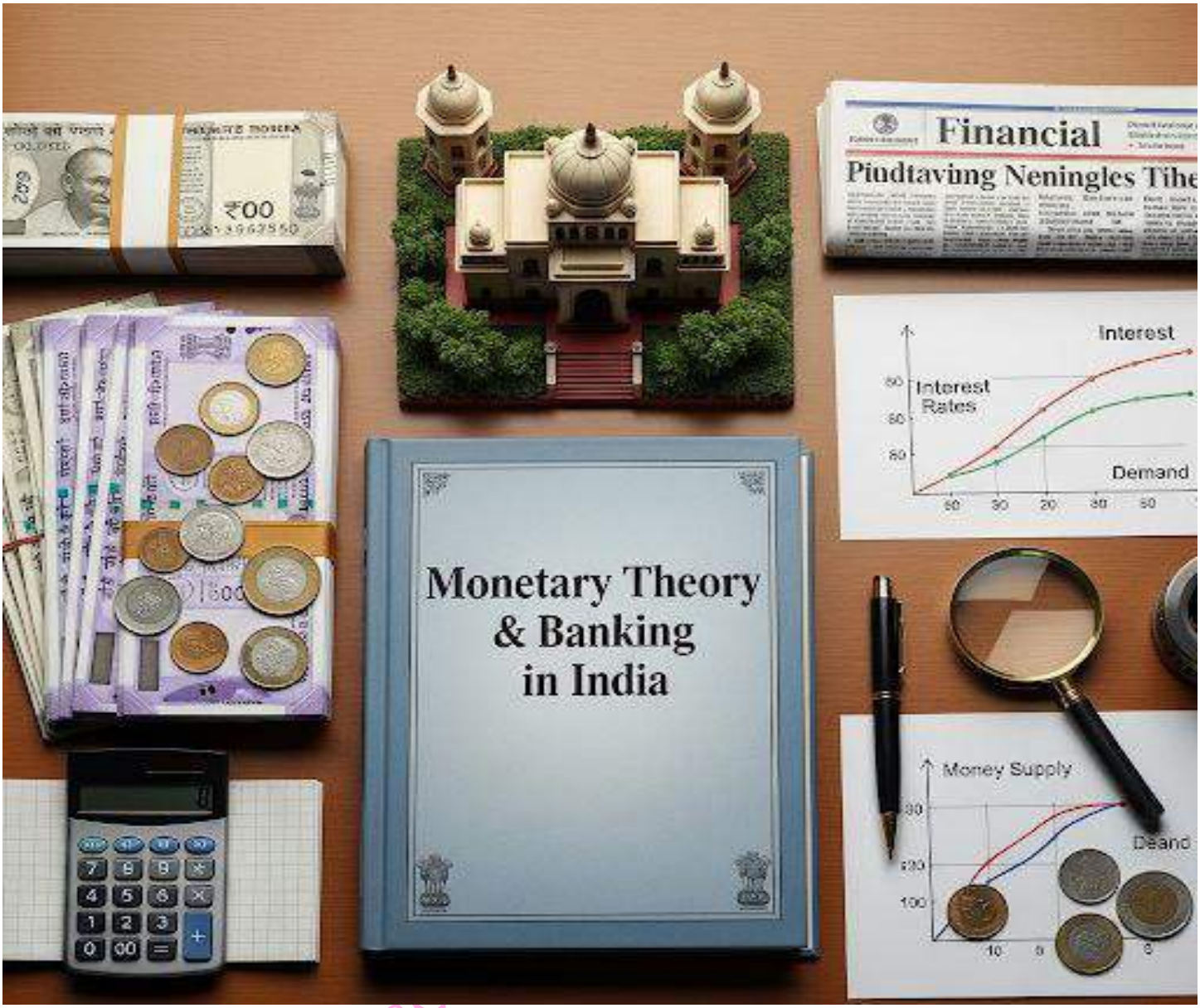


Name: Jyoti Yadav

Designation: Assistant Professor

Department: Management And Commerce Department

Subject: Business Statistics

Overview

Purpose of this Subject

- Help students understand the structure and working of the money and banking system in India.
- Explain the role of commercial banks, RBI, and development financial institutions.
- Develop awareness about how monetary policy influences the economy.
- Provide knowledge of financial systems, including credit creation, interest rates, and inflation.

Outcome of this Subject

- Understand key concepts of money supply, banking operations, and the financial system.
- Analyse the functions and importance of RBI and commercial banks.
- Gain insight into development banks and non-banking financial institutions.
- Evaluate the impact of monetary policies on inflation, credit control, and the economy.

Future Scope in this Subject

- Banking Sector: For jobs in commercial banks, regional rural banks, cooperative banks, etc.
- Government & Financial Institutions: Like RBI, NABARD, SEBI, etc.
- Higher Studies: In Finance, Economics, MBA (Banking & Finance), or Competitive Exams (like IBPS, RBI Grade B).
- Financial Consulting & Research: Useful for careers in data analysis, economic research, and finance.

B.COM 5th

SUBJECT: MONETARY THEORY AND BAKING IN INDIA

Money is a medium of exchange that facilitates transactions for goods and services. It functions as a unit of account, a store of value, and a standard of deferred payment. Historically, money evolved from barter systems to commodities like gold and silver, and later to fiat currencies issued by governments. Modern money exists in both physical forms (coins, notes) and digital formats. The value of money is largely based on trust in the issuing authority, such as a central bank. In India, the Reserve Bank of India (RBI) is responsible for regulating the supply and stability of the currency. Money's liquidity, acceptance, and universal recognition make it a cornerstone of economic activity and financial systems worldwide.

Functions of Money:

- **Medium of Exchange**:

The primary function of money is to act as a medium of exchange, enabling transactions to take place. It eliminates the inefficiencies of barter systems by allowing people to exchange goods and services with universally accepted currency, ensuring smooth economic activity.

- **Unit of Account**:

Money serves as a common measure of value, allowing goods and services to be priced and compared. This standardization simplifies economic decisions and accounting practices, as prices are expressed in a consistent unit, making comparisons easier.

- **Store of Value**:

Money retains value over time, allowing individuals to save and store wealth for future use. This function is vital for economic stability, as it provides assurance that money saved today can be used to make purchases later without significant loss in value.

- **Standard of Deferred Payment**:

Money facilitates transactions involving future payments, such as loans, credit sales, or mortgages. It serves as a standard for contracts that require payments over time, ensuring trust and enforceability in financial agreements.

- **Liquidity**:

Money is the most liquid asset in an economy because it can be easily converted into other goods and services without losing value. This liquidity is vital for immediate transactions and quick responses to market changes.

- **Transfer of Value**:

Money can be transferred easily across distances and individuals, enabling the efficient movement of economic resources. It allows both domestic and international trade to flourish, contributing to economic growth.

- **Economic Indicator**:

The supply and demand of money help in determining economic conditions like inflation, deflation, or stability. Central banks monitor and adjust the money supply to control economic health.

- **Basis for Credit Systems**:

Money forms the foundation of credit systems, where financial institutions extend loans and credit based on money's reliability and universal acceptance.

Alternative Measures to Money Supply in India and their Different Components:

Reserve Bank of India (RBI) uses various measures of money supply to assess the liquidity in the economy and to guide monetary policy. The four main alternative measures of money supply are denoted as **M1**, **M2**, **M3**, and **M4**. Each measure includes different components that reflect varying degrees of liquidity.

1. **M1 (Narrow Money):**

- **Components**:
  - **Currency with the Public**: Physical money like coins and paper notes held by the public.
  - **Demand Deposits with Banks**: Current account deposits and savings deposits that can be withdrawn on demand.
  - **Other Deposits with the RBI**: Includes deposits of the government and public financial institutions with the RBI.
- **Liquidity**: M1 is the most liquid measure, representing money readily available for spending.

2. **M2:**

- **Components**:
  - **M1**: All components included in M1.
  - **Savings Deposits with Post Office Savings Banks**: Deposits in post office savings accounts that are not as liquid as bank deposits.
- **Liquidity**: M2 includes M1 and adds post office savings deposits, making it slightly less liquid than M1 but still readily accessible.

