**Season 20  
—  
Debating the 2019-2020 Stoa Policy Resolution**

Policy debaters always benefit by understanding the history of the year’s topic of study. The purpose of this article is to give competitors some background on the resolution:

***Resolved: The United States federal government should substantially reform its banking, finance, and/or monetary policy.***

**Table of Contents**

Monetary, Bank & Finance Terminology 2

Defining The Resolution 2

What “Monetary Policy” Is Not 3

The Origin of Money 4

Paper Money 6

Interest Rates 6

Bonds 8

Stocks 9

Mutual Funds 10

Liquidity 11

Inflation & Deflation 11

Mortgages and Mortgage-Backed Securities 13

Money Laundering 15

Credit Ratings & Credit Scores 15

Fractional Reserve Banking 17

Monetary, Bank & Finance Terminology

**

Stoa’s 2019-2020 Policy Resolution:

Resolved: The United States federal government should substantially reform its banking, finance, and/or monetary policy.

Banking, finance and monetary policy are in the news every day and are critical to the functioning of society. It’s a great topic for debate and long overdue. But unfortunately the topic is so broad and so deep that it lends itself to superficial or uninformed discussions, as well as to myriad squirrely possibilities outside the mainstream of public policy.

Normally in this space, we would do first a chapter tracing the background events of the topic throughout US history, followed by a second chapter on Status Quo issues and proposals for change and debate that are common in the literature today. This time, however, due to the complexity of the topic, we dedicate this first chapter simply to understanding the terminology of banking, finance and monetary policies, because they seem to speak a language all their own. Then we will do a second chapter on the history of the topic, covering major issues and events up to the present day.

Defining The Resolution

**Banking** - “The network of institutions and laws that provide a great variety of financial services. At its most basic, banking involves an institution holding money on behalf of customers that is payable to the customer on demand, either by appearing at the bank for a withdrawal or by writing a check to a third party. The banking system also provides loans to businesses and individuals.”[[1]](#footnote-2)

**Finance –** “Financial policies refers to policies related to the regulation, supervision, and oversight of the financial and payment systems, including markets and institutions, with the view to promoting financial stability, market efficiency, and client-asset and consumer protection.”[[2]](#footnote-3)

**Monetary Policy**  – “The term "monetary policy" refers to what the Federal Reserve, the nation's central bank, does to influence the amount of money and credit in the U.S. economy. What happens to money and credit affects interest rates (the cost of credit) and the performance of the U.S. economy.”[[3]](#footnote-4)

The scope of these definitions is enormous, meaning that Negative teams must be prepared with generic briefs that generally support the Status Quo in all of these areas, even if they cannot prepare for every specific policy change that might be proposed.

What “Monetary Policy” Is Not

Please carefully note an important contrast that is sure to be confused in some debates this year. “Monetary policy” is not just any federal action involving spending some money. It does NOT open up debate rounds to changing just anything they want to in the federal budget, either because they don’t like some federal program or because they want to reduce federal spending. Increasing or decreasing the federal budget, when done for policy reasons (a program to fund medical care or fight terrorism or pay pensions to the elderly, etc.) is simply a federal program for some policy. But when the cost of a program is analyzed and its effects (or the aggregate effects of ALL federal spending) on the economy from the resulting taxation or deficits it entails are considered, such an analysis is known as “Fiscal policy.” Monetary policy is about the supply of money and credit and is controlled by the Federal Reserve. Fiscal policy is about the size of the federal budget, the taxes and borrowing needed to sustain it, and the effects of that spending, taxation and borrowing on the nation’s economy. Fiscal policy is controlled by Congress through budget and taxation legislation. Congress can, of course, legislate changes in what the Federal Reserve does.

Fiscal policy is defined as “the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It is the sister strategy to monetary policy through which a central bank influences a nation's money supply. These two policies are used in various combinations to direct a country's economic goals.”[[4]](#footnote-5) Notice carefully how fiscal and monetary are “two policies” and are not the same thing.

The two types of policies can certainly affect one another. For example, monetary policies undertaken by the Federal Reserve may affect interest rates, which may encourage or discourage higher deficit borrowing by Congress as they consider a new budget. Higher interest rates coming from monetary policy may affect fiscal policy if Congress decides it cannot afford to pay the interest on an increasingly large national debt. It’s OK (i.e. topical) to write an Affirmative “monetary policy” change that has beneficial effects on “fiscal policies.” But it’s not OK (i.e. not topical) to write a “fiscal policy” plan (raise taxes, cut spending, reduce the deficit, etc.) and confuse it with “monetary policy” or hope that it has beneficial effects on monetary policy. The Federal Reserve changing interest rates is Monetary Policy. Congress trying to influence the economy through taxes, budgets or deficits are Fiscal Policy. Both affect the economy, but they are different types of policies. Don’t confuse the two.

Negative teams would do well to brief the difference between these two types of policies and practice explaining them during their club practice time, so that they can run this as a Topicality argument during the competitive season. I guarantee you will need it at some point in the year.

Monetary Policy is also “not” just anything that affects the economy. Even though the economy operates with money for virtually all transactions, this does not make anything that happens involving money topical for Affirmatives to regulate or change. Monetary policy has a specific definition in the literature and must be defined contextually as experts use it: referring to the supply of money and credit. These will “affect” the economy, but the economy itself is not “monetary policy.” Failure to respect these limits will make the resolution abusively broad and impossible to debate.

The Origin of Money

Money is a tool developed by civilizations in the ancient past to facilitate, expand, and lower the cost of trade. Primitive cultures in ancient times, lacking money, traded by barter. You had to find someone who had the goods you wanted and who also wanted the goods you had, and you traded directly with that individual. You might, for example, offer one of your pigs for a wagon load of his wheat.

