Functions of Banks

The banking system has two primary functions:

- Medium of exchange;
- Financial intermediation.

Medium of Exchange

The medium of exchange function is to provide the system of banking and payments—checks, credit cards, etc.

Financial Intermediation

A *financial intermediary* is intermediate between the saver and the investor and helps the financing of investment.

A bank is the basic example of a financial intermediary. The bank takes deposits from the saver and lends to the investor.

Benefits of Financial Intermediation

- Pooling of savings;
- Transfers across time and space;
- Pooling of risk;
- Reduce information costs.

Pooling of Savings

A financial intermediary pools the savings of many small savers and is able to make large investments. This process allows large investment projects to be financed.

Transfers Across Time and Space

Loans by a financial intermediary allow spending in excess of income now, with the loan paid off from future income.

This principle applies not only to a single household, but also applies to a developing country.

Pooling of Risk

A financial intermediary pools risk by diversifying its portfolio of loans and investments.

Reduce Information Costs

Taking advantage of economies of scale, a financial intermediary can skillfully assess the credit-worthiness of a potential borrower and can carry out the needed documentation and record keeping efficiently.

Reduce Transactions Costs

One can interpret each of these four benefits of financial intermediation as a reduction of transactions costs. A transactions cost is just any cost involved in a transaction.

If transactions costs were absent, then direct finance from the saver to the investor would be sufficient, and there would be no need for a financial intermediary. A large investment project could be financed by many small savers investing directly. A small saver could diversify by making a large number of small investments.

Separation of Banking Functions?

Arguing from a macroeconomic point-of-view, some economists contend that combining the medium of exchange function and the financial intermediation function in a bank is unwise.

Financial intermediation is unstable—a small drop in assets relative to liabilities can cause bankruptcy. An economy-wide financial crisis can occur, with the result that not just the financial intermediation function but also the medium-of-exchange function can be disrupted; and the economy can plunge into depression.

100% Money

Reacting to the banking crisis of the Great Depression, Fisher [1] argued that the two functions should be separated. Proposing that banks should be subject to a 100% reserve requirement, he advocated that banks should not be allowed to make loans or investments. A bank would take deposits and carry out the medium-of-exchange function only.

References

[1] Irving Fisher. *100% Money*. Adelphi, New York, revised edition, 1936. HG2481F52 1936.

[2] *The Economist*. Finance: Trick or treat?, October 23 1999. HG11E2.