

CA14 ECONOMICS

SECTION 9: MONEY AND BANKING

Syllabus references: MON-01 to MON-05

Purpose. Original DatalytIQs Academy teaching notes aligned to the KASNEB Revised Syllabus (June 2024).
Suggested study time: 10-12 hours. **Assessment threshold:** 70%. **No KASNEB endorsement is implied.**

Learning outcomes

After this section, the learner should be able to explain the nature and functions of money; compare monetary standards; analyse demand and supply of money; explain commercial-bank credit creation; distinguish central-bank functions and instruments; and evaluate monetary policy transmission and limitations.

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2. Monetary standards and payment evolution
3. Demand for money
4. Money supply and monetary aggregates
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6. Central bank and monetary policy
7. Transmission, effectiveness and limits

1. Nature and functions of money

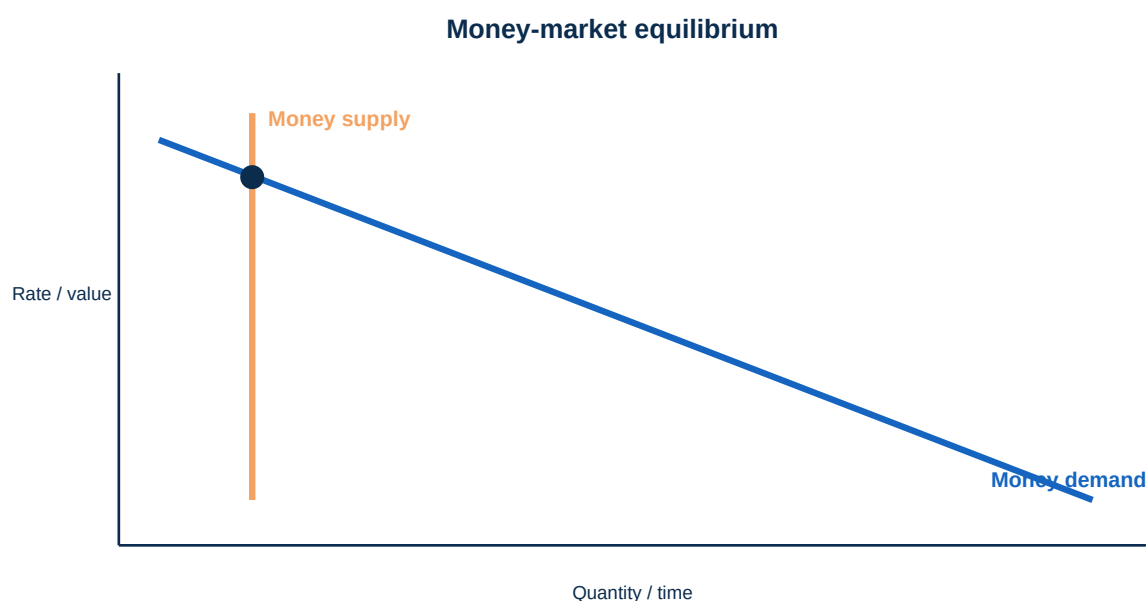
Money is any generally accepted medium for settling obligations. It serves as medium of exchange, unit of account, store of value and standard of deferred payment. Good money is durable, portable, divisible, recognisable, homogeneous, acceptable and sufficiently scarce. Money differs from income, which is a flow, and wealth, which is a stock of assets. Liquidity describes how readily an asset can meet obligations without material loss.

Function	Mechanism	Risk factor
Medium of exchange	Removes the double coincidence required by barter.	Instability reduces acceptability.
Unit of account	Provides a common pricing and accounting measure.	Rapid inflation weakens comparability.
Store of value	Transfers purchasing power through time.	Inflation erodes real balances.
Deferred payment	Denominates future obligations.	Unexpected inflation redistributes wealth.

Examination technique: State the proposition, explain the mechanism, apply it to the question and qualify the conclusion where assumptions or context matter.

2. Monetary standards and payment evolution

Commodity money has intrinsic use value; representative money is redeemable for a backing asset; fiat money derives acceptance from law, institutions and confidence. Bank deposits and regulated electronic balances perform monetary functions. Mobile payments improve convenience and inclusion but are payment arrangements, not automatically new net money: the underlying claim and settlement asset must be identified.



Examination technique: State the proposition, explain the mechanism, apply it to the question and qualify the conclusion where assumptions or context matter.

3. Demand for money

Transaction demand rises with income and payment needs. Precautionary demand provides a buffer against uncertainty. Speculative or asset demand reflects the opportunity cost of holding money relative to interest-bearing assets. In Keynesian analysis, a higher interest rate normally lowers speculative money demand. Financial innovation can change these relationships.

Examination technique: State the proposition, explain the mechanism, apply it to the question and qualify the conclusion where assumptions or context matter.

4. Money supply and monetary aggregates

The monetary base consists principally of currency and commercial-bank reserves at the central bank. Broader aggregates add transferable and less liquid deposits according to the official definition. An increase in the base does not translate mechanically into equal broad-money growth: bank capital, liquidity, credit demand, risk, regulation and the public currency preference matter.

Identity	Proposition
Currency-deposit ratio $c=C/D$	Public preference for currency relative to deposits.
Reserve-deposit ratio $r=R/D$	Bank reserves relative to deposits.
Simple deposit multiplier $1/r$	Maximum textbook expansion when no currency drain or excess reserves.
General multiplier $(1+c)/(r+c)$	Allows a currency drain, still under restrictive assumptions.

Examination technique: State the proposition, explain the mechanism, apply it to the question and qualify the conclusion where assumptions or context matter.

