Contents

People keep their surplus money in banks. Out of this money, banks give loans to the needy. Thus, banks are important and essential institutions in any modern society. They act as intermediaries between savers and borrowers. In this chapter, we shall discuss the process of money creation by commercial banks.

There exists a supreme institution which is called central bank. It issues currency, acts as banker of the government and of other banks, and controls supply of money and credit to maintain economic stability in the country. We shall also describe the main functions of a central bank.

1. Commercial Banks

1.1 Meaning of Commercial Bank

A commercial bank is a financial institution which accepts deposits from the public and gives loans for purposes of consumption and investment.

"A Banking Company is one which transacts the business of banking which means the accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise and withdrawable by cheque, draft or otherwise."

Banking Companies Act 1949

There are *two* essential functions that a financial institution must perform to become a commercial bank. These are:

(a) Acceptance of demand deposits that have cheque facilities.

(b) Lending

Acceptance of chequable deposits is necessary, but not sufficient condition for a financial institution to become a commercial bank. For example, post-office savings banks are not banks even though they accept chequable deposits from the public. This is because they do not perform the function of lending. In other words, they do not create demand deposits which are a part of money supply. Similarly, lending alone does not make any financial institution a bank. For example, many financial institutions like Life Insurance Corporation of India, Unit Trust of India, etc., give loan but they do not accept chequable deposits from the public. These financial institutions also do not create money and hence cannot be called banks.

1.2 Functions of Commercial Banks

Accepting deposits and lending money are the two primary functions of commercial banks.

(1) Accepting deposits

The primary function of every commercial bank is to accept deposits from the public. They accept deposits from the public. To attract savings, the banks accept mainly three types of deposits:

(a) demand deposits

(b) fixed deposits, and

(c) saving deposits

(a) **Demand deposits :** *Demand deposits (also known as current account deposits) are those deposits which are repayable by banks on demand.* These are chequable deposits. These can be withdrawn by any number of times. No interest is paid on such deposits. These deposits are made by businessmen to carry out their day to day transactions.

(b) **Fixed deposits (or Time deposits) :** *Fixed deposits are those deposits which can be withdrawn only after the expiry of certain fixed period, say a few months or a few years.* Fixed deposits are maintained both by firms and households. The rate of interest offered on such deposits depends on the time period. **The longer the period, the higher will be the interest rate.** No cheque facility is available on these deposits.

(c) **Saving account deposits :** Saving account deposits have the features of both demand deposits and saving deposits. Cheque facility is provided to the depositors. But some restrictions are imposed on number and amount of withdrawals. Hence, banks offer interest on these accounts but less than that on fixed deposits.

It should be noted that current deposits and some proportion of saving deposits are called chequable deposits (or demand deposits) whereas fixed deposits are non-chequable.

Demand deposits can be distinguished from time deposits as under :

Basis	Demand Deposits	Time Deposits
1. **Payable**	They are payable on demand.	These are deposits for a fixed period of time.

2. **Interest on deposits**	No interest is given on these deposits.	High rate of interest is given on such deposits.
3. **Restrictions on withdrawal**	There is no restriction on their withdrawals and deposits.	There are restrictions on their withdrawals. Money is paid on maturity.
4. **Cheque Facility**	They can be withdrawn by cheques.	They are not chequable deposits.
5. **Medium of Exchange**	They are used as medium of exchange.	They can not be used as medium of exchange.

(2) Advancing loans

Giving loans is another primary function of the commercial banks. They advance loans and earn interest income. Banks give loans mostly for productive purposes against collateral securities. The amount of loan is generally less than the value of the security offered. Banks advance following types of loans:

(a) **Cash credit :** Under this loan, a credit limit is sanctioned by the bank. The borrower may withdraw any amount within this sanctioned limit. The borrower is charged interest only on the amount of money that has been actually drawn and not on the amount that has been sanctioned.

(b) **Demand loans :** Demand loans refer to those loans which can be recalled on demand by the bank at any time. The entire sum of demand loan is credited to the borrower's account and interest is payable on the entire amount.

(c) **Short term loans :** They are given as personal loans against some collateral security. The money is credited to the account of borrower and the borrower can withdraw money from his account and interest is payable on the entire amount of loan granted.

