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CHRISTIAN ECONOMICS IN ONE LESSON

Part 8: Legitimate and Illegitimate Banking

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Wherefore then gavest not thou my money into the bank, that at my coming I might have required mine own with usury? (Luke 19:23).

The Greek word for **bank** is the word for table or stool. It was the same word used to identify the tables used by the money-changers in the temple (Matt. 21:12). The banker was a money-changer, a specialist in the currency business.

The legitimacy of banking is affirmed in this passage. The capitalist who entrusted his money to his three stewards expected a positive rate of return on his investment. The lowest rate of return acceptable to him was the rate of interest offered by a money-changer.

Risk Allocation

The fearful steward buried the coin entrusted to him. What kind of stewardship was that? The owner could have done the same thing with less risk. After all, he had to trust the steward with his coin. He could hardly be expected to trust his steward as much as he trusted himself. The owner of an asset generally takes better care of his assets than his agent will. The owner has more to lose than his agent does.

There are exceptions, of course. Some owners know that they are unreliable managers of their own wealth and seek trustees to act as their agents. But there is always risk involved in such a delegation of authority. The question is one of comparative risk. The owner must decide who is the more reliable money manager. It is his responsibility to make this decision.

The steward refused to hand back the coin in the first place. He accepted the responsibility of money management and then attempted to escape it by burying the coin. But there is no escape from risk. The devil tempted Jesus by quoting Psalm 91:12: "If thou be the Son of God, cast thyself down: for it is written, He shall give his angels charge concerning thee: and in their hands they shall bear thee up, lest at any time thou dash thy foot against a stone: (Matt. 4:6). Yet Jesus' life was not risk-free. "Jesus said unto him, It is written again, Thou shalt not tempt the Lord thy God" (v. 7).

The owner told the steward that the steward should have entrusted the money to a banker. There was inescapable risk in the arrangement for the steward: risk of losing the coin, or selecting the wrong banker, or not gaining a positive rate of return for the owner. The owner gave him good retroactive advice: put the money with the banker. Let the banker guarantee him a rate of return and then let the banker find the debtor or group of debtors who would repay the loan with interest. A banker specializes in portfolio risk allocation: the sharing of

risk. He places himself in between depositors—lenders to the bank—and debtors. The debtors repay the bank; the bank repays the depositors. The banker makes it on the interest rate spread: the difference between what the debtors pay him and what he pays his creditors, i.e., the depositors.

There is always risk. The depositor thinks that he can reduce his risk and increase his rate of return by handing over his money to the banker. The banker thinks he can assure himself a reward by using other people's money. The banker reaps a management fee from the borrowers. He is a middle-man in the transaction: allocating risk and reaping a fee.

There can be additional stages of risk management. The borrower thinks he can make a higher rate of return than the bank loan's rate of interest. Let us consider an example. I know a man who borrowed a million dollars from a bank in order to lend money to mobile home buyers at 18% to buy new mobile homes. He pays the bank 9%. He owns the mobile home park where these people live, so they cannot easily drive off his park with his collateral for these loans. The bank, on the other hand, would find it risky to make loans to dozens of mobile home buyers in dozens of different parks. It would cost too much to monitor the bank's collateral. The bank is not in the mobile home park business. My friend makes \$180,000 a year in interest on the money he has loaned out. He pays \$90,000 in interest a year to the bank. He pockets \$90,000 a year because he knows how to find fairly reliable debtors who will pay 18% to buy a mobile home.

It is all a matter of risk allocation. The mobile home buyers are paying a market rate of interest to my friend, given the risks involved to lenders in lending to mobile home buyers. My friend is paying a market rate of return to the bank, given two decades of having never missed a payment. The banker looks at my friend and imputes one degree of risk; he would impute a much higher degree of risk for a mobile home buyer. Because of the difference in portfolio risk allocation, the transaction becomes profitable for all concerned. Everyone gets what he wants at a price he can afford: the mobile home buyer, my friend, the bank, and the bank's depositors.

An additional fact: my friend paid cash for the mobile homes, so he got a substantial discount from the manufacturer. He sold the homes to the buyers. He made an additional quarter of a million dollars on that part of the deal. That is, his capital base rose \$250,000. The banker did not know how to do this; the mobile home manufacturer got cash on a large transaction; and my friend never put up a dime of his own money—just his reputation.

