

Apr 16th, 1:00 PM - 1:20 PM

Is Fractional Reserve Banking Necessarily Immoral?

Ryan T. Beach

Cedarville University, ryantbeach@cedarville.edu

Jeffrey E. Haymond

Cedarville University, jhaymond@cedarville.edu

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Beach, Ryan T. and Haymond, Jeffrey E., "Is Fractional Reserve Banking Necessarily Immoral?" (2014). *The Research and Scholarship Symposium*. 6.

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Is Fractional Reserve Banking Necessarily Immoral?

RYAN BEACH

JEFF HAYMOND



Is Fractional Reserve Banking Necessarily Immoral?

What is Fractional Reserve Banking?

Objections to Fractional Reserve Banking

- Technical
- Moral

Warning: We Practice Fractional Reserve Banking!

- Legal Tender Laws
- Central Banking
- Free Banking

Analysis of FRB morality

What is Fractional Reserve Banking?

When Deposits are made to a bank, the bank can loan out most of it, while claiming they have the money to pay you back!

- When you deposit money in a bank, only a fraction of it stays on deposit; the rest is loaned out.
- When the person receives the loan spends it, \$\$ go to another bank, repeating the process
- Ultimately, if the central bank puts \$100 of reserves into the FRB system, \$1000 of money could enter the economy

So what's the problem?

- What if you go to the bank and want your money back?
- <http://www.youtube.com/watch?v=EOzMdEwYmDU>

Objections to Fractional Reserve Banking

Technical

- Inflationary: FRB leads to more claims on present purchasing power, but no more goods & services
- Deflationary: Can work in reverse in a crisis; Great Depression saw money supply shrink 30%
- Distortionary: Funds projects that are inconsistent with true consumer preferences
- Enables Boom/bust business cycle (with central banking support)

Moral

- Fraudulent
 - 2 people claiming ownership of the same asset; bank can't keep both promises (Hoppe)
 - If more present claims to purchasing power are made than there are present goods, it is fraudulent (Rothbard)
 - False weights/measures (North)
- Inflationary
 - Costs & benefits are unequal

Warning: We practice Fractional Reserve Banking!

Legal Tender Laws

Central banking

Free Banking

- Mitigates Inflation via risk of adverse clearings
- People free to adopt bank notes or refuse them
- Competition historically led to “good” money

If there were no fraud issues, if FRB were clearly understood and legal aspects known

- I.e., Depositors have no legal standing over their deposits
- Would FRB be immoral?
- Would it not just become MMMF?

Analysis of FRB morality

Main objection to FRB is fraud

- Yet, financial intermediation not criticized (usually)
- Legally the case is clear; depositors not entitled to \$\$ on demand
 - What if there was a large sign on every wall?
- With free banking, there is no requirement to take banknotes
 - No specified value of “Beachnotes” or “Haymondnotes”
 - Market pricing would determine; but Bank of Beach & Haymond would have incentive to keep valuable
 - No issue of 2 people claiming the same asset (banknotes freely fluctuating)
 - Also mitigates North’s objection to fixed weights and measures—by design it’s not fixed, but competition will tend to drive toward fixed prices

2nd Objection is Inflationary

- w/o legal tender laws competition and free banking provide options for people to avoid exploitation
- Boom/bust inflation restricted by principle of adverse clearings and competition

Conclusion

FRB not inherently immoral

- When combined with free banking and end of state monopoly and legal tender laws, money becomes just another asset
- Asset prices fluctuate; competition will drive banks to provide best combination of stability and banking services
- Key is voluntary, informed choice

Is 100% Reserve Banking Better?

- Probably, but markets will decide
- History has also chosen FRB when allowed