Commercial Bank & Credit Creati

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B.A. Part - I
(Hons.)

Commercial Bank

- The Financial Institutions which accepts deposit from the general public and offer loans for the purpose of consumption and investment are commercial bank e.g.SBI, UBI,PNB etc.
- the commercial bank have not authority to issue currency but they supply money as the create money by the way of demand deposit.

Money Creation: The commercial banks create money as follows:

- Bank receive cash deposits from the people. These deposits are called primary deposit.
- Bank lend money.
- The money is lent in the form of credit entry in the account of borrowers. This is called secondary deposits.
- They have demand deposit (primary deposit + secondary deposit)of the people.
- They keep a fix percent of demand deposit as cash reserve for. withdrawals.
- All demand deposits serve as money supply in the economy.

Example:

- how is money created if there is a single banking system in the economy and Bank receive deposits of Re. 1000 and the CRR is 10%.

  The money will created as follows:-

Round	Deposits (Receive)	Loans (Rs)	Cash Reserves (Rs) (CRR=10%)
1st	1000	900	100
2nd	900	810	90
3rd	810	729	81

(and so on till all excess reserves are exhausted)

Total	10,000	9,000	1,000

- This process continues till total Demand Deposits are Rs. 1000 and cash reserve ,Rs.1000

- As per above example if CRR is 10% and initial deposit is Rs.1000 .Then the Demand Deposits will be-
- Demand Deposits= 1\CRR x Cash reserve
- = 1\10% x 1000.
- = 100\10 x 1000.
- =10,000.
- money creation by commercial bank depends on

1. Cash balance with commercial bank which they can use as cushion money Higher Cash Balance, greater the money creation and vice versa
2. Higher the CRR, Lower the capacity to create money.

Credit Multiplier

- In India,CRR is determined not by commercial bank themselves but by the RBI.Therefore it is also called LRR(Legal Reserve Ratio).
- Once the CRR is known , we can find out " Credit Multiplier"
- K = 1 \ CRR. (k = Credit Multiplier)
- If CRR = 10% then
- K = 1 \ 10 = 100 \ 10 = 10
- Thus the credit multiplier is 10. Hence , Money creation is 10 times of cash reserve.

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