Indian Streams Research Journal
ISSN: 2230-7850 Impact Factor : 4.1625(UIF) Volume - 6 | Issue - 11 | December - 2016

CREDIT CREATION BY COMMERCIAL BANKS: AN ANALYTICAL STUDY

Bishnu Kant Jha
M. Com , M. A. (Economics),
Research Scholar (Faculty of Commerce)
L.N. Mithila University, Darbhanga .

ABSTRACT

Banking system is one of the many institutions that impinge on any economy affect its performance for the better or the worse. In what measure a given banking system contributes to economic development depends upon the governing policy. Economists have expressed a wise variety of opinions on the effectiveness of banking system in promoting or facilitating economic development. The importance of banking institutions is felt rather deeply in the underdeveloped economies in the sense that this economics are usually short of capital and the task of mobilisation of resources and their channelization to the priority sector belongs to such institutions. A commercial bank receives deposits which it has to repay according to its promise and makes them available to those who are really in need of them. The bank is actually distributing its deposits between the borrowers and its own vaults. Herein, lies the most delicate of the functions of a commercial bank.

Key Words: Banking System, Commercial Bank. Credit Creation, Deposit Mobilisation

INTRODUCTION

Commercial banks are concerned with accepting deposits of money from the public at large, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise, and employing the deposits so pooled in the form of loans and investment to meet the financial needs of business and other classes of society. Like other financial intermediaries, commercial banks act as mobilisers of pubic savings for their productive utilisation. However, the mechanism they provide for performing this function is fundamentally different from that of other institutions. A commercial bank is the only institution which accepts funds from the public in the form of demand deposits, i.e., deposit accounts which are subject to withdrawal by the owner on demand and subject to transfer to a third party by means of a cheque. A clear line of demarcation, therefore, exists in the functions of a commercial bank and all other financial institutions. Deposits with other financial institutions do not circulate as money, while those in the commercial banks do. In the field of lending also, commercial banks have specialised in providing funds to the business community with a view to satisfying their working capital needs. The provision of short-term loan by means of cash credit, discounting bills, hundis, promissory notes and other debt instruments distinguishes commercial banks from other financial intermediaries. In the process of the acceptance of deposits and provision of loans, commercial banks create money. This too is a characteristic feature of their function which sets them apart from other financial institutions.

NATURE OF COMMERCIAL BANKS

The nature of commercial banks indicates that these institutions act as repositories of public deposits and lenders of money. Besides, they manufacture money. From the previous analysis, it is clear that commercial banks always try to maintain their holdings of idle cash to the lowest extent possible. In their attempt to achieve this end, they unwittingly increase the total amount of money in circulation in the community. It, however, does not mean that they increase the total amount of legal tender currency which is an exclusive prerogative of the central bank.

When it is said that a banker is lending money, he is actually lending money in the deposit credit with a right to the borrower to draw cheques against it. For instance, let us take the case of a loan granted to a customer. Instead of paying away the whole loan in the form of liquid cash, the bank will place the amount to the credit of the borrower. Thus, the borrower acquires a claim against the bank, just as a sum of money deposited by him with the bank creates a claim against the bank. Assuming the borrower draws cheques in favour of other people, they pay these cheques into their own banks for collection, and their deposits og up. Here one may agree with Hartley Withers in that ‘every loan creates a deposit’. Again, by purchasing securities or any other banking assets also a bank is adding to the total supply of money.

When the bank buys securities, it pays for them by its own cheque. This cheque, life a currency not issued by the central bank, is an IOU (I Owe You) of the bank issuing it. And this is accepted by the seller of the securities because of his faith in the ability of the bank to produce cash on demand. The seller deposits this cheque in the very same bank or with any other bank where he has an account, thereby creating additional deposit money. Thus, the commercial banks as a system can and do increase the total amount of money in circulation by increasing the purchasing power of the people through the deposit money created by them.

AN ANALYTICAL STUDY

A close analytical study of the mechanism of banking will simplify matters more. Let us take the case of a community where there is only one bank and where the people are highly banking minded so that all transactions resettled by means of cheques. Furthers, let us assume that the total amount of legal tender currency in circulation is Rs. 10,000 and the bank knows by experience that 10 percent of its deposits as cash reserves is sufficient to meet the demands of its customers**.**

Since there is only one bank in the community, people will deposit all their money in this particular bank. The balance sheet of the bank would them be:

Liabilities	Rs.	Assets	Rs.
Deposits	10,000	Cash in Hand	10,000

According to our assumption, the bank need maintain a cash reserve of only 10 percent of the deposits and can safely lend the balance amount of Rs.9,000 to those who are in need of funds. The bank will place this amount the credit of the borrowers, giving them the right to operate their accounts with cheques. Their deposits will consequently go up by this amount. The balance sheet of the bank, then, would be:

