

MONEY SUPPLY EXPANSION AND RUN ON A BANK



vEcoSys

**Understanding ‘Money Supply  
Expansion’ and ‘Run on a Bank’  
(New Version)**

– By Prof. *Simply Simple*™



## MONEY SUPPLY EXPANSION AND RUN ON A BANK



Sometime back, I had covered a lesson on the working of the ‘Money Supply’.

In this lesson we’ll try to explore another angle of the same concept as well as understand the concept, “Run on a Bank”.



## MONEY SUPPLY EXPANSION AND RUN ON A BANK

In the earlier lesson, we saw that an increase in money supply should be done with an objective to benefit the economy as a whole.



## **MONEY SUPPLY EXPANSION AND RUN ON A BANK**

**But printing notes is not the best method to increase the supply of money in the economy as it fuels inflation.**

**However banks also have the power to 'create' money by their lending activities.**



## MONEY SUPPLY EXPANSION AND RUN ON A BANK

As always, let's take an example to understand this better...



Say there is a farmer called Mr. Manure...

## MONEY SUPPLY EXPANSION AND RUN ON A BANK

Suppose he deposits ₹100 in his savings bank account.

His savings bank account will reflect the ₹100 as deposit.

Although Mr. Manure does not physically have the money with him after depositing ₹100 in the bank, it still constitutes a part of the money supply because he still has the right to withdraw and spend it.



## **MONEY SUPPLY EXPANSION AND RUN ON A BANK**

**Now, what is his bank going to do with the money he has deposited?**

**It is surely NOT going to keep the ₹100 with itself till the time Mr. Manure came back to claim it.**

**If it were to do that then his money, instead of earning interest in the bank, would actually depreciate.**





## MONEY SUPPLY EXPANSION AND RUN ON A BANK

Now suppose the bank maintains a reserve of 10%, then it will keep ₹10 with itself and lend ₹90 to someone else who is in need.

The borrower, Mr. Spender can either take the loan of ₹90 and utilize it for value creation like funding his working capital or use it to invest in some asset.



## MONEY SUPPLY EXPANSION AND RUN ON A BANK

Remember that all this while the lending of ₹90 by the bank, in no way, would lead to a reduction of ₹90 from Mr. Manure's deposit as technically Mr. Manure can withdraw this amount if he needs it.