3. **M3 (Broad Money):**

- **Components**:
  - **M1**: All components of narrow money.
  - **Time Deposits with Banks**: Fixed deposits and recurring deposits with scheduled commercial banks that are less liquid since they cannot be withdrawn on demand without penalties.
- **Liquidity**: M3 is broader and includes longer-term deposits, making it less liquid than M1 but more comprehensive in covering the overall money supply in the economy.
- **Significance**: M3 is widely used by the RBI for policy analysis and is considered the "broad money" measure in India.

4. **M4:**

- **Components**:
  - **M3**: All components of broad money.
  - **Total Deposits with Post Office Savings Banks (excluding National Savings Certificates)**: This includes additional deposits in post office savings accounts, enhancing the coverage of money supply.
- **Liquidity**: M4 is the broadest measure, encompassing the entire spectrum of liquid and semi-liquid assets held by the public.

Meaning and Changing Relative Importance of each Component:

In India, the components of the money supply, represented by M1, M2, M3, and M4, have varying importance based on factors like economic development, technological advancements, and evolving financial systems.

1. **Currency with the Public**

This refers to physical money (coins and paper notes) held by the public, excluding currency held by banks and the government.

- **Changing Importance**: Traditionally, currency was the dominant form of money used for transactions. However, with the rise of digital payments, mobile banking, and fintech solutions, its relative importance has declined. Nevertheless, in rural areas and the informal economy, cash still plays a crucial role.

2. **Demand Deposits with Banks**

These are deposits in current and savings accounts that can be withdrawn on demand without any prior notice.

- **Changing Importance**: Demand deposits have gained importance due to the convenience of electronic fund transfers, debit cards, and online payments. The growth of e-commerce and digital banking has increased the reliance on demand deposits for daily transactions, leading to a shift from physical currency to digital forms of money.

3. **Other Deposits with the RBI**

These include deposits held by the government, financial institutions, and others with the RBI.

- **Changing Importance**: These deposits have limited direct impact on general economic transactions and are mainly used for interbank settlements or government operations. Their importance is relatively stable and low in the context of overall money supply.

4. **Savings Deposits with Post Office Savings Banks**

Deposits in savings accounts managed by post offices, offering modest interest rates with easy access.

- **Changing Importance**: Historically significant, especially in rural and semi-urban areas, post office savings deposits have declined in relative importance due to the expansion of commercial banking and the popularity of more flexible financial products. However, they remain vital for financial inclusion in underserved areas.

5. **Time Deposits with Banks**

These include fixed deposits (FDs) and recurring deposits (RDs) held with banks, which have a fixed tenure and yield higher interest than demand deposits.

- **Changing Importance**: Time deposits have grown in importance as households and businesses seek stable returns with minimal risk. Although not as liquid as other forms of money, their role in broad money (M3) has expanded due to the increased savings habit in both urban and rural populations.

6. **Total Deposits with Post Office Savings Banks (excluding National Savings Certificates)**

These are broader post office deposits that include fixed-term savings products offered by post offices.

- **Changing Importance**: With the development of more sophisticated financial instruments, the relative importance of these deposits has decreased, especially in urban areas. However, they continue to be significant in rural regions where access to formal banking remains limited.

Measurement of Money Supply
M0 = Currency in Circulation + Bankers Deposits in RBI + Other deposits in RBI
M1 = Currency with Public + Demand deposists with banking system (Current account, saving account) + other deposits with RBI
M2 = M1 + Savings deposits of post office savings banks
M3 = M1 + Time deposits with the banking system
M4 = M3 + All deposits with the post office savings banks

High Powered Money

High-powered money, also known as the monetary base or reserve money, consists of currency in circulation and the reserves held by commercial banks with the central bank (in India, the RBI).

High-powered money is termed "high-powered" because it serves as the foundation for the money supply in the economy, through the money multiplier effect. The central bank controls high-powered money directly, influencing liquidity and monetary policy outcomes like inflation and credit expansion. An increase in this money can significantly amplify the total money supply in the economy.

Uses of High-Powered Money:

- **Foundation for Money Supply Expansion:**

High-powered money forms the basis for the money supply through the money multiplier effect. When commercial banks hold reserves, they can lend a multiple of those reserves to borrowers, thereby expanding the overall money supply. This process magnifies the impact of the original high-powered money in the economy.

- **Liquidity Management by Commercial Banks:**

Commercial banks use high-powered money to manage their liquidity needs. By holding reserves with the central bank and maintaining cash, banks ensure they can meet the withdrawal demands of depositors and fulfill their daily payment obligations.

- **Tool for Monetary Policy Implementation:**

Central banks use high-powered money to control the money supply and influence interest rates. Through operations like open market operations (OMO), the Reserve Bank of India (RBI) buys or sells government securities, thereby injecting or withdrawing high-powered money from the banking system, impacting liquidity and inflation.

- **Bank Reserve Requirements:**

Banks are mandated to hold a portion of their deposits as reserves, either in cash or as deposits with the central bank. High-powered money is crucial for meeting these statutory reserve requirements like the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR), ensuring banking system stability.

- **Facilitating Interbank Transactions:**

High-powered money is used in interbank settlements, where banks clear their accounts and make payments to each other. This ensures smooth and timely financial transactions within the banking sector.

- **Government Financing:**

The government uses high-powered money in its day-to-day financial operations. When the central bank purchases government bonds, it injects reserve money into the system, enabling the government to finance its budgetary needs.

- **Currency Issuance:**

High-powered money includes currency in circulation. The central bank controls the issuance of currency notes and coins, which are then distributed to the public and the banking sector, facilitating everyday transactions.

- **Anchor for Exchange Rate Management:**

In cases of foreign exchange interventions, central banks may use high-powered money to buy or sell foreign currency. This helps stabilize the exchange rate and manage balance of payments issues.

Sources of Changes in High Powered Money:

Changes in high-powered money (reserve money) occur due to various factors that either increase or decrease the total amount of this money in the economy.

1. **Central Bank's Open Market Operations (OMO):**

- Central bank (like the RBI) buys or sells government securities in the open market.
- **Purchases** of securities inject high-powered money into the economy, increasing reserve money.
- **Sales** of securities absorb money from the economy, decreasing reserve money.

2. **Government's Cash Balances with the Central Bank:**

- When the government deposits funds with the central bank, high-powered money is withdrawn from circulation, reducing reserve money.
- Conversely, when the government withdraws funds for expenditure, it increases high-powered money in the economy.

3. **Changes in Foreign Exchange Reserves:**

- When the central bank buys foreign currency, it injects rupees into the economy, increasing high-powered money.
- Selling foreign currency drains rupees from the economy, reducing high-powered money.

4. **Central Bank Credit to the Government:**

- The central bank may extend credit to the government by purchasing government bonds or through direct lending. This increases high-powered money in the system.
- Repayment of this credit by the government reduces reserve money.

5. **Central Bank Credit to Commercial Banks:**

- When the central bank lends to commercial banks through instruments like the repo rate, it increases reserve money.
- Repayments of these loans by commercial banks reduce high-powered money.

6. **Currency Issued by the Central Bank:**

The issuance of new currency notes and coins by the central bank directly increases high-powered money, as it adds to the currency in circulation.

7. **Changes in Bankers' Deposits with the Central Bank:**

Bank reserves held with the central bank are a significant component of high-powered money. Any increase or decrease in these reserves affects the total reserve money.

8. **Monetary Policy Actions and Interventions:**

Central bank's policy measures, such as changing the Cash Reserve Ratio (CRR) or Statutory Liquidity Ratio (SLR), influence the level of high-powered money by impacting banks' reserve requirements.

Money Multiplier:

The **money multiplier** shows how much the total **money supply** in the economy can increase based on a given amount of **high-powered money** (also called base money or reserve money).

When you deposit money in a bank, the bank keeps a small portion as **reserves** (to meet withdrawals) and **lends out the rest**. The lent money is spent, deposited again, and re-lent – this cycle repeats, and **new money is created** at each step.

