The crucial flaw in the bank system.

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Abstract.

One of the main activities of banks is accepting deposits, lending on most of the money concerned, while telling depositors their money is safe, which it quite clearly is not, because loaned on money is never totally safe. That is fraud: indeed when any other financial institution does that (e.g. a mutual fund or private pension scheme), that activity is classed as fraud.

The latter problem can be dealt with via taxpayer backed deposit insurance and billion dollar bail-outs for banks in trouble, but that puts banks in a privileged position relative to other financial institutions, and indeed non-financial institutions and corporations. I.e. taxpayer backed deposit insurance and bailouts amount to a subsidy for banks. Plus taxpayer backing for depositors who want their money loaned out with a view to earning interest flouts a widely accepted principle, namely that it is not normally the job of governments / taxpayers to stand behind commercial activities, and having a bank lend on your money is certainly a commercial activity.

The solution is full reserve banking (also known as Sovereign Money), which consists of abandoning deposit insurance and bailouts, and giving depositor / investors the choice between, first, a totally safe method of storing money, which consists simply of having money lodged with government or the central bank, with that money earning little or no interest, and second, an account where money **is loaned out**, with the result that a higher rate of interest is earned, but depositor / investors carry the risks.

There is a simple flaw in the existing “fractional reserve” bank system which I’ve set out before (Musgrave (2014 & 2018a) and to which opponents of the existing bank system do not seem to pay much attention. The explanation of this flaw below is more detailed than the 2014 version (about 3,000 words rather than about 400), and this present version deals with the objections to the above “fraud accusation” made by George Selgin. Plus there are references to literature on the subject published since 2018. The flaw is as follows.

Banks have for centuries accepted deposits and loaned on most of the money concerned, while promising depositors or at least suggesting to depositors their money is safe. That promise is plain fraudulent and for the simple reason that loaned on money is never safe: the fact is that throughout history, most banks at some point get into trouble as a result of making silly loans and that “trouble”, time and again, leads to banks collapsing altogether. (For a brief history of banking going back about four thousand years, see Fuller (2019).

And in case there is any doubt that the latter basic activity of banks is fraudulent, note that when any other financial institution tells depositor / investors their money is safe, such institutions are prosecuted for fraud. By “other financial institutions” I mean private pension schemes, mutual funds (known as “unit trusts” in the UK) and so on.

Defenders of the existing bank system do not of course take the above fraud accusation lying down. Perhaps the most authoritative critic of the fraud accusation is George Selgin. However his arguments do not stand inspection, as is shown under the heading “George Selgin” below.

Incidentally some readers may object to the above suggestion that banks lend on depositors’ money and may wish to claim banks create the money they lend out of thin air. In fact as an article published by the Bank of England says (McLeay (2014) “banks do not act simply as intermediaries.” In other words, banks do act as intermediaries between lenders and borrowers as suggested above, but it’s not that simple. As the article explains, banks do at the same time create a certain amount of money from thin air every year.

Another incidental point is that having said above that critics of the existing bank system have overlooked the flaw set out here, it is true that numerous people have pointed to the fraudulent element in fractional reserve banking. Plus clearly numerous people have objected to bank bailouts. However, not enough attention has been devoted to the basic point made here, which is along the lines of “the system is fraudulent, but if that problem is dealt with via deposit insurance and bailouts, that is no solution because it equals a subsidy of banks.”

Having said banks get preferential treatment relative to other financial institutions, they actually get preferential treatment relative to non-financial institutions and corporations as well. Reason is that the latter corporations actually create money in a way not entirely different to the way in which banks do. That is, most countries count money in term accounts at banks where the term is around two months or less as money, which in turn means that anyone holding bonds in a non-bank corporation where the bond has about two months or less to run till maturity ought for the sake of consistency to be counted as the holder of money as well.

But banks, to repeat enjoy taxpayer backed deposit insurance and billion dollar bail outs, whereas non-bank corporations normally do not.

But perhaps there are good reasons for banks’ privileged status.

The excuses for banks' privileged status.

