

## **Magic of Modern Banking: Why Banks are so important?**

It is important to understand that in a capitalist society, banks form a very special status. In modern era we use Money as a medium of exchange and a store of value. Importance of smooth flow of money is like flow of blood in human body, one can't imagine life without it.

Banks apart from playing a role of facilitator in intermediation of payment process plays another important role of creating money.

### **Modern Banking Magic: Money out of thin air.**

Government around the world entrusts responsibility of creating and printing money, regulating money supply and interest rates to a public agency, this agency is known as Reserve Bank or Central Bank or Federal bank. In India we call monetary authority as Reserve Bank of India, in US it is known as Federal Reserve.

This central authority implements what is known as Fractional Reserve banking system. Implementation of fractional reserve banking system is the heart of modern society's progress and well-being. Under this system, when one deposits an amount in a bank in his account, the bank in turn keeps certain amount reserve and lends the rest of the money. Banks, in the process of lending out this money creates new money.

### **Let us take an example:**

Central authority has declared a rule that banks must keep Rs. 20 for every Rs. 100 deposits as a reserve and the rest it can lend out. Now, if you put Rs. 100 in a bank A in your accounts, our bank A will deposit Rs. 20 with central authority and the rest it can lend. If I go to Bank A and borrow Rs. 80, bank A will lend it to me. I will take that money from it and put it in my Bank B. My bank, will again keep Rs. 16 as reserve and can possible lend out Rs. 64.

A single Rs. 100 can create in total Rs. 500 in the whole banking system. This additional Rs. 400 is created out of thin air and this is the magic of modern banking. This allows society to invest money, without losing the ability to use it on demand. Banks play a pivotal role in this process, and that is why banks are the most important financial player in the modern society.

The controlling factor in this process was requirement of keeping 20% aside while banks lend money out. This ratio, through which central authority controls the flow of money in the system is known as Statutory lending ratio (SLR).

The central bank can also create or reduce money in the system by doing what is known as OPEN MARKET OPERATIONS (OMO). If RBI issues bonds at attractive interest rates, banks and other financial investors will purchase those bonds in return give money to RBI. This will reduce overall money in the system. Similarly when RBI repurchases bonds at attractive rates; investors will sell their securities and will get money back from the regulator.

RBI, Our reserve bank on December 15 on its review of its credit policy reduced SLR by 1% from 25% to 24%. This was done to ease the liquidity problem. After that step, banks could immediately lend the extra 1% of its money out, as it will have to keep that much less as reserve. RBI also announced plans to purchase government securities from the open market to release funds into the system.

These measures are expected to result in additional liquidity of Rs 48,000 crore being injected into the financial markets.

Whenever Banks need money for the short term, they borrow it from the central authority and it puts some securities as collateral. Reserve bank charges some interest rate on the cash borrowed by banks. This rate is usually less than the interest rate on the bonds, and this interest rate is called “repo rate”.

If the regulator wants to reduce money in the banking system, it will offer attractive rates to the banks and borrow money from them. This interest rate offered is known as “reverse repo”.

The central banks along with commercial banks play a crucial role in well-being of modern society. A wise man has said that there have been three great inventions since the beginning of time: fire, the wheel, and Central Banking!