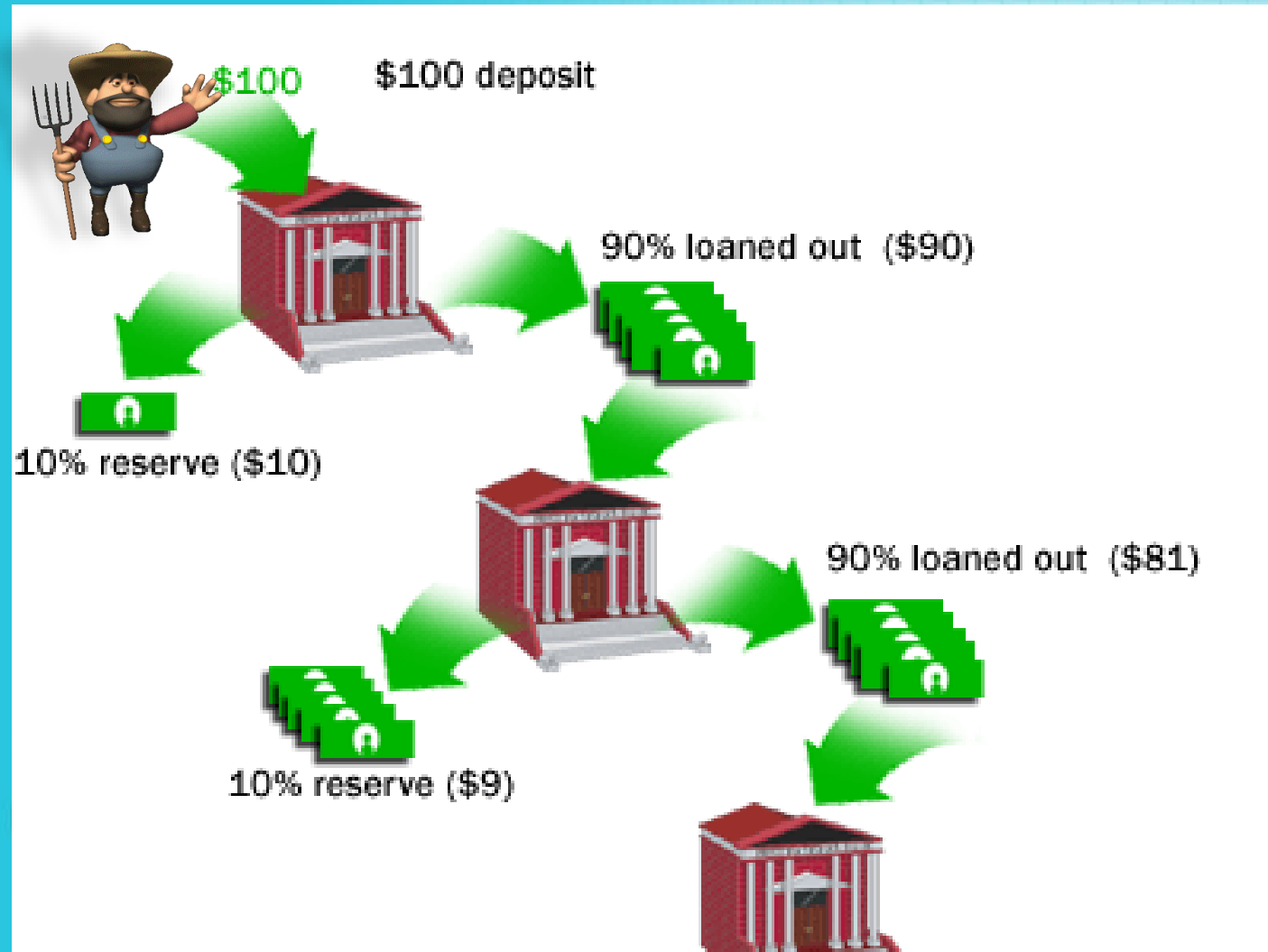
## MONEY SUPPLY EXPANSION AND RUN ON A BANK

Now let's say Mr. Spender makes a payment out of the borrowed money for buying an asset. The seller (Mr. Selar) of the asset in turn would deposit the ₹90 in his bank which would hold back 10% (₹9) in the bank and lend the balance ₹81 to another borrower and so on and so forth the cycle repeats itself as shown in the next slide.



# MONEY SUPPLY EXPANSION AND RUN ON A BANK

So this is how money grows & its supply increases...



## **MONEY SUPPLY EXPANSION AND RUN ON A BANK**

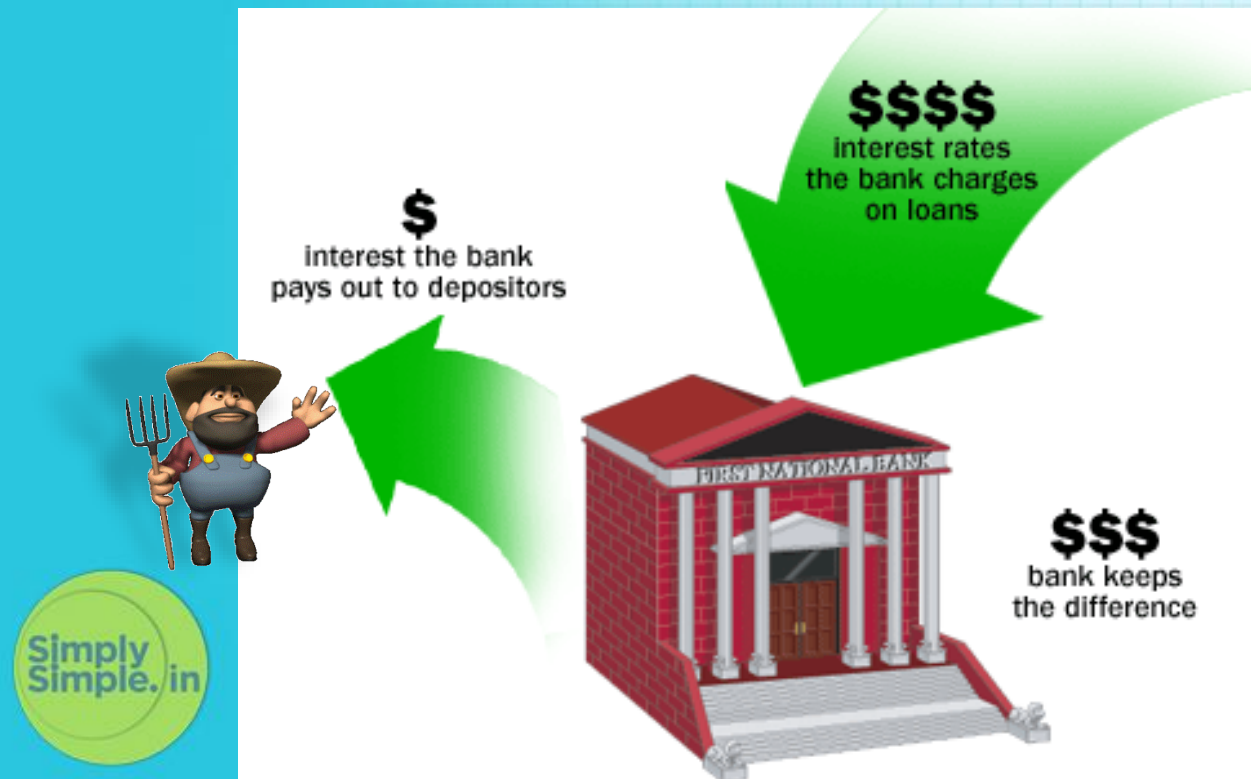
**All our banks keep part of the deposits as reserves for meeting the day-to-day redemption of other depositors and lend the remainder to their borrowers.**

