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Unit

Commercial Banking and Central Banking

LONG QUESTION ANSWERS

Q. 1. What do you mean by a commercial Bank? Also discuss its types.

Ans. Meaning of Commercial Bank : A commercial bank is that financial institution which accepts deposits from the people and gives loans for the purpose of consumption or investment. Besides, commercial banks these days perform various other functions such as credit creation, transfer of funds, agency jobs and general services.

According to Indian Banking Companies Act, "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, order or otherwise."

Prof. Hart has defined the bank as follows : "A banker is one who in the ordinary course of his business, receives money which he repays by honouring cheques of persons from whom or on whose account he receives it".

According to **Prof. Kinley**, "A bank is an establishment which makes to individuals such advances of money as may be required and safely made, and to which individuals entrust money when not required by them for use."

Types of Banks

The banks are generally classified on the basis of the functions performed by them. Following are the various types of banks :

1. Commercial Banks : The word 'bank' is used in the sense of a commercial bank. A commercial bank performs all

kinds of banking functions such as accepting deposits, advancing loans, credit creation and agency functions. They are also called joint stock banks as they are organised in the same manner as joint stock companies. They generally advance short-term loans to their customers, though in some cases they may advance medium-term loans also. The commercial banks in India are state-owned as well as private banks organised as joint-stock companies.

2. Industrial Banks : The industrial banks extend long-term loans to industries. In fact, long-term finance is their speciality. In addition, they also help industrial firms to sell their debentures and shares. Sometimes, they even underwrite the debentures and shares of big industrial concerns.

The industrial banks specialize in giving long-term loans to industries. As is well known, the commercial banks in view of their short-term deposits, are not in a position to extend long-term loans to industries. Ordinarily, the industrial banks perform three main functions:

(i) *Acceptance of long-term deposits.* Since the industrial banks give long-term loans, they cannot accept short-term deposits from the public.

(ii) *Meeting the credit requirements of industries.* The credit requirements of industries are of two types. *Firstly,* the industries require capital to purchase land to erect buildings and purchase heavy machinery. To meet these requirements, the industries need long-term loans. *Secondly,* the industries require short- term loans to buy raw materials and to make payment of wages to the workers. The short-term loan can be given to industries even by the commercial banks, but for long-term loans the industries depend upon the industrial banks alone.

(iii) *Other functions.* The industrial banks tender advice to big industrial firms regarding the sale and purchase of shares and debentures.

3. Agricultural Banks : The commercial and the industrial banks are not in a position to meet the credit requirements of agriculture. Hence, there arises the need for setting up special types of banks to finance agriculture. The credit requirements of the farmers are of two types. *Firstly,* the farmers require short-term loans to buy seeds, fertilizers, ploughs and other inputs. *Secondly,* the farmers require long-term loans to purchase land, to effect permanent improvements on the land to buy equipment and to provide for irrigation works. There are two types of agricultural banks: (i) Agricultural Cooperative Banks, and (ii) Land Mortgage Banks. (known as Land Development Banks in India) The former provide short-term credit, while the latter extend long-term loans to the farmers.

Both the types of banks have been set up as cooperative banks in India. Different segments of the cooperative banking sector address specific credit needs of diverse sections of the population, both in terms of location as well as tenor.