Did my friend own the land under the mobile homes? Yes,

but he did not pay cash for it. He bought the land from someone for a down payment and an agreement to pay off note with the land as collateral. He pays the owner of the land about 8% a year on the note. He collects rents each month on the land, which more than pays off the note, since he has filled up the park with mobile homes.

What was my friend's total cash investment on everything, land and the million-dollar loan? Under \$30,000. Meanwhile, he keeps over \$100,000 a year in interest payments plus net rent payments, while the tenants pay off the principal of the loans on their homes and his park. He has been doing risk-allocation deals like this for over two decades, although on a much smaller scale back when he began with almost no money. This is how some people make ten to one on their money (Luke 19:16).

So far, there is nothing wrong with the concept of banking. Some people have better knowledge about how to make money. They borrow money from other people who are content to make a lower rate of return. Everyone gets what he agreed to. There is risk for all, but risk is inescapable.

The Interest Rate's Risk Premium

The banker acts as a middleman. He borrows money from people at low rates of interest and lends it out to people at higher rates. But a series of temptations emerge. These temptations are difficult to resist. They involve misrepresentation and ultimately theft. They lead to economic catastrophes.

If the banker were a middleman between an individual depositor and an individual borrower, the depositor would be told that he would not be repaid until the loan was paid off. The banker takes the depositor's money and hands it over to a borrower. The money is not there for the borrower to collect. The bank does not have the money any longer; the borrower does. When the bank is paid, the borrower will be paid.

This is too much risk for depositors. They want a guaranteed return. But to provide this guarantee, the banker must deal with lots of depositors and lots of borrowers. He takes advantage of what is known as **the law of large numbers**. Statistical patterns emerge in every industry. These patterns become more predictable as the size of the sample increases. Some borrowers will default on their loans.

By pooling the bank's risk over a large number of loans risk allocation the banker can insure against the bank's bankruptcy when a few borrowers default. He adds an extra fraction of a percentage to the interest rate that he charges his borrowers. This extra money is used to offset loan default losses in the banker's portfolio of loans. This extra money is analytically like a premium for an insurance policy. This is the **risk premium** component of the interest rate. Every borrower pays a little extra in order to protect the banker from major losses on bad loans. The more accurate the banker is in identifying high-risk borrowers in advance and refusing to lend to them, the lower the general risk premium needs to be. He stays competitive by reducing his interest rate to borrowers.

There is a major risk in every bank's portfolio: that depositors will come down to the bank and demand to be paid before the borrowers pay off their loans. If the depositors have the right to demand their money back at any time, but borrowers have fixed repayment schedules, then the bank can get caught in a squeeze between money flowing out to depositors and much less money flowing in from borrowers. This results from a situation in which the bank has **borrowed short and lent long**. It has borrowed on a short-term basis from depositors and lent on a long-term basis to borrowers. The bank runs of the Great Depression of the 1930's were graphic examples of this process. The most famous example in American fiction is the scene of the run on the savings and loan association in the 1946 movie, *It's a Wonderful Life*. The most recent exam-

ple was the collapse of the savings and loan industry in the United States in the second half of the 1980's which was salvaged only by government spending in the hundreds of billions of dollars. Even the word **bankruptcy** points to the problem: the **bank** is **ruptured**, i.e., torn asunder. The tear takes place between the depositors' assets—legally available on demand—and the bank's immediate assets available to redeem its obligations to depositors.

Fractional Reserve Banking

The law of large numbers has led to a unique banking practice, which lies at the heart of modern inflation. The banker knows that normally, bank deposits will match bank withdrawals. The banker sees an opportunity. What if he could increase the number of loans and get paid interest on them, but without having to pay depositors any interest? What if he could find a way to protect himself against an unforeseen increase in net withdrawals by depositors?

If he were to set aside, say, 10% of the depositors' money in a reserve fund, he could lend out 90% of the money. He could use the 10% reserves to meet any unforeseen increase in withdrawals. He can still guarantee depositors money on demand even though there is not enough money in the bank to meet this obligation if all the depositors came down one day to get their money.

