

# Money & Banking

KAMERSCHEN / KLISE

SIXTH EDITION



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## Chapter 6

# Creation and Transfer of Deposits

What is a bank deposit? A simple question, isn't it? Anyone can answer it. Unfortunately most people will answer it incorrectly or, at best, inexactly. If, without reading farther, you can accurately define bank deposits, you are the exception.

There is a persistent confusion respecting deposits.

1. **Deposits are our most important money. Yet to the bank, the deposits of its customers are not money at all.**
2. **You take a handful of currency to the bank and deposit it. However, under no circumstances whatever do the bank's deposits consist of currency.**
3. **Most people suppose that a bank lends the deposits of its customers. In fact, however, no bank ever lends its deposits.**

These apparent contradictions result from the fact that we regularly use the word *deposit* in two entirely different, and completely inconsistent, ways. Ambiguity is inevitable unless we clearly specify which meaning the word is to have. We cannot possibly, in an analysis of bank operations, follow the common practice of allowing *deposit* to mean one thing one moment, something entirely different a moment later.

Specifically, we must decide whether we are going to consider a deposit as being the thing that is turned in to the bank—the actual checks on other banks and pieces of silver and **currency**—or as being the sums owed to depositors. These two things are not the same at all, for one is an asset, the other a liability of the bank.

Logically, perhaps, the term *deposit* should refer to the physical asset that one surrenders to the bank. There is no difficulty in understanding what has taken place if we say someone deposited \$50 of currency or made a deposit of **\$300**. The customer turned in that amount to the bank, and the word is used in accordance with the first definition.

But then we say, "The customer has a deposit of **\$300**," and we have swung over to the second definition. The deposit is an asset of the customer. It cannot possibly be at the same time an asset *of* the bank. Exactly what is the customer's deposit asset? Certainly it is not the handful of currency or the check the customer turned over to the bank teller, for these are now assets *of* the bank. The asset the customer received in exchange was a claim on the bank. From the bank's point of view, this deposit, as such, is a liability. When the bank increases its assets (currency, checks on other banks, other negotiable instruments), it increases its liabilities by an equal amount (or sometimes

gives other assets in exchange). In this respect it is no different from any other firm.

Two hundred years ago, banks gave their notes in exchange for coin (and other assets) rather than giving deposit credit for it as they do today. The increase in the bank's liability, offsetting the increase in its assets, was in the volume of its notes outstanding. There was no chance for ambiguity, since the promissory notes that one has given to others are clearly and unmistakably a liability for the giver. The item "Deposits" did not appear on the bank's balance sheet at all.

But as present-day banking techniques evolved, especially in the United States, the banks ceased to issue notes. Instead, when a customer brought in specie or other forms of money, the bank simply made a record in its books that it owed that sum to the individual. Probably some word other than "deposits" would have been less troublesome. If at the outset the banks had called these "Customer Accounts," perhaps, or "Public Credits," much confusion might have been avoided. Unfortunately they termed the liabilities "Deposits" because in a great many instances it was a deposit (asset) that created the liability.

But the importance of deposits (in the sense of liabilities) lies in the very fact that they do not necessarily result from deposits (in the asset sense). The particular asset that customers leave with the bank is not important. So although we may agree that, logically, *deposits* should refer to bank assets, we shall use this term only to refer to the bank's liabilities to its customers. This choice is not an arbitrary one. Bankers themselves universally agree in drawing up their balance sheets to list as deposits the sums that they owe. A bank never lists as deposits its holdings of currency and coin. These holdings of currency and coin are classified as Vault Cash and appear, quite properly, on the asset side of the sheet.

A bank's deposits, then, are the amounts that it owes to its customers. Most individuals whom the bank owes at any particular moment will be individuals who have brought some sort of money to the bank. These specific dollars then belong to the bank, which may use them in any way it wishes—as a basis for lending or for paying current expenses or as a pool of idle funds. The bank agrees in return to make the same number of dollars (but not the same pieces of currency) available to the customers at any time they may wish to have them.

But some individuals to whom the bank is in debt may never have brought any form of money to the bank. The bank's employees, the telephone company, the firms from which the bank buys its office supplies, all have claims of one sort or another on the bank. Periodically, usually the first of the month, the bank will change the form of most of these miscellaneous liabilities. Many of these creditors then hold deposits in the bank instead of their bills for goods and claims for wages. (Creditors who bank elsewhere will instead be paid by a cashier's check, which is another form of bank liability.)