**The assumption being, “Not all depositors would demand their money at the same time”.**



## MONEY SUPPLY EXPANSION AND RUN ON A BANK

Thus by expanding money supply as explained the bank is able to earn an interest and pass on a portion of the same to the depositor as interest income.



## **MONEY SUPPLY EXPANSION AND RUN ON A BANK**

**Let's get a better understanding of how bank's meet the redemption demand even as they lend most of the deposited money.**

**It does this through the help of the 10% reserves that it holds from all depositors.**

**The aggregation of the 10% that it holds becomes a large enough reserve to fund some of the expected redemptions.**



## **MONEY SUPPLY EXPANSION AND RUN ON A BANK**

**Remember not all depositors break their deposits.**

**This is the key principle that keeps the money supply engine chugging along.**

**Hence this 10% Cash Reserve Ratio (or CRR as it is popularly known) is good enough to handle redemptions.**

**Therefore the 90% that is given as loans to borrowers constitutes additional money supply for the economy.**





## MONEY SUPPLY EXPANSION AND RUN ON A BANK



Thus the ₹100 which was deposited with the bank created ₹190 for the economy at the first step and ₹271 ( $100 + 90 + 81$ ) at the second step and so on and so forth.

At a macro level, this causes the expansion of money supply.



## **MONEY SUPPLY EXPANSION AND RUN ON A BANK**

**But in case there is negative news about overall economy like what we witnessed in the 2008 economic meltdown, it may happen that a disproportionately large number of depositors approach the bank all at once to withdraw their deposits.**

**At such times the bank can get into a fix by not having the requisite money for meeting the depositor's demands. This is when we say, "there is a run on the bank".**



## **MONEY SUPPLY EXPANSION AND RUN ON A BANK**

**A bank run (also known as a run on the bank) occurs when a large number of bank customers withdraw their deposits because they believe the bank is, or might become, insolvent.**

**As a bank run progresses, it generates its own momentum: as more people withdraw their deposits, the likelihood of default increases, and this encourages further withdrawals.**