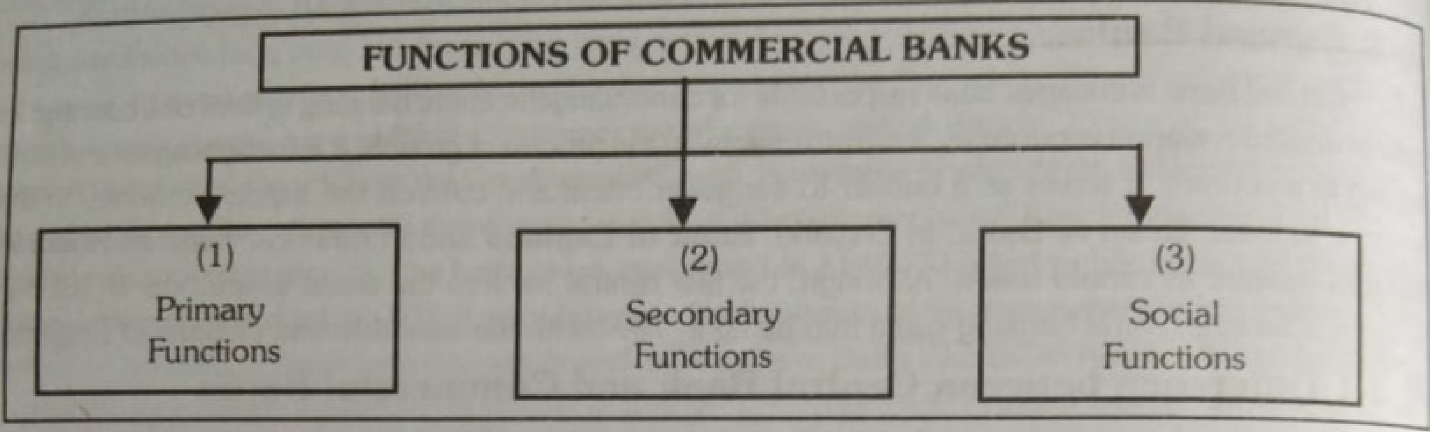
4. Foreign Exchange Banks : These are special types of banks which specialize in financing foreign trade. Their main function is to make international payments through the purchase and sale of exchange bills. As is well known, the exporters of a country prefer to receive the payment for exports in their own currency. Hence, there arises the problem of converting the currency of one country into the currency of another. The foreign exchange banks try to solve this problem. In other words, they convert home currency into foreign currency and *vice versa.* It is on this account that these banks have to keep with themselves stock of the currencies of various countries. Along with that, they have to open branches in foreign countries to carry on their business.

5. Indigenous Banks : According to *Indian Banking Enquiry Committee,* "Indigenous banker is a person or a firm which accepts deposits, transacts business in hundies and advances loans etc. They are known as mahajan, sahukar or saraf in India.

6. Central Bank : Every country in the world has a central bank which occupies a pivotal position in the monetary and banking structure of the country. It is the indisputed leader of the money market.

4. Functions of Commercial Banks

Functions of commercial banks can be divided into three parts :



4.1 Primary Functions

Commercial Banks perform two primary functions : (1) Accepting of Deposits and (2) Advancing of Loans.

(1) Accepting of Deposits

A bank accepts deposits from the public. People can deposit their cash balances in either of the following accounts as per their convenience:

(i) Fixed or Time Deposit Account: Cash is deposited in this account for a fixed period. The depositor gets receipts for the amount deposited. It is called Fixed Deposit Receipt. It comprises the name of the depositor, amount of the deposit, rate of interest and the period of deposit. This receipt is not transferable. If the depositor stands in need of the amount before the expiry of the fixed period, he can withdraw the same after paying the discount to the bank. This type of deposit attracts high rate of interest. Longer the period of deposit higher is the rate of interest. It is so because bank can use this amount for a longer period. It is also called *Time Liability of the bank.*

(ii) Current or Demand Deposit Account: A depositor can deposit his funds any number of times he likes and can also withdraw the same any number of times he wishes. Ordinarily, businessmen deposit their funds in this account. Generally, no interest is paid by the bank on the demand deposit account. Rather the bank demands some charges from the depositors if the amount lying in the account falls below the minimum limit. The amount from this account is withdrawn through cheques. This type of account is also called *Demand Liability*. In America, it is called *Chequing Account.*

(iii) Saving Deposit Account: This account is meant for encouraging small savings. Restrictions are imposed by the bank on the amount to be withdrawn by the depositor. If the latter wants to withdraw more money than is allowed then he has to give prior notice to the bank. Bank pays interest on this account although its rate is less than the rate of interest paid on fixed account.