This process **multiplies** the effect of the original deposit on the total money supply.

Money Multiplier Formula:

$$\text{Money Multiplier} = \frac{1}{\text{Reserve Ratio}}$$

- **Initial deposit: ₹1,000**
- **Reserve ratio: 10%**
- **Money multiplier = 1/0.10 = 10**

Suppose:

- Reserve ratio (**r**) = 10% or 0.10
- A person deposits ₹1,000 in a bank

Round	Deposit	Reserve (10%)	Loan Given Out	Cumulative Money Created
1	₹1,000	₹100	₹900	₹1,000
2	₹900	₹90	₹810	₹1,900
3	₹810	₹81	₹729	₹2,710
4	₹729	₹72.90	₹656.10	₹3,439
5	₹656.10	₹65.61	₹590.49	₹4,095
6	₹590.49	₹59.05	₹531.44	₹4,685
7	₹531.44	₹53.14	₹478.30	₹5,216
8	₹478.30	₹47.83	₹430.47	₹5,694
9	₹430.47	₹43.05	₹387.42	₹6,125
10	₹387.42	₹38.74	₹348.68	₹6,513

Then:

1. The bank keeps ₹100 (10%) as reserves.
2. It lends out ₹900.
3. That ₹900 is spent and ends up as a deposit in another bank.
4. That bank keeps ₹90 (10%) and lends ₹810.
5. This process continues.

Conclusion:

What is high powered money?

High Powered Money refers to the monetary base of base money in the country. It includes,

I) currency held by the people,
II) cash reserves of the commercial banks with the RBI, and
III) vault cash of the commercial banks.

High-powered money

$$MB = C + R$$

C = currency in circulation

R = total reserves in the banking system

Components of High-Powered Money

High Powered Money = The total currency circulating in the public + Plus the currency that is physically held in the vaults of commercial banks + Plus the commercial banks' reserves, held in the central bank.

Key Points

- **Higher reserve ratio → smaller multiplier**
- **Lower reserve ratio → larger multiplier**
- The actual multiplier is usually **less than the theoretical maximum** because:
    - People may hold some cash (not redeposit everything)
    - Banks may keep excess reserves (not lend fully)

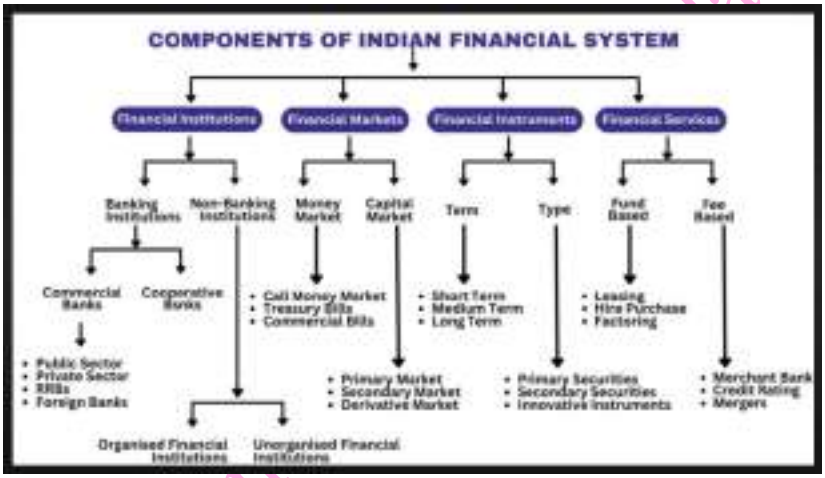
Term	Meaning
High-powered money	Money created by the central bank (cash + reserves)
Money multiplier	How many times more money the banking system can create based on base money
Formula	1 ÷ Reserve Ratio

Financial System:

A financial system refers to a set of institutions, markets, instruments, and services that facilitate the flow of funds between individuals, businesses, and governments. It plays a crucial role in the economic development of a country by efficiently allocating resources, mobilizing savings, facilitating investments, and managing risks.

In simpler terms, a financial system acts as a bridge between those who have excess money (savers) and those who need money (borrowers or investors). It supports economic activity by providing a structured way for people and organizations to manage money, raise capital, invest, and protect themselves against financial risks.

Components of a Financial System



The financial system comprises five main components:

1. Financial Institutions

These are organizations that facilitate financial transactions between savers and borrowers. They are categorized into:

- **Banking Institutions**:
    - Commercial Banks (e.g., State Bank of India, Bank of America)
    - Cooperative Banks
    - Regional Rural Banks (RRBs)
- **Non-Banking Financial Institutions (NBFIs)**:
    - Insurance Companies (e.g., LIC, ICICI Prudential)
    - Mutual Funds (e.g., HDFC Mutual Fund)
    - Pension Funds
    - Development Financial Institutions (e.g., NABARD, SIDBI)

Functions:

- Accepting deposits
- Lending money
- Providing financial services (insurance, investments, etc.)
- Facilitating investment and capital formation

2. Financial Markets

These are platforms where financial instruments are traded. They can be classified into:

- **Money Market**: Deals with short-term funds (less than one year)
    - Treasury bills
    - Commercial papers
    - Certificates of deposit
- **Capital Market**: Deals with long-term securities (more than one year)
    - Equity shares
    - Debentures
    - Bonds
- **Foreign Exchange Market**: Facilitates the trading of currencies
- **Derivatives Market**: Deals in financial contracts like futures, options, etc., to manage risk

Functions:

- Price discovery of securities
- Liquidity provision
- Capital allocation
- Risk transfer

3. Financial Instruments

These are the documents or contracts that represent a financial agreement between parties. They include:

- **Equity Instruments**: Shares or stocks
- **Debt Instruments**: Bonds, debentures, loans
- **Derivatives**: Futures, options, swaps
- **Hybrid Instruments**: Convertible debentures, preference shares

Functions:

- Represent ownership or creditor relationships
- Facilitate fundraising
- Help in managing financial risks

4. Financial Services

These are the services provided by financial institutions and intermediaries to facilitate transactions, investments, and risk management. Examples include:

- Asset management
- Investment advisory
- Insurance services
- Credit rating
- Portfolio management
- Custodial services

Functions:

- Enhance the efficiency of financial markets
- Assist in wealth creation
- Provide financial planning and investment strategies

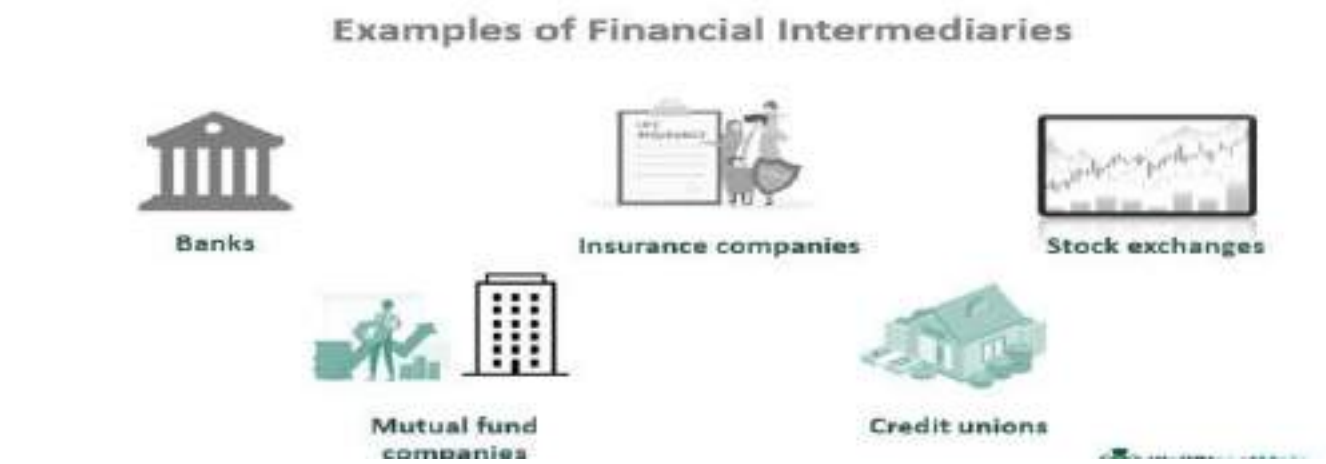
Conclusion

The financial system is a vital component of a country's economy. Its efficiency and stability significantly impact economic development, employment generation, and wealth distribution. By effectively mobilizing savings, allocating resources, facilitating investments, and managing risks, a sound financial system promotes sustainable growth and improves the standard of living.

