Management of Financial Institutions (MGT604)

Assignment No.1 **Marks: 15**

Solution:

1)

The following are the main tools through which the central government can control the money circulation in an economy.

A. **Interest rates control**
B. **Open market operations**
C. **Reserve requirements**

A. Interest rates control

The contraction of the monetary supply can be achieved *indirectly* by increasing the nominal interest rates. Monetary authorities in different nations have differing levels of control of economy-wide interest rates.

In Pakistan, the monetary authority i.e. state Bank of Pakistan can fluctuate specific interest rates on loans, savings accounts or other financial assets.
For example, by increasing the interest rates under its control the SBP can contract the money supply because higher interest rates encourage savings and discourage borrowing. Both of these effects reduce the size of the money supply.

B. Open market operations

It is a direct way to influence the money supply in an economy. For example, it can buy securities and exchanging money for the security it leads to increase in the money supply. In the same way, selling of securities for money lowers the money supply. The main open market operations for keeping the money in control in an economy are following:
The main open market operations are:

- Temporary lending of money for collateral securities ("Reverse Operations" or "repurchase operations", otherwise known as the "repo" market). These Operations are carried out on a regular basis, where fixed maturity loans.

- Buying or selling securities ("Direct Operations") on ad-hoc basis.

- Foreign exchange operations such as forex swaps.

C. **Reserve requirements**

Central Bank can also maintain money control through Reserve requirements by other Banks. In it a certain percentage of cash or deposited are held with the central bank thus limits are set on the money supply.

In practice, many banks are required to hold a percentage of their deposits as reserves. Even if reserves were not a legal requirement, prudence would ensure that banks would hold a certain percentage of their assets in the form of cash reserves.

2)

The open market operation is usually considered as the best measure to control the money supply in the economy because of following reasons:

- It produces immediate and frequent effects as compared to other tools of money supply control while the changes in reserve requirements can not be made frequently and on immediate grounds.
- The effects tend to be large within short period of time in contrast to other tools.
- It is easily reversible in contrast to other tools of money supply control.