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Fractional Reserve Banking: The Myth of Creation of Money

What does fractional reserve banking do? What do banks have to do to actually create money? And is it the same as the government issued currency that we use as cash?



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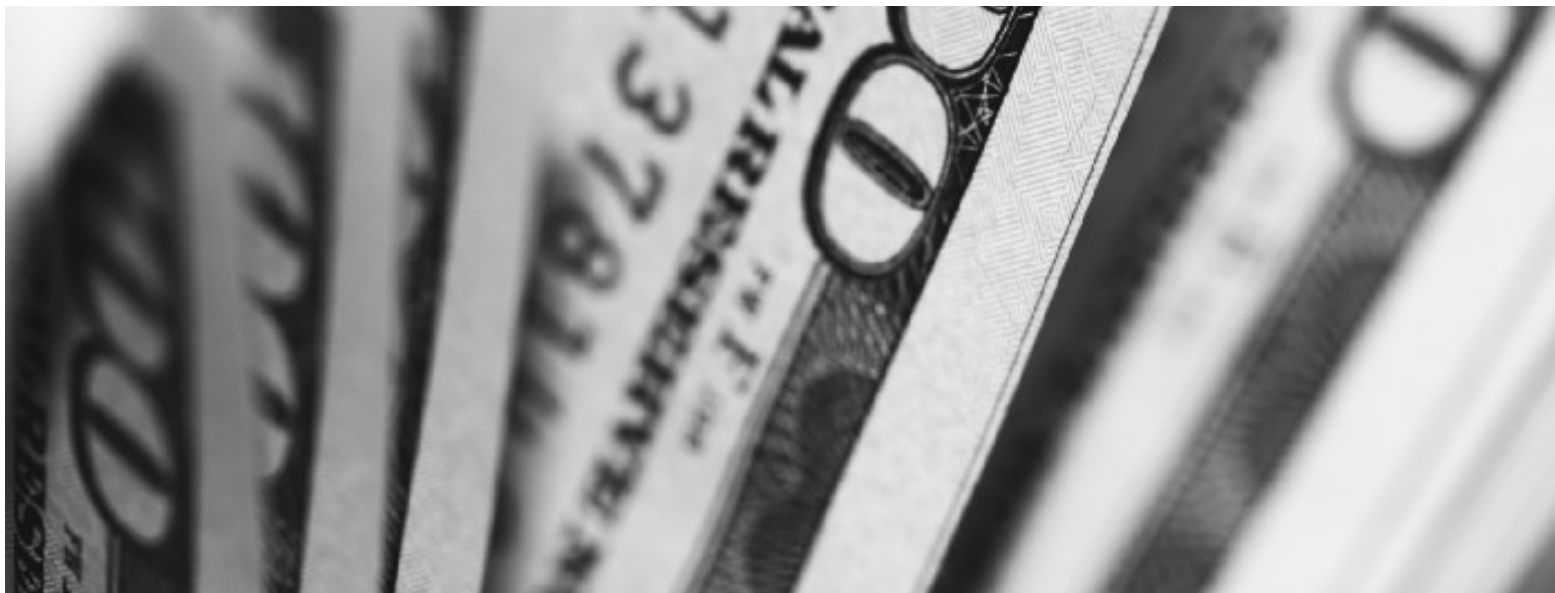


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There is a long perpetuated myth that fractional reserve banking creates money. This is false. FRB increases the velocity of money. Before getting into the specifics of why fractional reserve banking does not create money, and how it works to increase the velocity of money, it might be reasonable to discuss what fractional reserve banking is.

In fractional reserve banking, a bank lends out part of the money it takes in. When taking into account how much is lent out, along with how much is supposedly in each person's account, it appears that new money has been made. This can happen multiple times, as people continue to deposit money into different bank accounts and different banks. The appearance of more money is called the money multiplier. But there are issues with the idea.

FRB Does Not Create Money

Consider a more concrete example. Suppose a person has 10 oz of gold. He deposits the gold into a bank. At that point, the bank lends out 5 oz of gold to someone else. On the books, it may appear that there are now 15 oz of gold, when the 5 oz in circulation are added to the 10 oz in the bank account. But of course we know that the bank only has 5 oz of gold at the moment. So no gold has been created. That is a good thing. If gold was actually created, the bank would be in violation of a fundamental law of physics, and while banks are known to break laws, I do not think that this is one that even the too big to fail banks could break.