The tedious nature of this system quickly motivates anyone wanting to advance economically to develop something more efficient. After all, moving your pig all over town looking for someone who has the wheat you want is cumbersome, and at the end of the day you might never find what you are looking for. Or you might find the guy with the wheat, but he wants a cow, not a pig, so he won’t trade with you. Much time and effort are wasted in these inefficient markets.

Money could be anything that is widely accepted as a medium of exchange because everyone knows that other people will trade for it. Gold and silver have commonly been used in many civilizations, but other commodities[[5]](#footnote-6) have also been used, if they are compact enough to be carried easily and valuable enough to be useful in trade. It’s much easier to carry around a bag of silver or gold than a wagon load of wheat or a pig. And then, of course, you can buy anything from anyone, not just from the one person who happens to want your pig.

Gold and silver were originally measured and weighed out by the traders themselves during the transaction.[[6]](#footnote-7) It later occurred to civilizations that commerce could be expedited even more if a recognized authority (government) stamped units of precious metals with a mark that certified their value. Thus were born gold and silver coins.

Gold and silver became commonly used because they had what’s known as “intrinsic” value. That is, the metals themselves were useful, if someone wanted to use them, to make artwork, jewelry, or other social or industrial uses. And while even today gold and silver are still used for those things, money (whether metals or paper or anything else) derives its usefulness from its “extrinsic” value. That is, it has value because of what people are willing to trade for it, not because of what it physically contains or the qualities it possesses. If you have a gold coin, you are unlikely to melt it down and use it for jewelry; more likely you would trade it for something else. If you have a $20 bill, you are not likely to use its intrinsic value as a small piece of paper and write a shopping list on it. You instead use its extrinsic value and trade it for $20 worth of stuff you want.

Paper Money

Paper money began as receipts for precious metal coins deposited in banks. It was the next step in facilitating trade and commerce. Remember the difficulties of transporting your pig around town to trade with someone? Coins are easier, but still tedious, and vulnerable to theft. Paper receipts for gold coins can be carried, hidden, and divided more easily into smaller units. As long as others will accept your receipts, and the receipts are considered as good as the gold they represent, and the bank remains solvent, this will work. Anyone who wanted their physical coins could come back to the issuing bank and redeem the notes for the real thing.

The “bank notes” issued as receipts for coins deposited worked well, until human nature kicked in. Banks soon discovered that, since not everyone would show up to redeem the notes, they could issue more notes than they actually had in physical reserves on hand. As long as the paper circulated unquestioned in the economy and most people just trusted that the gold was in the bank, that would work. Banks could lend out and earn interest on more money than had actually been deposited in their vaults. You can easily see where this can go terribly wrong.

“Wildcat” banks also developed – that is, banks that were so far out in the woods that only a wild cat could find them. Someone might trade with you using a note promising $5 in gold from such a bank, but if you can’t find the bank, how do you know whether that note is any good? Similarly, with banks all over the country issuing notes, how could a business or individual in New York know whether a $5 note issued by a bank in St. Louis was of any value? What if the St. Louis bank had gone out of business last month (and there’s no Google to look up and instantly research it in New York)? Instead of facilitating trade, these kinds of issues sometimes slowed it down.

Interest Rates

Interest rates are the price of borrowed money.[[7]](#footnote-8) A dollar today is more valuable than a dollar a year from now, because giving up the use of that dollar and waiting a year for it inconveniences its holder. The borrower must pay the lender more than a dollar a year from now to compensate the lender for his delayed gratification and the denied use of his money during the lending period. This is sometimes referred to as the “time value of money,” and it is one of the components determining how an interest rate will be set.

In addition, the lender must also factor in “default risk.” That is, what is the likelihood that the borrower will actually pay back the loaned amount? If the risk is high, the lender will charge a higher interest rate to compensate for accepting the additional risk.

We must also factor in the risk of inflation, that is, a general rise in prices in the economy that makes money less valuable over time. If a year from now it will take $1.10 to buy what $1 buys today (10% inflation rate), then an interest rate of 10% would effectively be an interest rate of zero, since the lender would have no profit from his transaction at the end of the year, even though he is fully paid back with interest. If the lender expects 10% inflation, he will tack on 10% on top of whatever interest rate he was planning to charge, to overcome the effects of inflation. You can begin now to see why there could be a linkage between interest rates and inflation rates in an economy: higher real or expected inflation rates will lead to higher interest rates. You can also see why debtors (people who owe money) might welcome higher inflation, while creditors (people who lend money) would despise it. Debtors would be happy to pay back loans with dollars that are not worth as much, since they would be easier to obtain.

Usury laws also affect interest rates. Usury originally referred to the charging of any interest on a loan, but it has come to mean charging very high interest rates that could be considered abusive or harmful. States have laws regulating maximum interest rates that can be charged for loans, although some lenders find creative ways to get around them. When usury laws are in effect, those whose credit worthiness is poor will either not be able to borrow money at all (because the interest rate sufficient to motivate lenders to take the risk is above the legal maximum) or else such borrowers will turn to illegal sources of borrowed funds, with potentially dangerous consequences.

