February, 2016

Demand Deposit Difficulties

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2/6/16

Introduction

It is impossible to guarantee for sure that funds held in a demand deposit account are always available on demand to its holder. A promise of a bank to this effect is fiction. Why this is so is the proposition I demonstrate in this essay. Moreover, even movements of funds among individual banks can be a source of instability in the economy while total demand deposits are constant.

Checks drawn on demand deposits are a major part of all means of payment especially for commercial enterprises but less so for households. Demand deposits have another effect because they are a potential source of instability in the economy. For this reason it is important to see how banks handle demand deposits in order to understand how they can be harmful.

Demand deposits allow their holders to withdraw or deposit funds without prior notice. Both withdrawals and deposits take the form of checks going into or out of a holder's demand deposit account. Although these movements of funds among the banks need not affect total demand deposits in all banks, they can still affect the whole economy because such movements affect individual banks.

Bank Policy and its Effects

Every check drawn on a demand deposit account in a bank reduces the amount in that account. The check is deposited in another account either in the same bank or in another bank. When both accounts are in the same bank there is no effect on that bank's total demand deposits, assets and liabilities. When the check is deposited in another bank, then two banks are affected. This leads us to examine the balance sheets of both banks before and after this event.

Bank A

Begin	Liabilities	Assets
Customer A's demand deposit	100	100

Customer A in Bank A starts with 100 in his demand deposit. It is a liability of Bank A. Bank A must have an equal amount of assets. These assets may include vault cash, loans to a customer of Bank A or funds on deposit at Bank A's account at a Federal Reserve Bank. The Federal Reserve System operates a clearing house for its member banks. How this affects the situation enters my analysis later. Say customer A writes a check for 50 payable to customer B who has a demand deposit account in Bank B. Now consider the new balance sheet for Bank A as well as the balance sheet for Bank B now in the story.

Bank A

period 1	Liabilities	Assets
Customer A's demand deposit	50	100
Debt to Bank B	50	-

Bank B

Period 1	Liabilities	Assets
Customer B's demand deposit	50	0
Loan to Bank A	0	50

A closer look at Bank A's assets is necessary because it owes 50 to Bank B, a debt it must settle. Let Bank A's assets be in the form of loans to its customers, say 80, and in the form of its deposit at a Federal Reserve Bank, 20. While it can write checks on its Fed account in favor of another member bank of the Fed, it does not have enough in this account to settle its whole debt to Bank B. Bank A could enter the Federal Funds Market and borrow enough to settle its debt to Bank B but these are short term loans, over night or a few days. This gives Bank A little time to repay these loans. Still it might borrow in the Federal Funds Market if it thought some checks would come into its demand deposit accounts. Thus Bank A could rely on incoming deposits that could offset the withdrawals. Indeed a common force may be acting on all banks to borrow and lend in step, up or down. Bank A has another resource. It could borrow for a longer term from a Federal Reserve Bank and avoid the need to call in loans or reduce loans to its customers. Perhaps some of its loans to customers now falls due. By not renewing these loans it could increase its liquid assets by enough to ease the burden of payment of its debt to Bank B.

It follows that a shift of funds in demand deposit accounts from one bank to another sets in motion actions with the potential to destabilize all banks. None of these effects would occur were there only one bank. There is another way to say this. The U. S. banking industry cannot survive unregulated competition. It needs suitable regulation. There is no reasonable alternative.