As a result the bank owes no more and no less. It has simply changed the form of its liabilities. The process is somewhat akin to that of a corporation that sells bonds (borrows on long term) and uses the receipts to pay off its

short-term indebtedness, except that the bank, instead of converting short-term liabilities to long-term, is converting them to demand liabilities. These deposits are, of course, completely indistinguishable thereafter from deposits originating in other ways.

Still a third and extremely important group has claims upon the bank because its members have borrowed from the bank. There has been an exchange of liabilities. The bank holds the borrower's promissory note and the borrower holds a deposit in the bank. It is very important to realize that the deposits of these borrowers as well as the deposits provided for the employees and business creditors mentioned in the preceding paragraph are not "borrowed" from the first group of deposits. They are in addition to those deposit liabilities. And this power to create deposits is the reason banks are so important to the economy.

## CREDIT EXPANSION BY THE INDIVIDUAL BANK

Usually a commercial bank makes a loan by crediting the borrower's account. There is no need to pass currency back and forth. It is more convenient for the borrower to spend the proceeds of the loan by drawing checks against his new deposit. These checks are received by other people, who can either:

1. cash them, forcing an increase of currency in circulation outside the banks; or
2. deposit them to their own accounts, possibly in the same bank, more likely in other banks.

So far as the total money supply is concerned, the interrelations between an increase in deposits and the resulting drain of currency into circulation are more significant for the banking system as a whole than for the individual bank. We shall consider them later in this chapter.

If the loan-created deposit is transferred to other accounts in the *same* bank, the bank's total deposits are unaffected by the transfer. The bank owes less to the person who has written the checks (in this case, the borrower) and more to those who have received them.

However, as the borrower writes checks against the new deposit, the bank that lent the money will most likely lose reserves and deposits to other banks. Total deposits of the banking system are unaffected by the transfer of deposits from one bank to another, but the shifts are of vital significance to the individual banks.

## Old Deposits and New

Interbank transfers of funds go on continuously, whether banks are expanding credit, contracting credit, or simply maintaining the volume of their loans. Every day a bank receives from its depositors checks drawn on other

banks. These checks increase its deposit liabilities and at the same time equally increase its reserves, drawn from the banks upon which the checks are written. Every day a bank also loses deposits and reserves as its own depositors write checks that are deposited in other banks.

Take the case of a bank with deposits of \$2,500,000 and vault cash reserves of \$500,000. If a substantial part of these deposits were transferred all at once to other banks, this bank would have insufficient reserves. The bank's management knows that such a transfer would be most unlikely, however. It expects to retain this \$2,500,000 deposit total, with increases in some deposit accounts offsetting decreases in others. On the other hand, it quite rightly expects that if it were to make a loan by creating a new deposit, it would probably lose to other banks nearly that amount of deposits and reserves.

Why can the total of the old deposits be expected to remain in the bank when most of the newly created deposits are expected to disappear? The reason is simple. The old deposits are part of the existing money supply, the new are not. Over a period of time the bank has succeeded in building up its deposits to a certain figure. It has from time to time created deposits by its own lending and investing, but nearly all those deposits that it created itself have long since been transferred to other banks. In turn it has received deposits as the result of the spending of deposits created by other banks. Most of the bank's existing deposits are the result of past lending and investing by approximately 14,500 other commercial banks. Daily transfers of the existing money stock will ordinarily cause little change in its total of deposits. Since the bank has many depositors, the law of large numbers applies. Some will be withdrawing funds, but others will be depositing funds. The results will usually average out, and the bank can expect to receive from other banks about as much as it pays out to others. But of new money, whether created by itself or by others, it can expect to hold or gain more or less permanently only its proportionate share.

Suppose, for example, there are two banks in a community. For the moment we shall ignore all other banks. One of these banks has deposits of \$1 million, the other of \$5 million. As long as neither is increasing the money supply, both banks might expect their deposits and reserves to remain relatively stable. There may be five times as many people depositing checks in the large bank, but there are also five times as many writing checks on that bank. There is no reason for the larger bank to gain deposits from the smaller or to lose deposits to it.

But if now either bank makes a loan of \$6,000, where are these \$6,000 likely to lodge after they have changed hands a few times? We should expect that they will become merged with the money previously existing, which was divided between the two banks on a 5 to 1 ratio. The smaller bank should gain about \$1,000, the larger bank about \$5,000.

In reality, of course, it is not one bank versus another, but one bank versus approximately 14,500 other banks. A bank that makes a loan may retain some of the new deposit that it has created, but the chances are that it will not retain much of it.