Liabilities	Rs.	Assets	Rs.
Deposits(original)	10,000	Cash in Hand	10,000
Deposits (i.e. credit Balance of borrowers)	9,000	Loans to clients	9,000
	19,000		19,000

These deposits, now standing to the credit of the borrowers are, as we know, claims against the bank. As such they command a purchasing power and hence they may be considered as good as money. Suppose the borrowers draw cheques in favour of their creditors. The payees of these cheques will not require liquid cash over the counter since they are highly banking minded, according to our supposition. On the other hand, they will deposit these cheques with our supposed single bank for collection. Here what happens is merely a transfer of the credit balance of the borrowers to the credit of the accounts of the payees of their cheques. In short, although the total amount of legal tender currency in circulation is only to the order of Rs. 10,000, our bank, through the process of creating additional deposit money, has brought into effective circulation an additional amount of Rs. 9,000, thereby raising the total supply of money from Rs. 10,000-19,000. The power of the bank to increase the amount of money in circulation does not come to an end here. It can further increase the supply of money.

As shown in the above balance sheet, the amount of the deposits of the bank is now Rs.19,000. The assumption is that the bank should maintain a cash reserve ratio of only 10 percent. The maintain this, the bank only needs to provide an additional amount of Rs. 900 over and above the amount of Rs. 1,000 which it already maintains. Even then there is a balance of Rs. 8,100 in the vaults of the bank which it can lend without undergoing any risk. Now the balance sheet position would be:

Liabilities	Rs.	Assets	Rs.
Deposits(original)	10,000	Cash in Hand	10,000
Deposits (deposited by the Payees of the cheques issued by the first borrowers) Deposits (credit balance of Subsequent borrowers)	9,000 8,100	Loans to clients Loans to Clients. 9,000 8,100	17,100
	27,100		**27,100**

Here the bank has to keep an additional cash reserve of Rs. 810. The total cash reserves increase to Rs.2,710. Still there is a balance of loanable funds with the bank, amounting to Rs. 7,290.

Thus, the bank can go on increasing the creation of additional money. However, there are questions that crop up. Is it possible for the bank to increase credit without any limit? Is the power of the bank to increase the supply of deposit money unlimited? The answer is definitely in the negative.

LIMITATIONS ON THE CREATION OF CREDIT

The power of commercial banks to create credit is limited mainly by the cash reserves which they have to hold against their deposits and the total amount of legal tender currency issued by the central bank. Every bank has to meet the demands of its customers to pay cash over the counter. So, a working reserve of liquid cash is always necessary for a bank.

Of course, if the people are highly banking minded, a lower cash reserve will be sufficient. But in the case of a community where the habits are not well developed, a higher cash reserve will be essential. In either case, a cash reserve is necessary. This acts as a brake on the power of the banks to create credit. To revert to the previous illustration, our supposed bank can go on creating further and further credit money till it finds that it has no more liquid cash to maintain the 10 percent cash reserve ratio. In other words, it is in a position to supply more and more credit up to an additional amount of Rs. 90,000. If it wants to expand credit still further, either there should be an additional supply of liquid cash, which entirely is the sole prerogative of the central bank, or the cash ratio should be lowered which can be done only at its own peril. Moreover, a minimum cash reserve ratio is prescribed by law in most countries. Thus, a bank's power to create credit it limited by two factors, viz., the cash reserve ratio and the total amount of legal tender currency.

So far, the analysis was confined to a community where there is only one bank. This is not a realistic assumption. But admittedly, the multiplicity of banks will not make any material alteration in the mechanism of credit creation and the limitations on it. The banking system, taken as a whole, will be conducting its operations on the very same lines. The only difference is that if any bank tries in an isolated manner to expand credit more than the other banks, it will lose cash to other banks. So in the case of a network of branches, each bank will have to keep in step with the others whenever it is creating credit.

CONCLUSION

Commercial banks can increase the total amount of money in circulation through the process of credit creation. In the words of Sayers, 'Bankers are not merely purveyors of money, but also, in an important sense, manufacturers of money.

REFERENCES:

1. *Pandey, Rama Nand (1989), Commercial Banks and Rural Development, Deep and Deep Publications, New Delhi, pp.64-65*
2. *Ibid, p.67*
3. *Bhole, L M (1982), Financial Markets and Institutions, Tata McGraw Hill Publishing Company, New Delhi, pp.8-9*
4. *Mathur, K B L (2010), Indian Banking Sector: Sound and Resilient, Yojana, Vol. 54, No. 2, February, p.10*
5. *Shekhar, K C and Shekhar, Lekshmy (2014), Banking Theory and Practice, Vikas Publishing House Pvt. Ltd., New Delhi, pp.8-15*
6. *Ibid, pp. 15-20*