5. Commercial-bank credit creation

A bank creates a deposit when it grants a loan, subject to balance-sheet, capital, liquidity, risk and regulatory constraints. In the simple reserve model, an initial reserve injection supports successive deposits and loans as recipients redeposit funds. This is a system-wide process, not one bank multiplying cash without limit. Loan repayment, cash withdrawals, excess reserves and defaults contract or constrain deposits.

Examination technique: State the proposition, explain the mechanism, apply it to the question and qualify the conclusion where assumptions or context matter.

6. Central bank and monetary policy

Central-bank functions include currency issue, banker and adviser to government, banker to banks, settlement oversight, reserve management, lender of last resort, financial-stability support and monetary policy. Instruments may include the policy rate, open-market operations, reserve requirements, standing facilities, foreign-exchange operations and communication. The exact operational framework must be checked against dated official central-bank material.

Examination technique: State the proposition, explain the mechanism, apply it to the question and qualify the conclusion where assumptions or context matter.

7. Transmission, effectiveness and limits

A policy change can affect short-term market rates, bank funding, credit conditions, asset prices, exchange rates, expectations, aggregate demand, output and inflation. Transmission has variable lags and depends on banking competition, fiscal conditions, credibility, balance sheets and whether inflation is demand-driven or supply-driven. Monetary tightening cannot directly create rainfall, oil supply or port capacity.

Examination technique: State the proposition, explain the mechanism, apply it to the question and qualify the conclusion where assumptions or context matter.

Worked examples

Worked example 1

Illustrative: with required reserve ratio $r=0.10$ and no cash leakage or excess reserves, the simple maximum deposit multiplier is $1/0.10=10$. An initial reserve increase of KES 20 million supports up to KES 200 million deposits, including the initial deposit. This is a theoretical ceiling, not a forecast.

Reasonableness check: Confirm the direction, units and economic interpretation before finalising the answer.

Worked example 2

Illustrative: if $c=0.25$ and $r=0.10$, $m=(1+c)/(r+c)=1.25/0.35=3.571$. A KES 50 million base increase supports a theoretical KES 178.6 million money-supply increase. Check: currency leakage reduces the multiplier below 10.

Reasonableness check: Confirm the direction, units and economic interpretation before finalising the answer.

Worked example 3

If nominal interest is 12% and expected inflation 7%, the approximate real interest rate is 5%; the exact Fisher calculation is $(1.12/1.07)-1=4.67\%$. Interpret this as the expected change in purchasing power before tax and risk.

Reasonableness check: Confirm the direction, units and economic interpretation before finalising the answer.

Common errors and corrections

Error	Correction
Giving a definition without mechanism	Explain the causal link and apply it to the facts.
Using accounting language for an economic concept	Identify opportunity cost, implicit cost or real/nominal basis explicitly.
Drawing an unlabeled diagram	Label axes, curves, initial position, change and result.
Treating a historical pattern as a guarantee	Use it only to guide emphasis; cover the full syllabus.

Original DatalytiQs examination-style practice

Question 1 - Explain

Distinguish money, income and wealth, and show why liquidity matters.

DatalytiQs model answer: Money is a generally accepted settlement asset; income is a flow per period; wealth is a stock. Liquidity determines how readily wealth can perform the payment function.

Question 2 - Calculate

The monetary base rises by KES 30 million, $c=.20$ and $r=.10$. Estimate the theoretical broad-money change.

DatalytiQs model answer: $m=1.20/.30=4$; estimated change=KES 120 million. State restrictive assumptions.

Question 3 - Analyse

Explain how a higher policy rate may reduce inflation.

DatalytiQs model answer: Trace policy rate to market rates, borrowing and saving, credit/asset/exchange-rate expectations, aggregate demand and price pressure; qualify using lags and supply shocks.

Question 4 - Evaluate

Should a central bank always tighten policy when inflation rises?

DatalytiQs model answer: Diagnose demand versus supply drivers, expectations and second-round effects; weigh output, employment, exchange-rate and credibility consequences.

Revision summary

Core rule: Reconstruct the model from definitions, assumptions, relationships and diagrams. Memorised labels without mechanism do not earn strong analytical marks.

Evidence requirements

Evidence ID	Learning Objectives	Assessment criteria
E9.1	Classify payment instruments by monetary function and underlying claim.	Correct method, complete interpretation, labelled working and original learner submission.
E9.2	Calculate simple and currency-leakage multipliers with assumptions.	Correct method, complete interpretation, labelled working and original learner submission.
E9.3	Construct a commercial-bank balance-sheet expansion sequence.	Correct method, complete interpretation, labelled working and original learner submission.
E9.4	Map the monetary-policy transmission mechanism.	Correct method, complete interpretation, labelled working and original learner submission.
E9.5	Evaluate a dated central-bank decision using verified official evidence.	Correct method, complete interpretation, labelled working and original learner submission.

Mastery checklist

Check	Marked
I can classify payment instruments by monetary function and underlying claim..	
I can calculate simple and currency-leakage multipliers with assumptions..	
I can construct a commercial-bank balance-sheet expansion sequence..	
I can map the monetary-policy transmission mechanism..	
I can evaluate a dated central-bank decision using verified official evidence..	
Progression rule: Complete E9.1-E9.5 before the section quiz. A score below 70% triggers targeted remediation.	

References and version

KASNEB. *Certified Public Accountants (CPA) Revised Syllabus, June 2024*, Paper No. 4: Economics. Version 1.0, revised 18 October 2026. This is original DatalytlQs Academy instructional content.

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