Understanding the financial system and its components helps individuals and organizations make informed financial decisions and contributes to the overall economic well-being of a nation.

What Is a Financial Intermediary?

A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment bank, mutual fund, or pension fund. Financial intermediaries offer a number of benefits to the average consumer, including safety, liquidity, and economies of scale involved in banking and asset management. Although in certain areas, such as investing, advances in technology threaten to eliminate the financial intermediary, disintermediation is much less of a threat in other areas of finance, including banking and insurance.



- **Banks:** Banks primarily utilize the deposits made by clients to support other eligible clients in need. The interest earned for providing loans serves as income for the banks. Banks also offer several other services like forex services, insurance for deposits, and credit cards.
- **Insurance companies:** Insurance companies provide various insurance policies like life insurance, home insurance, and liability insurance designed to give financial protection to the customers. They deal with different entities like brokers and agents for completing the transactions. It pools policy holders' premiums and invests them in various investment vehicles like bonds and other money market instruments. Moreover, this way, they make a huge profit and pay claims and other liabilities without incurring massive losses even if the payouts are large. The income from their investments ensures that the insurance company is cushioned against this.
- **Stock exchanges:** The stock exchange reflects a marketplace where buyers and sellers engage in trading financial instruments like stocks and derivatives. It connects companies that need funding and investors who have excess funds to invest as an intermediary. Even with a small amount of money, one can have an ownership interest in a blue-chip company which may have otherwise been impossible.
- **Mutual fund companies**: Generally, fund managers in mutual fund companies invest the money collected from retail investors in different financial assets and distribute the return to the retail investors proportional to their investment. Based on the client preferences and investment fund managers focusing on growing the investors' wealth, select appropriate securities and compile them to form the portfolio. Mutual fund companies help clients with investment management.
- **Credit unions:** Credit unions are usually non-profit entities owned by their members. It functions similar to banks; however, they offer better savings rates and reduced borrowing costs, that is, loans at competitive rates.

Functions of Financial Intermediaries:

Financial intermediaries perform several critical functions in the financial system:

- **Maturity Transformation**:

Intermediaries like banks provide maturity transformation by converting short-term liabilities (deposits) into long-term assets (loans). This function supports long-term investment projects with short-term funds.

- **Risk Transformation**:

By pooling and diversifying risks, financial intermediaries, like insurance companies and mutual funds, reduce the financial risk to individual investors and policyholders.

- **Cost Reduction**:

Intermediaries reduce transaction costs through economies of scale. By aggregating funds from many investors, intermediaries can invest in products and markets that might otherwise be inaccessible to individual investors due to high minimum investment requirements.

- **Information Provision**:

Intermediaries reduce information asymmetry in the market by conducting due diligence on borrowers and providing valuable financial advice and information to investors.

Benefits of Financial Intermediaries:

- **Enhanced Capital Allocation**

Efficient allocation of capital leads to more productive economic activities and fosters innovation by ensuring that capital reaches promising businesses and projects.

- **Economic Stability**

By smoothing out fluctuations in interest rates and helping manage financial risks, financial intermediaries contribute to the overall economic stability.

- **Support for Personal Financial Goals**

They help individuals save for long-term goals, such as retirement and education, and manage risks through insurance products.

Challenges Faced by Financial Intermediaries:

- **Regulatory Compliance**

Financial intermediaries face significant regulatory requirements designed to ensure financial stability but which can also increase operational costs and affect business models.

- **Technological Change**

The rapid pace of technological innovation presents both opportunities and challenges, requiring ongoing investment in new technologies to stay competitive and manage risks like cybersecurity threats.

- **Market and Credit Risks**

Changes in the economic environment, such as fluctuations in interest rates, credit defaults, and market volatility, pose risks to the operations and profitability of financial intermediaries.

- **Reputation and Trust**

Maintaining trust with clients is crucial, especially in times of financial crisis or when handling sensitive client data. Mismanagement and fraud can severely damage a financial institution's reputation and viability.

MONETARY THEORY AND BANKING IN INDIA

Unit - 2

Name: Jyoti Yadav

Assistant Professor

Unit II: Indian Banking System (Monetary Theory and Banking in India)

Course: Monetary Theory and Banking in India
Programme: B. Com
Semester: Fifth

Learning Objectives

- Understand the definition, importance and functions of banks.
- Learn the structure of the commercial banking system in India.
- Study Regional Rural Banks and Cooperative Banks.
- Master the process of credit creation and the money multiplier.
- Understand determinants of money supply and total bank credit.

What Is Bank?

A **bank** is a place where people keep their money safe. It also helps people save, borrow, and manage their money. In simple words, a bank works like a trusted friend that keeps your money and gives it back when you need it.

Meaning of Bank

The meaning of a bank is an institution that accepts money from people, keeps it secure, and provides services like loans, savings accounts, and money transfers.

Definition of Bank:

"Bank is a financial intermediary institution which deals in loans and advances" Cairn Cross.

"Bank is an institution which collects idle money temporarily from the public and lends to other people as per need." R.P. Kent.

"Bank provides service to its clients and in turn receives perquisites in different forms." P.A. Samuelson.

"Bank is such an institution which creates money by money only." W. Hock.

"Bank is such a financial institution which collects money in current, savings or fixed deposit account; collects cheques as deposits and pays money from the depositors' account through cheques." Sir John Pagette.

Indian Company Law 1936 defines Bank as" a banking company which receives deposits through current account or account or any other forms and allows withdrawal through cheques or promissory notes.

About Indian Banking System:

Indian Banking System consists of a network of financial institutions regulated primarily by the Reserve Bank of India (RBI). It includes scheduled and non-scheduled banks, with scheduled banks further classified into commercial banks (public, private, foreign, and regional rural banks) and cooperative banks. Public sector banks dominate, holding a significant market share. The system supports economic growth by mobilizing deposits, extending credit, and offering financial services. Recent developments like digital banking and financial inclusion initiatives have modernized the system. The RBI regulates the banking system to ensure stability, efficient monetary policy transmission, and customer protection.

History of Indian Banking System:

1. **Pre-Independence Era (Before 1947):**

- **Ancient and Medieval Periods**: Banking in India began with indigenous bankers like Seths and Shroffs. They engaged in lending and bill exchange activities.
- **Early Modern Period (18th Century)**: The first modern bank, the Bank of Hindustan, was established in 1770 in Calcutta but ceased operations in the early 19th century.
- **Presidency Banks**: Between 1806 and 1843, three presidency banks—Bank of Bengal, Bank of Bombay, and Bank of Madras—were established by the British East India Company. These banks later merged to form the Imperial Bank of India in 1921, which was the precursor to the State Bank of India (SBI).
- **Swadeshi Movement and Indian Banks**: The early 20th century saw the rise of indigenous banks like Punjab National Bank (1894), Bank of Baroda (1908), and Canara Bank (1906) during the Swadeshi movement, promoting Indian-owned enterprises.

2. **Post-Independence Era (1947–1991):**

- **Nationalization of Banks (1969 and 1980)**: In 1969, 14 major commercial banks were nationalized, followed by six more in 1980. This marked a shift toward government control to enhance financial inclusion, expand rural banking, and support economic development.
- **Establishment of the Reserve Bank of India (1935)**: The RBI was established as the central bank, regulating the financial system and managing monetary policy.
- **Regional Rural Banks (RRBs) (1975)**: RRBs were established to cater to rural and agricultural needs, ensuring banking services reach remote areas.

