Fraction ... Er ... Fictional Reserve Banking

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→ *Washington's Blog.*

As the New York Federal Reserve Bank explains on its website:

Reserve requirements affect the potential of the banking system to create transaction deposits. If the reserve requirement is 10%, for example, a bank that receives a $100 deposit may lend out $90 of that deposit. If the borrower then writes a check to someone who deposits the $90, the bank receiving that deposit can lend out $81. As the process continues, the banking system can expand the initial deposit of $100 into a maximum of $1,000 of money ($100+$90+81+$72.90+...=$1,000). In contrast, with a 20% reserve requirement, the banking system would be able to expand the initial $100 deposit into a maximum of $500 ($100+$80+$64+$51.20+...=$500). Thus, higher reserve requirements should result in reduced money creation and, in turn, in reduced economic activity.

Of course, many Austrian economists have criticized fractional reserve banking. For example, Murray Rothbard wrote:

Let's see how the fractional-reserve process works, in the absence of a central bank. I set up a Rothbard Bank, and invest $1,000 of cash (whether gold or government paper does not matter here). Then I "lend out" $10,000 to someone, either for consumer spending or to invest in his business. How can I "lend out" far more than I have? Ahh, that's the magic of the "fraction" in the fractional reserve. I simply open up a checking account of $10,000 which I am happy to lend to Mr. Jones. Why does Jones borrow from me? Well, for one thing, I can charge a lower rate of interest than savers would. I don't have to save up the money myself, but can simply counterfeit it out of thin air. (In the 19th century, I would have been able to issue bank notes, but the Federal Reserve now monopolizes note issues.) Since demand deposits at the Rothbard Bank function as equivalent to cash, the nation's money supply has just, by magic, increased by $10,000. The inflationary, counterfeiting process is under way. "Unfortunately, while banks depend on the warehouse analogy, the depositors are systematically deluded. Their money ain't there."

The 19th-century English economist Thomas Tooke correctly stated that "free trade in banking is tantamount to free trade in swindling." But under freedom, and without

government support, there are some severe hitches in this counterfeiting process, or in what has been termed "free banking."

First, why should anyone trust me? Why should anyone accept the checking deposits of the Rothbard Bank?

But second, even if I were trusted, and I were able to con my way into the trust of the gullible, there is another severe problem, caused by the fact that the banking system is competitive, with free entry into the field. After all, the Rothbard Bank is limited in its clientele. After Jones borrows checking deposits from me, he is going to spend that money. Why else pay for a loan? Sooner or later, the money he spends, whether for a vacation, or for expanding his business, will be spent on the goods or services of clients of some other bank, say the Rockwell Bank. The Rockwell Bank is not particularly interested in holding checking accounts on my bank; it wants reserves so that it can pyramid its own counterfeiting on top of cash reserves. And so if, to make the case simple, the Rockwell Bank gets a $10,000 check on the Rothbard Bank, it is going to demand cash so that it can do some inflationary counterfeit pyramiding of its own.

But, I, of course, can't pay the $10,000, so I'm finished. Bankrupt. Found out. By rights, I should be in jail as an embezzler, but at least my phoney checking deposits and I are out of the game, and out of the money supply.

Hence, under free competition, and without government support and enforcement, there will only be limited scope for fractional-reserve counterfeiting. Banks could form cartels to prop each other up, but generally cartels on the market don't work well without government enforcement, without the government cracking down on competitors who insist on busting the cartel, in this case, forcing competing banks to pay up...
Hence the drive by the bankers themselves to get the government to cartelize their industry by means of a central bank.

Similarly, Ron Paul wrote in October:

Whenever instability turns up, we see efforts to socialize the losses, but rarely do people question the source of instability. Economist Jesús Huerta de Soto places the blame on the institution of fractional-reserve banking. This is the notion that depositors' money in use as cash may also be loaned out for speculative projects, then re-deposited. The system works as long as people do not attempt to withdraw their money all at once. In the face of such a demand, banks turn to other banks to provide liquidity. But when the failure becomes system-wide, they turn to government.

The core of the problem is the conglomeration of two distinct functions of a bank. The first is warehousing, whereby banks keep money safe and provide checking, ATM access, record keeping, and online payment, services for which consumers are traditionally asked to pay. The second service the bank provides is a loan service, seeking out investments and putting money at risk in search of return.

The institution of fractional reserves mixes these functions, such that warehousing becomes a source for lending. The bank loans out money that has been warehoused—and stands ready to use in checking accounts or other forms of checkable deposits—and that loaned money is deposited yet again in checkable deposits. It is loaned out again and deposited, with each depositor treating the loan money as an asset on the books. In this way, fractional reserves create new money, pyramiding it on a fraction of old deposits. An initial deposit of $1,000, thanks to this "money multiplier," turns into $10,000. The Fed adds reserves to the balances of member banks in the hope of inspiring ever more lending.

