# The Wall Street Ponzi Scheme called Fractional Reserve Banking

Borrowing from Peter to Pay Paul

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Cartoon in the New Yorker: *A gun-toting man with large dark glasses, large hat pulled down, stands in front of a bank teller, who is reading a demand note. It says, "Give me all the money in my account."*

Bernie Madoff showed us how it was done: you induce many investors to invest their money, promising steady above-market returns; and you deliver – at least on paper. When your clients check their accounts, they see that their investments have indeed increased by the promised amount. Anyone who opts to pull out of the game is paid promptly and in full. You can afford to pay because most players stay in, and new players are constantly coming in to replace those who drop out. The players who drop out are simply paid with the money coming in from new recruits. The scheme works until the market turns and many players want their money back at once. Then it's game over: you have to admit that you don't have the funds, and you are probably looking at jail time.

A Ponzi scheme is a form of pyramid scheme in which earlier investors are paid with the money of later investors rather than from real profits. The perpetuation of the scheme requires an ever-increasing flow of money from investors in order to keep it going. Charles Ponzi was an engaging Boston ex-convict who defrauded investors out of $6 million in the 1920s by promising them a 400 percent return on redeemed postal reply coupons. When he finally could not pay, the scam earned him ten years in jail; and Bernie Madoff is likely to wind up there as well.

Most people are not involved in illegal Ponzi schemes, but we do keep our money in accounts that are tallied on computer screens rather than in stacks of coins or paper bills. How do we know that when we demand our money from our bank or broker that the funds will be there? The fact that banks are subject to "runs" (recall Northern Rock, Indymac and Washington Mutual) suggests that all may not be as it seems on our online screens. Banks themselves are involved in a sort of Ponzi scheme, one that has been perpetuated for hundreds of years. What distinguishes the legal scheme known as "fractional reserve" lending from the illegal schemes of Bernie Madoff and his ilk is that the bankers' scheme is protected by government charter and backstopped with government funds. At last count, the Federal Reserve and the U.S. Treasury had committed $8.5 trillion to bailing out the banks from their follies.1 By comparison, M2, the largest measure of the money supply now reported by the Federal Reserve, was just under $8 trillion in December 2008.2 The sheer size of the bailout efforts indicates that the banking scheme has reached its mathematical limits and needs to be superseded by something more sustainable.

What fractional reserve lending is and how it works is summed up in Wikipedia as follows:

> "Fractional-reserve banking is the banking practice in which banks keep only a fraction of their deposits in reserve (as cash and other liquid assets) with the choice of lending out the remainder, while maintaining the simultaneous obligation to redeem all deposits immediately upon demand. This practice is universal in modern banking. . . .The nature of fractional-reserve banking is that there is only a fraction of cash reserves available at the bank needed to repay all of the demand deposits and banknotes issued. . . . When Fractional-reserve banking works, it works because:
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> "1. Over any typical period of time, redemption demands are largely or wholly offset by new deposits or issues of notes. The bank thus needs only to satisfy the excess amount of redemptions.
> "2. Only a minority of people will actually choose to withdraw their demand deposits or present their notes for payment at any given time.
> "3. People usually keep their funds in the bank for a prolonged period of time.
> "4. There are usually enough cash reserves in the bank to handle net redemptions.
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> "If the net redemption demands are unusually large, the bank will run low on reserves and will be forced to raise new funds from additional borrowings (e.g. by borrowing from the money market or using lines of credit held with other banks), and/or sell assets, to avoid running out of reserves and defaulting on its obligations. If creditors are afraid that the bank is running out of cash, they have an incentive to redeem their deposits as soon as possible, triggering a bank run."

Like in other Ponzi schemes, bank runs result because the bank does not actually have the funds necessary to meet all its obligations. Peter's money has been lent to Paul, with the interest income going to the bank.

