Creating a Mirage of Economic Growth
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by Doug Carey

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“From now on, depressions will be scientifically created.”
- Congressman Charles A. Lindbergh Sr., 1913 (father of the aviator)

Bubble formation is not random. Some may believe it is, but bubbles are in fact a predictable byproduct of the fractional reserve system upon which our economy is built. By stimulating and amplifying lending through its fractional reserve system, the Federal Reserve systematically creates the mirage of growth, from which deception systemic crises inevitably result.

As I will show, fractional reserve lending injects money into the economy that is fundamentally unbacked by any assets, and the Fed, with its ability to lend and print money at will, enables this sleight of hand to occur with impunity on a truly massive scale. The effect is that we have an ever-growing amount of money chasing a finite amount of goods around the economy.

Is it any wonder bubbles develop as investors search for value that simply doesn’t exist?

Before I explain in more detail how the fractional reserve system perpetuates the illusion of wealth creation, first let’s look at the underpinnings of this system and how it evolved.

The origins of fractional reserve lending

In medieval England, gold and silver coins were the basis for everyday transactions. But transporting precious metals was a burden even for the strongest businessman. So many enterprising entrepreneurs of the day, mostly the goldsmiths, offered to safely store the gold and silver for people and issue them paper receipts for a claim on their deposits, charging a small fee for storage.

The happy customers could walk off with their paper receipts and a lot less weight to carry around. It appeared to be a win-win situation. And it normally was, until the safe-keepers of the gold and silver realized that only a very small percentage of the depositors ever came in at the same time to demand their property. Some of them decided that they could make a little extra money by loaning out some of the gold and silver that they were holding for their customers. As long as there was enough on hand to pay out those who came in demanding their property, nobody was the wiser. But if customers demanded more of their gold and silver than the goldsmith had on hand, there would be the equivalent of a bank run, and the goldsmith would most certainly have gone to jail for fraud or, perhaps, suffer the pain of medieval torture.

The preceding illustration is, of course, a historical example of fractional reserve lending. The goldsmiths were lending out more than they had on hand, keeping only a fraction of the gold and silver in their vaults. This practice in those days was illegal. But countries around the world soon came to find out that they could massively expand credit and short-term economic growth if this practice were legalized throughout their banking systems.

Fractional reserve lending in the last 100 years

Fractional reserve lending became entrenched in the United States in the early part of the 20th century. While banks in those days lent out more than they had on hand, there was no Federal Reserve System to be the lender of last resort, and there was no Federal Deposit Insurance Corporation (FDIC) to guarantee deposits. As early as 1907, the dangers of such a system were realized when large depositors went to the bank window demanding their money. Because the banks had lent most of it out, they could not provide the depositors with all of their money. This in turn led to more fear from other depositors, and the “Panic of 1907” commenced.

Under the guise of halting bank runs that naturally occur when fractional reserve lending exists, the Federal Reserve system was created in 1913, enabling an enormous expansion of the banking system and all of the problems that come...
Created by Congress under the Federal Reserve Act, the Fed was to serve as the central bank of the U.S. and would be the lender of last resort when bank runs occurred. Rather than reduce or eliminate the root cause of banking panics, fractional reserve lending, the Fed would now see to it that this scheme could shift into overdrive. Knowing that the Fed was there to bail them out with loans, banks had little to fear in a bank run.

But that moral hazard the Fed created for banks was hardly its most damaging effect. Through open market operations, the Fed prints money to buy Treasury bonds from banks, thus increasing the amount of money in the banking system. Through quantitative easing, the Fed has become even bolder, by printing money and buying all sorts of impaired securities from banks, government agencies, and other countries, as well as other places they won’t disclose. These actions create the potential for debasement of the dollar and uncontrollable inflation.

So how does fractional reserve lending create bubbles and a mirage of growth? A simple example illustrates how this system can turn a million dollars into ten million. If I deposit $1000 into a bank and that bank has a 10% reserve ratio, meaning that it must keep 10% of deposits on hand, then it is free to lend out $900 of my money. That $900 goes out and likely eventually gets deposited into the banking system again. Of this $900, 90% can be lent out again. So $810 goes back out. Taking this to the limit, we find that my $1000 becomes $1000*(1/Reserve Ratio)=$10,000. This money multiplier is how money is created in the banking system.

The ill effects of the fractional reserve system

There have been countless arguments over the years as to whether this type of money creation amounts to a giant Ponzi scheme, but recently I discovered an interesting twist on that argument. The question put to me was, why is this money creation any different than a person spending $1,000 at the local store, then the owner of that store spending 90% of that $1,000, and so on ad infinitum? Wouldn’t this multiplier effect be the exact same as the money multiplier effect in terms of how it affects GDP growth? But fractional reserve lending and the amplifying role of the Fed are different. Allow me to explain with a hypothetical illustration.

In this example we have three depositors and a 10% reserve ratio in the banking system. Person A has $100. He can either spend it or deposit it in a bank. He chooses to deposit it at the local bank.

<table>
<thead>
<tr>
<th>Person A</th>
<th>Owns</th>
<th>Spends</th>
<th>Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>100</td>
<td>0</td>
<td>100</td>
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The bank can now lend our $90 of this deposit. It is lent out to person B who spends $10 of this money and eventually redeposits $80 of it.

<table>
<thead>
<tr>
<th>Person B</th>
<th>Borrows</th>
<th>Spends</th>
<th>Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>90</td>
<td>10</td>
<td>80</td>
</tr>
</tbody>
</table>

The bank now lends out 90% of this $80 to person C.

<table>
<thead>
<tr>
<th>Person C</th>
<th>Borrows</th>
<th>Spends</th>
<th>Deposits</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>72</td>
<td>10</td>
<td>62</td>
</tr>
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</table>

Now person A comes back a few months later and asks for his $100 back. Of course, the bank has lent 90% of his money out. But never fear, the bank can simply go to the Federal Reserve’s discount window for a loan to cover this amount. The bank can also go to other banks for a loan at the federal funds rate to cover it. Because the Fed can print money at will, these banks will rarely if ever have to worry about their reserves on hand. So person A gets his $100 back and spends the money, thus increasing overall GDP.

Now let’s look at the total amount of money spent in our hypothetical economy. Though we started with just $100 in the entire economy, which is the total that would have been spent in the absence of fractional reserve lending, by the end of the sequence I describe above, $120 dollars has been spent in this hypothetical economy. That means that $20 of hypothetical “GDP” has entered this economy, unbacked by any actual assets, as a direct result of fractional reserve lending. That is GDP that’s simply not real.
Some would say that even with fractional reserve lending, every dollar lent out is usually backed by a dollar’s worth of assets somewhere. This of course assumes these assets have not declined in value and each loan has some type of collateral. This might be true, but with the Federal Reserve involved, it is no longer the case. Banks are using money created out of thin air by the Fed to amplify the effects of fractional reserve lending on the economy. To make matters worse, the Fed is using open market operations and quantitative easing to print money and feed it to the banking system, which in turn uses fractional reserve lending to multiply the amount of money sloshing around at least tenfold.

It should come as little surprise, then, that since the Great Depression we’ve experienced the ill effects of excessive credit many times, with the housing and tech bubbles standing out as the most recent examples. In a world of fractional reserve lending with no Federal Reserve, there is always the possibility of bank runs. With the Federal Reserve thrown into the mix, we are guaranteed that there is more money than there are assets to back it. The Fed can print money with impunity since the dollar is backed by nothing except faith. It is no surprise then that we have ongoing bubbles created as too much money is chasing too few goods. And much of our GDP growth, as we have seen in the past decade, was merely a mirage created by a massive increase in debt.

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