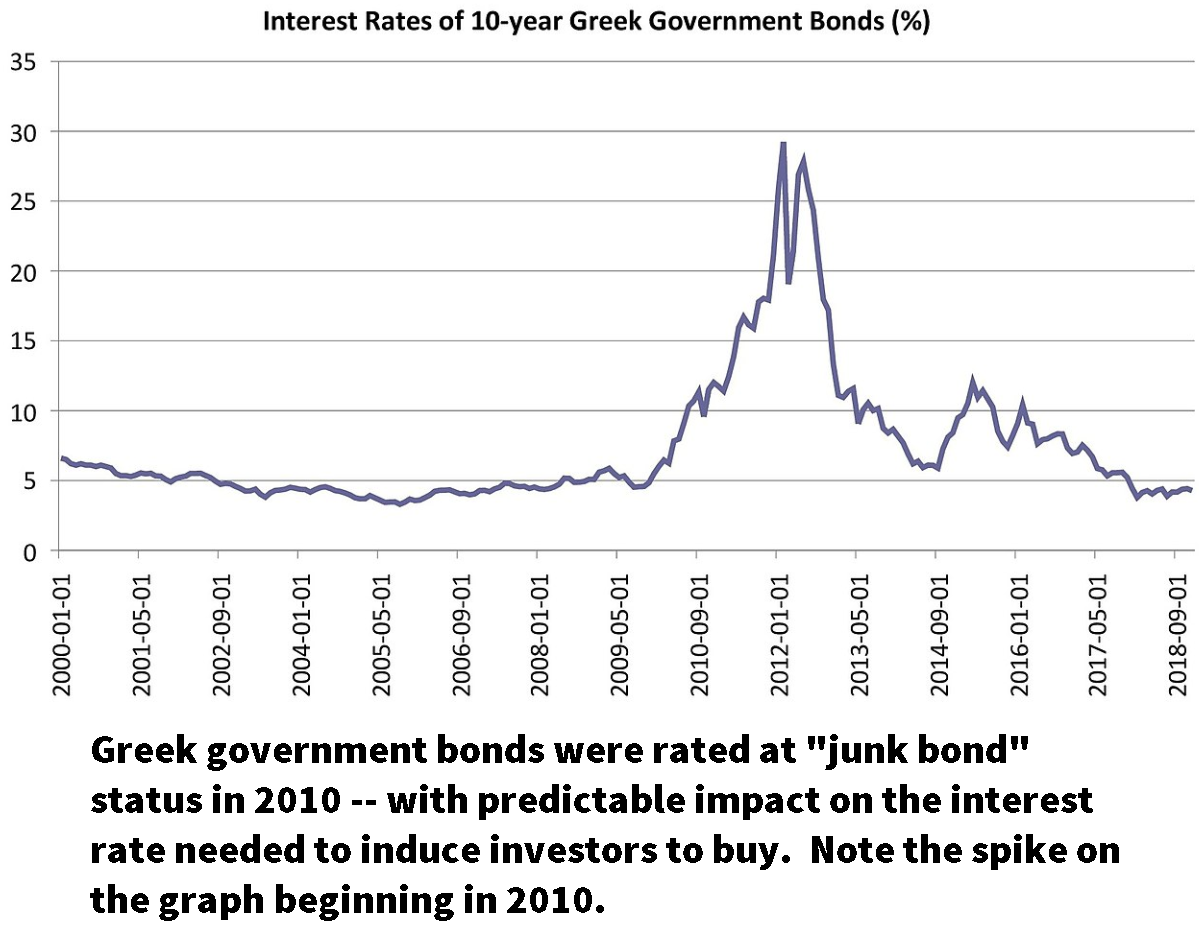
Interest rates can have widespread effects on the economy. Higher interest rates discourage borrowing, which means things in the economy that depend on borrowed financing will diminish. Examples include home sales, automobile sales, business expansion, and credit card purchasing. Slowing these down may result in reductions in business profitability and reduced employment, due to reduced demand for the goods and services that the workers were producing.

Bonds

A bond is a contract to borrow money at a fixed interest rate for a specific period of time, and the contract can (in most cases) be traded on the markets among willing buyers and sellers. The federal government, city, state and county governments, quasi-government organizations (e.g. airports), and corporations issue vast quantities of bonds every year.

Interest on bonds issued by non-federal levels of government (often called “municipal” bonds) are free from federal income taxes. This allows the issuer to offer a slightly lower interest rate, since buyers will recoup the difference by enjoying a lower income tax liability.

Markets have developed agencies that rate bond issuers as to their credit worthiness, giving buyers some information about the risk they are undertaking in purchasing their bonds. Lower rated borrowers must offer higher interest rates to induce bond purchasers to buy. Bonds rated below a certain quality level are known as “junk bonds.”

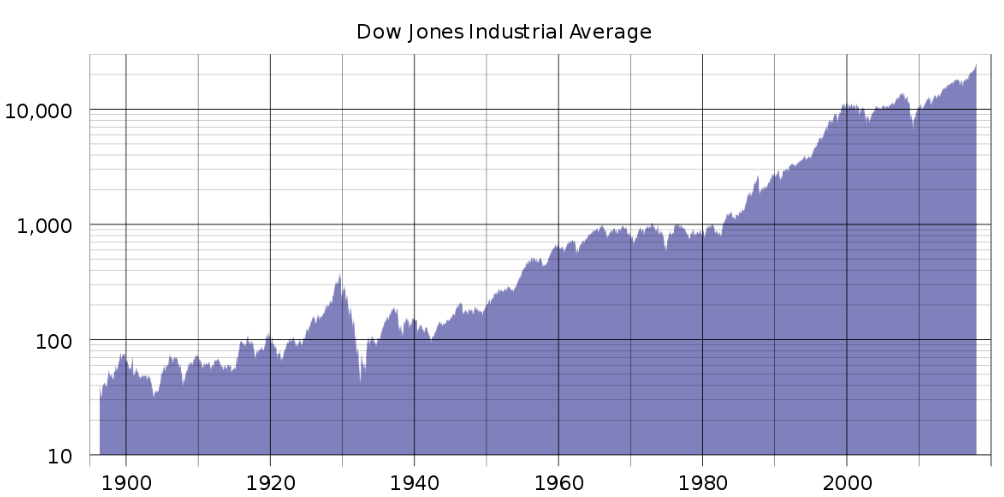
Even though a bond is a contract for a fixed amount of money and a fixed interest rate, the value of both can still fluctuate as market conditions change over time. For example, imagine a 10-year bond sold for $10,000 in 2019 with a 3% interest rate. The buyer will receive interest payments of $300/year for 10 years and his full $10,000 back in 2029. However, let’s say two years later, in 2021, he decides to sell the bond to someone else. If interest rates in the market have risen since then (say, to 4%), any potential bond buyer could just as easily purchase a new $10,000 bond from someone else and get 4% ($400/year) interest. Such a buyer would have no reason to buy a $10,000 bond paying $300/year in interest unless the price is discounted. The 3% bondholder may find a buyer if he lowers his selling price from $10,000 to $8,500. At that price, the annual $300 interest payment would amount to 3.5% of the $8,500 price of the bond (300 / 8500 = 0.035) to the new buyer. The new buyer would also benefit from the additional $1,500 he would expect to receive 8 years from now when the bond matures, which might be enough to compensate him for the slightly lower (3.5% versus 4%) interest rate. This exercise demonstrates that as interest rates rise, the value of existing bonds falls. The opposite is also true: if interest rates fall, existing bonds become more valuable and their sale price will rise.

