InSight Bulletin: A Multidisciplinary Interlink International Research Journal
Peer Reviewed International, Open Access Journal.
ISSN : 3065-7857 / Website: https://ibrj.us / Volume-2, Issue-12 / December - 2025

Original Article

The Role of Monetary Policy in Credit Creation of Commercial Banks

Dnyaneshwar Sahebrao Throat
Assistant Professor in Economics, Mahatma Gandhi Vidyamandir Samajshree Prashantdada Hiray Arts, Science & Commerce College, Nampur, Tal. Baglan, Dist-Nasik Maharashtra

Manuscript ID:
IBMIIRJ -2025-021216

Submitted: 10 Nov. 2025

Revised: 15 Nov. 2025

Accepted: 20 Dec. 2025

Published: 31 Dec. 2025

ISSN: 3065-7857

Volume-2

Issue-12

Pp. 70-74

December 2025

Correspondence Address:
Dnyaneshwar Sahebrao Throat
Assistant Professor in Economics,
Mahatma Gandhi Vidyamandir Samajshree Prashantdada Hiray Arts, Science & Commerce College, Nampur, Tal. Baglan, Dist-Nasik. Maharashtra.
Email:
thoratdnyneshwar469@gmail.com

Quick Response Code:

Web. https://ibrj.us

DOI: 10.5281/zenodo.18373364

DOI Link:
https://doi.org/10.5281/zenodo.18373364

Abstract

This study inspects how monetary policy touches the amount, direction, and usefulness of credit creation in modern economies. Central banks affect commercial banks' ability and inclination to afford credit through mechanisms like reserve requirements, interest rate changes, and open market activities. This research paper explores the theoretical underpinnings of credit creation, assesses the ways in which monetary policy influences it, and considers the consequences for price increases, financially sustainable growth, and financial stability. It comes to the conclusion that although monetary policy is still a significant element in determining loan availability, its efficacy is influenced by things like market expectations, financial rules, advancements in digital finance, and the larger macroeconomic environment. This research paper's main objectives is to analyze how monetary policy affects commercial banks' ability to create credit.

Keywords: *Monetary Policy, credit creation, Commercial bank, Dear & Cheep Money Policy*

Introduction

This study focuses on how monetary policy affects commercial banks' capacity to credit creation. The foundation of the economy is create credit, which permits long-term economic expansion, investment, consumption, and employment. Monetary policy, which attempts to maintain price stability and sustainable economic growth, is the main tool used by central banks to monitor and affect the availability of credit. However, the relationship between monetary policy and credit creation is complicated and influenced by economic indicators as well as the actions of financial institutions. Assessing the association proves essential for assessing how well policies stabilize economies and averts financial crises.

Objectives

1. To study credit creation.
2. To understanding The Role of Monetary Policy in Credit Creation of Commercial banks.

Theoretical Framework and Research Methodology

The researcher has used descriptive, analytical, qualitative methods. Besides this, he has preferred close reading of the primary and secondary sources. The material in the presented research article has been collected based on reference books on Indian Economy & Banking Management, government information and magazines, articles in current newspapers, and the Internet sources.

Research Problems

The major research questions of this study are as follows….
1. What is credit creation?
2. What is the role of monetary policy in Credit creation of Commercial banks?

Textual Analysis

The concepts of credit creation, the role of monetary policy in credit creation of commercial banks challenges are presented in the research paper are as follows…

How to cite this article:
Throat, D. S. (2025). The Role of Monetary Policy in Credit Creation of Commercial Banks. InSight Bulletin: A Multidisciplinary Interlink International Research Journal, 2(12), 70–74. https://doi.org/10.5281/zenodo.18373364

Credit creation

Banks only retain a little amount of money on hand when they receive deposits from the general public and businesses, lending the rest to others. The borrowed funds are reintroduced into the financial system as new deposits. This pattern keeps happening and generates a lot of recognition in the economy For instance. Main Deposit: Customers' initial deposit. Recent minor deposits are created when banks give out money and borrowers use it; this money then re-enters the banking system.

Credit Multiplier shows the number of times banks can raise deposits.

