

# Credit creation

Literature, Russian Literature



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CREATION AND MONEY SUPPLY PROJECT SUBMITTED TO PROF. RASHMI

CREDIT CREATION Credit creation is one of the important functions of a commercial bank. It constitutes the major component of money supply in the economy commercial banks differs from other financial institutions in this aspect. Other financial institutions transfer money from the lenders to the borrowers. Commercial banks while performing the same function, they create credit or bank money also. Professor Sayers says, " Banks are not merely purveyors of money, but in an important sense, they are the manufacturers of money".

The process of credit creation occurs when banks accepts deposits and provide loans and advances. When the customers deposit money with the bank, they are called primary deposits. This money will not be withdrawn immediately by them. Hence banks keeps a certain amount of deposits as reserves which is known as cash reserve ratio and provide the balance amount as loans and advances. Thus, every deposit creates a loan.

Commercial banks give loans and advances against some security to the public. But the bank does not give the loan amount directly. It opens an account in the name of the borrower and deposits the amount in that account.

Thus, every loan creates a deposit. The loan amount can be withdrawn by means of checks. They create deposits while lending money also. These deposits created by banks with the help of primary deposits are called derivative deposits. Customers use these loans to make payments. While paying they issue a checks against these deposits. The person who receives

the checks, deposit it in another bank. For that bank, this will be the primary deposit. A part of the deposit will be kept as a reserve and the balance will be used for giving loans and advances. This process is repeated by other banks.

When all the banks involve in this process, it is called Multiple Credit Creation. This can be explained with an example. Suppose, if a person deposits Rs. 1, 000/- in a bank. Rs. 1000/- is the primary deposit. The minimum cash reserves ratio is 10% to meet the demand of its depositors. Now the bank can lend out Rs. 900/- i. e. Primary deposit - Cash reserve = Derivative deposit. Rs. 1, 000 - Rs. 100 = Rs. 900 (10% of 1000 is Rs. 100) The bank will give the amount to his creditor only in his account which is opened in his name. The borrower can deposit the amount with the bank.

The bank can lend out Rs. 810/- out of Rs. 900/-, which has come back to the bank in the second round as primary deposits. This process will continue and if there is no cash leakage the credit creation would be processed as in the below figure: [pic] This process can be explained with a formula. Total credit created = Original deposit x Credit multiplier co-efficient. Credit multiplier co-efficient =  $1/\text{CRR} \times 1/10\% = 1/10/100 = 10$  Total Credit created =  $1000 \times 10 = 10000$  If CRR rises to 20%, the credit created will be  $1/20/100 = 100/20 = 5$  So  $1000 \times 5 = \text{Rs. } 5000/-$

It is clear, that the amount of credit created depends upon the cash reserve ratio. Higher the CRR, lesser will be the credit created and vice versa.

Limitations: ? Credit creation depends upon the amount of deposits. ? There exists an inverse relation between credit creation and cash reserve ratio.

During inflation the CRR will be high to reduce credit. ? Banking habits of the people are well developed; it will lead to expansion of credit. ? Loans are sanctioned by banks against some security. If enough securities are available, then credit creation will be more and vice versa. If all commercial banks, follows a uniform policy regarding CRR, this credit creation would be smooth. ? If the liquidity preference of the people is high, the credit creation will be less and vice versa. ? If business conditions are bright then demand for credit will be more. ? Customers should be willing to borrow from the banks to facilitate credit creation. ? Credit control policy of the Central Bank, for example during the depression, the RBI encourages the commercial banks to expand credit. CONCLUSION:- To conclude, we can say that credit creation by banks is one of the important & only sources to generate income.

And when the reserve requirement increased by the central bank it would directly affect on the credit creation by bank because then the lendable funds with the bank decreases and vice versa. MONEY SUPPLY The total supply of money in circulation in a given country's economy at a given time. There are several measures for the money supply, such as M1, M2, and M3. The money supply is considered an important instrument for controlling inflation by those economists who say that growth in money supply will only lead to inflation if money demand is stable.

In order to control the money supply, regulators have to decide which particular measure of the money supply to target. The broader the targeted measure, the more difficult it will be to control that particular target. However, targeting an unsuitable narrow money supply measure may lead to

a situation where the total money supply in the country is not adequately controlled. In economics, money supply or money stock is the total amount of money available in an economy at a particular point in time.