3. **Liberalization and Beyond (1991–Present):**

- **Economic Reforms (1991)**: Liberalization opened the banking sector to private and foreign players, leading to the emergence of new private banks like ICICI Bank, HDFC Bank, and Axis Bank.
- **Technological Advancements**: The introduction of digital banking, online payments, and financial technology (fintech) transformed the industry. The Unified Payments Interface (UPI) is a significant milestone in India's digital payment landscape.
- **Financial Inclusion Initiatives**: Schemes like Pradhan Mantri Jan Dhan Yojana (PMJDY) and small finance banks have enhanced banking penetration across the country.

Types of Banks:

1. **Commercial Banks:**

- **Public Sector Banks (PSBs)**: These banks are majority-owned by the government. They include major banks like State Bank of India (SBI), Punjab National Bank (PNB), and Bank of Baroda. PSBs play a significant role in the economy by providing a wide range of financial services and promoting financial inclusion.
- **Private Sector Banks**: These banks are owned by private individuals or institutions. Prominent examples include HDFC Bank, ICICI Bank, and Axis Bank. They are known for their customer service, technology adoption, and competitive products.
- **Foreign Banks**: These are banks incorporated outside India but operate within the country. Examples include Citibank, HSBC, and Standard Chartered. They cater to international businesses and high-net-worth individuals.

2. **Regional Rural Banks (RRBs):**

RRBs are established to provide banking services in rural and semi-urban areas. They aim to promote financial inclusion and support agricultural and rural development. They are sponsored by commercial banks and operated with government support. Examples include Uttar Bihar Gramin Bank and Karnataka Vikas Grameena Bank.

3. **Cooperative Banks:**

- **Urban Cooperative Banks**: These banks operate in urban and semi-urban areas, offering services similar to commercial banks but on a smaller scale. They focus on serving local communities and small businesses.
- **Rural Cooperative Banks**: These banks operate in rural areas and include State Cooperative Banks (SCBs) and District Cooperative Banks (DCBs). They provide credit and other financial services to farmers and rural residents.

4. **Development Banks:**

Development banks focus on providing long-term finance for the development of industries and infrastructure. They include institutions like the Industrial Development Bank of India (IDBI) and the National Bank for Agriculture and Rural Development (NABARD), which play a crucial role in economic development and sectoral financing.

5. **Small Finance Banks:**

Established to promote financial inclusion, small finance banks provide basic banking services to underserved and unbanked sections of society. They focus on micro banking, including small loans and deposits. Examples include Ujjivan Small Finance Bank and Equitas Small Finance Bank.

6. **Payments Banks:**

Payments banks offer limited banking services, primarily focusing on payments and remittances. They cannot provide loans or accept term deposits but can accept deposits, provide remittance services, and offer basic banking products. Examples include Paytm Payments Bank and Airtel Payments Bank.

7. **Post Office Banks:**

Managed by India Post, these banks offer savings accounts, fixed deposits, and recurring deposit schemes. They aim to provide banking services in rural and remote areas where traditional banks may not have a presence.

Commercial Banks:

A commercial bank is a financial institution that provides services like loans, certificates of deposits, savings bank accounts bank overdrafts, etc. to its customers. These institutions make money by lending loans to individuals and earning interest on loans. Various types of loans given by a commercial bank are business loans, car loans, house loans, personal loans, and education loans.

As per the commercial bank definition, it is a financial institution whose purpose is to accept deposits from people and provide loans and other facilities. Commercial banks provide basic services of banking to their customers and small to

Importance:

1. Mobilization of savings and capital formation

Commercial banks encourage people to save by offering deposits and interest. These savings are converted into loans, supporting investment and capital formation in the economy.

2. Facilitation of trade and industry through credit

By providing loans, overdrafts, and trade finance, banks support business operations. This credit enables industries and traders to expand production and trade efficiently.

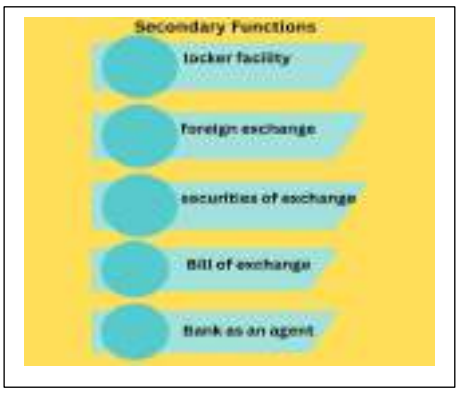
3. Implementation of monetary policy through RBI

Commercial banks act as instruments of the Reserve Bank of India to regulate money supply. They follow RBI's guidelines on lending, interest rates, and liquidity control.

4. Promotion of financial inclusion and development

Banks provide financial services to rural and underprivileged sections. This promotes balanced economic growth and reduces inequality in society.

Functions of Commercial Banks:



Primary Functions of Commercial Banks:

• Accepting Deposits from the public in savings account, current account, fixed deposits, recurring deposits, deposits from NRIs.

• Lending money to the public for their various purposes like personal loans, housing loans, vehicular loans, etc.

•Providing overdraft facility to the credit card holders.

Secondary Functions of the Commercial Banks:

• Issue debit, credit and prepaid cards.

• Issue Letter of Credit and Bank Guarantee.

• Collect amounts through cheques and other instruments.

• Sale and purchase of shares and debentures.

• Act as investment bank for Initial Public Offering (IPO) by a private company.

• Help in anti-money laundering through KYC process.

• Become an intermediary between its customers and other institutions, like payment of insurance premium, payment of various bills, direct benefit transfer (DBT) scheme of government, etc.

• Provide facilities such as Electronic Clearing Service, transfer of funds domestically and internationally, locker facilities, foreign exchange, etc

Structure of Commercial Banking System in India

The following diagram illustrates the broad structure of the banking system in India:

Note: RBI is the central bank and regulator of the banking system.

RESERVE BANK OF INDIA

It is the central bank of the country and regulates the banking system of India. The structure of the banking system of India can be broadly divided into scheduled banks, non-scheduled banks and development banks.

1. SCHEDULED BANKS

Banks that are included in the second schedule of the Reserve Bank of India Act, 1934 are considered to be scheduled banks. All scheduled banks enjoy the following facilities:

• Such a bank becomes eligible for debts/loans on bank rate from the RBI

• Such a bank automatically acquires the membership of a clearing house.

Scheduled banks are further divided into commercial and cooperative banks.

A. COMMERCIAL BANKS

The institutions that accept deposits from the general public and advance loans with the purpose of earning profits are known as Commercial Banks. Commercial banks mark significant importance in the economic development of a country as well as serving the financial requirements of the general public.

Commercial banks can be broadly divided into public sector, private sector, foreign banks and RRBs

I. **Public Sector** Banks Refer to a type of commercial banks that are **nationalized** by the government of a country. In public sector banks, the major stake is held by the government. In India, public sector banks operate under the guidelines of Reserve Bank of India (RBI), which is the central bank. Some of the Indian public sector banks are State Bank of India (SBI), Corporation Bank, Bank of Baroda, Dena Bank, and Punjab National Bank.

Nationalized Banks

Owned and controlled by the Government of India, these banks focus on social banking. They mobilize savings and provide credit to priority sectors.

II. **Private Sector** Banks Refer to a kind of commercial banks in which major part of share capital is held by private businesses and individuals. These banks are registered as companies with limited liability. Some of the Indian private sector banks are Industrial Credit and Investment Corporation of India (ICICI) Bank, and Housing Development Finance Corporation (HDFC) Bank.

III. **Foreign Banks** Refer to commercial banks that are headquartered in a foreign country, but operate branches in different countries. Some of the foreign banks operating in India are Hong Kong and Shanghai Banking Corporation (HSBC), Citibank, American Express Bank, Standard & Chartered Bank. In India, since financial reforms of 1991, there is a rapid increase in the number of foreign banks.

IV. Regional Rural Banks

RRB established under the Regional Rural Banks Ordinance, **1975** with the aim of ensuring sufficient institutional credit for agriculture and other rural sectors. The area of operation of RRBs is limited to the area notified by the Government. RRBs are owned jointly by the Government of India, the State Government and Sponsor Banks. An example of RRB in India is Arunachal Pradesh Rural Bank. Kerala Grameen Bank is the biggest RRB in India by business.

