United States House of Representatives
Committee on Financial Services
Subcommittee on Domestic Monetary Policy and Technology
Hearing on "Fractional Reserve Banking and the Federal Reserve:
The Economic Consequences of High-Powered Money"
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Congressman Ron Paul
Statement for the Record

During a time of economic crisis, when the topic of stability of the banking and financial sector is at the forefront of most people's minds, it is ironic that the most important factor in the development of the modern banking system is precisely the one topic which is almost never mentioned. The elephant in the room is, of course, fractional reserve banking. In a speech in October 2010, Mervyn King, Governor of the Bank of England, referred to fractional reserve banking as "financial alchemy", an analogy which is particularly apt. Just as alchemists attempted to turn worthless lead into something thousands of times more valuable, modern-day financial alchemists attempt to turn a limited number of bank deposits into an unlimited amount of money and credit. But while the alchemists were never successful in their endeavors, financial alchemists have been all too successful at creating money and credit out of thin air, sowing the seeds for the destructive booms and busts of the business cycle.

Fractional reserve banking is the practice by which banks accept deposits but only keep a fraction of those deposits on hand at any time. In practice, nearly 100% of deposits are loaned out, yet depositors believe that they can withdraw the full amount of their deposit at any time. Loaned funds are then redeposited and reloaned up to the limit of the bank's reserve requirements, compounding the effect. While mainstream economists extol this "money multiplier" as a nearly miraculous process that results in a robust economy, low reserve requirements actually enable banks to create trillions of dollars of credit out of thin air, a process that distorts the structure of production and gives rise to the business cycle.

Imagine that A deposits $100 in a bank. The bank keeps 10% on reserve and loans $90 to B. B deposits that same $90, the bank keeps 10% on reserve, loans the remainder to A, and the cycle continues on and on. Eventually the bank has a combined deposit total of $1000. Theoretically there is now $1000 that can be spent. Yet while the amount of money and credit in the system has increased, the amount of real savings and real production has not changed.

Everyone understands the absurdity of this little example, but once this same process is

expanded throughout the economy, the means by which that $100 deposit turns into $1000 of credit is treated almost as magic. The fact that ten times as much money is chasing the same amount of goods, that the new credit benefits earlier recipients more than later recipients, and that distortion to the capital structure then ensues, are all completely ignored.

Once the boom phase of the business cycle has run its course and the bust commences, some people will naturally look to hold cash. So they withdraw money from their bank accounts in order to hold physical currency. But bank deposits consist of a huge amount of credit pyramided on top of a small of amount of original cash deposits. Each dollar of cash that is withdrawn unwinds the multiplier, resulting in a contraction in credit. And if depositors attempt to withdraw more funds than are available in reserves, the entire of house of cards comes crashing down. This is the very real threat facing some European banks today.

Since the amount of deposits always exceeds the amount of reserves, it is obvious that fractional reserve banks cannot possibly pay all of their depositors on demand as they promise – thus making these banks functionally insolvent. While the likelihood of all depositors pulling their money out at once is relatively rare, bank runs periodically do occur. The only reason banks are able to survive such occurrences is because of the government subsidy known as deposit insurance, which was intended to backstop the stability of the banking system and prevent bank runs. While deposit insurance arguably has succeeded in reducing the number and severity of bank runs, deposit insurance is still an explicit bailout guarantee. It thereby creates a moral hazard by encouraging bank deposits into fundamentally unsound financial institutions and contributes to instability in the financial system.

Rather than enhancing stability, deposit insurance creates instability by rewarding risky behavior on the part of banks. Why engage in sound banking and lending practices if the government promises always to bail out your bank and its depositors? Deposits legally are considered loans to the bank, but depositors are promised by the government that they never will lose a penny of their deposits. Therefore depositors need not perform due diligence when selecting a bank with which to do business. Whether the bank is sound or unsound is immaterial, since deposits are guaranteed by the government. Thus risky banks which would be forced out of business in a free market are guaranteed access to funds with which they engage in their financial alchemy.

Throughout much of banking history, bankers and politicians have colluded to their mutual benefit. Bankers fund government wars in exchange for special protections from the government. In the 19th century, U.S. banks were required to purchase government bonds in order to back their issues of banknotes, thus ensuring funding for government boondoggles. And when too many banknotes were issued and depositors sought to exchange them for gold and silver coin, governments suspended specie redemption, allowing banks to keep their gold and silver and refuse redemption of

their notes. Ultimately taxpayers and savers were the victims of this unholy alliance.

Unfortunately, not much has changed since then. Banks continue to loan money to the government through purchases of Treasury debt, enabling wars of aggression abroad and a massive police and welfare state at home. And when banks make mistakes they are never forced to take losses or go out of business. Smaller banks are merged by federal regulators into larger banks, while banks that are deemed to be “too big to fail” are given billions of dollars worth of bailouts so that they can live to fail another day.

The solution to the problem of financial instability is to establish a truly free-market banking system. Banks will no longer require government charters in order to operate. They will no longer be forced to comply with arbitrary government reserve regulations that treat money loaned to the government as an asset worth more than gold in the vault. And most importantly, banks will no longer have a government backstop of any sort in the event of failure. Banks, like every other business, should have to face the spectre of market regulation. Those banks which engage in sound business practices, keep adequate reserves on hand, and gain the confidence of their customers will survive, while others fall by the wayside. Banking, like any other financial activity, is not without risk – and the government should not continue its vain and futile pursuit of trying to eliminate risk. Get government out of the way and allow the market to function. This will result in a more stable system that meets the needs of consumers, borrowers, and investors.