“Credit Creation”

For CBCS, 2nd Semester
Economics (HC-2016)

Aparna Sengupta
Associate Professor
HOD, Department of Economics.

Introduction: -

The money supply of a country consists of notes and coins. The Central bank is the primary source of money supply in an economy through circulation of currency.

It ensures the availability of currency for meeting the transaction needs of an economy and facilitating various economic activities, such as production, distribution and consumption.

However, for this purpose, the Central bank needs to depend upon the reserves of commercial banks. These reserves of commercial banks are the secondary source of money supply in an economy. The most important function of a commercial bank is the **creation of credit**.

Meaning of Credit Creation: -

Credit creation is the process by which the money supply of a country or of an economic or monetary region is increased. In most modern economies, most of the money supply is in the form of bank deposits. So credit creation is also known as ‘**Deposit Creation’**. It is a situation in which banks make more loans to customers and business, with the result that the amount of money in circulation (being passed from one person to another) increases.

In simple terms, credit creation is the expansion of deposits. Banks can expand their demand deposits as a multiple of their cash reserves because demand deposits serve as the principal medium of exchange.

Commercial Banks create credit by advancing loans and purchasing securities. They lend money to individuals and businesses out of deposits accepted from the public. However, commercial banks cannot use the entire amount of public deposits for lending purposes. It is legally compulsory for the banks to keep a certain minimum fraction of their deposits as reserves. The fraction is called the Legal Reserve Ratio (LRR) and is fixed by the Central Bank. After keeping the required amount of reserves, Commercial banks can lend the remaining portion of public deposits.

The two most important aspects of credit creation are:

1) **Liquidity**:- The bank must pay cash to its depositors when they exercise their right to demand cash against their deposits.

2) **Profitability**:- Banks are profit driven enterprises. Therefore, a bank must grant loans in a manner which earns higher interest than what it pays on its deposits.

   The bank’s credit creation process is based on the assumption that during any time internal, only a fraction of its customers genuinely need cash. Also the bank assumes that all its customers would not turn up demanding cash against their deposits at one point in time. The bank is thus enabled to erect a vast superstructure of credit on the basis of a small cash reserve. The bank is able to lend money and charge interest without parting with cash. The bank loan creates a deposit, or it creates a credit for the borrower.

Similarly, the bank buys securities and pays the seller with its own cheque which again is no cash, it is just a promise to pay cash. The cheque is deposited in some bank and a deposit is created or credit is created. **This is credit creation**.

Basic Concepts of Credit Creation: -

1) **Cash Reserve Ratio (CRR)**: - Banks know that all depositors will not withdraw all deposits at the same time. Therefore, they keep a fraction of the total deposits for meeting the cash demand of the depositors and lend the remaining excess deposits. **CRR** is the percentage of total deposits which the banks must hold in cash reserves for meeting the depositors' demand for cash.

2) **Excess Reserves**: - The reserves over and above the cash reserves are the excess reserves. These reserves are used for loans and credit creation.

3) **Credit Multiplier**: - Given a certain amount of cash, a bank can create multiple times credit. In the process of multiple credit creation, the total amount of derivative deposits that a bank creates is a multiple of the initial cash reserves.

Limitations of Credit Creation: -

When banks would prefer for creating credit to increase profits, there are many limitations. These limitations make the process of creating credit non-profitable.

1) If the banks are unwilling to utilize their surplus funds for granting loans, then the economy is headed towards recession.

2) If the public withdraws cash and holds it with themselves, then it reduces the banks' power to create credit.