1.3 Money (or Credit) Creation by Commercial Banks

Money creation is one of the most important functions of commercial banks. Commercial banks are an important source of money supply in an economy. They add to money supply by creating demand deposits. Money creation is the process of expansion of credit through derivative deposits. It is also known as 'Deposit creation' and 'Credit creation'.

Money creation by banks is determined by :

(i) The amount of initial deposits or primary deposits

(ii) The Legal Reserve Ratio (LRR)
LRR is the minimum ratio of deposits legally required by the commercial bank to be kept as cash.

Process of money (credit) creation

The process of money creation by banks can be illustrated with the help of an example. Suppose that all banks receive initial cash deposits of ₹ 1,000 and LRR is 10%. It means banks are required to keep only 10% of deposits (i.e., ₹ 100) and lend the remaining amount of ₹ 900. Banks do not give loans in cash rather open an account in the borrower's name and deposit the loan amount in his account. The borrower is free to withdraw the amount as and when they wish.

This kind of deposit is called **secondary deposit or derivative deposit**. Derivative deposit is the creation of loan. Suppose, borrowers withdraw the entire amount of loan and spend it for making payments of goods and services received. The sellers of these goods and services receive ₹ 900 as revenue and deposit the same in their respective banks. It will increase the demand deposits of banks by ₹ 900. They keep 10% of these new deposits i.e.,₹ 90 as cash reserve and lend the remaining amount of ₹ 810. The borrowers will again use their loans for making payments which again comes back into the accounts of those who have received these payments. Banks again will keep 10% of ₹ 810 and lend the remaining amount of ₹ 729 (810 - 81). Like this in each successive round creation of deposits will be 90% of previous round. In each round, increase in deposits becomes smaller and smaller till it becomes almost zero. The total deposits will ultimately be of ₹ 10,000 which is 10 times the initial deposits of ₹ 1,000. The working of the process of money creation has been shown in the following table :

Process of Money (credit) Creation

Round	**Deposits (₹)**	**Cash Reserves (LRR = 10%) (₹)**	**Loans (₹)**
Initial Deposits	1000	100	900
First Round	900	90	810
Second Round	810	81	729
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Total	10,000	1,000	9,000

From the example, we observe that the initial cash deposits were just ₹ 1000. Banks are able to create total deposits of 10,000 which are 10 times of the initial deposits. Ten times is nothing but the value of money multiplier. The supply of money in the economy is increased by ₹ 10,000 in form of demand deposits.

$$\text{Money (or credit) Multiplier} = \frac{1}{LRR} = \frac{1}{.10} = 10$$

$$\text{Total demand deposits} = \text{Money Multiplier} \times \text{Cash Reserves}$$

$$= 10 \times 1000 = ₹\ 10{,}000$$

Here, LRR refers to the cash reserves of banks.

Assumptions

The process of credit creation is based on the following two assumptions.

(i) All the depositors do not approach the banks for withdrawal of cash at the same time and also they do not withdraw their entire amount.

(ii) All receipts and payments in the economy are made through banks. In other words, all receipts are deposited in banks and all payments are made through cheques .

Limitations

Following are the important limitations on the part of commercial bank to create credit :

(i) **Amount of cash :** Commercial banks create credit on the basis of total amount of cash in the country. Hence, there should be the larger availability of cash. But the amount of cash that a bank may have is subject to control by central bank.

(ii) **Currency deposit ratio :** The creation of credit by commercial banks also depends upon the ratio of currency held by public to their holdings of bank deposits $\left(\frac{C}{DD}\right)$. This is called currency deposit ratio (CDR). Higher the CDR lower will be the power of banks to create credit.

(iii) **Legal reserve ratio :** Another important limitation is the legal reserve ratio. As the credit potential is inversely related to the reserve ratio, the higher the legal reserve ratio, the lower will be the proportion of excess funds and lesser is the quantum of money (credit) creation.

2. Central Bank

2.1 Meaning of Central Bank

Central bank is an apex (supreme) institution in the banking and financial structure of a country. It is the leader of the money market. It supervises, regulates and controls the whole banking and financial system. It is called central bank because it occupies a central position in the monetary and banking structure of the country.

