Full-Reserve Banking V/s Fractional-Reserve Banking

For Prelims: Full-Reserve Banking, Fractional-Reserve Banking, Bank run, Deposit Insurance and Credit Guarantee Corporation

For Mains: Issues Related to Banking Sector in India

Source: TH

Why in News?

Economists are engaged in a debate regarding **Full-Reserve Banking (100% reserve banking) versus Fractional-Reserve Banking.**

- While both systems have their **proponents and critics,** understanding the key differences between them is crucial in assessing their potential impact on economic growth **and** financial stability.

What is Full-Reserve Banking V/s Fractional-Reserve Banking?

- **Full-Reserve Banking: Safeguarding Deposits**
    - Under full-reserve banking, **banks are strictly prohibited from lending out** demand deposits received from customers reducing the risk of ban runs.
    - Instead, they must always hold 100% of these deposits in their vaults, acting merely as custodians.
    - Banks serve as **safekeepers of depositors' money,** charging fees for this service.
        - Banks can only lend money received as **time deposits.**
- **Fractional-Reserve Banking: Expanding Credit and Risk**
    - Fractional-reserve banking system, currently in practice, **allows banks to lend more money than the cash they hold** in their vaults.
        - This system relies **heavily on electronic money for lending.**
    - **Bank runs** are a potential risk if many depositors simultaneously demand cash.
        - However, central banks can provide emergency cash to avert immediate crises.
- **Differing Perspectives:**
    - Supporters of fractional-reserve banking argue that it **spurs investment and economic growth** by freeing the economy from relying solely on real savings from depositors.
        - On the other hand, advocates of full-reserve banking argue that it **prevents crises inherent in the fractional-reserve system** and leads to **a more stable economy.**

What is the Difference Between Demand Deposits and Time Deposits?

- **Demand Deposits:**
    - Demand deposits refer to funds held in a bank account that can be **withdrawn at any time** without any notice or penalty.

        - These are also known as **"current accounts."**
    - It **provides high** liquidity and flexibility for everyday transactions and payments.
        - Since customers can withdraw funds on demand, **banks typically pay little to no interest on these accounts.**
- **Time Deposits:**
    - Time deposits are funds held in a bank account for a **fixed period**, commonly known as a **"term" or "tenure."**
        - The account holder agrees not to withdraw the funds until the term expires.
    - In return for locking in their money, **the bank rewards the account holder with a higher interest rate** compared to demand deposits
        - However, withdrawing the funds before the **maturity date typically incurs a penalty.**

What is Bank Run?

- **About:**
    - A bank run refers to a situation **where a large number of depositors simultaneously withdraw their funds from a bank,** often due to concerns about the bank's solvency or stability.
- **Impact:**
    - **Liquidity Crisis:** A sudden and massive withdrawal of funds can lead to a **liquidity crisis for the bank.**
        - The bank may not have enough cash reserves to meet all the withdrawal requests, which can further fuel panic among depositors.
    - **Contagion Effect:** A bank run on one bank can **create a ripple effect,** spreading fear and panic to other banks in the system.
        - This contagion effect can lead to a **broader** financial crisis if it isn't contained promptly.
    - **Loss of Confidence:** A bank run can **erode public confidence in the entire banking system**, leading to a loss of trust in financial institutions.
        - This can result in a long-term decrease in deposits, making it harder **for banks to lend and support economic growth.**
    - It can also lead to **increased informalisation of economy.**

Note:

In India, the **Deposit Insurance and Credit Guarantee Corporation (DICGC)** provides deposit insurance for bank deposits up to a **certain limit (currently ₹5 lakh per depositor per bank).** However, in the event of a bank failure, depositors with funds exceeding this limit may face losses.