Ownership structure (typical):

- Central Government – 50%
- Sponsor Bank – 35%
- State Government – 15%

B. COOPERATIVE BANKS

A Cooperative Bank is a financial entity that belongs to its members, who are also the owners as well as the customers of their bank. They provide their members with numerous banking and financial services. Cooperative banks are the primary supporters of agricultural activities, some small-scale industries and self-employed workers.

As membership is practically open to all inhabitants of a locality, people of different status are brought together into the common organization.

Features of Cooperative Banks in India

- They belong to their members who are both the owners and customers of the bank.
    - Thus, it can be said that the **customers are the owners** of these banks.
- Cooperative Banks are named so because these have the cooperation of stakeholders as the motive.
- They **operate on the principle of "one person, one vote"** in decision making in decision-making and are managed on the basis of cooperation, self-help, and no profit no loss.
- **Along with lending,** these banks **also accept deposits.**

– They are incorporated and **registered under the States' Cooperative Societies Act** passed by the concerned state.
– The National Bank for Agriculture and Rural Development **(NABARD) is the apex body of the cooperative sector in India.**

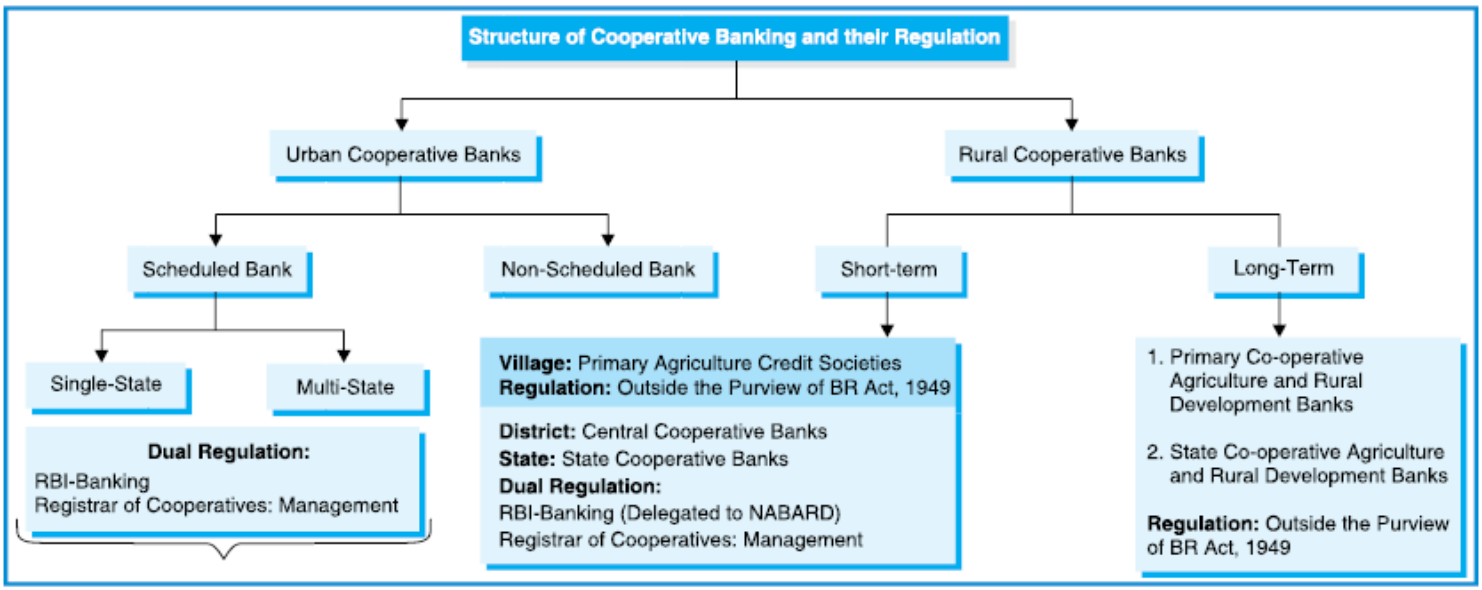
Regulation of Cooperative Banks in India

These banks in India, broadly, come under the dual control of:

- **Reserve Bank of India**: Under the **Banking Regulation Act, 1949**, and the **Banking Laws (Application to Co-operative Societies) Act, 1965,** the RBI is responsible for regulating banking aspects of these banks, such as capital adequacy, risk control, and lending norms.
- **Registrar of Co-operative Societies (RCS) of respective State or Central Government:** They are responsible for regulation of management-related aspects of these banks, such as incorporation, registration, management, audit, supersession of board of directors, and liquidation.

Structure of Cooperative Banks in India

These banks, under the Banking System in India, are primarily categorized into – Rural Cooperative Banks (RCBS), and Urban Cooperative Banks (UCBS). They are further sub-categorised as shown below:



Significance of Cooperative Banks in India

Due to their very nature of working, they play crucial roles in the Indian economy. Some of their major roles can be seen as follows:

- **Financial Inclusion**: By reaching out to the unbanked and underbanked sections of society, they play a crucial role in promoting financial inclusion.
- **Easy Access to Credit**: They offer easy access to credit to their customers that too at competitive interest rates.
- **Promoting Savings**: They encourage saving habits by offering deposit accounts tailored to rural needs.
- **Local Development**: These banks understand local needs better and thus play a significant role in rural development by funding various agricultural and rural development activities.
- **Rural Development**: The majority of these banks operate in rural areas, catering to the specific needs of farmers, small businesses, and low-income households.
- **Financial Literacy Promotion**: They often act as financial literacy educators, empowering **rural communities** to make informed financial decisions.

Banking Regulation (Amendment) Act, 2020

In light of the crises related to some UCBs, the Banking Regulation Act, 1949 was amended through the Banking Regulation (Amendment) Act, 2020. It is aimed to bring all the UCBs and Multi-State Cooperative Banks under the direct supervision of the **Reserve Bank of India (RBI)**.

Difference between Commercial Banks and Cooperative Banks

Basis of Difference	Commercial Banks	Cooperatives Banks
Formed as	Joint-stock Banks.	Co-operative organizations.
Governing Act	Banking Regulation Act 1949.	Co-operative Societies Act of 1904.
Regulation	Subject to the control of the Reserve Bank of India directly.	Subject to the rules laid down by the Registrar of Co-operative Societies.
SLR and CRR Requirements	Relatively Higher.	Relatively Lower.
Services Offered	Larger scope in offering a variety of banking services.	Lesser scope in offering a variety of banking services.
Area of Operation	Large-scale operation, usually countrywide.	Small-scale operation, usually limited to a region.
Main functions	Mostly provide short-term finance to industry, trade, and commerce, including priority sectors like exports, etc.	Usually cater to the credit needs of agriculturists.
Rate of interest	Offer lower rates of interest on deposits compared to co-op banks.	Offer a slightly higher rate of interest on deposits.
Borrowers	Borrowers of commercial banks are only account holders and have no voting power as such, so they cannot have any influence on the lending policy of these banks.	Borrowers are member shareholders, so they have some influence on the lending policy of the banks, on account of their voting power.
Flexibility in lending	Commercial banks are free from any rigidities in terms of lending options.	Co-operative banks do have not much scope for flexibility on account of the rigidities of the bylaws of the Co-operative Societies.

2. NON- SCHEDULED BANKS

All the banks which are ***not*** included in the second schedule of the Reserve Bank of India Act, 1934. They are not eligible to borrow from the RBI for normal banking purposes except for emergencies. They operate on a smaller scale, often serving local communities, and are generally not eligible for borrowing from the RBI or membership in the clearinghouse, while maintaining their cash reserves independently.

Key characteristics of non-scheduled banks

- **Not on the RBI's Second Schedule:**

They are excluded because they fail to meet the criteria outlined by the RBI under the RBI Act, 1934.

- **Limited scale and influence:**

Non-scheduled banks are typically smaller, operate on a regional basis, and have a narrower range of influence.