Formula;

Credit Multiplier = 1÷ Reserve Ratio

Credit creation = Banks by deposits > giving loans > loans coming back as deposits > creating more money in the

Each deposit creates a loan every loan creates a deposit

Showing in this chart credit creation

S.N	Types of Amount / Bank Types	Amount	'A' bank Percentage		Amount of 'A' bank use for loan	'B' Bank Percentage		Amount of 'B' bank use for loan	'C' Bank Percentage		Amount of 'A' bank use for loan	'D' Bank Percentage	
			80%	20% self		80%	20% self		80%	20% self		80%	20% self
1	Primary Deposit	200000 ₹	160000	4000	160000	128000	32000	128000	102400	25600	102400	81920	20480
2	Secondary Deposit	500000	400000	100000	400000	320000	80000	320000	256000	64000	256000	204800	51200
3	Other Deposit	Same procedure as above of credit creation											

There are four Type banks—A, B, C, and D—as well as one customer, according to the text above. Here, let's examine how these commercial banks generate credit. It is as follows: A consumer has deposited $200,000 with Bank A. A portion of the deposit, totaling 160,000 euros, was loaned by Bank A to Bank B. A portion of the sum was retained as 20,000 euros. Afterwards, 20% of this sum is handed to itself, and the remaining 80% is loaned to the subsequent bank, or "C" bank. This cycle ends at Bank "D."

Theoretical Framework of Credit Creation

1. **The Banking structure and Money Multiplier**

   According to conventional monetary theory, banks act as intermediaries, compelled by distance desires, to convert deposits into loans. By extending loans that turn into new deposits, banks can increase the money supply from side to side the money multiplier progression. Many contemporary theories disagree, arguing that banks create money endogenously through lending decisions rather than acting as simple disinterested parties

2. **Endogenous Money Theory**

   According to endogenous money theory, banks' evaluations of risk and profitability determine the creation of credit, with central banks meeting liquidity requirements. According to this perspective, central banks have more indirect and regulatory control on the creation of credit.

3. **Loan able Funds vs. Credit Creation Approached**

   While the credit creation method maintains that banks make loans regardless of savings, the loan able funds model contends that savings influence lending ability. The latter is substantially supported by contemporary empirical data, highlighting the significance of central bank policy in determining bank lending incentives.

The role of Monetary Policy in Credit Creation

The Reserve Bank of India, the nation's central bank, is responsible for carrying out monetary policy. Through both quantitative and qualitative measures, monetary policy contributes to the regulation of credit generation by commercial banks. Credit control is simply the process of adjusting credit volume to business or economic transaction volume. To the chip money policy, Dear money policy is implemented when the economy produces too much money. Low-cost money policy a cheap money policy is implemented when the economy fails to produce the required amount of money. Two tools are utilized in the implementation of monetary policy in credit control. One is a quantitative tool that displays the amount of money flow and takes the shape of data. Qualitative tools which act as a guide and guide. Such tools are as follows.

1. **Bank Rate**

   Bank Rate the rate at which the Reserve Bank of India lends to commercial banks is called bank rate. Commercial banks raise interest rates when the Reserve Bank of India raises the bank rate. When loans become more costly, fewer loans are taken out, which results in less investment, money in the economy, and employment? This monetary policy is referred to as an expensive monetary policy. When the Reserve Bank of India reduces the rate, the opposite of the above situation occurs. Cheap loans > more loans are taken > more investment, more money in the economy > more employment, expansion of money supply is called an easy monetary policy

2. **Reserve Requirements**

Central banks have direct control over the money multiplier by modifying the needed reserves. Banks' ability to lend is diminished by higher reserve requirements. Reduced reserve requirements increase the amount of credit that can be created. Reserve requirements are nevertheless essential in emerging economies even though many developed economies no longer heavily rely on them.

3. **Open Market Operations**

Securities can be purchased and sold on the open market by the Reserve Bank of India. Government securities, commercial papers, foreign currencies, gold, and other items are all bought and sold by the central bank. When bonds are issued by the Reserve Bank of India to sell securities like gold, etc. The RBI receives the funds that commercial banks purchase from banks. The creation of credit declines. In times of economic recession, it is helpful. The money owed is received in the form of checks when the RBI purchases securities, i.e., when individuals, banks, and other organizations sell RBI securities. Bank deposits rise. Credit expansion and creation take place. During a recession, it is helpful.

