FRACTIONAL RESERVE BANKING: HOW IT WORKS AND ITS IMPORTANCE

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ABSTRACT

The article analyzes the basic principles of money creation in the fractional reserve banking system. The connection between the emergence of banking crises and the functioning of the fractional reserve system is shown. The author concludes that partial reserves are directly related to the creation of crises. It artificially increases the supply of credit and lowers interest rates, making money more accessible. An excess (or rather, the appearance that there is an excess) of money in the "economy" allows entrepreneurs to increase the savings rate (i.e., the share of income that is directed not to current consumption, but to investment). An investment boom begins. Investment decisions are made taking into account the fact that there are more resources (fixed assets, investment goods, natural resources, labor) in the "economy". However, this is an illusion: there are no more resources in the "economy". There is only more money, and money is not a resource, but only a mirror image of it. The author's goal is not to find someone's mistakes, but to correctly state the problem, show the possibilities of change, and also justify the need to separate the deposit-crediting and investment activities of banks.

Keywords: Federal Reserve, fractional reserve, bank,

INTRODUCTION

Fractional reserve is a banking activity that encourages commercial banks to benefit from lending a portion of their customers' deposits while keeping just a limited portion of these deposits as actual money and usable for withdrawals. In practice, this monetary system can make funds out of the air by deducting a fraction of consumers' deposit accounts (Evans, 2013).

To put it another way, these banks are allowed to keep a certain proportion (a tiny percentage) of the money invested in their deposits, allowing them to lend out the remainder. Whenever a bank makes a credit, the funds are counted as collateral from both the bank and the individual that borrows them, effectively doubling the initial sum. This currency is then re-used, re-invested, and re-loaned many times, resulting in the multiplier impact, which is how fractional reserve banking generates fresh liquidity.

Rothbard (1993) argue that the fractional reserve banking structure relies on lending and debt, which often necessitates a central bank putting fresh money into circulation so commercial banks can have withdrawals. Most central banks often act as legislative bodies that set minimum reserve requirements, among other items. Most countries' financial institutions depend on this type of banking structure. It is indeed popular in the north America as well as several other free-trade nations.

In the gold trading age, the idea of fractional banking originated with the understanding that not all citizens require their deposits immediately. When people laid their silver and gold coins in gold-smiths, a promissory note was issued to them. The notes were subsequently recognized as an exchange and used by the holders in commercial transactions. As the notes were directly used for exchange, the goldsmiths knew that not all saver would remove their deposits instantly (Hulsmann, 2003). They began utilizing savings to issue high interest loans and bills in parallel to the deposits' holding fee. The goldsmiths then changed from guardians of valuables and interest-paying accounts.

If the bill holders lost confidence in the goldsmiths, they will simultaneously remove all their coins and other investments. If a bank would not have enough funds to fund mass retirement, it will eventually become insolvent. Due to the danger faced by banks on customer deposits, different policymakers also introduced legislation to set up a single supervisory body to oversee the banking industry. In 1667, Sweden was the first nation to create a central bank, preceded by other nations. Central banks have been authorized to control commercial banks, establish reserve criteria and function as last resort lenders for commercial banks impacted by banks.

Reserve conditions, also known as reserve ratios, are central bank standards that specify the minimum amount of reserves a bank must maintain. The United Kingdom, Canada, Hong Kong, Australia, New Zealand and Sweden and are among the countries that do not have reserve rules and regulations. Instead, capital regulations impose restrictions on these countries' banks. When a commercial bank's deposits run out, these countries' central banks move in to own required reserves.

The deposits are held in the separate bank account or at the Federal Reserve Bank closest to the bank in the United States. The Reserve Conditions are provided by the Board of Governors of the Federal Reserve, and they are one of the instruments used by the Fed to guide monetary policy. Financial institutions with reserves of less than $15.2 million were not expected to hold capital as of January 2016. Financial institutions with deposits ranging from $15.2 million to $110.2 million were intended to keep a 3 percent reserve requirement, whereas those with deposits above $100.2

million were required to maintain a 10 percent reserve requirement (Hulsmann, 2003). The first $2 million in contingency obligations were removed from the reserve provisions under the Garn-St. Germaine Act of 1982.