As Elgin Groseclose, Director of the Institute for International Monetary Research, wryly observed in 1934:

> "A warehouseman, taking goods deposited with him and devoting them to his own profit, either by use or by loan to another, is guilty of a tort, a conversion of goods for which he is liable in civil, if not in criminal, law. By a casuistry which is now elevated into an economic principle, but which has no defenders outside the realm of banking, a warehouseman who deals in money is subject to a diviner law: the banker is free to use for his private interest and profit the money left in trust. . . . He may even go further. He may create fictitious deposits on his books, which shall rank equally and ratably with actual deposits in any division of assets in case of liquidation."3

How did the perpetrators of this scheme come to acquire government protection for what might otherwise have landed them in jail? A short history of the evolution of modern-day banking may be instructive.

**The Evolution of a Government-Sanctioned Ponzi Scheme**

What came to be known as fractional reserve lending dates back to the seventeenth century, when trade was conducted primarily in gold and silver coins. How it evolved was described by the Chicago Federal Reserve in a revealing booklet called "Modern Money Mechanics" like this:

> "It started with goldsmiths. As early bankers, they initially provided safekeeping services, making a profit from vault storage fees for gold and coins deposited with them. People would redeem their "deposit receipts" whenever they needed gold or coins to purchase something, and physically take the gold or coins to the seller who, in turn, would deposit them for safekeeping, often with the same banker. Everyone soon found that it was a lot easier simply to use the deposit receipts directly as a means of payment. These receipts, which became known as notes, were acceptable as money since whoever held them could go to the banker and exchange them for metallic money.
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> "Then, bankers discovered that they could make loans merely by giving their promises to pay, or bank notes, to borrowers. In this way, banks began to create money. More notes could be issued than the gold and coin on hand because only a portion of the notes outstanding would be presented for payment at any one time. Enough metallic money had to be kept on hand, of course, to redeem whatever volume of notes was presented for payment.
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> "Transaction deposits are the modern counterpart of bank notes. It was a small step from printing notes to making book entries crediting deposits of borrowers, which the borrowers in turn could 'spend' by writing checks, thereby 'printing' their own money."

If a landlord had rented the same house to five people at one time and pocketed the money, he would quickly have been jailed for fraud. But the bankers had devised a system in which they traded, not things of value, but paper receipts for them. It was called "fractional reserve" lending because the gold held in reserve was a mere fraction of the banknotes it supported. The scheme worked as long as only a few people came for their gold at one time; but investors would periodically get suspicious and all demand their gold back at once. There would then be a run on the bank and it would have to close its doors. This cycle of booms and busts went on throughout the nineteenth century, culminating in a particularly bad bank panic in 1907. The public became convinced that the country needed a central banking system to stop future panics, overcoming strong congressional opposition to any bill allowing the nation's money to be issued by a private central bank controlled by Wall Street. The Federal Reserve Act creating such a "bankers' bank" was passed in 1913. Robert Owens, a co-author of the Act, later testified before Congress that the banking industry had conspired to create a series of financial panics in order to rouse the people to demand "reforms" that served the interests of the financiers.4

Despite this powerful official backstop, however, the greatest bank run in history occurred only twenty years later, in 1933. President Roosevelt then took the dollar off the gold standard domestically, and Federal Reserve officials resolved to prevent further bank runs after that by flooding the banking system with "liquidity" (money created as debt to banks) whenever the banking Ponzi scheme came up short.

**"Too Big to Fail": The Government Provides the Ultimate Backstop**

When these steps too proved insufficient to keep the banking scheme going, the government itself stepped up to the plate, providing bailout money directly from the taxpayers. The concept that some banks were “too big to fail” came in at the end of the 1980s, when the Savings and Loans collapsed and Citibank lost 50 percent of its share price. Negotiations were conducted behind closed doors, and “too big to fail” became standard policy. Bank risk was effectively nationalized: banks were now protected by the government from loss regardless of risk-taking or bad management.

