

Money Multiplier, Meaning, Mechanism, Factors, Significance

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The money multiplier is a key concept in macroeconomics and banking that shows how an initial deposit can generate a multiple increase in the total money supply through repeated rounds of bank lending.

Money Multiplier Meaning

Money Multiplier refers to the total amount of money that can be created in the economy from an initial deposit or currency issued by the central bank.

Money Multiplier = $1/\text{Reserve Ratio}$. Where the Reserve Ratio (or **Cash Reserve Ratio**) is the fraction of deposits that banks are required to keep as reserves.

Money" here does not mean only the currency notes. "Money" here refers to the aggregate money supply, that is, the total stock of money supply which includes the currency with the Public and Demand and Time Deposits with the Banks.

“Multiplier” here does not mean that the actual currency gets multiplied. “Multiplier” here means that the “Aggregate money supply” increases due to the initial “currency” printed by the **RBI**.

Mechanism of Money Multiplier

The money multiplier works through the fractional reserve banking system:

- Banks receive deposits from the public.
- Banks keep a fraction of deposits as reserves (as mandated by the RBI) and lend the rest.
- The loaned money is spent and redeposited into banks, which again retain a fraction and lend the remainder.
- This cycle continues, expanding the aggregate money supply multiple times relative to the initial deposit.

Example:

Suppose the RBI prints ₹100 and deposits it in banks. Banks are required to keep 10% as reserves (₹10) and can lend out ₹90. The ₹90 loan is spent and deposited back into the banking system. Banks now keep 10% (₹9) and lend ₹81. This process continues, creating new deposits again and again.

Total money supply = Initial deposit × Money Multiplier

- Money Multiplier = $1 \div \text{Reserve Ratio} = 1 \div 0.10 = 10$
- So, $₹100 \times 10 = ₹1,000$ total money supply

Factors Affecting the Money Multiplier

The Money Multiplier is influenced by several economic and banking factors that determine how effectively deposits can be converted into a larger money supply in the economy.

- **Currency Deposit Ratio:** Currency Deposit Ratio is the proportion of money people hold in the form of cash with themselves. Lower the currency deposit ratio, higher the Money Multiplier.
- **Reserve Ratio:** Lower the reserve Ratio of banks, higher the Money Multiplier
- **Credit creation:** Higher the credit creation, higher the Money Multiplier
- **Banking habits of people:** Higher the banking habit of people (i.e., more people depositing money in banks rather than holding cash), higher the Money Multiplier.
- **Reverse repo deposits with RBI:** An increase in reverse repo deposits with the RBI reduces the funds available for banks to lend, thereby lowering the money multiplier and slowing the expansion of the total money supply.

Money Multiplier Significance

- **Credit Creation:** Enables banks to provide loans, stimulating investment and consumption.
- **Monetary Policy Tool:** Helps the RBI control liquidity, inflation, and economic growth.
- **Economic Growth:** By increasing money supply, it supports business expansion, job creation, and overall economic activity.
- **Policy Planning:** Guides the central bank in managing reserve requirements and regulating the financial system.

UPSC CSE Previous Year Question

Q. The money multiplier in an economy increases with which one of the following? [2019]

- (a) Increase in the cash reserve ratio
- (b) Increase in the banking habit of the population
- (c) Increase in the statutory liquidity ratio
- (d) Increase in the population of the country

Answer (b) Increase in the banking habit of the population

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