The Fractional Reserve Banking Paradox!

Post a Blog here… http://austrianenginomics.blogspot.com/

Fractional Reserve Banking can function quite well in a free society with NO Central Bank! Yes, bank failures **must** happen to keep the natural fallible-human free market checks and balances in place. These failures prevent risky practices from snowballing into a national or systemic collapse. However, there are those within most macro economic persuasions that believe Fractional Reserve Banking is, at minimum deceitful, or more likely, fraudulent. They believe in having a 100% commodity (e.g. gold) backed currency.

Let's imagine an island with no formal banking system. Now pretend there is a person, Stanley, who possessed money (… say "real" money; e.g. gold) and had an interest either keeping it in a very safe place where he would expect to **pay** someone to guard it and ensure its future withdrawal when demanded, OR ***investing*** it in a low risk venture. Exploring the "investment" option, let's say there is another person, Ralph, interested in purchasing an item of value but he has nothing of value himself to exchange. The conditions are ripe for Stanley, the gold owner, to "loan" his money to Ralph enabling him to purchase the desired item immediately.

Now let's imagine Stanley and Ralph do not know each other and have ***no*** interest in a relationship. Along comes a budding financier, Henry, who owns an insignificant pittance of "real" money himself. However, Henry is willing to act as a ***facilitator*** (banker) to:

1. Hold Stanley's gold for a storage/insurance fee, OR
2. **Invest** Stanley's gold by loaning it to Ralph and charging him sufficient interest to pay Stanley a percentage, plus award himself the difference as compensation for his ***facilitator*** role.

Assuming Stanley chooses the "investment" option (#2), which opens the door for a loan to Ralph, Henry must:

1. Discourage Stanley from redeeming his investment before Ralph has paid his loan back.
2. Ensure Ralph is a satisfactory credit risk by reviewing his past behavioral patterns in honoring commitments.

We now have a "Fractional Reserve" Banking System with NO central bank. In this case Henry has a pittance of money in reserve (a risky condition) to cover an unanticipated redemption request by Stanley or loan default by Ralph.

Does Fractional Reserve Increase the Money Supply?

In the simple case above we have instantly DOUBLED the money supply on the island. Stanley perceives he has 100% buying power deposited in his "demand account" in Henry's "bank", PLUS Ralph now has 100% of the original stash of gold deposited by Stanley.

Next, Ralph purchases his desired item with the borrowed gold from Henry, and then the selling merchant deposits the gold into Henry's brother's bank. Sure enough, the same exact process happens again with a new set of characters and we have now:

1. TRIPLED the money supply on the island, and
2. DOUBLED the aggregate debt, and
3. PURCHASED items valued at TWICE the original quantity of gold deposited by Stanley.

One may visualize how this process could continue and progressively increase the aggregate island debt, money supply, and *potential*[(1)] sales as a result of the small initial deposit of

Copyright © 2009 by Russell M. Randall. All rights reserved.

Stanley's gold. Of course, there must be multiple transfers between the "depositor's" banks, the "merchant's" banks, the "debtor's" banks, so the doubling or tripling of the money supply in the example would require many more transactions in reality. In our real world, government has taken the responsibility to mandate a 10% reserve for "demand" accounts held by member banks in today's financial markets. Had Henry and his fellow ***"facilitators"*** used the 10% reserve rule, the mathematical logic of carrying the sequential deposit/lend/spend/deposit/lend/spend activities to an extreme would allow a TEN-FOLD increase in money supply, debt, and *potential* [(1)] spending to occur.

Will the Money Supply Increase Stop After a Ten-Fold Increase?

The good news in this frighteningly leveraged condition is that ***saturation*** would be reached at the TEN FOLD level within this simplified banking system. At that point the payments for loans could be constantly enabling new loans of the same amount as long as the 10% reserve in all banks remained in place. Hence, new incremental increases in debt are limited to the commensurate increase in Output that may be purchased. But, that's just a dream…

Who Should Determine the Level of Henry's Reserves?

