Base	Year
------	------

Commodity	Price	Weight	Index	
		Kshs.		
А	50		1	100
В	20		1	100
С	10		<u>1</u>	100
			3	<u>300</u>

Assume that one year later the price of A is Kshs.45/=, B Kshs.25/= and C Kshs. 15/=.

Base Year

Commodity	Price	WeightIndex		
		Kshs.		
А		45	1	90
В		25	1	125
С		15	<u>1</u>	150
			3	365

index for all items = 121.6

The index number in the second year is 121.6, showing a pinctcase in price of 21.6 per cent over the base year. If the commodition of the are all differently weighted a different result will be obtained. For example, suppose that one will then be compiled as follows:-

Preview	nade	01-	
Commodity	Price	Weight	Index
		Kshs.	
А	50	1	100
В	20	4	400
С	10	<u>20</u>	<u>2,000</u>
		25	<u>2,500</u>

Index for all items = 100



Commodity	Price	WeightIndex	
	Kshs.		
А	50	1	90
В	20	4	500
С	10	20	<u>3,000</u>
		25	<u>3,590</u>

Index for all items 143

By weighting C heavily this index shows a rise in prices of 43.6 per cent, although individual prices show only the same change as before. By weighting commodity A

account or deposit account. These are created by commercial banks and the process is called credit creation.

Credit Creation

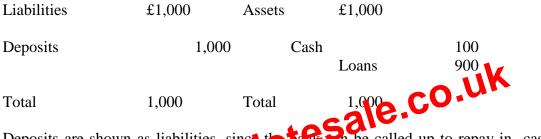
The ability of banks to create deposit money depends on the fact that bank deposits need to be only fractionally backed by notes and coins. Because the bank does not need to keep 100 per cent reserves, it can use some of the money deposited to purchase income-yielding investments.

Illustration

i. A Single Monopoly Bank

Consider first a country with only one bank (with as many physical branches as is necessary) and assume that the bank has found from experience that it needs only to hold 10% of cash s a proportion of total deposits – proportion of transactions that customers prefer to settle by means of cash, rather than cheque. Now imagine the balance sheet of the bank look like this:

Initial Position of single bank



Deposits are shown as liabilities, since the task can be called up to repay in cash any amounts credited to customers in this way. Assess consist of cash held by the bank, plus loans, which represents the obligations of borrowers towards the bank. The cash ratio take ratio of cash held ($\pm 100,000$) to its liabilities (($\pm 1,000,000$), and is 10 beccent in this case.

Suppose now a customer deposits (liabilities) in this initial position will be:

 $\frac{120}{1,020} \quad x \qquad 100 = 11.8\%$

This is unnecessarily high, nearly 12 per cent compared to the conventional ratio of 10 per cent. The bank can therefore safely make additional interest-bearing loans. If it lends an extra £180,000, according deposits will rise from £1,020,000 to £1,200,000, so that the 10 per cent ratio of cash to deposit is restored. The final position is as shown below, and indicates that bank deposits have been created to the extent of ten times the new cash deposit.

Addition of cash deposit raises cash reserves and cash ratio

Liabilities	£1,000	Assets	£1,000	
Deposits	1,020	Cash Loans	900	120
Total	1,020	Total	200	1,020

According to Keynes, securities can be bought and sold on the free market before the government redeems them, and the price at which they are sold does not have to be equal to their face value. It can be higher or lower than the face value depending on the level of demand for securities. He defined the market rate of interest as

Market rate of		fixed government rate of interest on securities
Interest	=	Market price of securities

It follows therefore, that when the market price of securities is high the market interest rate will be low. Also if the market price of securities (high holders of securities) will sell them now and hold money. Hence the demand for money is high when the interest rate is low. On the other hand when the market price of securities is low, the market rate of interest will be high. Also if the market price of securities is low, it can be expected to rise. Hence people will buy securities at a low price, hoping to sell them at higher prices. In buying securities, people part with money. Hence the demand for money is low when interest rate is high. It follows, therefore, that the demand curve for money for the speculative motive slopes downwards as shown on the next page.

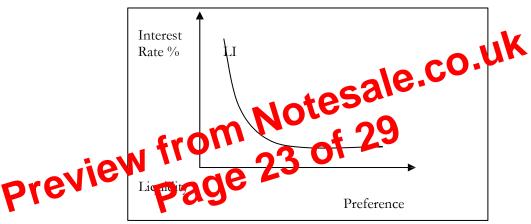


Figure 2.4 Interest Rates and Liquidity Preference

It flattens out at the lower end because there must be a minimum rate of interest payable to the people to persuade them to part with money. This perfectly elastic part is called *liquidity trap*.

The total demand for money at any given interest rte is the sum of the demands for the active balances and the speculative motive. Thus, the total demand curve for money is obtained by the horizontal summation of the two demand curves. The LM curve is a locus of points representing all the different combinations of interest rates and income levels consistent with equilibrium in the money market. The LM curve is shown in the following diagram.

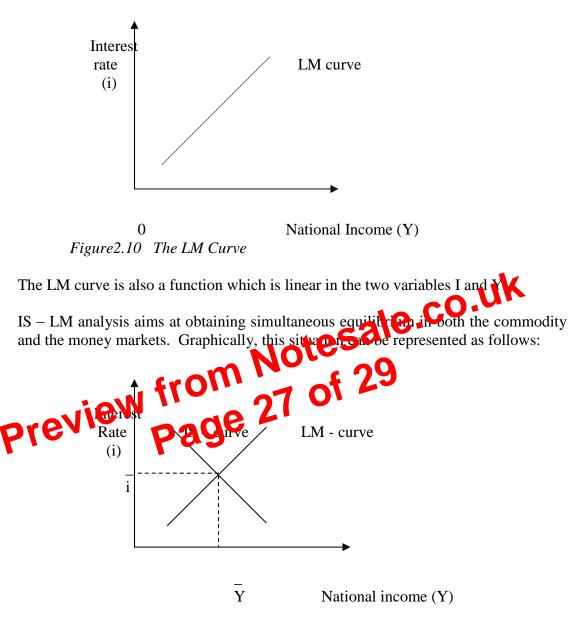


Figure 2.11 Equilibrium in both the commodity and money markets.

The equilibrium in the two markets is represented graphically by the intersection of the IS and LM curves.

The commodity market for a simple two – sector economy is in equilibrium when Y = C + I. The money market, on the other hand, is in equilibrium when the supply of money (M_s) equals the demand for money (M_d). The demand for money is in turn made up of the transaction – precautionary demand (M_{DT}) and speculative demand for money (M_{DS}).