Stocks

Stocks are units of ownership in a corporation. The buyer of a share of stock owns a small percentage of the company and has the right to vote in annual corporate meetings, as well as a right to receive dividends (cash distributed by the corporation to the shareholders out of the profits) if any are declared. Most corporations are not required to pay dividends to the shareholders, but might instead choose to use some or all of the profits to reinvest in growing the company, pay bigger bonuses to the top executives, hold as cash for future needs, or to pay down debt (e.g. buy back bonds).

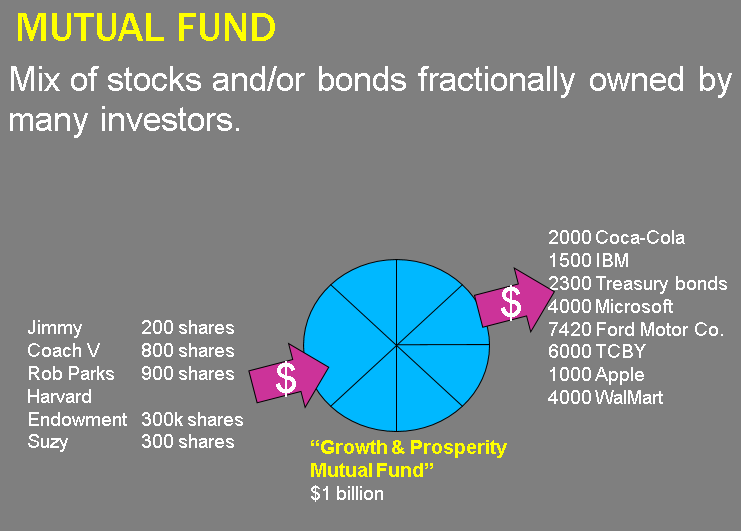
Publicly traded stocks are bought and sold in vast quantities every day on the stock exchanges, like the New York Stock Exchange on Wall Street. Stocks represent an opportunity for the investor to profit from the growth of a successful company, since his shares become more valuable as the corporation becomes more valuable. They can also represent tremendous risk, since many factors can contribute to the value of a stock, and they are often factors either unknown to the investor or even if known, out of his control.

In addition to general business risks and market forces, stock market investors face risks from fraud and corrupt dealing. Corporate leaders may have incentives to hide bad news or cover up losses in order to prevent the stock price from falling. Those with connections in the company who are privy to information not generally known may buy or sell the stock based on such secret knowledge, or may advise their friends to engage in such transactions, known as “insider trading.” For example, if you or a friend has seen the balance sheet and know that tomorrow the company is going to announce a big drop in profits, you would have a big incentive to sell off all your stock today. This is illegal, but the few cases that are known and prosecuted are probably only the tip of the iceberg.

While each stock is individually priced based on the market’s evaluation of its own merits, there are general indices that are commonly used in the media to measure the stock market as a whole. The most well known is the “Dow Jones Industrial Average.” It measures the value of a very limited basket of stocks, and is often used as an indicator of the stock market in general. Other indices commonly used include the NASDAQ Composite Index (mostly high-tech stocks), the Standard and Poor’s (S&P) 500 (an index of 500 stocks), and the Wilshire 5000 (a broad measure trying to capture almost all of the market).