There are several ways to define " money," but standard measures usually include currency in circulation and demand deposits. Money supply data are recorded and published, usually by the government or the central bank of the country. Public and private-sector analysts have long monitored changes in money supply because of its possible effects on the price level, inflation and the business cycle. That relation between money and prices is historically associated with the quantity theory of money. There is strong empirical evidence of a direct relation between long-term price inflation and money-supply growth.

These underlie the current reliance on monetary policy as a means of controlling inflation. This causal chain is however contentious, with some heterodox economists arguing that the money supply is endogenous and that the sources of inflation must be found in the distributional structure of the economy. Purpose: Money supply data is recorded and published in order to monitor the growth of the money supply. Public- and private-sector analysts have long monitored this growth because of the effects that it is believed to have on real economic activity and on the price level.

The money supply is considered an important instrument for controlling inflation by economists who say that growth in money supply will only lead to inflation if money demand is stable. Convention: Because (in principle) money is anything that can be used in settlement of a debt, there are

varying measures of money supply. Since most modern economic systems are regulated by governments through monetary policy, the supply of money is broken down into types of money based on how much of an effect monetary policy can have on that type of money.

Narrow money is the type of money that is more easily affected by monetary policy whereas broad money is more difficult to affect through monetary policy. Narrow money exists in smaller quantities while broad money exists in much larger quantities. Each type of money can be classified by placing it along a spectrum between narrow (easily affected) and broad (difficult to affect) money. The different types of money are typically classified as M's. The number of M's usually range from M0 (most narrow) to M3 (broadest) but which M's are actually used depends on the system.

The typical layout for each of the M's is as follows:

- M0: Physical currency. A measure of the money supply which combines any liquid or cash assets held within a central bank and the amount of physical currency circulating in the economy. M0 (M-zero) is the most liquid measure of the money supply. It only includes cash or assets that could quickly be converted into currency. This measure is known as narrow money because it is the smallest measure of the money supply.
- M1: M0 + demand deposits, which are checking accounts.

This is used as a measurement for economists trying to quantify the amount of money in circulation. The M1 is a very liquid measure of the money supply, as it contains cash and assets that can quickly be converted to currency.

- M2: M1 + small time deposits (less than \$100, 000), savings

deposits, and non-institutional money-market funds. M2 is a broader classification of money than M1. Economists use M2 when looking to quantify the amount of money in circulation and trying to explain different economic monetary conditions. M2 is key economic indicator used to forecast inflation.

M3: M2 + all large time deposits, institutional money-market funds, short-term repurchase agreements, along with other larger liquid assets. The broadest measure of money; it is used by economists to estimate the entire supply of money within an economy.

Fractional-reserve banking: The different forms of money in government money supply statistics arise from the practice of fractional-reserve banking. Whenever a bank gives out a loan in a fractional-reserve banking system, a new type of money is created. This new type of money is what makes up the non-M0 components in the M1-M3 statistics.

In short, there are two types of money in a fractional-reserve banking system: central bank money (physical currency) commercial bank money (money created through loans) - sometimes referred to as checkbook money. In the money supply statistics, central bank money is M0 while the commercial bank money is divided up into the M1-M3 components.

Generally, the types of commercial bank money that tend to be valued at lower amounts are classified in the narrow category of M1 while the types of commercial bank money that tend to exist in larger amounts are categorized in M2 and M3, with M3 having the largest.

The Reserve Bank of India defines the monetary aggregates as:

- Reserve Money (M0): Currency in circulation + Bankers' deposits with the RBI + '

Other' deposits with the RBI = Net RBI credit to the Government + RBI credit to the commercial sector + RBI's claims on banks + RBI's net foreign assets + Government's currency liabilities to the public - RBI's net non-monetary liabilities.

- M1: Currency with the public + Deposit money of the public (Demand deposits with the banking system + ' Other' deposits with the RBI).
- M2: M1 + Savings deposits with Post office savings banks.
- M3: M1+ Time deposits with the banking system = Net bank credit to the Government + Bank credit to the commercial sector + Net foreign exchange assets of the banking sector + Government's currency liabilities to the public - Net non-monetary liabilities of the banking sector (Other than Time Deposits).
- M4: M3 + All deposits with post office savings banks (excluding National Savings Certificates).

