(iv) **Transfer of Funds:** The banks provide the facility of fund transfer to its customers through the instruments of cheque, demand draft or electronic transfer from one place to another or one person to another.

(v) **Agency Functions:** Banks receive and collect different types of payments on behalf of their clients through the instruments of cheques, drafts, bills and promissory notes etc. Banks also buy and sell gold, silver and other securities on behalf of their customers.

(vi) **Sale and Purchase of Foreign Exchange:** This is another important function of a commercial bank which has increased tremendously with increasing volume of international trade particularly in the era of globalization.

(vii) **General Utility Services:** In modern days the banks also perform some very useful functions for the benefit of its customers and the economy like collection and publication of data, advisory functions, issue of lockers and underwriting of loans, shares and debentures issued by the government.

28.7 CREATION OF CREDIT BY COMMERCIAL BANKS

Credit creation is one of the most important functions of a commercial bank. Banks create credit out of the deposits that is mobilized by them. Credit creation is also called money creation or deposit creation. Therefore, commercial banks are also known as creator of money or credit.

The process of credit/money creation: Money is not created by commercial banks by actually printing of notes or minting of coins. The money is created by granting loans and advances to public and making relevant entries into the books of accounts of the lending banks.Loans are granted out of the deposits received by the banks. Normally, the amount of loan granted by a bank is greater than the amount of deposits received by it. This is mainly because of the fact that when money is deposited by the depositors in a bank, the bank by its experience knows that not all the money would be withdrawn by the depositors at once at any point of time. This peculiar habit of the depositors leaves the bank with huge amount of surplus fund which in turn is used to create loans by the banks. The banks keep certain proportion of its total deposits in form of cash to honour the demand of its customers. Further, every commercial bank is required to keep certain proportion of its total deposits with the R.B.I. which is known as *Cash Reserve Ratio* (CRR). Besides CRR, the bank is also required statutorily to maintain certain proportion of its total deposits as liquid assets in form of cash, gold, and certain government approved securities. This is known as *Statutory Liquidity Ratio* (SLR). The CRR and SLR together form the *Legal Reserve Ratio* (LRR) which is determined by the central bank of a country (R.B.I. in case of India). When LRR is increased by the central bank the capacity of the commercial banks to create deposit or credit decreases and when LRR is decreased the capacity to create more credit increases.

Notes

Thus, there exists an inverse relationship between LRR and the quantity of money created in an economy. Given the quantity of deposits and LRR at any point of time, the total quantity of money created in an economy during a given period of time would be as follows:

Total quantity of money created: Quantity of deposits × 1/LRR. Let us understand the process of money or credit creation in an economy with the help of an example. Let us assume that the bank receives an initial deposit of ₹ 1000 and the LRR is 10%. It means the bank has an excess reserve of ₹ 1000 – (1000 x 10%) = ₹ 900 to lend to the borrowers. It must be noted that the borrowers are not paid the amount of loan as cash but the same is credited in their account. Thus in the first round an extra deposit of ₹ 900 is created out of which the bank is free to advance loan worth ₹ 900 – (900 × 10%) = ₹ 810. In the second round an extra deposit of ₹ 810 is created and the total amount of money in the economy becomes ₹ 1000 + 900 + 810 = ₹ 2710. If the process continues the total amount of money created in the economy with ₹ 1000 would be ₹1000 × 1/10% = 1000 × 1/0.1 = ₹ 1000 × 10 = 10,000 (Ten Thousand). If the amount of LRR is 20% then the initial deposit of ₹ 1000 would create the total amount of money in the economy worth ₹ 1000 × 1/0.2 = ₹ 5000 (Five Thousand). **Thus, a higher LRR would create less amount of money and a lower LRR would create a higher amount of money in the economy.**

It should further be noted that only a fraction of total deposits is kept as cash reserves by banks because of two reasons. *First*, Banks by their experiences know that all depositors are not going to withdraw their money at the same time so the surplus money could be used to create loans and extra deposits. *Second*, there is a continuous flow of deposits in the banks, so banks are comfortable with their cash reserves.

INTEXT QUESTIONS 28.3

1. Which of the following statements are true and which are false?

    (i) Commercial banks are controlled and operated only by the public sector.

    (ii) Rate of interest on savings account deposits is less than fixed deposits.

    (iii) Functions of commercial banks are rising day by day in modern economy.

    (iv) Overdraft facility is an important form of granting loan to the public by banks.

    (v) Increase in legal reserve ratio reduces credit creating power of commercial banks.