There are limits, however, to the amount of support even the government’s deep pocket can provide. In the past two decades, the bankers’ lending scheme has been kept going by an even more speculative scheme known as “derivatives.” This is a complex subject that has been explored in other articles, but the bottom line is that more dollars are now owed in the derivatives casino than exist on the planet. (See Ellen Brown, “It’s the Derivatives, Stupid!” and “Credit Default Swaps: Derivative Disaster Du Jour,” www.webofdebt.com/articles.)

Attempting to fill the derivatives black hole with taxpayer money must inevitably be at the expense of other essential programs, such as Social Security and Medicare. Interestingly, Social Security and Medicare themselves are in some sense Ponzi schemes, since earlier retirees collect their benefits from the contributions of later workers. These programs, too, may soon be facing bankruptcy, in this case because their mathematical models failed to account for a huge wave of Baby Boomers who would linger longer than previous generations and demand expensive drugs and care through their senior years, and because the fund money has have been drawn on by the government for other purposes. The question here is, should the government be backstopping private banks that have mismanaged their investment portfolios at the expense of workers contractually entitled to a decent retirement from a fund they have paid into all their working lives? The answer, of course, is no; but there may be a way that the government could do both. If it were to nationalize the banking system completely – if the government were to assume not just the banks’ losses but their profits, oversight and control – it might have the funds both to maintain Social Security and Medicare and to provide a sustainable credit mechanism for the whole economy.

**Replacing Private with Public Credit**

Readily available credit has made America “the land of opportunity” ever since the days of the American colonists. What has transformed this credit system into a Ponzi scheme that must continually be propped up with bailout money is that the credit power has been turned over to private parties who always require more money back than they create in the first place. Benjamin Franklin reportedly explained this defect in the eighteenth century. When the directors of the Bank of England asked what was responsible for the booming economy of the young colonies, Franklin explained that the colonial governments issued their own money, which they both lent and spent into the economy:

> “In the Colonies, we issue our own paper money. It is called ‘Colonial Scrip.’ We issue it in proper proportion to make the goods pass easily from the producers to the consumers. In this manner, creating ourselves our own paper money, we control its purchasing power and we have no interest to pay to no one. You see, a legitimate government can both spend and lend money into circulation, while banks can only lend significant amounts of their promissory bank notes, for they can neither give away nor spend but a tiny fraction of the money the people need. Thus, when your bankers here in England place money in circulation, there is always a debt principal to be returned and usury to be paid. The result is that you have always too little credit in circulation to give the workers full employment. You do not have too many workers, you have too

> little money in circulation, and that which circulates, all bears the endless burden of unpayable debt and usury."

In an article titled "A Monetary System for the New Millennium," Canadian money reform advocate Roger Langrick explains his concept in contemporary terms. He begins by illustrating the mathematical impossibility inherent in a system of bank-created money lent at interest:

> "[I]magine the first bank which prints and lends out $100. For its efforts it asks for the borrower to return $110 in one year; that is it asks for 10% interest. Unwittingly, or maybe wittingly, the bank has created a mathematically impossible situation. The only way in which the borrower can return 110 of the bank's notes is if the bank prints, and lends, $10 more at 10% interest . . . . The result of creating 100 and demanding 110 in return, is that the collective borrowers of a nation are forever chasing a phantom which can never be caught; the mythical $10 that were never created. The debt in fact is unrepayable. Each time $100 is created for the nation, the nation's overall indebtedness to the system is increased by $110. The only solution at present is increased borrowing to cover the principal plus the interest of what has been borrowed."

The better solution, says Langrick, is to allow the government to issue enough new debt-free dollars to cover the interest charges not created by the banks as loans:
"Instead of taxes, government would be empowered to create money for its own expenses up to the balance of the debt shortfall. Thus, if the banking industry created $100 in a year, the government would create $10 which it would use for its own expenses. Abraham Lincoln used this successfully when he created $500 million of 'greenbacks' to fight the Civil War."