If all the bankers get together to create a reserve fund to cover the short-term obligations of any given bank, this could be called insurance. This is what has been done. The system is called central banking. The bankers of each nation have gotten together under the legal umbrella of the governments of this world to create a system of fractional reserves.

With a legal reserve requirement of 10%, the local banker lends out 90% of the money and keeps 10% on deposit at the central bank. He sends the \$10 to the nation's central bank to meet his bank's legally mandatory reserve requirements. This seems innocent enough. For the local banker, it is innocent. But there is a problem for the banking system as a whole.

Let us say that the depositor deposits cash. Let us say that he deposited \$100. The bank puts aside \$10 for its reserve account and lends out \$90 in cash. There has been no increase in the money supply. So far, so good. But the banking industry has long had a special situation that no other industry enjoys by law. A bank's promise to pay money—cash—is considered as good as the cash. Its promises to pay cash circulate as if they were cash. These promises may be in the form of bank notes or checks.

Consider the original cash deposit of \$100. If the bank does not need cash in its vault to meet today's withdrawals, it sends all \$100 to the central bank. It is allowed by law to create loans for up to \$90. The \$10 is credited to the bank's reserve requirements. So far, so good.

The bank then makes a loan of \$90 to a borrower. But the borrower does not demand cash. Instead, the money is placed in his bank account. It is a ledger entry, the bank's promise to pay cash but not cash itself. The borrower then spends it for whatever it is he wants to buy. He writes a check for \$90.

The central bank is sitting with \$100 in its vault. The local bank's borrower has just spent \$90. The total amount of money in the economy is now \$190.

It gets worse. The person who just sold the bank's borrower \$90 worth of something now takes this check to his bank. His banker sends \$9—not in cash, but as a ledger entry—to the central bank and issues a new loan to another borrower for \$81, which enters the economy. The process continues. The second bank's borrower goes out and spends his \$81. The recipient takes the \$81 to his bank, which sends \$8.10 to the central bank and issues \$72.90 in new loans. And

so it goes until a total of \$900 in new loans is created. The original \$100 in cash that is sitting in the central bank serves as a legal reserve for the \$900 in newly created bank loans. The banking system's 10% reserve requirement has led to the creation of \$900 in new money.

When private individuals do this, it is called counterfeiting. When the fractional reserve banking system does this, it is called progressive monetary policy.

Money: A Unique Good

Money is unlike any other economic good. When the cost of producing other goods falls, thereby enabling producers to increase production, all consumers benefit or are at least not hurt in their capacity as consumers. They might lose money as investors who invested in a rival production process, but consumers are not harmed when additional products or services become available without price increases. Consumers have more choices; this is an increase in their wealth.

Money is different. Additional money may aid the person who gets access to it early before prices rise, but those who do not get access to it early find that they face higher prices. They may have to reduce their purchases. While the science of economics does not enable us to say for sure whether society as a whole is better off under the new conditions of more money in circulation and higher prices, we do know that some people will be worse off under the new conditions. This means that money is unique: unlike other goods, an increase in the money supply cannot be said to increase the wealth of consumers as a whole. An increase in the supply of grain or steel or some other scarce economic resource is beneficial to consumers. Increased production increases wealth. Not so with money. An increase in the money supply merely redistributes wealth: *to* those who spend the newly created money before prices rise and *from* those who see their money income stay the same while prices are rising.

This is why monetary inflation cannot be said to increase a society's wealth. Meanwhile, some people do lose. So, when governments allow the banking system to adopt fractional reserves, they allow a system of wealth redistribution: from those who trust the money to those who distrust it and get rid of it by buying things before prices rise.

If new gold mines are discovered, there will probably be an increase in the money supply, though not very much, since most of the gold that has been mined over the last century is still in someone's possession. The percentage increase derived from new gold production is normally minimal. The threat of inflation-driven wealth redistribution from gold mining activities is minimal compared to the same threat from governments or banks that have the legal authority to create money out of nothing.