- **Independent cash reserves:**

They are not required to maintain their cash reserves with the central bank, but rather with themselves.

- **No RBI financial assistance:**

They are not eligible to borrow funds from the RBI for normal banking operations.

- **No clearinghouse membership:**

They are generally not allowed to join the clearinghouse, which is a system for clearing checks and other instruments, limiting their ability to participate in inter-bank transactions.

- **Riskier and less regulated:**

Due to limited regulatory oversight and fewer reporting requirements to the RBI, these banks are considered riskier and do not offer the same level of depositor protection as scheduled banks.

3. **DEVELOPMENT BANKS**

Development banks are financial institutions that provide long-term funds for capital-intensive investments. They are also known as development finance institutions (DFI) or long-term lending institutions. These banks lend at low and stable interest rates to promote long-term investments with social benefits. Unlike commercial banks, development banks do not accept deposits from the public. Therefore, they do not rely solely on savings mobilization. Development banks are specialized institutions that provide medium and long-term credit lending facilities. Their primary objective is to serve the public interest rather than earn profits. They offer financial assistance to both public and private sector institutions.

Key Features of Development Banks:

- **Financial Expertise:** Development banks are expert financial bodies that perform dual functions: granting medium and long-term finances to private entrepreneurs and promoting the economic development of the country.
- **Financing Sectors:** These banks provide medium and long-term finances to both the industrial and agricultural sectors, as well as to both private and public sectors.
- **Examples in India:** Some prominent development banks in India include the Industrial Development Bank of India (IDBI), the Industrial Credit and Investment Corporation of India (ICICI), and the Export-Import (EXIM) Bank of India.

Importance of Development Banks

- Development banks lay the foundation for industrial growth and development in the country.
- They meet long-term capital needs.
- They undertake promotional activities.
- They help medium and large sectors.

Objectives of Development Banks in India

- Promotion of self-employment projects
- Reviving sick units
- Improving the capital market in the country

- Generating more exports and promoting import substitution
- Promoting science and technology in new areas by extending risk capital
- Improving the management of large industries by providing them adequate training
- Encouraging modernization and improvement in the technology sector

Types of Development Banks in India

SIDBI (Small Industries Development Bank of India)

- Established in 1990 under an Act of Parliament
- Wholly-owned subsidiary of the Industrial Development Bank of India (IDBI)
- Headquartered in Lucknow

Functions:

  - Initiating technical upgradation and modernization of existing units
  - Expanding channels for marketing small-scale industry products domestically and internationally
  - Promoting employment-generating industries, particularly in semi-urban areas
  - Curbing migration of people to urban areas

IFCI (Industrial Finance Corporation of India)

The IFCI was the first specialized financial institution to provide term finance to large businesses in India. It was set up under the Industrial Finance Corporation Act on July 1, 1948.

Objectives of IFCI

The primary objective of the IFCI is to provide long and medium-term financial offerings to large-scale businesses. It especially offers its services when ordinary bank accommodation does not suit the undertaking or the finance cannot be raised in a profitable manner from the issue of shares.

Functions of IFCI

- Setting up a new industrial undertaking
- Expansion and/or diversification of existing industrial business
- Renovation and modernization of existing businesses
- Meeting the working capital needs of the industries, with some exceptions

IDBI (Industrial Development Bank of India)

The Industrial Development Bank of India, popularly known as IDBI, came into existence as a Development Institution under the IDBI Act of 1964. It is headquartered in Bombay, Maharashtra.

The IDBI is regarded as a public financial institution as per the Companies Act 1956. It continued as DPI till 2004 when it was converted into a banking organization. The Industrial Development Bank of India Act of 2003 was passed to convert the DPI into a bank.

Under the name of the Industrial Development Bank of India Ltd., a new company was incorporated as a government company under the Companies Act on September 27, 2004. Thus, w.e.f. October 1, 2004, it came to be known as IDBI Ltd. it works as a bank in terms of the Repeal Act.

The IDBI Bank Ltd. was finally merged with IDBI Ltd. and was known as IDBI.

NABARD (National Bank for Agriculture & Rural Development)

- Established on 12th July 1982 under a special act by the parliament
- Headquartered in Bombay (Maharashtra)
- Functions:
    - Uplifting rural India by increasing credit flow for the promotion of agriculture and non-farm sectors

- Apex bank of the country, taking care of cottage industry, small and village industries, and other rural credit institutions

Role:

- Undertake monitoring and evaluation of projects it has been refinancing.
- Refinance financial institutions that finance the rural sector.
- Regulate institutions that provide financial assistance to the rural economy.
- Provide training facilities to institutions assisting rural development.
- Regulate cooperative banks and Regional Rural Banks (RRBs) in India.

EXIM Bank

The Export-Import Bank of India (EXIM Bank) is a financial institution established under the Export-Import Bank of India Act of 1981 and under act on 01 Jan 1982. It is a public sector financial institution with the primary objective of financing Indian exports that generate foreign exchange for the country. EXIM Bank also extends term loans for foreign trade.

Functions:

- Finance imports and exports of goods and services in India and developing countries worldwide.
- Provide lease financing for exports and imports of machinery and equipment.
- Finance joint ventures in foreign countries.
- Undertake limited merchant banking operations, such as issuing shares, bonds, stocks, and debentures of Indian companies involved in international trade.
- Provide technical, financial, and administrative assistance to businesses engaged in export and import activities.

National Housing Bank

The National Housing Bank (NHB) is a state-owned bank and regulatory authority in India established under the National Housing Bank Act of 1987. It was created on July 8, 1988, and is headquartered in New Delhi.

NHB is responsible for regulating and refinancing social housing activities, including research. Owned by the Reserve Bank of India, it was established to promote private real estate acquisition. The institution aims to foster inclusive expansion with stability in the housing finance sector.

Functions:

- Regulate housing finance institutions, including banks, housing finance companies, and non-banking financial companies.
- Refinance housing loans provided by primary lending institutions.
- Promote the development of the housing finance market in India.
- Undertake research and studies on housing finance and related matters.
- Provide training and capacity building for personnel engaged in the housing finance sector. Process of Credit Creation by Banks

What is Credit Creation by Bank?

Credit creation is the mechanism through which commercial banks create money in the form of demand deposits. These deposits are generated when banks lend a portion of the deposits they receive while maintaining a mandatory reserve with the central bank (RBI in India).

- **Credit Money:** Credit Money is not a printed currency, but is created through loans issued by banks. When a bank lends money, it does not hand over physical cash, but rather credit to the borrower's account, which increases the supply of money.
- **Primary deposit:** These are initial deposits made by customers with commercial banks. They serve as the foundation for the bank's lending activities and credit construction process.
- **Derivative Deposits**: Also called secondary deposits, these are created when the bank lends money to borrowers, and the amount is credited to the borrower's account. This new deposit can again be used by the borrower for payments, continuing the cycle.

Credit creation is a key function of commercial banks. When banks receive deposits, they keep a fraction as reserves (as required by the RBI) and lend out the remainder. The lent funds are usually redeposited in banks, enabling further lending and creating credit multiple times.

Process of Credit Creation by Banks

This section explains how banks create credit step-by-step using the fractional reserve system. The process leads to a multiplier effect, expanding the total money supply in the economy.

1. **Acceptance of Primary Deposits:** When a customer deposits ₹10,000 in Bank A, this is considered a primary deposit. It becomes a liability for the bank, but also a source for future lending.
2. **Reserve Maintenance as per CRR:** Banks are required to hold a Cash Reserve Ratio (CRR) with the RBI. For instance, if CRR is 10%, Bank A keeps ₹1,000 as reserve and is allowed to lend the remaining ₹9,000.
3. **Issuing Loans:** The bank lends ₹9,000 to a borrower, who uses this money for transactions. This creates a new derivative deposit when the amount is deposited in another bank.
4. **Secondary Deposits & Re-lending**: The second bank (say, Bank B) receives ₹9,000. It keeps ₹900 (10%) as reserve and lends ₹8,100. This cycle continues, with each bank keeping a fraction in reserve and lending the rest.
5. **Credit Multiplier Effect:** The process continues until the entire lending capacity of the banking system is exhausted. A single initial deposit leads to multiple loans and deposits, increasing the overall money supply.

