CREDIT

The word credit is an evolution of a Latin word "Credo "which means "entrust & I put my faith in.

The word Credit has been described by Gide in the following way.

"An exchange which is compute after the expiry of certain period of time after payment".

In simple words credit may be thought of a buying goods and services at present and promising to make payment at some time in future. But this apparently simple phenomenon of credit work mysteriously throughout our economic system. It is an important element of our everyday transactions.

CREDIT CREATION:

Creation of credit is one of the most important functions of commercial banks. Because of this function commercial banks are sometimes called the factories for the manufacturing of credit and money.

The process of credit creation has been explained in detail below:

In simple words credit creation means the multiple loaning by commercial banks. Single banks can't create credit. But banks in multi banking system can grant several loans out of a single deposit.

Let us first understand few things which play an essential role in the process of credit creation.

1. **Primary Deposits**:

When a person deposits some money in the commercial banks, the bank opens account in the name of that person. The depositor is given the checque book. Now he can withdraw his amount from his account by drawing checques on the bank. The account so opened by the bank or the deposit so created is called the primary deposit.

2. **Secondary Deposits**:

However, when a bank advanced a loan, it opens the account in the name of the borrower and the borrower is given a right to draw checques on the bank. The account so opened or the deposit so made is called the secondary deposit. These deposits play the central role in the process of credit creation.

3. **Reserves:**

All the commercial banks are required to keep certain amount of cash with the central banks. Such cash kept with the central banks is called reserve and it is always expressed as a percentage of bank's demand deposit liabilities. In other words.

Reserve is an amount of funds equal to the specific percentage of bank's own deposit liabilities which the bank must keep in deposit with the central bank.

4. **Need for Reserve**:

It is legally binding on at the commercial banks to hold certain reserve with the central bank. The basic reason behind it is the control and dominance of the central banks. Such legal reserves permit the central bank to exercise control over lending process of commercial banks.

5. **Reserve Ratio**:

As discussed earlier commercial banks have to keep certain amount of reserves with the central bank. The amount of such reserve is calculated as the basis of ratio called reserve ratio.

$$Reserve\ Ratio = \frac{Amount\ of\ Reserve}{Commercial\ Bank's\ demand\ deposit\ liabilities}$$

For Example:

Suppose the bank has Rs.1, 00,000 worth of deposit liabilities.

Now if the reserve ratio is set at 20% then reserve will be:

$$.\frac{20}{100} = \frac{amount\ of\ reserves}{100{,}000}$$

Amount of reserves = Rs.20, 000

In this case banks have to deep reserve worth Rs.20, 000 with the central bank.

Let us now explore the process credit creation.

ASSUMPTIONS:

First tae certain assumptions. These assumptions will be further discussed in the last part of this question.

1. All banks are required to hold 20% of the demand deposit liabilities as reserve with the central bank.
2. The system has a developed banking infrastructure. People have got matured bank habits and all payments and receipts are made through checques. Also the loan advanced by one bank is deposited by the borrower in his bank.
3. Normal circumstances are prevailing in the economy. There is neither too much nor too low credit.
4. No credit control policy is being acted upon by the central bank.