

How Banks Create Money

Chapter 20: Banks and the Magic of Finance · Topic 2

Key Concept

When someone deposits money in a bank, the bank keeps a small portion as a reserve and lends out the rest to borrowers.

This loaned money often gets deposited into another bank account, which can then be partially loaned out again, repeating the cycle multiple times.

Through this process, the total amount of money circulating in the economy becomes larger than the original amount deposited, a concept called the money multiplier effect.

This process is carefully regulated by central banks (like the Reserve Bank of India) to ensure banks maintain enough reserves and the money supply stays stable and appropriate for the economy.

Quick Revision Notes

- Banks create money through credit creation.
- Banks keep a reserve and lend out the rest of deposits.
- Loaned money often gets re-deposited elsewhere.
- This can be loaned out again, repeating the cycle.
- This expands the total money in circulation.
- This is called the money multiplier effect.
- Central banks regulate this process.
- The Reserve Bank of India regulates Indian banks.

Practice Questions

- 1 Explain credit creation in your own words.
- 2 Research the role of the Reserve Bank of India.
- 3 Discuss why banks must keep some money in reserve.
- 4 Explain the money multiplier effect simply.
- 5 Discuss why this process needs regulation.
- 6 Research what happens if banks lend too much without reserves.