Credit Creation Formula

This section introduces the mathematical formula used to calculate the total credit created in the banking system. It's crucial for understanding the scope and scale of money supply expansion.

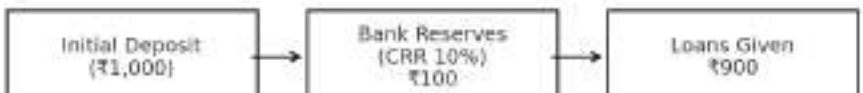
Formula

Total Credit Creation = Initial Deposit × Credit Multiplier
Credit Multiplier = 1 / CRR

This formula highlights that a lower CRR leads to a higher credit multiplier, thereby increasing the total money created in the system.

- Example 1: If an initial deposit is ₹10,000 and CRR is 10%:
  Multiplier = 1 / 0.10 = 10
  Total Credit = ₹10,000 × 10 = ₹1,00,000
- Example 2: If CRR is reduced to 5%:
  Multiplier = 1 / 0.05 = 20
  Total Credit = ₹10,000 × 20 = ₹2,00,000

Schematic: Credit Creation Process (First Rounds)



Detailed Example (with CRR = 10%, initial deposit = ₹1,000):

Different Bank	Deposit (₹)	Reserve (10%) (₹)	Loan (₹)
1	1000.00	100.00	900.00
2	900.00	90.00	810.00
3	810.00	81.00	729.00
4	729.00	72.90	656.10
5	656.10	65.61	590.49

Total deposits after many rounds approach: Initial Deposit × (1 / CRR) = ₹1,000 × 10 = ₹10,000 (theoretical limit).

Importance of Credit Creation by Banks

Credit creation is central to economic development, as it enables increased investment, production, and consumption. Here's why it's so critical:

- **Supports Economic Growth**: By providing loans to businesses and individuals, credit creation enables capital formation. This leads to industrial growth, infrastructure development, and higher GDP.
- **Ensures Financial Inclusion:** People who lack ready funds can borrow for education, health, or business. Credit creation helps in making financial services accessible to a broader population.
- **Effective Monetary Policy Transmission**: When the RBI changes interest rates or CRR, it affects the banks' ability to create credit. Thus, monetary policies are effectively implemented through the credit creation channel.
- **Promotes Employment:** Businesses use loans to expand operations, which creates job opportunities. Thus, credit creation indirectly leads to employment generation.
- **Enables Wealth Generation**: Individuals can buy homes, invest in enterprises, or build assets using bank credit. Over time, this helps build personal and national wealth.

Limitations of Credit Creation by Banks

Powerful, credit construction has its limitations. These factors can restrict the capacity of banks to effectively create money.

- **High CRR or SLR:** If the central bank increases CRR or SLR, banks will have to keep high reserve. It reduces the amount available for credit.
- **Limited cash in banks:** If banks receive low deposits, their borrowing capacity falls. The credit construction process depends a lot on the amount of public deposits.
- Risk of debt lapse: When borrowers fail to repay, banks are damaged. It further inhibit lending and credit construction.
- **Liquidity crisis:** If too many depositors withdraw money at the same time, banks may face cash deficiency. This forces banks to keep more stores, limiting their borrowing power.

- **Leakage and Cash withdrawal:** If funds leave the banking system and remain out as cash, the multiplier effect is broken. Leakage credits reduce the total capacity of creation.

Determination of Money Supply

Key Determinants of Money Supply

- **High-Powered Money (H):**

This is the base money controlled by the central bank, consisting of currency in circulation with the public and the reserves held by commercial banks.

- **Central Bank Policies:** The central bank directly influences high-powered money through actions like buying or selling government securities (open market operations) to inject or withdraw money from the economy.

- **Money Multiplier (m):**

This factor determines how much the money supply expands for every unit of high-powered money. The money multiplier is influenced by:

- **Reserve Ratio (r):** The percentage of deposits that banks are legally required to hold as reserves. A higher reserve ratio reduces the amount banks can lend, decreasing the multiplier and money supply.
- **Currency Ratio (k) (or Currency-Deposit Ratio):** The ratio of currency the public chooses to hold as cash versus the amount they deposit in banks. A higher currency ratio reduces the amount of money available for banks to lend, decreasing the money multiplier and money supply.

- **Money Supply Formula:**
  The money supply (M) is calculated as the product of high-powered money (H) and the money multiplier (m).
  - **M = H * m**

  Where,

  M= Money Supply

  H= High Powered Money

  M= Money multiplier

Other Influencing Factors

- **Commercial Bank Behaviour:**

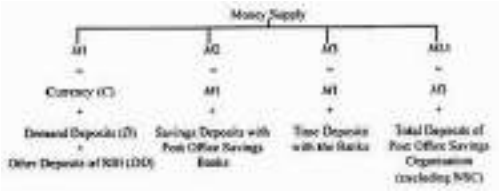
Banks determine the total amount of demand deposits through their lending practices.

- **Public Behaviour:**

The public's preference for holding cash versus making deposits affects the money multiplier.

- **Economic Conditions:**

Broader economic activity, government fiscal policies, and financial innovations can also influence the size and composition of the money supply.



Total Bank Credit

Total bank credit refers to the aggregate loans and advances provided by the banking system to various sectors. It is influenced by deposit mobilization, monetary policy, interest rates, credit demand in the economy, and the health of banks (NPAs).

Determination of Total Bank Credit:

Determining total bank credit is essential for understanding how much financial resources are available for lending and investment in an economy. Bank credit refers to the total amount of loans and advances extended by commercial banks to various sectors including individuals, businesses, and governments. This measure is a key indicator of economic activity and financial stability.

Components:

Total bank credit encompasses all types of loans and advances that banks provide.

- **Personal Loans:**

Loans extended to individuals for personal use, such as home loans, auto loans, and personal lines of credit.

- **Business Loans:**

Credit facilities provided to businesses for operational needs, capital investments, and expansion.

- **Commercial Paper and Trade Credit:**

Short-term borrowing arrangements and credit extended for trade transactions.

- **Government Loans:**

Loans given to government entities for public projects and expenditures.

The sum of these components represents the total bank credit, reflecting the financial resources available for economic activity.

Factors Influencing Total Bank Credit:

Several factors impact the total amount of credit that banks can extend:

1. **Reserve Requirements**

Central banks set reserve requirements that dictate the proportion of deposits banks must hold as reserves. This requirement impacts how much money banks have available for lending. A lower reserve requirement means banks can lend more, increasing total bank credit. Conversely, a higher reserve requirement restricts lending capacity, reducing total bank credit.

2. Capital Adequacy

Banks are required to maintain a certain level of capital relative to their risk-weighted assets, as mandated by regulations like Basel III. Capital adequacy ensures banks can absorb potential losses and remain solvent. Higher capital requirements might limit a bank's ability to extend credit, while lower requirements could allow for more lending.

3. Monetary Policy

Central banks influence total bank credit through monetary policy tools:

- **Open Market Operations (OMO):** By buying or selling government securities, central banks affect the amount of money available in the banking system. Purchasing securities injects liquidity, enabling banks to extend more credit, while selling securities withdraws liquidity, reducing credit availability.
- **Interest Rates:** Central banks set key interest rates, which influence borrowing and lending rates across the economy. Lower interest rates reduce the cost of borrowing, encouraging banks to extend more credit. Higher rates have the opposite effect, discouraging borrowing and reducing credit extension.

4. Economic Conditions

The broader economic environment plays a significant role:

- **Economic Growth:** During periods of strong economic growth, demand for credit typically rises as businesses expand and consumers spend more. In contrast, during economic downturns, demand for credit may decline due to lower business investment and consumer spending.
- **Inflation:** High inflation can erode the real value of loans, impacting lending behavior. Central banks may adjust monetary policy in response to inflation, affecting total bank credit.