One excuse for letting banks claim deposits are safe is that that claim equals claiming banks' liabilities (i.e. deposits) are fixed in value (inflation apart) which turns those liabilities into a form of money, which in turn increases the money supply, which is stimulatory. Well the simple answer to that is that central banks can create infinite amounts of money any time for stimulus purposes and at zero real cost by simply pressing buttons on computer keyboards. Moreover, central banks can do that without fraud in any shape or form being involved and without creating any sort of privileged status for commercial banks. (Incidentally, the above point that deposits are fixed in value, inflation apart, might seem a contradiction in terms, since inflation clearly erodes the value of money. However, the point here is that deposits are fixed in value relative to for example shares, used cars, houses etc which are quite clearly not fixed in value: witness the dramatic fall in shares as a result of the Corona virus crisis.)

Having criticised commercial banks for enjoying privileged status, it should of course be admitted that central banks also enjoy privileged status of a sort, but then any country absolutely has to decide what its basic form of money will be and has to have some sort of institution to issue that money. If it's not a central bank, then the Treasury can issue money (as was the case in the UK in WWI). To object to the privileged status of central banks is like objecting to a privilege enjoyed by the army or the police, that is the right to use firearms.

And not only can central banks create whatever amount of money is needed to compensate for withdrawing commercial banks' right to create money, but commercial banks are so hopeless that issuing the right amount of money at the right time that central banks have had to issue astronomic amounts of money first in reaction to the bank crisis that erupted in 2007/8 and second in reaction to the Corvid crisis. Thus any idea that we can do without some sort of central money issuing authority, central bank or other authority, is plain unrealistic.

Should taxpayers back commercial ventures?

Another illogical aspect to the existing system is that it flouts a widely accepted principle, namely that it is not normally the job of taxpayers to rescue commercial ventures which go wrong. And having a bank (or mutual fund, pension scheme, or stockbroker) lend on or invest depositor / investors' money is definitely a commercial activity.

Deposit insurance.

To summarise, the central flaw in fractional reserve banking is that the basic activity of such banks, namely accepting deposits, lending on depositors' money while telling depositors their money is safe is fraudulent. But if that problem is dealt with via deposit insurance and bail-outs for banks in trouble, that means banks get privileged status relative to other institutions, financial and non-financial.

In contrast to the latter nonsense, it would be perfectly possible to have a system where that nonsense is disposed of. To do that, deposit insurance and bailouts need to be abandoned, and anyone who wants a totally safe account needs to be allowed to lodge their money with government or the central bank. Little or no interest would be earned on that money. Indeed, that facility is to all intents and purposes already available in countries which have state run savings banks (e.g. "National Savings and Investments" in the UK).

As for those who want to have their money loaned on or invested, there is absolutely nothing wrong with that, as long as it is made abundantly clear to them that they may lose as well as make money and that there is no taxpayer funded bailout for them when things go wrong.

It would even be legitimate for a mutual fund or similar to invest or lend on most of depositor / investor's money while promising depositor / investors they can turn a portion of their investment into cash any time and have the fund transfer that money to someone of the depositor / investor's choosing. That arrangement would not involve the flaw explained above as long as investors are made fully aware that they may never get as much money back from the fund as they originally put in. After all, any individual is free to engage in the latter activity off their own bat at the moment: that is, anyone is free to buy stock exchange quoted shares, and then sell a few of them when they need to pay someone some cash.

And the above "safe account and risky investment account" arrangement is of course the one, or at least is very close to the one that has been advocated by numerous leading economists and organisations for a long time, e.g. Positive Money, Wolf (2014), Tobin (1987), Kotlikoff (2010), Joseph Huber (2000) and Fisher (1936).

George Selgin.

Probably the most authoritative and active critic of the above "fraud charge" over the last twenty years or so is George Selgin. One of his criticisms is that fraud does not take place unless someone actually loses money.

To be exact, on p.86 of Selgin and White (1995), the authors invoke a definition of fraud which does not stand inspection. The definition is "failure to fulfil a voluntarily agreed upon transfer of property". (Incidentally and for those tempted to claim the latter work of Selgin and White is now a bit dated, those two authors have constantly repeated the points made in their 1996 work since that time: i.e. that 1996 work is dealt with here because it is one of their earliest expositions of their ideas. And moving on around twenty years, Selgin's defence of fractional reserve is very much on-going: for example one of his more recent articles on this subject was last year: Selgin (2019))

Anyway, the answer to Selgin and White's "transfer of property" point is that there is such a thing in law as a fraudulent offer, which itself is fraud, even if there is no failure to "transfer property".