**This can destabilize the bank to the point where it faces bankruptcy!**



## **MONEY SUPPLY EXPANSION AND RUN ON A BANK**

**When a run comes, Mr. Manure's bank must quickly increase its cash to meet depositors' demands.**

**It does so primarily by selling assets, often hastily and at fire-sale prices.**

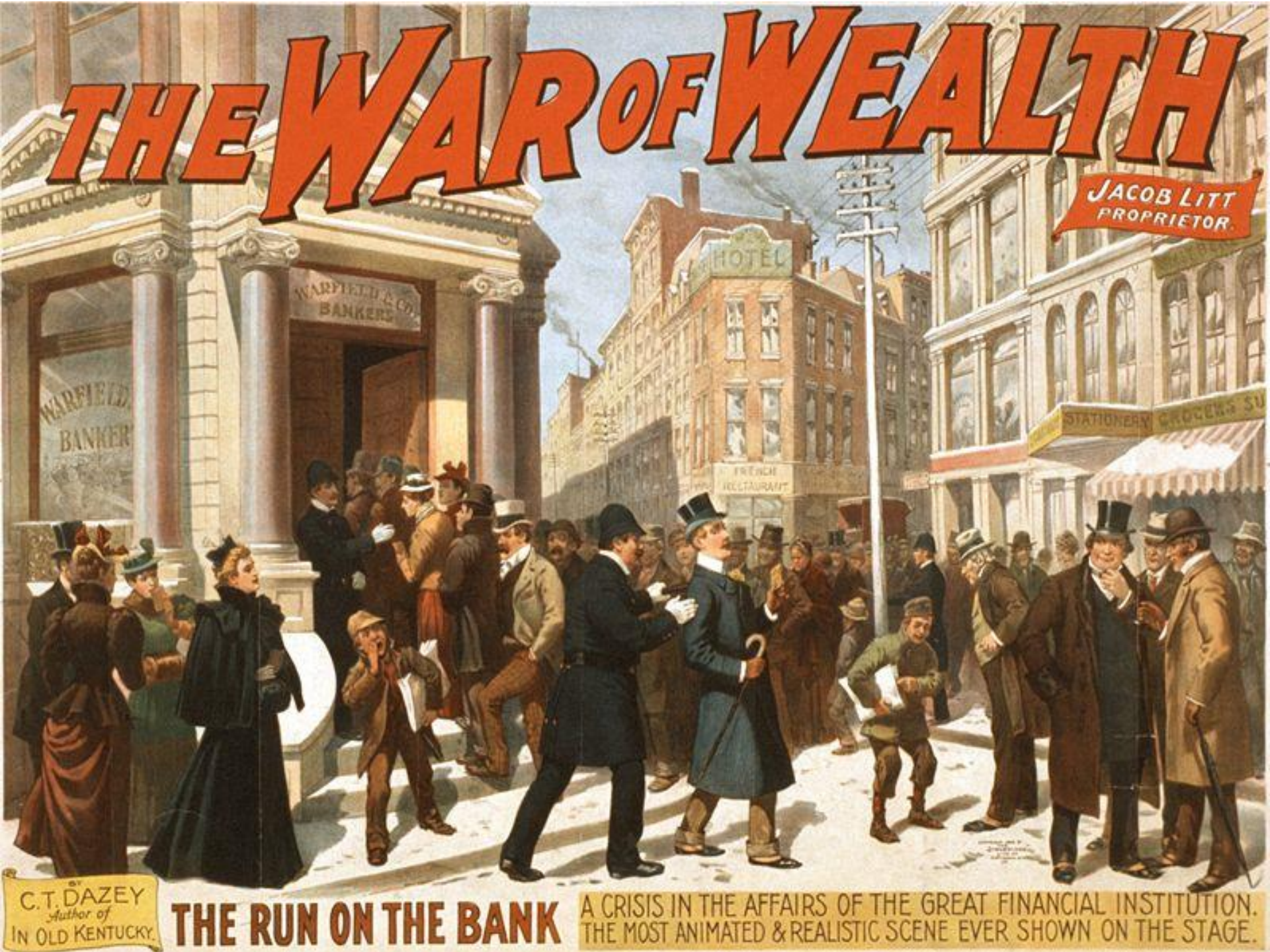
**As it holds little capital and is highly leveraged, losses on these sales can further hurt the health of the bank's books of accounts.**



## MONEY SUPPLY EXPANSION AND RUN ON A BANK

The run on a bank has been captured very interestingly in pictorial form in the next slide.





# THE WAR OF WEALTH

JACOB LITT  
PROPRIETOR.

WARFIELD & CO.  
BANKERS

WARFIELD  
BANKER

HOTEL

FRENCH  
RESTAURANT

STATIONERY GROCERIES SU

C.T. DAZEY  
Author of  
IN OLD KENTUCKY.

## THE RUN ON THE BANK

A CRISIS IN THE AFFAIRS OF THE GREAT FINANCIAL INSTITUTION.  
THE MOST ANIMATED & REALISTIC SCENE EVER SHOWN ON THE STAGE.

## MONEY SUPPLY EXPANSION AND RUN ON A BANK



Hope this lesson has succeeded in further clarifying the concept of “Expansion of money supply” well as “Run on a bank”.



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