(iv) Home Safe Saving Account: This account has been introduced recently by the banks. A small portable safe is provided to the depositor at his place. Key of the safe is kept by Bank. Depositor puts his small savings in it as convenient to him and after sometime hands the same over to bank and gets it entered in his account. Many banks collect the saved amount by deputing an agent to the place of the depositor. Interest paid on this account is less than the one paid on saving account.

on Post office Saving

(v) Recurring Deposit Account: Under this account a specified amount is deposited every month for a specific period, say, 12, 24, 36 or 60 months. This amount cannot be withdrawn before the expiry of the given period except under exceptional circumstances. Interest on the amount deposited is also credited to the account of the depositor. Like time-deposit account, interest paid on this account is higher than other accounts.

(2) Advancing of Loans

Another primary function of the commercial banks is to advance loans. A certain part of the cash received by the banks as deposits is kept in the reserve and the rest is given as loan. Banks advance loans mostly for productive purposes, on approved security. The amount of loan is generally less than the value of the security. Banks advance following types of loans:

(i) Cash Credit: The debtor is allowed to withdraw a certain amount on a given security. The debtor withdraws the amount within this limit, as per his requirement and also repays it. Interest is charged by the bank on the amount actually withdrawn.

(ii) Over-Draft: Clients who have current account with the bank get the sanction to withdraw more money than is lying in the said account. It is called over draft. This facility is available for short-term to reliable persons. Supposing a person has Rs. 10,000 lying in current account. If the bank allows him to issue cheques upto Rs. 12,000, then the amount of Rs. 2,000 will be called over- draft.

(iii) Loans and Advances: These loans are given in the form of a fixed amount. Bank enters the amount of loan in the account books of the debtor. The latter can withdraw it any time. The interest is chargeable on the whole amount from the day the loan is sanctioned irrespective of the fact that the debtor withdraws the whole amount or part of it.

(iv) Discounting of the Bill of Exchange: It is another method of giving advance by the banks. Under this method, banks give advance to their clients on the basis of their bills of exchange before the maturity of such bills. A deduction is made out of the face value of the bill for the period the bill is yet to run. This deduction is called discounting of the bill. The banks discount only the trade bills. The bills are discounted at the market rate of interest. On the expiry of the maturity period, the amount mentioned in the bill is collected from the party concerned by the bank.

(v) Investment in Government Securities: Purchasing of government securities by the banks tantamounts to advancing loans by them to the government. Banks prefer to buy government securities as these are considered to be the safest investment.

(3) Credit Creation: One of the main functions of banks these days is to create credit. Banks create credit by giving more loans than their primary deposits.

4.2 Secondary Functions

Besides the above primary functions, banks also perform many secondary functions such as agency functions, general utility and social functions.

(1) Agency Functions

Banks act as agents to their customers in different ways:

(i) Collection and Payment of Various Items: Banks collect cheques, rent, interest etc. on behalf of their customers and also make payment of taxes, insurance premia etc. on their behalf.

(ii) Purchase and Sale of Securities: Banks normally are more knowledgeable with regard to stock and share business. As such they buy, sell and keep in safe custody, the securities on behalf of their customers.

(iii) Trustee and Executor: Banks also act as trustees and executors of the property of their customers on their advice.

(iv) Remitting of Money: Banks also remit money from one place to the other through bank drafts.

(v) Purchase and Sale of Foreign Exchange: Banks buy and sell foreign exchange and thus promote international trade. This function is mainly discharged by Foreign Exchange Banks.

(vi) Letter of References: Banks also give information about economic position of their customers to domestic and foreign traders and likewise provide information about economic position of domestic and foreign traders to their customers.

(2) General Utility Services

Commercial banks also provide certain services of general utility to the society:

(i) Locker Facilities: Banks provide locker facilities to their customers. People can keep their gold or silver jewellery or other important documents in these lockers. Their annual rent is very nominal.

(ii) Traveller's Cheque and Letters of Credit: Banks issue traveller's cheque and letters of credit to their customers so that they may be spared from the risk of carrying cash during their journey.

(iii) Business Information and Statistics: Being familiar with the economic situation of the country, the banks give advice to their customers on financial matters on the basis of business information and statistical data collected by them.