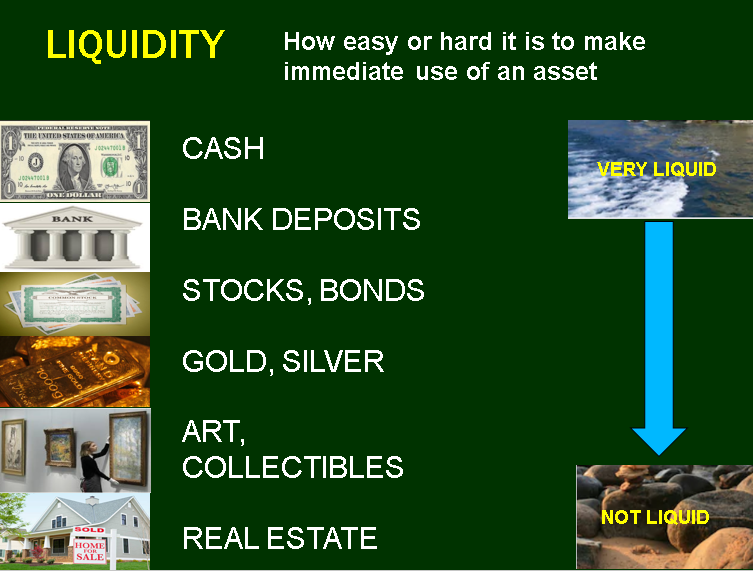
Mutual Funds

A mutual fund is an entity that invests in a mix of stocks and/or bonds by pooling money from many investors. Each investor owns a fractional share of the grand mix of investments held by the mutual fund. The managers of the mutual fund buy investments consistent with the advertised strategy of the fund. For example, an “Energy Fund” might buy only stocks in companies involved in business related to energy, like oil companies. A “Municipal Bond Fund” might buy only bonds from non-federal government entities. An “Index Fund” might buy only the stocks listed in one of the stock market indices mentioned earlier. In the picture here, the “Growth & Prosperity Mutual Fund” is buying mostly investments that the fund managers think have good prospects for future growth. Several investors listed on the left have invested their money in the fund, and the fund then goes out and buys the stocks or bonds listed on the right. There are good reasons investors might find mutual funds to be a better way of investing than buying individual stocks or bonds.

First, investors may see wisdom in diversification. Investing all your money in one or a few stocks could be risky. But buying a diverse cross-section of the market means that even if one corporation or bond issuer goes bankrupt, the rest will not. In the picture above, if Jimmy had bought 200 shares of Apple, and Apple went bankrupt, he would lose everything. But because Jimmy instead bought 200 shares of the Fund, even if Apple goes bankrupt, he would lose only the small percentage of his Fund investment that was in Apple. The rest of his investment is spread out across the other companies that the Fund invested in, and would not be lost. Of course, if Apple shares triple in value, Jimmy’s mutual fund investment will not triple in value, since only the small portion invested in Apple would benefit. Mutual funds make diversification easy for the average investor, because with a single small investment, he instantly has a broad portfolio that is likely to be more stable and less risky than betting it all on one stock.

Second, (some) mutual funds offer the potential benefit of professional management. Perhaps the average investor does not know enough about the markets to wisely pick which are the best investments. But he invests in a mutual fund with the hope that the professional and highly compensated mutual fund investment managers will be smarter than himself, and they will make more money in the market than he could. Experts are divided over whether, in the long term, any professional manager can do better than the market, since the market is by definition the sum total of all investment decisions made by all investors over time, and predicting markets may require clairvoyant skills not available to mortal men. A person may be able to flip a coin and get it to come up tails 6 times in a row on one occasion, but that does not mean he is an expert coin-flipper. In the long term, his coin flips will average out to 50-50 just like everyone else’s.

Liquidity

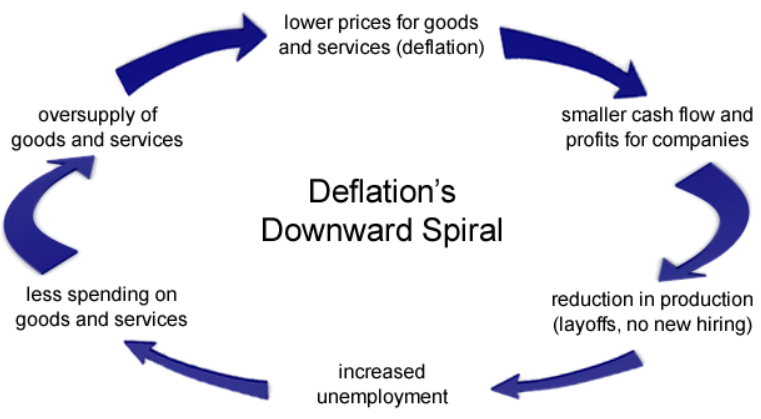
Liquidity is the concept of how readily an asset can be used in trade. “Liquid” assets are ones that are readily available and easily disposed of, and can immediately be redeemed for their full value with little or no hassle.

Individuals or institutions that have great assets might still have “liquidity problems” if their assets cannot be readily used in the market in a time of need. A bank that owns a vast portfolio of loans outstanding might have such a problem if suddenly many depositors appear at the teller windows demanding their savings. Although the bank is rich in assets, it doesn’t have the liquidity to satisfy the demand for cash, and may face significant problems. George Washington, who owned large tracts of land in Virginia and dozens of slaves, had to borrow money to make the trip to New York for his first inauguration, since he had inadequate cash to pay for it. That’s a liquidity problem.

Inflation & Deflation

In the discussion of interest rates above, we mentioned the concept of “inflation,” a general rise in the price level. Many (not all) economists believe inflation is the result of an excessive increase in the money supply. There are good historical examples of inflation caused by this phenomenon. In the 16th and 17th century, Spain brought to Europe vast quantities of silver mined from its New World colonies. The sudden infusion of all this new money substantially raised price levels in Spain and elsewhere in Europe.

Paper money creates even more risk of inflation, since it is even easier to generate than new supplies of precious metal. Printing paper money has been used numerous times by governments throughout history in attempts to solve their budget shortfalls by creating money out of nothing. Classic examples include Germany in the 1920s, where hyper-inflation led to shoppers carrying baskets full of paper money just to buy small items from the stores. The ensuing economic collapse led to social unrest and the rise of the Nazi party in the years that followed.