Variable reserve ratio

1. **Cash Reserve Ratio**

The Reserve Bank of India requires all commercial banks to maintain a set percentage of their total deposits (net of demand and time deposits) in cash, known as the Cash Reserve Ratio. According to Section 42(1) of the Reserve Bank of India Act, 1934, all commercial banks must have a cash reserve ratio. Non-scheduled banks are permitted to retain Cash Reserve Ration monies in accordance with Section 18. Banks must retain more money with the Reserve Bank of India if the RBI raises the Cash Reserve Ratio. When a result, lending capability rises, it falls. This could lead to a credit crunch. Conversely, the Reserve Bank of India's lending capability rises when it lowers the Cash Reserve Ratio. This could lead to the increase of credit. The Practical Impact of Monetary Policy on Credit Creation

2. **Statutory Liquidity Ratio**

Every commercial bank must retain a certain percentage of its total deposits (net of demand and time deposits) in cash, gold, or authorized government securities. The statutory liquidity ratio is the name given to that sum. According to Section 24 of the Banking Regulation Act of 1949, all banks are subject to the Statutory Liquidity Ratio requirement. A credit crisis could result if the Reserve Bank of India raises the statutory liquidity ratio since there would be less money available to lend to banks. The amount of money available for lending to banks may rise if the Reserve Bank of India lowers the statutory liquidity ratio, which could result in an expansion of credit.

3. **Repo and Reverse Repo transactions**

'Repurchase Obligations' or 'Repurchase Obligations' is what Repo stands for. Any commodity can be the subject of a repo transaction. The RBI raises the reverse repo rate in the case of inflation. The goal is to increase bank lending to the Reserve Bank, hence decreasing bank liquidity. As a result, banks are less able to provide loans to their clients. Conversely, the RBI lowers the reverse repo rate when there is deflation. The goal is to reduce bank lending to the Reserve Bank, which will boost banks' short-term liquidity. This improves banks' capacity to provide loans to clients.

4. **Marginal Standing Facility**

In its 2011 monetary policy announcement, the Reserve Bank of India introduced the "Marginal Standing Facility." This policy allows commercial banks to borrow up to 2% of their Net Demand and Time Liabilities from the Reserve Bank of India for a 24-hour period (including the night) in the event of an unexpectedly high liquidity requirement. This loan has a higher interest rate than the repo rate. The Statutory Liquidity Ratio securities may be used by the bank as collateral for this loan.

5. **Standing Deposit Facility**

In 2022, the Reserve Bank of India introduced a new instrument known as the Standing Put down Service. The rate at which it takes non-contiguous deposits from participants on a night-time foundation is known as LAF. LAF's rate is lower.

Qualitative equipment

The Reserve Bank of India's money creation policy is guided and directed by qualitative instruments.

1. **Determining the difference between the collateral value and the loan amount.**

In return for a loan, banks require security from you. A loan is made out of a portion of the guarantee value. For instance, the security is worth ₹1000. Let's say the interest rate is 20%, meaning that the loan amount is ₹800 and the interest rate is 20% of that amount.

2. **Control over consumer goods**

To satisfy their wants, consumers purchase consumer products For instance, vehicles, household goods etc. The Reserve Bank of India places restrictions on commercial banks' consumer loans for items like washing machines, gold, and silver in order to lower consumer demand for these things during a boom era. In order to encourage customers to spend more on customer goods during a recession, the Reserve Bank of India loosens business banks' jurisdiction over consumer goods. Currently, this tactic is not very beneficial.

3. **Moral Understanding**

The Reserve Bank of India is described as a friend, scholar, and advisor. Seminars and communication are scheduled with the bank for this.

4. **Publicity**:

The Reserve Bank of India produces a variety of reports, including those on foreign exchange, statistics, and policy.

5. **By Order:**

All banks are subject to orders from the Reserve Bank of India. Concerning lending, prudence, branch growth, etc.

6. **Direct Action**
   The Reserve Bank of India takes active action if commercial banks disregard its rules and directives.
7. **Expectations and Forward Guidance**
   Lending decisions made by banks are influenced by both accepted prospect surroundings and recent policies. Central banks can create these opportunities and decorative policies with the aid of presumptuous leadership.

