Meta data of E- Content (Pre production)

S. N.	AREA OF MATA DATA	TO BE FILLED BY CONTENT GENERATOR(S)
1	Topic	Credit Creation
2	Subject	Macroeconomics
3	Topic connected which area of subject?	Money/ Credit Creation
4	Class/ Level	Class XII
5	Objectives	To enable the child to: 1. Understand the meaning of money 2. Know about the features of high powered money 3. Understand the meaning of multiplier and total deposits 4. Comprehend how commercial banks create money through the process of taking deposits and making loans 5. Learning activity to calculate the value of multiplier, initial deposits and total deposits.
6	Summary	Money is anything which is generally acceptable as a medium of exchange and at the same time acts as a measure of value, store of value and means of deferred payments. Commercial banks create money, in the form of bank deposits, by making new loans. When a bank makes a loan, it credits the customer's bank account with a bank deposit of the size of

		the mortgage. At that moment, new money is created and this process has been explained in the resource with the help of numerical example.
7	**Key Words**	**Money creation, credit creation, money, total deposits, initial deposits, legal reserve ratio, multiplier, high powered money**
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MONEY

DEFINITION: It is anything which is generally acceptable as a medium of exchange and at the same time acts as a measure of value, store of value and means of deferred payments.

High Powered Money (H)

High powered money or monetary base refers to the total liability of the monetary authority of the country i.e. Central Bank (RBI). It consists of :

- Currency (notes and coins in circulation with the public and vault cash of commercial banks)
- Deposits held by Government of India and commercial banks with RBI.

TOTAL DEPOSITS

They are created due to a new deposit in bank and is many times the initial deposit. The multiple by which deposits can increase due to an initial deposit is called money multiplier.

Money multiplier =1/LRR (where LRR is legal reserve

PROCESS OF CREDIT CREATION BY COMMERCIAL BANKS

Credit creation (or deposit creation or money creation) by the banks is determined by

(i) The amount of the initial fresh deposits and

(ii) The Legal Reserve Ratio (LRR), the minimum ratio of deposit legally required to be kept as cash or in liquid form by the banks.

It is assumed that all the money that goes out of banks is re deposited into the banks, and LRR consists of CRR and SLR decided by RBI.

Example: - Let the LRR be 20% and there is a fresh deposit of Rs.10, 000. As required the banks keep 20% i.e. Rs.2, 000 as cash. Suppose the banks lend the remaining Rs. 8,000. Those who borrow, use this money for making payments.

As assumed those who receive payments put the money back into the banks. In this way bank receives fresh deposits of Rs. 8,000.

The bank again keep 20% i.e. Rs.1, 600 as cash and lend Rs.6, 400, which is also 80% of the last deposits. The money again comes back to the banks leading to a fresh deposit of Rs.6, 400. The money goes on multiplying in this way this process continues till new deposit become nil, and ultimately total money creation is Rs.50, 000.

TOTAL MONEY CREATION = INITIAL DEPOSIT X 1/LRR

= 10000 x1/20%

= 10000 x100/20

Total money creation = 50,000

The whole process can be explained through following table:-

	Deposits (Rs.)	**Legal Reserve Ratio (20%)**	**Secondary Deposit (Lending) Rs.**
Initial Deposit Round I . . . Round N	10000 8000	2000 1600	8000 6400 . . . .
s	**50000**	**10000**	**40000**

Where **Money multiplier is 1/LRR**

=1/20%
=1/20*100
=10/2
= 5

It is the multiple by which total deposits increase due to initial deposit.

In short, Commercial banks create money, in the form of bank deposits, by making new loans. When a bank makes a loan, for example to someone taking out a mortgage to buy a house, it does not typically do so by giving them thousands of rupees worth of banknotes. Instead, it credits their bank account with a bank deposit of the size of the mortgage. At that moment, new money is created. Bank deposits are simply a record of how much the bank itself owes its customers. So they are a liability of the bank, not an asset that could be lent out. When a bank makes a loan to one of its customers it simply credits the customer's account with a higher deposit balance. At that instant, new money is created.

Student's Activity:

1. Calculate the value of money multiplier and total deposit created if initial deposit is of Rs 500 crores and LRR is 10%.
2. **** If total deposits created by commercial banks is Rs 12,000 crores and legal reserve requirements is 25%, then calculate the amount of initial deposits.
3. Calculate the legal reserve requirements if initial deposit of Rs 200 crores lead to the creation of total deposits of Rs 1600 crores.