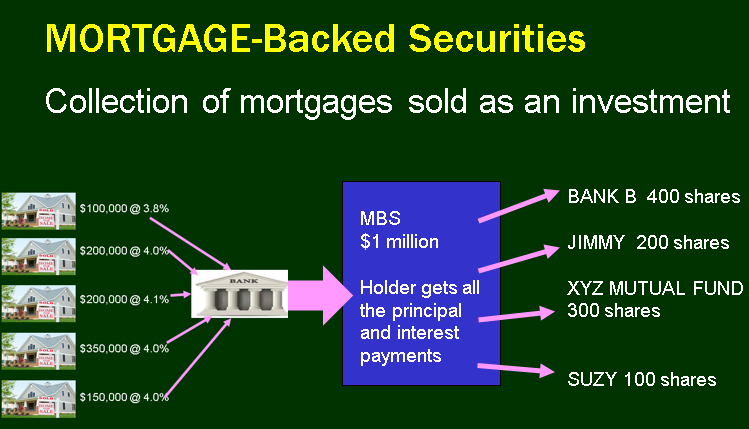
Deflation is the opposite: A general decline in prices, possibly related to a decline in the money supply. While lower prices sound good, this can have devastating effects as well. Those owing debts must pay back the sums they owe, not only with interest but with currency that is now harder to obtain (because it is worth more – since more must be exchanged for it). Imagine the effect of owing a mortgage on your home and the bank tells you they are doubling the interest rate tomorrow. Many debtors will be unable to handle the shock and will go bankrupt. The unpaid loans may ripple through the economic system, as those to whom the money is owed now find themselves poorer and unable to carry out their obligations or engage in normal economic transactions. The entire economy slows down. Lower price levels reduce business profitability and reduced levels of economic activity lead businesses to lay off workers or shut down, leading to higher levels of unemployment. Many (not all) economists believe the Great Depression in the United States was either caused by or aggravated by a reduction in the money supply and the resulting deflation.

Mortgages and Mortgage-Backed Securities

The 2007-2008 financial crisis (or “housing crisis,” about which more in the next chapter) cannot be understood without understanding how home mortgages and the after-market for such transactions is arranged. A mortgage is a loan secured by real estate as collateral. If you don’t pay back the loan, the bank or mortgage company forecloses (takes possession of) the property and kicks you out.

If that’s all there were to it, it would be simple, but sadly it’s not. Banks and mortgage companies take in large numbers of mortgages from many borrowers. Instead of servicing that mortgage (receiving and processing the payments, sending receipts to the home buyer, going after late payments, etc.), they may choose instead to sell the mortgage contract to someone else. The mortgage buyer may want to receive the stream of income coming from the mortgage payments, while the bank may want the mortgage (and the administrative hassles) off their books so they can turn around and lend out the money again and make more profit on more transactions.

The bank may also package up a large bundle of mortgages into a single investment and sell it to willing investors in the market, who will be entitled to receive the payments coming in from all the home buyers. The resulting investment is known as a “Mortgage-Backed Security” (MBS).



Many of these transactions are facilitated by FNMA (“Fannie Mae”), the Federal National Mortgage Association.

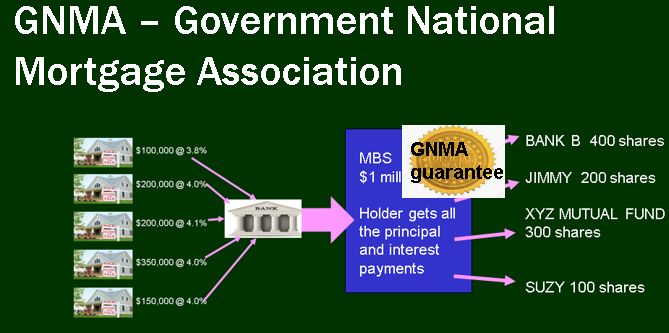
“FNMA was created in 1938 to establish a secondary mortgage market for loans insured by the Federal Housing Administration. In 1968, Fannie Mae became a shareholder-owned company that could buy any mortgage, not just those insured by the government. Its stock was listed on the New York Stock Exchange. Fannie Mae buys mortgages from banks…That gives banks money to make more loans. It also transfers the risk of default from the bank to Fannie Mae.  …under the conservatorship of the Federal Housing Finance Agency …all of FNMA's profits go to the U.S. Treasury. ”[[8]](#footnote-9)

Others are managed by FHLMC (“Freddie Mac”), the Federal Home Loan Mortgage Corp.

“Fannie Mae is often called the sister of Freddie Mac. The Federal Home Loan Mortgage Corporation buys mortgages and packages them into mortgage-backed securities. It is also owned by the government. The Emergency Home Finance Act of 1970 created the FHLMC to compete with Fannie Mae. It could buy any loan and securitize most of them. FNMA was restricted to Federal Housing Association approved loans. Fannie Mae and Freddie Mac are not only different in their genesis, but also in their target market and products. Fannie Mae buys mortgages from large retail banks. Freddie Mac buys them from smaller thrift ones. The subprime mortgage crisis overwhelmed Fannie and Freddie's ability to guarantee all those bad loans. After many bailouts and attempts to keep them solvent, the federal government nationalized the two.”[[9]](#footnote-10)

On top of these institutions, the federal government also further subsidizes the home mortgage market through GNMA (“Ginnie Mae”), the Government National Mortgage Association.

“Part of the U.S. Department of Housing and Urban Development (HUD), Ginnie Mae was established in 1968 to promote home ownership. …Since 1970, Ginnie Mae has guaranteed mortgage-backed securities to help open the home mortgage market to first-time homemakers, low-income borrowers, and other underserved groups. …private lending institutions approved by Ginnie Mae originate eligible loans, pool them into securities, and issue mortgage-backed securities that are guaranteed by Ginnie Mae.”[[10]](#footnote-11)



Money Laundering

The banking system contains any number of steps where financial transactions are recorded, either on paper or in electronic records. But there are any number of individuals (or businesses) engaged in illegal activities that they would prefer not to have recorded or disclosed. They may be engaged in business activities that are illegal, like drug dealing or human trafficking. They may be involved in terrorism and moving money across international borders to fund violent activities.