(iv) Help in Transportation of Goods: Big businessmen or industrialists after consigning goods to their retailers send the Railway Receipt (Consignment Note) to the bank. The retailers get this Receipt from the bank on payment of the value of the consignment to it. Having obtained the Railway Receipt from the bank they get delivery of the consignment from the Railway Goods Office. In this way banks help in the transportation of goods from the production centres to the consumption centres.

4.3 Social Functions

In modern times, banks also perform following significant functions relating to economic development and social welfare of the country:

(1) Banks collect idle savings of the people and invest the same in productive activities. Thus, they help in accelerating the **rate of capital formation.**

(2) Banks are also taking part in capital market. They have been giving long-term advances to industry, agriculture, small-scale industry, traders, transporters etc. They also finance export trade.

(3) Banks give **loans to weaker sections of the society** on low rate of interest. Small artisans, landless agricultural labourers and poor classes get cheap loans from the banks.

(4) Commercial banks have opened their branches in rural areas and small towns to provide banking facilities to the people living therein.

(5) Since banks do not give loans for speculative and unproductive activities, bank credit can be used **productively.**

(6) Banks also give credit at low rate of interest to finance such programmes as are meant for **rural development** and **removal of unemployment.**

(7) The commercial banks either of their own or through their subsidiaries, perform several financial functions. These include **mutual funds, Merchant banking, Housing Finance, Factory Leasing factoring, Stock Investment** etc.

In short, a modern bank performs several functions which are of great significance to the economic growth of a country. A bank is no longer an institution required to accept deposits and advance loans. It plays a significant role in the economic development and social welfare of a country.

CHAPTER 13

FUNCTIONS OF A CENTRAL BANK

Q. What is a Central Bank ? Explain the functions of a Central Bank.

Ans. Meaning of Central Bank

A Central Bank is said to be the head of the banking and monetary system of a country. Central banks exist almost in every big and small country of the world. It is the central monetary authority and controls the banking system of the country. Central Bank may be considered as a specialised branch of banking which differs from other banks for the distinct functions it performs. Generally, the Central Banks are run and managed by the Government of the respective countries.

Definition of a Central Bank. Presently a Central Bank performs a number of functions for which it is difficult to give a precise definition of Central Bank. Different writers have defined it in different ways embracing one or the other function or functions performed by a Central Bank. Some of the important definitions of Central Bank are as follows :

1. According to **Dr. Dekock,** a central bank is, "A bank which constitutes the apex of the monetary and banking structure of its country and which performs as best as it can, in the national economic interest."

2. **Shaw** says, "The one true but at the same time all sufficing function of a Central Bank is control of credit."

Similarly, many other writers have defined a central bank highlighting the various functions that it performs. For instances, according to **Vera Smith,** it has the monopoly of note-issue and for Hawtrey, Central Bank is the lender of the last resort. However, the definition given by **Dekock** is considered best as it embraces almost all the important functions of central bank. The best thing to understand the meaning of central bank is to study the functions that it performs.

Functions of a Central Bank

The important functions that a central bank performs may be described as follows:

1. Note-Issue. In almost every country the most important function of a central bank is to issue notes or paper money. The central banks has the monopoly of note-issue. No other bank enjoys the privilege of note-issue. Central Bank is empowered to print and circulate currency notes for the sake of uniformity and simplicity. Notes are issued by the central bank on the basis of some rules and regulations that may be different in different countries. In India, Reserve Bank is the central bank and it enjoys the monopoly of note-issue of all denomination except one rupee note which is issued by the Government of India.

2. Control of Credit. Control of credit *i.e.* lending activities of commercial banks, is an important function of the central bank. It directly regulates the supply of legal tender money and controls the supply of bank money or credit money through credit controls. Credit control refers to the regulation of credit creation by the commercial banks. Central bank enjoys certain powers by virtue of which it can take steps to expand or contract credit-creation of the commercial banks. During inflation, efforts are made to contract bank credit. In depression, central bank takes steps so as to expand bank credit.