**National Credit from a Truly National Banking System**

In Langrick's example, a private banking industry pockets the interest, which must be replaced every year by a 10 percent issue of new Greenbacks; but there is another possibility. The loans could be advanced by the government itself. The interest would then return to the government and could be spent back into the economy in a circular flow, without the need to continually issue more money to cover the interest shortfall.

The fractional reserve Ponzi scheme is bankrupt, and the banks engaged in it, rather than being bailed out by its victims, need to be put into a bankruptcy reorganization under the FDIC. The FDIC then has the recognized option of wiping their books clean and taking the banks' stock in return for getting them up and running again. This would make them truly "national" banks, which could dispense "the full faith and credit of the United States" as a public utility. A truly national banking system could revive the economy with the sort of money only governments can issue – debt-free legal tender. The money would be debt-free to the government, while for the private sector, it would be freely available for borrowing at a modest interest by qualified applicants. A government-owned bank would not need to rob from Peter to advance credit to Paul. "Credit" is just an accounting tool – an advance against future profits, or the "monetization" (turning into cash) of the borrower's promise to repay. As British commentator Ron Morrison observed in a provocative 2004 article titled "Keynes Without Debt":

> "[Today] bank credit supplies virtually all our everyday means of exchange,

> and this brings into sharp focus the simple fact that modern money is no longer constrained by outmoded intrinsic values. It is pure fiat [enforced by law] and simply a glorified accounting system. . . . Modern monetary reform is about displacing the current economic paradigm of 'what can be afforded' with 'what we have the capacity to undertake.'"5

The objection to government-issued money has always been that it would be inflationary, but today some "reflating" of the economy could be a good thing. Just in the last year, more than $7 trillion in purchasing power has disappeared from the money supply, including wealth destruction in real estate, stocks, mutual fund shares, life insurance and pension fund reserves.6 Money is evaporating because old loans are defaulting and new loans are not being made to replace them.

Fortunately, as Martin Wolf noted in the December 16 Financial Times, "Curing deflation is child's play in a 'fiat money' – a man-made money – system." The central banks just need to get money flowing into the economy again. Among other ways they could do this, says Wolf, is that "they might finance the government on any scale they think necessary."7

Rather than throwing money at a failed private banking system, public credit could be redirected into infrastructure and other projects that would get the wheels of production turning again. The Ponzi scheme in which debt is just shuffled around, borrowing from one player to pay another without actually producing anything of real value, could be replaced by a system in which the national credit card became an engine for true productivity and growth. Increased "demand" (money) would come from earned wages and salaries that would increase "supply" (goods and services) rather than merely servicing a perpetually increasing debt. When supply keeps up with demand, the money supply can be increased without inflating prices. In this way the paradigm of "what we can afford" could indeed be superseded by "what we have the capacity to undertake."

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**Notes**

1. Kathleen Pender, "Government Bailout Hits $8.5 Trillion," San Francisco Chronicle (November 26, 2008).
2. "Federal Reserve Statistical Release H.6, Money Stock Measures," www.federalreserve.gov (December 18, 2008).
3. Robert de Fremery, "Arguments Are Fallacious for World Central Bank," The Commercial and Financial Chronicle (September 26, 1963), citing E. Groseclose, Money: The Human Conflict, pages 178-79.4. Robert Owen, The Federal Reserve Act (1919); "Who Was Philander Knox?", www.worldnewsstand.net/history/PhilanderKnox.htm. (1999).
5. Ron Morrison, "Keynes Without Debt," www.prosperityuk.com/prosperity/articles/keynes.html (April 2004).
6. Martin Weiss, "Biggest Sea Change of Our Lifetime," Money and Markets (December 22, 2008).

7. Martin Wolf, "'Helicopter Ben' Confronts the Challenge of a Lifetime," Financial Times (December 16, 2008).