Because money is used to buy other things, an increase in the money supply does not increase an economy's wealth. It is true that South American gold mining increased Spain's wealth from 1500 to about 1650. Spain got the new money early and spent it on imports from foreign nations. The new gold and silver supplies did not increase the wealth of the European economy. Some people surely lost: those on fixed monetary incomes. Nobles were generally losers, especially those living outside of Spain. They were owed rents by tenants, and the value of these fixed rents kept falling. This is one reason why nobles after 1500 grew weaker as a group compared to kings and businessmen.

The popular cry for more money is really a cry for more output of the things money can buy. People want more things; they know that if they, as individuals, had more money, they could buy more things. They would grow richer. But what is true for an individual is not true for an entire economy. If a society had an option—either more money or more of the

things that money can buy—it would be foolish to ask for more money. If it were to get more money, then the number of things each unit of money would buy would eventually drop. Those who bought early would win; those who hesitated would lose.

Fractional reserve banking enables the banking system as a whole to increase the money supply. Fractional reserve banking is an engine of monetary inflation. It enables bankers to lend out newly created money and receive interest on the loans. This benefits individual bankers, but it penalizes (1) those who are unable increase their money income before prices rise, (2) savers who lend money at interest and receive bank depreciated money, and (3) those who subsequently lose their money, jobs, and income when banks go bankrupt as a result of the banking system's issuing of credit.

Booms and Busts

When the banking system as a whole issues fiat money, it increases the supply of loanable funds. This increase initially lowers interest rates. It appears as though lenders—depositors—have decided to increase their rate of saving. This is an illusion. There has been no new saving; there has merely been an increase in the money supply. Had savers actually made the money available, they would not be able to bid up prices. For every unit of money available for borrowers to spend, there would be a unit less to spend by savers. Thus, fiat money created by the banking system sends out false signals to borrowers, who assume that cheap money—i.e., lower interest rates—means cheap goods and services.

Businessmen come to the banks and borrow more money than they would have had interest rates not dropped. They use the money to expand their operations or start new businesses. They rent more space, order more raw materials, and hire more labor. This is the boom phase of the business cycle, and it is very popular.

But the boom has been built on an illusion: increased thrift in the society. As businesses expand and workers start spending more money, the economy heats up. There is more demand for consumer loans. Things look good; people start spending more. This increased demand forces up prices. This, in turn, forces up interest rates on long-term loans, since lenders want to compensate themselves for the depreciation of the value of money. Costs rise. Businesses are trapped by rising expenses. They try to borrow more money to finish their longer-term projects that they began because owners had thought that lower interest rates meant more capital rather than merely more money. Some businesses begin to fail because they cannot pay the higher rates of interest. Other businesses begin to cut back. They fire workers. They stop ordering more tools of production and raw materials. The boom turns into a bust.

The business cycles is not some natural occurrence. It is not the product of sun spots, as a few economists thought might be the case in the late nineteenth century. The business cycle is the creation of fiat money-based monetary policies. People like the boom; they do not like the bust. Like people who eat too many sweets during the Christmas holidays, they have to suffer the discomfort of diets beginning January 2. If they refuse, they will remain bloated. They will eat themselves to death. Economies that refuse to stop inflating are like obese people who refuse to stop eating. People die; so do currencies.

Monetary inflation is what causes the boom-bust cycle. If the government required the banking system to keep 100% reserves, then the likelihood of the business cycle would be drastically reduced, assuming that the government stayed out of the money creation business.

Under 100% reserve banking, commercial banks could

not legally promise depositors to pay them the deposit money on demand. If the depositor's money is loaned out to a borrower, it is not available to the depositor. What if a depositor wanted his money immediately? He could go to his bank and request a loan. He could use his deposit in the bank as collateral for the loan. If he had \$100 invested in an account paying 6% for one year, the bank could use a different depositor's newly deposited money to lend the first depositor \$100 at 10% interest. When the first depositor's money came back in one year from some borrower, he the depositor would pay the bank \$110. Because he was being paid 6% on the money he had deposited in his account, he would owe the bank an additional four dollars.

Under 100% reserve banking, everyone knows in advance what his obligations are, and no newly created fiat money gets injected into the economy. A loan is an asset for the bank; a deposit is a liability for the bank. The two must balance. The bank makes its money on the difference between the interest charged and the interest paid. But to maintain the balance, there must not be something for nothing. The depositor cannot be paid if the money is not loaned out. But he cannot get access to his money until the loan is paid off. If it is not paid off, the bank must make good on its promise by reducing its capital. But the bank knows this risk in advance and allocates its loan portfolio to insure against such statistically predictable losses.