“Money laundering” involves moving money, especially cash currency, through legitimate businesses to conceal its origins or destinations and make it appear legitimate. Businesses that deal with large amounts of cash, like casinos and restaurants, are convenient covers for such activities, since illegal cash can be mixed in with legal receipts, the books can be altered to account for the extra revenue, and perhaps no one will be the wiser.

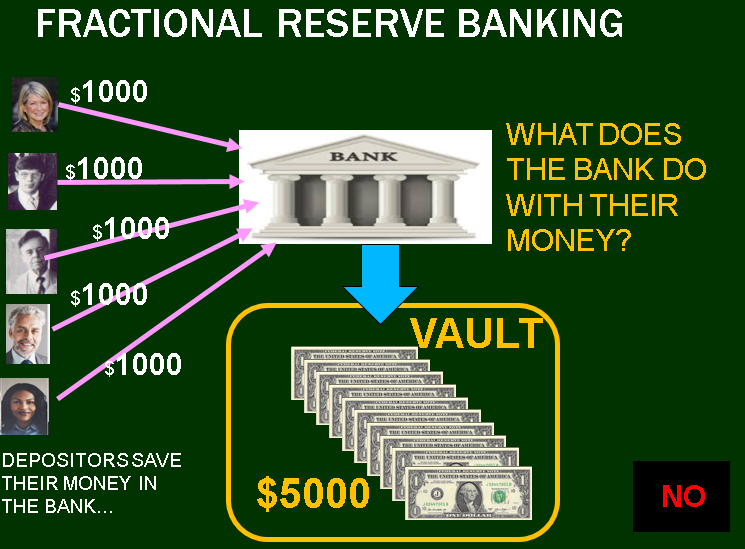
The federal government has numerous laws and banking regulations on the books to combat such practices, and they will likely be the subject of some debates this year.

Credit Ratings & Credit Scores

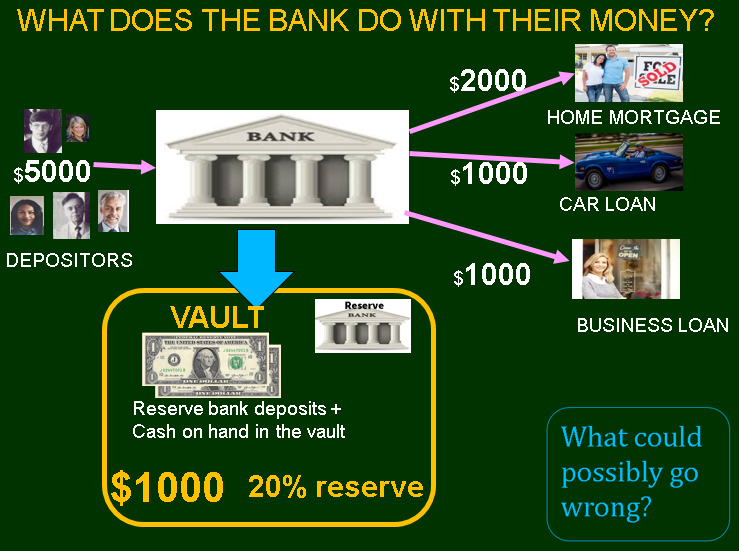
In the last generation, many aspects of American consumers’ economic life have become intertwined and influenced by credit scores. A credit score is a numerical evaluation published by one of the three large credit rating agencies (TransUnion, Equifax and Experian) based on its evaluation of the individual’s economic circumstances, history, reliability and track record. When you pay your mortgage on time (or don’t), apply for a credit card and pay the bill on time (or don’t), go bankrupt, get rich, and other events in your economic history, these all get recorded and scored by the rating agencies.

The score each individual attains will be checked at numerous times in their interactions in the economy. Someone applying to rent an apartment, for example, will have their credit score checked, since it may serve as an indicator of their reliability about paying the rent on time. Applying for a new credit card or a home mortgage will also trigger credit checks, and approval may be contingent on the score. The score may also affect what interest rate will be charged once approval is given, since lower scores may represent a higher default risk, triggering a higher interest rate.

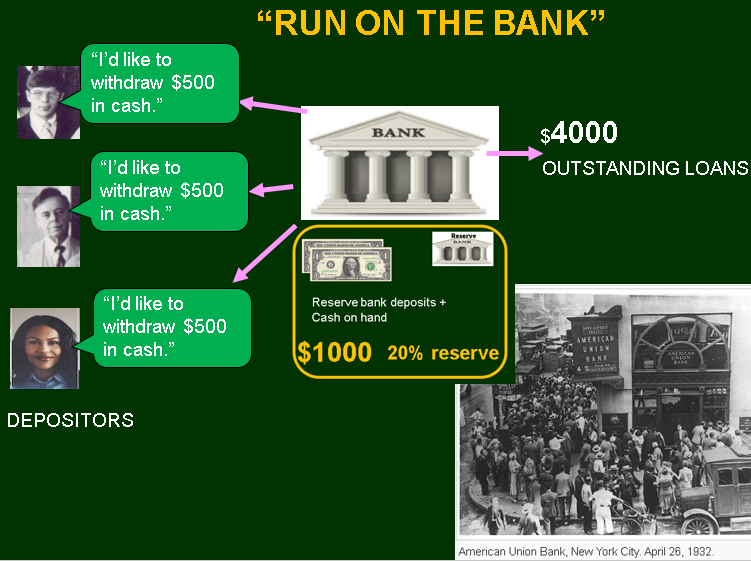
“Credit scores and the agencies that provide them have long been a point of contention among consumer advocates, not only because the system further marginalizes those who are already struggling, but also because it offers very limited opportunities to improve one’s financial standing. Even obtaining, understanding, and correcting official credit reports can be tricky, time-consuming, and, in some cases, costly.  As a result, consumer advocates have called for greater accessibility and pushed  alternative credit indicators. That two major providers of score data have been intentionally deceiving Americans confirms what those advocates have been saying all along: This is a deeply dysfunctional system that is hurting the Americans who can least afford it.”[[11]](#footnote-12)