As customers, we believe that we can have both perfect security for our money, withdrawing it whenever we want and never expecting it not to be there, while still earning a return on that same money. In a true free market, however, there tends to be a tradeoff: you can enjoy the service of a warehouse or loan your money and hope for a return. The Fed, by backing up fractional-reserve banking with a promise of endless bailouts and money creation, attempts to keep the illusion going.

The history of banking legislation can be seen as an elaborate attempt to patch the holes in this leaking boat. Thus have we created deposit insurance, established the "too-big-to-fail" doctrine, and approved schemes for emergency injections to keep an unstable system afloat .
And at least some people claim that the fractional reserve banking system is guaranteed to create unsustainable levels of debt.

<u>From Fractional to Fictional Reserves</u>

But whatever you think about fractional reserve banking, whether or not you agree with its critics, the truth is that we *no longer have it.*

As the above-linked NY Fed article notes:

In practice, the connection between reserve requirements and money creation is not nearly as strong as the exercise above would suggest. Reserve requirements apply

only to transaction accounts, which are components of M1, a narrowly defined measure of money. Deposits that are components of M2 and M3 (but not M1), such as savings accounts and time deposits, have no reserve requirements and therefore can expand without regard to reserve levels.

And as Steve Keen notes - citing Table 10 in Yueh-Yun C. OBrien, 2007. "Reserve Requirement Systems in OECD Countries", Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, 2007-54, Washington, D.C:

The US Federal Reserve sets a Required Reserve Ratio of 10%, but applies this only to deposits by individuals; banks have no reserve requirement at all for deposits by companies.

So huge swaths of loans are not subject to any reserve requirements.

With the repeal of Glass-Steagall, deposits have been used to speculate in every type of investment under the sun, using insane amounts of leverage. Instead of the traditional 10-to-1 ratio, the giant banks and hedge funds were using much higher levels of leverage.

For example, Congresswoman Kaptur told Bill Moyers that while - on paper - there are 10-to-1 reserve requirements, banks like JP Morgan were using ***100 to 1*** leverage. She said that, with derivatives, leverage might be *much higher*.

And remember that most of the credit in our economy is actually through the shadow banking system, *not* through traditional depository banking.

As the Washington Times wrote in February 2009:

"Before last fall's financial crisis, banks provided only $8 trillion of the roughly $25 trillion in loans outstanding in the United States, while traditional bond markets provided another $7 trillion, according to the Federal Reserve. The largest share of the borrowed funds - $10 trillion - came from securitized loan markets that barely existed two decades ago. . . .

Mr. Regalia [chief economist at the U.S. Chamber of Commerce] said ... 70 percent of the system isn't there anymore,' he said."

Bernanke, Summers, Geithner and the boys have been working as hard as they can to re-start the shadow banking system, and traditional loans to individuals and small businesses have plummeted. So the percentage of shadow banking system lending to the all lending has probably skyrocketed again.

The NY Fed continues:

Furthermore, the Federal Reserve operates in a way that permits banks to acquire the reserves they need to meet their requirements from the money market, so long as they are willing to pay the prevailing price (the federal funds rate) for borrowed reserves. Consequently, reserve requirements currently play a relatively limited role in money creation in the United States.

In other words, as we've repeatedly written, reserves can be obtained once a binding loan commitment is made.

As William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, said in a speech last July:

Based on how monetary policy has been conducted for several decades, banks have always had the ability to expand credit whenever they like. They don't need a pile of "dry tinder" in the form of excess reserves to do so. That is because the Federal Reserve has committed itself to supply sufficient reserves to keep the fed funds rate at its target. If banks want to expand credit and that drives up the demand for reserves, the Fed automatically meets that demand in its conduct of monetary policy. In terms of the ability to expand credit rapidly, it makes no difference.

Bernanke has proposed the elimination of *all* reserve requirements:

The Federal Reserve believes it is possible that, ultimately, its operating framework will allow the elimination of minimum reserve requirements, which impose costs and distortions on the banking system.

And - according to Steve Keen - about 6 OECD countries have *already* done away with reserve requirements altogether (Keen confirmed that Australia requires no reserves; I know that Mexico doesn't require reserves; and Canad, New Zealand, Sweden and the UK supposedly require no reserves as well).

How Can An Insolvent Company Have Any Reserves?

Everyone knows that banks are required to have reserves, and that the giant banks supposedly have massive sums of excess reserves.

But does that really mean anything when everyone who runs the numbers says that the giant banks are (once again) *insolvent*?

Specifically, if we took away mark-to-the-moon valuations, forced the big boys to put their SIV off-sheet liabilities back onto their balance sheets, and stopped all of the fraud, spinning and other hanky-panky (of which Lehman's Repo 105s were just a

tiny part), it would be obvious that the too big to fails were deeper into the hole than Wiley Coyote after he fell of the cliff and hit the ground.

So any "reserves" that the TBTFs have are fake, courtesy of the taxpayer, Uncle Sugar, and plain old puppetry .

We no longer have a fractional reserve banking system. Reserves are just a fiction.