So fractional reserve banking does not add to the supply of money, no matter how much certain economics would like to believe that it does. However, fractional reserve banking does something else, which is quite important, when the system runs properly. Specifically, it increases the amount of currency in circulation, and thus increases the velocity of money. To understand this point, let us consider another example.

FRB Does Increase the Velocity of Money

Suppose there are 1,000,000 bike, and for our purposes, suppose all bikes are indistinguishable. Most people do not need their bikes all the time. Perhaps 10% of the time. Meanwhile, suppose that 2,000,000 people need a bike, at least some of the time. Well, since there are only 1,000,000 bikes, we have a problem. But most of the bikes are spending their time gathering dust. Perhaps there is something that can be done to help those who do not have bikes out. Suppose those 1,000,000 “store” the bikes in a “bike

bank.” Now that bank lends out those bikes to those who need them at the moment. So long as everything runs smoothly, everyone who needs a bike for a while is able to get one, so even though there are only 1,000,000 bikes, 2,000,000 people are able to have a bike to ride, when needed.

That is how fractional reserve banking works. The amount of money has not changed at all. Instead, the money spends less time gathering dust, and more money is kept in circulation. That is why fractional reserve banking is useful: it increases the velocity of money. But it is also dangerous. Going back to our bike example. Suppose that you go to your bike bank, and need to get your bike out so you can go on a trip. But the bank has lent out too many bikes, and now it cannot give you a bike. When that happens, people lose faith in the bank, and everyone starts trying to get bike.

This happened during the 1920s and a lot of banks crashed, and there are now a number of safeguards in place to prevent future bank failures, although it is still possible. This is why fractional reserve banking is a double edged sword.

FRB Needs an Increasing Supply of Money

One other point about fractional reserve banking is that it needs an increasing supply of money. This is because banks charge interest. If there is \$1,000 in circulation, and \$10 is paid in interest, then either that interest has to come out of money in circulation, thus requiring velocity of money to increase, or it requires a greater supply of money. In order to prevent the system from collapsing, the only way to cover interest, in the long term, is

to increase the supply of money over time. Of course, this needs to be done with any growing economy, so that is fine, but the rate at which supply needs to be increased has to take into account interest. If money is not regulated, except by supply and demand, natural dynamics have to be enough to cover the needed increase.

So Fractional Reserve Banking isn't the creation of money. And yet, it also is the creation of money. In this section, I'll go beyond Fractional Reserve Banking, and explain how FRB is used to create new money.

While fractional reserve banking does not create money, the creation and actual **use** of bank IOUs does. But that money is not the same money that went into the banks, or which comes out of the banks when you make a withdrawal.

Money

I should have probably started with this at the very beginning. In order to talk about money, we need to know what money is. Money is a medium of exchange, a unit of accounting, and a store of value. Anything can be money, from gold to fabric with pictures of dead people on it, so long as it is accepted as an intermediary in an exchange. If it is not accepted as an intermediary in exchange, then it is not money.

FRB+

When banks lend out your money to other people, they write IOUs in its place. Meanwhile, they continue to report that you have your total balance available. But again, when fractional reserve banking creates IOUs, those IOUs are not necessarily money. Think about to the gold example. Now consider the following.

Consider two banks, bank A and bank B, and three individuals, Alice, Bob, and Carol. Alice deposits 2 oz of gold into her account at bank A. Bank A then loans out 1 oz of gold to Bob. In place of that one oz, the bank places an IOU. That IOU is not money, at least not yet. They could just sit there until the debt is repaid. If however those IOUs are traded around, such as is the case in our banking system, then they become money.

For instance, suppose bank A and bank B have accounts with each other, and that Bob has an account at bank B. Now, further suppose that Alice purchases something from Bob for 1 oz of gold, using “money” from her checking account. When this happens, bank A clears the IOU for 1 oz of gold that it owes to Alice. It then writes an IOU to bank B and puts it into B’s account.

It is this use of the IOUs that turns them into money. Furthermore, that money is backed by the faith in the banks to be able to provide the base currency upon request. Essentially, these IOUs are currency derivatives that, in our case, happen to be traded around and thus become money. But it is not the fractional reserve banking itself that turns it into money, but the way in which these derivatives are used that does so.

Additionally, these IOUs are only exchanged between banking institutions. It is not a currency system which is used directly by the people.

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