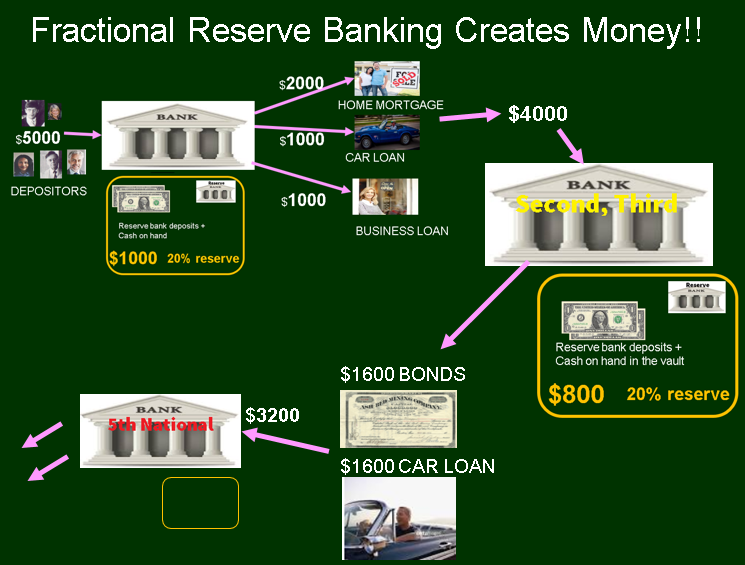
Fractional Reserve Banking

When depositors put their money in the bank, what happens to it? Does it all go into the vault to await them coming to the teller window to withdraw it or write checks on it?

No. Banks use depositors’ money to make profits by lending it out at interest to others. They will keep in reserve (either cash in the vault or deposited in another bank, a reserve bank) the remainder that is not loaned out or invested elsewhere. The reserve is held to supply the needs of depositors who might be expected to withdraw some of their money, but who are not expected to demand all of their money at once.

In the picture here, the bank takes in deposits of $5000, keeps 20% as reserves, and loans out the remaining $4000, hoping to earn a rate of return (the interest rate) on those loans, such as home mortgages, car loans and business loans. What could possibly go wrong with this practice?

What could happen is something like what happened to the American Union Bank on 26 April 1932 (see picture). If enough people show up wanting to withdraw money, it will exceed their reserves. The bank lacks the liquidity to cover all the withdrawals. It may have to close down temporarily to block depositors’ access to funds. It may have to sell its assets at deep discounts to get some kind of liquidity to raise cash quickly. It may have to borrow reserves from other banks, if they are willing to lend. It may have to merge or be absorbed by a more solvent bank. It may receive some kind of government bailout. Or it may shut down, go out of business and lose all of its depositors’ funds.

Another important fact about fractional reserve banking is that it has a big impact on the money supply. If we take the example above (during better times, minus the bank panic), we find that the supply of money expands as it is loaned out, deposited, and loaned out again. The $5000 initially deposited, is loaned out as $4000 into the hands of other consumers, where it will end up in other banks. That $4000 in other banks gets loaned out (minus 20% reserves), so $3200 ends up being spent and deposited. The cycle will keep going (minus 20% each time) but at this point look at the total amount of money now in the system. The depositors’ initial $5000 is on the books at the first bank. Then there is $4000 on the balance of the second and third banks, and the $3200 in the last bank. The initial $5000 is now $12,200 in the economy.

1. Farlex Financial Dictionary. © 2012 [↑](#footnote-ref-2)
2. <https://stats.oecd.org/glossary/detail.asp?ID=4469> [↑](#footnote-ref-3)
3. <https://www.federalreserveeducation.org/about-the-fed/structure-and-functions/monetary-policy> [↑](#footnote-ref-4)
4. <https://www.investopedia.com/insights/what-is-fiscal-policy/> [↑](#footnote-ref-5)
5. For example, sea shells in Papua New Guinea. [↑](#footnote-ref-6)
6. For example, Gen. 23:16 “and Abraham weighed to Ephron the silver, which he had named in the audience of the sons of Heth, four hundred shekels of silver, current money with the merchant.” Around 2000 BC. [↑](#footnote-ref-7)
7. An interest rate on a loan is sometimes referred to as “APR” – Annual Percentage Rate. [↑](#footnote-ref-8)
8. K. Amadeo 2019 [www.thebalance.com/what-is-fannie-mae-fnma-3305986](http://www.thebalance.com/what-is-fannie-mae-fnma-3305986) (ellipses added) [↑](#footnote-ref-9)
9. K. Amadeo 2019 [www.thebalance.com/what-is-fannie-mae-fnma-3305986](http://www.thebalance.com/what-is-fannie-mae-fnma-3305986) [↑](#footnote-ref-10)
10. <https://www.investopedia.com/terms/g/ginniemae.asp> (ellipses added) [↑](#footnote-ref-11)
11. [https://www.theatlantic.com/business/archive/2017/01/credit-scores-cfpb/512162](https://www.theatlantic.com/business/archive/2017/01/credit-scores-cfpb/512162/) [↑](#footnote-ref-12)