"Central bank is an apex bank of the monetary and banking structure of a country. It controls the supply of money and credit in the country".

Almost all the countries in the world have their central banks. Reserve Bank of India is the central bank of India which was established on April 1, 1935. The Bank of England was the first to function as a central bank in 1844. Federal Reserve System operates as the Central Bank of USA.

2.2 Distinction Between a Central Bank and Commercial Banks

There are certain basic differences between a central bank and commercial banks. They are as follows :

Basis	Central Bank	Commercial Banks
1. Nature	Central bank is a supreme institution of the monetary and banking structure of the country.	Commercial banks deal in money and credit for the purpose of earning profit.
2. Object	It acts in the public interest.	Their main objective is to earn profits.
3. Note-Issue	It has sole monopoly over note-issue.	Commercial banks have no legal power to issue notes.

4. Ownership	It is generally a government owned institution.	Commercial banks may operate both in private as well as public sectors.
5. Number	There is only one central bank in a country.	There are a number of commercial banks in every country.
6. Banker	It is a banker of the government. It is also the banker of the commercial banks. It does not directly deal with the public.	Commercial banks directly deal with the public.

2.3 Functions of a Central Bank

A central bank performs a number of important functions in every economy. The major functions of a central bank are discussed below :

1. **Issue of currency :** The central bank enjoys the sole legal right to issue currency notes. The currency so created is called **'high powered money'.** That is why it is called **'Bank of Issue'**. These notes circulate throughout the country as legal tender money. Like any other central bank, the RBI has the sole right to issue currency notes.

Following are the main reasons for giving the monopoly right of note-issue to the central bank.

(i) It brings about uniformity in note circulation.
(ii) It is easier to control credit when there is a single agency of note issue.
(iii) It keeps the public faith in the paper currency.
(iv) It helps in the stabilisation of the internal and external value of the currency.

2. **Banker, Agent and Advisor to the Government** : Central bank everywhere in the world acts as banker, agent and advisor to the government.

(a) **Banker**

- As a banker to the government, it manages the banking accounts of government departments.
- It performs the same banking functions for the government as commercial bank performs for its customers. It accepts deposits and makes payment for the government.
- It also gives short period loans to the government.

(b) **Agent**

- As an agent to the government, it buys and sells securities, treasury bills on behalf of the government.
- It also manages public debt.

(c) **Advisor**

- Central bank gives advice to the government on economic and financial matters such as deficit financing, devaluation of currency, foreign trade policy, foreign exchange policy etc.

3. **Banker to the Banks :** The central bank has the same relationship with the commercial banks as the latter has with the general public.

(i) Commercial banks are required to keep a part of their deposits with the central bank in the form of cash. The central bank is the **custodian of the cash reserves of the commercial banks.**

(ii) The central bank uses these reserves to meet the cash requirements of individual commercial banks.

(iii) The central bank supervises, regulates and controls the commercial banks. The supervision of banks may be related to their licensing, branch expansion, management, amalgamation (merging of banks) and liquidation (the winding up of banks).

4. **Lender of the Last Resort :** The central bank acts as a lender of the last resort. When a commercial bank fails to meet the obligations of its depositors from all its sources, it can finally approach the central bank. The central bank comes to its rescue and gives loans as lender of the last resort. Central bank gives loans to these banks against the approved securities and bills of exchange. However, commercial banks are supposed to approach other sources first like the call money market and should then only approach the Central bank. That is why, central bank is called the lender of the last resort.

5. **Clearing House Function :** As the custodian of the cash reserves of the commercial banks, the central bank acts as the clearing house for these banks. Since all banks have their accounts with the central bank, the central bank can easily settle the claims of various banks against each other simply by book entries of transfers from and to their accounts. This method of settling accounts is called clearing house function of the central bank. The significance of this function is that it economises the use of money in the banking operations.

6. **Custodian of Nation's Foreign Exchange Reserves :** Central bank is the custodian of nation's foreign exchange reserves. The central bank maintains foreign exchange reserves in order to promote international trade and stabilise exchange rate.