This banking system can exist with no central bank or government involved. However, once Henry grows his business he will quickly realize he needs some "reserve" or capital (i.e. the bank's own cache of gold or "skin" in the game) to satisfy redemption demands in excess of loan repayments. The amount of the reserve will be learned from the "school of hard knocks" from which all successful entrepreneurs have graduated. Henry would have learned quickly that a reserve of some magnitude would be necessary once he learned the investment, withdrawal, and default behaviors of his customers. He would have learned methods to tie up deposits via contracts, if necessary, to prevent premature withdrawals that may trigger a run on his bank, or methods to recall loans in the event his reserves become depleted.

During the 1980's and '90's the mood and momentum of powerful U.S. financial-cartel elites [(2)] and congress encouraged the repeal or modification of restrictive regulations (e.g. Glass Steagall, Gramm-Leach-Bliley Act), which paved the way for massive unchecked credit expansion in our fiat currency world. The financial system constraint of the noted 10% reserve requirement became totally ineffective due to the scores of "innovative" means to avoid the reserve limitation. From 2000 to '07, the credit expansion march continued, more than making up for the equity bust early in the decade. Inevitably the 2007-2008 credit crisis occurred, which created an unprecedented shock to the system that has forced an accommodating U.S. Central Bank and Treasury to open the monetary and credit spigots full blast. They are attempting to "revive" the economy via force-feeding an ever-greater aggregate credit expansion by any means, even if the consumers and business are reluctant to plunder their way into greater and greater debt levels relative to their output. It is government's hope that the blistering pace of credit expansion will return. Unfortunately, consumers and business are now finally balking at the idea, and by default, government is picking up the credit expansion slack via unprecedented deficit spending and loan guarantees.

What Prevents a Cataclysmic Bank Run Nationwide?

It is of utmost importance that a few banks **take unwarranted risks every year** and **GO BUST**, thus ***harming depositors*** who entrusted their savings to the bank. Then, true-to-form, this local "catastrophe" would be announced around the state, nation, or world and discourage other banks from depleting their reserves too deeply, or making proportionally too many high-risk loans, and follow the same fate. It would also encourage all depositors to perform some due-diligence on

Copyright © 2009 by Russell M. Randall. All rights reserved.

their own banks. Without these "local catastrophies", depositors would become complacent and moral hazard would become pervasive...

Of course, the alternative is to empower the State to become the “lender of last resort”, and act as the experienced and knowledgeable “big brother” force of power that would require a specific reserve percentage for all banks, thus taking ownership of default or bank-run risks. The act of incorporating this “lender of last resort” concept has created a **systemic** nationwide exposure to a leveraged excess credit condition greater than any we’ve experienced in the history of the Republic. What happens when the “last resort” central bank fails?

Should Fractional Reserves be Prohibited?

With no fractional reserve within a bank, it forces the depositor to PAY for the bank's service of storing, guarding, and insuring his money, which would not be lent out. In such a restricted system, the only source of money for a bank to loan must be from its own accumulated hoard of gold or silver.

Why not recognize a legitimate need exists for a free-market "facilitator" to help a depositor match up with a borrower, conduct risk analysis, and document and administer transactions? This "facilitator" might be commonly known as a BANK!! THERE IS NO NEED FOR A CENTRAL BANK IN THIS PICTURE!!!!!

CONCLUSION:

A fractional reserve banking system in a free society is a logical and tolerable means of operating a viable banking operation! However, the critical importance of allowing failure to occur and subsequently harm a limited number of depositors ***is a necessary ingredient***. The cries of pain must be heard around the community, state, and world when an aggressive risk-prone bank that cut its reserves to a vulnerable level, and invited a run on its over-leveraged assets fails. This failure would discourage potential depositors from falling prey to another similarly risk-prone bank.

I believe private entrepreneurs and citizens could learn and manage this process. The state, in the role of “lender of last resort”, has invited moral hazard to the greatest degree we’ve experienced in the history of the Republic.

By Russell M. Randall, 6-2-2009
Home page: www.austrianenginomics.com

Reference:
(1) Potential; Gross economic Output and associated Sales may not increase at all during the expansion of the money supply. There is the “potential” that a short-lived spurt of spending and associated production may result from an expansion in the money supply, which typically comes at the expense of R&D or capital equipment investment.
(2) Financial-Cartel Elites refers to executives who control interests of the Central Bank, Treasury, Major Brokerage, Banking, and Investment Firms, Private Equity Firms, Hedge Funds, and Agencies (Fannie Mae and Freddie Mac).

Copyright © 2009 by Russell M. Randall. All rights reserved.