Impacts of Monetary Policy on the Economy Through Credit Creation

1. **Economic Growth**
   Growth in recognition encourages investment and spending, strengthening group authority. Experiential research demonstrates strong relationships between credit intensification and GDP growth, particularly in emerging nations.
2. **Inflation Dynamics**
   If credit growth surpasses productive capability, inflation may result from the expansion of the money supply caused by credit formation. Interest rate increases are a tool used by central banks to curb inflationary credit booms.
3. **Financial Stability**
   Asset bubbles, like booms in the property sector, can result from excessive credit creation. On the other hand, sudden tightening may result in credit crunches, which would slow the economy and raise the default risk.

Modern Challenges in the Conduct of Monetary Policy

1. **Low-Interest Rate Environments**
   Unconventional policies are required since the middle bank's capacity to stimulate lending during regular equipment is diminished by consistently low down rates.
2. **Digital Finance and Faintish**
   Faintish, digital lending platforms and crypto currencies more and more pressure credit flows exterior usual banking channels, complicating procedure programme.
3. **Global Capital Flows**
   Cross-border financial transactions can reduce the effectiveness of domestic policy, particularly in unlocked economies.
4. **Post Crisis Regulation**
   A stricter framework after 2008 increased stability but made it harder for banks to react to monetary easing.

Major Findings

1. The amount of credit shaped by commercial banks is significantly influenced by monetary policy. When the central bank implements an expansionary monetary policy, interest rates are lowered, reserve requirements are reduced, the money supply is increased, and commercial banks have more liquidity and are more inclined to extend larger credit. Contractionary policy also limits the availability of credit.
2. Changes in interest rates directly impact the supply and demand for loans. Variations in the impact of the policy rate: Customers' borrowing costs and banks' lending productivity higher interest rates discourage credit uptake, whereas lower rates encourage borrowing and credit development.
3. Reserve requests determine the lending capability of banks. The portion of deposits that banks can lend out is reduced by increased distance ratios. Reduced reserve ratios increase credit creation by making more money available for lending.
4. Liquidity and credit expansion are impacted by open market operations. The purchase of securities by central banks increases liquidity, enabling banks to extend credit. Securities sales deplete liquidity, limiting banks' ability to make loans
5. The physical state of the banking system affects the effectiveness of monetary policy; during times of high bank capitalization and low non-performing loans, banks react to monetary policy signals more forcefully. However, when monetary policy is expansionary and there is financial hardship or a high level of non-performing loans, banks might not pass to expand lending.
6. Banks' lending practices are influenced by inflation prospects; price increases are typical; in order to reduce risk, banks may raise attention fees and reduce acknowledgment services. Continuous increase increases banks' willingness to lend.
7. Depending on the size and organization of banks, the broadcast instrument changes. Compared to smaller banks, large, well-capitalized institutions are typically less responsive to tense financial procedures. Sharper credit restrictions in financial constriction are frequently tolerated by smaller banks.
8. The Sect's oral credit allocation is influenced by monetary policy Banks often favor lending to low-risk or high-return sectors during tight plan periods, while expansionary policy can increase lending to SMEs, agriculture, real estate, and developed industries.
9. The impact of monetary policy on credit quality If banks stop demonstrating principles to improve credit issuance, an expansionary approach could result in increased credit risk. Reduction often lowers mortgage volumes but increases credit eminence.
10. . There is occasionally an uneven relationship between monetary policy and the production of credit. Credit responds more forcefully to limiting than to facilitation. Due to risk aversion or low credit demand, banks may hesitate to make an intentional suffocating offer during policy simplification.

Conclusion

Monetary policy is still an excellent tool for controlling the production of credit, predicting macroeconomic outcomes, and maintaining economic stability. Central banks direct evolving behaviour in banking coordination through bank rates, liquidity supervision, and regulatory trends. However, the relationship between monetary policy and credit creation is more active than ever due to the growing challenges of monetary markets, digital funding, worldwide wealth flows, and new rules. In a constantly shifting economic landscape, policymakers must strike a balance between promoting economic growth, controlling inflation, and ensuring financial stability.

Acknowledgement
I would like to express my sincere gratitude to all those who contributed, directly or indirectly, to the completion of this research paper. I am deeply thankful to my institution, Mahatma Gandhi Vidyamandir Samajshree Prashantdada Hiray Arts, Science & Commerce College, Nampur, for providing a supportive academic environment and necessary resources for this study.

Financial support and sponsorship
Nil.

Conflicts of interest
The authors declare that there are no conflicts of interest regarding the publication of this paper.

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