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शक्ति उत्थान आश्रम लखीसराय बिहार

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Money and Banking

MONEY CREATION OR CREDIT CREATION BY COMMERCIAL BANKS CREDIT is defined as finance made available by one party to another party on a certain rate of exchange.

The capacity of banks to create money or credit depends on (i) Amount of primary deposits and (ii) Legal reserve ratio (LRR).

Legal Reserve Ratio (LRR):- is fixed by the central bank of a country and it is the minimum ratio of deposit legally required to be kept as cash by banks.

Cash Reserve Ratio (CRR):- It is a part of LRR which is to be kept with the central bank. Statutory **Liquidity Ratio (SLR):**- It is a part of LRR which is to be kept with the bank themselves.

Commercial bank's demand deposits are a part of money supply. Commercial banks lend money to the borrowers by opening demand deposit account in their names. The borrowers are free to use this money by writing cheques. According to definition demand deposits are a part of money supply. Therefore, by creating additional demand deposits bank create money. Money creation depends upon two factor:

Primary deposits and Legal Reserve Ratio (LRR). Deposit Multiplier = 1/LRR Total Deposit creation = Initial deposit X 1/LRR. Repo rate: Repo rate is the rate at which the central bank of a country (Reserve Bank of India in case of India) lends money to commercial banks in the event of any shortfall of funds. Repo rate is used by monetary authorities to control inflation.

Description: In the event of inflation, central banks increase repo rate as this acts as a disincentive for banks to borrow from the central bank. This ultimately reduces the money supply in the economy and thus helps in arresting inflation. Reverse repo rate: Reverse repo rate is the rate at which the central bank of a country (Reserve Bank of India in case of India) borrows money from commercial banks within the country. It is a monetary policy instrument which can be used to control the money supply in the country.

Description: An increase in the reverse repo rate will decrease the money supply and vice- versa, other things remaining constant. An increase in reverse repo rate means that commercial banks will get more incentives to park their funds with the RBI, thereby decreasing the supply of money in the market.

Fiat Money: - Fiat money is currency that a government has declared to be legal tender, but it is not backed by a physical commodity. The value of fiat money is derived from the relationship between supply and demand rather than the value of the material from which the money is made.

Fiduciary Money: - Money that depends for its value on confidence that it is an accepted medium of exchange. It originated as a paper certificate that was a promise to pay a certain amount of gold or silver to the bearer. From the Latin fiducia meaning confidence or trust. High Powered Money: - This is the monetary aggregate that the Federal Reserve has control over through its monetary policy. Also called High Powered Money because the effect o