

BANKING

★ **COMMERCIAL BANK**: A commercial bank is a financial institution that accepts deposits from the general public and advances loans for the purpose of consumption and investment.
eg → HDFC, ICICI, Yes bank, etc.

➤ A financial institution is a banking institution if it performs these 2 functions:

→ Accepting chequable deposits.

→ Advancing loans.

For example

- LIC is a financial but not a bank.
- Post offices are not banks

➤ Money Creation by Commercial Banks

① • Banks receive cash deposits from the people. These are called **PRIMARY DEPOSITS**.

② • Banks keep cash reserves from these deposits and lend money (loan) many times more than their cash reserves.

③ • Banks do not lend money in the form of cash, but make a credit entry in the accounts of the borrowers. These credit entries are called **SECONDARY DEPOSITS** (derivative deposits).

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- ④ • The borrowers can issue cheques against loans in their accounts.
- ⑤ • These primary and secondary deposits are called **DEMAND DEPOSITS** held by the commercial banks.

Assumptions:

- ① There is a 'single banking system' in the country.
- ② All the transactions take place through banks only.

→ Let initial bank deposits = ₹1000 and LRR = 10%.

	Rounds	Deposits (₹)	Loan (₹)	LRR (₹)
Primary Deposit	Ist	1000	900	100
	II nd	900	810	90
Secondary Deposits	III rd	810	729	81
	IV th	729	656.1	72.9
	...	...	...	...
	Total	10,000	9,000	1,000

↓
Demand deposits

$$\text{Demand deposits} = \frac{1}{\text{LRR}} \times \text{Initial Deposits}$$

- Higher the LRR (Legally Reserve Requirement/Ratio), lower the capacity to create money.
- Besides this LRR, banks also hold excess reserves as 'vault cash'. Higher the vault cash, lower the capacity to create money.

LRR ↑↓ Money Creation ↓↑ {Inverse Relation}

⑥ • These demand deposits are many times more than the cash reserves (LRR) of the commercial banks. Banks know by their historical experience that all the depositors would not come on the same day to withdraw all their money by way of cash. If experience shows that withdrawals are 10%, then banks keep 10% as cash reserves.

⑦ • All these deposits serve as money supply in the economy. This money created by the banks is called BANK MONEY.

★ CRR and Credit Multiplier

• CRR is determined by the Reserve Bank of India. So, it is also called Legal Reserve Ratio.

• Credit Multiplier means the number of times the commercial banks can create credit per unit of their cash reserves with the RBI.

• The commercial banks have to keep cash reserves with the RBI, is called CRR.

$$\text{Credit Multiplier (K)} = \frac{1}{\text{CRR}}$$

• Credit Multiplier shows the maximum amount of money that the commercial banks can create by their given cash reserves with the RBI.

Ques- Suppose in an economy, initial deposits of ₹ 500 crore lead to creation of total deposits worth ₹ 10000 crore. Calculate the value of money multiplier.

Ans-

$$\text{Demand deposits} = \frac{1}{LRR} \times ID$$

$$10000 = \frac{1}{LRR} \times 500$$

$$LRR = \frac{500}{10000} = \frac{1}{20} = 0.05$$

$$\text{Money multiplier} = \frac{1}{LRR} = \frac{1}{0.05} \times \frac{100}{100}$$

$$= \frac{100}{5} = 20$$

★ THE CENTRAL BANK

→ The central bank is an apex bank (head) that controls the entire banking system of a country. Reserve Bank of India (RBI) is the central bank of India.

• Functions of Central Bank

(i) Bank of issuing notes: Central bank has the monopoly right of issuing notes. This is called currency authority function of the central bank.

(ii) Banker of the government: Central bank is a banker, agent and financial advisors of the government.

- As a banker, it manages accounts of government.
- As an agent, it buys and sells securities on behalf of the government.
- As an advisor, it frames policies to regulate the money market.

(iii) Banker's bank and Supervisory role:

- The central bank accepts deposits from commercial banks and offers them loan.
- The central bank provides clearing house facility to the commercial banks.
- The central bank ensures that commercial banks follow directions issued by it.

(iv) Lender of the last resort: If a commercial bank fails to get financial accommodation (help) from anywhere, it approaches the central bank as a last resort.