The need for controlling credit cannot be over-emphasized these days. Credit plays more predominant part in the economic life of a country than money itself, though latter is the basis of the former. If credit is left uncontrolled, it gives rise to business fluctuations. Fluctuations in the volume of credit, cause wide fluctuations in the price level and purchasing power of money, which results in social and economic distress of the people. There is a time when banks may not be prepared to meet the genuine needs of trade and industry for finance and hence the Central Bank must take appropriate measures to stimulate bank advances. Similarly, at other times, the bank may be creating alarmingly more credit and it may also be flowing into undesirable channels. This being the case, the Central Bank must step into control such undesirable tendencies, by regulating and controlling the creation and distribution of credit by banks.

3. Banker to the Government. The Central Bank is also a government Bank. As a government bank, the Central Bank renders all those services to the Government which other banks render to their customers. The Central Bank maintains the account of Government. It makes collections, disbursements and remittances on behalf of the Government. It provides short period loans to meet the current requirements of the Government. It also manages long term finance of the Government by sale of securities. As an agent to the Government, it buys and sells the foreign currencies.

The Central Bank also acts as the financial adviser to the Government. In this capacity, it guides the Government in securing the best possible terms in respect of Treasury Bills and securities. It also renders expert advice on financial problems to the various organs of the Government.

4. Banker's Bank. Central bank is described as banker's bank. It provides banking facilities to the other banks as they serve the people at large. All commercial banks have to deposit their financial liabilities with the central bank and it provides credit and discounting facilities to them. In every country, the Central Bank is empowered to supervise the working of the member banks. For this reason the Central Bank can impose certain obligations on the member banks and thus keep a control on them. These conditions are imposed on the member banks in order to ensure sound banking system.

Every member bank is required to keep a certain percentage of its total liability on deposits with the Central Bank *e.g.*, in U.S.A. the member banks are required by law to keep proportions varying from 13 to 3 per cent of their deposit liabilities with the Federal Bank. In India under the Reserve Bank Act of 1934, the scheduled banks are required to keep a proportion varying from 5 to 2 per cent of their deposit liabilities with the Reserve Bank. The Reserve Bank Act 1934 was subsequently amended in 1956 and the Reserve Bank was now empowered to increase the ratio to 20% of demand liabilities and 8% of time liabilities.

The other obligations imposed on Scheduled bank in India are : (*i*) a bank cannot open new branches without the permission of the Reserve Bank, (*ii*) a bank which is carrying on its functions in more than one state and also has branches in Mumbai and Kolkata must have at least Rs. 10 lakhs as paid-up capital; (*iii*) a bank must keep 20% of its total liabilities in India in the form of cash, gold or sound securities and (*iv*) a bank has to transfer 20% of its profits to the Fund till it is equal to its paid up capital.

5. Lender of the last resort. Wherever a commercial bank is in financial difficulty or on the verge of failure or liquidation, the ultimate source of help is central bank. Central bank saves other banks from failure or liquidation by providing them credit facilities. In this way, central bank is described as the lender of the last resort to other banks in their hour of need.

6. Adviser to the Government. Central bank also acts as adviser to the Government of financial and other related matters. It gives appropriate advice to the government in financial, fiscal, monetary and at large economic matters.

7. Control of public debt. Central bank also controls public debt. It raises public debt *i.e.* borrows from the different sources and general masses on behalf of the Government. It raises loans from the public on behalf of the Government. Central Bank performs the function of management of public debt.

8. Custodian of foreign exchange reserves. A central bank is also described as the custodian of foreign exchange reserves. It keeps reserves of foreign currencies. In India, for instance, Reserve Bank controls the whole reserves of nation's foreign exchange. All foreign exchange is acquired by the Reserve Bank. It allows quotas of foreign exchange to traders for international remittances.

fact, availability of money refers to credit control. There are two methods of credit control:(1) Quantitative Credit Control and (2) Qualitative or Selective Credit Control.

(1) Quantitative Credit Control

Main objective of quantitative credit control is to control the total volume of credit in the country. In other words, those methods whereby the central bank controls the quantity of credit in a country, are called quantitative credit control methods. These include the following methods.

