

Last week my subcommittee held a hearing on fractional reserve banking and the moral hazard created by government (taxpayer) insured deposits. Fractional reserve banking is the practice by which banks accept deposits but only keep a fraction of those deposits on hand at any time. In practice, nearly 100% of deposits are loaned out, yet depositors believe that they can withdraw the full amount of their deposit at any time. Loaned funds are then redeposited and reloaned up to the limit of the bank's reserve requirements, compounding the effect.

As Murray Rothbard put it, "Fractional reserve banks ... create money out of thin air. Essentially they do it in the same way as counterfeiters. Counterfeiters, too, create money out of thin air by printing something masquerading as money or as a warehouse receipt for money. In this way, they fraudulently extract resources from the public, from the people who have genuinely earned their money. In the same way, fractional reserve banks counterfeit warehouse receipts for money, which then circulate as equivalent to money among the public. There is one exception to the equivalence: The law fails to treat the receipts as counterfeit." *

While mainstream economists extol this "money multiplier" as a nearly miraculous process that results in a robust economy, low reserve requirements actually enable banks to create trillions of dollars of credit out of thin air, a process that distorts the structure of production and gives rise to the business cycle. Once the boom phase of the business cycle has run its course and the bust commences, some people will naturally look to hold cash. So they withdraw money from their bank accounts in order to hold physical currency. But bank deposits consist of a huge amount of credit pyramided on top of a small amount of original cash deposits. Each dollar of cash that is withdrawn unwinds the multiplier, resulting in a contraction in credit. And if depositors en masse attempt to withdraw more funds than are available in reserves, the entire house of cards comes crashing down. This is the very real threat facing some European banks today.

Since the amount of deposits always exceeds the amount of reserves, it is obvious that fractional reserve banks cannot possibly pay all of their depositors on demand as they promise – thus making these banks functionally insolvent. While the likelihood of all depositors pulling their money out at once is relatively rare, bank runs periodically do occur. The only reason banks are able to survive such occurrences is because of the government subsidy known as deposit insurance, which was intended to backstop the stability of the banking system and prevent bank runs. While deposit insurance arguably has succeeded in reducing the number and severity of bank runs, deposit insurance is still an explicit bailout guarantee. It thereby creates a moral hazard by encouraging bank deposits into fundamentally unsound financial institutions and contributes to instability in the financial system.

The solution to the problem of financial instability is to establish a truly free-market banking system. Banks should no longer have a government backstop of any sort in the event of failure. Banks, like every other business, should have to face the spectre of market regulation. Those banks which engage in sound business practices, keep adequate reserves on hand, and gain the confidence of their customers will survive, while others fall by the wayside.

Banking, like any other financial activity, is not without risk – and the government should not continue its vain and futile pursuit of trying to eliminate risk. Get government out of the way and allow the market to function. This will result in a more stable system that meets the needs of consumers, borrowers, and investors.

* Murray N. Rothbard, [*The Mystery of Banking*](#), 2nd ed. (Auburn, Alabama: Ludwig von Mises Institute, 2008), p. 98.