[pic] Link with inflation: Monetary exchange equation: Money supply is important because it is linked to inflation by the " monetary exchange equation":

$MV = PQ$

- M is the total dollars in the nation's money supply
- V is the number of times per year each dollar is spent
- P is the average price of all the goods and services sold during the year
- Q is the quantity of goods and services sold during the year where:
- velocity = the number of times per year that money turns over in transactions for goods and services (if it is a number it is always simply nominal GDP / money supply)
- nominal GDP = real Gross Domestic Product ? GDP deflator
- GDP deflator = measure of inflation.

Money supply may be less than or greater than the demand of money in the economy In other words, if the money supply grows faster than real GDP



growth (described as "unproductive debt expansion"), inflation is likely to follow ("inflation is always and everywhere a monetary phenomenon"). This statement must be qualified slightly, due to changes in velocity. While the monetarists presume that velocity is relatively stable, in fact velocity exhibits variability at business-cycle frequencies, so that the velocity equation is not particularly useful as a short run tool.

Moreover, in the US, velocity has grown at an average of slightly more than 1% a year between 1959 and 2005 (which is to be expected due to the increase in population, unless money supply grows very rapidly). Another aspect of money supply growth that has come under discussion since the collapse of the housing bubble in 2007 is the notion of "asset classes." Economists have noted that M3 growth may not affect all assets equally. For example, following the stock market run up and then decline in 2001, home prices began an historically unusual climb that then dropped sharply in 2007.

The dilemma for the Federal Reserve in regulating the money supply is that lowering interest rates to slow price declines in one asset class, e. g. real estate, may cause prices in other asset classes to rise, e. g. commodities.

Percentage: In terms of percentage changes (to a small approximation, the percentage change in a product, say  $XY$  is equal to the sum of the percentage changes  $\%X + \%Y$ ). So:  $\%P + \%Y = \%M + \%V$  That equation rearranged gives the "basic inflation identity":  $\%P = \%M + \%V - \%Y$  Inflation ( $\%P$ ) is equal to the rate of money growth ( $\%M$ ), plus the change in velocity ( $\%V$ ), minus the rate of output growth ( $\%Y$ ).

Bank reserves at central bank When a central bank is "easing", it triggers an increase in money supply by purchasing government securities on the open market thus increasing available funds for private banks to loan through fractional-reserve banking (the issue of new money through loans) and thus grows the money supply. When the central bank is "tightening", it slows the process of private bank issue by selling securities on the open market and pulling money (that could be loaned) out of the private banking sector.

It reduces or increases the supply of short term government debt, and inversely increases or reduces the supply of lending funds and thereby the ability of private banks to issue new money through debt. Note that while the terms "easing" and "tightening" are commonly used to describe the central bank's stated interest rate policy, a central bank has the ability to influence the money supply in a much more direct fashion. Conclusion: Assuming that prices do not instantly adjust to equate supply and demand, one of the principal jobs of central banks is to ensure that aggregate (or overall) demand matches the potential supply of an economy. Central banks can do this because overall demand can be controlled by the money supply. By putting more money into circulation, the central bank can stimulate demand. By taking money out of circulation, the central bank can reduce demand. For instance, if there is an overall shortfall of demand relative to supply (that is, a given economy can potentially produce more goods than consumers wish to buy) then some resources in the economy will be unemployed (i. e., there will be a recession). In this case the central bank can stimulate demand by increasing the money supply. In theory the extra demand will then lead to job creation for the unemployed resources (people, machines, land), leading

back to full employment (more precisely, back to the natural rate of unemployment, which is basically determined by the amount of government regulation and is different in different countries).

However, central banks have a difficult balancing act because, if they put too much money into circulation, demand will outstrip an economy's ability to supply so that, even when all resources are employed, demand still cannot be satisfied. In this case, unemployment will fall back to the natural rate and there will then be competition for the last remaining labor, leading to wage rises and inflation. This can then lead to another recession as the central bank takes money out of circulation (raising interest rates in the process) to try to damp down demand.