(1) Bank Rate: Bank rate is an important weapon of credit control. Bank rate is that minimum rate of interest at which Central Bank of a country is willing to discount the first-grade securities of other banks or lends on approved securities. Rise in bank rate raises rate of interest and fall in bank rate lowers rate of interest. Weapon of bank rate is used mainly to achieve economic stability. When there is inflation in the country, bank rate is raised. As a result, there is contraction of credit, fall in aggregate demand and hence fall in prices. On the contrary, to check deflation in the country, bank rate is lowered.

(2) Open Market Operations: When the Central Bank of a country, or the government, buys or sells securities in the open market then this operation is called Open Market Operation. If the credit is to be contracted in a country, the Central Bank begins to sell securities in the open market. On the contrary, if the Central Bank wants to expand credit, it begins to buy securities in the open market. In the event of inflation, Central Bank sells securities in the open market . As a result of it, credit is contracted, aggregate demand goes down and prices fall. On the contrary, during depression or falling prices, the Central Bank buys securities as a result of which credit expands, aggregate demand increases and prices rise.

(3) Change in Minimum Reserve Fund: According to this method, all banks are required to keep a given percentage of their total deposits as cash reserve with the Central Bank. If the central bank wants to contract credit, it raises the cash reserve ratio. As result, banks have to keep a larger portion of their deposits with the central bank. They are left with less amounts of deposits. Their power to create credit is curtailed correspondingly. On the other hand, when the central bank wants to expand credit, it lowers the cash reserve ratio. This leaves the banks with more amounts of deposits to create credit.

(4) Change in Liquidity Ratio: Under this method every bank is required to keep a given proportion of its deposits as cash with itself. It is called *"Liquidity Ratio."* When the Central Bank is to contract credit, it raises the liquidity ratio. On the contrary, when the Central Bank is to expand credit, it lowers the liquidity ratio.

(2) Qualitative or Selective Credit Control

It aims at regulating the amount of credit for certain selective purposes. It is therefore called Selective Credit Control. Different forms of qualitative credit control are as under:

(1) Change in Margin Requirements of Loans: Under this method, credit granted for certain specific purposes is controlled. When the central bank feels that the traders are stock-piling certain commodities as a result of which their prices are rising, then the central bank controls credit sanctioned for these goods by changing margin requirement. It means that the margin between the value of the goods pledged as security and the amount of loan is increased. Supposing a person pledges goods worth Rs. 100 as security with a bank and get a loan amounting to Rs. 80. In this example, margin requirement is Rs. 20, or say 20 percent. If the marginal requirement is raised, then the borrower will have to pledge goods of greater value in order to secure loan of a given amount. This way credit is contracted. Supposing, margin requirement is raised to 40 percent. It would mean that bank will now sanction loan amounting to Rs. 60 only against the security of goods worth Rs. 100 only. On the contrary, if the marginal requirement is lowered, there will be an expansion of credit.

(2) Rationing of the Credit: Central Bank is the lender of the last resort in a country. Hence, if it so chooses, it introduces rationing of credit in order to control credit. Rationing of credit can be done in four ways: (i) It can decline loan to any given bank (ii) Central Bank can reduce the amount of loans given to all the banks (iii) Central bank can fix the quota of the credit given to different banks (iv) Central Bank can determine the limit of the credit granted to industry and trade. As a result of credit rationing banks become extra cautious in advancing loans and thus credit is contracted.

(3) Direct Action: Sometimes, Central Bank is obliged to take direct action against other banks. Central Bank does not give any financial accommodation to any bank that does not comply with its instructions. Central bank imposes strict restrictions on the functioning of defaulting banks. Consequently, all the banks have to pursue the same credit control policy as is enunciated by the central bank.

Credit creation — refers to the power of commercial banks to increase deposits either by advancing loans or through investment in securities.

- In this process every loan creates deposits. (secondary

OR

- Credit creation — refers to that power of the banks which enables them to expand their secondary deposits through loans, advances, investments, more than their primary deposits (initial deposits).

- Commercial banks create credit on the basis of their deposits.

- Credit-creation is considered to be the main function of commercial banks.

- creation of deposits will lead to creation of credit

Money Supply and Credit Creation

- Money is said to be created when the banks, through their lending activities, make a net addition to the total supply of money in the economy. Likewise, money is said to be destroyed when the loans are repaid by the borrowers to the banks.

