CASH RESERVE RATIO

Cash Reserve Ratio (CRR)

– By Prof. Simply Simple

CASH RESERVE RATIO

- It is a bank regulation that sets the minimum reserves each bank must hold by way of customer deposits and notes
- These deposits are designed to satisfy cash withdrawal demands of customers
- Deposits are normally in the form of currency stored in a bank vault or with the central bank like the RBI
- CRR is also called the Liquidity Ratio as it seeks to control money supply in the economy

CASH RESERVE RATIO

Effects on money supply…

- **CRR is used as a tool in monetary policy, influencing the country's economy, borrowing and interest rates**
- **CRR works like brakes on the economy's money supply**
- **CRR requirements affect the potential of the banking system to create higher or lower money supply**
- **Let us now understand how CRR requirements affects the potential of banks to 'create' higher or lower money supply**

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CRR and liquidity…

- **For e.g. say…the CRR is pegged by RBI at 10%. if a bank receives Rs. 100 as deposit, then they can lend Rs. 90 as a loan and will have to keep the balance Rs. 10 in customer's deposit account**

- **Now, the borrower who has received Rs. 90 as a loan will deposit the same in his bank**

- **The borrower's bank will now lend out Rs. 81 (Rs. 90 X 90%) and keep Rs. 9 in his deposit account**

- **As this process continues, the banking system can expand the initial deposit of Rs.100 into a <u>maximum of Rs. 1000</u> (Rs. 100 + Rs. 90 + Rs. 81….=Rs. 1000)**

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Similarly…

- **For e.g. say…the CRR is pegged by RBI at 20%. if a bank receives Rs. 100 as deposit, then they can lend Rs. 80 as a loan and will have to keep the balance Rs. 20 in customer's deposit account**
- **Now, the borrower who has received Rs. 80 as a loan will deposit the same in his bank**
- **The borrower's bank will now lend out Rs. 64 (Rs. 80 X 80%) and keep Rs. 16 in his deposit account**
- **As this process continues, the banking system can expand the initial deposit of Rs.100 into a maximum of Rs. 500 (Rs. 100 + Rs. 80 + Rs. 64….=Rs. 500)**

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So…

- **The higher the cash reserve (CRR) required, the lower the money available for lending**
- **Every time the borrowed money comes into a deposit account of a customer, the bank has to compulsorily keep a part of it as reserves**
- **This reduces credit expansion by controlling the amount of money that goes out by way of loans**
- **This directly affects money creation process and in turn affects the economic activity**
- **Hence central banks in the world increase the requirement of cash reserves whenever they feel the need to control money supply**

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To sum it up…

- **CRR is increased to bring down inflation which happens due to excessive spending power**
- **Spending power is augmented by loans - if money that goes out as loans is controlled, inflation can be tamed to some extent**
- **Conversely, if the government wants to stimulate higher economic activity and encourage higher spending to achieve economic growth, they will lower CRR**
- **A lower CRR allows the bank to lend more money and will fuel consumption and spending**
- **Thus…banks indirectly enjoy the power to create more money**

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Hope you have now understood the concept of Cash Reserve Ratio.

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