# 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.