- The creation of credits or deposits is one of the most important functions of commercial banks. Giving of loans by the banks leads to creation of money. ~~While~~

- We must remember that deposits can not be created by one bank alone, but by the banking system as a whole.

The process of Credit Creation

- It is a fact that the banks do not create deposits out of thin air. It means that somebody has to initiate the process.

Suppose, Mr A goes to the bank and deposits Rs 10,000 with it. It must be noted that the banking system can increase its deposits to a "multiple" of the original amount deposited.

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- This is so because banks keep only part of the deposits with them. They can advance the balance as loans to various borrowing customers.

- This is possible only because those who deposit their money with the banks do not normally withdraw it. No doubt, they have the right to withdraw it whenever they want but they do not actually withdraw. So the banks can re-lend their depositor's money to others.

- When a certain amount is deposited with a bank, its assets and liabilities go up simultaneously by an equal amount. This is shown in the following table :-

Banks' Balance sheet

	Liabilities	Assets
Deposits		
Rs 10,000	Rs 10,000	2,000 (cash reserve) 8,000 (Loan) 10,000

Normally, the person who has deposited this money with the bank is not going to withdraw it. If the bank retains the amount with itself, it will be keeping ~~ex~~ "non-earning assets". So it would be better for banks to invest a part of this cash in an "earning assets" (loan). We assume that there is only one type of earning assets that is "loans + advances" to various borrowers.

- Banks can not re-lend the entire Rs 10,000 but only a part of it. Because it must keep some cash in reserve in order to meet its obligation to the original depositor.

- Let us suppose bank keeps 20% cash in reserve and lends the rest. It will make addition to money supply. But at the time of original deposit there was no addition to the money supply. Cash in circulation goes down by Rs 10,000. and Bank's money goes up by an equal amount.

P. 4

- Suppose Bank re-lends Rs 8,000 to another customer, money supply goes up, that is cash in circulation is increased by Rs 8,000. The bank has made up its contribution to credit creation.

- The process is shown in the following table:-

Position of Banks (All Banks)	New Deposits (Rs)	New loans and Investment	Cash Reserve 20%
First Bank	10,000	8000	2000
Second Bank	8,000	6400	1600
Third Bank	6400	5120	1280
Fourth Bank	5120	4096	1024
Fifth Bank	4096	3276.80	819.20
Sixth Bank	3276.80	2621.40	655.40
Seventh Bank	2621.40	2097.20	524.20
Eigth Bank	2097.20	1677.70	419.50
Ninth Bank	1677.70	1324.20	335.50
Tenth Bank	1342.20	1073.70	268.50
- - -	- -	- -	- -
- - -	- -	- -	- -
Total for all	50,000	40,000	10,000

An initiating deposit of Rs 10,000 is made with the banking system. The first stage bank receives this money, keeps Rs 2000 as reserves and lends Rs 8000. The borrowers receive cash and make the payments to their creditors. The creditors deposit it with the second stage banks. This bank will keep Rs 1600 as reserves and lend Rs 6400. This continues over and over again the process of credit-creation by the ~~stage~~ Banking system as a whole.

- Once the process is completed the banking system as a whole presents the following picture. This is "consolidated" "balance-sheet" of all banks.

Total Deposits	Whole Liabilities	Whole Assets
50,000	Rs 50,000	10,000 (cash reserve) 40,000 (loan) 50,000 Rs

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— It may be noted that the initial deposit of Rs 10,000 has now become the cash reserve of all the banks who have created Rs 50,000 of new deposits.

— (multiplier here is 5) But this can be more or less depending upon the cash reserves kept by the banks.