Banks must retain at least the necessary amount of reserves. They are entitled to keep more than the necessary percentage of reserves. Excess reserves are those reserves that are held in excess of what is needed. Starting October 1, 2008, the Federal Reserve was approved by the Financial Services Regulatory Relief Act of 2006 to pay interest on excess assets. Excess reserves are held by certain banks as a precautionary measure in the event of large cash withdrawals by consumers, especially during times of economic instability (Evans, 1993).

There are particular explanations why understanding the whole mechanism of fractional reserve banking is essential, one of which is that most of what economists refer to as "money" is produced by fractional reserve banking. Money may be thought of as having two roots. To begin, economists used to refer to "outside money" as "foundation money," which was presumably referred to as "central bank money". This is the money, or savings, that the Federal Reserve, the country's central bank, creates and deposits through the financial sector.

The financial system, which produces a particular form of currency, "deposit money," takes the place of base money, which is why it's called base money. Deposit currency, also known as "inside money," is money created by the fractional reserve banking process. Banks receive a deposit, issue a loan, and the loan, in turn, becomes another deposit, that becomes a further loan, and so on. A new form of capital is generated as a result of financial intermediation, such as loans and savings, which lies on top of base money (Selgin, 2012).

To truly comprehend the essence of what we call liquidity in an economy and how the central bank's policies influence the money supply, one must first comprehend the framework through which banks convert deposits into loans. We all hear that about the different instruments of monetary policy, many of them are intended to regulate the amount of money in circulation. These methods operate as part of the mechanism, mostly via the banking sector. The Federal Reserve, for example, may alter reserve conditions to compel banks to keep more or fewer reserves in their vaults, allowing for more or less inside-money formation.

For instance, lowering reserve standards at the Federal Reserve would normally enable banks to lend out more funds, which would result in more deposits, allowing the fractional reserve banking mechanism to produce more money in circulation (Block and Davidson, 2011). If the central bank raises the reserve requirement, the trend would

operate in the opposite direction, with reserves contracting and the money supply shrinking.

The Federal Reserve and, more broadly, the financial system placed outside currency, or base money, into circulation by purchasing and selling shares on the open market. Via fractional reserve banking, the Federal Reserve will change the sum of base money in the economy, allowing the whole financial sector to extend loans to make more deposits. As a technological issue, it is critical to comprehend this mechanism if one is to fully comprehend the instruments that the central bank employs.

In the United States, monetary strategy is typically implemented by free market activities. When we purchase or sell US government securities in the open market, we are adding to or subtracting from the financial system's assets (Selgin, 2012). So, if we purchase US government securities on the open market, we are releasing assets into the banking sector, which are then converted into loans and savings, on which they accumulate.

Indeed, the mechanism will also operate in reverse, as citizens wish to remove deposits from financial intermediaries that have been borrowed out as different types of investments. Liquidity issues may arise in the financial sector for a variety of reasons. The Federal Reserve was assigned this as one of its primary duties when it was formed. We were supposed to function as a lender of last resort, ensuring that banks still had a demand to sell otherwise decent assets in order to obtain the reserves needed to repay depositors in times of recession.

In terms of the importance of fractional reserve banking, one of the most important advantages of it, in my opinion, is that it pools a number of smaller deposits and can lend it out in a multitude of sectors, some to large companies, but also to small businesses and households—institutions that banks are unable to lend to because of their proximity and knowledge of the needs of small businesses and neighborhoods (Block and Davidson, 2011). Therefore, I believe that the primary advantage of banks, and of financial services in general, is the knowledge they carry to the table for lending out capital that most of us don't have, or that would be prohibitively costly for most of us to obtain.

One of the causes the goldsmith tale appeals to so many people, particularly students, is because there's a popular misconception that when you deposit money in a bank, it stays in the vault. Of course, you're aware that putting your money in that bank earns you interest, and the interest must come from somewhere. When you think about it, you realize that the bank is spending the capital for you, and the return you get is derived

from the proceeds of those transactions. And your money isn't just lying in a vault doing nothing, but will be effective and bring a value.

CONCLUSION

To conclude, Fractional reserve banking is a financial mechanism where banks only keep a portion of the funds deposited by their consumers as deposits. This encourages them to borrow money from others who wish to borrow (e.g. to go to university, to buy a new car or a house). This method generates revenue and thus improves the availability of money. However, it is necessary to notice that when new capital is made, the total economic wealth remains unchanged.

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