low level of cash transactions lead to low demand for money since there is less need to hold money in cash form for purposes of carrying out transactions.
2. **The general price level.** High general price level leads to high liquidity preference since people tend to hold money in cash form to enable them meet their needs whereas low level of general prices leadsto low liquidity preference because less cash money is required to meet needs to earn more money.
3. **Level of interest rate**. Low interest rate on financial assets increases demand for money because people do not see much reward in investing their money whereas high interest on financial assets leadsto low liquidity preference as people prefer investing their money infinancial asset.
4. **Income levels.** People with low incomes tend to hold most of their wealth in cash form since they are likely to need it any time. While those with high income have low liquidity preference since they can invest their money elsewhere to earn interest in both short term and long term investments.
5. **Degree of uncertainty**. High degree of uncertainty leads to high demand for money since people tend to hold more cash as precaution against unforeseen requirements and less money is held in cash or near cash form when people are certain about the future.

6. **Knowledge of banking services.** Adequate knowledge about banking services leads to low liquidity preference since people invest in facilities such as fixed deposits to earn interest and where people have limited knowledge about banking services liquidity preference is high since people find it convenient to hold their money in cash form rather than in asset form.
7. **Availability of investment incentives**. Provision of investment incentives such as subsidies in a country leads to low liquidity preference as people invest their money in different economic activities for a profit. On the other hand, limited provision of investment incentives leads to high liquidity preference as people are reluctant to invest in different economic activities due to low profit levels resulting from high cost of production.
8. **Level of speculation.** High level of speculation leads to high liquidity preference as people hold cash to take advantage of future positive trends in both money and capital markets. Where the level of speculation is low, liquidity preference is low.
9. **Level of development of financial institutions/Nature of distribution of commercial banks.** High level of development of financial institutions leads to low liquidity preference as people make use of banks by keeping their money in them and by buying financial assets offered by commercial banks. On the other hand, low level of development of financial institutions leads to high liquidity preferencebecause banking becomes an inconvenience.

Reasons for high liquidity preference in LDC’S;

- Low level of income
- High level of speculation
- High level of cash transactions
- High degree of uncertainty
- High general price level

- Low interest rates on financial assets
- Limited knowledge of services provided by commercial banks.
- Poor distribution of banks
- Stringent requirements for opening and running bank accounts.

Reasons for low liquidity preference in developing countries;

- High level of income.
- Low level of speculation.
- Low rates of inflation or high price level.
- Low degree of uncertainty.
- High level of development of commercial banks and other financial institutions
- High interest rates on financial assets.
- Increased awareness or knowledge of services provided by commercial banks.