(v) Custodian of Foreign Exchange: Central bank is the sole custodian of nation's foreign exchange reserve. It also exercises managed floating. Managed floating refers to the sale and purchase of foreign exchange with a view to achieving stability of exchange rate for the domestic currency.

(vi) Clearing House Function: The central banks perform the function of clearing house. The cheques of two banks are

cleared through their accounts with central bank. They avoid the transfer of cash.

- (vii) **Control of credit** : The central bank controls the supply of money to cope up with the situation of inflation and deflation by regulating the 'creation of credit' by the commercial banks.

CENTRAL BANK

COMMERCIAL BANK

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|--|--|
| (i) The central bank is an apex bank that controls the entire banking system of a country. It accepts deposits from the commercial banks and advances loan to them. It doesn't deal with the general public. | (i) Commercial bank is a financial institution that accepts deposits from the general public and advances loans to the general public. |
| (ii) The central bank issues notes & controls money supply in the economy. | (ii) Commercial banks also generate money by way of credit creation. |
| (iii) Central bank is a sole custodian of forex reserves of country. | (iii) Commercial bank is not custodian of forex reserves of country. |
| (iv) Central bank is a note issuing authority. | (iv) Commercial bank is not a note issuing authority. |
| (v) It focuses on growth and stability of the country. | (v) It focuses on profit maximisation. |

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★ CONTROL OF MONEY SUPPLY BY CENTRAL BANK

Quantitative Instruments

- Bank Rate
- Open market operations
- Repo rate
- Reverse repo rate
- Cash reserve ratio (CRR)
- Statutory Liquidity Ratio (SLR)

Qualitative Instruments

- Margin requirement
- Rationing of credit
- Moral suasion

① **Quantitative Instruments**: They are those instruments of credit control which focus on the overall supply of money in the economy.

1) **Bank Rate**: It is rate of interest at which the RBI lends money to the commercial banks, to meet their ~~short~~ long-term needs.

Inflation → Bank rate ↑
Deflation → Bank rate ↓

2) **Open market operations**: It refers to buying and selling of government securities by the central bank (RBI) from public and commercial banks.

↓ money supply Inflation → Sale of security by RBI
↑ money supply Deflation → purchase of securities by RBI

3) **Repo Rate**: The rate at which the RBI offers (2-14 days) short-term loans to the commercial

banks by buying ~~and~~ the government securities in the open market.

Inflation $\rightarrow$ Repo rate $\uparrow$

Deflation $\rightarrow$ Repo rate $\downarrow$

4) **Reverse Repo Rate**: The rate at which RBI accepts deposits from the commercial banks (through government securities).

$\rightarrow$ When commercial banks have surplus funds, they can deposit money with RBI and earn interest. The rate of interest paid by the central bank on such deposits is called the reverse repo rate.

Inflation $\rightarrow$ Reverse Repo rate $\uparrow$

Deflation $\rightarrow$ Reverse Repo rate $\downarrow$

5) **Cash reserve ratio (CRR)**: It refers to the bank's total deposits requirements to be kept with the RBI.

Inflation $\rightarrow$ CRR $\uparrow$

Deflation $\rightarrow$ CRR $\downarrow$

6) **Statutory Liquidity Ratio (SLR)** Every bank is required to maintain a fixed percentage of its assets in the form of liquid assets. (cash / gold / govt. security)

Inflation $\rightarrow$ SLR $\uparrow$

Deflation $\rightarrow$ SLR $\downarrow$

* CRR and SLR both are also considered as LRR.

(B) Qualitative Instruments : They are those instruments of credit control which focus on select sectors of the economy.

1) Margin requirement : The margin requirement refers to the difference between current values of securities offered for loan and the value of loan granted.
Inflation $\rightarrow$ Margin requirement $\uparrow$
Deflation $\rightarrow$ margin requirement $\downarrow$

2) Rationing of credit : It refers to fixation of credit quotas for different business activity. RBI fixed credit quotas for different business activities and commercial banks cannot exceed the quota limit while granting loans.
Inflation $\rightarrow$ Introduction of credit rationing
Deflation $\rightarrow$ introduction of credit rationing

3. Moral Suasion : It means rendering an advice to the commercial banks by the RBI to follow its directives.
Inflation $\rightarrow$ RBI advises to restrict loans
Deflation $\rightarrow$ RBI advises to be liberal in lending loans.