The big problem comes when the banks have made promises that inherently cannot be fulfilled: money available on demand when the money has been loaned out. When such promises are allowed by the government despite the fact that the promise is inherently impossible to fulfill under all conditions, the government has authorized a form of deception that can lead large numbers of depositors to make decisions that are more risky than they imagine. Someone has to bear this risk, but the depositors neither understand it nor want to bear it. They want someone else to bear it, such as the government, e.g. government-guaranteed deposit insurance.

Something for Nothing

Depositors want the illusion of safety: "My money on request." They also want something for nothing: "My money is loaned out for a year. Give me my money back immediately with all the interest accrued so far." They want a guarantee that supposedly reduces their risk of loss to zero: "Government-insured." The bank promises to let any depositor get his money on demand by taking certain risks based on the law of large numbers. The money demanded by existing depositors in any time longer than a week period will **usually** be offset by the money deposited by new depositors. If depositor A wants his money, depositor B probably has deposited enough money to pay depositor A. But there is a problem here: the money which is deposited by depositor B and handed to depositor A is supposed to earn a rate of interest for depositor B. The loan made by the bank with the money deposited by depositor A had a fixed rate of interest attached to it. What happens if interest rates have gone up in the meantime? A bank cannot legally charge the original borrower of depositor A's money an extra rate of interest in order to pay depositor B a competitive market rate of interest, which has gone up. Where will the extra money needed to pay depositor B come from? Out of the bank's profits or the bank's capital.

If enough depositors start pulling out their money, and if interest rates keep climbing, then a lot of banks are going to go bankrupt. Then those depositors who did not pull out their money early in the process will find that there was a lot more risk in the arrangement than the now defunct bank's written guarantee indicated. The bank will not be able to repay them what they had deposited.

Any government that allows banks to promise what is statistically impossible—all of depositors' money on demand under all conditions—is authorizing banks that take risks with depositors' money that depositors know nothing about. Banks earn their money by lending out depositors' money. That money is obviously gone for a time. It was used to make loans. All the depositors cannot get access to their money when others are using it unless the banking system has the ability to create money out of nothing. This is called **fiat money**. This is the Latin word for "let there be." God can speak things into existence by the power of His word (Gen. 1). Man cannot. When man says "let there be more," he is either lying or else he is about to say to someone else, "let there be even less."

Bank Runs and Depressions

Biblically, there is nothing immoral about charging interest on commercial loans or non-emergency consumer loans. There is also nothing wrong with banking, which is an institutional arrangement developed by the market to allocate lending risks. The problem with banking comes when bankers take advantage of the law of large numbers and start promising what cannot be fulfilled: an open-ended guarantee that any depositor can get his money on demand.

The bankers know that most people will not demand their deposit money at one time. Thus, if funds deposited equal funds withdrawn, the banks can set aside reserves and be confident that they will not be confronted by more withdrawals than deposits.

But there is a problem if governments allow banks to make such promises. The borrowers will deposit the newly borrowed money. This allows the bank to lend more money to borrowers who will deposit that money, and so on. The lower the legal reserve set aside to protect the system from unexpected withdrawals, the more money the banking system as a whole will create. This creates the boom. Prices rise. Then comes the bust. People start demanding their deposits. Businesses cannot repay the loans early. The bank runs begin: lines of fearful depositors in front of tellers' booths. The bust can become a banking collapse. The money supply shrinks as deposits go out in cash and are not re-deposited. This bankrupts more businesses. The downward spiral is as unpleasant, or even more unpleasant, than the boom was.

Conclusion

It is not banking that is immoral; it is fractional reserve banking that is immoral. By allowing the banking system to profit from a form of monetary inflation, governments create boom-bust cycles. These cycles redistribute wealth in both phases: the boom and the bust. The biblical standard is 100% reserve banking: deposits equal loans but without promises to depositors that they can get their money with interest on demand—an inherently impossible promise to keep for the banking system as a whole.

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