To illustrate, if I take money from you and offer to put it on a horse and guarantee that you won't lose money, that is a fraudulent offer, because, as everyone knows, any horse can fall at the first fence. Whether the horse wins or not is irrelevant: it does not alter the fact that a fraudulent offer has been made.

Then in the next paragraph, the authors argue that banks only act fraudulently if they claim to operate 100 percent reserve accounts when in fact they operate fractional reserve accounts. As they put it, "…it is fraudulent for a bank to hold fractional reserves if and only if the bank misrepresents itself as holding 100 percent reserves, or if the contract expressly calls for the holding of 100 percent reserves.' If a bank does not represent or expressly oblige itself to hold 100 percent reserves, then fractional reserves do not violate the contractual agreement between the bank and its customer…". (The authors make much the same point near the bottom of their p.88).

Well the simple answer to that is that about 90% of depositors don't have any idea what the phrases "100 percent reserve" or "fractional reserve" mean! Thus the authors' "100 percent / fractional reserve" point is plain irrelevant.

The reality is that most depositors have always been persuaded by banks that depositors' money is safe, and the second undeniable reality is that that money just isn't totally safe: witness the fact that taxpayers had to come to the rescue of sundry banks during the bank crisis that started in 2007/8!

Moreover, why did governments ever introduce deposit insurance (in the early 1930s in the US and somewhat later in the UK)? The reason is very simple and common sense, namely that it was generally regarded as unacceptable that ordinary households and small businesses should lose some or all of their stock of money! In other words when bank failures came thick and fast in the 1920s and 30s particularly in the US, the general view was that the scandal consisted of the fact that ordinary depositors thought their deposits were safe: they certainly did not regard their deposits (as Selgin and White suggest) in the same light as stock market quoted shares, where the general public fully accepted that come a stock market crash, shareholders could lose big time and would react with a cavalier "you win some you lose some" attitude. Thus, and contrary to Selgin and White's suggestions, it was obviously very unclear in those days exactly how safe bank deposits were supposed to be.

Incidentally Caplan (2011) also makes the above "depositors should be aware that deposits are not safe" claim.

Free markets.

Next, in the para starting "But whether the informed…" (p.88), Selgin and White argue that a ban on fractional reserve would amount to an unjustified interference with the right of banks and depositors to come to mutually acceptable agreements. Nair (2013) and Rozeff (2010) express similar sentiments.

That's a good point, but that point is catered for via the risky accounts that are inherent to full reserve banking (mentioned above).

About the only remaining question is the one raised by but not answered by Selgin and White in relation to risky accounts. That is (to quote S&W), "…the question of whether a warning sticker really is needed to avoid misleading customers . . . . . and, if so, to the question of how explicit the sticker must be.”

Well I suggest that if banks offering risky accounts had to publish the sort of “health warning” or “sticker” that mutual funds etc are required to publish and with equal frequency, then banks would be competing on a level playing field with respect to those other financial institutions.

Moreover, those of a Selgin persuasion cannot possibly object to banks making it totally clear that deposited money is not safe in the case of risky accounts because those of a Selgin persuasion claim that depositors are already aware their money can go up in smoke.

Of course there is a slight clash between the latter “go up in smoke” money and the claim earlier in this paper to the effect that money by definition is something the value of which is fixed, inflation apart. The answer to that clash is that while money is **normally** regarded as something which is fixed in value, there is no good reason to stop anyone trying to use something else as money, unless obvious harm results from that attempt: if someone wants to try using bottles of whiskey as money, it is not obvious why that attempt should be made illegal.

And finally, George Selgin is of course far from being the only person to criticise full reserve banking. However this is not the place to deal with all those other criticisms: I dealt with about forty such criticisms in section 2 of Musgrave (2018b).

Endnote.

If you wish to comment on the above article, you can do so after the version of the article which appears at the Medium site here: https://medium.com/@ralph_47183/the-crucial-flaw-in-the-bank-system-2b1d36b194de

That "Medium" version is identical to the above version.

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