



**Module:** English

**Branch:** Commercial Sciences

**Level:** Second year Bachelor

## Lecture 05: The Money Creation by banking System

Most of the money in circulation is created, not by the printing of banknotes by the Central Bank, but by the commercial banks themselves

### Objectives

After reading this unit, you should be able to:

- Understand the meaning of Money Creation
- Clarify the process of creating Money
- Define Money Multiplier.

### 1- Full reserve banking

In this case, the commercial bank maintains a full cash reserve to cover the total amount of the deposit. This situation does not allow the commercial bank to create any new deposit, and therefore the bank in this situation is considered merely an intermediary that receives savings in the form of deposits (and at the same time they are considered among the bank's assets), considering that This process is nothing more than a transfer of the same amount from circulation to the bank's treasury. There is no addition to the volume of the monetary mass in circulation, and therefore there cannot be a double expansion or contraction in the volume of deposits to which the bank is committed.

### 2-Partial reserve banking

As banks resorted to investing most of their deposits in profitable assets and keeping part of the cash reserve, banks were able to increase their profits. Thanks to these profits, the ability of banks to provide additional services to the public has increased.

The banks' reliance on partial reserves, meaning maintaining a portion of the cash reserve instead of a reserve of 100% of deposits, has enabled them to create money, meaning that banks are able to convert each dinar of cash reserves into several dinars of deposits.

### 3- Money creation process

In fact, there are steps that are taken into consideration in this process:

- Legal reserve requirements: In fact, banks set aside part of their accounts as cash reserves. These amounts are kept in cash as deposits with the Central Bank in accordance with the law.

- Using cash reserves as input: The banking system converts reserves into a larger amount. This process is called the “bank deposit multiplier.”
- The multiplicity of commercial banks in the banking system
- There is no leakage of money balances into circulation (scriptural money remains without banknotes)

**Illustrative example:**

Suppose a person deposits \$1,000 into his current account at Bank1. The change in the balance sheet of Bank 1 regarding the new demand deposit is shown in the following table

Liabilities	Assets
Deposits 1000	Reserves 1000
Total 1000	Total 1000

In this example, we will assume that the legal reserve requirement is 10%, so the bank must set aside \$100 from the \$1,000 deposit. Therefore, the bank resorts to investing this surplus amount \$900 in order to obtain a profit, by lending it to a customer who wants to buy a car,. The following table shows this situation:

Balance sheet of Bank 1

Liabilities	Assets
Deposits 1000	Reserves 100 Credits 900
Total 1000	Total 1000

The person who borrowed the money takes \$900 (cash or check) and deposits it into his account at another bank. The Balance sheet of Bank 2 for the new deposit becomes as follows:

Liabilities	Assets
Deposits 900	Reserves 900
Total 900	Total 900

In turn, Bank 2 deducts the legal reserve percentage of 10% from \$900 (i.e. the amount of the legal reserve is \$90), and the remainder (\$810) is loaned by the bank to a person who wishes to buy a specific commodity.

Balance sheet of Bank 2

Liabilities	Assets
Deposits 900	Reserves 100 Credits 810
Total 900	Total 900

The following table shows the process of creating money resulting from depositing \$1,000.

Banks	Deposits in Banks	Required reserves	Loans made by Bank
1	1000	100	900
2	900	90	810
3	810	81	729
4	729	72.90	656.10
.	.	.	.
.	.	.	.
.	.	.	.
Total	10000	1000	9000

The total of creating money= 1000+900+810.....

$$=1000 \frac{1}{1-\frac{9}{10}} = 1000 \frac{1}{0.1} = 10000$$

That is, the total creation of deposit money;

$$\text{Initial deposit} \frac{1}{\text{Required reserve ratio}}$$

In our example,  $1000 \frac{1}{0.1} = 10000$

$\frac{1}{\text{Required reserve ratio}}$  is called Money multiplier. In our example  $\frac{1}{0.1}=5$  is money multiplier