- The general formula for deposits is given below :—

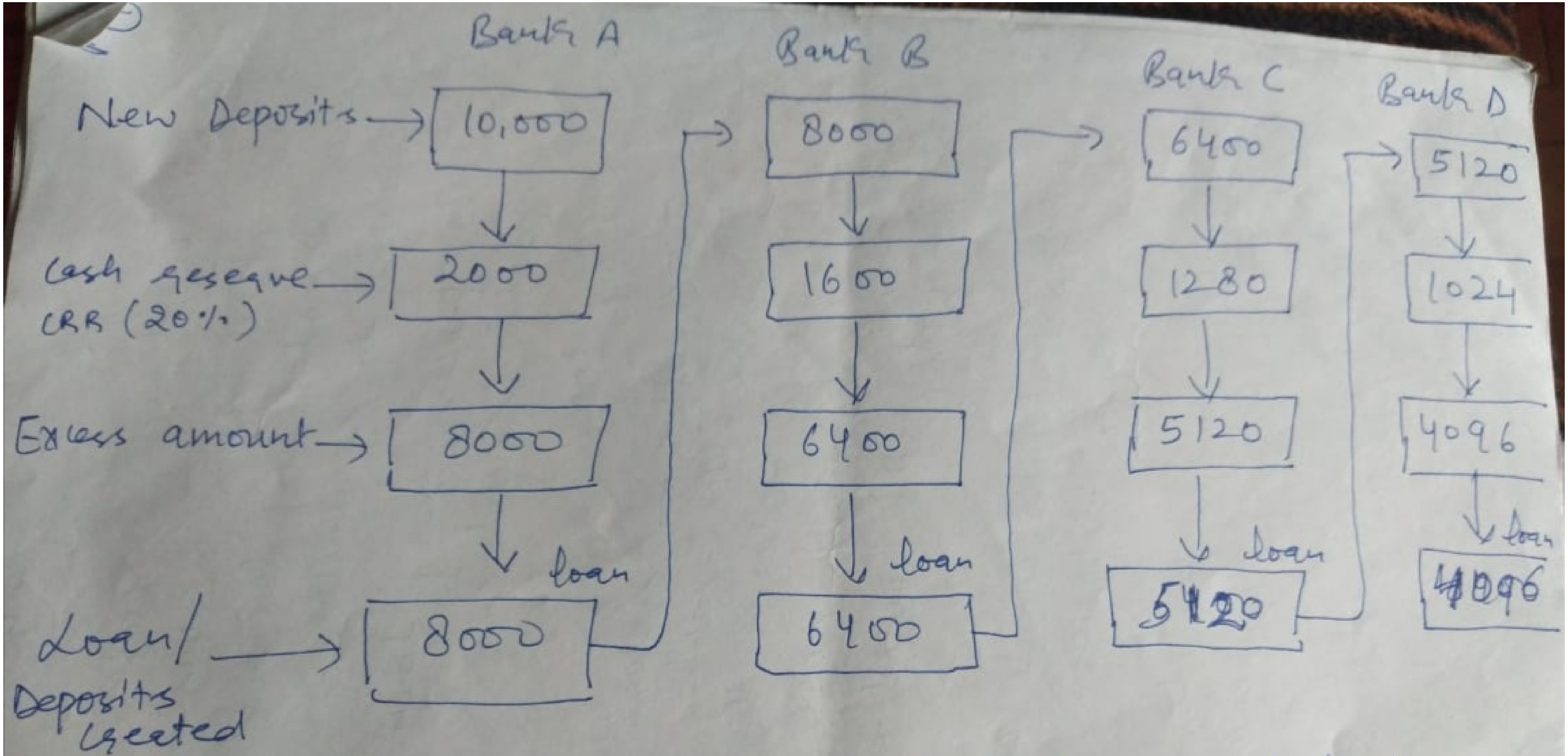
$$\text{The Deposits} = \frac{d}{1-r} = \frac{10,000}{1-0.20} = \frac{10,000}{1-\frac{1}{5}}$$

$$= \text{Rs } 50,000$$

(Where, d – initial deposits, r — its proportion re-lent or cash reserve (20%))

In this multiple expansion of deposits, three parties have been at work — The public, The bank and the borrowers.

Greater the cash reserve ratio, the lower will be the value of deposit multiplier. In other words, increase in CRR or r will lead to contraction of credit creation by the banks and vice-versa.



This way, initial deposits of some cash amount in the banking system will lead to expansion of deposits. This is the process of credit creation.